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The Uncertain Future of Equity Crowdfunding and Entrepreneurial Finance in Japan : a Comparative Summary

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By Matt Klomparens

In the spring of 2014, Japanese legislators approved an amendment to the Financial Instruments and Exchange Act, effectively relaxing restrictions on equity fundraising and setting the stage for Japanese companies to raise investment capital through online crowdfunding platforms. This change in Japanese securities law closely follows an analogous development in the United States, as represented by Title III of the Jumpstart Our Business Startups Act (JOBS Act).

Title III similarly aims to open access to equity crowdfunding to the general public and went into effect in May 2016 after approximately four years of rulemaking deliberation by the United States Securities and Exchange Commission (SEC). The SEC has approached Title III of the JOBS Act with exceptional caution, recognizing potential economic impact and regulatory challenges presented by the statute. Title III allows privately held businesses to make public offerings of equity to non-accredited investors through SEC registered crowdfunding platforms. Concerns about fraudulent offerings and the potential for unsophisticated investors to lose substantial portions of their wealth in high-risk startup investments have guided the SEC's lengthy rulemaking process.

This paper offers a comparative review of the implementation of equity crowdfunding in Japan, looking to the political history, agency rulemaking procedures, overlying economic strategies, and cultural differences shaping the landscape of Japanese entrepreneurship.

I. Introduction to Equity Crowdfunding and Regulatory Concerns

"Crowdfunding" as a concept is nothing new. In the typical instance, a seller advertises a prototype product that she intends to manufacture on a larger scale. The seller produces a snappy demonstration video, gathers several testimonial statements, and presents the entire pitch on a website platform like Kickstarter or Indiegogo. The offering is made available to buyers and interested donors for a specified time window, and, if enough people contribute to meet the fundraising goal, then the seller gets to keep the funds and distribute the product offering to purchasers. A broad variety of these crowdfunding platforms has evolved in the United States in worldwide, with some focusing on charitable donations, independent musicians, art projects, video game development, and even pornography.

Although there are numerous success stories among entrepreneurs who have launched fruitful crowdfunding campaigns, many startups find that traditional crowdfunding is not a viable business development strategy. Business-to-business (B2B) product offerings are a poor fit, for example, because such crowdfunding offerings are made to the crowd, typically comprised of tech-savvy consumers rather than business customers with specialized needs. At the same time, an innovator may lack the marketing expertise and sales force that may be needed to succeed with the traditional route of industry trade shows and door-to-door sales. For many early-stage businesses, founders will "bootstrap" the venture with their personal finances and approach local angel investors to sell an ownership interest in the company. Prior to the JOBS Act, privately held companies were extremely limited in how they could solicit investments.

The JOBS Act, passed by the United States Congress in 2012, introduced some dramatic changes to how privately held securities would be regulated in the United States. Gathering the most attention among these reforms was Title III, the so-called Crowdfund Act, which established a framework through which company owners could offer equity ownership in their companies to the public at large through registered crowdfunding portals. The law aimed to strike a balance between opening access to a massive pool of investment capital for startup founders while simultaneously shielding a new class of investors—many of whom would lack investment expertise and the safety net of a large savings account—from fraud and personally catastrophic investments. After all, start-up investments are notoriously high-risk and even the most successful venture capital firms admit that their returns derive from scrupulous due diligence methodologies and deep, diversified investment portfolios. The baseline assumption for most early-stage investments is that the startup will fail to earn a profit. Venture capitalists rely on the rare wildly successful company to recoup these losses. The concern is that new investors will lack the judgment and business acumen to protect themselves from the inordinately high levels of investment risk.

This is where the SEC comes in. By crafting a regulatory framework distinguishing a variety of categories of securities offerings, walling off issuances to highly wealthy, “accredited” investors from the generally available offerings issued under Title III. The former categories entail more relaxed information disclosure standards and a much more relaxed stance on allowing investors to take on risky investments. As for Title III offerings, the SEC's rules went into effect in May 2016 and the machinery for United States equity crowdfunding has been set in motion. Companies, founders, and investors alike will be subject to a much more cautious and restrictive set of regulations governing Title III offerings.

As a result, there are many conflicting opinions about whether equity crowdfunding in the United States is likely to succeed. On the one hand, an early wave of fraudsters and burned investors could kill the interest and faith in equity crowdfunding investments before the system is able to build momentum and evolve. Close regulatory oversight is intended to prevent abuses and make the investment risks as transparent as possible without closing the door to non-accredited investors.

On the other hand, there is concern that the most promising companies will continue to migrate to private placement offerings and equity ownership agreements with angel investors and venture capitalists. A large number of small equity stakeholders can result in higher administrative costs, corporate governance issues, shareholder disputes, and a variety of other distractions that some fear will inhibit business development goals. Also, angel investors and venture capital firms commonly assume an advisory role or even directorial authority to guide their investment company through a labyrinth of decisions that can shape a company's future potential for success. These private investors typically obtain a much more significant stake in fledgling companies, with their investments often protected with corporate governance preferences and other contractual downside defenses. Some investors assert that startup founders with the best ideas and the most leverage will continue to find value in these relationships and avoid Title III offerings altogether. Thus, the companies that do decide to make Title III offerings are likely to be those who struck out with professional investor networks and lack a sophisticated appreciation of corporate governance and compliance issues. In other words, the companies that are most likely to fail.

One certainty is that equity crowdfunding is a new, unproven concept that has generated a great deal of buzz among entrepreneurs, investors, academics, regulators, and legislators. As a leader in technology and entrepreneurial activity, many eyes will be fixed on the United States over the next year to see how the story develops. Japan, another technology-focused economy, has already rolled out a similar system of equity crowdfunding within the past year. The story of equity crowdfunding in Japan is different from that of the United States on many levels, but both governments remain optimistic that these systems will incentivize innovation and secure long-term economic growth.

II. Abenomics and the Path to Equity Crowdfunding Legislation

In January 2013, the newly re-elected Japanese Prime Minister, Shinzo Abe, unveiled a set of economic policies designed to revitalize Japan's slumping economy.[1] The plan, widely known as "Abenomics," utilized a three-pronged strategy comprised of a fiscal stimulus of ¥10.3 trillion, a drastic quantitative easing measure intended to combat deflation, and a system of structural reforms geared to create long-term economic

[1] James McBride and Beina Xu, Abenomics and the Japanese Economy (Council on Foreign Relations, Feb 15, 2016), archived at http://perma.cc/DL48-GVCA.

growth.[2] Along with tax and labor law reforms, Abe has also called for more progressive changes, at least relative to Japanese conservative cultural standards. For example, Abe asked Japanese businesses to hire more women into the workforce, with a particular focus on executive officer positions.[3] Abe also hopes to spur improvement with another essential driver of economic growth—Japanese startups—and has committed to "creat[ing] a welcoming environment for talented entrepreneurs [and] their employees."[4] A June 2013 cabinet report summarizing the Abenomics initiatives points to venture investments and crowdfunding as particularly important avenues toward economic growth. The report states, "[i]n order to allow more and more funds to flow from individuals to venture companies . . . the government will strive for measures to make investment in venture companies and new businesses easier for private companies."[5] Further, "[t]he government will consider fund raising framework[s] such as crowdfunding with the aim to increase supply of risk money in commercializing technologies and ideas and to utilize local resources."[6]

Despite the Prime Minister's high-priority attention, fostering a culture of entrepreneurship in Japan will be easier said than done. A 2014 report by the Global Entrepreneurship Monitor (GEM) ranks Japan in a distant last place among Asian

[2] See The Economist, Abenomics Picks up Speed: The Battle for Japan (The Economist, June 28, 2014).
[3] Bryce Covert, Abenomics Will Boost Japan's Economy by Helping Its Women Workers (ThinkProgress, Apr 22, 2013), archived at http://perma.cc/D4YK-MWNK.
[4] Shinzo Abe, The Next Stage of Abenomics is Coming (The Wall Street Journal, Sept 18, 2014), archived at http://perma.cc/BTN8-EHZ2.
[5] Cabinet Secretariat of Japan, Japan Revitalization Strategy – Japan is Back (June 2013).
[6] Id.

countries for levels of early-stage entrepreneurial activity (as a percentage of the total adult population).[7] Out of seventy countries worldwide, Japan ranked second to last in this category, with only Suriname at lower levels of entrepreneurship activity.[8] The same 2014 report indicated that only 2.5% of Japan's population aged between eighteen and sixty-four expected to start a business by 2017.[9]

Enter the significant legislative measures taken to incentivize investments in startups in 2014. In May 2014, the National Diet, Japan's bicameral legislature, amended the Financial Instruments and Exchange Act (FIEA) to relax restrictions on equity offerings by privately held companies and to allow non-accredited investors to invest in securities offerings advertised by private companies via equity crowdfunding platforms.[10] Just as the SEC spent multiple years grappling with the JOBS Act in the course of its rulemaking efforts, so has Japan's Financial Services Agency with the equity crowdfunding provisions of the amended FIEA. It is worth noting that Japan had already permitted a narrower form of "crowdfunding" in which companies were restricted to offering securities only to accredited investors—that is, extremely wealthy individuals granted special permission to invest in these kinds of high-risk startup equity offerings. The term "crowdfunding" is used in this paper to refer to the kinds of public offerings made possible by the amended FIEA and Title III of the JOBS Act, in which any member

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[7] Slavica Singer, José Ernesto Amorós, and Daniel Moska, Global Entrepreneurship Monitor: 2014 Global Report 40 (Global Entrepreneurship Monitor 2014).
[8] Id at 40–42.
[9] Id at 33.
[10] Hiroki Sugita and Eric Sibbitt, Japan Adopts New Legislation to Facilitate Equity Crowdfunding for Start-up Companies (O'Melveny & Myers 2014), archived at http://perma.cc/WSH5-G8FX.

of the public can be afforded the opportunity to invest in a company's securities offering as long as certain other regulatory requirements are met.

As equity crowdfunding and other startup-friendly policies are implemented, there are some signs that Abe's economic reforms are starting to pave the way for entrepreneurial growth. In its most recent 2015/16 report, the Global Entrepreneurship Monitor ranks Japan twelfth among sixty-two countries in its rankings of each country's governmental policies supporting entrepreneurship and government entrepreneurship programs.[11] Many commentators have noted that the country's small population of entrepreneurs is growing in response to Abe's economic initiatives and in light of cultural shifts among Japanese students.[12] Still, these sparks of entrepreneurial behavior may nonetheless fail to ignite the innovative fire that Abe is hoping for. Japan is ranked fiftieth in the GEM report's ranking of countries by their social and cultural norms favoring entrepreneurship.[13]

III. Japan's Financial Services Agency Implementation Strategy

The Financial Services Agency (FSA) is Japan's analogue to the SEC in the United States. The FSA has regulatory authority to oversee banking, financial securities exchanges, and insurance industries in Japan. The agency thus serves a vital role in working towards Prime Minister Abe's goals for long-term economic growth. In a

[11] Donna Kelley, Slavica Singer, and Mike Herrington, Global Entrepreneurship Monitor: 2015/16 Global Report 142–44 (Global Entrepreneurship Monitor 2016).
[12] See, for example, Kevin Ready, The Evolution of Japanese Startups: Innovation from the Ground Up (Forbes, Oct 11, 2015), archived at http://perma.cc/JR7X-FRC6.
[13] Id at 152.

September 2015 report, the FSA lists capital market reforms and cross-border transactions as top strategic priorities.[14] Following the May 2014 amendment to the FIEA, the FSA assumed the responsibility of crafting the rules and guidelines it would use to regulate equity crowdfunding in Japan. The FIEA technically went into effect in early 2015, however, the regulatory requirement that equity crowdfunding offerings be channeled only through platforms registered with the FSA has resulted in extremely low levels of equity crowdfunding platform providers. As a result, equity crowdfunding has not yet taken off to the extent Abe and his team of advisers had hoped. The FSA continues to reassess and refine its policies and rules concerning equity crowdfunding in efforts of advancing economic growth goals.

The FSA is well aware of the uphill battle it faces in changing Japan's entrepreneurial culture. A December 2013 report notes a "twofold difference in the new business launch rate between the [United States] and Japan, with the [United States] rate at 9.3% and Japan's at just 4.5%."[15] The report also notes a significant disparity in venture capital investments, with an estimated $26.7 billion (equivalent to approximately ¥2.7 trillion) in investments by United States venture capital firms compared to just ¥102.6 billion in investments by Japanese venture capitalists.[16] In other words, Japanese venture capital investments are less than 4% of those made in the United States. The FSA

[14] Financial Services Agency, Summary Points from Strategic Directions and Priorities 2015–2016 5, 16 (Financial Services Agency, Sept 2015).
[15] Financial Services Agency, Report by the "Working Group on the Provision of Risk Money to Emerging and Growing Companies" of the Financial System Council 1, (Financial Services Agency, Dec 25, 2013).
[16] Id.

recognizes that there are significant differences in the size and makeup of the Japanese and United States economies, but nonetheless finds that venture capital investments are well below the desired level.[17]

A special FSA committee called the Working Group on the Provision of Risk Money to Emerging and Growth Companies ("FSA Working Group") issued an investigative report on three of the main points covered in the FIEA amendment: crowdfunding, the trading and selling of non-listed shares, and "the promotion of investment in start-ups by venture capital providers that are subsidiaries of insurance companies."[18]

With respect to crowdfunding, the FSA Working Group established three broad categories, namely "donation-type," "purchase-type," and "equity-type."[19] With respect to equity-type crowdfunding, the group further splits the category into two parts: "partnership-rights-based" and "share-based."[20] The partnership-rights-based equity category is analogous to private securities offerings to accredited investors to the United States made under SEC Regulation D, § 506(b). As with the 2012 JOBS Act, the amended FIEA relaxed regulatory restrictions on these types of offerings. However, these offerings had already been fairly frequent use prior to the legislation. The share-based equity category relates to public offerings of securities interests relatively analogous to those covered by Title III of the JOBS Act.

[17] Id.
[18] Id at 3.
[19] Financial Services Agency, Report by the Working Group at 3.
[20] Id.

The FSA closely followed the passage of the JOBS Act and the SEC rulemaking process during this time period. As the Working Group report notes, "[The JOBS Act] has opened the way for fund procurement through investment crowdfunding, which was [formerly] difficult in practice . . . . Taking these regulatory changes in the [United States] into consideration, the Working Group explored the possibility of establishing a system for both partnership-rights-based and share-based equity crowdfunding."[21]

IV. Japan's Venture Capital and Emerging Companies Fundraising Ecosystem

Many attribute the Japanese disinterest in entrepreneurship relative to other countries to cultural differences, and, perhaps most importantly, general aversion to risk. Just as this impacts the number of entrepreneurs and new enterprises emerging in Japan, it also limits access to the investment capital necessary for research and development, marketing, and growth. Startup investments are widely considered to be fickle and unpredictable, and most Japanese are inclined to overlook high risk-high reward entrepreneurial endeavors for lower but more reliable economic gains.

Along with these limitations and cultural differences, there are some other notable patterns that have emerged in the world of Japanese venture fundraising. These may play a significant role in the evolution of Japanese crowdfunding and entreprenurial finance. First, a large percentage of venture investment capital in Japan comes from corporations rather than independent venture capital firms. In the second quarter of 2015, one source estimates that 80% of entrepreneurial investment capital was sourced from corporate

[21] Id at 4.

investors.[22] The ratio ranged from 61% to 71% in the four preceding quarters.[23] By comparison, less than 25% of entrepreneurial investment capital in the United States was sourced from corporate investors during the same term, with a much larger percentage deriving from venture capital firms.[24]

This presents Japanese entrepreneurs with a much different calculus in preparing their business development and fundraising strategies as compared to the United States. As a broad generalization, many American startups proceed through several rounds of investment fundraising, working their way up the ladder from seed fundraisings with angel investors to larger Series A and Series B fundraisings with venture capital firms. Percentages of control in the company are conceded along the way, and often the heavyweight investors usually attempt to direct the enterprise towards a lucrative exit, typically through acquisition by a corporation or private equity firm. While some corporations are actively focused on building relationships with young, promising companies early on, often these relationships are maintained through licensing agreements and intellectual property purchases rather than via corporate equity investments. Corporate investments are more likely tied to the venture and private equity funds than to startups directly.

By contrast, there is some evidence that Japanese corporations are more inclined to see startups as extensions of research and development projects and as future

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[22] James Riney, Corporate Venture Capital is King in Japan (Tech Crunch, Aug 13, 2015), archived at http://perma.cc/6TYH-L4MR.
[23] Id.
[24] Id.

acquisition targets. Absent a robust venture capital industry, some see a trend in Japanese corporations opting to build the investment pipeline network themselves—albeit on a much smaller scale relative to venture investments in most developed countries. From the entrepreneurs' perspective, there is less reason to distinguish between corporate investment capital and venture fund investment capital, even if for no better reason than that venture capital is so difficult to come by.

There is another noteworthy and perhaps unexpected benefit of the prevalence of corporate investments that ties in to the risk-averse culture. As one venture capitalist notes, "[i]n a country that is inherently risk averse, the backing of a brand-name company conveys stability, and that stability helps tremendously."[25] Consider a new company marketing a B2B product. Customers may be extremely hesitant to make the product investment if concerned about the longevity of the company. Products may require service and maintenance. Businesses may in the long term prefer less costly product upgrades as compared to switching to a competitor's offering. Thus, the risk aversion of potential customers may be assuaged by the signal of stability communicated by corporate backing.

In summary, the framework for early-stage company investments in Japan is currently much smaller and more conservative relative to the United States. On the whole, each of the important players in the ecosystem—entrepreneurs, investors, and customers—are guided by cultural norms much different than those that have led to the energized, volatile, and fiercely competitive technology startup environment in the

[25] Riney, Corporate Venture Capital is King in Japan (cited in note 22).

United States. As the FSA looks to the JOBS Act implementation process as an important reference in its own rulemaking processes, and as the governmental leadership carries forward its campaign to mobilize Japanese innovation, it will be interesting to see how the regulators strike its balance of incentives amidst what promises to be a glacial shift in social and cultural norms.

V. Conclusion

The future relevance and utility of equity crowdfunding will become clearer over the next year as the United States, Japan, and several other countries work towards rolling out and re-tooling this investment mechanism in efforts to incentivize innovation and realize benefits to economic growth. The implementation of the long-awaited Crowdfund Act in the United States in May 2016 promises to breathe new life into the debate surrounding the issue. Although there is much doubt about the effectiveness of equity crowdfunding arising from American investors and entrepreneurs alike, many also see the development as an opportunity to democratize entrepreneurial finance by providing new access to investment opportunities to the general public.

Equity crowdfunding in Japan has gotten off to a hesitant start but remains an important component of Prime Minister Abe's aggressive economic growth plan. The FSA will no doubt be viewing the Crowdfund Act implementation with a watchful eye as they attempt to craft a balanced set of rules to protect investors, afford entrepreneurs with easier access to investment capital, and generate interest and faith among a broad swathe of new investors. As another essential piece of Abe's economic mission, the Japanese government has been tasked with reshaping the cultural norms that many believe to be the basis for Japan's long trend of underperformance in entrepreneurial activity. Aversion to risk and a greater attribution of value to social groups than to individual independence have likely contributed to the low interest in entrepreneurship, and these social norms may also bleed over to impact the perceptions of investors and potential customers. In many ways, the pace of Abe's revolutionary mission will be fixed to the rate at which social customs change. Even so, there are some indications that the tectonic shift of these cultural changes is gaining pace. Regulators, investors, entrepreneurs, and certainly securities lawyers will stay tuned.