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Alma Pekmezovic

Gordon Walker

THE GLOBAL SIGNIFICANCE OF CROWDFUNDING: SOLVING THE SME FUNDING PROBLEM AND DEMOCRATIZING ACCESS TO CAPITAL

ALMA PEKMEZOVIC
GORDON WALKER*

ABSTRACT

This Article provides a comprehensive review of the crowdfunding phenomenon. It argues that equity crowdfunding ("ECF") and, to a lesser extent, peer-to-peer lending ("P2PL") offer the possibility of a global solution to the small and medium-sized enterprise ("SME") funding problem. In the United States, the SME funding problem is exacerbated by the markedly diminishing rate of startup formation, a factor that injects a degree of urgency into resolving the optimal means to implement ECF. Here, as with the "fin-tech" revolution, the law lags behind technological developments. The second main argument is that ECF enhances access to capital for SMEs globally while simultaneously democratizing access to investments for ordinary citizens. The Article begins by providing definitions, business models, and historical background before outlining the SME funding problem and new constraints on SME lending since the global financial crisis. ECF is placed within the so-called "financing escalator" and is distinguished from venture capital and angel financing. The global market for crowdfunding

* Dr. Alma Pekmezovic, LL.M. (UCLA), Ph.D. (La Trobe) is a Lecturer at La Trobe University School of Law, Melbourne, Australia and a Research Fellow at Bucerius Law School, Hamburg, Germany. Dr. Gordon R. Walker, SJD (Duke) is a Professor of Law at the Law School, Hamad Bin Khalifa University, in strategic partnership with the Pritzker School of Law, Northwestern University, Chicago, Illinois, United States under the auspices of the Qatar Foundation, Doha, Qatar; Emeritus Professor of Law at La Trobe University, Melbourne, Australia; and Visiting Professor at the University of Houston Law Center. Thanks to Professors Dean Pawlowic, Stephen Black, and Eric Chiappinelli of Texas Tech University School of Law for their comments on earlier drafts.

is reviewed in order to indicate growth trends in the sector. Some common legal issues associated with crowdfunding are presented before a review of crowdfunding globally. Dominant models in some Organisation for Economic Co-operation and Development (OECD) countries and the potential for crowdfunding to assist SMEs in the undeveloped world are explored. The conclusion outlines key considerations and choices for legislators considering the regulatory puzzles presented by crowdfunding.

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INTRODUCTION

This Article reviews crowdfunding and considers its implications for securities regulation and fundraising law.[1] We consider the utility of crowdfunding for small and medium-size enterprises ("SMEs") and the regulatory approach taken in OECD jurisdictions such as New Zealand, Australia, the United States, the European Union, and the United Kingdom to equity crowdfunding ("ECF") and, to a lesser extent, peer-to-peer lending ("P2PL").[2] These alternative forms of fundraising have grown as a result of technological innovation and the fallout from the global financial crisis ("GFC") in 2008–09, which resulted in tightened bank credit and increased constraints on SMEs' access to capital.[3] Restrictions on SME access to capital are especially prevalent in the early-stage risk capital market, and it is here that ECF and P2PL are attractive solutions.

These new sources of entrepreneurial finance significantly expand the sources of financing available to SMEs by permitting equity investing and lending from micro angel and retail investors who can now participate in venture capital or angel financing—i.e., early startup financing to fledgling companies with significant potential.[4] Crowdfunding has the potential not only to improve access to finance for SMEs (thereby enhancing domestic resource mobilization), but also to democratize access to investment opportunities. Crowdfunding investment opportunities are

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[1] *See, e.g.*, Neil Parmar, *Crowdfunding is Opening Investment Doors*, WALL ST. J. (Nov. 9, 2014), http://www.wsj.com/articles/crowdfunding-is-opening-investment-doors-1415569542 [https://perma.cc/48HX-88UW]; *see also, e.g.*, Angus Loten & Ruth Simon, *Small-Business Optimism Surges With Solid Economy,* WALL ST. J., Jan. 2, 2015, at B1.

[2] *See, e.g.*, FIN. CONDUCT AUTH., CP13/13: THE FCA'S REGULATORY APPROACH TO CROWDFUNDING (AND SIMILAR ACTIVITIES), (Oct. 24, 2013), http://www.fca.org.uk/news/cp13-13-regulatory-approach-to-crowdfunding [https://perma.cc/K43X-9KXN].

[3] AUSTL. GOV'T CORPS. & MKTS. ADVISORY COMM., CROWD SOURCED EQUITY FUNDING REPORT (May 2014).

[4] *See* Caitlin Fitzsimmons, *Crowdfunding: How to become your own venture capitalist,* AUSTL. FIN. REV. (Mar. 19, 2015), http://www.afr.com/personal-finance/how-to-become-your-own-venture-capitalist-20150319-1m2soe [https://perma.cc/UUW4-HYNM].

now available to a larger pool of investors, including retail and noninstitutional investors. They are no longer restricted to accredited investors, as is the case under some legislative frameworks.[5]

ECF, in particular, should facilitate the flow of funding to SMEs and microfirms, which are unable to access traditional sources of finance.[6] Although this kind of investing carries well-documented risks, it offers significant improvements in SME access to finance and the potential to enhance portfolio diversification for retail investors.[7] As a result, we argue that ECF and P2PL offer the prospect of a solution to the SME funding problem in those countries with good communications infrastructure, including Internet and mobile telephony. Moreover, ECF has the potential to drive economic recovery from the GFC by mobilizing the small business engine for job creation.[8] Governments are well aware of the potential of these new forms of fundraising.[9] For

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[5] *Id.* at 29. For a discussion of the U.S. position, see Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 101 (forthcoming 2016).

[6] It has been estimated that more than 200 million SMEs lack access to traditional finance worldwide. Rep. of the Comm. of Experts on Sustainable Dev. Fin., at 25, U.N. Doc. A/69/315 (2014), http://www.un.org/ga/search/view_doc.asp?symbol=A/69/315&Lang=E [https://perma.cc/JQT6-VUWH]. The World Bank Group states:

> There are 420–510 million micro, small, and medium enterprises worldwide, of which 360–440 million are in emerging markets. When asked to list their main constraints to growth, access to finance tops the list for entrepreneurs in lower-income countries. Globally, fewer than 30 percent of these firms use external financing, of which half are underfinanced. The total unmet need for credit among MSMEs in emerging markets is estimated at US$2.1–2.5 trillion, approximately 14 percent of the GDP of these countries.

WORLD BANK, FINANCING FOR DEVELOPMENT POST-2015 32 (Oct. 2013), https://www.worldbank.org/content/dam/Worldbank/document/Poverty%20documents/WB-PREM%20financing-for-development-pub-10-11-13web.pdf [https://perma.cc/9LZ2-5T4L].

[7] TIM KOLLER ET AL., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES 33 (5th ed. 2010). *See generally* BEVIS LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986).

[8] Sara Hanks, *Online capital-raising by small companies in the USA after the JOBS Act compared to the same process in the European Union,* 8(3) CAP. MKTS. L.J. 261, 265 (2013).

[9] *Id.*

example, the new ECF and P2PL regime in New Zealand flows directly from the so-called "Business Growth Agenda" of the New Zealand government.[10]

As we shall see, however, the central dilemma for regulators is how to tailor securities laws and any applicable ECF or P2PL exemptions to the financial needs of SMEs, while at the same time ensuring an adequate level of investor protection. Because ECF and P2PL are susceptible to information asymmetries and agency costs, the new regulatory frameworks typically mandate certain safeguards designed to protect the investor.[11] We identify three common regulatory mechanisms that focus on (1) regulating crowdfunding intermediaries via a licensing regime; (2) regulating the investment opportunities of the crowd investor; and (3) ex post governance regulation of the crowdfunded firms. Thus, intermediaries that operate ECF and P2PL platforms are often required to obtain a license, maintain a disclosure regime, and ensure that investors are able to exercise an informed choice. An alternative and complimentary regulatory mechanism requires crowdfunded firms to make a disclosure and comply with various corporate governance requirements intended to enhance transparency. Another mechanism focuses on the regulation of nonaccredited investors' investment opportunities and typically results in limitations placed on the ability of such investors to participate in ECF and P2PL campaigns. Nonaccredited investors may participate in crowdfunding subject to certain restrictions; for example, they can only invest a fraction of their net wealth or assets in ECF and P2PL and are hence subject to investment caps imposed by the legislature.[12]

Different regulatory tools have implications for investor protection and compliance costs for firms seeking funding via ECF

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[10] *See* Alma Pekmezovic & Gordon Walker, *Equity Crowd Funding in New Zealand*, 33(1) CO. & SEC. L.J. 63, 64 (2015).

[11] For a discussion on agency costs, see, for example, *Kickstarter Game Scam: A Non-Starter*, STUFF (May 3, 2012), http://www.stuff.co.nz/technology/games/6846137/Kickstarter-game-scam-a-non-starter [https://perma.cc/8HHZ-JF39]. *See generally* M. C. Jensen & W. H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[12] AUSTL. GOV'T CORPS. & MKTS. ADVISORY COMM., CROWD SOURCED EQUITY FUNDING REPORT §§ 6.4.1–6.4.2 (May 2014).

or P2PL. We explore various regulatory approaches and comment on their likely effectiveness. Investor safeguards must be balanced against economic utility—for example, job creation—and SME demand for crowdfunding and peer-to-peer financing.[13] It is notorious that SMEs in all countries face funding constraints, but also that such entities are a key driver of private sector employment.[14] Thus, there is a policy imperative to encourage funding options for SMEs and craft exemptions in securities regimes to facilitate crowdfunding.[15]

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[13] *Id.* § 6.6.2.

[14] *Id.* § A4.1.

[15] *See id.* § 2.1.2. In December of 2014, the Commonwealth of Australia released its Financial System Inquiry: Final Report. The Final Report stated that funding for SMEs was essential to facilitate productivity growth in the Australian economy. *See generally* DEP'T OF TREASURY, FINANCIAL SYSTEM INQUIRY: FINAL REPORT (2014) (Austl.), http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf [https://perma.cc/S8P8-MWV3]. Recommendation 18 approved a graduated regime for fund raising to facilitate crowdfunding. *Id.* at 143–92. The recommendation was met with approval from the industry. *See* James Eyers, *Change laws to make crowdfunding easier*, AUSTL. FIN. REV., Dec. 8, 2014, at 6; Nassim Khadem, *Crowdfunding in Australia goes under public microscope,* SYDNEY MORNING HERALD*,* Dec. 9, 2014, at 23; Richard Gluyas, *Review falls short for P2P lenders*, AUSTRALIAN, Dec. 9, 2014. A discussion paper on crowdfunding was promulgated in December of 2014; *see* DEP'T OF TREASURY, CROWD-SOURCED EQUITY FUNDING (2014) (Austl.), http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Crowd%20Sourced%20Equity%20Funding/Downloads/PDF /CSEF%20Discussion%20Paper.ashx [https://perma.cc/9YBF-D8TP]. The Australian federal government's 2015–2016 budget introduced an AU$5.5 billion Growing Jobs and Small Business package, which included a provision for crowdfunding. These measures were further elaborated in DEP'T OF TREASURY, FACILITATING CROWD-SOURCED EQUITY FUNDING AND REDUCING COMPLIANCE COSTS FOR SMALL BUSINESSES (2015) (Austl.), http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2015/Crowd-sourced%20equity%20funding/Key%20Documents/PDF/Crowd-sourced-equity-funding.ashx [https://perma.cc/5CN9-9N2E]. The policy rationale behind these initiatives was clear: to increase fundraising opportunities for SMEs and increase employment. Similar concerns prompted the introduction of an ECF regime in Malaysia. The Malaysian Securities Commission (SC) and the Malaysian Business Angels Network (MBAN) sponsored the Synergy and Crowdfunding Forum on September 14, 2014. The SC issued a public consultation document on Crowdfunding. *See* SEC. COMM'N MALAY., PROPOSED REGULATORY FRAMEWORK FOR EQUITY CROWDFUNDING—PUBLIC CONSULTATION PAPER NO. 2/2014 (Aug. 21, 2014), http://www.sc.com.my/wp-content/uploads/eng/html/consultation/140821_PublicConsultation_2.pdf [https://perma.cc/FFB3-5T9B]. In February of 2015, the Securities Commission Malay released new guidelines to

Part I of this Article examines definitions of crowdfunding and P2PL and provides an historical background. We look at portals that match crowdfunding investors and investees and offer insights into crowdfunding practices in various parts of the world including developing countries. We explore a variety of crowdfunding models including donation-based, reward-based, lending, and equity crowdfunding.

Parts II and III consider the SME financing problem in the context of the GFC, which imposed lending constraints on traditional providers of finance. We review the lower end of the fund-raising spectrum—including venture capital, angel investing, and public equity financing—via lower-tier market segments at existing securities exchanges such as the Alternative Investment Market (AIM) at the London Stock Exchange. We then turn to place crowdfunding within that spectrum. Here, our aim is to add to the nascent literature on crowdfunding and SMEs' access to capital. Crowdfunding is an underresearched area of finance, despite its potential to close the entrepreneurial funding gap.

Parts IV and V focus on the ECF model adopted in New Zealand and other jurisdictions, including the regulatory frameworks in the European Union and the United States. We discuss regulatory convergence and divergence at the international level and point to common legal issues associated with ECF and P2PL. This leads to a consideration of how to optimally design securities regulation carveouts for SMEs using crowdfunding and P2P portals. Given that the ECF and P2PL are relatively new activities, the regulatory approach is evolving in the jurisdictions under review in this Article. We summarize insights from our analysis and provide recommendations for further reform. These recommendations may be utilized by policymakers in developing regulatory frameworks to deal with the risks and issues raised by ECF and P2PL.

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facilitiate equity crowdfunding under section 34 of the Capital Markets and Services Act 2007. On September 22, 2015, amendments to Malaysia's securities regulation regime were passed that enabled ECF. *See* Capital Markets and Services (Amendment) Act 2015 (Malay.) (CMSA) *and* Securities Commission (Amendment) Act 2015 (Malay.) (SCMA). Pursuant to the CMSA amendment, private companies hosted on a registered ECF platform are given a safe harbor from provisions in the Companies Act 1965 that prohibit private companies from offering shares to the public. Asia-Pacific crowdfunding is covered by the website Crowdfund Vibe. CROWDFUND VIBE, http://crowdfundvibe.com [https://perma.cc/V464-ESE7].

I. CROWDFUNDING AND P2PL: DEFINITIONS, BUSINESS MODELS, AND HISTORICAL BACKGROUND

A. Definitions

The term "crowdsourcing" has been defined as the "practice of obtaining needed services, ideas, or content by soliciting contributions from a large group of people, especially from the online community."[16] Typically, crowdsourcing involves the outsourcing of tasks to an undefined group of people through an open call. By contrast, "crowdfunding" enables entrepreneurs who traditionally face financing constraints to obtain capital from anyone in the world via the Internet.[17] Crowdfunding—as a form of crowdsourcing—is designed to facilitate raising capital.[18] The key difference between crowdsourcing and crowdfunding is that in crowdsourcing, the crowd provides labor. Under the crowdfunding model, the crowd provides funds.[19] Related terms are "crowd intelligence" (knowledge of the crowd), "crowd production" (creation of the crowd), and "crowd evaluation" (thoughts of the crowd).[20]

According to IOSCO, crowdfunding is an "umbrella term describing the use of small amounts of money, obtained from a large number of individuals or organizations, to fund a project, a business or personal loan, and other needs through an online web-based platform."[21] The advantage of raising funds online is that the

[16] *Crowdsourcing*, MERRIAM-WEBSTER DICTIONARY, http://www.merriam-webster.com/dictionary/crowd-sourcing [https://perma.cc/QB8A-MTPH]. *See generally* Jeff Howe, *The Rise of Crowdsourcing*, WIRED MAGAZINE, June 2006, at 1–4, http://archive.wired.com/wired/archive/14.06/crowds.html, [https://perma.cc/TLV3-E6WP] (The identification and naming of the phenomenon of crowdsourcing is generally attributed to this seminal article).

[17] Steven Bradford, *Crowdfunding and the Federal Securities Laws,* 2012 COLUM. BUS. L. REV. 1 (2012).

[18] Wikipedia itself is an example of crowdsourcing. *See* Tony Weimer, *Ten examples of crowdsourcing*, CALLCENTREHELPER.COM (Nov. 24, 2010), http://www.callcentrehelper.com/ten-examples-of-crowdsourcing-14133.htm [https://perma.cc/N3ME-NKVY].

[19] Sammie Schweissguth, *Crowdsourcing vs. Crowdfunding: What's the Difference*, CROWDSOURCE (July 23, 2013), http://www.crowdsource.com/blog/2013/07/crowdsourcing-vs-crowdfunding-whats-the-difference/ [https://perma.cc/J6NV-8FEE].

[20] *See generally* JEFF HOWE, CROWDSOURCING: WHY THE POWER OF THE CROWD IS DRIVING THE FUTURE OF THE BUSINESS 47 (2008).

[21] Eleanor Kirby & Shane Worner, *Crowd-funding: An Infant Industry Growing Fast* 4 (Int. Org. Sec. Comm'n, Working Paper No. SWP3/2014,

Internet substantially reduces transaction costs and makes it possible to collect small amounts of funds from a large pool of funders.[22] The aggregation of a large number of small contributions can result in considerable amounts of capital.[23] Examples of crowdfunding Internet sites include MyMajorCompany,[24] Kiva,[25] Kickstarter,[26] Crowdcube,[27] and IndieGoGo.[28] These sites allow companies and entrepreneurs to turn to a "crowd" of potential investors for financing.[29]

Crowdfunding exists because of Internet technology. Schwienbacher et al. define crowdfunding as "[an] open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes."[30] A narrower definition used in the entrepreneurial context refers to "the efforts by entrepreneurial individuals and groups—cultural, social, and for-profit—to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the Internet, without standard financial intermediaries."[31]

The three key components of crowdfunding are (1) a large number of investors; (2) the provision of relatively small amounts of

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2014), http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf [https://perma.cc/K4B5-K5WN].

[22] *Id.* at 22.

[23] *See* Karen E. Wilson & Marco Testoni, *Improving the Role of Equity Crowdfunding in Europe's Capital Markets*, 9 BRUEGEL POL'Y CONTRIBUTION 2 (2014).

[24] MYMAJORCOMPANY, https://www.mymajorcompany.com/ [https://perma.cc/W2MY-Q3C2].

[25] KIVA, http://www.kiva.org/ [https://perma.cc/J9RJ-46PV].

[26] KICKSTARTER, https://www.kickstarter.com/ [https://perma.cc/9AQH-ULZ9].

[27] CROWDCUBE, http://www.crowdcube.com/ [https://perma.cc/YC73-XM3T].

[28] INDIEGOGO, https://www.indiegogo.com/ [https://perma.cc/Y7UG-ZW2H].

[29] *See, e.g.*, MYMAJORCOMPANY, *supra* note 24, *see also* Paul Belleflamme et al., *Crowdfunding: Tapping the Right Crowd*, 29(5) J. BUS. VENTURING 585, 585 (2014).

[30] Belleflamme et al., *supra* note 29, at 588. *See* ARMIN SCHWIENBACHER ET AL., THE OXFORD HANDBOOK OF ENTREPRENEURIAL FINANCE 369–90 (David Cummings ed., 2012). This definition builds on a definition of crowdsourcing provided in Frank Kleeman et al., *Un(der)paid Innovators: The Commercial Utilization of Consumer Work Through Crowdsourcing*, 4(1) SCI., TECH. & INNOVATION STUD., 5–26 (2008).

[31] Ethan Mollick, *The Dynamics of Crowdfunding: An Explanatory Study,* 29 J. BUS. VENTURING 1, 2 (2014).

money from each investor; and (3) the use of the Internet, which is used for its convenience and ability to connect individuals across the globe.[32] For example, individuals may seek relatively small amounts of capital—often under $1,000—in order to fund a one-time project or event, and the capital may be provided by family or friends.[33] Alternatively, entrepreneurs use crowdfunding as a form of seed financing in order to fund the startup of a firm.[34] Thus, equity crowdfunding may be used as a substitute for traditional forms of formal venture financing, where funders are treated as investors who receive equity stakes or similar consideration in exchange for funding a project or product. As stated, we refer to this type of funding as ECF.[35] The advantage of utilizing ECF is that the emerging company need not rely on a substantial investment from a small number of venture capitalists or angel investors but can turn to a large number of investors for small contributions, which makes "backing new businesses [more] affordable."[36] In a setting like New Zealand, where there are no more than one hundred angel investors, this can be a significant advantage.[37] The same could be said of other jurisdictions where private equity is relatively undeveloped.

Crowdfunding may also be used as a lending model. Here, funders typically offer capital in the form of a loan, expecting to receive a return of the capital invested. They can also invest on the basis of philanthropic goals such as wanting to promote a certain social good or objective.[38] The British Peer-to-Peer Finance Association provides the following definition of peer-to-peer finance:

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[32] *Id.* at 1.

[33] *Id.* at 3.

[34] *Id.*

[35] FIN. CONDUCT AUTH., *supra* note 2.

[36] Michael Murray, *Want to Grow Your Business? It's Time to Get Social,* INDEP., Mar. 10, 2011, § 2, http://www.independent.co.uk/news/business/sme/want-to-grow-your-business-itrsquos-time-to-get-social-2238088.html [https://perma.cc/Z9AX-5CA5].

[37] MINISTRY OF ECO. DEV., BASELINE REVIEW OF ANGEL INVESTMENT IN NEW ZEALAND 47 (2007) (N.Z.), https://www.med.govt.nz/about-us/publications/publications-by-topic/evaluation-of-government-programmes/archive/report.pdf [https://perma.cc/45PE-QYN6]. The emergence of information exchanges in New Zealand, notably the United Kingdom–based Angel Investment Network, may have contributed to an increase in that number.

[38] Mollick, *supra* note 31, at 3.

"platforms that facilitate financial services via direct, one-to-one contracts between a single recipient and one or multiple providers."[39] Thus, P2PL is a form of crowdfunding and is usually referred to as "crowd lending" or "debt crowdfunding."[40] Borrowers seek capital and lenders provide capital via websites.[41] A P2PL platform, rather than a bank, acts as an intermediary between borrower and lender.[42] This often allows lenders to obtain higher returns. The website handles the contractual relationships and disburses the funds.[43] In the United Kingdom, Zopa was the first platform to offer this kind of service in 2005.[44] RateSetter is another U.K. P2PL platform that also recently launched in the Australian market.[45] Smava is a German platform,[46] and Babyloan is a French provider.[47] Another example is the British crowdfunding platform Buzzbnk; however, this platform primarily focuses on donation-based loans, with lenders receiving only a symbolic payment back.[48] The U.S.-based Prosper is currently regarded as the market leader

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[39] *See* PEER-TO-PEER FIN. ASS'N, LAUNCH OF PEER-TO-PEER FINANCE ASSOCIATION, http://p2pfa.info/p2pfa-launch [https://perma.cc/T8X3-D4NL].

[40] *See generally* Scott E. Hartley, *Kiva.org: Crowd-Sourced Microfinance and Cooperation in Group Lending* (Harv. U. Berkman Ctr. Internet & Soc'y, Working Paper, 2010), http://ssrn.com/abstract=1572182 [https://perma.cc/9B5C-YN2M].

[41] *Id.* at 7.

[42] *How peer-to-peer lending works*, ZOPA, http://www.zopa.com/peer-to-peer-lending [https://perma.cc/R7DU-7FFZ].

[43] *How lending works*, ZOPA, http://www.zopa.com/lending/how-lending-money-works [https://perma.cc/6275-822D].

[44] *Peer-to-peer lending: Banking without banks,* ECONOMIST, Mar. 1, 2014, at 69–70, http://www.economist.com/news/finance-and-economics/21597932-offering-both-borrowers-and-lenders-better-deal-websites-put-two [https://perma.cc/CST6-EW6G].

[45] Mitchell Neems, *RateSetter launches in Australia, Plans to Challenge Banks*, AUSTL. BUS. REV. (Nov. 11, 2014), http://www.theaustralian.com.au/business/financial-services/ratesetter-launches-in-australia-plans-to-challenge-banks/story-fn91wd6x-1227119113243 [https://perma.cc/DH29-TCET].

[46] *See* SMAVA, http://www.smava.de/ [https://perma.cc/96RH-YDTT].

[47] *See* BABYLOAN, http://www.babyloan.org/fr/ [https://perma.cc/3QLM-K8BJ].

[48] *See* BUZZBNK, https://www.buzzbnk.org/ [https://perma.cc/G3CB-BDT5]. The site includes the following proviso: Buzzbnk is a platform to raise social loans which means the primary purpose for backing a venture is the social or environmental outcome they seek to achieve and any financial returns secondary. *Id.* The loans are not secured. *Id.*

in P2PL.[49] Another U.S.-based P2P lending site is the Lending Club.[50] These sites gained particular popularity in the wake of rising bank interest rates following the GFC.

Some websites also facilitate peer-to-peer foreign exchanges connecting individuals and corporations online to exchange currencies directly.[51] Examples of P2PL foreign exchange platforms are CurrencyFair, launched in Ireland in 2010, and TransferWise, launched in the United Kingdom in 2011.[52] A U.K. site, Kantox, offers peer-to-peer foreign exchange hedging.[53] The reward for financing a project may often be nonfinancial in nature, such as being credited in a movie, having creative input into the design of a product, or being given the opportunity to meet with the creators of the project.[54] Funders may also receive special rewards and benefits by gaining access to funded products at an earlier date, at a better price, or with special conditions attached to the product.[55] We refer to this type of crowdfunding as "reward crowdfunding" or "pre-sales crowdfunding."[56] Both reward crowdfunding and donation crowdfunding can be thought of as crowd sponsoring; there is no financial return involved for the backers.[57] One of the main platforms offering crowd sponsoring

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[49] *See How it Works*, PROSPER, https://www.prosper.com/welcome/how-it-works/ [https://perma.cc/C9QH-FEYV].

[50] LENDINGCLUB, http://www.lendingclub.com [https://perma.cc/L87D-D2SH].

[51] *See* Sebastian C. Moenninghoff & Axel Wieandt, *The Future of Peer-to-Peer Finance*, ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFTLICHE FORSCHUNG 466–87, at 3 (2013).

[52] *See* CURRENCYFAIR, http://www.currencyfair.com [https://perma.cc/FEP6-XDUU]; *see also* TRANSFERWISE, http://www.transferwise.com [https://perma.cc/2T5Y-27L9].

[53] *How it Works*, KANTOX, http://kantox.com/en/how-it-works-kantox [https://perma.cc/M639-GBS7].

[54] Ethan Mollick, *The Danger of Crowding out the Crowd with Equity Crowdfunding,* 2 U. PENN. PUB. POL'Y INITIATIVE 1 (2014), http://publicpolicy.wharton.upenn.edu/live/files/201-a [https://perma.cc/UCW4-5WZ4].

[55] *Id.*

[56] *See generally* Ethan Mollick & Venkat Kuppuswamy, *After the Campaign: Outcomes of Crowdfunding* (U.N.C. Kenan-Flager Bus. School Res. Paper Series, Research Paper No. 2376997, 2014), http://ssrn.com/abstract=2376997 [https://perma.cc/B5KV-8BY7].

[57] The website BetterPlace.org is a German donor pooling platform. Crowdfunding or crowd sponsoring can be used for political purposes. BETTERPLACE.ORG, http://www.betterplace.org/de/ [https://perma.cc/MN9B-CVUA]. For example, Barack Obama collected about $750 million for his presidential campaign in

is the U.S.-based Kickstarter platform.[58] Similar platforms have emerged in the European setting.[59] The Open Source Science Project allows researchers to propose research projects to the crowd and pitch for funding online.[60] This project is intended to give researchers access to alternative funding models and bypass traditional funding routes such as those that are typically available through the government, charity, or industry.[61]

Crowd sponsoring should be distinguished from "equity crowdfunding" (crowd investing) and P2PL (crowd lending)—sometimes collectively referred to as financial reward crowdfunding—and the focus of this Article. Financial reward crowdfunding carries higher risks than crowd sponsoring, and hence, necessitates a special regulatory response. Investor protection, in particular, is an important consideration for financial reward crowdfunding.[62] The main risks that contributors face in crowd investing and crowd lending models are loss of invested capital, fraud, and lack of transparency with respect to charges, as well as interest rates and expected yields. Furthermore, the level of uncertainty in crowd investing and crowd lending is greater compared to other models because it is difficult to assess the quality of the projects and the ability of the entrepreneur to generate equity value.

There is considerable interest in the potential of crowdfunding to improve access to finance in developing countries.[63] As a

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2008. Most of this amount was raised via the Internet and came from small donors who contributed $200 or less. *See* Tahman Bradley, *Final Fundraising Figure: Obama's $750M,* ABC NEWS (Dec. 5, 2008), http://abcnews.go.com/Politics/Vote2008/story?id=6397572&page=1 [https://perma.cc/QT4C-PFGH]; *see also* Jose Antonio Vargas, *Obama Raised Half a Billion Online*, WASH. POST (Nov. 20, 2008), http://voices.washingtonpost.com/44/2008/11/obama-raised-half-a-billion-on.html [https://perma.cc/3QQW-Y6FM].

[58] *See* KICKSTARTER, *supra* note 26.

[59] *See* EURO. CROWDFUNDING NETWORK, http://eurocrowd.org/directory-of-members/ [https://perma.cc/HX88-4QNT].

[60] *See* OPEN SOURCE PROJECT, http://www.theopensourcescienceproject.com/ [https://perma.cc/X7K4-8BXE].

[61] *Id.*

[62] Andy Kollmorgen, *Crowdfunding Risks and Rewards: Is It Time to Regulate Crowdfunding in Australia*, CHOICE (June 25, 2014), https://www.choice.com.au/money/financial-planning-and-investing/stock-market-investing/articles/crowdfunding-risks-and-rewards [https://perma.cc/64M3-BG57].

[63] WORLD BANK, CROWDFUNDING'S POTENTIAL FOR THE DEVELOPING WORLD 4–5 (2013), http://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf [https://perma.cc/B8V4-CNY6].

result, there is no doubt that the rise of financial crowdfunding has significant potential to contribute to economic growth and development. However, this form of finance is also associated with various risks.[64] The various issues and risks that ECF gives rise to are explored in later sections of this Article.

B. Crowdfunding Business Models

In this Section, we consider crowdfunding business models adopted by existing portals. We can distinguish between these models along several dimensions, including the form of securities offered to the crowd (i.e., equity or debt securities); the minimum investment required; the fee structures adopted; and whether investors can invest directly into startups or whether their investments are pooled via special purpose vehicles.[65]

The typical crowdfunding model may be described as follows.[66] First, a funding target—the sum to be raised—is set.[67] Second, funders are encouraged to donate or pledge or to make advance purchases of items.[68] Third, where the target is reached, the funds are released, minus any fees payable to the crowdfunding intermediary.[69] Where the target is not reached, the contributions are returned to the funder.[70] This model is the "all-or-nothing model" or the "threshold pledge model."[71] The key feature of this model is that the platform and the project owner agree on a concrete pledging period and the funding target.[72] The funders promise to pay a specified amount only if the set target

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[64] EURO. SECU. MKT. AUTH., POSITION PAPER: CROWDFUNDING 3 (Apr. 2014), http://www.esma.europa.eu/system/files/2014-smsg-010.pdf [https://perma.cc/T6NZ-NB8B].

[65] Lars Hornuf & Armin Schwienbacher, *The Emergence of Crowdinvesting in Europe* 2 (U. of Munich Dep't of Econ., Discussion Paper No. 2014-43, 2014), http://ssrn.com/abstract=2481994 [https://perma.cc/6HDF-X5XB].

[66] *See* J. Barrett, *Crowdfunding: Some Legal and Policy Considerations*, 18 N.Z. BUS. L. QUARTERLY 296, 296 (2012).

[67] *Id.*

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] Joachim Hemer, *A Snapshot on Crowdfunding* 15–16 (Fraunhofer Inst. for Sy. and Innovation Res., Working Paper No. R2/2011, 2011), http://www.econstor.eu/handle/10419/52302 [https://perma.cc/5EYR-DTLE].

[72] *Id.* at 15.

threshold is reached within a specified period. They provide pledges and the pledged amounts are typically held in an escrow account managed either by the crowdfunding platform or a partner financial institution.[73] Interested funders can view the current status of the project and the number and amount of incoming pledges.[74] Payments are only released from the escrow account and transferred to the project owner if the funding target is reached.[75] This is intended to protect the single investor, as funds are only payable if a large number of investors are willing to fund a project.

Under a crowd lending model, the threshold principle is applied to release loan pledges from the crowd once the target loan amount is reached.[76] The P2PL provider then collects the repayment installments from the debtor (the project initiator), and forwards them to each crowd lender.[77]

In an equity or investment model, the platform and the project initiators define a time period and target threshold.[78] This target is then divided into thousands of equal slices, which are offered as equity shares or to crowd investors at a specified price—for example, $10 per share.[79] Crowd investors then pledge to buy the shares if the target threshold is reached.[80] Some platforms, such as the French platform wiseed.com, may also create subsidiary companies to hold all of the shares in the crowdfunded venture, which are then on-sold to the crowd.[81] Here, a subsidiary company acts as a single investor in the proposed venture and sells shares to crowd investors.[82] From the perspective of the issuing firm, one advantage of a special purpose vehicle (SPV) holding shares in an issuer on behalf of investors is that investments are pooled.[83] Rather than having a fragmented share register with a large number of small investors, the crowdfunding firm can reduce

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[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.* at 16.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] GUIDE ENTREPRENEUR, https://s3-eu-west-1.amazonaws.com/wiseed-public-fr/mediatheque/guide_entrepreneurs.pdf [https://perma.cc/QA73-736B].
[82] *Id.*
[83] *Id.*

transaction costs by utilizing an interposed SPV between itself and its investors.[84]

Finally, some crowdfunding platforms may only target members of a closed circle of potential investors, and function in a similar vein to investment clubs or angel investor groups. For example, they may only target accredited investors. This may be referred to as the club model.[85] Two examples of this model in the United States, CircleUp and FundersClub, are restricted to accredited investors.[86] The aim is to reduce the size of the crowd to those for whom investments are made available.[87] This may also be achieved through the imposition of high investment minimums, the effect of which is to make platforms only available to investors who are able to adhere to such limits.

C. Historical Background

Crowdfunding is not a new phenomenon. For instance, a campaign in 1884 led by the newspaper proprietor Joseph Pulitzer helped fund the installation of the pedestal for the Statue of Liberty in New York Harbor with donations of $1 or less.[88]

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[84] This structure is utilized by the U.K. equity crowdfunding platform Seedrs. *See* SEEDRS, http://www.nea2fguide.co.uk/wp-content/uploads/2013/02/FAQ-SEEDRS.pdf [https://perma.cc/6M7D-8FNU]. Seedrs uses the following disclaimer:

> The nominee structure allows us to manage the investment for you while still giving you the full economic interest in the business. If you held the shares directly, you would have to deal with the various obligations and hassles of being a legal shareholder, and the start-up would have to manage the administrative complexities of having a large number of shareholders. By using a nominee structure, you get the benefits of being a shareholder—financial returns as well keeping informed about the business's progress—and the start-ups gets the benefits of your investment without either of you having to face the burdens of a direct shareholding.

Id.

[85] Hemer, *supra* note 71, at 17.

[86] *See* CIRCLEUP, https://circleup.com/faq/#investors-q-can-non-accredited-investors-invest [https://perma.cc/L5UF-V696]; FUNDERSCLUB, https://support.fundersclub.com/hc/en-us/articles/204968777-How-do-I-start-investing-with-FundersClub [https://perma.cc/6U5X-32LT].

[87] Hemer, *supra* note 71, at 17.

[88] *The Statue of Liberty and America's Crowdfunding Pioneer,* BBC (Apr. 25, 2013), http://www.bbc.com/news/magazine-21932675 [https://perma.cc/7GQ8-FCGM].

Pulitzer helped raise more than $100,000 in six months from 125,000 people.[89]

In its modern iteration, crowdfunding can be traced back to the microfinance and microcredit movements.[90] Thus, crowdfunding has been described as the fusion of two preexisting concepts, namely crowdsourcing and microfinance,[91] and is generally regarded as a progression of the crowdsourcing model described above.[92] The objective of the microfinance movement is to reduce poverty among impoverished communities by facilitating access to finance for individuals who cannot access traditional bank-based financing.[93] Receiving parties demonstrate creditworthiness to financiers or donors by aggregating individual claims.[94] A key characteristic of microfinance is that individuals donating or lending money can develop a personal connection to the beneficiaries of their contributions because they provide loans based on the profiles of the beneficiaries and their goals, as opposed to providing funding through opaque intermediaries or other lending channels.[95] The Grameen Bank, established over thirty years ago to assist the poor in the developing world, is regarded as a pioneer in the field of microfinance and a precursor to crowd lending.[96] A crucial difference between crowdfunding and microfinance is that under a crowdfunding model, the size of investment is scaled

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89 *Id.*

90 *See generally* BEATRIZ ARMENDARIZ & JONATHAN MORDUCH, THE ECONOMICS OF MICROFINANCE (2d ed. 2010); ABHIJIT BANERJEE & ESTHER DUFLO, POOR ECONOMICS: A RADICAL RETHINKING OF THE WAY TO FIGHT GLOBAL POVERTY (reprint ed. 2012); 5 HANDBOOK OF DEVELOPMENT ECONOMICS: 4703–77 (Dani Rodrik & Mark Rosenzweig eds., 2009) (Neth.); *see also* J. Morduch, *The Microfinance Promise*, 37 J. ECON. LIT. 1569 (1999).

91 Richard Harrison, *Crowdfunding and the Revitalization of the Early Stage Risk Capital Market: Catalyst or Chimera?*, 15(4) VENTURE CAP.: INT'L J. ENTREPRENEURIAL FIN. 283, 285 (2013).

92 STEVEN DRESNER, CROWDFUNDING: A GUIDE TO RAISING CAPITAL ON THE INTERNET 45 (2014).

93 Anand Giriharadas & Keith Bradsher, *Microloan Pioneer and His Bank Win Nobel Peace Prize*, N.Y. TIMES (Oct. 13, 2006), http://www.nytimes.com/2006/10/13/business/14nobelcnd.html?_r=0 [https://perma.cc/42L9-BMUB]; *see also* Jon Westover, *The Record of Microfinance: The Effectiveness/Ineffectiveness of Microfinance as a Means of Alleviating Poverty*, ELEC. J. SOC. (2008).

94 Giriharadas & Bradsher, *supra* note 93.

95 *See* KIVA, http://www.kiva.org/lend [https://perma.cc/FM7G-AB8U]; *see also* KIVA, http://www.kiva.org/about/microfinance [https://perma.cc/W9LZ-EJ4P].

96 *See* GREENBANK, http://www.grameen-info.org/ [https://perma.cc/55TP-H9JA].

down owing to mass support or crowd support, whereas under a microfinance model, the aggregate amount sought is scaled down.[97] This does not preclude the crowdfunding of microloans or micro-donation campaigns.[98]

In the developed world, crowdfunding first emerged in the music and film industries.[99] This is consistent with private sponsorship and donations historically favoring the arts and culture. McFedries suggests the term "crowdfunding" was first used in 2006.[100] Michael Sullivan coined the term to describe his website fundavlog.com, which promoted video blogs.[101] In 2009, the term gained prominence with the establishment of the popular crowdfunding platform Kickstarter.[102] The rise of websites such as Facebook, Twitter, and LinkedIn—websites generally associated with the emergence of Web 2.0—as well as the popular payment services site PayPal, enabled crowdfunding to gain greater visibility.[103]

II. SME FINANCING AND THE GFC

A. The Financing Problem for SMEs

SMEs comprise the majority of businesses in most European Union countries and are the key private sector employment driver.[104] For example, in the European Union, SMEs represent 99 percent of all European enterprises.[105] They account for 58.6

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[97] DRESNER, *supra* note 92, at 35.

[98] *Id.*

[99] *See* Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 LOY. L.A. ENT. L. REV. 375 (2009).

[100] Paul McFedries, *Crowdfunding*, WORDSPY (2013), http://www.wordspy.com/words/crowdfunding.as [https://perma.cc/8H66-TX7E]; *see also* KEVIN LAWTON & DAN MAROM, THE CROWDFUNDING REVOLUTION: SOCIAL NETWORKING MEETS VENTURE FINANCING 49 (2010).

[101] Daniela Castrataro, *A Social History of Crowdfunding*, SOC. MEDIA WEEK (2011), http://socialmediaweek.org/blog/2011/12/a-social-history-of-crowdfunding/ [https://perma.cc/P5BR-PJXJ].

[102] *Id.*

[103] DRESNER, *supra* note 92, at 11.

[104] EUROSTAT, KEY FIGURES ON EUROPEAN BUSINESS, 10–11 (2011), http://ec.europa.eu/eurostat/documents/3930297/5967534/KS-ET-11-001-EN.PDF [https://perma.cc/HUV4-TJLS]; *see also* EUR. COMM'N, EUROPEAN COMMISSION ACTION PLAN 1 (2011), http://europa.eu/rapid/press-release_MEMO-11-879_fr.htm?locale=en [https://perma.cc/7T5E-JAM5].

[105] EUROSTAT, *supra* note 104, at 11.

percent of the total gross value added ("GVA") produced by private businesses and provide more than two-thirds of all employment opportunities in the private sector.[106]

The continued economic relevance of SMEs is contingent on their ability to obtain finance for sustainable growth. SME access to finance tends to be a common issue confronting both developing and developed countries.[107] For example, 97 percent of all enterprises in New Zealand have fewer than twenty employees and are hence SMEs.[108] The former Ministry of Economic Development in New Zealand notes that "access to financing can be an issue for startup firms and firms that have intellectual property on account of their lack of collateral and likely cash flow."[109] Similarly, a recent World Bank study notes that, while SMEs make up a large part of the emerging private sector in most countries, they are more constrained in their access to capital than large firms.[110] These constraints are more pronounced in developing as opposed to developed countries, with SME loans constituting 13 percent of GDP in developed countries, compared to 3 percent in the developing world.[111]

The GFC downturn resulted in a deterioration of financing conditions.[112] The European Commission in its Consultation Paper on Crowdfunding in the EU observes that "European SMEs

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[106] *Id.*

[107] Thorsten Beck et al., *Is Small Beautiful? Financial Structure, Size and Access to Finance* 2 (World Dev., Working Paper No. 5806, 2011), https://www.researchgate.net/publication/228202340_Is_Small_Beautiful_Financial_Structure_Size_and_Access_to_Finance [https://perma.cc/B2PY-HALS].

[108] *New Zealand Business Demography Statistics: At February 2014,* STATISTICS N.Z. (2014), http://www.stats.govt.nz/browse_for_stats/businesses/business_characteristics/BusinessDemographyStatistics_HOTPFeb14.aspx [https://perma.cc/E44G-9X85].

[109] MINISTRY OF ECO. DEV., *supra* note 37, at 9.

[110] Beck et al., *supra* note 107, at 13–14.

[111] Oya Pinar Ardic et al., *Small and Medium Enterprises: A Cross-Country Analysis with a New Data Set* 5 (World Bank, Working Paper No. 5538, 2011), https://openknowledge.worldbank.org/ [https://perma.cc/CGX8-RBX4].

[112] *See generally* ORG. FOR ECON. CO-OPERATION AND DEV., THE IMPACT OF THE GLOBAL CRISIS ON SME AND ENTREPRENEURSHIP FINANCING AND POLICY RESPONSES 17 (2009), http://www.oecd.org/cfe/smes/43183090.pdf [https://perma.cc/XH46-JYW4] (Ger.). In the German context, *see* Michael Bräuninger & Jörg Hinze, *Konjunkturschlaglicht: Deutschland in der Rezession*, 88(12) WIRTSCHAFTSDIENST 823 (2008) (Ger.) *and* Mechthild Schrooten, *Internationale Finanzkrise—Konsequenzen für das deutsche Finanzsystem*, 88(8) WIRTSCHAFTSDIENST 508 (2008) (Ger.).

largely depend on bank financing, but since the financial crisis banks are much more restrictive in their lending."[113] For example, in the United Kingdom alone, there was an estimated gap between the demand and supply of SME lending of between £26 billion and £59 billion in 2012.[114] Similarly, in the United States, one of the main negative outcomes of the GFC crisis was the loss of bank funding for SMEs.[115] According to the Federal Deposit Insurance Corporation, banks held roughly $590 billion of small-business loans in the third quarter in 2014—still 17 percent below 2008 highs.[116] This phenomenon has far-reaching effects on economic development and job creation because new firms have special importance in generating new jobs. In the United States, emerging companies generate an average of three million jobs in the first year, whereas older companies lose one million jobs annually.[117] The problem is compounded in the United States by a slowdown in the number of startups.[118]

In the Eurozone, there is empirical evidence to show that SMEs place increased importance on non-bank lending and the institutions providing it, with SMEs relying on alternative forms of finance such as leasing contracts.[119] A 2013 report by the European Central Bank suggests that the smaller a firm, the larger the likelihood that its funding application will be declined by a

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113 EUR. COMM'N, CONSULTATION PAPER: CROWDFUNDING IN THE EU—EXPLORING THE ADDED VALUE OF POTENTIAL EU ACTION 6 (2013).

114 GR. BRITAIN DEP'T FOR BUS., INNOVATION AND SKILLS, BREEDON REPORT: BOOSTING FINANCE OPTIONS FOR BUSINESS 16 (2012), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32230/12-668-boosting-finance-options-for-business.pdf [https://perma.cc/3V3Q-5L93].

115 DRESNER, *supra* note 92, at 9.

116 Loten & Simon, *supra* note 1, at B5.

117 *See* TIM KANE, KAUFFMAN FOUND., THE IMPORTANCE OF STARTUPS IN JOB CREATION AND JOB DESTRUCTION 2, 6 (2010), http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2010/07/firm_formation_importance_of_startups.pdf [https://perma.cc/VWK7-ADL8].

118 *See* Robert Litan, *Start-Up Slowdown*, FOREIGN AFFAIRS (2015), https://www.foreignaffairs.com/articles/americas/2014-12-15/start-slowdown [https://perma.cc/LDL9-Q7NE].

119 Helmut Kraemer-Eis & Frank Lang, *The Importance of Leasing for SME Finance* (Eur. Inv. Fund Research & Mkt. Analysis, Working Paper No. 2012/15, 2012), http://www.eif.org/news_centre/research/eif_wp_2012_15_The%20importance%20of%20leasing%20for%20SME%20finance_August_2102.pdf [https://perma.cc/Z8CR-UR44].

bank.[120] The rate for rejection was 17.9 percent for micro enterprises, followed by 13.5 percent for small enterprises, 5.7 percent for medium-sized enterprises, and 3.4 percent for large enterprises.[121] There are also significant variations between member states with respect to SMEs' access to banking finance.[122] Accordingly, it is pertinent to review SME financing and explore alternative sources of financing. While there are many sources of financing, our focus is on SME access to P2PL and ECF.[123]

B. Sources of Finance for SMEs

1. Public Equity

Stock exchanges play a key role in mobilizing equity capital. However, in some jurisdictions, where the legal protections of creditors are strong, a preference has arisen for bank-oriented financing models.[124] The introduction of the Basel Capital Accords—Basel II and Basel III—and the GFC downturn, however, have led to a tightening of bank credit policies.[125] Basel II triggered a fundamental change in banks' attitudes towards SMEs.[126] The recommendations adopted by the Basel Committee require banks to establish rating processes, which are intended to more accurately assess the risks of granting a loan.[127] Quantitative

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[120] *See* EUR. COMM'N, SURVEY ON THE ACCESS TO FINANCE OF ENTERPRISES 4 (2013), http://ec.europa.eu/growth/access-to-finance/data-surveys/index_en.htm [https://perma.cc/6U6G-DT24]; EUR. COMM'N, EVALUATION OF MARKET PRACTICES AND POLICIES ON SME RATING 6 (2014) http://ec.europa.eu/enterprise/policies/finance/index_en.htm [https://perma.cc/6D4B-NPEQ].

[121] EVALUATION OF MARKET PRACTICES AND POLICIES ON SME RATING, *supra* note 120, at 6.

[122] *Id.*

[123] On general sources of finance, see Allen N. Berger & Gregory F. Udell, *A More Complete Conceptual Framework for SME Finance*, 30 J. BANKING & FIN. 2945, 2948–52 (2006).

[124] RAFAEL LA PORTA ET AL., WORLD BANK, INVESTOR PROTECTION: ORIGINS, CONSEQUENCES, REFORM 17–18 (1999), http://www1.worldbank.org/finance/assets/images/Fs01_web1.pdf [https://perma.cc/N43T-P5EW].

[125] Dorothea Schäfer, *The New Basel Capital Accord and its Impact on Small and Medium-sized Companies*, 40(6) ECON. BULL. 209, 209 (2003).

[126] *Id.*

[127] *See* Alexandra Schindele & Andrea Szczesny, *Debt Costs of German SMEs in the Dilemma of Basel II and the Financial Crisis* (Univ. of Wuerzburg Working Paper, 2013), http://www.researchgate.net/publication/281088344 _The _impact_of_Basel_II_on_the_debt_costs_of_German_SMEs [https://perma.cc/X9

and qualitative aspects are taken into account.[128] One consequence of Basel II has been to reduce the ability of banks to grant loans during economic downturns.[129] Banks are required to apply their ratings, which increases their risk awareness.[130] Banks now demand more transparency when lending and generally are only willing to lend to well-established companies.[131]

As a result, SMEs face hurdles in satisfying the risk requirements of banks, making it critical for them to consider alternative sources of finance, such as shadow banking[132] and public equity.[133] But while an IPO allows companies to raise new capital, it also triggers a range of disclosure obligations. New entrants encounter a multitude of costs through both the IPO process and the continuing obligations and expenses associated with going public.[134] The fixed nature of some compliance costs creates a disproportionate burden on SMEs, reducing the attractiveness of an IPO.[135] In fact, IPOs for startups are relatively rare.[136]

NH-LTVB]; *see also* Monica Bartolini et al., *International Financial Reporting Standards and SMEs: The Effects on Firm Rating According to Basel II*, 10(1) INT'L J. ACCT., AUDITING & PERFORMANCE EVALUATION 43, 48 (2014).

[128] Bartolini et al., *supra* note 127, at 55.

[129] RYM AYADI & ANDREA RESTI, THE NEW BASEL CAPITAL ACCORD AND THE FUTURE OF THE EUROPEAN FINANCIAL SYSTEM, CTR. FOR EUR. POL'Y STUDIES 44 (2004).

[130] HENDRIK HAKANES & ISABEL SCHNABEL, MAX PLANCK INST. FOR RESEARCH ON COLLECTIVE GOODS, BANK SIZE AND RISK TAKING UNDER BASEL II 21–23 (2011), http://www.coll.mpg.de/pdf_dat/2005_06online.pdf [https://perma.cc/94UU-4XL4].

[131] *Crowdfunding: Many Scrappy Returns*, ECONOMIST, Nov. 19, 2011, at 36; *see also* AYADI & RESTI, *supra* note 129, at 45; JEFF MADURA, FINANCIAL INSTITUTIONS AND MARKETS 507 (Michael R. Reynolds, 8th ed. 2008); WORLD BANK, GLOBAL FINANCIAL DEVELOPMENT REPORT 2014: FINANCIAL INCLUSION 129 (2014).

[132] *See Shadow and Substance,* ECONOMIST, May 10, 2014, at 1–16.

[133] *MittelstandsMonitor 2009: Deutsche Wirtschaft in der Rezession—Talfahrt auch im Mittelstand* 53, KFW BANKENGRUPPE (2009) (Ger.), ftp://ftp.zew.de/pub/zew-docs/mimo/MittelstandsMonitor_2009.pdf.

[134] Xiaohui Gao et al., *Where Have All the IPOs Gone?*, 48(6) J. FIN. & QUANTITATIVE ANALYSIS 1663, 1675, 1687 (2013).

[135] Michael Dambra et al., *The JOBS Act and IPO Volume: Evidence that Disclosure Affects the IPO Decision*, 116 J. FIN. ECON. 121, 124–25. *See* HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 293 (Björn Espen Eckbo ed., 1st ed. 2007).

[136] *Spurring Job Growth Through Capital Formation While Protecting: Hearing Before Senate Committee on Banking, Housing and Urban Affairs*, 112th Cong.

The past decade has witnessed a wave of regulatory changes that have increased the costs associated with going public. The proliferation of fraud cases in the wake of the corporate governance crisis at the end of 1990s created a shift towards greater corporate transparency and accountability.[137] In particular, the post-Enron American crisis provided an impetus for increased regulation of IPO markets.[138] As a result, SMEs faced higher entry barriers, reducing the benefits of an IPO.[139]

In response to increased regulation, a number of securities exchanges have reorganized their market segments with the aim of reducing the costs of entry and promoting greater access to public equity capital.[140] A feature of the new frameworks is that initial listing and subsequent disclosure requirements progress from the lowest to the highest market segment.[141] The emergence of lower-tier market segments, such as the Alternative Investment Market (AIM) at the London Stock Exchange (LSE), Alternext on the NYSE Euronext, access on the Munich Stock Exchange, the Alternative Market (NZAX) and its successor (NXT) on the New Zealand Exchange, or the Growth Enterprise Market (GEM) on the Hong Kong Stock Exchange, "represent a major experiment in market design."[142] However, these market segments are

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1–3 (2011) (statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School).

[137] CORPORATE, PUBLIC AND GLOBAL GOVERNANCE: THE G8 CONTRIBUTION 68 (Michele Fratianni et al. eds., 2007). *See* OLIVER MARNET, BEHAVIOUR AND RATIONALITY IN CORPORATE GOVERNANCE 175 (2008); Gregory A. Mark, *Realms of Choice: Finance Capitalism and Corporate Governance*, 95 COLUM. L. REV. 969, 979 (1995); Edward B. Rock, *America's Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L. QUARTERLY 367, 375–77 (1996); Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2029 (1993); Margaret O'Sullivan, *Corporate Governance and Globalization*, 570 ANNALS AM. ACAD. POL. & SOC. SCI. 153, 154 (2000).

[138] Sharon Hannes, *Managers vs. Regulators: Post-Enron Regulation and the Great Depression*, 3 HARV. BUS. L. REV. 279, 318–19 (2013).

[139] *Id.*

[140] Valerie Revest & Alessandro Sapio, *Does the Alternative Investment Market Nurture Firm Growth? A Comparison between Listed and Private Companies*, 4 INDUS. & CORP. CHANGE 953, 956 (2013).

[141] *Id.* at 955; *see* LONDON STOCK EXCH. PLC, CORPORATE GOVERNANCE FOR MAIN MARKET AND AIM COMPANIES 94 (Nigel Page ed., 2012).

[142] Laura Bottazzi & Marco Da Rin, *Europe's 'New' Stock Markets* (EFA 2003 Annual Conference Paper, Innocenzo Gasparini Inst. for Econ. Research, Working Paper No. 218, 2002), http://papers.ssrn.com/sol3/papers.cfm?abstract

rarely accessed by SMEs. As a result, small entrepreneurs continue to face financing constraints, despite these innovations.

Against this background, crowdfunding offers a viable alternative for SME fundraising. Moreover, crowdfunding can precede other forms of financing such as bank financing, angel and venture capital financing, and IPOs, thereby helping startups move up the "funding escalator."[143] In particular, crowdfunding has the potential to function well in the seed phase of finance, when a relatively small amount of money might be sufficient to get a project off the ground. Seed financing is particularly important in the design and development phase of the venture financing lifecycle while the business is still taking shape.[144] This stage precedes the startup phase, where firms are beginning to realize an idea or product and enter into the product development stage.[145] During this stage of financing, capital is needed to develop an idea or product and the firm is unlikely to have made any commercial profit yet.[146] Later, once the firm has developed its products, the firm is likely to enter into an expansion-development stage requiring additional capital to further finance increased production, make new acquisitions, and increase its working capital.[147]

2. Private Equity

Prior to the IPO stage, SMEs rely on several heterogeneous providers of finance.[148] At law, these providers access carveouts

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_id=319260 [https://perma.cc/CK5H-73BD]. *See* Stephanie Rousseau, *London Calling? The Experience of the Alternative Investment Market and the Competitiveness of Canadian Stock Exchanges*, 23 REV. BANKING & FIN. L. 51, 53 (2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=319260 [https://perma.cc/T8YW-J46C].

[143] EUR. COMM'N, COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS: UNLEASHING THE POTENTIAL OF CROWDFUNDING IN THE EUROPEAN UNION 2 (2015), http://eur-lex.europa.eu/ [https://perma.cc/BS2F-VYEP].

[144] Mateo Rossi, *The New Ways to Raise Capital: An Explanatory Study of Crowdfunding*, 5(2) INT'L J. FIN. RES. 8, 9 (2014), http://www.sciedu.ca/journal/index.php/ijfr/article/viewFile/4536/2618 [https://perma.cc/J3R7-P35J].

[145] *Id.*

[146] *Id.*

[147] *Id.*

[148] OECD, GLOBALISATION AND SMALL AND MEDIUM ENTERPRISES (SMES) 117 (1997).

or exclusions to prospectus requirements, such as those applying to sophisticated or accredited investors.[149] The private equity market is comprised of informal networks and institutions, such as high net worth individuals known as "angels" and specialized financial intermediaries—venture capitalists—who provide direct capital to promising firms.[150] Private equity provides capital to firms that have difficulties raising sufficient debt finance or obtaining public equity capital.[151] Accordingly, the private equity market has the potential to fill the gap between self-financing and conventional capital market activity by offering entrepreneurs an attractive midpoint.[152]

Private equity offers a number of benefits.[153] First, in comparison to debt, private equity does not result in fixed repayment obligations.[154] Another advantage is availability at an earlier stage than debt financing.[155] This is useful for firms that lack assets capable of being used as collateral.[156] Second, the private equity infusion of funds enhances the credibility of the firm, increasing its net worth and overall financial strength.[157] This, in turn, improves the access of the firm to other forms of financing, such as debt financing.[158]

The provision of equity finance may increase a firm's chances of survival. Private investors can lend significant managerial support and advice.[159] The provision of financing by a particular investor may lead to a preferred relationship with other institutions.[160] Although the level of involvement in a venture differs

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[149] 17 § C.F.R. 230.506 (2015).

[150] DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING: AN INTERNATIONAL PERSPECTIVE 3–14 (2014).

[151] *Id.* at 10.

[152] Roger Leeds & Julie Sunderland, *Private Equity Investing in Emerging Markets*, 15(4) J. APPLIED CORP. FIN. 111, 111–12 (2003).

[153] SOPHIE MANIGART & MIGUEL MEULEMAN, FINANCING ENTREPRENEURIAL COMPANIES: HOW TO RAISE PRIVATE EQUITY AS A HIGH GROWTH COMPANY 71 (2004).

[154] GREG N. GREGORIOU ET AL., VENTURE CAPITAL IN EUROPE 314 (2007).

[155] *Id.*

[156] *Id.*

[157] *Id.* at 316.

[158] *Id.*

[159] *See* OXFORD HANDBOOK OF ENTREPRENEURSHIP 356, 413 (Mark Casson et al. eds., 2006).

[160] *See* INVESTOR ENGAGEMENT 85 (Roderick Martin et al. eds., 2007).

between private investors, monitoring can provide the entrepreneur with an incentive to maximize the value of the venture.[161] However, only a minority of SMEs are able to obtain private equity.[162] Private equity investors are usually attracted to rapidly growing SMEs, such as innovative technology firms with a high potential for profits and expansion.[163]

3. Venture Capital

This Section provides an insight into the financial behavior of venture capital firms and investigates a number of complex factors, including the relatively slow development of the venture capital industry, the selection criteria employed by venture capital firms, and the importance of different exit channels. Venture capital is sometimes seen as a solution to the financing problems of SMEs. However, as the following discussion demonstrates, venture capital is only available for a minority of SMEs, particularly in the developing world.[164] Further, entrepreneur resistance can prove to be an important barrier when entrepreneurs are unwilling to confer control rights to financiers.[165]

The economic functions of venture capitalist companies include risk pooling, risk diversification, specialization, and syndication.[166] The venture capitalist carries out two important functions: capital acquisition and capital provision.[167] Prior to investing in businesses, the venture capitalist has to accumulate enough capital

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[161] *Id.* at 113–16.

[162] *See* DEP'T FOR BUS. INNOVATION & SKILLS, FINANCING A PRIVATE SECTOR RECOVERY 14 (2010).

[163] *Id. See generally* PETER THIEL, ZERO TO ONE (2014).

[164] *See* SHANTI DIVAKARAN, PATRICK J. MCGINNIS & MASOOD SHARIFF, WORLD BANK, PRIVATE EQUITY AND VENTURE CAPITAL IN SMES IN DEVELOPING COUNTRIES 4–6 (Apr. 2014), http://ssrn.com/abstract=2419273 [https://perma.cc/5BGD-XFFA].

[165] *See* Nina Rosenbusch et al., *Does Acquiring Venture Capital Pay Off for the Funded Firms? A Meta-Analysis of the Relationship Between Venture Capital Investment and Funded Firm Financial Performance*, 28(3) J. BUS. VENTURING 335, 339–40, 348 (2013).

[166] *See* Xuan Tian, *The Role of Venture Capital Syndication in Value Creation for Entrepreneurial Firms*, 16(1) REV. FIN. 245, 246–47 (2012).

[167] PAUL GOMPERS & JOSHUA LERNER, THE VENTURE CAPITAL CYCLE 3 (2nd ed. 2004).

and secure commitments from investors.[168] Traditionally, the participants in venture capital funds are institutional investors and wealthy individuals.[169] Examples of corporate venture programs are Google Ventures, Dell Ventures, and Oracle Ventures.[170] Venture capital firms specialize in investing in particular types of firms, considering the industry, technologies, geographic region, and stage of development of the firm. There are differences between individual and corporate venture capitalists.[171]

In the pre-investment period, the venture capitalist has the necessary knowledge to screen firms, evaluate risks and returns, conduct due diligence, and contract with young growth firms.[172] Venture capitalists act as institutionalized meeting points for entrepreneurs and potential investors;[173] they have the skills to identify profitable investment opportunities. In addition, venture capitalists bear search and information costs, which results in a reduction in transaction costs incurred by the original suppliers of finance.[174] For example, the use of standardized contracts

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[168] *Id.*

[169] *See* Bob Zider, *How Venture Capital Works*, 76(6) HARV. BUS. REV. 131 (1998), https://hbr.org/1998/11/how-venture-capital-works [https://perma.cc/W5LE-X96B]; Rami Rahal, *Will Corporate Venture Capital Disrupt the Traditional Investment Ecosystem?* (Dec. 16, 2014), http://www.entrepreneur.com/article/240904 [https://perma.cc/VP2N-FM5L]; TEREZA TYKVOVA & UWE WALZ, CTR. FOR EUR. ECON. RESEARCH, ARE IPOS OF DIFFERENT VCS DIFFERENT? 7–10 (Apr. 2004), http://ftp.zew.de/pub/zew-docs/dp/dp0432.pdf [https://perma.cc/48T3-KTXP].

[170] *Id.* at 1214. *See* Sandip Basu, Corey Phelps & Suresh Kotha, *Towards Understanding Who Makes Corporate Venture Capital Investments and Why*, 26(2) J. BUS. VENTURING 153 (2011); *see also* David Benson & Rosemarie H. Ziedonis, *Corporate Venture Capital as a Window on New Technologies*, 20(2) ORG. SCI. 329 (2009).

[171] *See* Luc Armel G. Da Gbadji, Benoit Gailly & Armin Schwienbacher, *International Analysis of Venture Capital Programs of Large Corporations and Financial*, 39(5) ENTREPRENEURSHIP THEORY & PRACTICE 1213 (2014), for a discussion on corporate venture capitalists (detailing the development of the corporate venture capital business model).

[172] *E.g.* Annalise Croce, José Martí & Samuele Murtinu, *The Impact of Venture Capital on the Productivity Growth of European Entrepreneurial Firms: 'Screening' or 'Value Added' Effect?*, 28(4) J. BUS. VENTURING 489, 490–91 (2013).

[173] *See* Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47(3) J. FIN. ECON. 243, 245, 248–51 (1998).

[174] GOMPERS & LERNER, *supra* note 167, at 157, 160, 241.

reduces negotiation costs.[175] Consequently, venture capitalists have a level of expertise that justifies their involvement as financial intermediaries. In the post-investment period, the active participation of venture capitalists in the monitoring of the firm leads to mitigation of agency costs.[176] The venture capitalist may be in a better position than the original suppliers of finance to deal with market imperfections and reduce agency costs resulting from the opportunistic behavior of entrepreneurial owners.[177]

Agency theory has been applied to venture capital investments, even though such investments occur in private companies.[178] It is worth noting that the venture capital firm itself acts as an agent on behalf of the original providers of capital.[179] In fact, the venture capital firm fulfills a dual role: it acts as both a principal and an agent.[180] The venture capitalist assumes the role of the original supplier of finance in providing finance and monitoring the firm.[181] The objective of the original providers of capital is to maximize the value of their investment. High returns, stability through diversification, and liquidity are key concerns for the investors.

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[175] *See* KEVIN MCNALLY, CORPORATE VENTURE CAPITAL: BRIDGING THE EQUITY GAP IN THE SMALL BUSINESS SECTOR 200 (David Story ed. 1997).

[176] *See* Violetta Gerasymenko & Jonathan D. Arthurs, *New Insights into Venture Capitalists' Activity: IPO and Time-to-Exit Forecast as Antecedents of their Post-Investment Involvement*, 29(3) J. BUS. VENTURING 405, 408, 419 (2014).

[177] *See* GOMPERS & LERNER, *supra* note 167, at 171; *see also* FREDERIC S. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS: INTERNATIONAL EDITION 194 (8th ed. 2008). Cash-efficient startups may need less monitoring by venture capitalists. Darian M. Ibrahim, *Should Angel-Backed Startups Reject Venture Capital?*, 2 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 251, 252, 261–62 (2013).

[178] John Callahan & Steven Muegge, *Venture Capital's Role in Innovation*, *in* INT'L HANDBOOK ON INNOVATION 641, 654 (Larisa V. Shavinina ed. 2003); *see* Michael Klausner & Kate Litvak, *What Economists Have Taught us About Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP 54, 56–57 (Michael J. Whincop ed., 2001).

[179] *See* PIERRE-YVES MATHONET & THOMAS MEYER, J-CURVE EXPOSURE: MANAGING A PORTFOLIO OF VENTURE CAPITAL AND PRIVATE EQUITY FUNDS 254–56 (2007).

[180] *Id.*

[181] *See* GOMPERS & LERNER, *supra* note 167, at 3.

There are inter-country differences concerning the size and effectiveness of the venture capital market.[182] The venture capital market is a vibrant source of direct capital for SMEs in the United States, but this cannot be said of all countries.[183] The levels of venture capital financing are higher in developed countries due to the presence of established public capital markets and institutional investors.[184] Looking at the differences between the European Union and the United States, it is clear that the U.S. venture capital industry is more developed. For instance, the average European venture capital fund is small, containing on average approximately €60 million vis-à-vis €130 million in the United States, which is smaller than the optimal size necessary for making a substantial contribution to individual companies.[185] Moreover, U.S. venture capital funds invest around €4 million on average in a company compared to €2 million invested by their European counterparts.[186] Early-stage capital investments in the United States are, on average, €2.2 million per company, while such investments amount to an average of €400,000 per company in the European setting.[187]

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[182] *See* Garry D. Bruton, Vance H. Fried & Sophie Manigart, *Institutional Influences on the Worldwide Expansion of Venture Capital*, 29(6) ENTREPRENEURSHIP THEORY & PRACTICE 737 (2005); *see also* Yong Li & Shaker A. Zahra, *Formal Institutions, Culture, and Venture Capital Activity: A Cross-Country Analysis*, 27(1) J. BUS. VENTURING 95 (2012).

[183] *See* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1068–69 (2003); Paul A. Gompers & Joshua Lerner, *The Venture Capital Revolution*, 15(2) J. ECON. PERSPECTIVES 145, 145, 163 (2001); Bob Zider, *How Venture Capital Works*, 76(6) HARV. BUS. REV. 131, 132 (1998).

[184] *See generally* Pekka Stenholm, Zoltan J. Acs & Robert Wuebker, *Exploring Country Level Institutional Arrangements on the Rate and Type of Entrepreneurial Activity*, 28(1) J. BUS. VENTURING 176 (2013).

[185] *See* Press Release, European Commission, New EU fundraising rules: boosting venture capital for SMEs and easing access to credit (Dec. 7, 2011), http://europa.eu/rapid/press-release_IP-11-1513_en.htm?locale=en#footnote-1 [https://perma.cc/ULB8-RL8A]; *see also* JOSH LERNER ET AL., NESTA, ATLANTIC DRIFT: VENTURE CAPITAL PERFORMANCE IN THE UK AND THE US 14 (June 2011), http://www.nesta.org.uk/sites/default/files/atlantic_drift.pdf [https://perma.cc/6TCN-8A4S].

[186] *Id.*

[187] Kristiina Raade & Catarina Dantas Machado, *Recent Developments in the European Private Equity Markets,* EUR. COMM'N 26 (Apr. 2008), http://ec

Generally, only a fraction of firms that submit business plans to venture capital organizations are successful.[188] Without a good risk-return ratio, a company is unlikely to be deemed an attractive investment. Venture capitalists often prefer to make a small number of large investments instead of spreading their investments over a large number of smaller businesses.[189] It is costly for the venture capital fund manager to monitor a large number of firms in the portfolio. Further, private investors in venture capitalist funds may favor later-stage deals.[190] Early-stage investments are considered to be higher risk.[191] Such investments require a long-term strategy.[192] The selection of profitable later-stage investments enables the venture capitalist to build a reputation without having to wait for the investment to materialize.

After closing the fund, the venture capitalist collects information about potential investments and promotes the fund.[193] The venture capitalist then screens companies and conducts due diligence to determine the strengths, weaknesses, profitability, and risks associated with particular ventures.[194] Venture capital firms use a number of selection criteria to decide on the suitability of potential applicant firms.[195] The selection process usually

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.europa.eu/economy_finance/publications/publication12419_en.pdf [https://perma.cc/Y7GH-X7XZ].

188 *See generally* Paul A. Gompers & Joshua Lerner, *The Money of Invention: How Venture Capital Creates New Wealth*, 2(43) UBIQUITY 1 (2002); Armin Schwienbacher, *Financing the Business*, *in* THE ROUTLEDGE COMPANION TO ENTREPRENEURSHIP 193, 195 (Ted Baker & Friederike Welter eds., 2015).

189 MARK VAN OSNABRUGGE & ROBERT J. ROBINSON, ANGEL INVESTING: MATCHING START-UP FUNDS WITH START-UP COMPANIES 25 (2000).

190 GREG N. GREGORIU ET AL., VENTURE CAPITAL IN EUROPE 29 (1st ed. 2007); *see also* Douglas Cumming, *Public Economics Gone Wild: Lessons from Venture Capital*, 36 INT'L REV. FIN. ANALYSIS 259 (2014).

191 *See* GOMPERS & LERNER, *supra* note 167, at 145.

192 *Id.*

193 *Id.* at 397–98.

194 *See* Suzanne de Treville, Jeffrey S. Petty & Stefan Wager, *Economies of Extremes: Lessons from Venture Capital Decision Making*, 32 J. OPERATIONS MGMT. 387, 390 (2014).

195 *Id.* at 389. *See* Thomas Hellmann, *Entrepreneurship and the Process of Obtaining Resources*, 16(1) J. ECON. & MGMT. STRATEGY 81, 81–82 (2007); *see also* Dan K. Hsu et al., *What Matters, Matters Differently: A Cojoint Analysis of the Decision Policies of Angel and Venture Capital Investors*, 16(1) VENTURE CAPITAL: INT'L ENTREPRENEURIAL FIN. 1 (2014).

consists of an assessment of the abilities of the management team.[196] The talents, experience, and skills of the management are considered a key determining factor in selection.[197] Second, the venture capital firm will consider the potential market size of the product or service offered by the firm, its originality, and its marketability.[198] The selected firm needs to fit into the general investment strategy of the venture capitalist. Another precondition often imposed is that the applicant has obtained one or several rounds of angel financing.[199] The objective is to select an enterprise with a good risk-return and provide it with capital and management support before selling it at a higher price.[200]

Once suitable investment opportunities are identified, the venture capitalist seeks to reach an agreement with the investee business about the deal.[201] If both parties agree, the venture capital firm will begin disbursing funds to the firm.[202] In the post-investment period, the venture capitalist monitors the firm to ensure the proper use of funds.[203] At the end of the fund life cycle, venture capitalists seek to exit by selling their stake to third parties via a trade sale, an IPO, or a secondary transaction.[204]

4. Business Angels

Venture capitalists and business angels play similar roles and may sometimes co-invest.[205] In essence, angels are private informal

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[196] *See* Hsu et al., *supra* note 195, at 2–3.

[197] *Id.*

[198] *Id.* at 8, 14, 20.

[199] *See* GOMPERS & LERNER, *supra* note 167, at 183.

[200] *See* Thomas F. Hellmann & Veikko Thiele, *Friends or Foes? The Interrelationship between Angel and Venture Capital Markets,* NAT'L BUREAU OF ECON. RESEARCH 2 (May 2014), http://www.nber.org/papers/w20147.pdf [https://perma.cc/AB4F-S4S8].

[201] Tyzoon T. Tyebjee & Albert V. Bruno, *A Model of Venture Capitalist Investment Activity*, 30(9) MGMT. SCI. 1051, 1053 (1984).

[202] *See* Hsu et al., *supra* note 195.

[203] *See* Umit Ozmel, David T. Robinson & Toby E. Stuart, *Strategic Alliances, Venture Capital, and Exit Decisions in Early Stage High-Tech Firms*, 107(3) J. FIN. ECON. 655, 658 (2013).

[204] *See* Douglas Cumming, Grant Fleming & Armin Schwienbacher, *Legality and Venture Capital Exits*, 12(2) J. CORP. FIN. 214, 216 (2006); GOMPERS & LERNER, *supra* note 167, at 397.

[205] ANNAREETTA LUMME ET AL., INFORMAL VENTURE CAPITAL: INVESTORS, INVESTMENTS AND POLICY ISSUES IN FINLAND 54 (1998); *see also* Christophe

venture capitalists. The angel finance market is a non-intermediated market which consists of a diverse pool of investors.[206] Business angels are private individuals who use their own money to invest in an unlisted company in which they have no family connections.[207] Obtaining information about transactions between entrepreneurs and business angels is often difficult because such transactions occur in an informal, unregulated market. The marketplace for angel finance is characterized by informational opacity[208] and operates in obscurity.[209] Finding business angels can be difficult, as they keep a low profile and prefer to remain anonymous; however, business angel networks have emerged to allow entrepreneurs to connect with angels.[210] Such networks may be compared to crowdfunding portals that match entrepreneurs with crowd investors.

In the literature, distinctions are made between types of angels, including business and knowledge angels.[211] Our focus is only on business angels. The provision of finance to unlisted young and high-growth firms is one investment option.[212] Business angels can be selective and may choose to invest in young growth firms for diversification purposes.[213] Given this, SMEs wishing to obtain angel financing need to demonstrate the quality of their venture.

Bonnet & Peter Wirtz, *Raising Capital for Rapid Growth in Young Technology Ventures: When Business Angels and Venture Capitalists Coinvest*, 14(2–3) VENTURE CAPITAL: INT'L J. ENTREPRENEURIAL FIN. 91, 92 (2012).

[206] *See* Allen N. Berger & Gregory F. Udell, *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, 22(6–8) J. BANKING & FIN. 613, 630 (1998).

[207] Colin M. Mason & Richard T. Harrison, *Business Angel Networks and the Development of the Informal Venture Capital Market in the U.K.*, 9(2) SMALL BUS. ECON. 111, 112 (1997).

[208] Stuart Paul & Geoff Whittam, *Manna from Heaven? The Entrepreneurs' Experience of Angel Funding*, *in* ADVANCES IN INTERDISCIPLINARY EUROPEAN ENTREPRENEURSHIP RESEARCH 321, 321 (Michael Dowling et al., 2005).

[209] Stephen Prowse, *Angel Investors and the Market for Angel Investments*, 22(6–8) J. BANKING & FIN. 785, 785 (1998).

[210] Mason & Harrison, *supra* note 207, at 111.

[211] *See* Emmanuel Muller et al., *Knowledge Angels: fostering innovation in knowledge-intensive business services through creative individuals—Observations from Canada, China, France, Germany and Spain* 25 (2013), http://www.jaheraud.eu/docrech/cccc/Knowledge_Angels_EM_AZ_JAH_2013.pdf [https://perma.cc/W9G3-WZT3].

[212] *Id.*

[213] *See, e.g.*, Andrew L. Maxwell et al., *Business angel early stage decision making*, 26(2) J. BUS. VENTURING 212 (2011).

Business angels often view themselves as being constrained by the lack of promising entrepreneurs and investment projects.[214] Consequently, they do not need to allocate a significant percentage of their capital to their private equity portfolio.[215]

Business angels frequently base their investment decisions on idiosyncratic considerations and may invest at an earlier stage than venture capitalists.[216] Investing close to home may be important. The investor's stage of life may also have an impact on the decision and their willingness to provide finance to early-stage or later-stage firms. Investors have different degrees of experience in the investment cycle and are likely to select a stage that allows them to apply their strengths.[217] Higher-risk investments may require a longer-term horizon for realizing returns.[218] While certain investors will accept longer, others will not want to wait several years for gains.[219]

The individual considerations of business angels may not match the needs of the venture or the objectives of the entrepreneur. Business angels may reject investment opportunities because they are unfamiliar with the underlying technology. Alternatively, if they have reason to believe the entrepreneur has overestimated the value of the venture and its growth prospects, they may refuse to provide financing. Business angels, however, may be motivated by noneconomic considerations when providing funds to unquoted firms.[220] They may be willing to make a tradeoff between financial and nonfinancial returns.[221] Examples of relevant noneconomic motivations include the excitement of being involved in the development of a new business, job creation, assisting minority entrepreneurs, or funding particular high-technology projects.[222]

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[214] *See, e.g.*, Colin M. Mason & Richard T. Harrison, *Why 'Business Angels' Say No: A Case Study of Opportunities Rejected by an Informal Investor Syndicate*, 14(2) INT. SMALL BUS. J. 35, 37 (1996).

[215] *Id.* at 36.

[216] *See, e.g.*, *id.* at 36; *see also* Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1420 (2008).

[217] *See, e.g.*, Mason & Harrison, *supra* note 214, at 36.

[218] *See* Ibrahim, *supra* 216, at 1410.

[219] *See, e.g.*, *id.* at 1408.

[220] *See* Colin M. Mason & Richard T. Harrison, *Is it worth it? The rates of return from informal venture capital investments*, 17(3) J. BUS. VENTURING 211, 220 (2002).

[221] *Id.*

[222] *See, e.g.*, *id.*; *see also* Mason & Harrison, *supra* note 214, at 36.

An advantage of angel financing is that it can fill the small equity gap. The absence of interest costs and fixed repayment obligations is attractive for young startup firms. Obtaining angel financing is important for many firms, as it can lead to second round venture capital financing.[223] However, despite the value-adding advantages for SMEs, the angel finance market is not efficient. This is due to its fragmented nature, its reliance on ineffective communication channels, and the anonymity of angels.[224]

In the previous Section, we compared several financing options, including internal finance, debt capital, and equity finance.[225] The analysis revealed that different groups of financiers are likely to have heterogeneous incentive structures.[226] The extent to which financiers engage in monitoring when providing finance varies between different groups of financiers.[227] For example, venture capital firms prefer to be involved in management.[228] Although bank financing has historically been predominant, recent trends cast doubt on its continued availability.[229] Recent economic downturns, the consolidation of the banking industry, and the erosion of relationship banking limit the pool of credit.[230] In light of the limited availability of debt finance, entrepreneurs need to look toward expanding their equity base through alternatives. It is in this climate of limited access to capital that crowdfunding and P2PL create new means of fund raising for SMEs. However, there are crucial differences between venture capitalists, business angels, institutional investors, and crowd investors.[231] These differences are explored in the section below.

5. *Differences Between Venture Capitalists, Angels, and Crowd Investors*

In this Section, we draw attention to the differences between public fundraising via ECF and P2PL platforms and private equity channels such as venture capital and angel financing.

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[223] *See, e.g.*, Ibrahim, *supra* note 216, at 1418.
[224] *See, e.g.*, Mason & Harrison, *supra* note 220, at 217.
[225] *See supra* Part II.B.
[226] *See id.*
[227] *See* Wilson & Testoni, *supra* note 23, at 4.
[228] *See id.* at 6.
[229] *See, e.g.*, *id.* at 4.
[230] *See, e.g.*, *id.*
[231] *See infra* Part II.B.5.

Crowdfunding primarily relies on standardized contracts provided by the crowdfunding intermediaries, whereas private contracting tends to be the norm in angel investing and venture capital investing.[232] Private contracting allows venture capitalists and angel investors to enter into tailor-made contracts with entrepreneurs that can include various clauses, such as anti-dilution provisions, convertible preference shares, monitoring rights, and board representation to ensure control.[233] Moreover, business angels refrain from buying common shares without voting rights, which tends to be common in crowdfunding.[234] Thus, some fundamental protections available to business angels and venture capitalists ex ante through tailor-made contracts may be missing in the typical crowdfunding scenario.[235] Instead, crowdfunding platforms often offer standardized financial contracts to the issuer.[236] These boilerplate contracts contain limited covenants to protect crowd investors, but not to the same level of ex ante protections that entrepreneurs would commit to with either business angels or venture capitalists.[237]

Angel investors and venture capitalists function as sophisticated private parties who can utilize shareholder agreements and other governance structures that are generally unavailable to the crowd, and thus are more able to effectively constrain self-dealing and other entrepreneurial actions designed to maximize the entrepreneurs' private benefits of control.[238] This, in turn, can result in efficiency gains and a reduction of agency costs as firms—which would otherwise be unregulated—commit to greater monitoring and better governance rules ex ante. In contrast, crowd investors do not participate on the boards of crowdfunded firms,

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[232] Lars Hornuf & Armin Schwienbacher, *Crowdinvesting—Angel Investing for the Masses?*, 1, 6, 8 (3 Handbook of Res. on Venture Capital, Working Paper, 2014), http://ssrn.com/abstract=2401515 [https://perma.cc/4SL5-QG8K].

[233] *Id.* at 8.

[234] *Id.* at 9.

[235] *See, e.g.*, *id.* at 9; *see also* Zachary Griffin, Note, *Crowdfunding: Fleecing the American Masses*, 4 J.L. Tech. & Internet 375, 394 (2013).

[236] See Hornuf & Schwienbacher, *supra* note 232, at 9.

[237] *See* Lars Hornuf & Armin Schwienbacher, Should Securities Regulation Promote Crowdinvesting? 1, 15, 32 (2015) (unpublished manuscript) http://ssrn.com/abstract=2412124 [https://perma.cc/JA3N-8ESS].

[238] Lucian A. Bebchuk, *A Rent Protection Theory of Corporate Ownership and Control* (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), http://www.nber.org/papers/w7203 [https://perma.cc/AM39-DKSM].

and owing to small equity stakes, they may lack the necessary incentives to participate in the monitoring of the internal governance of the investee firms.[239] Moreover, unlike business angels or venture capitalists, crowd investors are not experts in developing and valuing firms.[240] They do not have the same level of expertise and knowledge about firms, and their individual equity investments are generally much smaller than those of angel investors or venture capitalists.[241] This led Hornuf and Schwienbacher to conclude that crowd investors are likely to offer less value-add than business angels or venture capitalists.[242]

Nevertheless, where crowd investors participate in ECF, there is evidence to suggest that they can be efficient in channeling funds to appropriate fund seekers and participating in product development, thereby creating value for the firm.[243] In fact, crowd investors often become the future users of a product once it has been realized and have an incentive to disseminate information about the product.[244] They may act as both patrons of the project and customers at the same time.[245] Accordingly, entrepreneurs can benefit from crowdfunding in a number of ways: they not only receive funds for seed financing or early startup financing, but they also benefit from word of mouth by their investors and potential customers through social media.[246] Furthermore, some firms, especially smaller firms, may not find it economically worthwhile to seek venture capital or angel financing due to the costs associated with using this form of capital and the ex ante commitments required of them by venture capitalists or angel investors.[247]

The advantages of using crowdfunding extend beyond providing access to financing to market validation of the firms' products

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[239] Wilson & Testoni, *supra* note 23, at 8.

[240] *See id.* at 6.

[241] *See, e.g.*, *id.* at 2.

[242] Hornuf & Schwienbacher, *supra* note 65, at 25.

[243] F. Kleeman et al., *Un(der)paid Innovators: The Commercial Utilization of Consumer Work through Crowdsourcing*, 4(1) SCI., TECH., AND INNOVATION STUD. 5, 18–19 (2008).

[244] *See, e.g.*, Rossi, *supra* note 144, at 12.

[245] *See, e.g.*, *id.*

[246] Rossi, *supra* note 144, at 15; *see also* P. Belleflamme & T. Lambert, *Crowdfunding: Some Empirical Findings and Microeconomic Underpinnings* (Lourvain Sch. of Mgmt. Research Inst., Working Paper No. 2014/04, 2014), http://ssrn.com/abstract=2437786 [https://perma.cc/7NGK-FJD6].

[247] *See* Rossi, *supra* note 144, at 10.

or services, brainstorming, market testing in the form of comments, feedback and ideas from the crowd, and developing a potential pool of loyal clients early in the startup process.[248] Being able to pre-sell products or services assists the firm in evaluating users' reactions and allows for further fine-tuning or customizing of its products or ideas. The firm can involve the investor and consumer community in problem solving and ensure that it obtains ample feedback before sinking its resources into production. Moreover, market testing occurs at little or no cost to the entrepreneur.

In addition, as shown in the previous section, venture capitalists may focus on certain investments, such as high-risk, high-return investments in technology-based companies only.[249] By comparison, crowd investors may have a much broader investment spectrum.[250]

In the long run, crowdfunding platforms can help entrepreneurs benefit from the so-called "big data" paradigm.[251] By analyzing data trails left online by investors and entrepreneurs using ECF and P2PL, crowdfunding platforms may be able to better match investors and companies and thus facilitate investment deals.[252] The SEC has stated that it believes that it is important for funding portals to be subject to a recordkeeping requirement in order to create a meaningful audit trail of crowdfunding transactions and communications.[253]

Finally, a solution for the perceived lack of *ex ante* investor protections in the ECF context may be allowing crowd investors to co-invest with business angels—an approach that has been adopted by some platforms such as MyMicroInvest in Belgium.[254] That solution allows crowd investors to invest alongside professional investors, and thereby benefit from the financial contracting and post-investment monitoring skills of such investors.[255] The advantage of such an approach is that it facilitates collaboration between

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[248] *See id.* at 12.

[249] *See supra* Part II.B.3.

[250] Wilson & Testoni, *supra* note 23, at 5.

[251] INNOVATION POLICY AND THE ECONOMY, VOL. 14, 63, 93 (Josh Lerner & Scott Stern eds., 2014).

[252] *Id.*; *see also* Wilson & Testoni, *supra* note 23, at 7.

[253] Proposed Crowdfunding Rules under Title III of the JOBS Act, Securites Act Release No. 33-9470; Exchange Act Release No. 34-70741, File No. S7-09-13, at 261 (Oct. 2013) [hereinafter Proposed Crowdfunding Rules].

[254] *See* MICROINVEST, https://www.mymicroinvest.com/en/faq [https://perma.cc/CN3B-M7TR].

[255] Wilson & Testoni, *supra* note 23, at 9.

professional investors and retail investors. Moreover, angel investors can act to maintain various short-term and long-term investor protections for the crowd investor and thereby better align the interests of the entrepreneurs with those of the investors.[256]

III. THE GLOBAL MARKET FOR CROWDFUNDING

Crowdfunding is a new funding model in a number of countries. One study reported 240 crowdfunding platforms globally in 2011—and this number is growing rapidly.[257] According to the *2013 Crowdfunding Industry Report,* crowdfunding raised $2.7 million globally in 2012, an increase of 81 percent compared to 2011.[258] This figure accounts for all types of crowdfunding, including donation-based, lending-based, reward-based, and equity-based crowdfunding.[259] North America and European platforms account for approximately 95 percent of the total market, raising more capital than anywhere else in the world.[260] In 2011, the North American crowdfunding market grew by 86 percent, followed by 105 percent in 2012—reaching an amount in excess of $1.6 billion.[261] European platforms raised $9.45 million—an increase of 65 percent in 2012 compared to 2011.[262] The financing gap is largest in South America and Africa, where $800,000 and $65,000 was raised respectively.[263] The aggregate 2012 funding volume in Asia was $33 million; in Oceania, $76 million.[264] The United States, therefore,

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[256] Daniel Isenberg, *The Road to Crowdfunding Hell*, HARV. BUS. REV., Apr. 23, 2012, https://hbr.org/2012/04/the-road-to-crowdfunding-hell/ [https://perma.cc/524F-CWK6].

[257] Hemer, *supra* note 71, at 19.

[258] MASSOLUTION, THE 2013 CROWDFUNDING INDUSTRY REPORT 7, at 8 (2013), http://www.compromisoempresarial.com/wp-content/uploads/137356857-Massolution-2013CF-Excerpt-Revised-04182.pdf [https://perma.cc/F5ND-4MQ6]. In late 2015, the crowdfunding industry was valued at $16.2 billion worldwide. *See Crowdfunding takes root in Asia in boon to entrepreneurs*, GULF TIMES, Nov. 18, 2015, at Business 2.

[259] MASSOLUTION, *supra* note 258, at 9.

[260] *See, e.g.*, *id.*

[261] *Id.*

[262] *Id.*

[263] *Id.* at 23.

[264] *Id.*

leads the field in crowdfunding.[265] Donation-based crowdfunding represents the highest volume of crowdfunding, while equity-based crowdfunding is used to a lesser extent mainly because of the absence of crowdfunding legislation.[266]

The majority of crowdfunding project applications were submitted to the established platforms such as MyMajorCompany, IndieGoGo, and Kickstarter, with 18,000, 15,000 and 12,000 applications submitted to each of these sites respectively.[267] The acceptance rate varies highly between platforms, with PledgeMusic accepting and processing 77 percent of all applications received, while the rate was lower for Kickstarter (42 percent) and Uluie (31 percent).[268] Conversely, MyMajorCompany only accepts 0.2 percent of applications and Sonicangel accepts 0.8 percent.[269] These figures suggest that the platforms utilize vastly different selection criteria and methods. Sonicangel—with a high success rate of 92 percent—appears to have one of the most successful business models, whereas other platforms such as SellaBand, MyMajorCompany, SliceThePie, IndieGoGo, and Kickstarter have lower success rates, between 42 and 84 percent.[270]

The majority of crowdfunding projects are derived from the creative industry and the not-for-profit sector.[271] Here, crowdfunding has been used primarily to support creative ideas, projects, and ventures, as opposed to innovations. This is because crowdfunding is particularly suited to case-by-case funding of single projects that are compelling and attract many individuals, but are limited in scope. Funders are often peers from the same creative industry and willing to back artists in a similar position.[272]

A leading study estimates the likelihood of obtaining entrepreneurial financing via crowdfunding in the same order of magnitude as in the international venture capital business, which has

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[265] *U.S. Leads World in Burgeoning Crowdfunding Trend*, FORBES (Apr. 12, 2013), http://www.forbes.com/sites/groupthink/2013/04/12/u-s-leads-world-in-burgeoning-crowdfunding-trend/.

[266] *Id.* at 58–59.

[267] Hemer, *supra* note 71, at 21.

[268] *Id.*

[269] *Id.*

[270] *Id.* at 21–22.

[271] *Id.* at 23.

[272] *Id.* at 27.

success rates of between 1 and 5 percent.[273] The author concludes that there are presently few genuine entrepreneurial ventures funded through crowdfunding platforms.[274]

Crowdfunding entrepreneurs face various challenges that often prevent them from achieving their funding goals. For example, some entrepreneurs have trouble estimating and activating their network capabilities when seeking funding.[275] They often do not realize the importance of growing their network prior to launching an online campaign or underestimate the time it takes to build such a network.[276] Crowdfunding is often not fully understood by entrepreneurs. As a result, few use this novel way of financing despite the potential that it provides.[277] The key elements for a successful crowdfunding campaign appear to be a clear understanding of the crowdfunding process, aims, targets, and timeframes; the selection of an appropriate crowdfunding or P2PL platform; and successful investor communication.[278] According to Mollick, personal networks, the attributes of the project, and geographic location also play a crucial role.[279] It is difficult to predict whether entrepreneurial funding activities will gravitate towards a dominant equity crowdfunding platform internationally. The most effective market structure is likely to emerge based on a number of factors, including market size, business model, the cost of participating on a particular platform, special features, and services provided.[280] There is a great deal of experimentation involved across different models, and the market for crowdfunded

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[273] *Id.* at 22.

[274] *Id.* at 23.

[275] *See* Julie S. Hui et al., Understanding and Leveraging Social Networks for Crowdfunding: Opportunities and Challenges 678 (unpublished manuscript, featured in Designing Interactive Sys., 2014), http://delivery.acm.org/10.1145/2600000/2598539/p677-hui.pdf?ip=128.239.114.252&id=2598539&acc=ACTIVE%20SERVICE&key=B33240AC40EC9E30.491D1E721DB3290B.4D4702B0C3E8B35.4D4702B0C3E38B35&CFID=561855669&CFTOKEN=79078245&__acm__=1447833649_0263b3ae38ae62c260134826c13913a7 [https://perma.cc/MG6X-YJFB].

[276] *Id. at* 680.

[277] *See* Hemer, *supra* note 71, at 3–8.

[278] *See generally* P. Belleflamme et al., *Individual Crowdfunding Practices*, 15 VENTURE CAPITAL: INT. J. ENTREPRENEURIAL FIN. 313, 315–16 (2013).

[279] *Id.* at 316. Mollick, *supra* note 31, at 14.

[280] Belleflamme et al., *supra* note 278, at 315–16; Ajay Agrawal et al., *The Geography of Crowdfunding* 20 (Nat'l Bureau of Econ. Research, Working Paper No. w16820, 2011), http://www.nber.org/papers/w19133 [https://perma.cc/82PY-4UDV].

equity capital remains at an evolutionary stage. The next section considers the various regulatory regimes currently available. This is prefaced by an overview of the legal issues associated with crowdfunding.

IV. COMMON LEGAL ISSUES ASSOCIATED WITH CROWDFUNDING

A. Prudential Supervision

Crowdfunding and P2PL sites perform a complex function. They bring potential investors and entrepreneurs together, and facilitate the transmission of funds and disclosure to and from entrepreneurs to investors.[281] However, crowdfunding and peer-to-peer platforms are not banks or deposit takers. They use escrow accounts in which funds are held and do not reinvest these funds for further purposes. For example, the British crowd platform Buzzbnk states:

> Buzzbnk is not a bank in a legal or financial sense—we do not hold saving deposits and act only as an agent to introduce the Backers to the Ventures. Funds are held on behalf of the Ventures until the fundraising period is either successful and the funds are transferred or if unsuccessful, returned to the Backer.[282]

Such clauses ensure that crowdfunding platforms are not subject to prudential supervision. While crowdfunding platforms cooperate with other payment providers such as PayPal or specific banks, they prefer to be seen as facilitators of payments rather than deposit-taking institutions.

B. Taxation

Crowdfunding is typically subject to taxation, since it is a means to receive income on goods and services. Applicable taxes are sales tax, income tax, and capital gains tax.[283] It is less clear

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[281] MoneyTalkNews, *Investing In People: How Crowdfunding Works*, MINT LIFE BLOG (June 26, 2013), https://blog.mint.com/trends/investing-in-people-how-crowdfunding-works-0613/ [https://perma.cc/GUY6-WDKS].

[282] *See* BUZZBNK, http://buzzbnk.melontech.com/StaticPages/FAQ.aspx [https://perma.cc/UZ6S-7BL9].

[283] *See* KICKSTARTER, https://www.kickstarter.com/help/taxes [https://perma.cc/Z6SY-57N7]; Kevin Frisch, *The Tax Implications of Equity Crowdfunding in the U.S.*, LAW FOR CHANGE, http://www.lawforchange.org/NewsBot.asp?MODE=VIEW&ID=6362 [https://perma.cc/U46N-TS2T].

how crowdfunding projects with nonfinancial rewards are to be taxed—if at all—and such projects may be in a gray area in regards to taxation. Perhaps some crowdfunding platforms ought to be classified as non-profit platforms, while other platforms that provide crowdfunding with financial rewards ought to be classified as for-profit platforms.

C. Money Laundering

Money laundering is another risk associated with crowdfunding. However, the World Bank does not deem this risk to be greater in ECF than in other investing systems.[284] Platforms such as Kickstarter, Indiegogo, and RocketHub comply with international and U.S. anti-money laundering laws.[285]

D. Credit Regulation and Peer-to-Peer Platforms

Under a crowd lending model, lending takes place in the absence of a traditional bank. Accordingly, the discretionary power over the granting of a loan is transferred from the bank or bank manager to the crowd—consisting of individual loan providers—which makes an assessment of the worthiness of the borrower.[286] Providing a loan via a peer-to-peer platform is therefore associated with various risks, the principal risk being the default of the borrower and inability to repay the loan.

British P2PL platforms have launched a P2PF association: P2PFA.[287] The association is a self-regulatory body that seeks to promote certain standards of conduct and consumer protection amongst British P2PL platforms such as Zopa, FundingCircle, and RateSetter.[288] The operating principles of the association set out key requirements for the operation of P2PF platforms. They cover the following:

- senior management;
- minimum operating capital requirements;

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[284] WORLD BANK, CROWDFUNDING'S POTENTIAL FOR THE DEVELOPING WORLD 45 (2013).

[285] *Id.*

[286] *See* Moenninghoff & Wieandt, *supra* note 51, at 4–5.

[287] *See* PEER-TO-PEER FIN. ASS'N, http://p2pfa.info/about-p2p-finance [https://perma.cc/76FH-LMDQ].

[288] *Id.*

- segregation of participants' funds and auditing of the segregated bank account;
- appropriate credit and affordability assessment;
- appropriate anti-money laundering and anti-fraud measures;
- clear rules governing use of the platform, consistent with these Operating Principles;
- marketing and customer communications that are clear, fair and not misleading;
- secure and reliable IT systems;
- fair complaints handling; and
- the orderly administration of contracts in the event a platform ceases to operate.[289]

E. Investor Protection and Cross-Border Access to Investments

One particular issue is the problem of cross-border access to investments via crowdfunding platforms. To what extent should crowdfunding platforms be available to non-domestic investors? The solution may be to make investments via platforms only available to domestic investors by way of a meaningful jurisdictional disclaimer. For example, the Swiss crowdfunding platform Investiere.ch only addresses domestic investors and accredited investors from certain countries, such as Germany.[290] Similarly, portals such as AngelList.com and Shekra.com are only accessible to screened high-net worth investors.[291] The British crowdfunding platform Crowdcube includes the following proviso on its site:

> Viewing pitches and investing may not be lawful in some countries. In other countries, only certain categories of person may be allowed to view pitches on Crowdcube. Any person resident outside the United Kingdom who wishes to view pitches must

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[289] *See Operating Principles,* PEER-TO-PEER FIN. ASS'N, http://p2pfa.info/wp-content/uploads/2015/09/Operating-Principals-vfinal.pdf [https://perma.cc/U28S-S8XG].

[290] *See* INVESTIERE, https://www.investiere.ch/content/our-selection-criteria [https://perma.cc/MRU3-L9EV].

[291] *See* ANGELLIST, https://angel.co/help/startups/how-do-i-get-featured-to-investors [https://perma.cc/TL46-EV2B]; *Shekra Investors Network,* SHEKRA, http://www.shekra.com/en/howitworks.php [https://perma.cc/A67A-NNJ8].

> first satisfy themselves that they are not subject to any local requirements that prohibit or restrict them from doing so.[292]

In addition, using the site to initialize crowdfunding projects is restricted to citizens of the United Kingdom.[293] Conversely, some platforms will accept non-domestic ventures. For example, Buzzbnk states that "Buzzbnk is developed for primarily UK based ventures although we will accept organisations registered in other countries under certain criteria."[294]

Platforms without financial rewards, on the other hand, tend to attract projects from other countries. For instance, Indiegogo is a global platform with campaigns running in 200 countries and regions.[295]

F. Designing an Appropriate Disclosure Regime for the Crowd

The primary audience for disclosure is the crowd—the actual and potential investors of the securities offered for sale.[296] The crowd is likely to be heterogeneous—including representatives of various social groups, as well as different economic and political circles—and geographically dispersed. Furthermore, crowds can be "mad"—irrational and foolish, subject to hype—but they can also be "wise"—rational, sensible and intelligent.[297]

Behavioral psychology offers two distinct narratives of the crowd, focusing on the phenomenon of crowds in economic bubbles (crowds engaging in concerted irrational or suboptimal economic behavior) and crowds as a source of collective intelligence.[298]

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[292] *See FAQs,* CROWDCUBE, https://www.crowdcube.com/faqs/investing-in-equity/i-am-not-based-in-the-uk-can-i-still-register-and-invest [https://perma.cc/AZT3-FR5Y].

[293] *See FAQS,* CROWDCUBE, https://www.crowdcube.com/faqs/raising-through-equity/who-can-start-a-pitch [https://perma.cc/2YU9-5SWM].

[294] *See Buzzbnk FAQs,* BUZZBNK BLOG (Feb. 16, 2011), http://blog.buzzbnk.org/2011/02/16/buzzbnk-faqs/ [https://perma.cc/265G-9R5K].

[295] *See About Us,* INDIEGOGO, https://www.indiegogo.com/about/our-story [https://perma.cc/Y84C-VFJB].

[296] *See* Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the Crowd*, 38 VT. L. REV. 827, 829 (2014).

[297] *Id.* at 830.

[298] *See generally* TIM PHILIPS, CHARLES MACKAY'S EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS (Infinite Ideas Ltd. 2009); Gordon R. Walker, *Securities Regulation, Efficient Markets and Behavioural Finance:*

Surowiecki, for example, suggests that crowds have the capacity to be wise, owing to such factors as cognitive and conceptual diversity, collective knowledge, independence (relative freedom from the influence of others), and decentralization.[299] The wisdom of the crowd consists of developing solutions using others' propositions and developing collective solutions, which lead to better outcomes overall. Surowiecki states:

> The idea of the wisdom of crowds … takes decentralization as a given and a good, since it implies that if you set a crowd of self-interested, independent people to work in a decentralized way on the same problem, instead of trying to direct their efforts from the top down, their collective solution is likely to be better than any other solution you could come up with.[300]

From a regulatory perspective, it is difficult to predict what type of crowd will be participating in an offering, whether that crowd will have the attributes of a "wise" crowd or have a tendency to act irrationally, and what type of regulatory approach ought to be adopted. The actual and potential crowd audience is difficult to define. Moreover, investor profiles may change as the crowdfunding market matures, and different investors may have conflicting objectives. Indeed, it is difficult to empirically assess the nature of the investor crowd. Accordingly, it is important to adopt a regulatory approach to best address the needs of a crowd of diverse investors.

From the securities regulation perspective, however, the crowd can be conflated with the public, and prima facie full disclosure on any offer is required.[301] This requirement is then tempered by the small monetary value of the investment. The small monetary value of the investment is the flipside of the sophisticated investor exclusion, leading to the conclusion that an exemption for such investments is warranted. The law does not prohibit the racegoer from betting small (or large) amounts on a horse. It should not prohibit an investor making a small investment via a licensed ECF platform where arguably the "form guide" is more reliable. One

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Reclaiming the Legal Genealogy, 36 H.K. L.J. 481 (2006) (discussing behavioral psychology generally).

[299] JAMES SUROWIECKI, THE WISDOM OF CROWDS xviii (Anchor Books, 1st ed. 2005).

[300] *Id.* at 70.

[301] *See* Heminway, *supra* note 296, at 829–30.

logical extension of this argument is to propose a sliding scale or spectrum of disclosure tied to the quantum of funds to be invested.

G. Pre- and Post-Investment Problems: "Soft Facts" and "Peer Drivers"

Potential crowd investors often make investment decisions based on limited information and imperfect knowledge of the products or services offered. This gives rise to the information asymmetry problem described by Akerlof.[302] Receivers of funds have more knowledge about the viability of the project than investors.[303] In addition, moral hazard problems arise because entrepreneurs may utilize funds for personal gain.[304]

Suppose that a project is not adequately developed or proven at the time the campaign is launched on a crowdfunding or P2PL platform and that consumers may be unable to try out the project or service prior to investing in it.[305] Often, the only available source of information may be the campaign description published by the creators of the project. The latter may be biased, incomplete, or limited in scope. This makes it difficult for potential backers to evaluate the quality or utility of a project. Backers can rely on third-party endorsements and the number of backers (prominently displayed on the crowdfunding platform site for each project) to gauge the likely success of a project. For example, Zhang and Liu find that investors are more likely to contribute to projects in the ECF or P2PL setting where the projects have already garnered support from the community.[306] Conversely, prior contributions may have the opposite effect in donation-based crowdfunding models, where a potential backer has less need to support a project as a result of prior

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[302] George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 QUARTERLY J. ECON. 488, 489 (1970).

[303] Gmeleen Faye B. Tomboc, *The Lemons Problem in Crowdfunding*, 30 J. MARSHALL J. INFO TECH. & PRIVACY L. 253, 266 (2013).

[304] *Id.*

[305] *See* Ferdinand Thies & Michael Wessel, *The Circular Effects of Popularity Information and Electronic Word-of-Mouth on Consumer Decision-Making: Evidence from a Crowdfunding Platform* 1 (22nd European Conference on Information Systems, Tel Aviv, 2014), http://ecis2014.eu/E-poster/files/0810-file1.pdf [https://perma.cc/UVA8-U3NQ].

[306] J.J. Zhang & P. Liu, *Rational Herding in Microloan Markets*, 58 MGMT. SCI. 892, 893 (2012).

donations.[307] A study published by Ahlers et al. finds that firms that have been in business longer prior to seeking ECF are more likely to raise capital, as well as firms with a greater number of board members, higher levels of education (as measured by the percentage of board members holding MBAs), and firms with better networks.[308]

Moritz et al. published a study examining investor communication in the context of crowdfunding.[309] The authors adopt an "exploratory qualitative research approach based on semi-structured interviews" with seventeen crowdfunding participants: six crowd investors, six new ventures, and five third parties.[310] The authors develop a "theoretical framework and present it in a set of six propositions."[311] "The results indicate that the venture's overall impression—especially perceived sympathy, openness, and trustworthiness—is important to reduce the perceived information asymmetries of [crowd] investors."[312] Thus, it is important for entrepreneurs to communicate "soft facts." This is typically done via pseudo-personal communication channels, such as videos.[313]

In addition to soft facts, Moritz et al. found that crowd investors are also influenced by other market participants.[314] This is consistent with the findings of Zhang and Liu. Peer effects are important drivers of crowdfunding. Hence, third-party endorsements are regarded as quality signals and serve to reduce information asymmetry.[315] This may lead to information cascades and "herd behavior" in the sense that individual investors choose to make decisions based on the actions of others rather than on private information available to them.[316] The upshot is that investors end up supporting already successful projects, i.e., projects that are already successful in terms of the number of backers. As a result,

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[307] *See* Thies & Wessel, *supra* note 305, at 2.

[308] Gerrit K.C. Ahlers et al., *Signaling in Equity Crowdfunding*, 39 ENTREPRENEURSHIP THEORY & PRAC. 955, 956–63 (2015).

[309] Alexandra Moritz et al., Investor Communication in Equity-Based Crowdfunding: A Qualitative-Empirical Study 1 (2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2462282 [https://perma.cc/N3F3-WD2M].

[310] *Id.*

[311] *Id.*

[312] *Id.*

[313] *Id.*

[314] *Id.*

[315] *Id.*

[316] *See* Thies & Wessel, *supra* note 305, at 4.

already successful campaigns receive further popularity boosts, leading to positive upward information cascades.[317] Conversely, projects that lack a high number of backers may experience a negative downward information cascade.[318] Hui et al. find that the "majority of failed project creators cited the inability to successfully leverage an online audience as a main reason for failing."[319]

The above analysis suggests that crowd investors are often hype driven and subject to social contagion processes—a fact that may be exploited by crowdfunding platforms.[320] Crowdfunding platforms often adopt business models that seek to establish positive funding momentums by imposing short investment spans, creating funding limits, and making the funding process transparent. This process is designed to generate a feeling of urgency amongst investors. Entrepreneurs can also exploit information cascades by artificially trying to kick-start a campaign using preappointed guinea pigs who act as buyers.[321]

According to Burtch, herding behavior is a negative externality of crowdfunding.[322] However, from an entrepreneurial perspective, the reverse is also true. Herding can be regarded as a positive externality because it results in a snowball effect and helps entrepreneurs meet their financing objectives. Other potential pitfalls of crowd wisdom may be summarized as pluralistic ignorance and groupthink (members of the group coming to incorrect decisions or assumptions based on a desire to find conformity within a group);[323] bandwagoning (assumption of falsehoods to be true by any one member of a group and other members buying into the same falsehood); and the Dunning-Krueger effect (a cognitive

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[317] *Id.*

[318] *Id.*

[319] Julie Hui et al., Understanding the Role of Community in Crowdfunding Work (2014) (unpublished manuscript), http://egerber.mech.northwestern.edu/wp-content/uploads/2012/11/Gerber_UnderstandingtheRoleofCommunityinCrowdfundingWork.pdf [https://perma.cc/E9TC-CGAR].

[320] *Id.*

[321] Daniel Sgroi, *Optimizing Information in the Herd: Guinea Pigs, Profits and Welfare*, 39 GAMES & ECON. BEHAVIOR 137, 137 (2002).

[322] *See generally* Gordon Burtch, *Herding Behavior as a Network Externality*, 32 ICIS CONF. (2011), http://www.researchgate.net/publication/221599843_Herding_Behavior_as_a_Network_Externality [https://perma.cc/3UJC-RPJG].

[323] Isenberg, *supra* note 256.

bias, with unskilled individuals rating their own abilities higher than average).[324]

V. CROWDFUNDING REGULATION IN A GLOBAL CONTEXT

The aim of this Part is to examine crowdfunding regulation in a global context. It is structured as follows: first, we examine the various capital market innovations introduced to close the SME financing gap prior to the introduction of crowdfunding regulation. Here, we use Australia and New Zealand as case studies. Second, we turn to specific crowdfunding models in select jurisdictions and examine the nature of these models and the rationales for the introduction of crowdfunding regulation. This analysis is intended to provide an overview of the various capital market law reform options available to regulators in order to enhance SME access to capital. Particular attention is paid to the New Zealand model, which we regard as the leading model in the Southern Hemisphere.

A. Australia

In the past, Australia has attempted to solve the SME financing problem via various means. For example, the Australian Corporations Act 2001 (Cth.) contains various provisions that are designed to facilitate "small scale offerings," or low-value capital raisings.[325] The relevant rules are contained in Chapter 6D of the Act.[326] The latter chapter requires a disclosure document to be lodged with the Australian Securities and Investment Commission—Australia's corporate regulator—prior to the making of an offer of securities to an investor.[327] Exemptions to this rule are contained in Section 708 of the Act, which provides that no disclosure is required when a personal offer is made, i.e., an offer of less than AU$2 million and involving no more than twenty investors in a twelve-month period; or alternatively, the offer is made to sophisticated or professional investors.[328] A sophisticated investor is defined as someone with net assets greater than

[324] DRESNER, *supra* note 92, at 64–65.
[325] *Corporations Act 2011* (Cth) ch. 6D, s 708 (Austl.).
[326] *Id.* at ch. 6D.
[327] *Id.* at s 704–07.
[328] *Id.* at ss 708(1), (8), (11).

AU$2.5 million or gross income of at least AU$250,000 in the last two years.[329] Professional investors, on the other hand, include listed entities with assets of at least AU$10 million.[330] Unless one of these exemptions applies, a company cannot raise funds from investors generally and must target sophisticated or professional investors. Because non-exempt offers must be accompanied by a prospectus, the costs of compliance and complexity in obtaining financing from the public are increased.[331]

The law also provides for the use of "offer information statements"—abbreviated information statements—rather than a prospectus if the total amount raised by a corporate body or specific related entities is AU$10 million or less.[332] Moreover, there are specific "sophisticated investor" exemptions that allow companies to raise funds from sophisticated investors without a disclosure document.[333] In addition, the Venture Capital Act 2002 provides for so-called Venture Capital Limited Partnerships (VCLPs) and Early Stage Venture Capital Limited Partnerships (ESVCLPs) that enjoy tax concessions.[334] For example, "the ESVCLP program was established in 2007 and is aimed at further encouraging investment in early-stage companies."[335] All partners in ESVCLPs are exempt from tax on any share of the income derived by the partnership.[336] Lastly, Australia has introduced certain public-private equity co-investment schemes whereby government and private sector capital are pooled to invest in new Australian companies commercializing innovative ideas.[337] Such coinvestment

[329] *Id.* at s 708(8).

[330] *Id.* at s 708(11).

[331] Pekmezovic & Walker, *supra* note 10, at 68.

[332] *Corporations Act 2011* (Cth) ch. 6D, s 709(4) (Austl.).

[333] *Id.* at s 708(8)–(10).

[334] *Factsheet: Early Stage Venture Capital Limited Partnerships*, AUSTL. GOV'T DEP'T OF INDUS. & SCI (2015), http://www.business.gov.au/grants-and-assistance/venture-capital/esvclp/Documents/ESVCLP-FactSheet.pdf [https://perma.cc/SCN8-E5JR] [hereinafter *Factsheet*].

[335] AUSTL. GOV'T: INNOVATION INV. FUND, VENTURE CAPITAL IN AUSTRALIA 4 (2013).

[336] *Factsheet, supra* note 334.

[337] AUSTL. GOV'T: THE TREASURY AND THE DEP'T OF INDUS., INNOVATION, SCI., RESEARCH AND TERTIARY EDUC., REVIEW OF VENTURE CAPITAL AND ENTREPRENEURIAL SKILLS: FINAL REPORT 17–20 (2012), http://www.avcal.com.au/documents/item/516 [https://perma.cc/W3QQ-3Z6X].

programs are coupled with tax incentives, and together they help to attract capital to the high-risk venture capital sector. Table 1 below provides an overview of these reforms.

TABLE 1: SME CAPITAL MARKET REFORMS IN AUSTRALIAN LAW

	RELEVANT LEGISLATION	KEY PROVISIONS
LOW-VALUE CAPITAL RAISINGS	Sections 708(1)–(7) of the *Corporations Act 2001 (Cth)*	• Australian provisions contain bright-line rules that say disclosure (via a prospectus) is required unless exceptions apply. Key exceptions include small scale offerings and sophisticated investors.[338] • The exemption from the prospectus requirement for small scale offerings allows up to twenty personal offerings in any period of twelve months (the "20/12" rule).[339] • Under the 20/12 rule, the number of investors, rather than the number of offerees, is counted, subject to a financial ceiling.[340] • The exemption is available when three conditions are satisfied: (1) the offers are personal offers for issue or sale of a body's securities; (2) none of the offers results in a breach of the twenty investors ceiling; and (3) none of the offers results in a breach of the $2 million ceiling.[341] • In future reform proposals, thresholds are likely to be relaxed in the future, for example, through higher limits for the amount of funding that can be raised under the "20/12" prospectus exemption, or for a larger number of investors investing under that same exemption.[342]

338 *Corporations Act 2011* (Cth) ch. 6D, s 708 (Austl.)
339 *Id.* at s 708(1).
340 *Id.* at s 708(3)–(4).
341 *Id.* at s 708(1).
342 AUSTL. SEC. & INV. COMM'N, PRODUCTIVITY COMMISSION: REVIEW OF BARRIERS TO BUSINESS ENTRIES AND EXITS IN THE AUSTRALIAN ECONOMY 22 (2015).

	RELEVANT LEGISLATION	KEY PROVISIONS
OFFER INFORMATION STATEMENTS	Section 709(4) of the *Corporations Act 2001 (Cth)*	• A body, a related body corporate, or a controlled entity offering to issue securities may use an offer information statement instead of a prospectus if the total of all amounts raised by the body or specified related entities is AU$10 million or less.[343] • The offer information statement is primarily intended to be a fundraising mechanism for SMEs, though it is not limited to those enterprises.[344] The main requirement is that the company includes an audited financial report covering a twelve-month period and has a balance date no later than six months before the securities are first offered.[345]
SOPHISTICATED INVESTORS	Sections 708(8)–(10) of the *Corporations Act 2001 (Cth)*	• The *Corporations Act 2011* permits offers to sophisticated investors without a disclosure document.[346] A potential investor might derive sophistication from one or more of these three factors: (1) the amount of the investment; or (2) the financial status or income of the investor; or (3) the investment experience of the investor.[347] • Two types of "sophisticated investors" are encompassed. One is the large investor. If the investor is paying at least AU$500,000 or has a gross income or net assets that exceed the prescribed minimum, the offer is exempt.[348] • A sophisticated investor is a person with net assets of at least AU$2.5 million or a gross income for each of the past two financial years of at least AU$250,000.[349] Another is the "professional" or experienced investor to whom the offer is made.[350]

343 *Corporations Act 2011*, s 709(4) (Austl.).
344 *Id.*
345 *Id.* at s 715(2).
346 *Id.* at ss 708(8)–(10).
347 *Id.* at ss 708(8)(a)–(c).
348 *Id.* at ss 708(8)(a)–(b).
349 *Id.* at ss 708(8)(c), (9A)–(9C).
350 *Id.* at s 708(11).

	RELEVANT LEGISLATION	KEY PROVISIONS
VENTURE CAPITAL SECTOR	*Venture Capital Act 2002*	• Venture Capital Limited Partnerships (VCLP) were established in 2002.[351] • Early Stage Venture Capital Limited Partnerships (ESVCLP) programs.[352] • The ESVCLP program was established in 2007 and is aimed at further encouraging investment in early stage companies.[353] All partners in ESVCLPs are exempt from tax on any share of the income derived by the partnership.[354] • The ESVCLP program replaced the Pooled Development Funds (PDF) program. Over AU$961 million has been invested in 707 Australian companies under the PDF program.[355] • Since the ESVCLP program was established in 2007, registered ESVCLPs have invested AU$64 million into fifty businesses.[356]
TAX CONCESSIONS		• The Australian government has several tax concession programs for the venture capital sector, including the Venture Capital Limited Partnerships (VCLP) and the Early Stage Venture Capital Limited Partnerships (ESVCLP) programs.[357] • Other tax concessions include the Research and Development (R&D) Tax Incentive and Enterprise Connect.[358]

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351 *Venture Capital Act 2002* (Cth) (Austl.); *Factsheet*, *supra* note 334.

352 *Venture Capital Act 2002* (Cth) (Austl.); *Factsheet*, *supra* note 334.

353 AUSTL. GOV'T: DEP'T OF IND. AND SCI.,EARLY STAGE VENTURE CAPITAL LIMITED PARTNERSHIPS (ESVCLPS): CUSTOMER INFORMATION GUIDE 6 (2015).

354 *Id.* at 23.

355 AUSTL. GOV'T: DEP'T OF IND. AND SCI., INNOVATION AUSTRALIA ANNUAL REPORT 2012–13 70 (2013).

356 *Id.* at 68.

357 AUSTL. GOV'T: BD. OF TAXATION, REVIEW OF TAXATION ARRANGEMENTS UNDER THE VENTURE CAPITAL LIMITED PARTNERSHIP REGIME: A REPORT TO THE ASSISTANT TREASURER 8–9, 11 (2011).

358 AUSTL. GOV'T: DEP'T OF IND., R&D TAX INCENTIVE: CUSTOMER INFORMATION GUIDE (AUSINDUSTRY SECTIONS) (2012); AUSTL. GOV'T: DEP'T OF IND., SINGLE BUSINESS SERVICE, http://www.business.gov.au/about-businessgovau/Pages/One-Website.aspx [https://perma.cc/EG7E-2BTR] (noting that Single Business Service replaced Enterprise Connect).

	RELEVANT LEGISLATION	KEY PROVISIONS

PUBLIC-PRIVATE EQUITY CO-INVESTMENT SCHEMES		• Government and private sector capital is pooled to invest in new Australian companies commercializing innovative ideas.[359]
		• Co-investment programs are coupled with tax incentives, and together they help to attract capital to the high-risk venture capital sector.[360]
		• "The current Australian Government equity-based venture capital programs comprise:
		  • the Innovation Investment Fund (IIF)—last funding tranche scheduled for 2013 [and cut from federal budget in 2014–2015];
		  • the Innovation Investment Follow-on Fund (IIFF)—investment period ceased in late 2012;
		  • the Pre-Seed Fund (PSF)—investment period ceased in late 2012; [ ]
		  • the Renewable Energy Venture Capital (REVC) Fund—investment period underway;" [361] and
		  • the Entrepreneurs' Infrastructure Programme 2014–2015; intended to supply AU$484.2 million over five years.

As of November 2015, however, Australia has no legislation in place to facilitate crowdfunding.[362] Companies may, however, raise financing via the exemptions in Section 708 or the Australian Small Scale Offerings Board (ASSOB).[363] ASSOB was created under ASIC Class Order 02/273, which provides an exemption

[359] REVIEW OF VENTURE CAPITAL AND ENTREPRENEURIAL SKILLS, *supra* note 337, at 17.

[360] *Id.* at 47.

[361] *Id.* at 17; *see also* AUSTL. GOV'T DEPARTMENT OF INDUS., ESTABLISHMENT OF THE ENTREPRENEUR'S INFRASTRUCTURE PROGRAMME—DISCUSSION PAPER (2014), http://www.industry.gov.au/industry/Documents/EntrepreneursInfrastructureProgrammeDiscussionPaper.pdf [https://perma.cc/9BQP-J22F].

[362] *See* Terence W. Wong, *Crowd funding: Regulating the new phenomenon*, 31 CO. & SEC. L. J. 89, 107 (2013).

[363] *Corporations Act 2011* (Cth) ch. 6D, ss 708(1)–(11) (Austl.); AUSTL. SMALL SCALE OFFERING BD., ASSOB PLATFORM: RULES OF ADMISSION FOR LIMITED COMPANIES 2 (2015).

from the fundraising provisions of the Corporations Act.[364] The board allows small companies to list their company on the board for registered investors.[365] To date, more than AU$130 million has been raised using the platform.[366] It costs a company $4,500 to list on the platform.[367] Furthermore, companies incur fees by remaining on the list.[368] Other than ASSOB, there are few equity crowdfunding platforms to which Australian companies may have recourse.[369] This not only substantially reduces competition in the crowdfunding market, but also reduces SMEs' access to capital.

B. New Zealand

Capital market law reforms aimed at SMEs have been enacted in various jurisdictions, including New Zealand. For example, New Zealand recently simplified the financial reporting requirements applicable to SMEs under the Financial Reporting Act 2013 in order to enhance the development of the SME sector.[370] New Zealand law also follows the cognate Australian "small scale offerings" exemptions, enabling issuers of debt and equity securities to fund up to $2,000,000 in any twelve-month period from twenty investors.[371] Other exemptions include the offers to wholesale investors exemption under the Financial Markets Conduct Act

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[364] *See generally* ASIC, *Business Introduction or Matching Services*, Class Order CO 02/273 (Mar. 2002) (Austl.).

[365] *About ASSOB*, AUSTL. SMALL SCALE OFFERING BD., https://www.assob.com.au/about.asp?page=1 [https://perma.cc/B8XJ-2VYZ].

[366] Chris Gay, *Equity Crowdfunding: Good for Capitalism or for Fraudsters?*, U.S. NEWS & WORLD REPORT (Nov. 21, 2012, 9:25 AM), http://money.usnews.com/money/personal-finance/mutual-funds/articles/2012/11/21/will-crowdfunding-unleash-innovation-encourage-securities-fraud-or-both [https://perma.cc/Q2WR-W7NA]; *see also* ASIC, *supra* note 364.

[367] *Our Fees*, AUSTL. SMALL SCALE OFFERING BD., https://www.assob.com.au/about.asp?page=3 [https://perma.cc/PYW2-T88D].

[368] *Id.*

[369] *See* Rose Powell, *VentureCrowd Fund-raising Adds $1.2m to Start-Up Ingogo's $9.1m Raising*, AUSTL. FIN. REV. (Sept. 30, 2014) (discussing the VentureCrowd platform, which enables sophisticated investors in Australia to invest up to AU$2,500.).

[370] ERNST & YOUNG, NEW ZEALAND FINANCIAL REPORTING GUIDE 2014/15 17 (2015).

[371] Financial Markets Conduct Act 2013, s 12 (N.Z.).

2013.[372] The latter covers investment businesses, persons engaged in investment activities, eligible investors, and persons making an investment of $750,000 or more.[373] Issuers issuing securities to wholesale investors are not required to comply with prospectus requirements.[374] New Zealand law also makes provisions for venture capital schemes, which allow companies to raise funds with substantial exemptions from the usual securities law requirements (such as prospectus requirements), but under the supervision of an independent venture capital scheme administrator.[375]

The New Zealand Stock Exchange has introduced a new high growth market segment (NXT) aimed at SMEs.[376] The key elements of the NXT disclosure regime are the setting by the firm of key operating milestones ("KOMs"), by which investors can measure and monitor business performance and receive quarterly business updates.[377] The KOMs will replace prospective financial information ("PFI") currently required in listing documents, and it is expected that this will reduce the initial listing costs for SMEs.[378] Table 2 provides an overview of key capital market law reforms aimed at SMEs. As discussed below, these include a new regime for ECF and P2PL via licensed intermediaries.

TABLE 2: NEW ZEALAND SME CAPITAL MARKET LAW REFORMS

	LEGISLATION	SUMMARY
FINANCIAL REPORTING	Financial Reporting Act 2013	Requirements are simplified for SMEs under FRA 2013. SMEs have the option of preparing *special purpose financial reports* for tax purposes.[379]

[372] *Id.* at s 3.
[373] *Id.*
[374] *Id.*
[375] *See* Financial Markets Authority, Securities Act (Venture Capital Schemes) Exemption Amendment Notice 2012 (N.Z.); Financial Markets Authority, Securities Act (Venture Capital Schemes) Exemption Notice 2008 (N.Z.).
[376] NXT, GUIDANCE NOTE: KEY OPERATING MILESTONES (Feb. 2015).
[377] *Id.* at 3.
[378] *See* NXT, GUIDANCE NOTE: LISTING AS A NXT COMPANY 7 (Feb. 2015).
[379] Financial Reporting Act 2013, ss 15, 19 (N.Z.).

	LEGISLATION	SUMMARY
EXEMPTIONS FROM PROSPECTUS REQUIREMENTS	Financial Market Conduct Act 2013	Key exemptions include the following: • Small scale offers: This exclusion follows the cognate Australian 20/12 rule. It enables issuers of debt and equity securities to raise funds up to AU$2 million in any twelve-month period from 20 investors; • Offers to wholesale investors: this covers investment businesses, persons engaged in investment activities, eligible investors, and persons making an investment of $750,000 or more; • Offers for persons in close relationships: this category comprises close business associates and relatives; • Offers through licensed intermediaries: ECF and P2PL.
NEW ZEALAND STOCK EXCHANGE: NEW HIGH GROWTH MARKET SEGMENT (NXT)		NXT is aimed at SMEs.[380] The key elements of the NXT disclosure regime are: • the setting by the firm of "key operating milestones" by which investors can measure and monitor business performance; • a quarterly business update; and • a set list of events requiring immediate disclosure to the market between business updates.[381] KOMs will replace prospective financial information currently required in listing

[380] *See* NXT, *supra* note 378, at 4.
[381] NXT, *supra* note 376, at 3, 7–10.

	LEGISLATION	SUMMARY
		documents, and it is hoped that this will reduce the initial listing costs for SMEs.[382] • Note that the London Stock Exchange has developed a market segment for high-growth companies, such as internet and technology companies that are expected to, in time, seek a listing on the main board.[383] • This new high-growth segment was developed jointly by the U.K. Government and London Stock Exchange. It is in addition to the second board called AIM, High Growth Segment.[384]
VENTURE CAPITAL SCHEMES	• *Securities Act (Venture Capital Schemes) Exemption Amendment Notice 2012 and* • *Securities Act (Venture Capital Schemes) Exemption Notice 2008*	• Companies can raise funds with substantial exemptions from the usual securities law requirements (such as prospectus requirements), but under the supervision of an independent venture capital scheme administrator.[385] • The New Zealand Financial Markets Authority (FMA) has designated 10 organizations, including Powerhouse Ventures Limited, to administer the venture capital scheme.

382 *See* NXT, *supra* note 378, at 7.

383 LONDON STOCK EXCH., HIGH GROWTH SEGMENT, http://www.lseg.com/sites/default/files/content/documents/HGS_flyer.pdf [https://perma.cc/FY8Z-A2FK].

384 LONDON STOCK EXCH., AIM, http://www.londonstockexchange.com/companies-and-advisors/main-market/companies/hgs/hgs.htm [https://perma.cc/425V-CGFK].

385 *See* Securities Act (Venture Capital Schemes) Exemption Amendment Notice 2012, 3–4 (N.Z.); Securities Act (Venture Capital Schemes) Exemption Notice 2008 (N.Z.).

	LEGISLATION	SUMMARY
		The scheme administrators operate under a *Code of Practice* and are exempt from various securities law requirements.[386] • A business that wants to raise funds from the public for a project or venture may apply to become a Registered Business under any scheme.[387] • A Registered Business that makes an offer of equity securities or participatory securities in compliance with the Code may rely on the exemptions stated in the Exemption Notice, including exemption from the requirement to have a registered prospectus and exemption from certain advertising requirements of the law.[388] • A company can raise no more than NZD $5 million.[389]
GOVERNMENT SUPPORT PROGRAMS		• Callaghan Innovation's Incubator Support Programme[390] • R&D Grants[391]

[386] Securities Act (Venture Capital Schemes) Exemption Amendment Notice 2012, at 4 (N.Z.).

[387] *Id.* at 2.

[388] *Id.*; *see also* Securities Act (Venture Capital Schemes) Exemption Notice 2008, 7 (N.Z.).

[389] Securities Act (Venture Capital Schemes) Exemption Amendment Notice 2012, at 5 (N.Z.).

[390] CALLAHAN INNOVATION, INCUBATORS, https://www.callaghaninnovation.govt.nz/incubators [https://perma.cc/UK5C-EC4B].

[391] CALLAHAN INNOVATION, RESEARCH AND DEVELOPMENT GRANTS, https://www.callaghaninnovation.govt.nz/sites/all/files/rd-grants-brochure-07-2015.pdf [https://perma.cc/HYL8-XZPE].

Under the now-repealed New Zealand Securities Act 1978, issuers were required to make full, timely, and accurate disclosure of relevant information to potential investors.[392] Under Section 33 of the Act, no securities could be offered to the public for subscription by or on behalf of an issuer unless the offer was made in an investment statement, as part of an authorized advertisement, or made in or accompanied by a registered prospectus.[393] Thus, the Act imposed various restrictions on offers to the public. Excluded from these restrictions were certain offerees who were not considered members of the public, such as relatives and close business associates of the issuer.[394] In addition, the Act excluded offers to professional or habitual large investors, as well as eligible persons, i.e., wealthy and experienced investors, from its ambit.[395] There was no crowdfunding regime per se. Crowdfunding was technically possible under the 1978 regime, but only to the limited extent provided by the exclusions to the prospectus requirements contained in Section 3 of the Securities Act 1978.[396] The same position holds true in Australia as of July 2015; ECF is possible but only via the exclusions or carveouts to the prospectus requirements in the Corporations Act 2001.[397]

1. Crowdfunding Under the Financial Markets Conduct Act 2013

The Financial Markets Conduct Act 2013 (FMC Act) and the Financial Markets Conduct Regulations 2014 (FMC Regulations) provide for two new forms of capital raising: crowdfunding and

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[392] The New Zealand model was followed by Papua New Guinea and Samoa. Securities Act 1978, s 54 (N.Z.).

[393] *See* Securities Act 1978, s 33 (N.Z.). The "offer to the public" requirement also appears in the relevant Hong Kong legislation: *see* Companies (Winding Up and Miscellaneous Provisions) Ordinance (2012) Cap. 32, § 1 (H.K.). There are no specific crowdfunding provisions in the Hong Kong legislation.

[394] Securities Act 1978, s 3 (N.Z.).

[395] *Id.* at s 2c.

[396] *Id.* at s 3.

[397] *See* Wong, *supra* note 362, for a discussion of ECF in Australia in the absence of specific legislative provisions. For an example of how ECF works in Australia in such a context, *see* Powell, *supra* note 369.

P2PL.[398] Under the FMC Act, financial products offered through licensed intermediaries are not subject to the standard disclosure obligations for financial products that apply under the financial market conduct legislation.[399] For this purpose, licensed intermediaries are persons licensed to provide crowdfunding or P2PL services under Part 6 of the FMC Act.[400]

Prior to the enactment of the FMC Act, providers of crowdfunding and peer-to-peer services ran the risk of contravening the Securities Act 1978.[401] The FMC removed this risk by creating a licensing regime that enables providers of crowdfunding and peer-to-peer services to provide licensed services under the supervision of the regulator, the Financial Markets Authority ("FMA").[402] Licensed crowdfunding and peer-to-peer service providers are not subject to the disclosure obligations for offers of financial products under Part 3 of the FMC Act.[403] This is a direct result of an exclusion contained in Clause 6 of Schedule 1 of the FMC Act, which states that a person providing a "prescribed intermediary service" is excluded from the disclosure obligations under Part 3.[404] Crowdfunding and peer-to-peer services are designated as prescribed intermediary services.[405]

Accordingly, the protection of investors is derived from the licensing regime in Part 6 of the FMC Act rather than Part 3 of the Act.[406] Licensed providers remain subject to various requirements, including disclosing to clients the nature of the services provided.[407] They are also subject to FMA supervision.[408] As

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[398] This section draws on Alma Pekmezovic & Gordon Walker, *Equity Crowdfunding in New Zealand*, 33(1) CO. & SEC. L.J. 63, 63–69 (2015).

[399] Financial Markets Conduct Act 2013, s 6 (N.Z.).

[400] *Id.* at s 390.

[401] Pekmezovic & Walker, *supra* note 398, at 63.

[402] *See* Financial Markets Conduct Act 2013; *Who needs a license?*, FIN. MKTS. AUTH., https://fma.govt.nz/compliance/licensing-and-registration/who-needs-a-licence/ [https://perma.cc/9EDR-CPEJ].

[403] Financial Markets Conduct Act 2013, pt 3 (N.Z.).

[404] *Id.* at ss 39–40, schedule 1, cl 6. Note that the exclusions contained in Schedule 1, Part 1 of the Act are similar to the carveouts in Section 708 of the Australian Corporations Act 2001.

[405] Financial Markets Conduct Regulations 2014, reg 184 (N.Z.).

[406] Financial Markets Conduct Act 2013, pts 3, 6 (N.Z.)

[407] *Id.* at ss 422–28.

[408] *Id.* at ss 414–15, 418–21.

indicated, the benefit of obtaining a market service license for crowdfunding under Part 6 of the FMC Act is that the disclosure obligations under Part 3 are inapplicable, and modified disclosure requirements apply instead.[409]

Generally, the disclosure obligations imposed on ECF providers are fewer than those that apply on a registered exchange.[410] A company issuing securities through crowdfunding services is subject to less disclosure than a company listed on the NZX.[411] Thus, companies can raise funds through licensed crowdfunding and peer-to-peer intermediaries' facilities without having to comply with public offer disclosure documents under securities or financial markets legislation.[412] Such exclusions from disclosure are intended to make it easier for SMEs to raise capital.[413]

Regulation 185 of the FMC Regulations 2014 defines the terms "crowd funding service" and "peer-to-peer lending services."[414] A person provides a "crowd funding service" if the following two elements are met:

- the person "provides a facility by means of which offers of shares in a company are made; and
- the principal purpose ... is to facilitate the matching of companies who wish to raise funds with many investors who are seeking to invest relatively small amounts."[415]

A person provides a P2P if:

- the person "provides a facility by means of which offers of debt securities are made; and
- the principal purpose ... is to facilitate the matching of lenders with borrowers who are seeking loans for personal, charitable, or small business purposes."[416]

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[409] *Id.* at ss 50–52, 422–28.
[410] *See generally id.*
[411] *Id.*
[412] *Id.*; *see also* Pekmezovic & Walker, *supra* note 398, at 63.
[413] Financial Markets Conduct Act, ss 3–4 (N.Z.).
[414] Financial Markets Conduct Regulations 2014, reg 185 (N.Z.).
[415] *Id.*
[416] *Id.*

2. Part 6 of the FMC Regulations 2014

Part 6 of the FMC Regulations 2014 contains provisions that

- allow crowdfunding services and P2PL services providers to be licensed (Reg. 184);[417]
- provide additional eligibility criteria, such as adequate systems and procedures to ensure that issuers do not raise more than $2 million in any twelve-month period (Reg. 186);[418] and
- set out adequate disclosure arrangements applicable to crowdfunding providers, disclosure statements for retail investors, conditions (including warning statements for investors), and client agreements (Reg. 186).[419]

These requirements are discussed below.

3. Licensing Requirements

Equity-based crowdfunding facilities and P2PL service facilities must apply to be licensed by the FMA.[420] The FMA issued the first equity crowdfunding licenses on July 31, 2014, to PledgeMe and Snowball Effect.[421] The criteria for obtaining a license to provide a crowdfunding service are set out in Section 396 of the FMC Act[422] and additional eligibility criteria apply under Regulation 186 of the FMC Regulations 2014.[423] The eligibility criteria for a crowdfunding service under Section 396(a) of the FMC Act are as follows:

- the provider has fair, orderly, and transparent systems and procedures for providing the service;

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417 Financial Markets Conduct Regulations 2014, reg 184 (N.Z.).

418 *Id.* at reg 186.

419 *Id.*

420 FIN. MKTS. AUTH., *supra* note 402.

421 *See FMA Issues First Equity Crowd Funding Licences*, FMA, MR No. 2014-25 (July 31, 2014) (N.Z.).

422 Financial Markets Conduct Act 2013, s 396 (N.Z.).

423 Financial Markets Conduct Regulations 2014, reg 186 (N.Z.).

- the service is designed primarily for offers by persons other than the provider and its associated persons;
- the provider has an adequate policy for identifying and managing the risk of fraud by issuers using the service (an anti-fraud policy);
- the provider has adequate disclosure arrangements to give investors, or to enable investors to readily obtain, timely and understandable information to assist investors to decide whether to acquire the shares (for example, through initial disclosure, or question and answer forums, or other information that is made available);
- the provider has an adequate policy (a fair dealing policy) for excluding an issuer from using the service if the provider has information (for example, from checks or assessments it carries out (if any)) that gives it reason to believe that the issuer, in relation to any dealing in shares using the service, has engaged in conduct that is misleading or deceptive or is likely to mislead or deceive or has made an unsubstantiated representation.[424]

Upon registration, licensed crowdfunding service providers have to meet and maintain certain minimum standards, as set out by the FMC Act and any applicable regulations.[425]

4. Required Disclosure Statements

Regulation 215 provides that a disclosure statement for a crowdfunding service or peer-to-peer service must contain a description of the following matters:

- the nature of the service provided;
- how investors apply for, and obtain, access to the facility and the eligibility criteria that apply;
- how issuers apply for, and obtain, access to the facility and the eligibility criteria that apply;

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[424] *Id.* at reg 186.

[425] FIN. MKTS. AUTH., CROWDFUNDING PLATFORMS, https://fma.govt.nz/compliance/role/crowdfunding-platforms/ [https://perma.cc/CS4G-MD9P].

- how investments are made and financial products are issued under the service; and
- how investor money is received and dealt with.[426]

In addition, the provider must disclose information about the nature and extent of the checks and assessments made by the provider of each issuer that offers financial products under the service;[427] the directors and senior managers of those issuers;[428] the risks involved in those financial products;[429] the nature and extent of the disclosure arrangements that apply in relation to the financial products offered under the service;[430] the charges that may be payable to the provider by an investor (or by an issuer);[431] the rights of the provider;[432] the nature of any restrictions or prohibitions;[433] and the nature and extent of any interest held by or in the provider that may materially adversely impact on the providers' ability to have fair, orderly and transparent systems and procedures for providing the service.[434] Further, investors must receive information about the "contact details of the provider and how the investors may complain about the service to the provider and to any dispute resolution scheme that is available."[435] Regulation 196 imposes an obligation to make a warning statement available.[436] The required statement is as follows:

> Equity crowdfunding is risky. Issuers using this facility include new or rapidly growing ventures. Investment in these types of businesses is very speculative and carries high risks. You may lose your entire investment, and must be in a position to bear this risk without undue hardship. New Zealand law normally requires people who offer financial products to give information to investors before they invest. This requires those offering

[426] Financial Markets Conduct Regulations 2014, reg 215(1) (N.Z.).
[427] *Id.* at reg 215(1)(f)(i).
[428] *Id.* at reg 215(1)(f)(ii).
[429] *Id.*
[430] *Id.* at reg 215(1)(g).
[431] *Id.* at reg 215(1)(h).
[432] *Id.* at reg 215(1)(i).
[433] *Id.* at reg 215(1)(k).
[434] *Id.* at reg 215(1)(l).
[435] *Id.* at reg 215(1)(m)–(n).
[436] *Id.* at reg 196(1).

> financial products to have disclosed information that is important for investors to make an informed decision. The usual rules do not apply to offers by issuers using this facility. As a result, you may not be given all the information usually required. You will also have fewer other legal protections for this investment. Ask questions, read all information given carefully, and seek independent financial advice before committing yourself.[437]

5. Requirement to Obtain Investor Confirmation

Regulation 197(1) requires crowdfunding service providers to obtain a confirmation from an investor to the effect that the investor has seen the warning statement about crowdfunding and understands the risks involved.[438] This confirmation must be obtained in writing in a separate document.[439]

6. Issuers Must Not Breach $2 Million Aggregate Limit

The regulations limit companies using crowdfunding, P2PL services, or the small offers exclusion under Schedule 1 of the FMC Act to a NZ$2 million "aggregate limit."[440] This means that issuers may not raise more than $2 million from the public in any twelve-month period.[441] At first glance, this appears to be a variation of the so-called "20/12" exclusion to the prospectus requirements of the cognate Australian legislation.[442] The key difference is that while the monetary limit is the same, the New Zealand provisions have no limit on the number of investors.[443] Further, those investors need not be sophisticated or have a high net worth.[444]

New Zealand was the first of the former British enclaves in the Southern Hemisphere (Hong Kong, Malaysia, Singapore, Australia, and New Zealand) to introduce a discrete regime for

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[437] *Id.* at reg 196(2).
[438] *Id.* at reg 197(1).
[439] *Id.* at reg 197(2).
[440] *Id.* at reg 186(1)(g).
[441] *Id.*
[442] *See supra* notes 338–39 and accompanying text.
[443] Financial Markets Conduct Regulations 2014, reg 186(1)(g) (N.Z.).
[444] *Compare* Financial Markets Conduct Regulations 2014, reg 186 (N.Z.), *with Australian Corporations Act 2001* (Cth.) ss 708(1)–(7) (Austl.).

crowdfunding.[445] The regime introduces relaxed disclosure requirements, while also introducing a form of merit regulation via the ability of the licensed intermediaries to choose and vet the firms they place on their platforms.[446]

C. Crowdfunding in the United States: The New Registration Exemption

The securities framework in the United States is based on the Securities Act of 1933 (Securities Act).[447] This Act operates in conjunction with the Securities Exchange Act of 1934 (Exchange Act), which created the U.S. Securities and Exchange Commission (SEC).[448] The Acts were enacted in response to the 1929 stock market crash.[449] The SEC is responsible for enforcing the securities laws and promoting public confidence in capital markets.[450] In addition, the Sarbanes-Oxley Act of 2002 (SOX Act) imposes various corporate governance, accounting, and financial reporting requirements on companies.[451]

Under the Exchange Act, companies are required to register the distribution of securities with the SEC prior to engaging in the interstate sale of securities.[452] This requirement pertains unless one of three exemptions applies under Regulation D.[453] These exemptions correspond to Rules 504, 505, and 506 respectively, with Rule 506 having the most impact.[454]

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[445] *New Zealand Equity Crowdfunding 1st Year in Review*, CROWDREADY, http://www.crowdready.com.au/updates/ [https://perma.cc/9W98-KMBA].

[446] *Id.*

[447] Securities Act 1933, Pub L. 73-22, 48 Stat. 74 (codified as 15 U.S.C.A. § 77a (West 2015)).

[448] SEC, SMALL BUSINESS AND THE SEC: A GUIDE FOR SMALL BUSINESSES ON RAISING CAPITAL AND COMPLYING WITH THE FEDERAL SECURITIES LAWS (Oct. 2013), http://www.sec.gov/info/smallbus/qasbsec.htm#regd [https://perma.cc/4ZGV-R8LK].

[449] *Id.*

[450] SEC, HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION, http://www.sec.gov/about/whatwedo.shtml [https://perma.cc/R65L-8SP4].

[451] Sarbanes-Oxley Act of 2002, Pub L. 107-204, 116 Stat. 745 (2002).

[452] SEC, *supra* note 448.

[453] *Id.*

[454] 17 C.F.R. §§ 200.504–506 (2015).

The SEC adopted Regulation D in 1982 with the aim of establishing certain exemptions for companies that issue securities.[455] The main purpose of the exemptions is to allow companies to issue securities without having to register them with the SEC.[456] Regulation D extends to accredited investors and uses income criteria for determining when the registration requirement does not apply.[457] For example, an accredited investor is defined as someone who, at the time of the purchase of the securities, has a net worth of $1 million or more, not including the value of his or her primary residence.[458] This is the so-called net worth test applied under Regulation D.[459] Alternatively, using an income-based definition, an accredited investor may also be defined as an individual with income exceeding $200,000 during the two most recent years or with joint income (with a spouse) above $300,000 in each of the two most recent years.[460] Accredited investors typically include banks, financial institutions, various investment funds, directors, and executive officers of an issuer; and individuals satisfying the net worth or income-based definitions applied under the Act.[461]

Section 4(a)(5) of the Securities Act exempts a company from registering offers and sales of securities with the SEC where the total offering price is less than $5 million and the offers or sales are made to accredited investors.[462] The company may make an offering to an unlimited number of accredited investors, but only up to thirty-five unaccredited investors.[463] The requirement under Rule 506, however, is that an unaccredited investor must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within

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[455] Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 358 (1984).

[456] *Id.*

[457] *Id.* at 368–69.

[458] *Id.* at 369; 15 U.S.C.A. § 77b(a)(15)(ii) (West 2015).

[459] Warren, *supra* note 455, at 382.

[460] SEC, INVESTOR BULLETIN: ACCREDITED INVESTORS, http://www.sec.gov/investor/alerts/ib_accreditedinvestors.pdf [https://perma.cc/5WL9-FEF9].

[461] *Id.*

[462] 15 U.S.C.A § 77d(a)(5) (West 2015).

[463] SEC, *supra* note 448.

this description."[464] This usually limits offerings to accredited investors only.[465] Furthermore, the issued securities are regarded as "restricted securities"—generally offered to friends and family—and purchasers may not resell them without registration or an applicable exemption.[466] Accordingly, an issuer is obliged to determine that the investor is purchasing the restricted securities for investment purposes only, rather than resale.[467]

As a result of this regulatory structure, small investors were generally unable to participate in investing in startups, while startups were unable to attract funds from small investors.[468] Regulation D, therefore, effectively precluded the emergence of crowdfunding projects online, as this involves the raising of capital with public solicitation from unaccredited investors.[469]

To date, websites such as Kickstarter in the United States have not been used to sell securities.[470] This was intended to change with the passage of the Jumpstart Our Business Startups (JOBS) Act.[471] The JOBS Act was passed on April 5, 2012, and it was originally expected that the Act would be implemented by the SEC by January 1, 2013.[472] President Obama described the JOBS Act for startups and small businesses as a potential "game changer."[473] The primary aim of the legislation is to promote the formation of new companies and spur job growth.[474] The Act introduces a new term—an "emerging growth company" ("EGC")—and deals with

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[464] 17 C.F.R. § 230.506 (2015).

[465] *Id.*

[466] Warren, *supra* note 455, at 366 n.63.

[467] DRESNER, *supra* note 92, at 151.

[468] Claudia Buck, *Personal Finance: Crowdfunding Helps Creative People Raise Money for Their Projects*, SACRAMENTO BEE (Apr. 7, 2013), http://www.sacbee.com/news/local/article2577111.html [https://perma.cc/A9YC-HAXK].

[469] DRESNER, *supra* note 92, at 10.

[470] Brad Hamilton, *The Colorado Crowdfunding Act—The Online Intermediary (Part 2 of 2)*, BUS. FIN. & SEC. L. BLOG (May 16, 2015), https://bradhhamilton.wordpress.com/2015/05/16/ [https://perma.cc/X9CC-2LX9].

[471] *Id.*

[472] *Id.*

[473] Jean Eaglesham, *Crowdfunding Efforts Draw Suspicion*, WALL ST. J., Jan. 18, 2013, C1.

[474] Thomas A. Martin, The Jobs Act of 2012: Balancing Fundamental Securities Law Principles with the Demands of the Crowd 2 (Apr. 12, 2012) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2040953 [https://perma.cc/ET32-VWFP].

crowdfunding as well as small issues.[475] There is significant overlap here, as an EGC may issue securities to a crowd via a crowdfunding platform referred to as a "funding portal" in the legislation while also relying on the small issues exemption.[476] Title I of the Act is devoted to EGCs, while Titles II and III deal with crowdfunding and small issues.[477] Title II permits startups to generally solicit accredited investors, while Title III of the JOBS Act allows startups and small businesses to use SEC-registered websites to raise debt or equity capital, effectively legalizing crowdfunding.[478] The SEC has stated:

> To the extent that crowdfunding rules are successfully utilized, the crowdfunding provisions of the JOBS Act should provide startups and small businesses with the means to raise relatively modest amounts of capital, from a broad cross section of potential investors, through securities offerings that are exempt from registration under the Securities Act. They also should permit small investors to participate in a wider range of securities offerings than may be available currently.[479]

Early euphoria surrounding the JOBS Act diminished during the rulemaking phase. Title II was implemented in September 2013; proposed rules under Title III came out in October 2013 but then stalled, and rules under Title IV (Small Company Capital Formation) were promulgated in March 2015. It was not until October 30, 2015 that the SEC issued revised rules for Title III.[480] The specific provisions of the JOBS Act are explored below.

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[475] *Id.* at 8, 13–14.

[476] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 304(h) (2012).

[477] *Id.*

[478] Title II removes the prohibition on general solicitation in Rule 506 (17 C.F.R. § 230.506 (2015)) offerings. Startups may solicit accredited investors provided they undertake "reasonable steps to verify" the accredited status of the investors. Some notable examples of Title II sites are AngelList, FundersClub, and CircleUp. For discussion, see Ibrahim, *supra* note 5, at 114–16.

[479] Proposed Crowdfunding Rules, *supra* note 253, at 344.

[480] *See* Press Release, SEC, SEC Adopts Rules to Facilitate Smaller Companies Access to Capital (Mar. 25, 2015); Press Release, SEC, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015). The latter rules will not come into force until 2016. For comment, see J.D. Harrison, *SEC finalizes key JOBS Act rules for small businesses*, WASH. POST (Mar. 25, 2015), https://www.washingtonpost.com/news/on-small-business/wp/2015/03/25/sec-finalizes-key-jobs-act-rules-for-small-businesses/ [https://perma.cc/BH78-Y95N] (discussing the Title IV rules)

1. The Crowdfunding Exemption Under Title III of the JOBS Act

Title III of the Act introduces a new exemption from the registration requirements under Section 5 of the Securities Act of 1933 in order to facilitate certain crowdfunding transactions.[481] This exemption is added as a crowdfunding transactional exemption under Section 4(a)(6) of the Securities Act.[482] In response to these amendments, the SEC published proposed Rule S7-09-13 in order to establish a framework for the implementation of the exemption. Under the proposed rule, a crowdfunding offering will fall within the exemption under the JOBS Act if the criteria outlined below are met.[483]

a. Limits on Maximum Funds that an Issuer Can Raise

First, the total amount raised must not exceed $1 million in a twelve-month period.[484] For example, a startup may raise $500,000 in a first crowdfunding and raise another $500,000 in a second crowdfunding within a year. However, when the startup has raised $1 million in the past twelve months, it will be unable to utilize crowdfunding.[485] This restriction, therefore, places the focus of the JOBS Act on new, very early-stage companies, rather than companies that have already received crowdfunding. The SEC has noted in this context that

> [t]he limitation on the amount that may be raised could benefit investors by reducing the potential for dilution or fraud. However, we recognize that the cap on the maximum amount that may be sold … also could prevent certain issuers from raising all the capital they need to make their businesses viable.[486]

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and Stacey Cowley, *SEC puts Wall St. Spin on crowdfunding model*, INT'L N.Y. TIMES, Nov. 2, 2015, at 15.

[481] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-105, § 302, 126 Stat. 306 (2012) (amending 15 U.S.C.A. § 77d(6) (West 2015)).

[482] *Id.* § 302(a). For a discussion of Title III crowdfunding, see Ibrahim, *supra* note 5, at 136. Ibrahim argues that Title III provides for true equity crowdfunding in the United States and represents a paradigm shift in entrepreneurial finance.

[483] Proposed Crowdfunding Rules, *supra* note 253, at 14.

[484] Jumpstart Our Business Startups (JOBS) Act § 302.

[485] DRESNER, *supra* note 92, at 83.

[486] Proposed Crowdfunding Rules, *supra* note 253, at 353.

b. Investment Caps

Second, individual investments in a twelve-month period are limited to the greater of $2,000 or 5 percent of an investor's annual income or net worth if annual income or net worth of the investor is less than $100,000, or 10 percent of annual income or net worth (not to exceed an amount sold of $100,000) if annual income or net worth of the investor is $100,000 or more.[487] Under the proposed SEC rules, it is envisaged that an issuer will be able to rely on the efforts of an intermediary to determine that an investor has not exceeded the investment limits.[488] To rely on an intermediary, however, the issuer must not have knowledge that the investor has exceeded or would exceed the investment limits.[489]

c. Registration Requirement: Channeling ECF Through Registered Brokers or "Funding Portals"

Third, transactions must be conducted through a registered broker dealer or a new type of registered entity called a "funding portal."[490] In this context, the SEC Commissioner has noted:

> Under the proposed rules, the crowdfunding intermediary is required to keep an eye out for fraud and to have a reasonable basis for believing that the issuer has complied with the requirements of the exemption. The crowdfunding intermediary will also provide a forum for information sharing, with communications by an issuer or paid promoter clearly identified as such.[491]

d. Disclosure Requirements

Companies wishing to conduct a crowdfunding offering would be required to disclose, in an offering document, certain information, including:

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[487] Jumpstart Our Business Startups (JOBS) Act § 302.

[488] Proposed Crowdfunding Rules, *supra* note 253, at 28.

[489] *Id.*

[490] Jumpstart Our Business Startups (JOBS) Act § 302.

[491] Luis A. Aguilar, Comm'r, SEC, Remarks at SEC Open Meeting: Harnessing the Internet to Promote Access to Capital for Small Businesses, While Protecting the Interests of Investors (Oct. 23, 2013) (transcript available at http://clsbluesky.law.columbia.edu/2013/11/19/sec-commissioner-aguilar-discusses-the-secs-crowdfunding-proposal/ [https://perma.cc/Z6CA-MEB9]). For a discussion, see Ibrahim, *supra* note 5, at 156. Ibrahim argues that funding portals ought to be redefined to function as reputational intermediaries to prevent the lemons problems in the equity crowdfunding market.

- basic information about the issuer;[492]
- information about officers and directors and each person owning 20 percent or more of the shares of the issuer;[493]
- "a description of the business of the issuer and the anticipated business plan;[494]
- a description of the financial condition of the issuer ... and [the] intended use of the proceeds of the offering;[495]
- the target offering amount ... and updates regarding progress in meeting the target offering amount;[496]
- the price to the public of the securities ... ;[497]
- certain related-party transactions;"[498] and
- financial statements of the issuer that, depending on the amount offered and sold during a twelve-month period, would have to be accompanied by a copy of the issuer's tax returns or reviewed or audited by an independent public accountant.[499]

The objective of disclosure in this context is to allow investors to better evaluate the quality of the offerings and the issuing firm.[500] Disclosure is intended to "reduce information asymmetry between investors and entrepreneurs" and "enhance both the transparency and efficiency of the [crowdfunding] market."[501]

Issuers who seek a greater target offering amount are required to disclose more information than those issuers who seek less capital.[502] The law takes a sliding scale approach to the question

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[492] Proposed Crowdfunding Rules, *supra* note 253, at 41.
[493] *Id.*
[494] *Id.*
[495] *Id.*
[496] *Id.*
[497] *Id.*
[498] *Id.* at 59.
[499] *Id.* at 65.
[500] *Id.* at 391.
[501] *Id.* at 391–92. The disclosure rules are based on an assumption that crowd investors will read the disclosure statements. For a discussion on the limits of disclosure and the efficient markets hypothesis in the context of crowdfunding, *see* Ibrahim, *supra* note 5, at 146.
[502] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-105, § 302(b), 126 Stat. 306 (2012) (amending 15 U.S.C.A. § 77d(6) (West 2015)).

of the issuer's financial condition.[503] For example, an issuer seeking $100,000 or less must only disclose its income tax returns for the most recently completed year, if any, and financial statements certified by the principal executive officer.[504] Conversely, where the issuer is seeking a target offering amount between $100,000 and $500,000, there is an obligation to disclose financial statements reviewed by an independent public accountant in accordance with any applicable standards and regulations published by the SEC.[505] Audited financial statements must only be disclosed if the issuer is seeking an amount above $500,000.[506]

As far as describing the financial condition of the issuer, the rules do not provide specific requirements as of yet.[507] However, this would likely include a discussion of liquidity and capital resources, as well as revenues and expenses, if applicable.[508] This requirement is particularly important for drawing attention to the cash needs of the enterprise and the likely sources of capital.

The JOBS Act also requires "a description of the stated purpose and intended use of the proceeds of the offering," as well as the target offering amount.[509] The key restriction here, as stated above, is that startups cannot raise more than $1 million a year using crowdfunding.[510] Furthermore, startups may choose to raise below $500,000 in order to avoid having to prepare financial statements that are audited by an independent accounting firm. The Act does not contain specific requirements with respect to how the "use of the proceeds" section is to be described, with firms likely to delineate such items as marketing, research and development, and other corporate purposes.[511]

2. Regulation of "Funding Portals" or Intermediaries

A "funding portal" is defined as "any person acting as an intermediary in a transaction involving the offer or sale of securities

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[503] *Id.*
[504] *Id.; see also* DRESNER, *supra* note 92, at 88.
[505] Jumpstart Our Business Startups (JOBS) Act § 302(b).
[506] *Id.*
[507] DRESNER, *supra* note 92, at 88.
[508] *Id.*
[509] Jumpstart Our Business Startups (JOBS) Act § 302(b).
[510] *Id.* § 302(a)(6)(A).
[511] *Id.* § 302(b)(1)(E)-(F).

for the account of others, solely pursuant to Section 4(6) of the Securities Act of 1933."[512] The "funding portal" or registered broker is responsible for, among other things, facilitating crowdfunding transactions and providing educational information to potential investors.[513] The SEC describes the function of funding portals as follows: "[t]he use of a registered intermediary to match issuers and investors would require that they incur certain transactions costs necessary to support the intermediation activity, but also would provide centralized venues for crowdfunding activities that should lower investor and issuer search costs."[514]

Further, the SEC has stated the "requirement [to conduct crowdfunding campaigns through online portals] should help issuers gain exposure to a wide range of potential investors, who also may benefit from having numerous investment opportunities aggregated in one place, resulting in lower search costs or burdens related to identifying suitable investment opportunities."[515]

A portal cannot engage in soliciting purchases, sales, or offers to buy securities offered or displayed on its website or portal, and it must take various measures to reduce fraud risk.[516] For example, an intermediary must register with applicable self-regulatory organizations and conduct due diligence measures.[517] The portal is prohibited from holding, managing, or otherwise handling investor funds or securities, and cannot offer investment advice or recommendations.[518] These restrictions are designed to protect investors.[519] Commenting on the latter requirement, the SEC notes "the requirement that the [bank] account in which funds are deposited be exclusively for the benefit of investors

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[512] 15 U.S.C.A. § 78c(a) (West 2015).

[513] Proposed Crowdfunding Rules, *supra* note 253, at 378.

[514] *Id.* For discussion, see Ibrahim, *supra* note 5, at 154–55. The author argues that funding portals should not be envisioned as passive entities, but as active reputational intermediaries whose role is not simply to match buyers and sellers but to serve as signals of startup quality. Funding portals should be primarily tied to startups, not investors. *See* Joan Macleod Heminway, *The New Intermediary on the Block: Funding Portals Under the Crowdfund Act*, 13 U.C. DAVIS BUS. L.J. 177, 178 (2013).

[515] Proposed Crowdfunding Rules, *supra* note 253, at 388.

[516] Jumpstart Our Business Startups (JOBS) Act § 302.

[517] *Id.*

[518] 15 U.S.C.A. § 78c(h) (2015).

[519] Proposed Crowdfunding Rules, *supra* note 253, at 401.

and the issuer would help prevent the intermediary or other parties from claiming or otherwise unlawfully taking funds from that account."[520] The restriction on offering investment advice corresponds to similar prohibitions on broker-dealers.[521]

Congress placed special emphasis on the educational role of the funding portal, requiring portals to ensure that investors have reviewed any relevant information.[522] Intermediaries must therefore—among other things—provide general disclosure to investors about the inherent risks involved in equity crowdfunding.[523] Further, investors must positively affirm that they understand they risk losing the entire investment and must be able to bear such loss.[524] Investors must answer questions with the aim of demonstrating "an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers; an understanding of the risk of illiquidity; and an understanding of such other matters as the Commission determines appropriate."[525] It is unclear how these requirements, particularly the latter, are to be implemented and whether the insertion of such matters into a websites' terms and conditions would suffice for the intermediary to ensure that investors are aware of the risks involved.

a. Electronic Bulletin Boards

Crowdfunding intermediaries may include an electronic bulletin board that allows potential investors to communicate about an offering.[526] This is not a legal requirement under the JOBS Act, although it was included in an earlier version of the House crowdfunding bill.[527] The SEC may adopt such a bulletin board requirement for funding portals as part of its additional rules.[528] The bulletin board would function as an open forum, allowing

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[520] *Id.*

[521] Jumpstart Our Business Startups (JOBS) Act § 302.

[522] *Id.*

[523] *Id.* With this view, funding portals' primary relationship is that with investors. *See* Ibrahim, *supra* note 5, at 156–58.

[524] Jumpstart Our Business Startups (JOBS) Act § 302.

[525] *Id.*

[526] DRESNER, *supra* note 92, at 119.

[527] Entrepreneur Access to Capital Act of 2011, 112 H.R. 2930 § 2(b) (2011).

[528] *See* Proposed Crowdfunding Rules, *supra* note 253, at 34.

the public to share knowledge about investment risks, businesses, and particular entrepreneurs.[529] The SEC has stated that "a premise of crowdfunding is that investors would rely, at least in part, on the collective wisdom of the crowd to make better informed investment decisions."[530]

b. Material Misstatements and Omissions

Title III of the JOBS Act introduces a cause of action under the newly created section 4a(c) of the Securities Act.[531] This cause of action is specifically targeted at crowdfunding offerings.[532] Pursuant to Section 4(a)(c), issuers are subject to liability for material misstatements or failing to comply with relevant disclosure obligations.[533] Liability will attach regardless of the issuer's knowledge or intent.[534] Section 4(a)(c) operates alongside the general anti-fraud provisions of Section 10(b) of the Securities Exchange Act and Rule 10b-5. These rules also apply to crowdfunding offerings.[535]

c. EGCs

An EGC is defined as an "issuer that had total annual gross revenues of less than $1,000,000 ... during its most recently completed financial year."[536] This definition is intended to cover startup companies.[537] EGC status confers special benefits on

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[529] DRESNER, *supra* note 92, at 120.

[530] Proposed Crowdfunding Rules, *supra* note 253, at 376. However, as the rules presently stand, it is unclear whether a funding portal could host an online discussion among investors about the quality of the startups. For a critique, *see* Ibrahim, *supra* note 5, at 156–57. Ibrahim argues that Title III should be amended to allow funding portals to function as true reputational intermediaries for the startups they list. This would entail greater due diligence on part of the intermediaries and allow intermediaries to signal a company's quality, and thus, reduce information asymmetries to such an extent as to prevent the emergence of a market for lemons.

[531] Jumpstart Our Business Startups (JOBS) Act of 2012, 15 U.S.C.A. § 77d-1(c) (West 2012).

[532] *Id.* § 77d-1.

[533] *Id.* § 77d-1(c)(2)(A).

[534] *Id.* § 77d-1(c)(2).

[535] *See generally id.* § 77d-1.

[536] *Id.* § 77b(a)(19).

[537] *Id.*

companies, including an exemption from certain executive pay disclosure requirements and account disclosure requirements.[538] There is a wholesale exemption from Section 404(b) of the SOX Act, which imposes internal controls and auditing requirements, and EGCs are also exempt from mandatory audit firm rotation rules.[539] As far as investor communications are concerned, EGCs are free to communicate openly with qualified institutional buyers and accredited institutional investors.[540] For example, EGCs can engage in general solicitation and general advertising when making offerings to accredited investors. The JOBS Act specifically instructs the SEC to modify its rules in this context and lift any such bans with respect to EGCs.[541]

d. Intrastate Crowdfunding Exemptions

Dissatisfaction with the slow implementation of rules on crowdfunding under the JOBs Act has resulted in states enacting their own intrastate crowdfunding exemptions.[542] One report maintains that thirteen states have intrastate crowdfunding exemptions in place, while fourteen other states are considering such exemptions.[543] Compliance costs are said to be much lower under intrastate exemptions as compared with the federal rules.[544] Examples of intrastate exemptions are the Kansas Exemption (effective since August 2011),[545] the InvestGeorgia Exemption (effective since December 2012),[546] as well as the Michigan[547] and Wisconsin[548] exemptions. However, according to state securities regulators, few firms have taken advantage of the new fundraising exemptions.[549]

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[538] *Id.* § 7262(b).

[539] *Id.*

[540] *Id.* § 77e(d).

[541] *Id.*

[542] *See State of the States—List of Current Active and Proposed Intrastate Crowdfunding Exemptions (Updated)*, CROWDFUNDINGLEGALHUB, http://crowdfundinglegalhub.com/ [https://perma.cc/D62A-UQP4].

[543] *Id.*

[544] *See Crowdfunding exemption movement*, WIKIPEDIA, https://en.wikipedia.org/wiki/Crowdfunding_exemption_movement [https://perma.cc/T8DU-MGQA].

[545] KAN. ADMIN. REGS. § 81-5-21 (2011).

[546] GA. COMP. R. & REGS. 590-4-2-08 (2012).

[547] 2013 Mich. Pub. Acts 167.

[548] WIS. STAT. ANN. § 551.202 (West 2014).

[549] Loten & Simon, *supra* note 1, at B5.

D. Crowdfunding in the European Union

Crowdfunding plays an important role as an alternative source of financing in the European Union.[550] It is estimated that in 2012, about €735 milllion was raised for all forms of crowdfunding in Europe.[551] The figure is rather marginal when compared to traditional retail bank-lending and non-financial institutions (€6 trillion in 2011), but relatively significant when compared to the financing provided by business angels (visible market segment estimated at €660 million in 2010) or venture capitalists in seed, startup, later, and growth stages (€7 billion in 2012).[552]

A survey conducted by the European Commission in 2014 found that more than 75 percent of project owners saw crowdfunding as a viable means to reduce dependence on banks and other traditional means of finance.[553] Moreover, the project owners saw crowdfunding as a useful way to test market demand for their products and services.[554] The respondents saw the primary benefits of crowdfunding as being community involvement, engagement in innovation, the democratization of finance, and the empowerment of entrepreneurs.[555] Thus, crowdfunding has been likened to angel investing for the masses.[556]

In June 2014, the European Commission set up an Expert Group—the European Crowdfunding Stakeholders Forum—to examine the potential and risks of crowdfunding.[557] The task of

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[550] *See* EUR. COMM'N, CROWDFUNDING IN THE EU—EXPLORING THE ADDED VALUE OF POTENTIAL EU ACTION (Oct. 2013), http://clientebancario.bportugal.pt/pt-PT/Publicacoes/OrganismosInternacionais/Documents/CE_Consultation_Crowd funding.pdf [https://perma.cc/N7B8-WU5B].

[551] EUR. COMM'N, UNLEASHING THE POTENTIAL OF CROWDFUNDING IN THE EUROPEAN UNION (Mar. 2014), http://ec.europa.eu/internal_market/finances/docs/crowdfunding/140327-communication_en.pdf [https://perma.cc/Q4YC-YF65].

[552] *Id.*

[553] EUR. COMM'N, SUMMARY—RESPONSES TO THE PUBLIC CONSULTATION ON CROWDFUNDING IN THE EU (Mar. 2014), http://ec.europa.eu/internal_market/consultations/2013/crowdfunding/docs/summary-of-responses_en.pdf [https://perma.cc/5F9F-DA32].

[554] *Id.*

[555] *Id.*

[556] *See* Hornuf & Schwienbacher, *supra* note 232, at 11.

[557] EUR. COMM'N, CROWDFUNDING, http://ec.europa.eu/internal_market/finances/crowdfunding/index_en.htm [https://perma.cc/J52A-GE57].

the Group is to assist the Commission in developing policies for crowdfunding and, more generally, to raise awareness with respect to crowdfunding in the wider financial ecosystem.[558] Furthermore, the Group will assess whether regulatory intervention is necessary at the E.U. level, as there is currently no coherent framework in place.[559] Earlier, in March of 2014, the European Commission adopted a communication on crowdfunding.[560] The communication expressly identifies some of the challenges to crowdfunding, including lack of awareness and understanding amongst entrepreneurs, challenges related to the protection of intellectual property, fraud, legal uncertainty, and consumer protection concerns.[561]

However, the Commission also recognizes the high potential benefits that crowdfunding may yield, including innovation, research and development, economic growth, community development, and job creation.[562] Supporting crowdfunding, therefore, is seen as an important aspect of driving economic development.[563] In its *Entrepreneurship 2020 Action Plan—Reigniting the Entrepreneurial Spirit in Europe,* the Union noted that it seeks to increase the level of employment by reinforcing entrepreneurship.[564] Accordingly, the European Union invites member states to "[a]ssess the need of amending current national financial legislation with the aim of facilitating new, alternative forms of financing for startups and SMEs [small to medium enterprises] in general, in particular as regards platforms for crowd funding ...."[565] In its *Consultation Paper* on Crowdfunding, the Commission observed:

> In the context of SME's finance ecosystem, it appears that crowdfunding may respond to the needs of many small start-ups that do not manage to access bank finance, venture capital

[558] EUR. COMM'N, CROWDFUNDING FOR THE CULTURAL AND CREATIVE SECTORS: KICK-STARTING THE CULTURAL ECONOMY (Mar. 2015), http://ec.europa.eu/culture/calls/general/0315/reference_en.pdf [https://perma.cc/J9LB-S3C4].

[559] EUR. COMM'N, UNLEASHING THE POTENTIAL OF CROWDFUNDING IN THE EUROPEAN UNION (Mar. 2014), http://ec.europa.eu/internal_market/finances/docs/crowdfunding/140327-communication_en.pdf [https://perma.cc/Q4YC-YF65].

[560] *Id.*

[561] *Id.*

[562] *Id.*

[563] *See id.*

[564] EUR. COMM'N, ENTREPRENEURSHIP 2020 ACTION PLAN—REIGNITING THE ENTREPRENEURIAL SPIRIT IN EUROPE (Oct. 2013), http://eur-lex.europa.eu [https://perma.cc/C4M7-556G].

[565] *Id.*

> or reach the stage of initial public offering (IPO). Crowdfunding could thus contribute to bridging the finance gap for small firms and innovative projects. It could complement other sources of finance. Better access to finance for small businesses would promote entrepreneurship and ultimately contribute to growth and job creation. Crowdfunding creates opportunities to turn larger groups of people, who otherwise would not have access to traditional channels of finance, into small-scale entrepreneurs.[566]

1. The Development of Crowdfunding in the European Union

Crowdfunding has been able to develop in the European Union as a result of a number of factors, including prospectus rules.[567] The relevant E.U. regulatory framework presently applying to financial return crowdfunding (i.e., crowd investing and crowd lending) includes the Directives on Prospectus,[568] Payment Services,[569] Markets in Financial Instruments,[570] Capital Requirements,[571] Alternative Investment Fund Managers,[572] Consumer Credit,[573] Distance Marketing of Financial Services;[574] and the Regulations on Capital Requirements,[575] European Venture Capital,[576] and European Social Entrepreneurship Funds.[577] No specific crowdfunding rules, however, apply at the E.U. level.[578] Thus, there is no comprehensive E.U. crowdfunding legislation, and member states are free to devise their own crowdfunding-specific laws and rules.[579]

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[566] EUR. COMM'N, CONSULTATION PAPER: CROWDFUNDING IN THE EU—EXPLORING THE ADDED VALUE OF POTENTIAL EU ACTION 7 (Oct. 2013), http://ec.europa.eu/internal_market/consultations/2013/crowdfunding/docs/consultation-document_en.pdf [https://perma.cc/93E9-MUYA].

[567] DRESNER, *supra* note 92, at 204–05.

[568] *See* Council Directive 2003/71, 2003 O.J. (L 345) 64 (E.U.).

[569] *See* Council Directive 2007/64, art. 1, 2007 O.J. (L 319) 1, 12 (E.U.).

[570] *See* Council Directive 2004/39, art. 1, 2004 O.J. (L 145) (E.U.). The Payment Services Directive might apply also to crowd sponsoring, where the business model adopted is such that it falls under the scope of this instrument.

[571] *Id.*

[572] *See* Council Directive 2011/61, art. 2, 2011 O.J. (L 174) 1, 14 (E.U.).

[573] *See* Council Directive 2008/48, art. 2, 2008 O.J. (L 133) 66, 71 (E.U.).

[574] Council Directive 2002/65, 2002 O.J. (L 271) 16 (E.U.).

[575] Commission Regulation 575/2013, art. 1, 2013 O.J. (L 176) 1 (E.U.).

[576] Commission Regulation 345/2013, art. 1, 2013 O.J. (L 115) 1, 8 (E.U.).

[577] Commission Regulation 346/2013, art. 1, 2013 O.J. (L 115) 18, 26 (E.U.).

[578] DRESNER, *supra* note 92, at 203, 206.

[579] *Id.* at 204–05.

Turning to prospectus requirements, however, it is clear that the E.U. Prospectus Directive has directly facilitated the development of crowdfunding.[580] The Directive was amended by Directive 2010/73/EU of November 24, 2010, which establishes exemptions from the obligation to publish a prospectus.[581] For example, if an offer is solely addressed to qualified investors, there is no need to publish a prospectus.[582] The Directive also mandates that offerings of €5 million or more must be made in accordance with an approved prospectus.[583] Where an offering, however, falls below €5 million, it is subject to prospectus requirements made by individual E.U. member states.[584] Thus, the E.U. framework allows member states to set their own prospectus requirements with respect to offerings below €5 million.[585] Member states cannot require publication of a prospectus with respect to offerings below €100,000.[586] Accordingly, offerings of less than €100,000 are exempt from the obligation to publish a prospectus and crowdfunders are able to raise capital without being subject to such a requirement.[587]

It remains to be seen whether specific crowdfunding legislation will be adopted at the E.U. level. Obviously, one of the dangers of having divergent regulatory approaches in place in each member state is that this may result in a fragmented internal market and, ultimately, a lack of growth of European crowdfunding in the long term. Some statistics indicate that the lack of information about applicable rules prevents some equity crowdfunding platforms from operating in more than one E.U. country.[588] Moreover, the cost of obtaining authorization to operate in another

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[580] Council Directive 2003/71, 2003 O.J. (L 345) 64, 71 (E.U.) (regarding the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC).

[581] Council Directive 2010/73, 2010 O.J. (L 327) 1, 6 (E.U.).

[582] *Id.* at 6.

[583] *Id.* at 5; *see also* Council Directive 2003/71, 2003 O.J. (L 345) (E.U.).

[584] Council Directive 2003/71, 2003 O.J. (345) (E.U.)*; see* Council Directive 2010/73, 2010 O.J. (L 327) 5 (E.U.).

[585] Council Directive 2003/71, *supra* note 584; *see* Council Directive 2010/73, *supra* note 584, at 5.

[586] Council Directive 2010/73, *supra* note 584, at 2, 7.

[587] *Id.*

[588] EUR. COMM'N, CROWDFUNDING INNOVATIVE VENTURES IN EUROPE: THE FINANCIAL ECOSYSTEM AND REGULATORY LANDSCAPE (2014).

member state may be prohibitive, and crowdfunding platforms may forego the benefits of operating beyond the borders of their member state.[589]

If implemented properly, E.U.-level crowdfunding rules may promote the emergence of cross-border crowdfunding platforms. The delays around the implementation of the JOBS Act, however, would seem to suggest that this process in the European Union may, as in the United States, be long and protected.[590] Accordingly, an alternative to adopting crowdfunding-specific rules at the E.U. level is implementing a mutual recognition regime whereby each member state would be required to permit a crowdfunding platform to operate within its borders so long as the platform is properly regulated in its home jurisdiction.[591] The advantage of adopting this approach is that it would allow member states to adopt their own rules with respect to crowdfunding.[592] Alternatively, the European Union may opt for a clear, unified approach to crowdfunding by adopting a set of comprehensive rules that set minimum requirements and apply to crowdfunding platforms in all member states.

2. The United Kingdom as a European Example

The United Kingdom possesses one of the most developed crowdfunding markets in the European Union.[593] A report published in 2013 indicated that loan-based crowdfunding platforms raised 480 million pounds sterling in 2013, of which 287 million was loaned to individuals—an increase of 126 percent compared to 2012.[594]

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[589] *See* Yong Li & Shaker A. Zahra, *Formal institutions, culture, and venture capital activity: A cross-country analysis*, 27 J. OF BUS. VENTURING 95 (2012).

[590] Kendall Almerico, *SEC Delays Equity Crowdfunding Piece of JOBS Act for Another Year*, ENTREPRENEUR (Dec. 8, 2014), http://www.entrepreneur.com/article/240558 [https://perma.cc/G9Y9-HXSB].

[591] DRESNER, *supra* note 92, at 210.

[592] DRESNER, *supra* note 92, at 211.

[593] *See generally* Andy Davis, *Beyond the Banks: Innovative Ways to Finance Britain's Small Businesses*, NAT'L ENDOWMENT FOR SCI. TECH. AND THE ARTS (Sept. 2011), https://www.nesta.org.uk/sites/default/files/beyond_the_banks_innovative_ways_to_finance_britains_small_businesses.pdf [https://perma.cc/57AQ-DV9X].

[594] NAT'L ENDOWMENT FOR SCI. TECH. AND THE ARTS, THE RISE OF FUTURE FINANCE, THE UK ALTERNATIVE FINANCING BENCHMARKING REPORT 44 (Dec. 2013), *cited in* FIN. CONDUCT AUTH., POLICY STATEMENT 2014 (2014), http://www

A total of 193 million pounds sterling was loaned to businesses, an increase of 211 percent compared to 2012; investment-based crowdfunding platforms raised 28 million pounds sterling in 2013, an increase of 618 percent compared to 2012.[595]

a. The First U.K. Platforms

Investment-based crowdfunding in the United Kingdom tends to be dominated by two platforms: Crowdcube and Seedrs.[596] Launched in February of 2011, Crowdcube was the first British equity platform and, at the time of its commencement, lacked authorization by the Financial Services Authority (FSA)—which has since been split into the Prudential Regulation Authority and the Financial Conduct Authority (FCA).[597]

Crowdcube relied on the so-called "intragroup offering" exemption when launching its platform.[598] This exemption allows a group company to issue shares solely to shareholders of another member of the same corporate group and, thereby, bypass securities regulations.[599] Utilizing this exemption, Crowdcube allowed investors to become nominal shareholders of a Crowdcube group company and invest in startup companies seeking capital, which were also Crowdcube group companies, with Crowdcube typically taking more than 50 percent of the share capital in a startup and handing back the shares to the original owners after attracting capital from investors.[600] In February of 2013, Crowdcube obtained FSA authorization and now simply intermediates a direct share issuance from the startup to investors.[601]

Crowdcube operates as a pure intermediary only. This model may be compared to that of Seedrs, which launched in 2012.[602] Unlike Crowdcube, Seedrs takes a number of steps in each crowdfunding transaction, including approving each listing as a financial

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.fca.org.uk/static/documents/policy-statements/ps14-04.pdf [https://perma.cc/ZU9S-87A9].

595 *Id.*

596 DRESNER, *supra* note 92, at 52.

597 *Id.* at 206.

598 *Id.*

599 *Id.*

600 *Id.* at 206–07.

601 *Id.* at 207.

602 *Id.*

promotion and conducting due diligence on each startup. Other platforms that have emerged are CrowdBnk, FundtheGap, and BanktotheFuture.[603] These platforms are now subject to regulation by the FCA, as successor to the FSA, and the code of practice published by the U.K. Crowdfunding Association.[604] The FCA regulations are considered first, followed by a discussion of the code of practice.

b. FCA Regulation

In the United Kingdom, crowdfunding falls within the regulatory scope of the FCA.[605] Broadly speaking, the main aims of the FCA include consumer protection and the promotion of effective competition in consumer markets.[606] In October of 2013, the FCA published a consultation paper outlining its proposal to regulate both the loan-based and investment-based crowdfunding industries.[607] Following consultation, in March of 2014, the FCA published a set of rules to regulate the crowdfunding industry.[608] These rules came into force in April 2014 but are subject to certain transitional provisions.[609] The FCA has stated that its aims in regulating the crowdfunding industry are, on the one hand, to make crowdfunding "more accessible to a wider, but restricted, audience" of investors and, on the other hand, to ensure that "only those retail investors who can understand and bear the various risks involved are invited to invest in unlisted shares or debt securities."[610] Further, the FCA observes: "If [intermediaries] target this wider but still restricted audience of retail investors appropriately, this may result in greater access to alternative (non-bank) finance options for businesses seeking finance."[611] Hence, the key premise underpinning the U.K. approach to equity crowdfunding is to make crowdfunding available to a restricted audience

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603 *Id.*

604 *See* UK CROWDFUNDING ASS'N, CODE OF PRACTICE, http://www.ukcfa.org.uk/code-of-practice-2 [https://perma.cc/DB8U-ULQQ].

605 FIN. CONDUCT AUTH., *supra* note 2, at 10–15.

606 *Id.* § 1.22.

607 *Id.* at 10.

608 *Id.* at 9.

609 *Id.* at 12.

610 *Id.* at 36.

611 *Id.*

of investors, thereby limiting those investors who can participate in ECF campaigns.[612]

The new FCA rules apply to two categories of financing: loan-based crowdfunding that extends to peer-to-peer platforms (these cover loans from individual investors to other individuals), peer-to-business lending platforms (covering loans from individuals to businesses), or a combination of these models, and investment-based crowdfunding platforms by which consumers purchase shares or debt securities in new or emerging companies.[613] The main policy rationales underpinning the rules are the protection of retail investors who, owing to a lack of knowledge, experience, or resources, may incur significant financial losses; and the effective promotion of competition within the crowdfunding markets.[614] The rules do not extend to donation-based or rewards-based crowdfunding.[615] Accordingly, some crowdfunding activities remain unregulated in the United Kingdom.[616]

Interestingly, the FCA regards loan-based crowdfunding as involving fewer risks than investment-based crowdfunding.[617] The main thrust of the rules is to require loan-based crowdfunding platforms to follow certain capital requirements rules, describe risks accurately, and have resolution plans in place to administer loans in case the platform fails.[618] For example, the rules expressly state that

> [a]n operator of an electronic system in relation to lending must take reasonable steps to ensure that arrangements are in place to ensure that P2P agreements facilitated by it will continue to be managed and administered, in accordance with the contract terms, if at any time it ceases to carry on the activity of operating an electronic system in relation to lending.[619]

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[612] *Id.*
[613] *Id.* at 4.
[614] *Id.* at 5.
[615] *Id.* at 11.
[616] *Id.*
[617] *Id.* at 6.
[618] *See generally* FIN. CONDUCT AUTH., FCA HANDBOOK: SYSC AVAILABLE, https://www.handbook.fca.org.uk/handbook/SYSC/4/1.pdf [https://perma.cc/HA2D-WLC4].
[619] *Id.* at Rule 4.1.8A (emphasis removed).

Such arrangements may include entering into an agreement with another firm to take over the management and administration of the P2P agreement; holding sufficient collateral in a segregated account to cover the costs of management and administration in the event of platform failure; and managing the loan book in a manner that ensures that income from P2P agreements facilitated by the firm is sufficient to cover the costs of managing and administering loans during the winding down process.[620] The FCA refers to loan agreements as P2P agreements.[621]

The minimum financial resources to be held by a loan-based crowdfunding platform are the higher of the following: £20,000 (increasing to £50,000 from 1 April 2017); or the sum of:

(1) 0.3% of the volume of loaned funds up to £50 million;
(2) 0.2% of the volume of loaned funds above £50 million up to £500 million; and
(3) 0.1% the volume of loaned funds above £500 million.[622]

The total value of loaned funds outstanding is defined as the total amount of funds that are currently being provided to borrowers under P2P agreements through an operator of an electronic system in relation to lending.[623]

As far as disclosure is concerned, examples of the types of information firms are expected to disclose to explain the specific nature and risks of a P2P agreement include the following:

- expected and actual default rates;
- a summary of the assumptions used in determining expected future default rates;
- a description of how loan risk is assessed, including a description of the criteria that must be met by the borrower before the firm considers the borrower eligible for a P2P agreement;
- the creditworthiness assessment of the borrower carried out; whether the P2P agreement benefits from any security and, if so, what; a fair description of

[620] *Id.* at Rule 4.1.8C.
[621] FIN. CONDUCT AUTH., *supra* note 594, at 5.
[622] FIN. CONDUCT AUTH., *supra* note 2, at 21.
[623] *Id.* app. 1 at 9.

the likely actual return, taking into account default rates and taxation;
- an explanation of how any tax liability for lenders arising from investments into P2P agreements would be calculated;
- an explanation of the firm's procedure for dealing with late loan payments and loans in default;
- the procedure for a lender to access their money before the P2P agreement has expired; and,
- lastly, an explanation of what would happen if the firm fails.[624]

c. Authorization Requirements for P2PL Platforms

The rules require firms running loan-based crowdfunding platforms as of April 1, 2014, to apply for full authorization from the FCA.[625] Transitional arrangements apply to firms that hold a consumer credit license from the Office of Fair Trading (OFT).[626] The FCA assumed responsibility for the regulation of consumer credit markets from the OFT on April 1, 2014.[627] All firms are required to become fully authorized by March 31, 2017.[628] However, OFT-regulated loan-based crowdfunding firms are not subject to the new prudential standards until they become fully FCA-authorized.[629] Firms with a valid OFT license on March 31, 2014 are granted "interim permission" and will be able to continue carrying on the consumer credit activities they are licensed for until they become authorized.[630] Upon becoming fully FCA-authorized, firms must submit financial and prudential reporting returns.[631] The FCA requires loan-based crowdfunding firms to comply with regular reporting requirements.[632] In addition, the rules provide investors with a right to complain,

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624 FIN. CONDUCT AUTH., *supra* note 2, app. 1 at 32.
625 FIN. CONDUCT AUTH., *supra* note 2, at 12.
626 *Id.*
627 *Id.* at 4.
628 *Id.* at 21.
629 *Id.*
630 *Id.* at 12.
631 *Id.* at 12, 34.
632 *Id.* at 34–35.

in the first instance, to the firm running the platform, and in the second instance, to the Financial Ombudsman Service.[633]

d. Restricting the Category of Investors Participating in ECF Campaigns

As stated, the new rules also extend to firms that operate investment-based crowdfunding platforms on which consumers can invest into equity or debt securities that are not listed or traded on recognized stock exchanges.[634] In this context, the FCA is of the view that, given the significant risks investors face when investing in unlisted securities that are hard to price or sell on a secondary market, firms offering investments on crowdfunding platforms (or other media) may only make a "direct offer financial promotion" to a restricted category of investors.[635] These are professional clients, retail clients who are advised, retail clients classified as corporate finance contracts or venture capital contracts, sophisticated or high net worth retail clients, or retail clients who confirm that they will not invest more than 10 percent of their net investible assets into these products.[636] A "direct offer financial promotion" is defined as (a) an offer by the firm or another person to enter into a "controlled agreement" with any person who responds to the communication, or (b) an invitation to any person who responds to the communication to make an offer to the firm or another person to enter into a controlled agreement, and which specifies the manner of response or includes a form by which a response may be made.[637] Accordingly, the FCA seeks to restrict direct offer financial promotions but not all promotions. For example, if a communication only gives general marketing information about the firm, it does not fall within this definition. Conversely, the restriction will apply if information is provided about a specified investment opportunity.[638]

The restriction described above is intended to protect retail investors who are subject to special risks. Such risks in the context

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633 *Id.* at 33.
634 *Id.* at 36.
635 *Id.* at 7.
636 *Id.* at 6–7.
637 *Id.* at 31.
638 *Id.* at 37.

of investment-based crowdfunding include the risk of capital loss, which is exacerbated if the price of the security is over-valued or where the security is a long-term debt security which will not return capital for up to twenty to twenty-five years.[639] Additionally, investors face the risk of dilution of shareholder value, illiquidity risks, and the risk that dividends may not be declared.[640] Illiquidity risks arise because there may not be a secondary market through which shares or debt securities acquired through ECF or P2PL platforms may be sold.[641] As a result, the profitable exit route is likely to be the sale of the venture to a third party.

The FCA considers longer-term illiquid unlisted debt securities offered by companies to carry more risk of capital loss for investors vis-à-vis short-term P2P agreements.[642] Consequently, the FCA maintains a clear distinction in its regulatory approach between P2P agreements and non-readily realizable securities.[643] Thus, if an individual signs a Restricted Investor Statement, firms can communicate direct offer financial promotions for non-readily realizable securities to that individual for twelve months after the date of the statement.[644] Firms have an obligation to satisfy that there are valid statements in place at the time they communicate a promotion, but firms are not required to ensure that individuals qualify as "restricted investors" on an ongoing basis.[645]

e. The U.K. Crowdfunding Association Code of Practice

Crowdfunding platforms wishing to obtain membership in the U.K. Crowdfunding Association must adhere to the principles set out in the United Kingdom Crowdfunding Association Code of Practice.[646] The principles apply to both FCA authorized and non-authorized platforms.[647] The key principles can be summarized as follows:

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639 *See id.*
640 *Id.* at 15.
641 *Id.*
642 *Id.* at 37.
643 *Id.* at 66.
644 *Id.* app. 1 at 17.
645 *Id.* app. 1 at 16–17.
646 UK CROWDFUNDING ASS'N, CODE OF PRACTICE (2014), http://www.ukcfa.org.uk/code-of-practice-2 [https://perma.cc/U932-47H3].
647 *Id.*

- Investments and donations are to be kept separate from the business, in client accounts or similar segregated money-handling structures.
- Transparency is regarded as paramount. Investors and donors must be able to see information on where their money is kept as well as the amount and any transactions.
- Firms must put processes in place to ensure that investment holdings are accessible in the event that the firm ceases to operate.
- Firms agree to provide a cooling-off period in case investors or donors change their mind after making an investment or donation.
- Terms and conditions must be clearly written and set out and explain exactly how the investment process works, what the duties and responsibilities of the platforms are, what due diligence has been undertaken, and what fees and charges will apply and when.
- Executive Directors' details will be published on the U.K. Crowdfunding Association website.
- Firms must ensure their IT systems and business processes are secure, reliable, and proportionate to the nature, scale, and complexity of the business and are sufficiently robust to facilitate compliance with applicable law, regulations, and the Code of Conduct.
- Firms must comply with the laws and regulations applicable to their sales and marketing activity, and ensure that all U.K. Crowdfunding Association members' communications are fair, clear, and not misleading; that risks and potential returns are presented in a balanced way; and that investors and donors are treated fairly.
- If investors or donors are unhappy about any aspect of a member's service, they are able to complain, and firms will publish their performance on complaints on the U.K. Crowdfunding Association website every year.[648]

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[648] *Id.*

3. The Netherlands, Germany, Italy, and France

The Netherlands is generally ranked highly in terms of number of crowdfunding platforms.[649] The leading equity platform in the Netherlands is Symbid.[650] Symbid operates in a manner whereby so-called cooperatives hold shares of the underlying start-ups, and investors can acquire membership units in the cooperatives.[651] Cooperatives allow an intermediary to manage the shares of the underlying company.[652] Adopting this cooperative structure has allowed Symbid to bypass the requirement of seeking authorization from a regulatory authority.[653]

In Germany, there are a number of crowdfunding platforms, including Bankless24, Bergfürst, Berlin Crowd, BestBC, Companisto, Crowdrange, Deutsche Mikroinvest, Devexo, Fundsters, Gründerplus, Innovestment, MyBusinessBacker, Power4Projects, Seedmatch, Startkapital Online, and United Equity.[654] One portal—Companisto—has set up a special purpose vehicle—Companisto Venture Capital GmbH—to pool investments from the crowd.[655] Crowd investors buy securities from this special purpose vehicle, which then invests on their behalf in the startup.[656] Companisto operates in a similar manner to the Dutch Symbid, allowing for investments to be pooled.[657] The total amount raised between 2011 and July 1, 2014 was €27.7 million.[658] In this period, 140 successful ECF campaigns were carried out.[659]

A common structure adopted in Germany by equity crowdfunding platforms is the silent partnership (Stille Beteiligung).[660] This structure allows investors to acquire silent partnership units

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[649] WORLD BANK, *supra* note 63, at 18.
[650] DRESNER, *supra* note 92, at 207.
[651] *Id.* at 207–08.
[652] *Id.* at 208.
[653] *Id.*
[654] Lars Hornuf & Armin Schwienbacher, *The Emergence of Crowdinvesting in Europe* 16 (2015), http://ssrn.com/abstract=2481994 [https://perma.cc/KH43-6Z43].
[655] *Id.* at 14.
[656] *Id.* at 10.
[657] *Id.* at 14.
[658] LMU FORSCHUNGSDATENBANK, CROWDINVESTING (July 1, 2014).
[659] *Id.*
[660] DRESNER, *supra* note 92, at 208.

from an investee company.[661] Such units are comparable to equity-like shares in a company. They give investors a pre-defined share of profits, but no voting rights.[662] Hence, voting rights cannot be sold via ECF platforms in Germany, but the sale of silent partnership units is permissible.[663] The advantage of utilizing this structure is that silent partnerships have beneficial tax treatment in Germany.[664] Germany has not passed specific laws regulating crowdfunding.[665] Crowdfunding, therefore, takes place within the existing paradigm of securities laws.[666] However, in November 2014, Germany passed a draft law on crowdfunding titled "Gesetzentwurf für ein Kleinanlegerschutzgesetz."[667] Under the proposed law, companies will be able to raise up to €1 million without having to register a prospectus.[668] Moreover, individual investors will be able to invest up to €10,000 per project.[669]

Italy has opted for crowdfunding-specific legislation by amending its existing securities law, the TUF (Testo Unico della Finanza).[670] The aim of the legislation is to legalize crowdfunding, and CONSOB (Commissione Nazionale per le Società e la Borsa), Italy's regulator and the equivalent of the SEC, is tasked with implementing the legislation.[671] The legislation went into force on December 17, 2012, and is available to innovative start-ups—so-called "startup innovativa."[672] The Act makes it possible for innovative startups to offer securities up to €5 million without

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[661] *Id.*

[662] *Id.*

[663] *Id.*

[664] *Id.* at 208–09.

[665] Ross S. Weinstein, *Crowdfunding in the U.S. and Abroad: What to Expect When You're Expecting*, 46 CORNELL INT'L L.J. 427, 447 (2013).

[666] *Id.*

[667] BUNDESFINANZMINISTERIUM, GESETZENTWURF FÜR EIN KLEINANLEGER SCHUTZGESETZ (Nov. 10, 2014), http://dip21.bundestag.de/dip21/btd/18/039/1803994.pdf [https://perma.cc/82PD-V7RE] (Ger.).

[668] *Id.*

[669] *Id.*

[670] Decreto Legge 18 ottobre 2012, n. 179 artt. 30, http://www.altalex.com/documents/leggi/2014/04/02/decreto-crescita-2-0-ricerca-assicurazioni-start-up-innovative#sezione9 [https://perma.cc/S94Z-2P67] (It.).

[671] CONSOB, DELIBERA N. 18592 (26 giugno 2013), http://www.consob.it/main/documenti/bollettino2013/d18592.htm [https://perma.cc/8QNY-K9GS] (It.).

[672] *Id.*

having to register a prospectus.[673] The definition of innovative startups focuses on firms whose sole or main purpose is to develop, produce, and sell innovative products and services with a high technological value.[674] Non-innovative startups, however, cannot take advantage of this exemption and continue to be bound by European Directive 2010/73, and are only able to raise capital up to €100,000 without the obligation to register a prospectus.[675] This, in our view, represents a significant limitation. Moreover, startups must be less than four years old in order to take advantage of the ECF exemption.[676] The crowdfunding exemption implemented in Italy, therefore, results in a very narrow exemption from generally applicable prospectus requirements.

In France, the current legislative framework permits companies to offer securities up to €1 million without having to register a prospectus.[677] Moreover, there is a licensing requirement in place. Crowdfunding platforms must be licensed by the supervisory authority.[678]

E. Crowdfunding in the Developing World

Crowdfunding is a way of extending access to capital for SMEs by merging the social web with entrepreneurial finance.[679] Accordingly, crowdfunding may be seen as a substitute for traditional financing channels (banks, business angels, and venture capitalists). The function of crowdfunding portals is to facilitate the information flow from early-stage enterprises to potential investors. The

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[673] *Id.*

[674] Antonio Coletti, Isabella Porchia, Filippo Benintendi & Simona Bormida, *Boosting Innovative Start-Ups in Italy: The New Framework* (Dec. 20, 2012) https://www.lw.com/thoughtLeadership/boosting-innovative-start-ups-italy [https://perma.cc/2NRK-9AR7].

[675] 2010 O.J. (L 327) 7 (E.U.).

[676] Coletti et al., *supra* note 674.

[677] Ordonnance 2014-559 du 30 mai 2014 relative au financement participative [Ordinance 2014-559 of May 30, 2014 on crowdfunding], LEGIFRANCE, May 30, 2008 (Fr.), http://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000029008408&categorieLien=id [https://perma.cc/JQH9-C529].

[678] Andrew Conway, *Crowd Funding: A Policy Response* 18–20, INST. OF PUB. ACCOUNTANTS (2015).

[679] Peter Lee, *Social Innovation*, 92 WASH. U. L. REV. 1, 57–58 (2014).

extensive reliance on crowdfunding in the developed world suggests that crowdfunding could become a useful tool in developing countries. Although crowdfunding is still in its infancy in developing countries, the potential of the market is significant.

1. Economic Growth, Democratization of Finance, and Women Entrepreneurs

One of the main advantages of utilizing crowdfunding in the developing world is that it allows developing countries to spur entrepreneurship, economic growth, and innovation. A related advantage of crowdfunding is that it democratizes access to capital. Entrepreneurs can raise funds without being part of a business angel or venture capital network and can target investors dispersed across the country.[680]

A key finding in a study published by Mollick is that crowdfunding in developed countries is less concentrated than venture capital funding, which often leads to the rise of startup clusters in a particular geographic location or region.[681] By contrast, crowdfunding has the potential to promote startups in rural areas or small towns, where local investors can engage in investing and support their local communities.[682] For example, Agrawal et al. show that geographic proximity is not an overriding criterion for crowdfunding investors and that crowdfunding eliminates distance-related economic frictions.[683] These characteristics of crowdfunding have an enormous potential for developing countries.

In addition, crowdfunding is associated with less gender bias than venture capital.[684] Venture capitalists primarily invest in technology-intensive types of firms, which are less likely to be funded by women.[685] Moreover, women raise significantly lower

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[680] Mollick, *supra* note 31, at 9.

[681] *Id.*

[682] *Id.*

[683] *Id. See* Jisun An et al., *Recommending Investors for Crowdfunding Projects* 2 (2014), http://researchswinger.org/publications/an14recommending.pdf [https://perma.cc/MT2A-QU4P].

[684] *See generally* Dan Marom et al., *Gender Dynamics in Crowdfunding: Evidence on Entrepreneurs, Investors, and Deals from Kickstarter* (2015), http://ssrn.com/abstract=2442954 [https://perma.cc/XE3L-8TH4].

[685] *Id.* at 41.

amounts of equity than men during the startup stage and less equity and debt at later stages of a firm's development cycle.[686] In fact, several studies point to women entrepreneurs being able to raise less capital than men, regardless of the source of capital.[687] As a result, women launch firms with significantly smaller amounts of capital than men.[688] The advantages of crowdfunding are that it has the potential to democratize the private equity market, reduce gender bias, and empower the economic development of women.

In the next section, we highlight some key platforms that have emerged in developing countries and discuss the main enabling factors that allow crowdfunding to develop. These factors are technological infrastructure, entrepreneurial culture, institutional and regulatory infrastructure, and community engagement.

2. Emerging Platforms

In sub-Saharan Africa, one example of a crowdfunding platform is Homestrings.[689] This website was launched between 2011 and 2013 and has thus far mobilized about $25 million in funds, covering thirteen countries in Africa.[690] The platform allows investors, particularly diaspora investors, to invest in projects, funds, bonds, and public-private partnership opportunities supported by the governments of Kenya, Ghana, and Nigeria, as well as First Quantum Minerals and Afren plc.[691] Another example of a platform is Startme, which focuses on traditional entrepreneurial campaigns.[692]

The MENA (Middle East and North Africa) region has seen the rise of online platforms such as the Lebanon-based Zoomaal.[693] This site offers both cause-related and entrepreneurial

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[686] *See* S. Coleman & A. Robb, *New Firm Financing for Women-Owned Firms: Evidence from the Kauffmann Firm Survey Data* at 2–3, 6 (2008), http://sbaer.uca.edu/research/usasbe/2009/PaperID82.pdf [https://perma.cc/V6Q4-SFK4].

[687] *Id.* at 8.

[688] *Id.* at 9.

[689] *See* HOMESTRINGS, https://www.homestrings.com/ [https://perma.cc/EY8V-PWA6].

[690] WORLD BANK, *supra* note 63, at 32.

[691] *Id.*

[692] *See* STARTME, http://www.startme.co.za/ [https://perma.cc/2922-SG6B].

[693] *See* ZOOMAAL, http://www.zoomaal.com [https://perma.cc/WB5B-9KQF].

campaigns.[694] Another successful equity crowdfunding platform is Eureeca, which, during its first campaign, raised $100,000 from twenty-three investors.[695]

The Latin American and the Caribbean regions have also seen a substantial growth in crowdfunding platforms since 2010. In Brazil, Catarse has raised over $4.1 million in over one thousand campaigns.[696] Another popular platform is Ideame, which has campaigns in six countries in the region: Argentina, Mexico, Chile, Brazil, Colombia, and Uruguay.[697] In Southeast Asia, notable platforms include Ignite Intent,[698] the Hot Start,[699] and Ideasplatform.[700]

3. Key Enabling Factors

A key enabling factor in developing countries is the implementation of the necessary technological infrastructure to support crowdfunding. Whether a developing country can move to crowdfunding structures depends on its ability to embrace new technologies and methodologies for capital formation. Crowdfunding can only work if individuals have access to reliable broadband Internet and mobile data networks. The presence of online social networks that allow investors to communicate with entrepreneurs and vice versa is also a crucial prerequisite for crowdfunding.[701] Hence, a report by the World Bank notes that the single most predictive factor for the rate of crowdfunding emergence is the rate of social media penetration.[702] The latter is strongly positively correlated with the rise of crowdfunding platforms.[703]

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[694] *Id.*

[695] *See* EUREECA, http://www.eureeca.com [https://perma.cc/UE87-56BP].

[696] WORLD BANK, *supra* note 63, at 33. *See* CATARSE, http://www.catarse.me [https://perma.cc/V69F-9ZRM].

[697] *See* IDEAME, http://idea.me [https://perma.cc/GPD2-SPE8].

[698] *See* IGNITEINTENT, http://www.igniteintent.com [https://perma.cc/9SRE-PVQL].

[699] *See* HOTSTART, http://www.thehotstart.com [https://perma.cc/RC2B-LLNY].

[700] *See* Ideasplatform Company Page, FACEBOOK, https://www.facebook.com/ideasplatform [https://perma.cc/QL95-XWYM] (note that the original ideasplatform.in is no longer an operating website).

[701] John S. Wroldsen, *The Crowdfund Act's Strange Bedfellows: Democracy and Start-Up Company Investing*, 72 U. KAN. L. REV. 357, 361 (2013).

[702] WORLD BANK, *supra* note 63, at 40.

[703] *Id.*

The institutional frameworks in developing countries must be designed in a way to facilitate access to capital and the development of crowdfunding platforms.[704] Crowdfunding relies on the existence of an entrepreneurial culture in a country. Entrepreneurial culture can be constrained, however, by factors such as red tape, bureaucracy, and lack of economic incentives.[705] Accordingly, countries wishing to promote crowdfunding and P2P lending must address policies and regulations that raise transaction costs and make the entry and conduct of business operations burdensome.[706] In addition, education campaigns, incubators, accelerators, startup weekends, and mentorship programs sponsored by the government or NGOs can play a key role in fostering entrepreneurial culture.[707]

VI. REGULATORY COMPETITION AND GLOBAL CROWDFUNDING

The various regulatory models considered above are in competition with one another. Based on these models, we can extrapolate the following regulatory options available to national regulators:

- no regulatory change;
- creating a specific regulatory framework for ECF and P2PL;[708]
- enacting carveouts or securities exemptions from the preexisting securities laws to exempt fundraising via

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[704] *Id.*

[705] C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 58–59 (2012).

[706] A recent empirical study of mobile money schemes found that heavy regulation is fatal to the success of such schemes. The study uses multi-sided platform economics and the role of ignition and critical mass to explore the success or failure of mobile money. *See* David Evans & Alexis Pirchio, *An Empirical Examination of Why Mobile Money Schemes Ignite in Some Developing Countries but Flounder in Most* (U. Chic. L. Sch., Coase-Sandor Inst. for L. and Econ., Working Paper No. 723, Mar. 2015), http://ssrn.com/abstract=257 8312 [https://perma.cc/8X4C-V86P].

[707] *Id.* at 8–9.

[708] *See, e.g.*, Bradford, *supra* note 705, at 8; Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments that Begs for a Happy Ending*, 102 KY. L.J. 865, 887 (2014); Marco Figliomeni, Note, *Grassroots Capitalism or: How I Learned to Stop Worrying About Financial Risks in the Exempt Market and Love Equity Crowdfunding*, 23 DAHOUSIE J. LEGAL STUD. 105, 106 (2014).

ECF platforms from general prospectus, registration and other requirements;[709]

- limiting such exemptions, if any, to accredited, or sophisticated, high net worth investors (the approach taken in the United States prior to the enactment of the JOBS Act);[710]
- making ECF available to all investors, including retail investors subject to caps on the amount of capital that retail investors can contribute to ECF campaigns (the approach in the United States after the implementation of the JOBS Act);[711]
- imposing various investment-related caps, such as limiting the number of issuers investors can invest in or limiting the amount of money an investor may invest per year (the limit may be determined by reference to a person's income or net worth; or arbitrary limits may be set regardless of a person's income or net worth);[712]
- making ECF available to retail investors without any restrictions or investment caps;[713]
- limiting ECF to certain types of issuers, such as innovative companies (the approach taken in Italy).[714]

The options for investor protection safeguards include:

- establishing a licensing framework for crowdfunding intermediaries (the approach taken in New Zealand; other examples include the FCA authorizations in the United Kingdom for CrowdCube and Seedrs) and enabling a form of merit regulation;[715]
- imposing various disclosure requirements on issuers;

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[709] *See* Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1436–37 (2012); Filgiomeni, *supra* note 708, at 115–16.

[710] *See* Cohn, *supra* note 709, at 1436.

[711] *See* Bradford, *supra* note 705, at 123–26.

[712] *Id.* at 124.

[713] *Id.* at 124–26.

[714] Garry A. Gabison, *Equity Crowdfunding: All Regulated But Not Equal*, 13 DEPAUL BUS. & COMM. L.J. 359, 390–91 (2014).

[715] Bradford, *supra* note 705, at 136; Figliomeni, *supra* note 708, at 116.

- requiring offerings to be conducted online and not through other means (the approach in the United States);
- requiring issuers to conduct offerings through only one intermediary;[716]
- imposing caps on the maximum amount of capital that an issuer can raise in a given year (the approach taken in New Zealand and the United States);[717]
- prohibiting intermediaries from directly holding funds and requiring them to deposit funds into an escrow account (the approach taken in the United States);[718]
- risk acknowledgment by the investor and the provision of educational materials to investors prior to investing;[719]
- providing cancellation rights and cooling-off periods (whereby an investor may withdraw the investment up until a certain point in time or until the crowdfunding campaign is closed);[720]
- addressing the holding of client money and conflicts of interest;[721]
- providing mechanisms to handle complaints and alternative dispute resolution;[722]
- providing guidelines on social media commentary (see, for example, U.S. electronic bulletin recommendations);[723] and

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[716] Wroldsen, *supra* note 701, at 367.

[717] Bradford, *supra* note 705, at 95; Van S. Wiltz, *Will the JOBS Act Jump-Start the Video Game Industry? Crowdfunding Start-Up Captial*, 16 TUL. J. TECH. & INTELL. PROP. 141, 160 (2013).

[718] Cohn, *supra* note 709, at 1442; Joan MacLeod Heminway & Sheldon Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 923–24 (2010).

[719] Figliomeni, *supra* note 708, at 115–16.

[720] Cohn, *supra* note 709, at 1440, 42; Wiltz, *supra* note 717, at 168–69.

[721] Bradford, *supra* note 705, at 136–37; Wiltz, *supra* note 717, at 166–67.

[722] George H. Friedman, *Alternative Dispute Resolution and Emerging Online Technologies: Challenges and Opportunities*, 19 HASTINGS COMM. & ENT. L.J. 695, 711–15 (1997); Anjanette H. Raymond & Abby Stemler, *Trusting Strangers: Dispute Resolution in the Crowd*, 16 CARDOZO J. CONFLICT RESOLUTION 357, 373–74 (2014).

[723] Thomas G. James, *Far From the Maddening Crowd: Does the JOBS Act*

- establishing rules or mechanisms to deal with platform failure or closure (the greatest risk here is that a platform may close without any data left behind on existing contracts).[724]

Because the ECF industry is still relatively young, it remains to be seen which model will become dominant internationally. There is no doubt that any future regulation will need to be adapted to crowdfunding platforms with different purposes. Obviously, a clear distinction can be made between crowdfunding platforms with non-financial rewards and those with financial rewards.[725] Regulation for crowdfunding should differ based on the goals of the funders and the purposes of the crowdfunding projects. Burdensome regulation may have the effect of stymieing the development of crowdfunding. The principal reason why entrepreneurs utilize ECF is precisely because it is less expensive than raising capital through a public offering, which involves costly prospectus obligations, or relying on banks or private equity channels.[726] On the other hand, a lax regulatory approach may result in losses to investors and lack of confidence in capital markets and crowdfunding in particular. To prevent fraud, some jurisdictions, such as the United Kingdom, have required crowdfunding platforms to register with an oversight body and regularly report to that body.[727] In other countries, such as Germany, there is no requirement for platforms to be registered, and crowdfunding platforms operate without any specific license.[728] The requirement that crowdfunding platforms be registered with a national oversight body leads to higher compliance costs, but also an increase in investor protection.

Provide Meaningful Redress to Small Investors for Securities Fraud in Connection with Crowdfunding Offerings, 54 B.C. L. REV. 1767, 1782 (2013).

[724] Bradford, *supra* note 705, at 144–45, 145 n.700; Gabison, *supra* note 714, at 369.

[725] Joan MacLeod Heminway, *What is a Security in the Era of Crowdfunding?*, 7 OHIO ST. ENTREPREN. BUS. L.J. 335, 359 (2012); Heminway & Hoffman, *supra* note 718, at 899–900.

[726] *See supra* notes 21–22, 247, and accompanying text.

[727] *See supra* Part V.D.2.c.

[728] Lars Hornuf & Armin Schwienbacher, Should Securities Regulation Promote Crowdinvesting? 16, 37 (June 11, 2015) (unpublished manuscript) (on file with the Ludwig-Maximilians-Universität München Library).

It is up to each individual jurisdiction to determine the extent to which securities regulation ought to apply to and overlap with crowdfunding regulation. The basic starting point is that securities regulation applies to crowdfunding to the extent that crowdfunding involves the offer and sale of equity or debt securities, which are regulated activities in most jurisdictions.[729] This may trigger a range of requirements, including mandatory disclosure and reporting requirements. The objective of imposing such requirements has historically been the prevention of fraud and investor protection, as well as the reduction of agency costs and information asymmetries.[730] A failure to comply with such requirements can result in misstatements, omissions to state material facts, and claims of securities fraud.[731]

The key problem with applying existing securities regulation laws to crowdfunding, however, is that such laws were not crafted for online fundraising. Compliance with existing securities regulations—i.e., disclosure and prospectus requirements—results in fixed compliance costs that increase the costs of obtaining capital for firms.[732] An advantage of such requirements is that they reduce agency costs. Owing to greater transparency and less information asymmetry, entrepreneurs have fewer opportunities to engage in self-dealing or extract private benefits.[733]

Optimal regulation involves a tradeoff between the costs of ensuring an appropriate level of investor protection and broadening access to capital for small and medium-sized firms that are disproportionately affected by compliance costs.[734] The upshot of a regulatory approach that is too focused on investor protection is limited access to capital for small firms, whereas regulation that permits extensive access to capital may result in weaker investor protection.[735] Furthermore, if the costs associated with investor

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[729] DRESNER, *supra* note 92, at 165, 169.

[730] JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION CASES AND MATERIALS 96 (12th ed. 2012).

[731] *Id.* at 96

[732] *Id.* at 97.

[733] *See* Mark Milian, *Kickstarter's Funded Projects See Some Stumbles*, BLOOMBERG (Aug. 21, 2012), http://www.bloomberg.com/news/articles/2012-08-21/kickstarter-s-funded-projects-see-some-stumbles [https://perma.cc/HF7D-3PFD].

[734] *See* DRESNER, *supra* note 92, at 171.

[735] ONTARIO SEC. COMM'N, OCS STAFF CONSULTATION PAPER 45-710, CONSIDERATIONS FOR NEW CAPITAL RAISING PROSPECTUS EXEMPTIONS 23 (2012),

protection are excessive, crowdfunding may cease to be a viable cost-effective means to raise capital for SMEs.[736] Regulators must, therefore, ensure that small firms can utilize ECF and P2PL in the first place, while setting the investor protection bar at an appropriate level. Indeed, Cumming and Johan point to empirical evidence that suggests that crowd investors do seek a certain level of investor protection.[737]

Investor protection is a particularly important consideration if the creation of a "market for lemons"—where only low-quality ventures would eventually choose ECF while high-quality ventures would continue to rely on venture capital or angel investor financing—is to be avoided.[738] The upshot would be a "crowdfunding market full of unrealistic, and likely fraudulent, sales pitches."[739] A high level of investor dissatisfaction and adverse publicity about ECF as a form of corporate fundraising could eventually result in the collapse of the crowdfunding market itself.[740] This is the worst case scenario as envisaged by Akerlof.[741]

For crowdfunding to have a positive economic impact in the long run, the regulatory framework must be designed in a manner that works for both investors and entrepreneurs alike.[742] As observed by the U.S. Investor Advisory Committee: "[a]lthough these goals are sometimes seen as operating at cross purposes,

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https://www.osc.gov.on.ca/documents/en/Securities-Category4/sn_20121214_45-710_exempt-market-review.pdf [https://perma.cc/6Q75-UP72].

[736] *Id.* at 51–52.

[737] Douglas Cumming & Sofia Johan, *Demand Driven Securities Regulation: Evidence from Crowdfunding*, 15 VENTURE CAPITAL: INT. J. ENTREPREN. FIN. 361, 376 (2013).

[738] *See* Ibrahim, *supra* note 5, at 108, 137–38; *see also* Wilson & Testoni, *supra* note 23, at 12.

[739] Edan Burkett, *A Crowdfunding Exception? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TENN. J. BUS. L. 63, 97–98 (2011).

[740] CORP. AND MKTS. ADVISORY COMM., CROWD SOURCED EQUITY FUNDING REPORT 18–20, 64, 119 (May 2014) http://www.camac.gov.au/camac/camac.nsf/0/3dd84175efbad69cca256b6c007fd4e8.html [https://perma.cc/WG5V-H9X5].

[741] *Id.*; Akerlof, *supra* note 302, at 496–97.

[742] Louis A. Aguilar, Comm'r, SEC, Remarks at Open Meeting on Proposal on Crowdfunding: Harnessing the Internet to Promote Access to Capital for Small Businesses, While Protecting the Interests of Investors (Oct. 23, 2013) (transcript available at http://clsbluesky.law.columbia.edu/2013/11/19/sec-commissioner-aguilar-discusses-the-secs-crowdfunding-proposal/ [https://perma.cc/W34W-ARKP]).

crowdfunding ultimately cannot succeed unless investors perceive the marketplace as fair and believe they have a reasonable chance of profiting on their investments."[743] The regulatory challenge, therefore, is to design a fair and cost-effective marketplace that facilitates small capital formation, while providing reasonable investor protection.[744]

The focus of regulators in some jurisdictions has been the protection of the retail investor involved in crowdfunding.[745] The approach taken under the JOBS Act in the United States, for example, is regulating not only the crowdfunding platforms, but also the investment opportunities of the crowd. This is done by imposing limits on the extent to which investors can assume risk.[746] Nonaccredited investors can only invest via crowdfunding platforms up to a certain amount of their annual net income or wealth.[747] This represents a significant limitation on investors' investment opportunities. In the U.S. setting, this is consistent with the historical focus of the SEC on the protection of nonaccredited investors.[748] The definition of "accredited investor" will therefore continue to be significant in the future, and crowdfunding intermediaries must closely monitor any relevant amendments in this regard. The Dodd-Frank Act of 2010 imposes an obligation on the SEC to review the definition in its entirety and to amend the definition as deemed necessary every four years, beginning in 2014.[749] Accordingly, questions as to the distinctions between retail investors and accredited or sophisticated investors will arise in the future.

An alternative regulatory approach is to focus on the corporate governance frameworks of the crowdfunded enterprises and

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743 SEC INV'R ADVISORY COMM., RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE: CROWDFUNDING REGULATIONS 1 (Apr. 10, 2014), http://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-adviser-crowdfunding-recommendation.pdf [https://perma.cc/99WM-5JPZ].

744 *Id.*

745 *See supra* Parts V.B, V.C.1, V.D.2.b.

746 *See supra* Part V.C.1.

747 *See* Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), 80 Fed. Reg. 21,806, 21,816–17 (Apr. 20, 2015).

748 DRESNER, *supra* note 92, at 117.

749 Press Release, SEC, SEC Adopts Net Worth Standard for Accredited Investors Under Dodd-Frank Act (Dec. 21, 2011) http://www.sec.gov/news/press/2011/2011-274.htm [https://perma.cc/QEF6-D62R].

the intermediaries.[750] The key pillars of a good corporate governance crowdfunding framework may be summarized as follows: transparency, information disclosure, investor and consumer protection, and appropriate regulation of the crowdfunding intermediaries—i.e., the operators of the websites through which crowdfunding activities are conducted.[751] Regulation must ensure, among other things, security of payment and platform functionality. In addition, intermediaries may have to comply with certain capital requirements, as is the case in the United Kingdom. Regulatory authorities must be able to control and monitor the activities of crowdfunding intermediaries.[752] This is important because crowd investors typically lack the control rights and ex ante contractual protections available to business angels and venture capitalists as part of their shareholder agreements with investee companies.[753]

Within the ECF context, regulatory authorities must find a balance between facilitating access to capital for SMEs and reducing the risks of securities fraud. The key regulatory objectives here are capital formation, investor protection, and the maintenance of fair and orderly capital markets.[754] Investors must be able to assess investment opportunities while having recourse to adequate disclosure. While ECF will never be risk-free—in the sense that investors may always make perfectly bad investment decisions notwithstanding having access to adequate disclosure—investors must be protected from fraud, misleading statements, and other misleading and deceptive practices. A crucial difference between trading shares in publicly listed companies and investing in small businesses is the lack of research analyst coverage.[755] Private companies, by definition, operate in a more opaque information setting.

In addition, the public offering rules must be designed in a way as to allow offerings to be conducted without a prospectus. The lack of onerous prospectus requirements, as we saw in the European setting, is fundamental to the emergence of crowdfunding. Public

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[750] *See supra* Part V.C.2.
[751] *See* discussion *supra* Part IV.
[752] *See supra* Part V.D.2.b.
[753] *See supra* text accompanying note 235.
[754] *See supra* text accompanying note 745.
[755] DRESNER, *supra* note 92, at 115.

offering rules, therefore, may be viewed as an important regulatory driver of crowdfunding. Simplified disclosure requirements are needed for SMEs seeking to utilize equity crowdfunding.

There are various caps that may be imposed on the maximum amount of capital that can be raised via ECF by issuers and the maximum amount of capital that investors may invest.[756] The rationale behind investment caps is to limit the potential losses that retail investors may incur as a result of participating in ECF campaigns. As stated, in the United States, the approach under the JOBS Act has been to limit the total monetary amount that an investor may invest in all issuers in a given year according to the person's income or net worth.[757] This requirement is intended to deter retail investors from concentrating their investments in the ECF market (a form of mandatory portfolio diversification).

In our view, however, ECF and P2PL differ substantially from other fundraising mechanisms, whether public or private (angel investing and venture capital), and require a special legislative response. Adopting a specific regulatory framework to cover ECF and P2PL appears to be the appropriate solution to regulating ECF and P2PL because preexisting securities law frameworks are inadequate. Indeed, a lack of legislative action in this field may disadvantage firms in some jurisdictions vis-à-vis firms that operate in jurisdictions where there has already been some regulatory accommodation for equity crowdfunding. An option here is to make ECF available, but only to the extent that it applies to a restricted group of investors (see the approach in the United Kingdom, for example). The focus in the United Kingdom, as we saw, is on sophisticated, experienced, and professional investors, as well as investors who certify they fall into the restricted investor category. Another approach may be to limit ECF to certain classes of issuer. ECF in Italy is confined to innovative startups only.[758]

Questions also arise in relation to pooled investment arrangements that are used by some platforms as an investment model. Should regulatory distinctions be made between investors holding legal, as opposed to beneficial, interests in the equity of an

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[756] *See supra* Parts V.C.1.a–b.
[757] *See supra* Part V.C.1.b.
[758] *See supra* Part V.D.3.

issuer? In particular, to what extent do such arrangements alter the disclosure obligations of issuers to investors? In principle, investors investing indirectly into an issue via a SPV should be entitled to the same information disclosure as those investors investing directly. Addressing these issues will require a consideration of how to fit any new ECF regulation within the preexisting corporate law framework.

Finally, national regulators will need to consider to what extent, if any, oversight of ECF and P2PL platforms should be shared with self-regulatory organizations. In the United Kingdom, the UK Crowdfunding Association has assumed a role by promulgating regulatory standards and rules affecting both non-FCA and FCA-authorized ECF providers. British P2PL providers have also launched a "peer-to-peer finance association" ("P2PFA"). The emergence of such self-regulatory bodies is likely to promote greater responsiveness and regulatory innovation.

Some jurisdictions, such as New Zealand, have granted crowdfunding intermediaries an important supervisory role, allowing intermediaries to deny issuers access to their platforms if there is reason to believe that the issuer has engaged in, or is likely to engage in, misleading and deceptive conduct.[759] Furthermore, intermediaries are expected to carry out due diligence and check the identity of the issuer and that of its directors and senior managers.[760] They are also tasked with educating investors about the risks of crowdfunding. Where investors are subject to investment caps, intermediaries must also ensure that any investment limits imposed on the investors are not breached.[761] In addition, intermediaries must have processes in place to ensure that the anti-money laundering requirements are not breached. The crowdfunding intermediaries, therefore, play a critical role in investor protection. To an extent, we are witnessing a form of "merit regulation," where the role of the licensed intermediary is akin to that of a government agency deciding on the merits of the offer. Indeed, we could characterize the New Zealand model as a hybrid of merit and disclosure regulation.

[759] Financial Markets Conduct Regulations 2014, s 195 (N.Z.).
[760] *Id.*
[761] *Id.*

CONCLUSION

Access to finance is a pressing concern for SMEs around the globe, particularly in the aftermath of the GFC. In this Article, we explored the potential of crowdfunding and P2PL to foster economic growth and innovation and bridge the financing gap that many startups and SMEs face. As shown, crowdfunding provides a novel method for entrepreneurs to obtain financing without having to rely on traditional funding mechanisms, such as debt finance, venture capital, or business angels.[762]

Technological innovation and the financial crisis of 2008–2009 are the key drivers behind crowdfunding. By harnessing Internet technology, crowdfunding and P2PL have altered the spectrum of capital raising options by allowing entrepreneurs using social media websites or online crowdfunding platforms to attract small amounts of capital from a large number of individuals to finance new ventures or support existing businesses. The main funders of early startup ventures have traditionally been venture capitalists and angel investors. This will change with the emergence of ECF and P2PL. At the very least, ECF and P2PL are likely to increase competition among suppliers of capital to SMEs and early startups.

We have considered a variety of different crowdfunding models that can be used to support a variety of purposes, including crowdfunding with financial rewards (crowd investing and crowd lending) and crowdfunding without financial rewards (crowd sponsoring). Our conclusion is that different forms of crowdfunding require different regulatory frameworks, as they are associated with different risks, different levels of complexity, as well as different user groups and purposes. For example, donation-based crowdfunding is most applicable to community-related and art-related projects, while ECF is applicable to startups that have a high-growth, sale, merger, or IPO strategy.[763] This may be contrasted with P2PL, which is most relevant to businesses seeking to improve their cash flow.

The focus of our discussion has been on the financial reward model of crowdfunding. In particular, we examined the regulatory

[762] *See supra* Parts I.A, II.B.5.
[763] WORLD BANK, *supra* note 63, at 34.

approach taken to crowd investing and crowd lending in a number of jurisdictions, including the United States, the United Kingdom, Germany, Italy, and New Zealand. Although crowdfunding is increasingly gaining prominence in the European context, particularly in jurisdictions such as the United Kingdom, no unified regulatory framework has been adopted at the E.U. level.[764] The European Commission has explored the potential of crowdfunding, and in the United States, the JOBS Act has been enacted with the aim of introducing a crowdfunding exemption to facilitate capital raising from the public.[765] The main thrust of the regulatory interventions surveyed has been to extend ECF to non-accredited investors, with regulation structured in a way that focuses on the crowdfunded enterprises, the intermediaries, or the crowd. There are marked differences between countries as to how these actors are regulated. This, in turn, involves certain tradeoffs between fostering capital access and protecting investors.

We considered the potential of crowdfunding in the developing world. While crowdfunding markets have been operating in many countries of the developed world, the developing world may be able to capitalize on this new form of funding. The main prerequisites for crowdfunding to emerge are access to technology, entrepreneurial activity, and the presence of light regulatory structures, which facilitate the necessary market conditions for investment in the startup ecosystem.

Crowdfunding is already a well-established financing instrument. The Internet and crowdfunding have revolutionized the ways in which funds are raised in the small business context.[766] Nevertheless, the bulk of crowdfunding is directed towards philanthropic projects and the creative industries, where artistic communities play an important role in supporting crowdfunding projects. Equity crowdfunding, on the other hand, plays a smaller role in the crowdfunding market. This is due to a number of factors, including the complexity of financing young and innovative startups and a legal context that may constrain or inhibit ECF. There is, therefore, considerable scope for improvement in this area. The main points for regulators to address are securities regulation

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[764] *See supra* Part V.D.1.
[765] *See supra* Part V.C.1.
[766] *See supra* text accompanying notes 22–24.

carveouts, prospectus requirements, investor protection, and the regulation of ECF and P2PL platforms.[767]

The crowdfunding market for providing seed and early-stage financing can be further developed to ensure that crowdfunding becomes a valid alternative to traditional financing channels for firms. In fact, given the limited number of institutional investors willing to finance SMEs, and the effects of the GFC on the banking sector, crowdfunding may be the only viable means for some firms to obtain early-stage financing. This is particularly the case in markets where there is a shortage of seed capital or an undersupply of projects that have the level of maturity to be funded by the traditional banking sector. Accordingly, compared to debt finance and private equity, crowdfunding may enable a larger number of firms to obtain financing. In addition, firms may benefit from other advantages associated with crowdfunding, including market testing and crowdsourcing. Although not a panacea to SME financing problems, P2P and crowdfunding platforms may improve the SME-financing market in the long term, and may be viewed as a source of competition to banks or as a financing alternative that increases consumer choice, promotes innovation, and facilitates entrepreneurship and economic growth. Crowdfunding is not intended to displace the role of the banks, angel investors, or venture capitals in providing later-stage funding.[768] Rather, the potential of crowdfunding lies in plugging existing financing gaps in the early stage funding cycle.

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[767] *See supra* Part VI.
[768] *See supra* Part II.B.5.