Crowdfunding: Solving the SME Funding Problem and Democratising Access to Capital

Alma Pekmezovic and Gordon Walker *

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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, offer the possibility of a global solution to the Small-to Medium sized Enterprise (SME) funding problem. In the USA, the SME funding problem is exacerbated by the so-called “start-up slowdown”. These two factors inject a degree of urgency into resolving optimal means to implement ECF. Here, as with the “fin-tech” revolution, the law lags technological developments. The second main argument is that ECF democratises access to capital for SMEs together with access to investments for ordinary citizens. The article begins by providing definitions, business models and historical background before moving to outline 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 distinguished from venture capital and angel financing. The global market for crowdfunding 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 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 confronting the regulatory puzzles presented by crowdfunding.

INTRODUCTION

This article reviews crowdfunding and considers its implications for securities regulation and fund raising law.¹ We consider the utility of this form of fund raising for Small and Medium Size

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¹ We consider the utility of this form of fund raising for Small and Medium Size
Enterprises (SMEs) and the regulatory approach taken in 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). These alternative forms of fund raising have grown as result of technological innovation and the fallout from the global financial crisis (GFC) in 2007-8 which resulted in tightened bank credit and increased constraints on SMEs’ access to capital. Restrictions on SME access to capital are especially prevalent in the early-stage risk capital market and it is here that ECF and P2PL present as 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 start-up financing to fledgling companies with significant potential. Crowdfunding has the potential not only to improve access to finance for SMEs, but also to democratise access to investment opportunities. Crowdfunding investment opportunities are now available to a larger pool of investors, including retail and non-institutional investors – they are not restricted to accredited investors only as is the case under some legislative frameworks, including Regulation D in the United States.3

ECF, in particular, should facilitate the flow of funding to SMEs and micro-firms which are unable to access traditional sources of finance.4 Although this kind of investing carries well-

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4 In 2011, crowdfunding platforms including equity-based, donation-based, reward-based and lending-based platforms raised a total of US$1.5 billion. Donation-based platforms accounted for the largest percentage of funds raised through crowdfunding, but are the slowest-growing category. ECF are growing at a rate of 114 percent, growing from a base of US$24.6 million in 2009 to US$61.5 million in 2010 and US$112.6 million in 2011. See Massolution,
documented risks, it offers significant improvements in SME access to finance and the potential to enhance portfolio diversification for retail investors. 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.

The rapid rise of crowdfunding and P2PL platforms globally suggests this form of alternative investing is gaining increased visibility amongst investors and entrepreneurs. Our aim is to provide an overview of the modern crowdfunding market, address the market dynamics of ECF and P2PL in an international context and highlight the present framework of legal rules applying to ECF and P2PL globally. As to the latter point, our focus is on securities regulation laws and special carve-outs for ECF and P2PL. In particular, we draw attention to investor protection and transparency requirements which have evolved to support crowdfunding.

As we shall see, 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. We identify three common regulatory mechanisms which focus on: (1) regulating crowdfunding intermediaries via a licensing regime; (2) regulation of the investment opportunities of the crowd investor; and (3) *ex post* governance regulation of the crowdfunded firms. Thus, intermediaries which operate ECF and P2PL platforms are often required to be licensed, maintain a disclosure regime and ensure that investors are able to exercise an informed choice. An alternative and complimentary regulatory mechanism is to require crowdfunded firms to make disclosure and comply with various corporate governance requirements intended to enhance transparency. A third mechanism focuses on the regulation of non-accredited investors’ investment opportunities and typically results in limitations placed on the ability of such investors to participate in ECF and P2PL campaigns. Non-accredited investors may participate in crowdfunding but only 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 legislator.

Different tools have differing implications for investor protection and compliance costs for firms seeking funding via ECF or P2PL. We explore various regulatory approaches and comment on their likely effectiveness. Investor safeguards must be balanced against economic utility (job creation, for example) and SME demand for crowdfunding and peer-to-peer financing. It is notorious that SMEs in all countries face funding constraints but also that such entities are a key driver of private sector employment. There is hence a policy imperative to encourage funding options for SMEs and craft exemptions in securities regimes to facilitate crowdfunding.9 For

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9 See Australian Government Corporations and Markets Advisory Committee, Crowd Sourced Equity Funding Report (May 2014) at para [2.1.2]. The Australian federal government Small Business Minister, Bruce Billson, has publicly advocated the introduction of an ECF regime for SMEs in Australia for this reason. See Fran Foo “Billson Pushes Crowdfunding” The Australian, October 7 2014, 27. In December 2014, the Commonwealth of Australia, Financial System Inquiry: Final Report was released. The Final Report stated that funding for SMEs was essential to facilitate productivity growth in the Australian economy. Ibid., 178. Recommendation 18 approved a graduated regime for fund raising to facilitate crowdfunding. Ibid., 177. The recommendation met with approval from industry: see J. Evers, “Change Laws to Make Crowdfunding Easier” The Australian Financial Review (8 December 2014) 6; N.
example, our view on quantitative limits or investment caps is that these should not be set by regulators. Rather, investors should decide, based on their own preferences and risk-averseness, how much to invest. Further, limiting the size of offers or the investment is likely to limit the potential of crowdfunding to improve SME funding opportunities.

Part 1 of the article examines definitions of crowdfunding and P2PL and provides an historical background. We look at some 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 2 and 3 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 before turning to place crowdfunding within that spectrum. However, our aim is to add to the nascent literature on crowdfunding and SMEs’ access to capital. Crowdfunding is an under-researched area of finance, despite its potential to close the entrepreneurial funding gap.

Parts 4 and 5 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 carve-outs for SMEs using crowdfunding and P2P portals. Given that the

ECF and P2PL are relatively new activities, the regulatory approach in the jurisdictions under review in this article is evolving. We summarise insights from our analysis and provide recommendations for further reform. These recommendations may be utilised by policymakers in developing regulatory frameworks to deal with the risks and issues raised by ECF and P2PL.

I. CROWDFUNDING AND P2P LENDING: 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.”10 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.11 Crowdfunding – as a form of crowdsourcing – is designed to facilitate capital raising.12 The key difference between crowdsourcing and crowdfunding is that in crowdsourcing the crowd provides labour, while under the crowdfunding model the crowd provides funds. Related terms are “crowd intelligence” (knowledge of the crowd), “crowd production” (creation of the crowd), and “crowd evaluation” (thoughts of the crowd).13

According to IOSCO, crowdfunding is an “umbrella term describing the use of small amounts of money, obtained from a large number of individuals or organisations, to fund a project, a

12 Wikipedia itself is an example of crowdsourcing.
business or personal loan, and other needs through an online web-based platform.” The advantage of raising funds online is that the internet substantially reduces transaction costs and makes it possible to collect small amounts of funds from a large pool of funders. The aggregation of a large number of small contributions can result in considerable amounts of capital. Examples of crowdfunding internet sites include MyMajorCompany, Kiva, Kickstarter, Crowdcube and IndieGoGo. These sites allow companies and entrepreneurs to turn to a “crowd” of potential investors for finance.

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.” 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.”

Accordingly, the three key components of crowdfunding are: (1) a large number of investors and

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15 Ibid 22.
17 https://www.mymajorcompany.com/
18 http://www.kiva.org/
19 https://www.kickstarter.com/
20 http://www.crowdcube.com/
21 https://www.indiegogo.com/
(2) the provision of relatively small amounts of money (3) obtained via the internet which is used for its convenience and ability to connect individuals across the globe. For example, individuals may seek relatively small amounts of capital – often under $1000 – in order to fund a one-time project or event, and the capital may be provided by family or friends.24 Alternatively, entrepreneurs use Crowdfunding as a form of seed financing in order to fund the start-up of a firm.25 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. The advantage of utilising 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.”26 In a setting like New Zealand, where there are no more than 100 angel investors, this can be a significant advantage.27 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 on return on the capital invested. They can also invest on the basis of philanthropic goals such as wanting to promote a certain social good or objective.28 The British Peer-to-Peer Finance Association provides the following definition of peer-to-peer finance: “platforms that facilitate financial services via direct, one-to-one contracts between a single recipient and one or multiple providers.”29 P2PL is hence a form of

24 Ibid., 3.
25 Ibid.
26 Michael Murray “Want to Grow Your Business? It’s Time to Get Social” The Independent, United Kingdom, 10 March 2011, 2 at 3.
27 Research, Evaluation and Monitoring Team, Industry and Regional Development Branch “Baseline Review of Angel Investment in New Zealand (Undertaken as Part of the Formation of the Seed Co-Investment Fund)” (Ministry of Economic Development, November 2007) <www.med.govt.nz> at 47. 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.
28 Ibid.
29 See website of the association, www.p2pfinanceassociation.org.uk/
crowdfunding and is usually referred to as *crowd lending* or *debt crowdfunding*. Borrowers seek capital and lenders provide capital via websites. A P2PL platform rather than a bank acts as an intermediary between lender and borrower. This often allows borrowers and lenders to obtain higher returns. The website handles the contractual relationships and disburses the funds.

In the U.K., Zopa was the first platform to offer this kind of service in 2005. RateSetter is another U.K. P2PL platform which recently also launched in the Australian market. Smava is a German platform, while Babyloan is a French provider. 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. The U.S. based Prosper is currently regarded as the market-leader in P2PL. Another U.S.-based P2P lending site is the Lending Club. These sites gained particular popularity in the wake of rising bank interest rates following the GFC.

Some websites also facilitate peer-to-peer foreign exchange connecting individuals and corporations online to exchange currencies directly. Examples of P2PL foreign exchange platforms are CurrencyFair, launched in Ireland in 2010, and TransferWise, launched in the UK

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31 Zopa was the first platform in the U.K. to offer this type of service. See http://www.zopa.com/
32 The Economist, “Peer-to-Peer Lending: Banking without the Banks” The Economist, 1 March 2014, 69-70.
34 http://www.smava.de/
35 http://www.babyloan.org/fr/
36 https://www.buzzbnk.org/. 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. The loans are not secured.
37 https://www.prosper.com/
38 http://www.lendingclub.com
in 2011. The UK site Kantox offers peer-to-peer foreign exchange hedging.

The reward for financing a project may often be non-financial 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. 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. We refer to this type of crowdfunding as reward crowdfunding or pre-sales crowdfunding. Both reward crowdfunding and donation crowdfunding can be thought of as crowd sponsoring since there is no financial return involved for the backers. One of the main platforms offering crowd sponsoring is the U.S. based Kickstarter platform. Similar platforms have emerged in the European setting. The Open Source Science Project allows researchers to propose research projects to the crowd and pitch for funding online. This project is intended to give researchers access to alternative funding models and bypass traditional funding routes through the government, charity or industry, for example.

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40 See www.currencysfair.com and www.transferwise.com
41 www.kantox.com
43 Ibid.
45 The website http://www.betterplace.org/de/ is a German donor pooling platform. Crowdfunding or crowd sponsoring can be used for political purposes. For example, Barack Obama collected about US$ 750 million for his presidential campaign in 2008. Most of this amount was raised via the internet and came from small donors who contributed US$200 or less. See Tahman Bradley, “Final Fundraising Figure: Obama’s 750M” (5 December 2008) available at <http://abcnews.go.com/Poltics/Vote2008/story?id=6397572&page=1> (last accessed 15 October 2014). See also Jose Antonio Vargas, “Obama Raised Half a Billion Online” Washington Post, November 20, 2008 available at <http://voices.washingtonpost.com/44/2008/11/obama-raised-half-a-billion-on.html> (last accessed 22 April 2015).
46 http://www.kickstarter.com/
47 http://www.europecrowdfunding.org/
48 See Open Source Science Project http://www.theopensourcescienceproject.com/
A sub-genre is *civic crowdfunding*. This category of crowdfunding covers projects and platforms which seek to attract funding for parks, green-space related projects, community centres and social services.\(^{49}\) The objective is to produce classic public goods and promote public-private fundraising initiatives.\(^{50}\) Civic crowdfunding may occur on generic crowdfunding platforms that focus on a wide array of projects, but some sites such as Spacehive or Citizinvestor cater specifically to this type of crowdfunding.\(^{51}\)

Crowd sponsoring should be distinguished from *equity crowdfunding (crowd investing)* and *peer-to-peer lending (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. The main risks 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 since it is difficult to assess the quality of the projects and the ability of the entrepreneur to generate equity value. However, it is the ECF that shows the most promise. The Ontario Securities Commission has stated:

> In a relatively short time, crowdfunding has become a new method of raising capital for a broad range of purposes using the internet. To date, it has mainly been used by people seeking to raise money for a specific project and does not generally involve the issuance of securities. However, in some jurisdictions, crowdfunding is emerging as a way for businesses, particularly start-ups and small and medium-sized enterprises, to raise capital by issuing securities.\(^{52}\)

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\(^{50}\) Ibid.


In addition, there is considerable interest in the potential of crowdfunding to improve access to finance in developing countries.\(^5\) As a 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. Although financial crowdfunding currently is not considered to be a systemic concern, the proliferation of various financial reward-based crowdfunding models is likely to create systemic issues, given the interconnectedness of the global financial markets.\(^4\) 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 draw 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 start-ups or whether their investments are pooled via special purpose vehicles.\(^5\)

The typical crowdfunding model may be described as follows.\(^6\) First, a funding target, i.e. the sum to be raised, is set. Second, funders are encouraged to donate or pledge or to make advance purchases of items. Third, where the target is reached, the funds are released minus any fees payable to the crowdfunding intermediary. Where the target is not reached, the contributions are returned to the funder.\(^7\) This model is the *all-or-nothing-model* or the *threshold pledge model*.\(^8\)

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\(^7\) Ibid.
The key feature of this model is that the platform and the project owner agree on a concrete pledging period and the funding target. The funders promise to pay a specified amount only if the set target 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. Interested funders can view the current status of the project and the number and amount of incoming pledges. Payments are only released from the escrow account and transferred to the project owner if the funding target is reached. 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. The P2PL provider then collects the repayment instalments from the debtor (the project initiator), and forwards these to each crowd lender.59

In an *equity or investment model*, the platform and the project initiators define a time period and target threshold. 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. Crowd investors then pledge to buy the shares if the target threshold is reached.60 Some platforms such as the French platform wiseed.com may also create subsidiary companies to hold all of the shares in the crowd funded venture which are then on-sold to the crowd.61 In this scenario a subsidiary company would act as a single investor in the proposed venture and sell shares to crowd investors. 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. Rather than having a fragmented share register with a large number of small investors, the Crowdfunding firm can reduce transactions costs by utilizing an interposed SPV between itself

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59 Ibid 15.
60 Ibid 16.
61 Ibid. See https://www.wiseed.com/fr (last accessed 15 October 2014).
and its investors.  

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.  

Two examples of this model are CircleUp and FundersClub in the United States which are restricted to accredited investors. The aim is to reduce the size of the crowd to whom investments are made available. 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 idea or phenomenon. There are early examples of what might now be considered crowdfunding. 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 Harbour with donations of $1 or less. Pulitzer helped raised more than $100,000 in six months from 125,000 people.

In its modern iteration, crowdfunding can be traced back to the microfinance and microcredit

62 This structure is utilized by the UK equity crowdfunding platform Seedrs. See https://www.seedrs.com/. Seedrs states on its site: “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. That said, if you would like to hold your shares directly, and the company agrees, you are more than welcome to do so.”

63 Ibid 17.

64 See https://circleup.com/ and https://fundersclub.com/

movements. 66 Thus, crowdfunding has been described as the fusion of two pre-existing concepts, namely crowdsourcing and microfinance67 and is generally regarded as a progression of the crowdsourcing model described above. 68 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.69 Receiving parties demonstrate creditworthiness to financiers or donors by aggregating individual claims. A key characteristic of microfinance is that individuals donating or lending money can develop a personal connection to the beneficiaries of their contributions since they provide loans based on the profiles of the beneficiaries and their goals and thus avoid providing funding through opaque intermediaries or other lending channels.70 The Grameen Bank – established some 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.71 A crucial difference between crowdfunding and microfinance is that under a crowdfunding model, the size of investment is scaled down owing to mass support or crowd support, whereas under a microfinance model the aggregate amount sought is scaled down.72 This does not preclude the crowdfunding of microloans or micro donation campaigns.73


70 See http://www.kiva.org/lend

71 See generally http://www.grameen-info.org/.

72 Dresner, above n 68, 35.

73 Ibid.
In the developed world, crowdfunding first emerged in the music and film industry. This is consistent with private sponsorship and donations historically favouring the arts and culture. McFedries suggests the term “crowdfunding” was first used in 2006. Michael Sullivan coined the term to describe his website www.fundavlog.com which promoted video blogs. In 2009, the term gained prominence with the establishment of the popular crowdfunding platform Kickstarter. The rise of websites such as Facebook, Twitter, LinkedIn – generally associated with the emergence of Web 2.0 – and the popular payment services site PayPal enabled crowdfunding to gain greater visibility.

II. SME FINANCING AND THE GFC

A. The Financing Problem for SMEs

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

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77 Dresner, above n 68, 11.
79 Eurostat, Key Figures on European Business, with a Special Feature on SMEs (2011) 11.
80 Ibid.
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. For example, 97 per cent of all enterprises in New Zealand have fewer than 20 employees and are hence SMEs. The former Ministry of Economic Development in New Zealand notes that “access to financing can be an issue for start-up firms and firms that have intellectual property on account of their lack of collateral and likely cash flow.” 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. These constraints are more pronounced in developing than the developed countries, with SMEs loans constituting 13 percent of GDP in developed countries compared to 3 percent in the developing world.

The GFC downturn resulted in a deterioration of financing conditions. The European Commission observes in its Consultation Paper on Crowdfunding in the EU that “European SMEs largely depend on bank financing, but since the financial crisis banks are much more restrictive in their lending.” For example, in 2012 in the U.K alone, there was an estimated gap

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81 Statistics New Zealand, Small Businesses in New Zealand (May 2014).
between the demand and supply of SME lending of between £26 billion and £59 billion.\textsuperscript{87} Similarly, in the U.S., one of the main negative outcomes of the GFC crisis was the loss of bank funding for SMEs.\textsuperscript{88} 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.\textsuperscript{89} 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.\textsuperscript{90} The problem is compounded in the U.S by a slowdown in the number of start-ups.\textsuperscript{91}

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.\textsuperscript{92} 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 bank.\textsuperscript{93} The rate for rejection is 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

\textsuperscript{88} Dresner, above n 68, 9.
\textsuperscript{89} Angus Loten and Ruth Simon, above n 1, B5.
\textsuperscript{91} See Robert Litan, “Start-Up Slowdown” (2015) 94 (1) \textit{Foreign Affairs} 47.
enterprises. There are also significant variations between Member States with respect to SMEs’ access to banking finance.

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. The latter form of financing is also referred to as “investment-based crowdfunding.” In the section below, we examine the sources of financing available to SMEs, including public equity and private equity.

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. The introduction of the Basel Capital Accords – Basel II and Basel III – and the GFC downturn, however, has led to a tightening of bank credit policies. Basel II triggered a fundamental change in banks’ attitudes towards SMEs. The recommendations adopted by the Basel Committee require banks to establish rating processes which are intended to more

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95 Ibid.
99 Ibid.
accurately assess the risks of granting a loan.\(^\text{100}\) Quantitative and qualitative aspects are taken into account.\(^\text{101}\) One consequence of Basel II has been to reduce the ability of banks to grant loans during economic downturns. Banks are required to apply their ratings, which has increased their risk awareness.\(^\text{102}\) Banks now demand more transparency when lending and generally are only willing to lend to well-established companies.\(^\text{103}\)

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\(^\text{104}\) and public equity.\(^\text{105}\) 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.\(^\text{106}\) The fixed nature of some

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\(^{101}\) Ibid.


\(^{104}\) See The Economist, “Shadow and Substance” Special Report International Banking, The Economist, 10 May 2014, 1-16.


compliance costs creates a disproportionate burden on SMEs, reducing the attractiveness of an IPO.\footnote{107} In fact, IPOs for start-ups are relatively rare.\footnote{108}

The past decade has witnessed a wave of regulatory changes, which 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.\footnote{109} In particular, the post-Enron American crisis provided an impetus for increased regulation of IPO markets.\footnote{110} As a corollary, SMEs faced higher entry barriers, reducing the benefits of an IPO.

In response to increased regulation, a number of securities exchanges have re-organized their market segments with the aim of reducing the costs of entry and promoting greater access to public equity capital.\footnote{111} A feature of the new frameworks is that initial listing and subsequent


\footnote{108} John C. Coffee, Statement of Professor John C, Coffee, Jr, Adolf A. Berle Professor of Law Columbia University Law School at Hearings Before the Senate Committee on Banking, Housing and Urban Affairs “Spurring Job Growth Through Capital Formation While Protecting Investors” United States Senate (Washington DC, 1 December 2011) 1-3 available at <banking.senate.gov> (last accessed 15 November 2014).


\footnote{111} Valerie Revest and Alessandro Sapio, “Does the Alternative Investment Market Nurture Firm Growth? A Comparison between Listed and Private Companies” (2013) Industrial and
disclosure requirements progress from the lowest to the highest market segment.\textsuperscript{112} The emergence of lower-tier market segments – such as the Alternative Investment Market (‘AIM’) at the London Stock Exchange (‘LSE’), Alternext at the NYSE Euronext, M:access at the Munich Stock Exchange, the Alternative Market (‘NZAX’) on the New Zealand Exchange or the Growth Enterprise Market (‘GEM’) at the Hong Kong Stock Exchange – ‘represent a major experiment in market design.’\textsuperscript{113} However, these market segments are rarely accessed by SMEs. As a result, despite these innovations, small entrepreneurs continue to face financing constraints.

It is against this background that crowdfunding can provide a viable alternative for SME fund raising. Moreover, crowdfunding can precede other forms of financing such as bank financing, angel and venture capital financing, and IPOs thereby helping start-ups move up the “financing escalator.”\textsuperscript{114} 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 spur a project to get 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.\textsuperscript{115} This stage precedes the start-up phase where firms are beginning to realise an idea or product and enter into the so-called product development stage. 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.\textsuperscript{116} The firm needs financial resources to begin making and commercialising its ideas and during this stage crowdfunding can play a role. Later, once the firm has developed its products, the firm is likely

\textsuperscript{112} Ibid 1.
\textsuperscript{116} Ibid 9.
to enter into an expansion-development stage requiring additional capital to further finance increased production, make new acquisitions and increase its working capital.\textsuperscript{117}

2. Private Equity

Prior to the IPO stage, SMEs rely on several heterogeneous providers of finance.\textsuperscript{118} At law, these providers access carve outs or exclusions to prospectus requirements such as those applying to sophisticated or accredited investors. The ‘private equity market’ is comprised of informal networks and institutions, such as high net-worth individuals known as ‘angels’ and specialised financial intermediaries – venture capitalists – who provide direct capital to promising firms.\textsuperscript{119} Private equity provides capital to firms that have difficulties raising sufficient debt finance or obtaining public equity capital. 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 mid-point.’\textsuperscript{120}

Private equity offers a number of benefits.\textsuperscript{121} First, in comparison to debt, private equity does not result in fixed repayment obligations.\textsuperscript{122} Another advantage is availability at an earlier stage than debt financing.\textsuperscript{123} This is useful for firms which lack assets capable of being used as collateral.\textsuperscript{124} Second, the private equity infusion of funds enhances the credibility of the firm increasing its net

\textsuperscript{117} Ibid.
\textsuperscript{118} OECD, \textit{Globalisation and Small and Medium Enterprises (SMEs)} (1997) 117.
\textsuperscript{123} Ibid.
\textsuperscript{124} Ibid.
worth and overall financial strength.\textsuperscript{125} This, in turn, improves the access of the firm to other forms of financing, such as debt financing.\textsuperscript{126}

The provision of equity finance may increase a firm’s chances of survival. Private investors can lend significant managerial support and advice.\textsuperscript{127} The provision of finance by a particular investor may lead to a preferred relationship with other institutions.\textsuperscript{128} Although the level of involvement in a venture differs between private investors, monitoring can provide the entrepreneur with an incentive to maximize the value of the venture.\textsuperscript{129} However, only a minority of SMEs are able to obtain private equity.\textsuperscript{130} Private equity investors are usually attracted to rapidly growing SMEs, such as innovative high-technology firms with a high potential for profits and expansion.\textsuperscript{131}

### 3. Venture Capital

This section provides an insight into the financial behaviour of venture capital firms. It investigates a complex of factors, including the relatively slow development of the venture capital industry, the selection criteria employed by venture capitalist firms and the importance of different exit channels. Venture capital is often seen as a solution to the financing problems of SMEs. However, as the following discussion demonstrates, venture capital is only available for a

\textsuperscript{125} Ibid.
\textsuperscript{126} Ibid.
\textsuperscript{127} Mark Casson and Nigel Wadeson (eds), \textit{The Oxford Handbook of Entrepreneurship} (2008) 498.
\textsuperscript{129} Ibid.
\textsuperscript{130} Great Britain Department for Business Innovation and Skills, \textit{Financing a Private Sector Recovery} (2010) 14.
\textsuperscript{131} Ibid. See generally, Peter Thiel, \textit{Zero to One} (New York: Crown Business, 2014).
minority of SMEs, particularly in the developing world. Further, entrepreneur resistance can prove to be an important barrier, as entrepreneurs are unwilling to confer control rights to financiers.

The economic functions of venture capitalist companies include risk-pooling, risk-diversification, specialization and syndication. The venture capitalist carries out two important functions: namely, capital acquisition and capital provision. Prior to investing in businesses, the venture capitalist has to accumulate enough capital and secure commitments from investors. Traditionally, the participants in venture capital funds are institutional investors and wealthy individuals. Venture capital firms specialise in investing in particular types of firms, having regard to their industry, technologies, geographic region, and stage of development. There are differences between individual and corporate venture capitalists. Examples of corporate


venture programs are Google (Google Ventures), Dell (Dell Ventures), Oracle (Oracle Ventures).\textsuperscript{139}

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.\textsuperscript{140} Venture capitalists act as institutionalized meeting points for entrepreneurs and potential investors.\textsuperscript{141} They have the skills to identify profitable investment opportunities. This results in a reduction of the transaction costs incurred by the original suppliers of finance as their search and information costs are borne by venture capitalists.\textsuperscript{142} The use of standardized contracts reduces negotiation costs.\textsuperscript{143} Consequently, venture capitalists have a level of expertise that justifies their involvement as financial intermediaries. In the post-investment period, on the other hand, the active participation of venture capitalists in the monitoring of the firm leads to a mitigation of agency costs.\textsuperscript{144} 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 behaviour of entrepreneurial owners.\textsuperscript{145}

\begin{footnotes}
\item[142] Gompers and Lerner, above n 135, 157.
\end{footnotes}
Agency theory has been applied to venture capital investments even though such investments occur in private companies.\(^\text{146}\) It is worth noticing, however, that the venture capital firm itself acts as an agent on behalf of the original providers of capital.\(^\text{147}\) In fact, the venture capital firm fulfils a dual role: it acts as both a principal and agent.\(^\text{148}\) The venture capitalist assumes the role of the original suppliers of finance in providing finance and monitoring the firm. The objective of the original providers of capital is to maximize the value of their investment. High returns, stability through diversification, and liquidity are the key concerns for the investors.

There are inter-country differences concerning the size and effectiveness of the venture capital market.\(^\text{149}\) The venture capital market is a vibrant source of direct capital for SMEs in the U.S, but this cannot be said of all countries.\(^\text{150}\) The levels of venture capital financing are higher in developed countries due to the presence of established public capital markets and institutional investors.\(^\text{151}\) Turning to differences between the EU and the U.S., 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 U.S.) and beneath the optimal size necessary for making a substantial contribution to individual companies.


\(^\text{148}\) Ibid.


Moreover, U.S. venture capital funds invest around €4 million on average in a company compared to €2 million invested by their European counterparts.\textsuperscript{153} Early-stage capital investments in the U.S. are on average €2.2 million per company, while such investments amount to an average of 400 000 per company in the European setting.\textsuperscript{154}

Generally, only a fraction of firms that submit business plans to venture capital organizations are successful.\textsuperscript{155} 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.\textsuperscript{156} It is costly for the venture capital fund manager to monitor a large number of firms in the portfolio. Further, venture capitalists favour later-stage deals.\textsuperscript{157} Early stage investments are considered to be higher-risk. Such investments require a long term strategy. The selection of profitable later-stage investments enables the venture capitalist to build a reputation without having to wait before the investment gains materialize.


\textsuperscript{153} Ibid.


After closing the fund, the venture capitalist collects information about potential investments and promotes the fund. The venture capitalist then screens companies and conducts due diligence to determine the strengths, weaknesses, profitability and risks associated with particular ventures.\(^{158}\)

Venture capital firms use a number of selection criteria to decide on the suitability of potential applicant firms.\(^{159}\) The selection process usually consists of an assessment of the abilities of the management team. The talents, experience and skills of the management are considered to be one of the key determinants.\(^{160}\) Second, the venture capital firm will consider the potential market size of the product or service offered by the firm, its originality and marketability. 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.\(^{161}\) 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.\(^{162}\)

Once suitable investment opportunities are identified, the venture capitalist seeks to reach an agreement with the investee business about the deal. If both parties agree, the venture capital firm will begin disbursing funds to the firm. In the post-investment period, the venture capitalist monitors the firm to ensure the proper use of funds.\(^{163}\) At the end of the fund life cycle, venture

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\(^{160}\) Gompers and Lerner, above n 135, 258.

\(^{161}\) Ibid.


capitalists seek to exit by selling their stake to third parties via a trade sale, an IPO or secondary transaction.164

4. Business Angels

Venture capitalists and business angels play similar roles and often co-invest.165 In essence, angels are private informal venture capitalists. The angel finance market is a non-intermediated market which consists of a diverse pool of investors. Business angels are private individuals who use their own money to invest in an unlisted company in which they have no family connections.166 Obtaining information about transactions between entrepreneurs and business angels is often difficult since such transactions occur in an informal, unregulated market. The marketplace for angel finance is characterized by informational opacity167 and operates in obscurity.168 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.169 Such networks may be compared to crowdfunding portals which match entrepreneurs with crowd investors.

169 Mason and Harrison, above n 166, 111-123.
In the literature distinctions are made between types of angels, including business and knowledge angels. Our focus is only on business angels. The provision of finance to unlisted young and high-growth firms is one investment option. Business angels can be selective and may choose to invest in young growth firms for diversification purposes. Given this, SMEs wishing to obtain angel financing need to demonstrate the quality of their venture. Business angels often view themselves as being constrained by the lack of promising entrepreneurs and investment projects. Consequently, they do not need to allocate a significant percentage of their capital to their private equity portfolio.

Business angels frequently base their investment decisions on idiosyncratic considerations. Investing close to home may be important. The investor’s stage of life may also have an impact on the decision and the 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. Higher-risk investments may require a longer term horizon for realizing returns. While some time horizons will be acceptable to certain investors, others will not want to wait several years for gains.

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171 Ibid.
174 Ibid.
175 Ibid.
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 finance. Business angels, however, may be motivated by non-economic considerations when providing funds to unquoted firms. They may be willing to make a trade-off between financial and non-financial returns. Examples of relevant non-economic 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.

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 start-up firms. Obtaining angel financing is important for many firms, as it can lead to second round venture capital. But despite the value-adding advantages for SMEs, the angel finance market is not efficient. This is due its fragmented nature, reliance on ineffective communication channels and anonymity of angels.

A comparison has been made between several financing options, including internal finance, debt capital and equity finance in the previous section. The analysis reveals that different groups of financiers are likely to have heterogeneous incentive structures. The extent to which financiers engage in monitoring when providing finance varies between different groups of financiers. For example, venture capital firms prefer to be involved in management. While bank financing has historically been pre-dominant, recent trends cast doubt on its continued availability. Recent economic downturns, consolidation of the banking industry, and the erosion of relationship banking limit the pool of credit. In light of the limited availability of debt finance, entrepreneurs need to look towards expanding their equity base through alternatives. It is in this climate of limited access to capital that Crowdfunding and peer-to-peer lending create a new means of fund

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178 Ibid.
raising for SMEs. However, there are crucial differences between venture capitalists, business angels, institutional investors and crowd investors. 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.

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. 179 Private contracting allows venture capitalists and angel investors to enter into tailor-made contracts with entrepreneurs which can include various clauses such as anti-dilution provisions, convertible preference shares, monitoring rights and board representation to ensure control. Moreover, business angels refrain from buying common shares without voting rights, which tends to be common in crowdfunding. 180 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. 181 While crowdfunding platforms often offer standardized financial contracts to the issuer, 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 business angels or venture capitalists. 182

180 Ibid.
Angel investors and venture capitalists function as sophisticated private parties who can utilize shareholder agreements and other governance structures, 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.¹⁸³ 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. By contrast, crowd investors do not participate on the boards of crowdfunded firms 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. Moreover, unlike business angels or venture capitalists, crowd investors are not experts in developing and valuing firms. 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.¹⁸⁴ This led Hornuf and Schwienbacher to conclude that crowd investors are likely to offer less value-add than business angels or venture capitalists.¹⁸⁵

Nevertheless, where crowd investors participate in ECF, there is evidence to suggest that they can be efficient in channelling funds to appropriate fund seekers and participate in product development, thereby creating value for the firm.¹⁸⁶ 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.¹⁸⁷ They may act as patrons of the project and customers at the

¹⁸⁴ Belleflamme, Lambert and Schwienbacher, above n 22. 590.
Accordingly, entrepreneurs can benefit from crowdfunding in a number of ways: they not only receive funds for seed-financing or early-start up financing, but they also benefit from word of mouth by their investors and potential customers through social media.

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.

In this way, the advantages of using crowdfunding are not only limited to access to finance but extend to market validation of the firms’ products 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 start-up process. Being able to pre-sell products or services assists the firm in evaluating users’ reactions and further fine-tuning or customizing 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. By comparison, crowd investors may have a much broader investment spectrum.

Furthermore, in the long-run crowdfunding platforms can help entrepreneurs benefit from the so-called “big data” paradigm. By analysing data trails left online by investors and entrepreneurs using ECF and P2PL, crowdfunding platforms may be able to better match investors and

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188 Wilson and Testoni, above n 16, 6.
190 Ibid.
191 Wilson and Testoni, above n 16, 5.
companies and thus facilitate investment deals.\textsuperscript{193} The SEC has stated:

\begin{quote}
We believe that it is important for funding portals to be subject to a recordkeeping requirement in order to create a meaningful audit trail of the crowdfunding transactions and communications.\textsuperscript{194}
\end{quote}

Finally, a solution for the perceived lack of \textit{ex ante} investor protections in the ECF context may be to allow crowd investors to co-invest with business angels – an approach which has been adopted by some platforms such as the MyMicroInvest in Belgium.\textsuperscript{195} The platform allows crowd investors to invest alongside professional investors, and thereby benefit from the financial contracting and post-investment monitoring skills of such investors.\textsuperscript{196} The advantage of such an approach is that it facilitates collaboration between 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 and those of the investors.\textsuperscript{197}

\section*{III. THE GLOBAL MARKET FOR CROWDFUNDING}

Crowdfunding is a new funding model growing in a number of countries. One study reported 240 crowdfunding platforms globally in 2011 but this number is growing rapidly.\textsuperscript{198} According to the 2013 \textit{Crowdfunding Industry Report}, crowdfunding has raised $2.7 billion globally in 2012, an increase of 81 percent compared to 2011.\textsuperscript{199} This figure accounts for all types of crowdfunding including donation-based, lending-based, reward-based and equity-based crowdfunding. North America and European platforms account for approximately 95 percent of the total market,

\begin{footnotesize}
\begin{enumerate}
\item Ibid. See also Wilson and Testoni, above n 16, 7.
\item SEC, \textit{Proposed Crowdfunding Rules under Title III of the JOBS Act} (October 2013) 261.
\item https://www.mymicroinvest.com/
\item Wilson and Testoni, above n 16, 9.
\item Hemer, above n 58, 9.
\end{enumerate}
\end{footnotesize}
raising more capital than elsewhere. In 2011, the North American crowdfunding market grew by 86 percent, followed by 105 percent in 2012 reaching amount in excess of $1.6 billion.\footnote{200} European platforms raised $945 million – an increase of 65 percent in 2012 compared to 2011.\footnote{201} The aggregate 2012 funding volume in Asia was $33 million; in Oceania, $76 million.\footnote{202} The U.S., therefore, leads the field in crowdfunding.\footnote{203} The financing gap is largest in South America and Africa where $0.8 million and $0.065 million was raised respectively.\footnote{204} Donation-based crowdfunding represents the highest volume of crowdfunding, while equity-based crowdfunding was used to a lesser extent mainly because of the absence of crowdfunding legislation.

The majority of crowdfunding project applications were submitted to the early established platforms such as MyMajorCompany, IndieGoGo and Kickstarter, with 18,000, 15,000 and 12,000 applications submitted to each of these sites respectively.\footnote{205} 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).\footnote{206} Conversely, MyMajorCompany only accepts 0.2 percent of applications and Sonicangel accepts 0.8 percent.\footnote{207} 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 of between 42 and 84 percent.\footnote{208}
The majority of crowdfunding projects are derived from the creative industry and the not-for-profit sector.\textsuperscript{209} Here, crowdfunding has been primarily used to support creative ideas, projects and ventures rather than innovations. This is because crowdfunding is particularly suited to case-by-case funding of single projects which 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.\textsuperscript{210}

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 success rates of between 1 and 5 percent.\textsuperscript{211} The author concludes that genuine entrepreneurial ventures funded through crowdfunding platforms are few at present.\textsuperscript{212}

Crowdfunding entrepreneurs face various challenges which often prevent them from achieving their funding goals. For example, some entrepreneurs have trouble estimating and activating their network capabilities when seeking funding.\textsuperscript{213} They often do not realise the importance of growing their network prior to launching an online campaign or underestimate the time it takes to build such a network.\textsuperscript{214} Crowdfunding is often not fully understood by entrepreneurs. As a result, few use this novel way of financing despite the potential that crowdfunding provides. 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

\textsuperscript{209} Ibid., 23.  
\textsuperscript{210} Ibid., 27.  
\textsuperscript{211} Ibid.  
\textsuperscript{212} Ibid.  
\textsuperscript{214} Ibid., 3.
crowdfunding or P2PL platform and successful investor communication. According to Mollick, personal networks, the attributes of the project and geographical location also play a crucial role. 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. There is a deal of experimentation involved across different models and the market for crowd funded equity capital remains at an evolutionary stage. The next section considers the various regulatory regimes currently available. This is prefaced by a generalised discussion 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, facilitate the transmission of funds and disclosure to and back from entrepreneurs to investors. However, crowdfunding and peer-to-peer platforms are not banks or deposit takers. They use escrow accounts in which monies are held and do not reinvest these monies 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.

Such clauses ensure that crowdfunding platforms are not subject to prudential supervision.


216 Ethan Mollick, above n 23, 2.


218 See Buzzbnk website: https://www.buzzbnk.org/StaticPages/FAQ.aspx
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. It is less clear how crowdfunding projects with non-financial rewards are to be taxed (if at all) and such projects may be in a grey zone as regards taxation. Furthermore, the tax status of the crowdfunding platforms themselves requires further consideration. The issue is whether some crowdfunding platforms ought to be classed as non-profit platforms, while other platforms which provide crowdfunding with financial rewards ought to be classed 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.\(^\text{219}\) Platforms such as Kickstarter, Indiegogo and RocketHub comply with international and U.S. anti-money laundering laws.\(^\text{220}\)

**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. 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.

\(^{219}\) World Bank, above n 53, 45.

\(^{220}\) Ibid.
British peer-to-peer lending platforms have launched a peer-to-peer finance association – P2PFA.\textsuperscript{221} The association is a self-regulatory body which seeks to promote certain standards of conduct and consumer protection amongst British peer-to-peer lending platforms such as Zopa, FundingCircle and RateSetter. The operating principles of the association set out key requirements for the operation of peer-to-peer finance platforms. They cover the following:

- Senior management
- Minimum operating capital requirements;
- 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.\textsuperscript{222}

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 here 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.\textsuperscript{223} Similarly, portals such as Angelist.com and Shekra.com are only accessible to screened high-net worth investors.\textsuperscript{224} The British

\begin{itemize}
\item \textsuperscript{221} See Peer-to-Peer Finance Association website: http://p2pfa.info/about-p2p-finance
\item \textsuperscript{222} See Peer-to-Peer Finance Association, Rules 2014 available at http://p2pfa.info/rules
\item \textsuperscript{223} https://www.investiere.ch/
\item \textsuperscript{224} See www.angelist.com and www.shekra.com
\end{itemize}
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 first satisfy themselves that they are not subject to any local requirements that prohibit or restrict them from doing so.\textsuperscript{225}

In addition, using the site to initialize crowdfunding projects is restricted to citizens of the U.K. Conversely, some platforms will accept non-domestic ventures. For example, Buzzbnk states:

Buzzbnk is developed for primarily UK based ventures although we will accept organizations registered in other countries under certain criteria.\textsuperscript{226}

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 two hundred countries and regions.\textsuperscript{227}

\textbf{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. The crowd is likely to be heterogeneous - including representatives of various social groups, 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.\textsuperscript{228}

Behavioural 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 behaviour) and crowds as a source of collective intelligence.\textsuperscript{229} Surowiecki, for example, suggests that crowds have the capacity to be wise owing to such factors as cognitive and

\textsuperscript{225} http://www.crowdcube.com/pg/crowdcube-faq-20
\textsuperscript{226} https://www.buzzbnk.org/StaticPages/FAQ.aspx
\textsuperscript{228} Joan MacLeod Heminway, “Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the Crowd” (2014) 38 \textit{Vermont Law Review} 827, 830.
conceptual diversity, collective knowledge, independence (relative freedom from the influence of others) and decentralization. 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.  

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. This requirement is then tempered by the small monetary value of the investment. The small monetary value of the investment is the flip-side 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 logical extension of this argument is to propose a sliding scale or spectrum of disclosure tied to the quantum of monies 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 to the typical information asymmetry problem described by Akerlof.\footnote{George Akerlof, “The Market for Lemons: Quality Uncertainty and the Market Mechanism” (1970) 84 Quarterly Journal of Economics 488.} Receivers of funds have more knowledge about the viability of the project than investors. In addition, moral hazard problems arise since entrepreneurs may utilise funds for personal gain.\footnote{Gmeleen Faye Tomboc, “The Lemons Problem in Crowdfunding” (2013) 30(2) The John Marshall Journal of Information Technology and Privacy Law 253.}

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.\footnote{Ferdinand Thies and Michael Wessel, “The Circular Effects of Popularity Information and Electronic Word-of-Mouth on Consumer Decision-Making: Evidence from a Crowdfunding Platform” (2014) Twenty Second European Conference on Information Systems, Tel Aviv available at <http://ecis2014.eu/E-poster/files/0810-file1.pdf> 1 (last accessed 15 October 2014).} 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.\footnote{J.J. Zhang and P. Liu, “Rational Herding in Microloan Markets” (2012) 58(5) Management Science 892-912.} 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 result of prior donations.\footnote{Thies and Wessel, above n 233, 2.} A study published by Ahlers et al finds that firms which 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.\footnote{Gerrit K. C. Ahlers, Douglas Cumming, Christina Günther and Denis Schweizer, “Equity Crowdfunding” (2013) 4 available at <http://ssrn.com/abstract=2362340 > (last accessed 10 November 2014).}
Moritz et al published a study examining investor communication in the context of crowdfunding.\textsuperscript{237} The authors adopt an exploratory qualitative research approach based on semi-structured interviews with 17 crowdfunding participants: six crowd investors, six new ventures, and five third parties. The authors develop a theoretical framework and present it in a set of six propositions. The results indicate that the venture’s overall impression — especially perceived sympathy, openness, and trustworthiness — plays a significant role in reducing the information asymmetries of crowd investors. Thus, it is important for entrepreneurs to communicate “soft facts.” This is typically done via pseudo-personal communication channels, such as videos.\textsuperscript{238}

In addition to soft facts, Moritz et al find that crowd investors are also influenced by other market participants. 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.\textsuperscript{239} This may lead to information cascades and “herd behaviour” in the sense that individual investors choose to make decisions based on the actions of others rather than on private information available to them.\textsuperscript{240} 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, already successful campaigns receive further popularity boosts, leading to positive upward information cascades.\textsuperscript{241} Conversely, projects which lack a high number of backers may experience a negative downward information cascade.\textsuperscript{242} 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.”\textsuperscript{243}


\textsuperscript{238} Ibid., 3.
\textsuperscript{239} Ibid.
\textsuperscript{240} Ibid
\textsuperscript{241} Ibid., 4.
\textsuperscript{242} Ibid.
The above analysis suggests that crowd investors are often “hype driven” and subject to social contagion processes – a fact which may be exploited by crowdfunding platforms.  

Crowdfunding platforms often adopt business models which seek to establish positive funding momentum by imposing short investment spans, funding limits and making the funding process transparent. This 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 pre-appointed “guinea pigs” who act as buyers.

According to Burtch, herding behaviour is a negative externality of crowdfunding. However, from an entrepreneurial perspective, the reverse is also true. Herding can be regarded as a positive externality since it results in a snowball effect and helps entrepreneurs meet their financing objectives. Other potential pitfalls of crowd wisdom may be summarised as: pluralistic ignorance and groupthink (i.e. members of the group coming to incorrect decisions or assumptions based on a desire to find conformity within a group); bandwagoning (i.e. 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 (i.e. a cognitive bias with unskilled individuals rating their own abilities higher than average).

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244 Ibid., 14.
248 Dresner, above n 68, 65.
IV. 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.

A. The Australian Model

Australia has attempted to solve the SME financing problem via various means. For example, the Australian Corporations Act 2001 (Cth.) contains various provisions which are designed to facilitate “small scale offerings” or low-value capital raisings. The relevant rules are contained in Chapter 6D of the Act. 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 offer of securities to an investor. Exemptions to this rule are contained in s 708 of the Act which provides that no disclosure is required where a personal offer is made, i.e. an offer of less than $2 million and involving no more than 20 investors in a 12 month period; or alternatively the offer is made to sophisticated or professional investors. A sophisticated investor is defined as someone with net assets greater than $2.5 million or gross income of at least $250,000 in the last two years. Professional investors, on the other hand, include listed entities with assets of at least $10 million. 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 finance from the public are increased.

249 Australian Corporations Act 2011 (Cth.) Chapter 6D.
250 Australian Corporations Act 2001 (Cth.) ss 708(1)-(7).
251 Corporations Act 2001 (Cth.), s 708.
The law also provides for the use of “offer information statements” – abbreviated information statements – rather than a prospectus where the total amount raised by a body corporate or specific related entities is AUD$10 million or less.\textsuperscript{252} Moreover, there are specific “sophisticated investor” exemptions which allow companies to raise funds from sophisticated investors without a disclosure document.\textsuperscript{253} In addition, the \textit{Venture Capital Act 2002} provides for so-called venture-capital limited partnerships (VCLPs) and Early Stage Venture Capital Limited Partnerships (ESVCLP) that enjoy tax concessions.\textsuperscript{254} For example, the ESVCLP program was established in 2007 and is aimed at further encouraging investment in early-stage companies. All partners in ESVCLPs are exempt from tax on any share of the income derived by the partnership.\textsuperscript{255} Lastly, Australia has introduced certain public-private equity co-investment schemes whereby government and private sector capital is pooled to invest in new Australian companies commercialising innovative ideas.\textsuperscript{256} Such co-investment programs are coupled with tax incentives and together they help to attract capital to the high risk venture capital sector.

Table 1 provides an overview of these reforms.

<table>
<thead>
<tr>
<th>Low-Value Capital Raisings</th>
<th>Relevant Legislation</th>
<th>Key provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ss 708(1)-(7) of the \textit{Corporations Act 2001 (Cth)}</td>
<td>Australian provisions contain “bright line” rules that say that disclosure (via a prospectus) is required unless exceptions apply. The key exceptions include the small scale offerings and sophisticated investors. The exemption from the prospectus requirement for</td>
</tr>
</tbody>
</table>

\textsuperscript{252} Australian \textit{Corporations Act 2001 (Cth.)} ss 709(4).
\textsuperscript{253} Australian \textit{Corporations Act 2001 (Cth.)} ss 708(8)-(10).
\textsuperscript{255} Ibid.
small scale offerings is defined to allow up to 20 personal offerings in any period of 12 months (the “20/12” rule).

Under the 20/12 rule, the number of investors, rather than the number of offerees, is counted, subject to a financial ceiling.

The exemption is available when three conditions are satisfied, namely that:

- the offers are personal offers for issue or sale of a body's securities;
- none of the offers results in a breach of the 20 investors ceiling; and
- none of the offers results in a breach of the $2m ceiling: s 708(1).

*Future Reform Proposals:* Thresholds are likely to be relaxed in 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.

<table>
<thead>
<tr>
<th>Offer information statements</th>
<th>s 709(4) the <em>Corporations Act 2001 (Cth)</em></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A body, a related body corporate or a controlled entity, offering to issue securities may use an offer <em>information statement</em> instead of a prospectus if the total of all amounts raised by the body or specified related entities is $10 million or less.</td>
</tr>
</tbody>
</table>

The offer information
statement is primarily intended to be a fundraising mechanism for SMEs, though it is not limited to those enterprises. The main requirement is that the company includes an audited financial report covering a 12-month period and have a balance date no later than 6 months before the securities are first offered.

<table>
<thead>
<tr>
<th>Sophisticated Investors</th>
<th>ss 708(8)-(10) of the Corporations Act 2001 (Cth)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The Corporations Act permits offers to be made to “sophisticated investors” without a disclosure document. A potential investor might derive “sophistication” from one or more of either three things:</td>
</tr>
<tr>
<td></td>
<td>(1) amount of the investment, or</td>
</tr>
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<td></td>
<td>(2) financial status or income of the investor, or</td>
</tr>
<tr>
<td></td>
<td>(3) investment experience of the investor.</td>
</tr>
<tr>
<td></td>
<td>Two types of “sophisticated investors” are encompassed. One is the large investor. If the investor is paying at least $500,000 or has a gross income or net assets that exceed the prescribed minimum, the offer is exempt.</td>
</tr>
<tr>
<td></td>
<td>A sophisticated investor is a person with net assets of at least $2.5 million or a gross income for each of the past two financial years of at least $250,000. Another is the</td>
</tr>
</tbody>
</table>
| **Venture Capital Sector** | **Venture Capital Act 2002** | • *Venture Capital Limited Partnerships* (VCLP), established in 2002  
• *Early Stage Venture Capital Limited Partnerships* (ESVCLP) programs  
• The ESVCLP program was established in 2007 and is aimed at further encouraging investment in early-stage companies. All partners in ESVCLPs are *exempt from tax on any share of the income* derived by the partnership.  
• The ESVCLP program replaced the Pooled Development Funds (PDF) program. Over $961 million has been invested in 707 Australian companies under the PDF program. Since the ESVCLP program was established in 2007, registered ESVCLPs have invested $64 million into 50 businesses |
<p>| <strong>Tax Concessions</strong> |  | • The Australian Government has several tax concession programs for the venture capital sector including the Venture Capital Limited Partnerships (VCLP) and the Early Stage |</p>
<table>
<thead>
<tr>
<th>Venture Capital Limited Partnerships (ESVCLP) programs</th>
<th>Other tax concessions: Research and Development (R&amp;D) Tax Incentive and Enterprise Connect</th>
</tr>
</thead>
</table>

**Public-Private Equity Co-Investment Schemes**

- Government and private sector capital is pooled to invest in new Australian companies commercialising innovative ideas.
- Co-investment programs are coupled with *tax incentives* and together they help to attract capital to the high risk venture capital sector.

The Australian Government equity-based venture capital programs comprise:

- the Innovation Investment Fund (IIF) — last funding in 201. 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; and
- the Entrepreneurs’ Infrastructure Programme 2014/15; intended to supply AUD$484.2 million over five
As of April 2015, Australia has no legislation in place to facilitate crowdfunding.\(^{257}\) Companies may, however, raise finance via the exemptions in s 708 or the Australian Small Scale Offerings Board (ASSOB). ASSOB was created under ASIC Class Order 02/273 which provides an exemption from the fundraising provisions of the Corporations Act. The board allows small companies to list their company on the board for registered investors. To date, more than A$135 million has been raised using the platform.\(^ {258}\) It costs a company $4,500 to list on the platform.\(^ {259}\) Furthermore, companies incur fees in remaining on the list. Other than ASSOB, there are few equity crowdfunding platforms to which Australian companies may have recourse.\(^ {260}\) This not only substantially reduces competition in the crowdfunding market, but also reduces SMEs’ access to capital.

**B. The New Zealand Model**

Capital market law reforms aimed at SMEs have been enacted in various jurisdictions, including New Zealand. For example, New Zealand has 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. New Zealand law also follows the cognate Australian “small scale offerings” exemptions, enabling issuers of debt and equity securities to funds up to $2 million in any 12-month period from 20 investors. Other exemptions include the offers to wholesale investors exemption under the Financial Markets Conduct Act 2013. The latter covers investment businesses, persons engaged in investment activities, eligible investors and persons making an investment of $750,000 or more. Issuers issuing securities to wholesale investors are not required to comply with prospectus requirements. New Zealand law also makes provision for


\(^{259}\) Ibid.

\(^{260}\) See Rose Powell, op. cit., discussing the VentureCrowd platform which enables sophisticated investors in Australia to invest up to AUD$ 2,500.
venture capital schemes which allow 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.\footnote{261 See New Zealand Securities Act (Venture Capital Schemes) Exemption Amendment Notice 2012, and Securities Act (Venture Capital Schemes) Exemption Notice 2008.}

The New Zealand Stock Exchange also proposes to introduce a New High Growth Market Segment (NXT) aimed at SMEs. 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 a quarterly business update. The KOMs will replace prospective financial information (PFI) currently required in listing documents and it is expected this will reduce the initial listing costs for SMEs. Table 2 provides an overview of key capital market law reforms aimed at SMEs.

<table>
<thead>
<tr>
<th>Legislation</th>
<th>Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Reporting</strong></td>
<td>Requirements are simplified for SMEs under FRA 2013. SMEs have the option of preparing \textit{special purpose financial reports} for tax purposes.</td>
</tr>
<tr>
<td>Financial Reporting Act 2013</td>
<td><strong>Exemptions from Prospectus Requirements</strong></td>
</tr>
<tr>
<td>Financial Market Conduct Act 2013</td>
<td>Key exemptions include the following:</td>
</tr>
<tr>
<td></td>
<td>- \textit{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 $2 million in any 12-month period form 20 investors</td>
</tr>
<tr>
<td></td>
<td>- \textit{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</td>
</tr>
<tr>
<td></td>
<td>- \textit{Offers for persons in close relationships}: This category comprises close business associates and relatives</td>
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<tr>
<td></td>
<td>- \textit{Offers through licensed intermediaries: ECF and P2PL}</td>
</tr>
</tbody>
</table>

**Table 2: New Zealand SME Capital Market Law Reforms**

New Zealand Stock Exchange: NXT is aimed at SMEs
The key elements of the NXT disclosure regime are:
• the setting by the firm of “key operating...
| **New High Growth Market Segment (NXT)** | **milestones** (KOMs) by which investors can measure and monitor business performance  
• a quarterly business update  
• a set list of events requiring immediate disclosure to the market between business updates.  
KOMs will replace prospective financial information (PFI) currently required in listing documents and it is hoped that this will reduce the initial listing costs for SMEs.  
  
• 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.  
• This new high-growth segment was developed jointly by the UK Government and London Stock Exchange. It is in addition to the second board called AIM, High Growth Segment, <http://www.londonstockexchange.com/companies-and-advisors/main-market/companies/hgs/hgs.htm>. |
| **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  
• The New Zealand Financial Markets Authority (FMA) has designated 10 organisations, including Powerhouse Ventures Limited, to administer the venture capital scheme. The scheme administrators operate under a *Code of Practice* and are exempt from various securities law requirements.  
• A business which wants to raise funds from the public for a project or venture may apply to become a Registered Business under any Scheme  
• A Registered Business which makes an offer of equity securities or participatory securities |
in compliance with the Code may rely on the exemptions in the Exemption Notice from the requirement to have a registered prospectus and from certain advertising requirements of the law.

- Company can raise no more than NZD$ 5 million

| Government support programs | • Callaghan Innovation’s Incubator Support Programme  
  • R&D Grants |

However, despite these innovations, financing continues to be a significant obstacle for SME growth and development. In the next section, therefore, we draw attention to crowdfunding as a possible solution to the SME financing problem. We begin with the New Zealand crowdfunding model and examine the crowdfunding models of other countries.

1. The Pre-existing Regulatory Model under the Securities Act 1978

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.\(^{262}\) Under s 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, or as part of an authorised advertisement, or made in or accompanied by a registered prospectus.\(^{263}\) Thus, the Act imposed various restrictions on offers to the public. Excluded from these restrictions were certain offerees such as relatives and close business associates of the issuer who were not considered members of the public. 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. 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 s 3 of the Securities Act 1978. The same position holds good in Australia as of April 2015. ECF

\(^{262}\) The New Zealand model was followed by Papua New Guinea and Samoa.

\(^{263}\) See Securities Act 1978, s 33. 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). There are no crowdfunding provisions in the Hong Kong legislation – see Schedule 17. Ibid.
is possible but only via the exclusions or carve outs to the prospectus requirements in the Corporations Act 2001 (Cth.).


The FMC Act 2013 and the Financial Markets Conduct Regulations 2014 (FMC Regulations) provide for two new forms of capital raising, namely crowdfunding and peer-to-peer lending. Under the 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. Licensed intermediaries for this purpose are persons licensed to provide crowd-funding or peer-to-peer lending services under Part 6 of the FMC Act.

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. 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). Licensed crowd-funding 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. 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. Crowdfunding and peer-to-peer services are designated as prescribed intermediary services.

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264 See Terence Wong, op. cit. for discussion of ECF in Australia in the absence of specific legislative provision. For an example of how ECF works in Australia in such context, see Rose Powell, “Crowdsourcing Adds $1.2m to Start-up Ingogo’s $9.1m Raising” The Australian Financial Review, 30 September 2014, 3.


266 Financial Markets Conduct Act 2013 (NZ), Sch 1, Pt 1, cl 6. Note that the exclusions contained in Sch 1, Pt 1 of the Act are similar to the carve outs in s 708 of the Australian Corporations Act 2001 (Cth).

Accordingly, the protection of investors is derived from the licensing regime in Part 6 the FMC Act rather than Part 3 of the Act. Licensed providers remain subject to various requirements, including making disclosure to clients about the nature of the services provided. They are also subject to FMA supervision. As 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 but instead modified disclosure requirements apply.

Generally, the disclosure obligations imposed on ECF providers are fewer than those that apply on a registered exchange. A company issuing securities through crowdfunding services is subject to less disclosure than a company listed on the NZX. 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. Such exclusions from disclosure are intended to make it easier for SMEs to raise capital.

Regulation 185 of the FMC Regulations 2014 defines the terms “crowd funding service” and “peer-to-peer lending services”. 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 in doing so is to facilitate the matching of companies who wish to raise funds with many investors who are seeking to invest relatively small amounts.

A person provides a “peer-to-peer lending service” if:

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

**Part 6 of the FMC Regulations 2014**

Part 6 of the FMC Regulations 2014 contains provisions which:

- allow crowdfunding services and peer-to-peer lending services providers to be licensed
Reg. 184);  
- provide additional eligibility criteria such as adequate systems and procedures to ensure that issuers do not raise more than $2m in any 12-month period (Reg. 186); 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)

These requirements are discussed below.

**Licensing Requirements**

Equity-based crowdfunding facilities and peer-to-peer lending service facilities must apply to be licensed by the FMA. The FMA issued the first equity crowdfunding licenses on 31 July 2014 to PledgeMe and Snowball Effect.268 The criteria for obtaining a license to provide a crowdfunding service are set out in s 396 of the FMC Act and additional eligibility criteria apply under Regulation 186 of the FMC Regulations 2014. The eligibility criteria for a crowdfunding service under s 396(a) of the FMC Act are as follows:

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

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.

**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;
- how investments are made and financial products are issued under the service; and
- how investor money is received and dealt with.\(^{269}\)

In addition, the provider must disclose information about the nature and extent of the checks and assessment made by the provider of each issuer that offers financial products under the service;\(^{270}\) the directors and senior managers of those issuers;\(^{271}\) the risks involved in those financial products;\(^{272}\) the nature and extent of disclosure arrangements that apply in relation to the financial products offered under the service;\(^{273}\) the charges that may be payable to the provider by an investor or by an issuers;\(^{274}\) the rights of the provider;\(^{275}\) the nature of any restrictions or prohibitions;\(^{276}\) 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

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\(^{269}\) Financial Markets Conduct Regulations 2014 (NZ), reg 215(1).
\(^{273}\) Financial Markets Conduct Regulations 2014 (NZ), reg 215(1)(g).
\(^{274}\) Financial Markets Conduct Regulations 2014 (NZ), reg 215(1)(h).
\(^{275}\) Financial Markets Conduct Regulations 2014 (NZ), reg 215(1)(i).
\(^{276}\) Financial Markets Conduct Regulations 2014 (NZ), reg 215(1)(k).
transparent systems and procedures for providing the service.\textsuperscript{277} Further, investors must receive information about the contact details of the provider and how they may complain about the service to the provider and to any dispute resolution scheme that is available.\textsuperscript{278} Regulation 196 imposes an obligation to make a warning statement available.\textsuperscript{279} 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 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.\textsuperscript{280}

\textit{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. This confirmation must be obtained in writing in a separate document.\textsuperscript{281}

\textit{Issuers must not breach $2 million aggregate limit} The regulations limit companies using crowdfunding, peer-to-peer lending services and/or the small offers exclusion under Schedule 1 of the FMC Act to a NZ$ 2 million “aggregate limit.” \textsuperscript{282} This means that issuers may not raise more than $2 million from the public in any 12-month period. At first glance, this appears to be a variation of the so-called “20/12” exclusion to the prospectus requirements of the cognate

\begin{flushleft}
\textsuperscript{277} Financial Markets Conduct Regulations 2014 (NZ), reg 215(1)(l).
\textsuperscript{278} Financial Markets Conduct Regulations 2014 (NZ), reg 215(1)(m)-(n).
\textsuperscript{279} Financial Markets Conduct Regulations 2014 (NZ), reg 196(1).
\textsuperscript{280} Financial Markets Conduct Regulations 2014 (NZ), reg 196(2).
\textsuperscript{281} Financial Markets Conduct Regulations 2014 (NZ), reg 197(2).
\textsuperscript{282} Financial Markets Conduct Regulations 2014 (NZ), reg 186(1)(g).
\end{flushleft}
Australian legislation.\textsuperscript{283} The key difference is that while the monetary limit is the same, the New Zealand provisions have no limit on the number of investors.

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

The securities framework in the U.S. is based on the *Securities Act* of 1933. This Act operates in conjunction with the *Securities Exchange Act* of 1934 which created the U.S. Securities and Exchange Commission (SEC). The Acts were enacted in response to the 1929 stock market crash. The SEC is responsible for enforcing the securities laws and promoting public confidence in capital markets. In addition, the *Sarbanes Oxley Act* of 2002 – commonly referred to as the SOX Act – imposes various corporate governance, accounting and financial reporting requirements on companies.\textsuperscript{284}

Under the *Securities Exchange Act*, companies are required to register the distribution of securities with the SEC prior to engaging in the inter-state sale of securities. This requirement applies unless one of three exemptions applies under Regulation D. These exemptions correspond to Rules 504, 505 and 506 respectively, with Rule 506 having the most impact.

The SEC adopted Regulation D in 1982 with the aim of establishing certain exemptions for companies which issue securities. The main purpose of the exemptions is to allow companies to issue securities without having to register them with the SEC. Regulation D extends to accredited investors and uses income criteria for determining when the registration requirement does not apply.\textsuperscript{285} 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, which does not include the value of his or her primary residence.\textsuperscript{286} This is the so-called net-worth test applied under

\textsuperscript{283} See the discussion below.
\textsuperscript{284} *Sarbanes Oxley Act* 2002.
\textsuperscript{285} Regulation D, Rule 505.
\textsuperscript{286} *Securities Act* 1933, section 2(15)(ii).
Regulation D. 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. 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.

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 offer or sales are made to accredited investors. The company may make an offering to an unlimited number of accredited investors, but only up to 35 unaccredited investors. 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 this description.” This usually limits offerings to accredited investors only. 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. Accordingly, an issuer is obliged to determine that the investor is purchasing the restricted securities for investment purposes only rather than re-sale.

As a result of this regulatory structure, small investors were generally unable to participate in investing in start-ups, while start-ups were unable to attract funds from small investors.

289 This requirement applies under Rule 506.
290 Dresner, above n 68, 151.
Regulation D, therefore, effectively precluded the emergence of crowdfunding projects online as this involves the raising of capital with public solicitation from unaccredited investors. 291

To date, websites such as Kickstarter in the U.S. have not been used to sell securities. This was intended to change with the passage of the Jumpstart Our Business Startups (JOBS) Act. The latter Act was passed on 5 April 2012 and it was originally expected that the Act would be implemented by the SEC by 1 January 2013. President Obama described the JOBS Act for start-ups and small businesses as a “potential game changer.”292 The primary aim of the legislation is to promote the formation of new companies and spur job growth. The Act introduces a new term – an “emerging growth company” (EGC) – and deals with crowdfunding as well as small issues. 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. Title I of the Act is devoted to EGCs, while Titles II and III deal with crowdfunding and small issues. In its final form, the JOBS Act allows start-ups and small businesses to use SEC-registered websites to raise debt or equity capital, and thereby, effectively legalises crowdfunding. The SEC has stated:

To the extent that crowdfunding rules are successfully utilized, the crowdfunding provisions of the JOBS Act should provide start-ups 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.293

Commenting on the wider economic effects of crowdfunding, the SEC notes:

291 Dresner, above n 68, 10.
293 SEC, Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) [17 CFR Parts 200, 227, 232, 239, 240 and 249; Release Nos. 33-9470; 34-70741; File No. S7-09-13; RIN 3235-AL37] at 344.
The availability of securities-based crowdfunding as a financing option could increase competition among suppliers of capital, resulting in a potentially lower cost of capital for all issuers, including those that choose not to use securities-based crowdfunding.\textsuperscript{294}

The specific provisions of the JOBS Act are explored below.

1. The Crowdfunding Exemption

Title III of the Act introduces a new exemption from the registration requirements under s 5 of the U.S. Securities Act 1933 in order to facilitate certain crowdfunding transactions. This exemption is added as a Crowdfunding transactional exemption under s 4(a)(6) of the Securities Act of 1933.\textsuperscript{295} 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:

\textit{Limits on Maximum Funds that an Issuer Can Raise}

First, the total amount raised must not exceed $1 million in a 12-month period. For example, a start-up may raise $500,000 in a first crowdfunding and raise another $500,000 in a second crowdfunding within a year. However, where the start-up has raised $1 million in the past 12 months, it will be unable to utilize crowdfunding.\textsuperscript{296} This restriction, therefore, places the focus of the JOBS Act on new, very early stage companies, rather than companies which have already received crowdfunding. The SEC has noted in this context that:

\begin{quote}
The 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
\end{quote}

\textsuperscript{294} Ibid 347.
\textsuperscript{295} JOBS Act s 302.
\textsuperscript{296} Dresner, above n 68, 83.
amount that may be sold ... also could prevent certain issuers from raising all the capital they need to make their businesses viable.297

**Investment Caps**

Second, individual investments in a 12-month period are limited to the greater of $2,000 or 5 percent of 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. 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.298 To rely on an intermediary, however, the issuer must not have knowledge that the investor has exceeded or would exceed the investment limits.299

**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.” In this context, the SEC Commissioner has noted:

Under the proposed rules, the 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 intermediary will also provide a forum for information sharing, with communications by an issuer or paid promoter clearly identified as such.300

**Disclosure Requirements**

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

- basic information about the issuer;

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297 SEC, Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 353.
298 SEC, Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 25.
299 Ibid.
• information about officers and directors and each person owning 20 percent or more of
  the shares of the issuer;
• a description of the issuer’s business and the anticipated business plan;
• a description of the financial condition of the issuer and the intended use of the proceeds
  of the offering;
• the target-offering amount and updates regarding progress in meeting the target-offering
  amount;
• the price to the public of the securities;
• certain related-party transactions;
• financial statements of the issuer that, depending on the amount offered and sold during a
  12-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.

The objective of disclosure in this context is to allow investors to better evaluate the qualitative
of the offerings and the issuing firm. Disclosure is intended to reduce information asymmetry
between investors and entrepreneurs and enhance the transparency and efficiency of the
crowdfunding market.\textsuperscript{301}

Issuers who seek a greater target-offering amount are required to disclose more information than
those issuers who seek less capital. The law, thus, takes a sliding scale approach to the question
of the issuer’s financial condition. 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 principal executive officer.\textsuperscript{302} 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

\textsuperscript{301} SEC, \textit{Proposed Crowdfunding Rules under Title III of the JOBS Act} (October 2013) at 390-391
\textsuperscript{302} Dresner, above n 68, 88.
applicable standards and regulations published by the SEC. Audited financial statements must only be disclosed if the issuer is seeking an amount above $500,000.

As far as describing the financial condition of the issuer is concerned, the rules do not provide specific requirements as yet. However, this would likely include a discussion of liquidity, capital resources, as well as revenues and expenses, if applicable. 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. The key restriction here, as stated above, is that start-ups cannot raise more than $1 million a year using crowdfunding. Furthermore, start-ups 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.

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 for the account of others, solely pursuant to section 4(6) of the Securities Act of 1933.” The “funding portal” or registered broker is responsible, amongst other things, for facilitating crowdfunding transactions and providing educational information to potential investors. The SEC describes the function of funding portals as follows:

303 Securities Act 1933, s 4A(b)(1) sub. (1)(D)(ii).
304 Dresner, above n 68, 88.
305 Ibid.
The 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.\(^{306}\)

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.\(^{307}\)

A portal cannot engage in soliciting purchases, sales or offers to buy securities offered or displayed on their website or portal, and must take various measures to reduce fraud risk. For example, an intermediary must register with applicable self-regulatory organizations and conduct due diligence measures. The portal is prohibited from holding, managing or otherwise handling investor funds or securities and cannot offer investment advice or recommendations.\(^{308}\) These restrictions are designed to protect investors. 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 and the issuer would help prevent the intermediary or other parties from claiming or otherwise unlawfully taking funds from that account.\(^{309}\)

The restriction on offering investment advice corresponds to similar prohibitions on broker-dealers.

Congress placed special emphasis on the educational role of the funding portal, requiring portals to ensure that investors have reviewed any relevant information.\(^{310}\) Intermediaries must, therefore, amongst other things provide general disclosure to investors about the inherent risks

\(^{307}\) Ibid 387.  
\(^{308}\) *JOBS Act*, s 304(a)(1).  
\(^{309}\) SEC, *Proposed Crowdfunding Rules under Title III of the JOBS Act* (October 2013) 400.  
\(^{310}\) *JOBS Act*, s 302(b).
involved in equity crowdfunding. Further, investors must positively affirm they understand they risk losing the entire investment and must be able to bear such loss. 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. 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.

**Electronic Bulletin Boards**

Crowdfunding intermediaries may include an electronic bulletin board that allows potential investors to communicate about an offering. This is not a legal requirement under the JOBS Act, although it was included in an earlier version of the House crowdfunding Bill. The SEC may adopt such a bulletin board requirement for funding portals as part of its additional rules. The bulletin board would function as an open forum allowing the public to share knowledge about investment risks, businesses and particular entrepreneurs. The SEC has stated:

> 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.

**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 of 1933. This cause of action is specifically targeted at crowdfunding

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311 s 4A(a)(3).
312 s 4A(a)(4).
313 Dresner, above n 68, 119.
316 Dresner, above n 68, 120.
317 SEC, Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) 376.
offerings. Pursuant to s 4(a)(c), issuers are subject to liability for material misstatements or failing to comply with relevant disclosure obligations. Liability will attach regardless of the issuer’s knowledge or intent. Section 4(a)(c) operates alongside the general anti-fraud provisions of s 10(b) of the Securities Exchange Act and Rule 10b-5. These rules also apply to crowdfunding offerings.318

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.” This definition is intended to cover start-up companies. 319 EGC status confers special benefits on companies including an exemption from certain executive pay disclosure requirements and account disclosure requirements. There is a wholesale exemption from s 404(b) of the Sarbanes-Oxley Act which imposes internal controls audition requirements and EGCs are also exempt from mandatory audit firm rotation rules. As far as investor communication is concerned, EGCs are free to communicate openly with qualified institutional buyers and accredited institutional investors. 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.

Intrastate Crowdfunding Exemptions

Dissatisfaction with the slow implementation of rules on crowdfunding under the JOBs Act’s has resulted in U.S states enacting their own intrastate crowdfunding exemptions. One report states that thirteen U.S. states have intrastate Crowdfunding exemptions in place while 14 other states are considering such exemptions.320 Compliance costs are said to be much lower under intrastate exemptions as compared with the federal rules.321 Examples of intrastate exemptions are the Kansas Exemption (effective since August 2011); the InvestGeorgia Exemption (effective since

318 Ibid.
319 Securities Act 1933 Act § 2(a)(19).
320 See www.crowdfundinglegalhub.com (last visited 10 November 2014)
December 2012), as well as the Michigan and Wisconsin exemptions. However, according to state securities regulators, few firms have taken advantage of the new fundraising exemptions.\footnote{Angus Loten and Ruth Simon, above n 1, B5.}

D. Crowdfunding in the European Union

Crowdfunding plays an important role as an alternative source of financing in the European Union. It is estimated that in 2012 about 735 million Euros were raised for all forms of crowdfunding in Europe.\footnote{See European Commission, above n 86, 2.} Compared to traditional retail bank-lending to non-financial institutions (6 trillion Euros in 2011) the figure is rather marginal but relatively significant compared to the financing provided by business angels (visible market segment estimated at 660 million euros in 2010), or venture capitalists in seed, start-up, later and growth stages (7 billion Euros in 2012).\footnote{European Banking Federation, \textit{Facts and Figures} (2012) available at: \url{http://www.ebf-fbe.eu/uploads/FF2012.pdf} (last accessed 22 April 2012). See also CSES, \textit{Evaluation of EU Member States’ Business Angel Markets and Policies Final Report} (2012) available at: \url{http://www.evca.eu/uploadedfiles/home/press_room/Yearbook_2012_Presentation_all.pdf} (last accessed 15 April 2015).}

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.\footnote{European Commission, \textit{Summary – Responses to the Public Consultation on Crowdfunding in the EU} (March 2014) available at \url{http://ec.europa.eu/internal_market/consultations/2013/crowdfunding/docs/summary-of-responses_en.pdf} (last accessed 15 October 2014).} Moreover, the project owners saw crowdfunding as a useful way to test market demand for their products and services.\footnote{Ibid.} The respondents saw the primary benefits of crowdfunding as being community involvement and engagement in innovation, the
democratization of finance and the empowerment of entrepreneurs.  

Thus, crowdfunding has been likened to angel investing for the masses.  

In June 2014, the European Commission set up an Expert Group – the European Crowdfunding Stakeholders Forum – to examine the potential and risks of crowdfunding. The task of 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. Furthermore, the Group will assess whether regulatory intervention is necessary at EU level, as currently there is no coherent framework in place. Earlier, in March 2014, the European Commission adopted a Communication on Crowdfunding. 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, and legal uncertainty and consumer protection concerns.  

However, the Commission also recognises the high potential benefits that crowdfunding may yield including innovation, research and development, economic growth, community development and job creation. Supporting crowdfunding, therefore, is seen as an important aspect of driving economic development. 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. Accordingly, the Union invites Member States to:

327 Ibid.
328 See Lars Hornuf and Armin Schwienbacher, above n 179, 11.
330 See European Commission, above n 85.
331 Ibid.
332 Ibid.
Assess the need of amending current national financial legislation with the aim of facilitating new, alternative forms of financing for start-ups and SMEs [small to medium enterprises] in general, in particular as regards platforms for Crowdfunding.\textsuperscript{333}

In its Consultation Paper on Crowdfunding, the Commission observes:

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 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.\textsuperscript{334}

\textbf{The Development of Crowdfunding in the EU}

Crowdfunding has been able to develop in the E.U. as a result of number of factors, including prospectus rules. \textsuperscript{335} The relevant E.U. regulatory framework presently applying to financial return crowdfunding (i.e. crowd investing and crowd lending) includes: the Directives on Prospectus,\textsuperscript{336} Payment Services, Markets in Financial Instruments,\textsuperscript{337} Capital Requirements.\textsuperscript{338}

\textsuperscript{335} Dresner, above n 68, 5.
Turning to prospectus requirements, however, it is clear that the EU Prospectus Directive has
directly facilitated the development of crowdfunding. The Directive was amended by
Directive 2010/73/EU of 24 November 2010 which establishes exemptions from the obligation
to publish a prospectus. For example, if an offer is solely addressed to qualified investors, there
is no need to publish a prospectus. The Directive also mandates that offerings of 5 million Euros
or more must be made in accordance with an approved prospectus. Where an offering, however,
falls below 5 million Euros, it is subject to prospectus requirements made by individual EU
Member States. The EU framework, thus, allows Member States to set their own prospectus
requirements with respect to offerings below 5 million Euros. Member States cannot require
publication of a prospectus with respect to offerings below 100,000 Euros. Accordingly,

Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC
L133/66)
concerning the distance marketing of consumer financial services and amending Council
on prudential requirements for credit institutions and investment firms and amending Regulation
(EU) No 648/2012 (OJ 27.06.2013, L176/1)
2013 on European venture capital funds (OJ 25.04.2013, L115/1);
the prospectus to be published when securities are offered to the public or admitted to trading
offerings of less than 100,000 Euros are exempt from the obligation to publish a prospectus and crowd funders are able to raise capital without being subject to such a requirement.

It remains to be seen whether specific crowdfunding legislation will be adopted at EU 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. Moreover, the cost of obtaining authorisation to operate in another Member State may be prohibitive and crowdfunding platforms may forego the benefits of operating beyond the borders of their Member State.

If implemented properly, EU-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 E.U. may, as in the U.S., be long and protected. Accordingly, an alternative to adopting crowdfunding-specific rules at EU level is to implement 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. The advantage of adopting this approach is that it would allow Member States to adopt their own rules with respect to crowdfunding. Alternatively, the EU may opt for a clear, unified approach to crowdfunding, adopting a set of comprehensive rules that set minimum requirements and apply to crowdfunding platforms in all Member States.

1. The U.K. as a European Example

The UK possesses one of the most developed crowdfunding markets in the European Union. A report published in 2013 indicated that loan-based crowdfunding platforms raised £480 million

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346 European Commission, above n 86, at [3.2.2].
347 Dresner, above n 68, 210.
348 Andy Davis, Beyond the Banks. Innovative Ways to Finance Britain’s Small Businesses (2012) 11 available at
in 2013, of which £287 was loaned to individuals – an increase of 126 percent compared to 2012. A total of £193 million was loaned to businesses, an increase of 211 percent compared to 2012; and investment-based crowdfunding platforms raised £28 million in 2013, an increase of 618 percent compared to 2012.  

The First U.K. Platforms

Investment-based crowdfunding in the U.K. tends to be dominated by two platforms, Crowdcube and Seedrs. Crowdcube was the first British equity platform to launch in February 2011 and at the time of its commencement lacked authorization by the Financial Services Authority (FSA) – which since then has been split into the Prudential Regulation Authority and the Financial Conduct Authority (FCA).

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


350 Dresner, above n 68, 52.

351 Ibid 206.

352 Ibid 206-207.
Crowdcube operates as a pure intermediary only. This model may be compared to that of Seedrs which launched in 2012. Unlike Crowdcube, Seedrs takes a number of steps in each crowdfunding transaction, including approving each listing as a financial promotion and conducting due diligence on each start-up. Other platforms which have emerged are CrowdBnk, FundtheGap and BanktotheFuture. These platforms are now subject to regulation by the FCA – the successor to the FSA – and the code of practice published by the U.K. Crowdfunding Association. The FCA regulations are considered first, followed by a discussion of the code of practice.

**FCA Regulation**

In the U.K., crowdfunding falls within the regulatory scope of the Financial Conduct Authority (FCA). Broadly speaking, the main aims of the FCA include consumer protection and the promotion of effective competition in consumer markets. In October 2013, the FCA published a consultation paper outlining its proposal to regulate both the loan-based and investment-based crowdfunding industries. Following consultation, the FCA in March 2014 published a set of rules to regulate the crowdfunding industry. These rules came into force in April 2014 but are subject to certain transitional provisions. 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, to ensure that “only those retail investors

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353 Ibid 207.
355 FCA, above n 2, 10.
who can understand and bear the various risks involved are invited to invest in unlisted shares or
debt securities.”

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. 

Hence, the key premise underpinning the UK approach to equity crowdfunding is to make
crowdfunding available to a restricted audience of investors and, thereby, limit those investors
who can participate in ECF campaigns.

The new FCA rules apply to two categories of financing: loan-based crowdfunding which
extends to peer-to-peer platforms (these cover loans from individual investors to other
individuals) and peer-to-business lending platforms (which covers 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. 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. The rules do not extend
to donation-based or rewards-based crowdfunding. Accordingly, some crowdfunding activities
remain unregulated in the U.K.

Interestingly, the FCA regards loan-based crowdfunding as involving fewer risks than
investment-based crowdfunding. 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. For example,
the rules expressly state that: “An operator of an electronic system in relation to lending must

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358 FCA, above n 2, 36 at [4.4].
359 Ibid.
360 Ibid 7 at [1.22].
361 Ibid 9.
362 FCA, Rule 4.18A.
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.”

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 which 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. The FCA refers to loan agreements as P2P agreements.

The minimum financial resources to be held by a loan-based crowdfunding platform are as follows:

- a) £20,000 (increasing to £50,000 from 1 April 2017); or
- b) the sum of:
  - i. 0.2% of the first £50 million of total value of loaned funds outstanding;
  - ii. 0.15% of the next £200 million of total value of loaned funds outstanding;
  - iii. 0.1% of the next £250 million of total value of loaned funds outstanding; and
  - iv. 0.05% of any remaining balance of total value of loaned funds outstanding above £500 million.

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.

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: expected and actual

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363 FCA, Rule 4.18A.
364 FCA, Rule 4.18C.
365 FCA, Rule 12.2.4 R.
366 FCA, Rule 12.2.5 R.
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 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.367

Authorization Requirements for P2PL Platforms

The rules require firms running loan-based crowdfunding platforms from 1 April 2014 to apply
for full authorization from the FCA. Transitional arrangements apply to firms that hold a
consumer credit license from the Office of Fair Trading (OFT). The FCA assumed responsibility
for the regulation of consumer credit markets from the OFT on 1 April 2014.368 All firms are
required to become fully authorized by 31 March 2017.369 OFT-regulated loan-based
crowdfunding firms are not subject to the new prudential standards, however, until they become
fully FCA-authorized. Firms with a valid OFT license on 31 March 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.370 Upon becoming fully FCA-authorized, firms must
submit financial and prudential reporting returns.371 The FA requires loan-based crowdfunding
firms to comply with regular reporting requirements. In addition, the rules provide investors with

367 FCA, Rule 14.3.7A.
368 FCA, above n 2, 4 at [1.2].
369 Ibid 21 at [3.3].
370 Ibid 12.
371 Ibid 34.
a right to complain, in the first instance, to the firm running the platform, and in the second instance, the Financial Ombudsman Service.\footnote{372
FCA, above n 2, 32.}

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. 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 using other media) may only make a “direct offer financial promotion” to a restricted category of investors.\footnote{373
Ibid 7.} 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.\footnote{374
Ibid.} A “direct offer financial promotion” is defined as an offer that contains (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 rests 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.\footnote{375
Ibid 37 at [4.11].} 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 the ambit of this definition. Conversely, the restriction will apply if information is provided about a specified investment opportunity.\footnote{376
Ibid 38.}
The restriction described above is intended to protect retail investors who are subject to special risks. Such risks in the context 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 20-25 years.\textsuperscript{377} Secondly, investors face the risk of dilution of shareholder value, illiquidity risks and the risk that dividends may not be declared.\textsuperscript{378} Illiquidity risks arise as there may not be a secondary market via which shares or debt securities acquired through ECF or P2PL platforms may be sold. Therefore, the profitable route of exit 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.\textsuperscript{379} Consequently, the FCA maintains a clear distinction in its regulatory approach between P2P agreements and non-readily realizable securities.\textsuperscript{380} 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 12 months after the date of the statement.\textsuperscript{381} There is an obligation on firms to satisfy that there are valid statements in place at the time of communicating a promotion but firms are not required to ensure that individuals qualify as “restricted investors” on an ongoing basis.\textsuperscript{382}

\textit{The UK Crowdfunding Association Code of Practice}

Adherence to the principles set out in the UK Crowdfunding Association Code of Practice is a requirement of membership of the UK Crowdfunding Association.\textsuperscript{383} The principles apply to

\textsuperscript{377} Ibid.
\textsuperscript{378} Ibid.
\textsuperscript{379} Ibid 39.
\textsuperscript{380} Ibid.
\textsuperscript{381} Ibid 43.
\textsuperscript{382} Ibid.
both FCA authorised and non-authorised platforms. The key principles can be summarised as follows:

- 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 and 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 in place processes to ensure that holdings of investments can continue to be accessed 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 UK 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 UK 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 UK Crowdfunding Association website every year.\(^{384}\)

\(^{384}\) Ibid.
2. The Netherlands, Germany, Italy and France

In terms of the number of crowdfunding platforms, the Netherlands is generally ranked highly.\textsuperscript{385} The leading equity platform in the Netherlands is Symbid.\textsuperscript{386} 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.\textsuperscript{387} Cooperatives allow an intermediary to manage the shares of the underlying company.\textsuperscript{388} Adopting this cooperative structure has allowed Symbid to bypass the requirement of seeking authorization from a regulatory authority.\textsuperscript{389}

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.\textsuperscript{390} The portal – Companisto – has set up a special purpose vehicle Companisto Venture Capital GmbH – to pool investments from the crowd. Crowd investors buy securities from this special purpose vehicle which then invests on their behalf in the start-up.\textsuperscript{391} Companisto operates in a similar manner to the Dutch Symbid, allowing for investments to be pooled. The total amount raised between 2011 and 1 July 2014 was €27.7 Million.\textsuperscript{392} In this period, 140 successful ECF campaigns were carried out.\textsuperscript{393}

\textsuperscript{385} World Bank, above n 53, 18.
\textsuperscript{386} Dresner, above n 68, 207.
\textsuperscript{387} Ibid 208.
\textsuperscript{388} Ibid.
\textsuperscript{389} Ibid.
\textsuperscript{391} Ibid 9.
\textsuperscript{392} LMU Forschungsdatenbank, Crowdinvesting (1 July 2014).
\textsuperscript{393} Ibid.
A common structure adopted in Germany by equity crowdfunding platforms is the silent partnership (*Stille Beteiligung*). This structure allows investors to acquire silent partnership units from an investee company. Such units are comparable to equity–like shares in a company. They give investors a pre-defined share of profits, but no voting rights. Hence, voting rights cannot be sold via ECF platforms in Germany, but the sale of silent partnership units is permissible. The advantage of utilizing this structure is that silent partnerships have beneficial tax treatment in Germany. Germany has not passed specific laws regulating crowdfunding. Crowdfunding, therefore, takes place within the existing paradigm of securities laws. However, in November 2014, Germany passed a draft law on crowdfunding titled “Gesetzentwurf für ein Kleinanlegerschutzgesetz.” Under the proposed law, companies will be able to raise up to €1 million without having to register a prospectus. Moreover, individual investors will be able to invest up to €10,000 per project.

Italy has opted for crowdfunding-specific legislation by amending its existing securities law (the TUF, *Testo Unico della Finanza*). The aim of the legislation is to legalize crowdfunding, and CONSOB (i.e. *Commissione Nazionale per le Società e la Borsa*), Italy’s regulator and the equivalent of SEC, is tasked with implementing the legislation. The legislation went into force on 17 December 2012 and is available to innovative startups – i.e. so-called startup innovativa. The Act makes it possible for innovative startups to offer securities up to 5 million Euros without having to register a prospectus. The definition of innovative start-ups focuses on firms whose

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394 Dresner, abnove n 48, 208-9.
395 Ahlers et al, above n 236, 10.
396 Ibid 209.
399 Article 30 of Decreto Crescita (Growth Decree), Raccolta diffusa di capitali di rischio tramite portali online (widespread collection of venture capital through online portals).
400 CONSOB, Regolamento (delibera n. 18592 del 26 giugno 2013) in materia di ‘Raccolta di capitali di rischio da parte di imprese start-up innovative tramite portali on-line’ (equity crowdfunding).
sole or main purpose it is to develop, produce and sell innovative products and services with a high technological value. Non-innovative start-ups, however, cannot take advantage of this exemption and continue to be bound by European Directive 2010/73 being able to raise capital up to 100,000 Euros without the obligation to register a prospectus. This, in our view, represents a significant limitation. Moreover, start-ups must be less than 4 years old in order to take advantage of the ECF exemption. 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.\footnote{Ordonnance n° 2014-559 du 30 mai 2014 relative au financement participatif available at http://www.legifrance.gouv.fr (last accessed 15 April 2015).} Moreover, there is a licensing requirement in place. Crowdfunding platforms must be licensed by the supervisory authority.

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. 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 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.

\textbf{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.402

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 start-up clusters in a particular geographic location or region.403 By contrast, crowdfunding has the potential to promote start-ups in rural areas or small towns, where local investors can engage in investing and support their local communities. 404 For example, Agrawal et al show that geographic proximity is not an overriding criterion for crowdfunding investors and crowdfunding eliminates distance-related economic frictions.405 These characteristics of crowdfunding have an enormous potential for developing countries.

In addition, crowdfunding is associated with less gender bias than venture capital.406 Venture capitalists primarily invest in technology-intensive types of firms, which are less likely to be funded by women. 407 Moreover, women raise significantly lower amounts of equity than men during the start-up stage and less equity and debt at later stages of a firm’s development cycle.408 In fact, several studies point to women entrepreneurs being able to raise less capital than men, regardless of the source of capital. As a result, women launch firms with significantly smaller

402 Ibid 17.
403 Ethan Mollick, above n 23, 9.
404 Ibid.
407 Ibid.
amounts of capital than men.\textsuperscript{409} The advantage of crowdfunding is 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 of, we highlight some key platforms that have emerged in developing countries and discuss the key enabling factors that allow crowdfunding to develop. These factors are: technological infrastructure, entrepreneurial culture, the institutional and regulatory infrastructure and community engagement.

\textit{Emerging Platforms}

In Sub-Saharan Africa, an example of a crowdfunding platform is Homestrings.\textsuperscript{410} The website was launched between 2011 and 2013 and has thus far mobilized about US$25 million in funds, covering 13 countries in Africa.\textsuperscript{411} The platform allows investors, particularly diaspora investors, to invest in projects, funds, bonds and private-public partnership opportunities supported by the government of Kenya, First Quantum Minerals, Ghana, Nigeria and Afren plc.\textsuperscript{412} Another example of a platform is Startme which focuses on traditional entrepreneurial campaigns.\textsuperscript{413}

The MENA (Middle East and North Africa) region has seen the rise of online platforms such as the Lebanon-based Zoomal.\textsuperscript{414} This site offers both cause-related and entrepreneurial campaigns. Another successful equity crowdfunding platform is Eureeca which during its first campaign raised $USZ 100,000 from 23 investors.\textsuperscript{415}

\begin{flushleft}
\textsuperscript{409} Ibid.
\textsuperscript{410} See www.homestrings.com
\textsuperscript{411} World Bank, above n 53, 32.
\textsuperscript{412} Ibid.
\textsuperscript{413} See www.startme.co.za
\textsuperscript{414} www.zoomaal.com
\textsuperscript{415} www.eureeca.com
\end{flushleft}
The Latin American and the Caribbean region have also seen a substantial growth in crowdfunding platforms since 2010. In Brazil, Catarse has raised over $US 3.1 million in over 1000 campaigns.416 Another popular platform is Ideame which has campaigns in six countries in the region, including Argentina, Mexico, Chile, Brazil, Colombia and Uruguay. 417 In South-East Asia, notable platforms include Ignite Intent,418 the Hot Start,419 and Ideasplatform.420

**Key Enabling Factors**

A key enabling factor in developing countries is 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 which allow investors to communicate with entrepreneurs and vice versa is also a crucial prerequisite for crowdfunding. 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.421 The latter is strongly positively correlated with the rise of crowdfunding platforms.422

The institutional frameworks in developing countries must be designed in a way to facilitate access to capital and the development of crowdfunding platforms. 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. Accordingly, countries wishing to promote crowdfunding and P2P lending must address policies and regulations that raise transactions costs and make the entry and conduct of business operations

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416 World Bank, above n 53, 33. See www.catarse.me
417 See http://idea.me
418 www.igniteintent.com
419 www.thehotstart.com
420 www.ideasplatform.in
421 World Bank, above n 53, 40.
422 Ibid.
In addition, education campaigns, incubators, accelerators, start-up weekends and mentorship programs sponsored by the government or NGOs can play a key role in fostering entrepreneurial culture.  

V. 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;
- Enacting carve-outs or securities exemptions from the pre-existing securities laws to exempt fundraising via ECF platforms from general prospectus, registration and other requirements:
  - Limiting such exemptions, if any, to accredited, or sophisticated, high-net worth investors (the approach taken in the U.S. prior to the enactment of the JOBS Act);
  - 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 U.S. after the implementation of the JOBS Act);
- 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);

423 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 and Alexis Pirchio, “An Empirical Examination of why Mobile Money Schemes Ignite in some Developing Countries but Flounder in Most” University of Chicago Law School, Coase-Sandor Institute for Law and Economics Working Paper No. 723 (March 2015) available at <http://ssrn.com/abstract=2578312> (last accessed 15 April 2015).

424 Ibid 51.
• Making ECF available to retail investors without any restrictions or investment caps;
• Limiting ECF to certain types of issuers, such as innovative companies (the approach taken in Italy);

The options for investor protection safeguards include:

• Establishing a registration framework for crowdfunding intermediaries (the approach taken in New Zealand and see also the FCA authorisations in the UK for CrowdCube and Seedrs as examples);
• Imposing various disclosure requirements on issuers;
• Requiring offerings to be conducted online and not through other means (approach in the United States);
• Requiring issuers to conduct offerings through only one intermediary;
• 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 U.S. for example);
• Prohibiting intermediaries from directly holding funds and requiring them to deposit funds into an escrow account (the approach taken in the U.S.);
• Risk acknowledgment by the investor and the provision of educational materials to investors prior to investing;
• Providing cancellation rights and cooling-off periods (whereby investor may withdraw the investment up until a certain point in time or until the crowdfunding campaign is closed;
• Addressing the holding of client money and conflicts of interest;
• Providing mechanisms to handle complaints and alternative dispute resolution;
• Providing guidelines on social media commentary (see, for example, U.S. electronic bulletin recommendations) and
• 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);

Since 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 ought to be made
between crowdfunding platforms with non-financial rewards and those with financial rewards. Regulation for crowdfunding should differ based on the goals of the funders and the purposes of the crowdfunding project. 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. 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 U.K. for example, have required crowdfunding platforms to register with an oversight body and regularly report to that body. In other countries, such as Germany, there is no requirement for platforms to be registered and crowdfunding platforms operate without any specific license. The requirement to require crowdfunding platforms to be registered with a national oversight body leads to higher compliance costs, but also an increase in investor protection.

It is for each 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. 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. A failure to comply with any such requirements can result in misstatements, omissions to state material facts and claims of securities fraud.

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 which

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increase the costs of obtaining capital for firms. 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 and extract private benefits. 426

Optimal regulation involves a trade-off between the costs of ensuring an appropriate level of investor protection and broadening access to capital for small and medium-sized firms which are disproportionately affected by compliance costs. The upshot of a regulatory approach which 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. Furthermore, if the costs associated with investor protection are excessive, crowdfunding may cease to be a viable cost-effective means to raise capital for SMEs. 427 Regulators must, therefore, ensure that small firms can utilise 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 which suggests that crowd investors do seek a certain level of investor protection.428

Investor protection is a particularly important consideration if the creation of a “market for lemons” is to be avoided in which only low-quality ventures would eventually choose ECF while high-quality ventures would continue to rely on venture capital or angel investor financing. 429 The upshot would be a “crowdfunding market full of unrealistic and likely fraudulent sales pitches.”430 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.431

As Akerlof explains:

In a more contentious case with different grades of good, even worse pathologies can exist. For it is quite possible to have the bad driving out the not-so-bad driving out the medium driving out the not-so-good driving out the good in such a sequence of events that no market exists at all.432

Hence, for crowdfunding to have a positive economic impact in the long-run, the regulatory framework must be designed in a manner which works for both investors and entrepreneurs alike. 433 As observed by the U.S. Investor Advisory Committee:

Although these goals are sometimes seen as operating at cross purposes, crowdfunding ultimately cannot succeed unless investors perceive the marketplace as fair and believe they have a reasonable chance of profiting on their investments.434

The regulatory challenge, therefore, is to design a fair and cost-effective marketplace, which facilitates small capital formation, while providing reasonable investor protections.435

The focus of regulators in some jurisdictions has been the protection of the retail investor involved in crowdfunding. The approach taken under the JOBS Act in the U.S., for example, is to not only regulate 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. Non-accredited investors can only invest via crowdfunding platforms to up a certain amount of their annual net income or wealth. This represents a significant limitation on investors’ investment

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435 Ibid.
opportunities. In the U.S. setting, this is consistent with the historical focus of the SEC on the protection of non-accredited investors. 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 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 commencing in 2014. 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 the intermediaries. The key pillars of a good corporate governance crowdfunding framework may be summarised 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. Regulation must ensure, amongst other things, security of payment and platform functionality. In addition, intermediaries may have to comply with certain capital requirements, as in the case in the U.K. Regulatory authorities must be able to control and monitor the activities of crowdfunding intermediaries. This is particularly important since 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 the investee companies.

Within the ECF context, regulatory authorities must find a balance between facilitating access to capital for SMEs and the risks of securities fraud. The key regulatory objectives here are: capital formation, investor protection and the maintenance of fair and orderly capital markets. 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 to 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.\textsuperscript{437} 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 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. 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. \textsuperscript{438} 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 since pre-existing securities law frameworks are inadequate. Indeed, a lack of legislative action in this field may disadvantage firms in some jurisdictions vis-à-vis firms which operate in jurisdictions where there has already been some regulatory accommodation for equity crowdfunding. An option here is to make ECF available,

\textsuperscript{437} Dresner, above n 68, 115.
\textsuperscript{438} See section on U.S. above.
but only to the extent that it applies to a restricted group of investors (see the approach in the UK, for example). The focus in the UK, as we saw, is on sophisticated, experienced and professional investors, and 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 start-ups only.

Questions also arise in relation to pooled investment arrangements which are used by some platforms as an investment model. Should regulatory distinctions be made between investors holding legal as opposed beneficial interests in the equity of an issuer? In particular, to what extent do any such arrangements alter the disclosure obligations of issuers to investors? In principle, investors investing indirectly into an issue via a SPV ought to 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 pre-existing company 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 UK, the UK Crowdfunding Association has assumed a role by promulgating regulatory standards and rules affecting both non-FCA and FCA-authorised 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 for instance, 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 or is likely to engage in misleading and deceptive conduct. Furthermore, intermediaries are expected to carry out due diligence and check

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439 See discussion above.
440 See discussion on the Italian framework above.
the identity of the issuer and that of its directors and senior managers. 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. 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 and must be regulated accordingly.

However, even if appropriate regulatory standards are adopted, there is a possibility that the crowdfunding industry may overheat. The overabundance of crowdfunding projects could become a problem in the future for entrepreneurs, making it more difficult to gain visibility.\footnote{Ibid.} The novelty of crowdfunding may wear off as more and more projects are funded online. Moreover, we may see the rise of oligopolies with some crowdfunding platforms taking others over, resulting in economies of scale, but also less competition between platforms. This, in turn, may lead to higher charges. Overregulation and bureaucracy are other threats which may pose a challenge to the industry. According to ESMA, consolidation in the sector is likely to occur over the next few years, with platforms either failing or merging, and some platforms benefitting from specialisation in a particular sector.\footnote{European Securities and Markets Authority, \textit{Advice on Investment-Based Crowdfunding} (2014) at [28] available at <http://www.esma.europa.eu/system/files/2014-1560_advice_on_investment-based_crowdfunding.pdf> (last accessed 20 February 2015).}

**CONCLUSIONS**

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 start-ups and SMEs face. As shown, crowdfunding provides a novel method for entrepreneurs to obtain finance.
without having to rely on traditional funding mechanisms, such as debt finance, venture capital or business angels.

Technological innovation and the financial crisis of 2007-9 are the key drivers behind crowdfunding. By harnessing internet technology, crowdfunding and peer-to-peer lending 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 start-up ventures have traditionally been venture capitalists and angel investors. This is will change with the emergence of ECF and P2PL. At the very least, ECF and P2PL are likely to increase competition amongst suppliers of capital to SMEs and early start-ups.

We have considered a variety of different crowdfunding models which 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, differing levels of complexity as well as differing user groups and purposes. For example, donation-based crowdfunding is most applicable to community-related and art-related projects, while ECF is applicable to start-ups that have a high-growth, sale, merger or IPO strategy.\(^{443}\) This may be contrasted with P2P lending 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 approach taken to crowd investing and crowd lending in a number of jurisdictions, including the United States, the UK, Germany, Italy and New Zealand. Although crowdfunding is increasingly gaining prominence in the European context, particularly in jurisdictions such as the U.K., no unified regulatory framework has been adopted at the E.U.

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\(^{443}\) World Bank, above n 53, 34.
level. The European Commission has explored the potential of crowdfunding and in the U.S., the JOBS Act has been enacted with the aim of introducing a crowdfunding exemption to facilitate capital raising from the public. The main thrust of the regulatory interventions surveyed has been to extend ECF to non-accredited investors with regulation structured in a way to either focus 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 trade-offs 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 start-up ecosystem.

Crowdfunding is already a well-established financing instrument. The internet and crowdfunding have revolutionised the ways in which funds are raised in the small-business context. Nevertheless, the bulk of crowdfunding is directed towards philanthropic projects and the creative industries where artistic communities play an important part in supporting crowdfunding projects. Equity crowdfunding, on the other hand, plays a smaller part in the crowdfunding market. This is due to a number of factors including the complexity of financing young and innovative start-ups 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 carve-outs, prospectus requirements, investor protection and the regulation of ECF and P2PL platforms.

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 undersupply of projects which 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 which 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 provision later-stage funding. Rather, the potential of crowdfunding lies in plugging existing financing gaps in the early-stage funding cycle.