



## **CROWDFUNDING AND THE REGULATORY HURDLES IN THE UNITED STATES AND EUROPE**

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## **PREFACE**

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With this master thesis I am finishing my time as an International Business Law Student at Tilburg University. It was a great year in which I learnt very much and in which I got to learn some interesting people from all over the world.

First of all I would like to thank my parents for their support over the years. They offered me the opportunity to study and live in Tilburg for which I am very grateful.

Secondly, I would like to thank my thesis coordinator Mr. D.A. Pereira Dias Nunes LL.M. for his substantiated support and comments on my thesis. He was always available for help and he stimulated me to do a research about crowdfunding.

I had a great time here at Tilburg University.

Job Ebisch

Tilburg, June 26<sup>th</sup>, 2012



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CHAPTER 1 - INTRODUCTION

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*“The basic idea of crowdfunding is to raise external finance from a large audience (“the crowd”), where each individual provides a very small amount, instead of soliciting a small group of sophisticated investors.”*

Paul Belleflamme et al., *Crowdfunding: tapping the right crowd*.

Crowdfunding is yet another hot topic in the world of finance. In a world where it is difficult nowadays for start-ups to attract outside capital at the very first stages, creative entrepreneurs have started to make use of a new way to finance their project, idea or business: crowdfunding.

The crowdfunding concept basically is derived from the broader concept of crowdsourcing. This concept implicates the use of the crowd to obtain ideas, contributions, feedback and solutions in order to develop corporate activities. The online encyclopedia Wikipedia and the operating system Linux are prominent examples of this.<sup>1</sup> In case of crowdfunding, the entrepreneur wants to convince a large group of people to deposit money the entrepreneur can use as an investment. Social networks (Twitter, Facebook, LinkedIn and other specialized blogs) play an important role in reaching these possible investors. Thus instead of raising investments from a small group of sophisticated investors, the crowdfunding idea is that of raising money from a large group of individuals that contribute for only a small amount. The amounts that have been obtained through crowdfunding have increased steadily with the “Trampoline Systems” example being one of the best.<sup>2</sup>

The example of Trampoline Systems, a UK-based software company, shows what crowdfunding can mean for a business. Trampoline Systems managed to raise \$6 million from a US hedge fund in 2007 to invest in its Series A stage. Series B investment would follow over time if the company could validate the fact that customers wanted what it was developing. However, the troubles in the global financial system caused such problems for the US hedge fund that it completely withdrew from the early stage venture investment. Trampoline Systems had to look for other options and one of them was crowdfunding, but a Series B investment via crowdfunding had never been done before by a tech business of Trampoline’s size. Nonetheless the company managed to raise £1 million through crowdfunding by splitting the funding process into three tranches. It is

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<sup>1</sup> Jeff Howe (2006), *The Rise of Crowdsourcing*, Issue 14.06 Wired Magazine, p. 1.

<sup>2</sup> Paul Belleflamme et al. (2011), *Crowdfunding: tapping the right crowd*, Core Discussion Paper 2011/32, p. 2-3.

therefore not surprising that Charles Armstrong, CEO of Trampoline Systems, predicts a bright future for the crowdfunding model:

*“There are very clear inefficiencies in the conventional funding model, not least because they have an inbuilt bias towards certain types of transaction. The cost to a venture capitalist of due diligence and completing a transaction of £ 100,000 is more or less the same as for one of £ 10 million. So there is a pressure to invest larger sums in a single transaction. People have been talking about the funding gap for the past 20 years -- but the last 18 months have exacerbated that. Transactions from £100,000 to £1 million are going to turn out to be very well matched for crowdfunding and other innovative models.”<sup>3</sup>*

This example shows that crowdfunding has the potential to raise large amounts of cash, not only for small projects but also for high-growth startups that typically would be financed by business angels and even venture capital funds. Trampoline Systems believes that crowdfunding is the best solution to bridge the funding gap and that it eventually will become an established technique of financing in the venture environment.<sup>4</sup>

But there are more recent examples of the success of crowdfunding projects. Scott Wilson, designer at MINIMAL in Chicago, designed the “Tiktok and LunaTik Multi-Touch Watch Kit.” These silicone rubber wrist straps for the Apple iPod Nano enables people to wear the iPod Nano like a wristwatch. This project received an astonishing amount of \$942,578 from 13,512 backers from the Internet community. Crowdfunding turned this simple but bright idea into a huge success.<sup>5</sup>

There even was an internet-based attempt to raise funds for saving the Swedish car manufacturer Saab, but this attempt eventually could not prevent Saab from going bankrupt.<sup>6</sup>

Crowdfunding is yet an older phenomenon as one might think. Already in the late 1990s crowdfunding emerged as a way for artists, filmmakers and musicians to raise donations from a community of online supporters. However, crowdfunding remained largely unnoticed by the general public until around the year 2006. During that time crowdfunding of social projects such as health care, aid for third-world countries, and support of democratic movements became more common and these projects started to attract a bigger audience. Nowadays crowdfunding even is an established manner of raising funds for non-profit ventures. Many intermediary services have been

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<sup>3</sup> James Silver (2010, 05 May), *The trust economy: A world of P2P money-lending*, Wired Magazine.

<sup>4</sup> Source: <http://crowdfunding.trampolinesystems.com/>

<sup>5</sup> Source: <http://www.kickstarter.com/projects/1104350651/tiktok-lunatik-multi-touch-watch-kits?ref=live>

<sup>6</sup> Sources: <http://nos.nl/artikel/323526-rechtbank-verklaart-saab-failliet.html> & <http://www.rescue-saab.com/en/association/index.php>



created the last couple of years that act as facilitators for crowdfunding. Web-based services like Kiva, Kickstarter and IndieGoGo are good examples of how crowdfunding has become well known globally.

More importantly, entrepreneurial ventures are also starting to see the possibilities of crowdfunding as a substitute seed-financing source. Mostly because of the fact that entrepreneurs have difficulties acquiring financing from the “traditional sources” like bank loans, angel capitalists and venture capital. This because the ventures are too innovative, are still in the “valley of death” (the period of time when a start-up firm receives their initial capital contribution to when it begins generating revenues but before the actual profits are gained. The firm is not yet earning significant income, increasing the probability that a start-up will die off before a steady income is established.<sup>7</sup>), are too complex or are simply too risky.<sup>8</sup>

*“Crowdfunding involves an open call, mostly through the Internet, for the provision of financial resources either in form of donation or in exchange for the future product or some form of reward and/or voting rights.”<sup>9</sup>*

This definition of crowdfunding implies that there is more than one way to structure the financing by the crowd. There are several models that can be used to finance a project or an entrepreneur. Crowdfunding generally is categorized in five different types: (1) the donation model; (2) the reward model; (3) the pre-purchase model; (4) the lending model; and (5) the equity model. These different types differ in what investors will receive in return for their donation.<sup>10</sup>

The donation model is the most simplistic crowdfunding model. Investors will get nothing in return for their investments but they will just donate a small amount of money to a charity project. GlobalGiving is a good example of a web-based service that works according to the donation model. Investors have the opportunity to offer some money to all kinds of charity projects all over the world. One can donate money for the homeless pregnant women in the US or can choose to invest in Cassava growing for food security in Kenia for instance.<sup>11</sup>

Next up are the reward and pre-purchase model. These models are actually quite similar to each other. Investors will donate a certain (often pre-determined) amount of money and will receive

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<sup>7</sup> Source: <http://www.nasdaq.com/investing/glossary/d/death-valley-curve>

<sup>8</sup> Joachim Hemer (2011), *A Snapshot on Crowdfunding*, Fraunhofer Institute for Systems and Innovation Research ISI, Working Paper No. R2/2011, p. 2.

<sup>9</sup> Paul Belleflamme et al. (2011), *Crowdfunding: tapping the right crowd*, Core Discussion Paper 2011/32, p. 5-6.

<sup>10</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 9-17.

<sup>11</sup> Source: [http://www.globalgiving.org/dy/v2/content/search.html?q=\\*](http://www.globalgiving.org/dy/v2/content/search.html?q=*)

a reward in return for their donation. This reward often is the item that is produced by the project itself; this could be a nice gadget but it could just as well be a good indie movie. A nice example of a reward/pre-purchase project is the “Hidden Radio & BlueTooth Speaker by John VDN & Vitor Santa Maria.” These two people managed to create a very beautiful and easy-to-use speaker that supports any phone, tablet or computer via BlueTooth technology. Investors had to pay the pre-purchase price of \$119 in order to receive this speaker after the first production models are made. The normal price would be more than \$175 if this gadget reaches the retail market.<sup>12</sup>

The fourth crowdfunding model is the lending model, often called peer-to-peer lending. This type of financing does not involve a donation unlike the other models but involves a loan. Investors provide the necessary amount of money temporarily and will expect repayment in return. In some cases, even interest is offered on the funds they supply.<sup>13</sup>

The lending model can be divided into two types of web-based lending services: services not offering interest and services offering interest. From the web-based lending services that does not offer interest is Kiva the most commonly known. Via Kiva people can lend money to projects all over the world, but they do not directly lend to the entrepreneurs in charge of that particular project. Instead they lend to the local institutions that Kiva partnered up with. Kiva calls them “field partners.” People that use this website to lend money to entrepreneurs will only receive the initial amount of their loan back. The interest will be used by the field partners to cover their operating costs.<sup>14</sup>

From the services that do offer interest on a loan are Prosper and Lending Club the two leading lending sites. When people lend money to the borrowers they actually purchase notes issued by Prosper or Lending Club themselves. These two websites then use the money to make loans to the underlying borrowers. By doing so, Prosper and Lending Club can charge 1% of the payments of the borrowers before they pass it on to the lenders. Both sites also charge borrowers an “origination fee” on each loan. This fee is charged for providing the services of screening borrowers and issuing the loans. This amount of this fee is determined by the loan grade of the listing and the loan term. A higher loan grade means a higher credit risk means a higher origination fee.<sup>15</sup>

Last but not least is the equity-based model. Equity crowdfunding offers investors an actual share of the profits or return of the business they are funding. In other words: the equity model is the model that involves the share of a security to an investor. This raises some regulatory issues. It

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<sup>12</sup> Source: <http://www.kickstarter.com/projects/2107726947/hidden-radio-and-bluetooth-speaker?ref=live>

<sup>13</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 13-15.

<sup>14</sup> Source: <http://www.kiva.org/about/how>

<sup>15</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 14-16.

is exactly because of this reason that this master thesis is focusing on equity-based crowdfunding because this is where the business law comes in. Where the first three models raise issues under civil law Business Law can play a role in the equity model and possibly the lending model where interest is offered. In the USA for instance, these crowdfunding models can raise two kinds of questions under the Federal Securities Laws:

- (1) Are the entrepreneurs raising funds on crowdfunding sites offering securities subject to the registration requirements of the Securities Act of 1933?
- (2) Are the securities offerings by the crowdfunding sites violations of Federal Securities Law? <sup>16</sup>

The answers to these two questions will be discussed later on in this thesis. In this introduction (Chapter 1) my goal is to give a general overview what crowdfunding is about and what the business law issues are that this thesis will address. The varieties in the crowdfunding models that have nothing to do with business law will be left out of the analysis.

In this thesis I want to provide clarity. What is equity- and debt-based crowdfunding and how does it work? What are the problems with these types of crowdfunding with regard to the securities laws and regulations? How does the USA and Europe deal with these issues and are the problems of a different nature? Can crowdfunding be a good solution to fill the funding gap? Or is crowdfunding just a hype that makes it easier for people to defraud investors? These are some examples of the research questions that arise regarding crowdfunding and its business laws. To come up with clear and substantiated answers to these questions, that is the goal of this thesis.

Chapter 2 shall start with the crisis in the Venture Capital Industry, the downfall of traditional Venture Financing and the rise of crowdfunding in the entrepreneurial and business world. What equity-based crowdfunding is shall also be explained in detail.

Chapter 3 shall start with the current state of affairs regarding the securities laws and regulations. Do they contradict with the principle of equity- and debt-based crowdfunding or are there not many issues to solve in this regard? There will be an analysis of the issues in the USA and of the issues in Europe. The obvious next step is to discuss what the governments are doing about those contradictions. How can this industry benefit from new rules and regulations? Do they need new regulation at all or is deregulation the way to go?

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<sup>16</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 19.

Subsequently in Chapter 4 shall be discussed what the agency problems are when it comes to crowdfunding. Can crowdfunding lead to “fraudfunding” or is crowdfunding a good solution for a start-up to acquire the necessary funds in these times of crisis?<sup>17</sup> And how about the investors? Equity- and debt-based crowdfunding can turn everybody into an investor but what about investor protection? This chapter will also evaluate if crowdfunding is a good financing solution for a start-up.

Chapter 5 will be the chapter where I will try to come up with innovative solutions on what lawmakers and policymakers should do about crowdfunding. These innovative solutions will contain proposals for regulatory changes. Maybe the conclusion is that securities laws should be loosened in order to promote crowdfunding initiatives but it could also be that the laws should be kept as strict as they are nowadays. It shall depend on the findings of my research.

The last chapter will be Chapter 6 and is the conclusion of this thesis. A brief summary of all the important issues addressed shall be given and this thesis shall end with an overall conclusion on the findings of my research. My personal opinion shall also be strongly represented.

Some preliminary remarks: equity- and debt-based crowdfunding will be the type of crowdfunding that will be analyzed because of the problems with regard to the securities rules and regulations. When another type of crowdfunding is discussed in this thesis, I shall make that clear.

This thesis is written in the spring semester of 2012 as a masterthesis for International Business Law at Tilburg University in the Netherlands.

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<sup>17</sup> Thomas Lee Hazen (2011), *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws - Why any Specially Tailored Exemption Should be Conditioned on Meaningful Disclosure*, North Carolina Law Review, p. 1.

## CHAPTER 2 - THE RISE OF CROWDFUNDING IN THE ENTREPRENEURIAL ENVIRONMENT

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### 2.1 The Crisis in the Venture Capital Industry

Venture Capital as one used to know it has changed the last couple of years. In September 2008 the financial crisis came to light with the bankruptcy of Lehman Brothers, the fourth largest investment bank in the USA.<sup>18</sup> A little while later, AIG (American International Group), the American multinational insurance corporation faced a serious liquidity crisis and needed \$40 billion in short-term financing.

As a result many other financial institutions all over the world came into serious trouble. Government intervention was needed to save more of these institutions from bankruptcy. It was a logical consequence that the venture capital industry would become a victim of the worldwide crisis as well.<sup>19</sup>

But what are the main causes of the financial crisis that affected the VC industry? There are three possible explanations: the US housing bubble, the subprime crisis and the deregulation of the financial markets.<sup>20</sup> But how are these explanations for the financial crisis linked to the VC industry? There are two broad arguments:

- (1) Decrease in the supply of money to VC funds: because of the financial crisis also difficulties occurred for VC funds. They had problems finding investors. Pension funds, banks and insurance companies are typically the most important group of investors in VC funds. These institutions however were directly affected because of the crisis. Some of these companies even went bankrupt, for example Lehman Brothers and Washington Mutual. Others were merged with another company to prevent them from bankruptcy like Merrill Lynch. Another group even received governmental support also to prevent them from going bankrupt. Big companies like AIG, Fannie Mae, Freddie Mac, Commerzbank and ABN AMRO received financial support from their governments to keep them afloat. Because of the financial troubles these institutions were forced to

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<sup>18</sup> Source: <http://news.bbc.co.uk/2/hi/7615931.stm>

<sup>19</sup> Joern Block et al. (2009), *What is the Effect of the Financial Crisis on Venture Capital Financing? Empirical Evidence from US Internet Start-Ups*, Venture Capital - An International Journal of Entrepreneurial Finance, Vol. 11, No. 4, p. 1.

<sup>20</sup> Joern Block et al. (2009), *What is the Effect of the Financial Crisis on Venture Capital Financing? Empirical Evidence from US Internet Start-Ups*, Venture Capital - An International Journal of Entrepreneurial Finance, Vol. 11, No. 4., p. 3.

decrease the share of their investments in risky assets such as VC funds. Another option that was used by these institutions was to simply not commit any more funds to VCs. Especially the institutional investors that just recently started investing in VC funds were cutting their losses this way. Moreover the exit market for VC investments, especially IPOs faced some tough exit challenges, which also led to a decline in the supply of money for VC funds.

- (2) Decrease in the valuation of VC-backed start-ups: because of the financial crisis VC-backed firms not only had difficulties collecting funds but also got difficulties generating enough revenues. Consumers and companies have less money to spend and will postpone purchases they otherwise would have made. Reduced sales of VC-backed firms will then lead to a lower firm valuation. In addition, there is a higher risk of bankruptcy for VC-backed start-ups.<sup>21</sup>

As stated in the first argument on how the financial crisis was linked to the VC industry, the exit market for VC investments faced some difficulties. Especially the market for Initial Public Offerings (hereinafter: IPOs) faced a serious decline during the financial crisis (Figure 1).

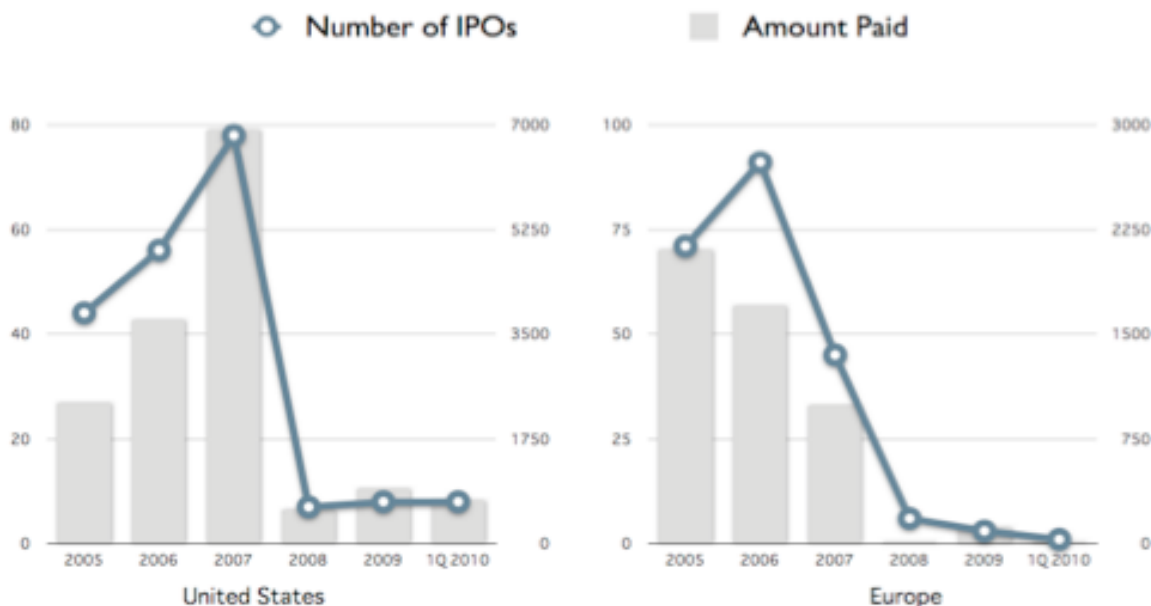


Figure 1: Venture Capital Backed IPOs in the United States and Europe

Source: Dow Jones VentureSource<sup>22</sup>

<sup>21</sup> Joern Block et al. (2010), *Venture Capital and the financial crisis: an empirical study across industries and countries*, Handbook of Venture Capital, Oxford University Press, Forthcoming, p. 5-6.

<sup>22</sup> Joseph A. McCahery et al. (2010), *Venture Capital Beyond the Financial Crisis: How Corporate Venturing Boosts New Entrepreneurial Clusters (and Assists Governments in Their Innovation Efforts)*, Tilburg University Legal Studies Working Paper Series No. 011/2010, p. 14.

Figure 1 shows us that there is a strong decrease in VC-backed IPOs in the US and Europe that started in the US in 2007 and in Europe in 2006. There are four main reasons why IPOs have seen such a strong decline:

- (1) Because of the Sarbanes-Oxley Act the regulatory costs for firms interested in an IPO have increased substantially. The fees for lawyers and auditors have increased significantly and these professionals can not be paid in stock. This implies a lot of extra costs that otherwise could be spend on engineers, marketing, sales staff and other revenue generating jobs. Even if a company can afford the high costs of lawyers and external auditors, it has to comply with the governance requirements of the New York Stock Exchange (NYSE) and NASDAQ. The 2002 proposals by both exchanges developed to strengthen the corporate governance of listed firms require: “(I) shareholder approval of most equity compensation plans; (II) a majority of independent directors with no material relationship with the company; (III) a larger role for independent directors in the compensation and nominating committees; and (IV) regular meetings of only non-management directors.”<sup>23</sup> These extensive requirements will imply higher costs for the firm, not only in cash but also in equity that is required by the company.
- (2) It is nowadays harder for a start-up to persuade investors. These companies are having difficulties showing that their business plan is clearly different and that they can operate more efficient than similar companies in the industry. Companies like Google and Facebook will still be able to go public but many smaller companies that are less differentiated will have a hard time. After the Dot-Com bubble the venture capital industry was forced to reduce their investments. The quarterly investments by these funds decreased over time from \$26.2 billion in the first quarter of 2000 to the \$6.5 billion at the end of the third quarter of 2001. The VC funds were forced to become more selective when investing in promising start-ups.<sup>24</sup>
- (3) The Wall Street Analyst settlement, a settlement that tried to remedy the misleading reports that analysts were publishing, had a huge impact on the analyst sector in the US. This settlement was set up to address conflicts between research and investment

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<sup>23</sup> Bengt Holmstrom et al. (2003), *The State of U.S. Corporate Governance: What's Rights and What's Wrong?*, ECGI Working Paper Series in Finance No. 23/2003, p. 22-23.

<sup>24</sup> Jeffrey E. Sohl (2003), *the US Angel and Venture Capital Market: Recent Trends and Developments*, Journal of Private Equity, Vol. 6, No. 2, p. 7.

banking. Ten of the largest firms agreed to divide their banking and research departments from each other. This has led to more analyst coverage and has increased the cost of equity research. Because of this settlement the incentive for financial firms to hire many analysts to cover smaller IPOs has been eliminated.<sup>25</sup>

- (4) Nowadays, companies that are direct competitors that are trying to be the dominant firm are bought up in an early stage. Facebook and Google for instance, they are buying up companies that are direct competitors or are developing complementary technology. As an example, on April 9, 2012 Facebook acquired the popular photo-sharing application Instagram. This start-up company, founded only two years ago and already having 30 million users, was bought for \$1 billion by the popular social network.<sup>26</sup> Facebook is already the most popular photo uploading service available on the Internet with 250 million photos uploaded to the site every day! So the acquisition of Instagram, rapidly growing and already a very popular photo-sharing application, is a strategic decision that Facebook made prior to its IPO. As Jennifer Grove on Venturebeat stated:

*“Facebook has traded \$1 billion in cash and stock for billions of dollars of value in its upcoming market offering.”<sup>27</sup>*

Facebook is not the only company pursuing the strategy of acquiring high-growth companies in an early stage; Google acquired the mobile payments technology company TxVia on April 2, 2012 for an undisclosed amount. In a blog post the Vice-President of Wallet and Payments at Google stated that the acquisition is done to complement the work already done on Google Wallet, a service that offers payments and discounts and the possibility to make mobile transactions using cellphones with NFC (Near-Field Communication) handsets. TxVia, founded in 2005, has connections with all the major payment networks and it manages around 100 million accounts.<sup>28</sup> In the 1990s these companies might have been able to perform an IPO but not anymore. The race of who will become the largest company is nowadays over in an early stage.<sup>29</sup>

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<sup>25</sup> David Weild et al. (2010), *Market Structure is Causing the IPO Crisis – and more*, GrantThornton Capital Markets Series, p. 14.

<sup>26</sup> Ben Popper (2012, April 9), *Facebook buys Instagram for \$1B, says it will keep the product independent*, VentureBeat.

<sup>27</sup> Jennifer van Grove (2012, April 9), *Answers to why Facebook is buying Instagram are hidden in plain sight*, VentureBeat.

<sup>28</sup> Ingrid Lunden (2012, April 2), *Google Buys TxVia, Banks On Better Payment Technology (And 100M Customers) For Google Wallet*, TechCrunch.

<sup>29</sup> Vivek Wadhwa (2012), *Facebook and the big IPO letdown*, WashingtonPost.com.



There is also an example of how the VC-market, in particular the VC-market for the US Internet industry, has been affected by the financial crisis. The evolution of the VC activity in the US Internet industry from January 2007 to May 2009 is shown in Figure 2. Two conclusions can be made out of this graph. First, the VC market grew significantly during the period before the crash. During that time the number of funding rounds increased as well as the total amount of funds raised. Second, in the period of the financial crisis, a decline in VC activity can be observed. For instance, the funding volume in October 2008 was only \$495 million compared to the funding volume of \$776 million in August 2008. In summary, the VC market for US Internet companies has not shut down completely during the financial crisis but there was a clearly visible decline in VC activity during that period.

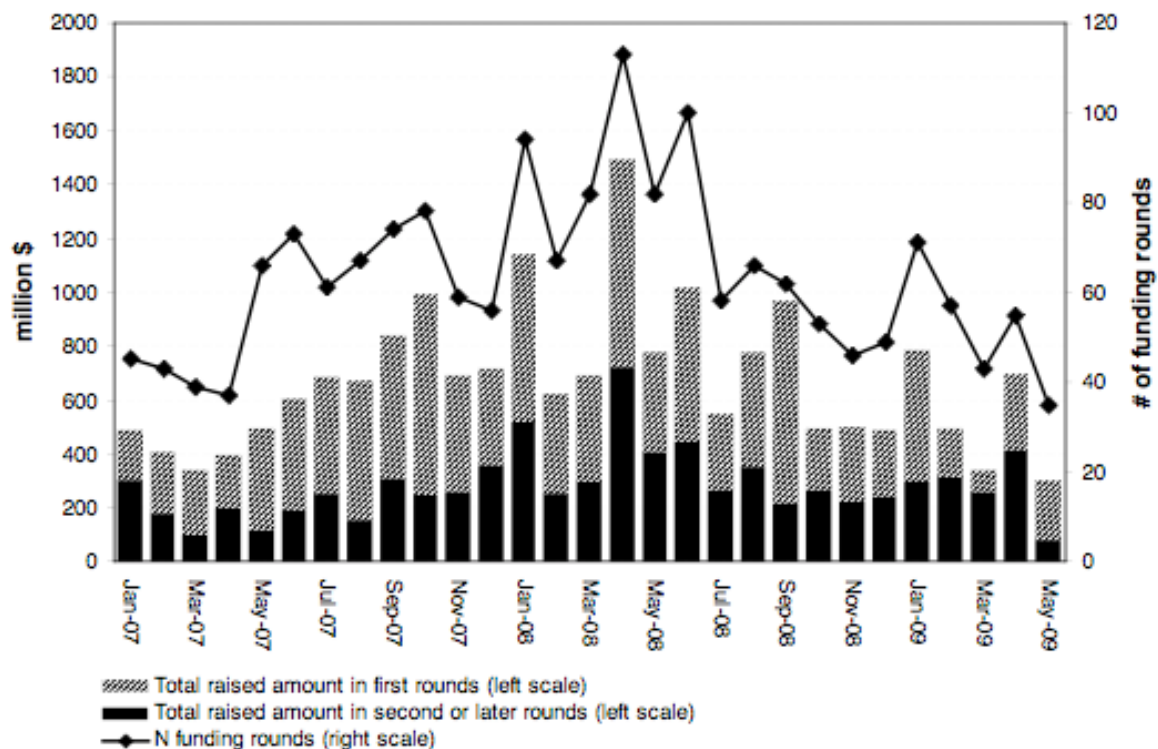


Figure 2: VC Funding in US Internet start-ups from January 2007 to May 2009

Source: Joern Block et al. (2009), *What is the Effect of the Financial Crisis on Venture Capital Financing? Empirical Evidence from US Internet Start-ups*.

The crisis in the VC industry turned out to be a global problem. Not only the US was affected by the crisis but also Europe and particularly Iceland and the Baltic countries. These countries were nearly insolvent during that time.<sup>30</sup>

It is clear that the effects of the financial crisis affect firms and start-ups. The financial crisis resulted in a decrease of the amount of funds that have been raised, especially with regard to later-stage funding rounds.<sup>31</sup> Start-ups that already received their initial funding from incubators/accelerators should keep in mind that further funding for their business should imply a significant discount as a result of the crisis. It is likely that firms have to cut their costs or have to postpone or cancel their expansion plans. During this crisis it shall be difficult for firms to raise the necessary funds to further finance their product development, marketing strategy and expansion efforts.<sup>32</sup>

The venture capital industry is often defined as a “venture cycle.” This venture cycle used to be as follows: it all starts with the creation of a venture fund; money from investors flows in, then the venture capital fund enters into partnerships with entrepreneurs. This is also shown in Figure 3:

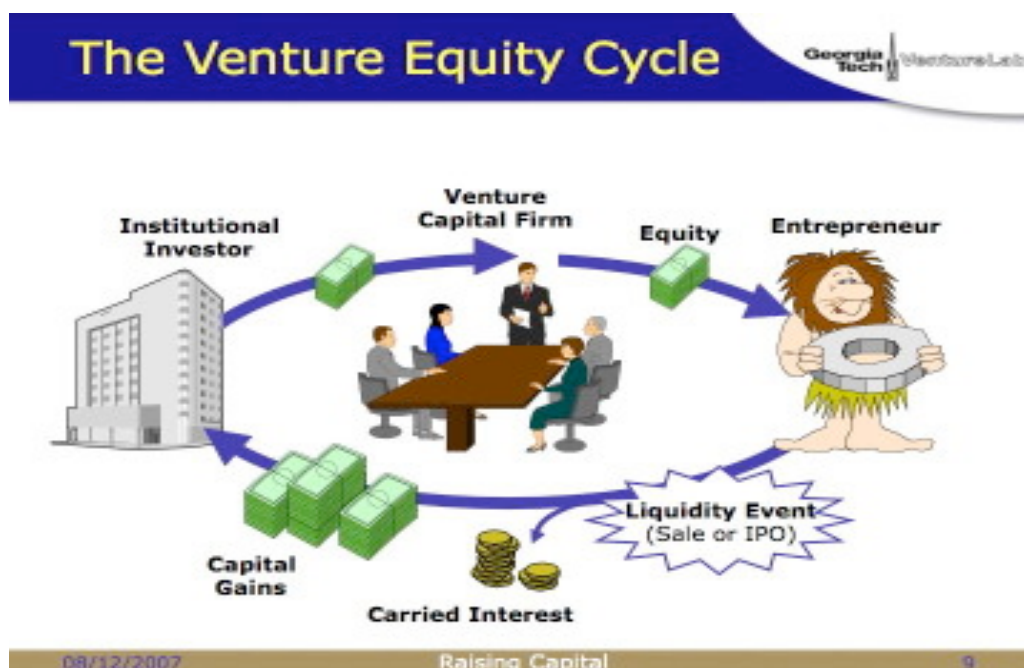


Figure 3: The Venture Equity Cycle Explained

Source: E.P.M Vermeulen, *International Business Law I: Lecture 9*

<sup>30</sup> Joern Block et al. (2010), *Venture Capital and the financial crisis: an empirical study across industries and countries*, Handbook of Venture Capital, Oxford University Press, Forthcoming, p. 12

<sup>31</sup> Joern Block et al. (2009), *What is the Effect of the Financial Crisis on Venture Capital Financing? Empirical Evidence from US Internet Start-Ups*, Venture Capital - An International Journal of Entrepreneurial Finance, Vol. 11, No. 4, p. 8-10.

<sup>32</sup> Joern Block et al. (2009), *What is the Effect of the Financial Crisis on Venture Capital Financing? Empirical Evidence from US Internet Start-Ups*, Venture Capital - An International Journal of Entrepreneurial Finance, Vol. 11, No. 4, p. 10.

The VC fund will actively develop, manage and monitor the firm and by doing so it will try to add value to its investment. If the firm eventually has grown significantly, the VC fund will exit the investee company through successful deals and the returns will be distributed to the initial investors. Then the VC cycle starts all over again by investing in another promising business.<sup>33</sup>

To successfully exit these firms, the IPO has always been the preferred option for VC funds. This type of exit mechanism usually offered the highest returns for VC funds when liquidating their successful investments. It also offered benefits for the founders of these firms because they were able to take back control from the VC fund after initiating an IPO.<sup>34</sup>

However there has been a significant decline in the number of IPO's since the beginning of the financial crisis (figure 1). Thus the preferred exit strategy for VC funds has seen a significant decline since the outbreak of the financial crisis. Because of this decline, other exit mechanisms have become more popular as an exit strategy with so-called "trade sales" being a good example. A trade sale allows a VC fund to sell their share in a company to an interested buyer. It also gives the fund control to negotiate the terms of the trade sale with the interested party.<sup>35</sup> The benefits of exiting through a trade sale are that it offers immediate liquidity without annoying lockup periods, costly disclosure requirements and obligations for venture capitalists to keep their board seats on the new public company. A trade sale can also literally happen overnight where instead the last couple of years have been very slow for VC-backed IPOs.<sup>36</sup> The current exit scenario when performing an IPO currently takes close to nine years. Therefore trade sales have become a preferred exit strategy for many firms because of regulatory burdens that firms face by doing an IPO.<sup>37</sup>

Because of the fact that IPOs are less common and are unavailable for the majority of VC-backed firms, VC funds have become more risk-averse. Therefore more funds decided to invest in companies that are in a later stage and are already profitable. As a consequence, funding gaps have appeared in the VC cycle. Even if there are investors that are willing to finance these start-ups,

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<sup>33</sup> Paul Gompers et al. (2001), *The Venture Capital Revolution*, Journal of Economic Perspectives, Vol. 15, No. 2, p. 152.

<sup>34</sup> Bernard S. Black et al. (1998), *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, Journal of Financial Economics, Vol. 47, p. 243.

<sup>35</sup> Source: <http://www.askventure.com/venture-capital-exits-trade-sale-vs-ipo-compared-and-analyzed/>

<sup>36</sup> Alexander Haislip (2011), *Essentials of Venture Capital*, Hoboken: John Wiley & Sons, Inc., Ch. 6, p. 121-122.

<sup>37</sup> Jose M. Mendoza et al. (2011), *The "New" Venture Capital Cycle (part I): The Importance of Private Secondary Market Liquidity*, Lex Research Topics in Corporate Law & Economics Working paper No. 1/2011, p. 2.

these investors will face a liquidity gap because of the long exit horizons. This liquidity gap needs to be solved by other/new liquidity options.<sup>38</sup>

A National Venture Capital Association (NVCA) survey with VC funds made clear that 96% of the venture capitalists believe that it will be more difficult to acquire funding and 93% thinks it will be harder to keep their existing portfolio companies. New commitments to VC have reduced and the amount of VC funds seeking investments has decreased. This will leave the financing landscape to other types of investment, for example angel groups and small VC funds that apply an investment model based on smaller amounts of financing and the opportunities of faster exits through trade sales.<sup>39</sup>

This may also leave an opportunity to the crowdfunding model as a means of financing these businesses and to spur entrepreneurship.

## 2.2 The Rise of Crowdfunding as a Means of Financing

The crowdfunding phenomenon is actually derived from the broader concept of ‘crowdsourcing’. Jeff Howe described in his 2006 article in Wired Magazine that:

*“Crowdsourcing represents the act of a company or institution taking a function once performed by employees and outsourcing it to an undefined (and generally large) network of people in the form of an open call. (...) The crucial prerequisite is the use of the open call format and the large network of potential labourers.”*<sup>40</sup>

The Internet community is growing larger and larger. Mobile phones and tablets are offering web access and have an increased portability, there is WiFi access to restaurants, coffee bars, libraries, train stations and airports and modern TVs have web-based applications, these are all factors that increase connectivity between people and that fuels the crowd. This means a lot for the crowdsourcing and crowdfunding model. The larger the crowd, the more information that can be derived from it, is what can be said about crowdsourcing (Wikipedia being one of the best examples). The same goes for crowdfunding, the larger the crowd, the more capital that can be

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<sup>38</sup> Jose M. Mendoza et al. (2011), *The “New” Venture Capital Cycle (part I): The Importance of Private Secondary Market Liquidity*, Lex Research Topics in Corporate Law & Economics Working paper No. 1/2011, p. 9-10.

<sup>39</sup> Colin Mason (2009), *Venture Capital in crisis?*, Routledge Taylor & Francis Group, p. 283.

<sup>40</sup> Jeff Howe (2006), *The Rise of Crowdsourcing*, Issue 14.06 Wired Magazine, p. 1.

derived from it. As the Internet community grows, the crowdfunding initiatives grow as well.<sup>41</sup> The latest statistics make clear that of a population of 7 billion people more than 2 billion people nowadays have access to the internet (a penetration of 32.7%).<sup>42</sup>

The development of Web 2.0 is seen as the main reason for the development of crowdsourcing and crowdfunding. Crowdfunding must be seen as an element of crowdsourcing, financial support from consumers/investors for a company or project. Web 2.0 created the possibility for the creation of networks for people who share common interests. For example: Facebook for friends and family, LinkedIn for your professional network and Crowdfunder<sup>43</sup> as an example of a platform for entrepreneurs and investors. There are three main characteristics that define Web 2.0:

- (1) collaboration permits to combine each other's knowledge and resources;
- (2) openness allows people to contribute freely to different projects;
- (3) participation is increased thanks to the ease of access and use of computers and internet.<sup>44</sup>

The new part in crowdfunding lies in the fact that a company can use these platforms and other new features of Web 2.0, particularly the networking and marketing function, to enable the mobilization of a large number of users of these crowdfunding platforms for the company's own purposes.<sup>45</sup>

Because of the rise of crowdfunding platforms all over the world, crowdfunding is becoming big business. For example, the popular crowdfunding platform Kickstarter had in October 2011 the millionth person to have ever pledged money to a Kickstarter project. The growth of new backers by month is shown in Figure 4:

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<sup>41</sup> Kevin Lawton et al. (2010), *The Crowdfunding Revolution: Social Networking meets Venture Financing*, Self-published, p. 13.

<sup>42</sup> Source: <http://www.internetworldstats.com/stats.htm>

<sup>43</sup> Source: [http://www.crowdfunder.com/CrowdAboutNow/info/crowdfunder\\_in\\_english/](http://www.crowdfunder.com/CrowdAboutNow/info/crowdfunder_in_english/)

<sup>44</sup> Sang-Heui Lee et al. (2008), *Web 2.0 and Opportunities for Small Businesses*, Service Business, Vol. 2, No. 4, p. 338.

<sup>45</sup> Joachim Hemer (2011), *A Snapshot on Crowdfunding*, Fraunhofer Institute for Systems and Innovation Research ISI, Working Paper No. R2/2011, p. 8.

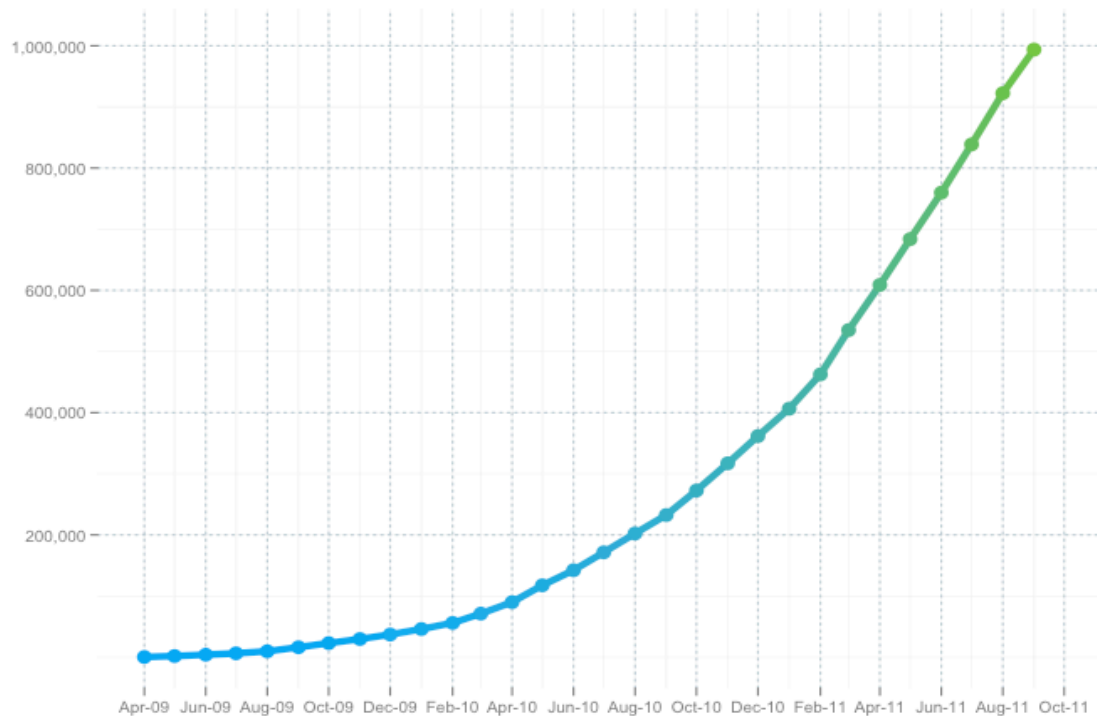


Figure 4: *New backers by Month on Kickstarter.com*

Source: <http://www.kickstarter.com/blog/one-million-backers>

These Kickstarter backers are also bringing in a lot of money for all the different projects that need funding. During the month October Kickstarter also announced that these backers have pledged more than \$100 million to projects. The platform now even has a current pace of more than \$2 million pledged a week which means that more than \$100 million a year will be pledged if this pace will continue.<sup>46</sup>

As was also stated in Chapter 1, there are different crowdfunding platforms that also operate in different ways. Roughly three kinds of platforms can be defined:

- (1) crowdfunding as a method for sponsorship with a non-financial return: websites that use the donation model, the reward model and/or the pre-purchase model are examples of this kind of platform (Kickstarter, IndieGoGo). Interested people can pledge money to projects of their choice and in return they receive some sort of non-financial return or even nothing at all. The return is normally based upon the financial involvement in the project and is set by the project owner;
- (2) debt-crowdfunding with a financial return (P2P-lending): nowadays some platforms are using crowdfunding for financing debt in start-ups. However to finance a start-up with debt entrepreneurs may be forced to offer irrational returns to crowdfunders to hedge the

<sup>46</sup> Source: <http://www.kickstarter.com/blog/one-million-backers>

associated risk. The lender that offers the debt will also pledge property as a security for the loan. If the entrepreneur for some reason cannot fulfill his loan obligations, then the start-up might lose valuable business assets or even personal assets.<sup>47</sup>

- (3) equity-based crowdfunding with a potential financial return and ownership: these platforms will offer direct investments in and direct returns from new start-ups or existing companies because investors will become partially owner of that company. This is a better model compared to the debt-crowdfunding model because it better aligns the interests of the potential investors and the entrepreneur.<sup>48</sup> Raising money through equity will allow the entrepreneur to use the cash to pay the start-up expenses rather than the loan payments. Moreover, when the start-up goes bankrupt, the entrepreneur will probably not have to repay the initial investors. Investors can even bring valuable business experience and know-how to the table.<sup>49</sup>

Another graph (Figure 5) shows the level of complexity of the different types of crowdfunding. Because crowdfunding platforms can be designed for donations, rewards, peer-to-peer lending and equity investments, the complexity of these platforms differs greatly. All these different types can be ranked in a graph, starting from the least complex form to the most complex (highly regulated) form: equity investments.

Equity-based crowdfunding will also be main focus of this thesis because of the financial regulations that are involved when offering equity.

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<sup>47</sup> Source: [http://www.forbes.com/2007/01/05/equity-debt-smallbusiness-ent-fin-cx\\_nl\\_0105nolofinancing.html](http://www.forbes.com/2007/01/05/equity-debt-smallbusiness-ent-fin-cx_nl_0105nolofinancing.html)

<sup>48</sup> Korstiaan Zandvliet (2011), *"Equity or Debt?" The Next Step in Crowdfunding*. Crowdfund News.

<sup>49</sup> Source: [http://www.forbes.com/2007/01/05/equity-debt-smallbusiness-ent-fin-cx\\_nl\\_0105nolofinancing.html](http://www.forbes.com/2007/01/05/equity-debt-smallbusiness-ent-fin-cx_nl_0105nolofinancing.html)

### 2.3 Equity-based Crowdfunding: the Business Models

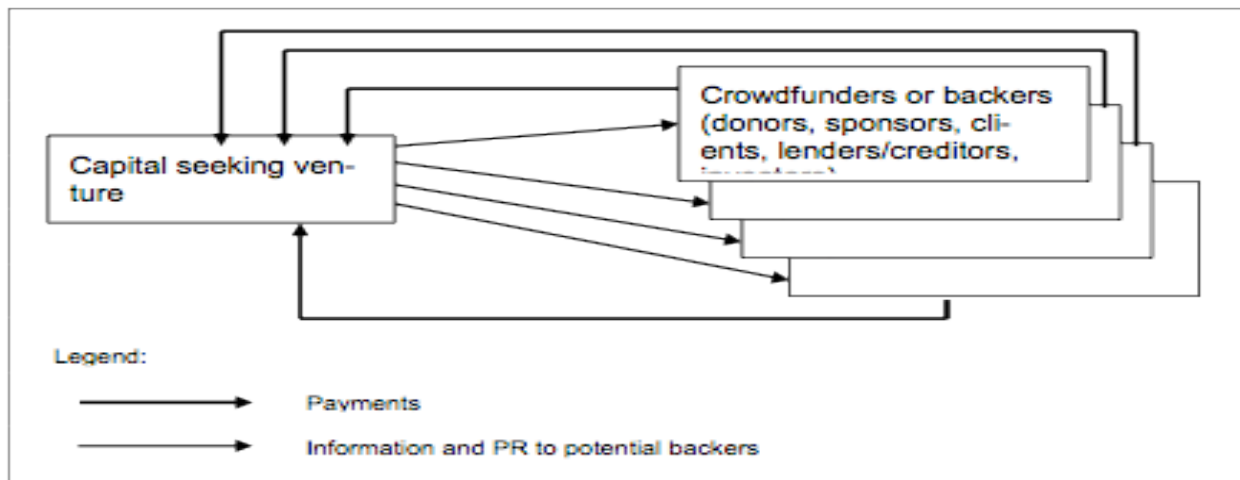


Figure 4: Basic actors in the crowdfunding process

Source: Joachim Hemer et al. (2011), *Crowdfunding und andere Formen informeller Mikrofinanzierung in der Projekt- und Innovationsfinanzierung*, final Report.

Figure 4 above explains the essential characteristics of crowdfunding. To make the graph not too complicated it is reduced to its basic elements.

This graph actually shows very simplistically the complexity levels of the different types of crowdfunding. As you can see, equity/investment types is the most complicated form of crowdfunding because it is a highly regulated form of financing because of all the securities rules and regulations it has to comply with. This is illustrated in Figure 5:

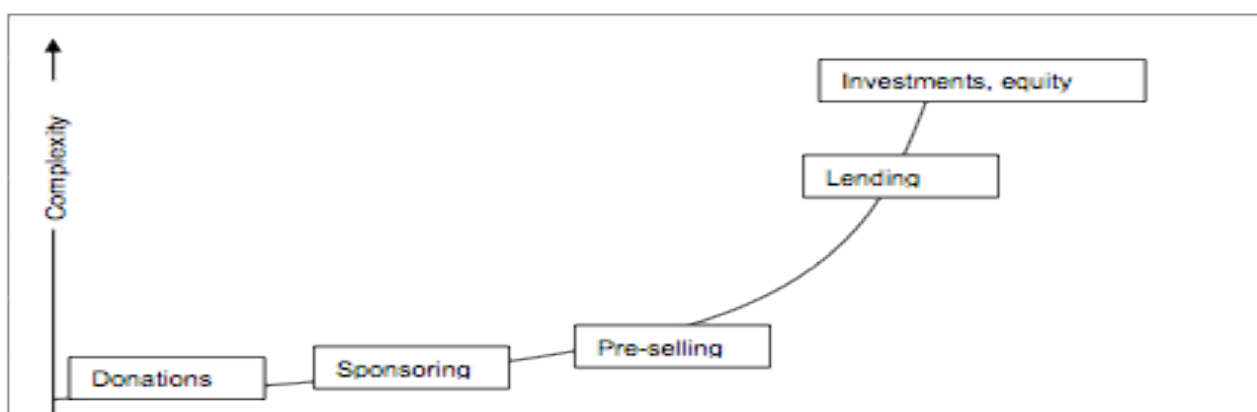


Figure 5: The major forms of capital provision ranked by process complexity

Source: Joachim Hemer et al. (2011), *Crowdfunding und andere Formen informeller Mikrofinanzierung in der Projekt- und Innovationsfinanzierung*, final Report.



Figure 5 shows the complexity of processes that crowdfunding platforms have to implement in order to receive capital: donations as the most basic form and equity investments as the most complicated form.

But how does equity-based crowdfunding work in practice? There are platforms, for example Symbid (Dutch based crowdfunding platform), that offer online equity-based investment that enables individuals to actually become partial owner of new start-ups. These platforms bring together entrepreneurs and investors so they can share in the funding of new and promising business ideas.

In order to acquire crowdfunding, companies and individuals can submit an idea for a new start-up or growth plan for an existing company to the platform. When this idea is submitted, the entrepreneur indicates how much capital will be required to start or grow this business. The chance of success depends on the amount of funding needed, marketing efforts and of course the strength of the business idea.<sup>50</sup>

Potential investors on this platform search for business ideas that they consider promising and have a chance of succeeding and promising good returns. The total amount of funding that a business idea receives will make up the ‘current funding’. The final goal is to receive the amount set by the entrepreneur to launch his start-up or growth plan.<sup>51</sup>

When a project or business has reached its set up financing objectives, the total amount of investments are converted into a single investment vehicle. This is a new legal entity developed for the purposes of making the investment in the entrepreneur’s venture. Each investor owns a certain stake in this new entity (the investment vehicle) equal to the proportion of his investment compared to the total investment amount. Subsequently, the new legal entity shall buy the predetermined amount of parts associated with the pre-determined level of funding that has been granted to the entrepreneur.<sup>52</sup>

To circumvent regulations of the Authority Financial Markets (AFM) and The Dutch National Bank (DNB), Symbid had to come up with a fiscal and legal construction that does not require a license according to these two institutions’ regulations. Therefore a “cooperative model” has been chosen. When a business idea has received the necessary funding, Symbid gathers all the capital received and transfers it into a cooperative. This will be the legal entity that invests in the venture of the entrepreneur. Individual investors are brought together into this legal entity. The reason why Symbid has chosen for the cooperative form is that membership certificates in cooperatives can be easily acquired and do not have to pass by a notary. The cooperative form in

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<sup>50</sup> Source: <http://www.symbid.com/howitworks>

<sup>51</sup> Source: <http://www.symbid.com/howitworks>

<sup>52</sup> Source: <http://www.symbid.com/howitworks>

the Netherlands is known for its flexibility and its democratic characteristics. Members/investors in this business form can do business on an equivalent level and members can also have the same limited liability as in the Dutch BV (“Besloten Vennootschap”) form if the company chooses for the cooperative form with exempt liability (“Coöperatie met Uitgesloten Aansprakelijkheid”). However the most important reason businesses choose the cooperative form is because of fiscal reasons. The Cooperative UA can be exempt from paying dividend taxes. This means that the company can distribute the profits to their members/investors on a tax-free basis. The Investors Cooperative UA has been set up in order to avoid double taxation. The legal entity of the entrepreneur will already pay corporate taxes but by setting up an Investors Cooperative UA the members/investors will not have to pay additional dividend taxes.<sup>53</sup> These regulations will fit into an equity-based crowdfunding platform in the Netherlands.<sup>54</sup>

If potential investors want to become a member of the platform they have to purchase membership certificates for €20 each in a Symbid Cooperative U.A. One or more memberships may be purchased. This framework then provides the possibility for members to pool the capital together before it is invested in an entrepreneur’s business idea or growth plan. The agreement with the entrepreneurs must be limited to a amount of €5 million with regard to the issuing of shares.<sup>55</sup>

The threshold of €5 million is raised in the amended Prospectus Directive of the European Commission in order to create a proportionate disclosure regime for Small and Medium Enterprises (SMEs) and Small Caps. The European Securities and Markets Authority (ESMA) stated that a full proportionate disclosure regime for SMEs and small caps could have a negative influence on the regulatory framework of these regulated markets and investor protection. They advised to seek the right balance between the objectives of reduction of the administrative burdens for these issuers and investor protection.<sup>56</sup>

Second, if an entity is set up for a fully funded business idea, representatives elected by the members, conduct the board. The Investor Cooperative U.A. is the entity where all the investors will be aggregated. Here they bring their combined knowledge, capital and network into the entity of the entrepreneur. Each investor will receive the number of memberships as in accordance with the amount invested on the platform. These memberships will represent the voting rights in the entrepreneur’s entity proportionate to the amount of memberships in the investors cooperative U.A.

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<sup>53</sup> Lex van Almelo (2010), *Fiscale Motieven Maken Coöperatie Populair*, De Accountant (mei 2010), p. 20-22.

<sup>54</sup> Source: <http://www.symbid.com/howitworks#legal>

<sup>55</sup> Article 1(a)(h) Amendments to Prospectus Directive 2003/71, No. 2010/73.

<sup>56</sup> Directive No.2010/73 amending Directives 2003/71 on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109 EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

The structure of this legal and fiscal framework is shown in Figure 6:

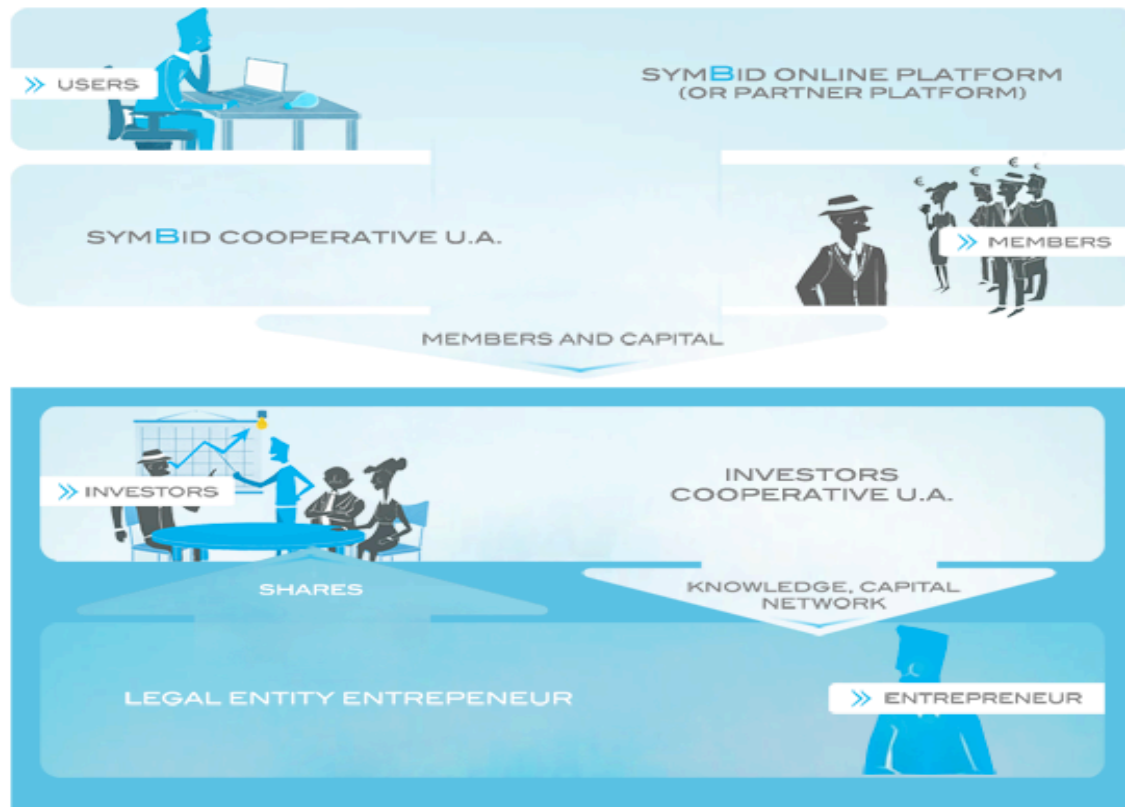


Figure 6: The Legal Framework used by Equity-Based Crowdfunding Platform Symbid

Source: <http://symbid.com/howitworks#legal>

Symbid complies to the Dutch corporate law rules with the use of this business model. Dutch corporate law will also be used in case that the entrepreneur's company goes bankrupt and Dutch tax regulations will apply for investments in entrepreneurs' legal entities.<sup>57</sup>

Then there was another equity-based crowdfunding platform called ProFounder, based in the US. However, it closed on February 17, 2012 but this will be discussed in paragraph 3.1.1. ProFounder was an online solution for entrepreneurs who wish to offer securities to non-accredited investors. Non-accredited investors are investors that do not meet the requirements of an accredited investor as defined in Rule 501 of Regulation D of the Securities Act of 1933. Examples are the requirement of an income exceeding \$200,000 in each of the two most recent years or the requirement of being a bank, insurance company, director, executive director, general partner of the company selling the securities, etcetera.<sup>58</sup>

<sup>57</sup> Source: <http://symbid.com/faqs>

<sup>58</sup> Source: <http://www.sec.gov/answers/accred.htm>

To be able to offer these securities ProFounder had to navigate through a complex legal environment to come up with an appropriate legal framework that could meet their goals. To serve the needs of entrepreneurs as well as investors ProFounder introduced a Regulation D, Rule 504 and a Regulation D, Rule 506 compliance structure.<sup>59</sup> It eventually turned out that this structure was not very successful.<sup>60</sup>

ProFounder does not serve as a crowdfunding platform for the masses, entrepreneurs looking for funding and potential investors must have a “substantial, pre-existing relationship” with the entrepreneur to be able to fund his business idea. ProFounder serves the function of “matchmaker” in this regard. Profinder describes itself not as a real “crowd”-funding platform but as a “community-based crowdfunding platform.” Because of this specific condition, an offer on ProFounder is exempt from the Securities and Exchange Commission (hereinafter: SEC) regulation because this type of offering is defined as a “private placement offering” (exempt under section 4(2) of the Securities Act of 1933). Moreover, because there is a pre-existing relationship, there is a reduced risk of fraud and investors can fund entrepreneurs they know and have faith in.<sup>61</sup>

Normally in the United States offerings of securities must be registered with the SEC. Section 5(c) of the Securities Act 1933 provides that no one may offer securities until a registration statement has been filed with the SEC but there are some exemptions available for entrepreneurs.<sup>62</sup> These will be elaborated in Chapter 3.1.1 of this master’s thesis.

## 2.4 Crowdfunding Decisions in the Context of Entrepreneurial Projects

An entrepreneur that is seeking finance for his company can use either equity or he can use debt as a source of financing. When an entrepreneur is offering equity the money received goes straight into the capital of the company. The investors receive shares in return for their investment and so they obtain partial ownership over the company but they also bear the risks.

When an entrepreneur is offering debt for finance, the parties that finance the entrepreneur will remain external parties. Most of the times this is done via bank loans. These parties do not receive ownership in the company but they bear a lower risk thanks to the collateral and their seniority of their claims over equity. For starting entrepreneurs, debt financing is normally not available because these companies often do not have the substantial tangible business assets that

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<sup>59</sup> Source: <https://www.profounder.com/faq>

<sup>60</sup> Source: <http://blog.profounder.com/2012/02/17/profounder-shutting-down/>

<sup>61</sup> David Lang (2011), *The Muth of the Crowd*, ProFounder, The Blog.

<sup>62</sup> Source: Securities Act § 5(c), 15 U.S.C. § 77e(c) (2010).

might be pledged for collateral or the required cash flows to ensure that they can pay their interests to the creditor.<sup>63</sup>

Banks typically are not likely to invest in start-up companies. Start-up companies' cash flows are very hard to predict and they typically rely on intangible assets, whose value is difficult to accurately determine, like marketing knowledge or technology, while banks want to rely on the tangible assets of the company for collateral that are relatively easier to accurately value. Financing a start-up is a very risky business for a bank because most of them will go bust and when they do, banks will have no tangible assets they can claim and sell on their behalf.<sup>64</sup>

Venture Capitalists therefore can provide a solution for start-ups to receive funding. Financing can be acquired by an "angel investor" (an investor who provides financial backing for small start-ups or entrepreneurs<sup>65</sup>), a corporate venture capitalist or a traditional VC fund. Corporate venture capital is defined as an investment of corporate funds in external start-ups or an investment by a corporation in start-ups that are spin-off businesses of such corporation.<sup>66</sup>

Entrepreneurs can offer equity in return to the venture capitalist but this means that the entrepreneur will lose full ownership over the company. However this is not a huge drawback. Venture capitalists will use their ownership to offer "value added services" to the start-ups they invest in. They can use their expertise and network of people to stimulate technical development of the start-up, they can use their experience and knowledge of industries and markets to mentor the entrepreneur and they can provide a reputational boost for the start-up to obtain new contracts and new rounds of financing, for instance.<sup>67</sup> The problem is that venture capitalists have become more conservative the last couple of years because IPOs have become unavailable as an exit strategy for most companies. Therefore they moved from investing in a start-up that is not likely to make profits at the initial stage, to mid- and later stage investments for companies that are already profitable. Because of this new strategy implemented by VC funds, liquidity gaps have appeared in the early stage financing rounds.<sup>68</sup>

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<sup>63</sup> Allen N. Berger et al. (1998), *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, Journal of Banking and Finance, Vol. 22, p. 8.

<sup>64</sup> Laura Botazzi et al. (2002), *Venture Capital in Europe and the Financing of Innovative Companies*, Economic Policy, Vol. 34, p. 5-7.

<sup>65</sup> Source: <http://guides.wsj.com/small-business/funding/how-to-get-funding-from-angel-investors/>

<sup>66</sup> Henry W. Chesbrough (2002), *Making Sense of Corporate Venture Capital*, Harvard Business Review, p. 5.

<sup>67</sup> Joseph A. McCahery et al. (2006), *Corporate Governance and Innovation Venture Capital, Joint Ventures, and Family Businesses*, Working Paper No. 65/2006, p. 8.

<sup>68</sup> Jose M. Mendoza et al. (2011), *The "New" Venture Capital Cycle (part I): The Importance of Private Secondary Market Liquidity*, Lex Research Topics in Corporate Law & Economics Working paper No. 1/2011, p. 9-10.

As was already stated in Chapter 1, Introduction, crowdfunding can possibly solve this liquidity gap. If an entrepreneur chooses to use crowdfunding to finance his company, he needs to take into account several factors:<sup>69</sup>

- Lack of pre-existing resources

For a company with little financial and human resources, VC funds seem the best solution: financial and non-financial support (value-added services). Crowdfunding can offer the entrepreneur the financial support but one can question if the crowd has the specific knowledge and know-how a VC fund or angel investor has.<sup>70</sup> Therefore it might be hard for crowdfunding to become a substitute of Venture Capital funding, it will rather be complementary to VC, with regard to the early stage liquidity gaps.

- Risk, moral hazard and information asymmetry

How to spread the risk? Offering debt will mean that the entrepreneur will bear the risk by himself. Equity on the other hand will spread the risk among the investors.

Moral hazard is also an issue that needs to be dealt with. To stage investments in multiple rounds is often done by investors to overcome this problem. If the entrepreneur reaches certain milestones and provides new information about the development of the product and its risks with regard to the market after a period of time, he might receive further funding.

Information asymmetry is also very important when investing in a start-up. Investors often lack the information the entrepreneur has about the Industry, about his past performance or about the start-ups opportunities on the market. On the other hand, the entrepreneur often is reluctant to disclose these types of information because of the number of investors or the possibility of “grab and steal” of ideas. Especially in case of crowdfunding, this might occur because of the larger amount of investors.<sup>71</sup>

- Organizational form

The organizational form that will be applied for the start-up might influence its success. Research shows that not-for-profit organizations tend to be more successful than the other forms. Not-for-profits even tend to raise 200% more when the funds are acquired through crowdfunding. These

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<sup>69</sup> Armin Schwienbacher et al. (2010), *Crowdfunding of Small Entrepreneurial Ventures*, Handbook of Entrepreneurial Finance, Oxford University Press, p. 9-12.

<sup>70</sup> Armin Schwienbacher et al. (2010), *Crowdfunding of Small Entrepreneurial Ventures*, Handbook of Entrepreneurial Finance, Oxford University Press, p. 9.

<sup>71</sup> Armin Schwienbacher et al. (2010), *Crowdfunding of Small Entrepreneurial Ventures*, Handbook of Entrepreneurial Finance, Oxford University Press, p. 10.

organizations are due to their nature more focused on the outcome of their business plan than on making profits.<sup>72</sup>

- Control preferences

Should investors in a crowdfunded start-up be able to influence the decision making of this company? There are many investors that own only a very small amount of the company so there might be difficulties for companies to give crowdfunders the opportunity to exercise their voting power.<sup>73</sup>

- Amounts required by entrepreneurs

Entrepreneurs shall have to calculate a pre-determined amount on a crowdfunding platform in order to show to possible investors how much they need to start up their business. For example, the crowdfunding platform Sprowd calculated their costs and expenses on € 705,000 in order to get their business up and running.<sup>74</sup>

- Legal issues regarding equity issuance and multiple investors

Securities rules and regulations may limit the possibilities of the crowdfunding concept. Entrepreneurs that seek funding for their start-up may want to sell securities to the public, but these offerings of securities to the public are prone to securities regulation in for instance the United States in Europe as well.<sup>75</sup>

- The “wisdom of the crowd” argument

The “wisdom of the crowd” theory states that a crowd can be more efficient when solving problems than individuals or certain groups. Crowdfunders that invested in a start-up might be able to share their knowledge in a Web 2.0 environment and so they might be able to support the entrepreneur with corporate matters. Crowdfunders however often lack the specific knowledge and know-how of angel investors and VC funds. Moreover, entrepreneurs might not be so willing to disclose proprietary information amongst the crowd.<sup>76</sup>

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<sup>72</sup> Armin Schwienbacher et al. (2010), *Crowdfunding of Small Entrepreneurial Ventures*, Handbook of Entrepreneurial Finance, Oxford University Press, p. 11.

<sup>73</sup> Armin Schwienbacher et al. (2010), *An Empirical Analysis of Crowdfunding*, p. 11.

<sup>74</sup> Source: <https://sprowd.com/pitch/sprowd/financials>

<sup>75</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 4.

<sup>76</sup> Armin Schwienbacher et al. (2010), *Crowdfunding of Small Entrepreneurial Ventures*, Handbook of Entrepreneurial Finance, Oxford University Press, p. 12.

## CHAPTER 3 - CROWDFUNDING AND THE SECURITIES RULES AND REGULATIONS

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### 3.1 The Current State of Affairs

#### 3.1.1 The United States

*“Crowdfunding and financial services are irrevocably interwoven. For practical adoption, a platform needs to protect and enable all parties involved. This will require progressive securitization initiatives to allow for capital to flow across geographic boundaries and provide the scale for even the most abstract ideas to prosper.”*

*Fred Bryant, Wealthforge Inc.*

Due to the tough regulatory environment in the United States the equity-based crowdfunding platform ProFounder decided to shut down on February 17, 2012. According to Jessica Jackley:

*“The current regulatory environment prevents us from pursuing the innovations we feel would be most valuable to our customers, and we’ve made the decision to shut down the company.”<sup>77</sup>*

ProFounder was established to solve the market inefficiencies in the United States with regard to the legal and administrative barriers to have access to capital. Dana Mauriello (founder of ProFounder): “the available capital existed but there were tremendous barriers to access it.” So they created a platform that offered entrepreneurs the possibility to use their social networks for the funding of their business projects in such a manner that it is simple, cheap and efficient with the involved securities laws. But eventually it became too difficult to pursue this business under the current laws and regulations so they had to shut down this innovative project.<sup>78</sup>

But what are the U.S. securities rules and regulations that make it so hard to create and run an equity-based crowdfunding platform?

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<sup>77</sup> Source: <http://blog.profounder.com/2012/02/17/profounder-shutting-down/>

<sup>78</sup> Dana Mauriello (2011), *Crowdfunding: Connecting Investors and Job Creators*, Written Testimony to the Committee on Oversight and Government Reform U.S. House of Representatives, Sub-Committee on TARP and Financial Services, p. 2.



In SEC v. W.J. Howey Co. the Supreme Court created a common law test to determine if a particular investment scheme is an “investment contract” and thus an offer of securities. This is also known as the “Howey” test. The court held that an investment contract subject to securities regulation is:

*“A contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”*<sup>79</sup>

But how does this relate to equity crowdfunding? The interests that are offered by the crowdfunding platforms and businesses are equity interests that offer the investors revenues and profit-sharing rights. Under section 2(a)(1) of the Securities Act 1933 these interests are investment contracts and thus securities as defined in the Howey test. The investment contract is created by the fact that investors pour money into a common investment pool in order to receive a certain share of the profits derived from the projects they funded. Symbid is an example of a platform that uses this structure.<sup>80</sup>

The Howey test has always been the standard test to define an “investment contract” security. It has been refined a couple of times but the basic elements have been the same, except for one condition. The word “solely” has been eliminated from the Howey test. The question now is:

*“whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”*<sup>81</sup>

Investors have complete freedom in picking the projects they like, but this implies that they will also completely rely on the expertise, knowledge and know-how of the entrepreneurs (managers of the business) to help the start-up become profitable and successful. Investors can “cherry pick” their projects but they will not contribute significantly to the profitability of a start-up by exercising control. So the equity- and lending-based crowdfunding platforms are offering securities if interest/profits are offered.<sup>82</sup>

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<sup>79</sup> Source: SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946).

<sup>80</sup> Edan Burkett (2011), *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, Tennessee Journal of Business Law, Vol. 13, p. 81-82.

<sup>81</sup> Source: SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476, 482 (1973).

<sup>82</sup> Edan Burkett (2011), *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, Tennessee Journal of Business Law, Vol. 13, p. 81-82.

As stated in the last sentence of the previous paragraph, the federal securities laws do not only apply to the equity interests in business but also involve some forms of debt financing. An investment contract even may be a security if returns are fixed payments or interests, as is the case with debt financing. The Securities Act § 2(a)(1) also makes clear that the definition of securities also implies “notes”, “bonds”, “debentures”, and “evidence of indebtedness”. In *Reves v. Ernst & Young* the Supreme Court gave an analysis that should clarify this problem.<sup>83</sup>

First, the Court starts with the presumption that “every note is a security.” It then comes up with a list of notes that are not to be defined as securities. Unfortunately, lending-based crowdfunding does not apply to any of the categories on that list. But the Court also gave a four-part test whether notes should be defined as securities, the so-called “family resemblance” test. Under this test, a note is presumed to be a security unless it has a strong resemblance to one of judicially crafted list of categories of instrument that are not securities.<sup>84</sup> The four factors are:

- 1) the motivations of the buyer and seller of the note;
- 2) the plan of distribution of the notes;
- 3) the reasonable expectations of the investing public;
- 4) “whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the investment, thereby rendering application of the securities Acts unnecessary.”<sup>85</sup>

With regard to crowdfunding, there are obvious problems considering the fourth factor: there is no regulatory scheme that covers crowdfunding loans. There are also problems with regard to the first factor: the motivations factor will clearly treat crowdfunding notes that offer interest as securities. The plan of distribution factor in *Reves* is met if the notes are “offered and sold to a broad segment of the public” so crowdfunding sites could meet this requirement of the test. These sites are open to the public and it can involve investments by a large number of people. The final factor is the “reasonable expectations” factor. Lower courts analyzed that “whether a reasonable member of the investing public would consider these notes/shares as investments” is to be the factor that determines if it is a security or not.<sup>86</sup> So if investors bought notes because of the interest rates/profits offered, these notes are to be defined as investments. The fact that the entrepreneur did

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<sup>83</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 20-23.

<sup>84</sup> Source: *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

<sup>85</sup> Source: *Reves v. Ernst & Young*, 494 U.S. 57 (1990).

<sup>86</sup> Source: *SEC v. Wallenbrock*, 313 F.3d 532, 539 (2002).

not describe the notes as investments is of little importance. What counts is the intrinsic nature of the transactions.<sup>87</sup>

Concluding this part about lending-based crowdfunding can be said that issuing debt through crowdfunding can also trigger securities rules and regulations, especially when offering interest.

Back to equity-based crowdfunding: the fact that these crowdfunding platforms qualify as an “investment contract” security brings us to the conclusion that they have to register with the SEC to be able to offer a security to anyone. But the SEC came up with some exemptions from the traditional registration requirements. Can equity crowdfunding platforms comply with these requirements?

Section 5 of the Securities Act 1933 defined the basic rule regarding the offer and sale of securities in the United States:

*“An offer for sale or sale includes every attempt or offer to dispose of, or solicitation of an offer to buy, a security...”*<sup>88</sup>

The terms of this provision are interpreted very broadly so an issuer of securities can violate the rules of this provision quite easily. Crowdfunding websites that offer securities to the public therefore should register with the SEC unless there is an exemption available.<sup>89</sup> Registration however is no good solution for start-ups because it is too expensive and time-consuming.<sup>90</sup>

The costs that involve the preparation and filing of the registration statement, the registration, accounting and legal fees will often exceed the amount that the entrepreneurs would like to acquire.<sup>91</sup> Registration also takes much time. Smaller companies do not have the ability like larger companies to quickly develop a registration statement.<sup>92</sup> The fast-paced developments in

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<sup>87</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 24-26.

<sup>88</sup> Source: Securities Act 15 U.S.C. at § 77b(3).

<sup>89</sup> Joan MacLeod Heminway et al. (2011), *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, University of Tennessee Legal Studies Research Paper #154, p. 25.

<sup>90</sup> Jeffrey J. Hass (1998), *Small Issue Public Offerings Conducted Over the Internet: Are They “Suitable” for the Retail Investor?*, California Law Review, Vol. 72.

<sup>91</sup> Tim Kappel (2009), *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.*, Loyola of Los Angeles Entertainment Law Review, p. 384.

<sup>92</sup> Stuart R. Cohn et al. (2011), *Capital Offense: The SEC’s Continuing Failure to Address Small Business Financing Concerns*, University of Florida Legal Studies Research Paper No. 2011-01, p. 80.

technology also mean that there is a compressed market lifetime and a quicker time-to-market requisite.<sup>93</sup>

Companies have possibilities to avoid the burdensome registration because there are some exemptions that might apply:

1) The private offering exemption in section 4(2) of the Securities Act or its regulatory safe harbor, Rule 506 of Regulation D

Section 4(2) of the Securities Act exempts “transactions by an issuer not involving any public offering.”<sup>94</sup> This means that an entrepreneur can privately offer to sell shares, but only to “sophisticated” investors where no protection from the Act’s provisions are needed.<sup>95</sup> So this provision would not grant the entrepreneur access to the general public.

The SEC adopted a safe harbor, Rule 506 of Regulation D, for section 4(2) of the Securities Act but this safe harbor does not offer a solution for the equity-based crowdfunding model. Purchasers in a Rule 506 offering must be accredited investors or must show that they are “capable of evaluating the merits and risks of the prospective investment.”<sup>96</sup> Accredited investors are investors that are sophisticated institutions or individuals that meet income and wealth standards.<sup>97</sup> The number of possible purchasers is also limited to no more than 35 purchasers of securities from the issuer in any offering within this section.<sup>98</sup> Moreover, Rule 506 also prohibits a general solicitation or general advertising of the offering.<sup>99</sup>

2) Section 4(5) of the Securities Act

This section is very similar to Rule 506. It permits issuers to sell securities only to accredited investors and only if there is no general advertising or solicitation of the offering.<sup>100</sup>

3) Rule 504 of Regulation D

This rule offers an exemption for limited offerings and sales of securities not exceeding the amount of \$1 million but just like Rule 506 is Rule 504 subject to the general advertising

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<sup>93</sup> Kevin Lawton et al. (2010), *The Crowdfunding Revolution: Social Networking Meets Venture Financing*, Self-published, p. 25.

<sup>94</sup> Source: Securities Act §4(2), 15 U.S.C. §77d(2) (2007).

<sup>95</sup> Thomas Lee Hazen (2003), *Federal Securities Law: Second Edition*, Federal Judicial Center, p. 47.

<sup>96</sup> Source: Rule 506(b)(2)(ii), 17 C.F.R. (2007).

<sup>97</sup> Source: Rule 501(a), 17 C.F.R. (2007).

<sup>98</sup> Source: Rule 506(b)(2)(i), 17 C.F.R. (2007).

<sup>99</sup> Source: Rule 502(c), 17 C.F.R. (2007).

<sup>100</sup> Source: Securities Act §4(5), 15 U.S.C. §77d(5) (2010).

restriction of Rule 502.<sup>101</sup> An exemption can be made if the offering is subject to registration requirements by the state or sold pursuant to a state exemption that limits sales to accredited investors.<sup>102</sup> ProFounder developed a structure to fit within this rule. They did so by limiting access only to people that have a pre-existing relationship with the entrepreneur (friends, family, etcetera) but ProFounder eventually had to shut down because of the unfavorable regulatory environment.<sup>103</sup>

#### 4) Rule 505 of Regulation D

This rule allows limited offers and sales of securities not exceeding \$5 million. This rule is not favorable for crowdfunding purposes because of the general solicitation prohibition and the rule equal to Rule 506 that an issuer may not sell to more than 35 investors.<sup>104</sup>

#### 5) Regulation A

This regulation applies to offerings by “non-reporting companies” of up to \$5 million. It is often called a “mini-registration” because of the fact that issuers have to file a disclosure document that must include quite extensive communications with investors.<sup>105</sup> The costs are estimated around \$40,000-60,000, which is often too expensive for crowdfunded businesses. Thus for small businesses and start-ups, Regulation A is not a viable option.<sup>106</sup>

The focus of the abovementioned was aimed at offerings of securities to the public but crowdfunding is more than that. Crowdfunding needs a platform (website) in order to bring entrepreneurs and investors together but the operation of this platform and the operators themselves can be subject to other regulatory issues, such as:

- Is a crowdfunding website a broker?

A broker is defined as “any person engaged in the business of effecting transactions in securities for the account of others.”<sup>107</sup> There are many, many “finders” and other persons willing to bring private investors and smaller companies together for a reward. Most of them will not be registered as broker-dealers with the “Financial Institutions National Regulatory

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<sup>101</sup> Source: Rule 502(c), 17 C.F.R. (2007).

<sup>102</sup> Source: Rule 504(b)(1), 17 C.F.R. (2007).

<sup>103</sup> Source: <http://blog.profounder.com/2012/02/17/profounder-shutting-down/>

<sup>104</sup> Source: Rule 505(b)(2), 17 C.F.R. (2007).

<sup>105</sup> Thomas Lee Hazen (2003), *Federal Securities Law: Second Edition*, Federal Judicial Center, p. 57.

<sup>106</sup> Edan Burkett (2011), *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, Tennessee Journal of Business Law, Vol. 13, p. 87-88.

<sup>107</sup> Source: Securities Exchange Act of 1934 §3(a)(4), 15 U.S.C. (2000).

Authority” (FINRA).<sup>108</sup> The analysis to determine if someone is a broker-dealer or not is very flexible and thus also quite unpredictable.<sup>109</sup>

It is therefore not possible to make absolutely clear that a crowdfunding website is a broker. However, crowdfunding sites do not meet the definitions that the SEC has allowed in other contexts. This could mean that crowdfunding websites could be required to register as a broker.<sup>110</sup>

- Is a crowdfunding website an exchange?

Section 3(a)(1) of the Securities Exchange Act states that an exchange is: “an organization, association, or group of persons that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood.”<sup>111</sup>

Additionally, Rule 3b-16 makes clear that to be defined as an exchange a crowdfunding site must “bring together the orders for securities of multiple buyers and sellers.”<sup>112</sup>

Crowdfunding sites apply a system where there is only one single seller and this system does not fall under the definition stated in Rule 3b-16 according to the SEC in the “Regulation of Exchanges and Alternative Trading Systems.”<sup>113</sup>

One can conclude from all the regulatory issues that there is no clear regulatory framework that gives entrepreneurs the opportunity to use crowdfunding as their source of financing. One could even call the system with regard to small offerings in the U.S. inefficient. The problem with this system was its overregulation regarding small offerings to prevent fraud on the investor. Fraud in these cases almost never occurs and if fraud were to happen, the positive effects on the job-market and revenue generation by start-ups would outweigh the negative effects.<sup>114</sup>

This is also what the U.S. government must have thought because recently (April 5, 2012) President Obama signed the “Jumpstart Our Business Start-ups Act “(JOBS Act). This act should

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<sup>108</sup> Thomas Lee Hazen (2003), *Federal Securities Law: Second Edition*, Federal Judicial Center, p. 61-62.

<sup>109</sup> David A. Lipton (2010), *Broker Dealer Regulation*, Securities Law Series Vol. 15 & 15A, 1-48.

<sup>110</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 33-34.

<sup>111</sup> Source: Securities Exchange Act of 1934 §3(a)(1), 15 U.S.C. (2000).

<sup>112</sup> Source: Securities Exchange Act of 1934 Rule 3b-16, 17 C.F.R. (2011).

<sup>113</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 33.

<sup>114</sup> Nikki Pope (2011), *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, Working Papers, Paper 19, p. 112-113.

make it easier for entrepreneurs that want to start their own business, especially through crowdfunding. This act should make funding more accessible for start-ups by allowing non-accredited investors to participate in the funding process.<sup>115</sup> This act shall be further discussed in paragraph 3.2.: (Government) Initiatives.

### 3.1.2. Europe

The United States recently adopted a legal structure in order to develop funding for smaller businesses (JOBS Act). Until now Europe lacks this kind of ecosystem. This gives the United States an advantage compared to Europe because they can offer better starting conditions to entrepreneurs.<sup>116</sup>

If crowdfunding platforms want to stay within the regulatory boundaries in the European Union they will need to comply with the Prospectus Directive. The basic rule stated in the Prospectus Directive is article 3(1):

*“Member States shall not allow any offer of securities to be made to the public within their territories without prior publication of a prospectus.”*<sup>117</sup>

However, article 3(2) of the Prospectus Directive offers some exemptions to this rule:

*“The obligation to publish a prospectus shall not apply to the following types of offer:*

- (a) an offer of securities addressed solely to qualified investors; and/or*
- (b) an offer of securities addressed to fewer than 100 natural or legal persons per Member State, other than qualified investors; and/or*
- (c) an offer of securities addressed to investors who acquire securities for a total consideration of at least EUR 50 000 per investor, for each separate offer; and/or*
- (d) an offer of securities whose denomination per unit amounts to at least EUR 50 000; and/or*
- (e) an offer of securities with a total consideration of less than 100 000, which limit shall be calculated over a period of 12 months.”*<sup>118</sup>

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<sup>115</sup> Heather R. Huhman (2012, May 4), *JOBS Act To Jumpstart The Job Market*, Forbes.

<sup>116</sup> Ross Dawkins (2012, March 6), *A Regulatory Hand for Crowdfunding?*, Europe-Economics.

<sup>117</sup> Source: Article 3(1) of the Prospectus Directive 2003/71/EC.

If securities are offered only to qualified investors, or to less than 100 natural or legal persons, or have a total consideration of less than €100,000 over a period of 12 months, the business shall be exempt from the obligation to publish a prospectus. But what are qualified investors?

*“Qualified investor” means:*

- (i) legal entities which are authorized or regulated to operate in the financial markets, including: credit institutions, investment firms, other authorized or regulated financial institutions, insurance companies, collective investment schemes and their management companies, pension funds and their management companies, commodity dealers, as well as entities not so authorized or regulated whose corporate purpose is solely to invest in securities;*
- (ii) national and regional governments, central banks, international and supranational institutions such as the International Monetary Fund, the European Central Bank, the European Investment Bank and other similar international organizations;*
- (iii) other legal entities which do not meet two of the three criteria set out in paragraph (f);*
- (iv) certain natural persons: subject to mutual recognition, a Member State may choose to authorize natural persons who are resident in the Member State and who expressly ask to be considered as qualified investors if these persons meet at least two of the three criteria set out in paragraph 2;<sup>119</sup>*

Small and medium-sized enterprises do not qualify as a “qualified investor”:

*“small and medium-sized enterprises means companies, which, according to their last annual or consolidated accounts, meet at least two of the three following criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43 000 000 and an annual net turnover not exceeding EUR 50 000 000.”<sup>120</sup>*

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<sup>118</sup> Source: Article 3(2) of the Prospectus Directive 2003/71/EC.

<sup>119</sup> Article 2(1)(e) of the Prospectus Directive 2003/71/EC.

<sup>120</sup> Article 2(1)(f) of the Prospectus Directive 2003/71/EC.



Certain individuals can qualify as a “qualified investor” but they must also meet certain requirements:

*“For the purposes of paragraph 1(e)(iv) the criteria are as follows:*

- (a) the investor has carried out transaction of a significant size on securities markets at an average frequency of, at least, 10 per quarter over the previous four quarters;*
- (b) the size of the investor’s securities portfolio exceeds EUR 0,5 million;*
- (c) the investor works or has worked for at least one year in the financial sector in a professional position which requires knowledge of securities investment.”*<sup>121</sup>

In 2010 some amendments were made to the original Prospectus Directive in Directive 2010/73/EU. It included some changes to the exemptions in article 3(2) of the Prospectus Directive:

*“The obligation to publish a prospectus shall not apply to the following types of offer:*

- (a) an offer of securities addressed solely to qualified investors; and/or*
- (b) an offer of securities addressed to fewer than 150 natural or legal persons per Member State, other than qualified investors; and/or*
- (c) an offer of securities addressed to investors who acquire securities for a total consideration of at least EUR 100 000 per investor, for each separate offer; and/or*
- (d) an offer of securities whose denomination per unit amounts to at least EUR 100 000; and/or*
- (e) an offer of securities with a total consideration in the Union of less than EUR 100 000, which shall be calculated over a period of 12 months.”*<sup>122</sup>

Because of these changes an offer can be made to 150 persons instead of 100 before a prospectus is necessary and the consideration amount is raised to €100,000 per investor.

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<sup>121</sup> Article 2(2) of the Prospectus Directive 2003/71/EC.

<sup>122</sup> Article 3(2) of Directive 2010/73/EU amending Directive 2003/71/EC.

Concluding these provisions in the Prospectus Directive one can state that the European Union does not offer very favorable rules with regard to crowdfunding. However article 1(2)(h) of the Prospectus Directive might offer a solution:

*“This Directive shall not apply to:  
securities offered in an offer where the total consideration of the offer is less than  
EUR 2 500 000, which limit shall be calculated over a period of 12 months.”*<sup>123</sup>

The 2010 amendments even raised the total consideration amount:

*“This Directive shall not apply to:  
securities offered in an offer where the total consideration of the offer is less than  
EUR 5 000 000, which limit shall be calculated over a period of 12 months.”*<sup>124</sup>

This rule excludes this offering from its scope of application. This means that the offering mentioned in Article 1(2)(h) is excluded from the regulations adopted in the 2010 amendments of the Prospectus Directive. This also means that the purpose mentioned in Article 1(1) of the Prospectus Directive does not apply to the exemption of Article 1(2)(h).

The Prospectus Directive is not the only European Directive of importance with regard to crowdfunding. The “Markets in Financial Instruments Directive” (MiFID) also plays an important role. This directive is adopted in order to provide a high level of protection to investors and to allow investment firms to provide their services across the whole European Union as a single market on the basis of home country supervision.<sup>125</sup>

The purpose of this Directive by the European Parliament is to cover undertakings that provide investment services and/or perform investment activities on a professional basis.<sup>126</sup> The relevant question is if crowdfunding websites are considered exchanges (or regulated markets) or not according to the MiFID I and the proposals for a MiFID II and a MiFIR.

Article 4(1)(14) of the MiFID states that a:

*“Regulated market means a multilateral system operated and/or managed by a  
market operator, which brings together or facilitates the bringing together of*

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<sup>123</sup> Article 1(2)(h) of the Prospectus Directive 2003/71/EC.

<sup>124</sup> Article 1(2)(h) of Directive 2010/73/EU amending Directive 2003/71/EC.

<sup>125</sup> Note (2) of MiFID I 2004/39.

<sup>126</sup> Note (7) of MiFID I 2004/39.

*multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorized and functions regularly and in accordance with the provisions of Title III.”*<sup>127</sup>

In order to be considered as a “regulated market”, the crowdfunding platform must bring together or facilitate the bringing together of multiple third-party buying and selling interests in financial instruments. Crowdfunding platforms in Europe however apply a system where there is only one single seller: the entrepreneur that pitches his business plan on a crowdfunding platform. This is different from the multiple third parties that sell interests in certain financial instruments. A pitch on a crowdfunding platform consists of one seller and multiple buyers possibly. Thus a crowdfunding platform should not be considered as a “regulated market.”

But will this change according to the MiFID II and MiFIR proposals? The definition of a regulated market has not changed in the MiFIR proposal. It still implies multiple third-party buying and selling interests in financial instruments.<sup>128</sup> The MiFID II proposal refers for the definitions to Article 2 of the MiFIR. These definitions shall also apply to MiFID II.<sup>129</sup> The proposals do not change anything to the definition of a regulated market, thus the regulations according to MiFID I, II and MiFIR will not apply to equity-based crowdfunding platforms because the definition of a regulated market does not correspond with the functioning of crowdfunding platforms.

## **3.2 (Government) Initiatives**

### **3.2.1 The United States**

*“For start-ups and small businesses, this bill is a potential game-changer. Because of this bill, start-ups and small businesses will have access to a bigger pool of investors.”*

President Barack Obama, signing the JOBS Act.

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<sup>127</sup> Article 4(1)(14) of MiFID I 2004/39.

<sup>128</sup> Article 2(1)(5) of MiFIR 2011/0296.

<sup>129</sup> Article 4(1) of MiFID II 2011/0298.

As already discussed in Chapter 3.1.1., the Jumpstart Our Business Start-ups Act (JOBS) Act should make it easier for entrepreneurs to acquire funding for their start-up or business idea, especially through crowdfunding.<sup>130</sup>

The JOBS Act offers exemptions that will exclude businesses from some registration provisions stated in the Securities Act of 1933 and the Securities Exchange Act of 1934. It is a new movement towards financial deregulation after an era of more and more regulation (Dot-com bubble and Enron and Parmalat scandals).<sup>131</sup> The National Venture Capital Association states that this Act:

*“... delivers appropriate forms of capital and liquidity to entrepreneurs at each stage of their growth ... achieving this goal by addressing:*

- 1) early stage capital requirements through crowdfunding;*
- 2) liquidity for growing companies by raising the shareholder limit; and*
- 3) growth capital through the IPO on ramp and the Regulation A/Regulation D provisions.”*<sup>132</sup>

In this chapter, the specific provisions about crowdfunding provided in the JOBS Act will be discussed. Chapter 3.3 then will discuss the advantages and disadvantages of this new bill.

Title III of the JOBS Act is all about crowdfunding. Crowdfunding in the title actually means: “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012,” The “CROWDFUND” Act.

The first amendment in this Act is the change in Section 302 of the Securities Act of 1933. It adds an additional clause, §4(6), to this section. This clause makes clear that “the aggregate amount sold to all investors by the issuer ... is not more than \$1,000,000.”<sup>133</sup>

In addition to clause §4(6), an issuer who offers or sells securities shall:

*“file with the Commission and provide to investors and the relevant broker or funding portal, and make available to potential investors -*

- (A) the name, legal status, physical address, and website of the issuer;*

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<sup>130</sup> Heather R. Huhman (2012, May 4), *JOBS Act To Jumpstart The Job Market*, Forbes.

<sup>131</sup> Edward Wyatt (2012, March 22), *Senate Passes Start-ups Bill, With Amendments*, The New York Times.

<sup>132</sup> The National Venture Capital Association, *Support HR 3606, the JOBS Act*, p. 1.

<sup>133</sup> Section 302 of the “CROWDFUND” Act of H.R. 3606, p. 10.

- (B) *the names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20 percent of the shares of the issuer;*
- (C) *a description of the business of the issuer and the anticipated business plan of the issuer;*
- (D) *a description of the financial condition of the issuer ...*
- (E) *a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;*
- (F) *the target offering amount, the deadline ... and regular updates regarding the progress of the issuer in meeting the target offering amount;*
- (G) *the price to the public of the securities ... and each investor shall be provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;*
- (H) *a description of the ownership and capital structure of the issuer ... ”*<sup>134</sup>

These disclosure requirements are adopted in order to give potential investors the necessary information needed to make a thought-out investment decision. The disclosure requirements stated in Section 4A have a so-called “sliding scale” approach. The higher the amount an issuer seeks, the more disclosure requirements. As an example, an issuer that needs \$100,000 or less only needs to disclose its income tax returns for the most recently completed year and financial statements certified by the principal executive officer. If the targeted amount is between \$100,000 and \$500,000, the issuer needs to disclose financial statements reviewed by an independent public accountant according to standards and procedures created by the SEC. If the issuer seeks more than \$500,000 it must disclose an audited financial statement.<sup>135</sup>

In order to fulfill the transactions that were just mentioned, a broker or funding portal as defined in section 3(a)(80) of the Securities Exchange Act of 1934 is necessary.<sup>136</sup> A funding portal is a new category of intermediaries that is created by the JOBS Act. It means:

*“any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others...”*<sup>137</sup>

<sup>134</sup> Section 4A(b)(1) of the “CROWDFUND” Act of H.R. 3606, p. 12-13.

<sup>135</sup> Section 4A(b) at sub (1)(D)(I, II, and III) of the “CROWDFUND” Act of H.R. 3606, p. 12.

<sup>136</sup> Section 4A(a)(1) of the “CROWDFUND” Act of H.R. 3606, p. 11.

<sup>137</sup> Section 3(a)(80) of the Securities Exchange Act of 1934.

According to the JOBS Act a crowdfunding platform must register with the SEC either as a broker or as a funding portal.<sup>138</sup>

This intermediary must take measures to reduce the risk of fraud with respect to these transactions. It will do so by obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such person.<sup>139</sup>

Investor protection is still very important, even with the recently adopted deregulation in the JOBS Act. Therefore the Congress put a limit on the amount that an investor can invest under the CROWDFUND exemption.

*“Transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that –*

- (B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, does not exceed –*
- (i) the greater of \$2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; and*
- (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000.”*<sup>140</sup>

In addition to this provision, section 4A(e) restricts the resale of these securities sold under the crowdfunding exemption. “Securities issued pursuant to a transaction described in section 4(6) may not be transferred by the purchaser for a period of one year beginning on the date of the purchase unless these securities are transferred (A) to the issuer of the securities; (B) to an accredited investor; (C) as part of an offering registered with the Commission; or (D) to a member of the family of the purchaser or the equivalent ...”.<sup>141</sup>

Title III, the CROWDFUND Act, is not the only chapter in the JOBS Act that is of importance with regard to crowdfunding. Title IV offers an expanded exemption under the

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<sup>138</sup> Section 4A(a)(1) of the “CROWDFUND” Act of H.R. 3606, p. 11.

<sup>139</sup> Section 4A(a)(5) of the “CROWDFUND” Act of H.R. 3606, p. 11.

<sup>140</sup> Section 302 of the “CROWDFUND” Act of H.R. 3606, p. 10.

<sup>141</sup> Section 4A(e) of the “CROWDFUND” Act of H.R. 3606, p. 14.

Regulations A & D. These “safe harbors” were amended in the JOBS Act and increased the aggregate offering amount ten-fold to \$50,000,000. The most importance change however is the fact that these securities now “may be offered and sold publicly.” So there are no more restrictions placed on these securities and thus they may be sold to anyone at anytime. The only requirements are that the issuer needs to file audited financial statements on an annual basis and needs to comply with other terms implemented by the SEC.<sup>142</sup>

Subsequently, Title V of the JOBS Act imposes another important change to the securities rules in the United States. Section 12(g)(1)(A) of the Securities Exchange Act of 1934 is amended. The threshold that triggers the obligation to report is raised from \$1,000,000 to \$10,000,000<sup>143</sup> and the class of equity security (other than exempted security) held by investors is raised from 750 to 2,000 or 500 persons, depending on the fact whether they are accredited investors or not.<sup>144</sup>

Finally, the JOBS act also introduces a new term in the regulatory environment in the United States: the “emerging growth company” (EGC). Companies that fall within this definition fall within a loosened regulatory environment as will be explained. The term is stated in Title I of this Act and it means:

*“An issuer that had total annual gross revenues of less than \$1,000,000,000 during its most recently completed fiscal year.”*<sup>145</sup>

But what are the benefits for companies being defined as an EGC? First of all, EGCs are exempt from the requirements of Section 14A, shareholder approval of executive compensation, subparts (a) and (b). These requirements are respectively (a) a separate resolution required in general, and (b) shareholder approval of golden parachute compensation. Moreover, an EGC may also refrain from the compensation disclosures of Section 953(b)(1) of the “Investor Protection and Securities Reform Act of 2010.”<sup>146</sup>

Secondly, there are certain financial disclosures and accounting pronouncements exemptions applicable for an EGC. The first exemption:

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<sup>142</sup> Thomas A. Martin (2012), *The JOBS Act of 2012: Balancing Fundamental Securities Law Principals with the Demands of the Crowd*, Willamette University College of Law, p. 16.

<sup>143</sup> Section 501 of Title V Private Company Flexibility and Growth of H.R. 3606, p. 20.

<sup>144</sup> Section 501 of Title V Private Company Flexibility and Growth of H.R. 3606, p. 20.

<sup>145</sup> Section 101 of Title I Reopening American Capital Markets to Emerging Growth Companies of H.R. 3606, p. 2.

<sup>146</sup> Section 102(a) of Title I Reopening American Capital Markets to Emerging Growth Companies of H.R. 3606, p. 3-4.

*“An emerging growth company need not present more than 2 years of audited financial statements in order for the registration statement of such EGC with respect to an initial public offering of its common equity securities to be effective...”*<sup>147</sup>

and the second:

*“An emerging growth company may not be required to comply with any new or revised financial accounting standard until such date that a company that is not an issuer is required to comply with such new or revised accounting standard.”*<sup>148</sup>

Moreover, EGCs can also refrain from the internal controls audit stated in Section 404(b) of the Sarbanes-Oxley Act of 2002 and the rules requiring mandatory audit firm rotation in Section 103(a)(3) of the same Act also do not apply in the case of an EGC.<sup>149</sup>

Thirdly, EGCs have more communicating possibilities with potential investors:

*“Notwithstanding any other provision of this section, an EGC or any person authorized to act on behalf of an EGC may engage in oral or written communications with potential investors that are qualified institutional buyers or institutions that are accredited investors...”*<sup>150</sup>

This gives an EGC the possibility to communicate openly with potential investors, as long as they are qualified institutional buyers or accredited investors. So the retail investors in crowdfunding start-ups do not apply for this exemption.

Additionally, the Commission or any national securities association may adopt or maintain a rule that prohibits any broker, dealer, or member of a national securities association from publishing or distributing any research report with respect to the securities of an EGC.<sup>151</sup>

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<sup>147</sup> Section 102(b)(2)(A) of Title I Reopening American Capital Markets to Emerging Growth Companies of H.R. 3606, p. 4.

<sup>148</sup> Section 102(b)(2)(B) of Title I Reopening American Capital Markets to Emerging Growth Companies of H.R. 3606, p. 4.

<sup>149</sup> Section 103 and 104 of Title I Reopening American Capital Markets to Emerging Growth Companies of H.R. 3606, p. 4.

<sup>150</sup> Section 105(d) of Title I Reopening American Capital Markets to Emerging Growth Companies of H.R. 3606, p. 6.

<sup>151</sup> Section 105(d) of Title I Reopening American Capital Markets to Emerging Growth Companies of H.R. 3606, p. 6.



Finally, the publication or distribution by a broker or dealer of a research report about an EGC shall not be seen as an offer for sale or offer to sell a security, even if the broker or dealer is participating or will participate in the registered offering of the securities of the issuer.<sup>152</sup>

As this chapter explained, the JOBS Act loosened the regulatory environment not only for the issuers of crowdfunded securities but also for growing start-up companies with the introduction of the “emerging growth company” definition. It is a first important step to the general acceptance of crowdfunding as a means of financing in the United States. It is yet to be seen if this Act will have the beneficial effects expected by the American government. It should spur entrepreneurship and should offer a solution to young, ambitious entrepreneurs in need for capital to expand or start their business idea.<sup>153</sup>

It must be said that the bill itself is effective from the date it was signed, still pending is how all the different sections that fall under the scope of the Securities and Exchange Commission will be regulated. The SEC has 270 days to focus on how to regulate the offerings that target non-accredited investors so the regulations that affect the SEC will not be in place until January 2013 when the review period is over.<sup>154</sup>

### 3.2.2 Europe

Where the United States already have adopted a new Act that created exemptions in the securities regulations to offer new opportunities for crowdfunders, Europe lacks these new regulations and it did not even come to a proposal yet. Europe does have regulations about the prospectus, investment firms and financial instruments (Prospectus Directive, MiFID I, II) but not about crowdfunding in particular.

In November 2011 however there was an Agora2011+ Conference in Bielsko-Biala (Poland). Agora2011+ was organized by EURADA, the European Association of Development Agencies, and the central theme was: “Maximizing the Opportunities offered by Crowdfunding.” The conference gave six recommendations for the EU administration to design and support the development of crowdfunding sources.<sup>155</sup>

EURADA is an institution with a membership of about 150 regional development agencies from across the European Union. They run conferences and seminars and keep their members up to

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<sup>152</sup> Section 105(a) of Title I Reopening American Capital Markets to Emerging Growth Companies of H.R. 3606, p. 5.

<sup>153</sup> Alex Fitzpatrick (2012, March 31), *Can the JOBS Act Jump-Start Entrepreneurship?*, Mashable.

<sup>154</sup> Tanya Prive (2012, April 24), *Entrepreneurs: What the JOBS Act means for you right now*, VentureBeat.

<sup>155</sup> The Bielsko-Biala Declaration, Maximizing the Opportunities Offered by Crowdfunding, p. 1.

date with the latest policy developments. It also lobbies and briefs the European Commission in order to influence the development of policy at the Commission.<sup>156</sup>

The six recommendations for the European Commission are very general and do not offer any specific regulatory advice, for example: “Public authorities should be interested in seeing the development and launch of a crowdfunding mechanism in all regions as it meets the needs of a lot of stakeholders either in the private or in the social sector.”<sup>157</sup>

Furthermore it states that EU administrations should ensure a minimum of regulations for crowdfunding activities and that they should avoid some of the unnecessary rules in some of the Directives, for instance the need to publish a prospectus when offering securities (Prospectus Directive). Moreover, the transaction costs should be kept as low as possible.<sup>158</sup>

The participants in the conference are also of the opinion that crowdfunding initiatives can answer to the needs and demands of innovative stakeholders. If this is adopted on a European level this could prevent disturbing regulatory environments on a national level and this could play a role in supporting a wide dissemination of the crowdfunding concept.<sup>159</sup>

To conclude the recommendations, the participants stated that member states, regions and cities should consider the use and promotion of the crowdfunding principle because it can support all forms of creativity and innovation and can have a strong impact on society in a cost-efficient way.<sup>160</sup>

These recommendations to the European Commission thus are very general and do not offer any specific recommendation to change any of the current regulations within the European Union. Also the goal of this conference is not to provide any specific regulatory advice but to invite the European Commission to support the declaration and to ensure the spin-off of initiatives within the field of crowdfunding.<sup>161</sup>

Although the EURADA conference can be a start when it comes to bringing it to the attention of members of the European Commission, it is not the only initiative in this regard. The European Crowdfunding Network (ECN) is also an institution that aims at supporting and promoting crowdfunding as an alternative manner of funding start-ups. By using the social media it

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<sup>156</sup> Source: [http://www.eurada.org/index.php?option=com\\_content&view=article&id=60&Itemid=71&lang](http://www.eurada.org/index.php?option=com_content&view=article&id=60&Itemid=71&lang)

<sup>157</sup> The Bielsko-Biala Declaration, Maximizing the Opportunities Offered by Crowdfunding, second recommendation, p. 3.

<sup>158</sup> The Bielsko-Biala Declaration, Maximizing the Opportunities Offered by Crowdfunding, third recommendation, p. 3.

<sup>159</sup> The Bielsko-Biala Declaration, Maximizing the Opportunities Offered by Crowdfunding, fifth recommendation, p. 4.

<sup>160</sup> The Bielsko-Biala Declaration, Maximizing the Opportunities Offered by Crowdfunding, sixth recommendation, p. 4.

<sup>161</sup> The Bielsko-Biala Declaration, Maximizing the Opportunities Offered by Crowdfunding, p. 4.

is trying to gather more supporters and create a larger community for carrying its activities and operations.<sup>162</sup>

The ECN can be seen as a pool of crowdfunding specialists and finance experts that try to bring crowdfunding to a new level. They provide a forum for interested parties in order to develop crowdfunding in Europe and to support all kinds of projects in different industries. The ECN is still in a very early phase though, it has not even launched officially yet.<sup>163</sup> Their main objective is clear however:

*“Our common goal is to create a more favorable European framework for funding start-ups and small businesses from a wide audience of investors.”*<sup>164</sup>

Concluding this chapter, it is clear that Europe is far behind on the United States when it comes to creating a favorable regulatory environment for crowdfunding. Where the United States already has a new Act in place, Europe is still at the level of initiatives from non-governmental bodies that try to influence the European Commission to create a Directive that should exempt crowdfunding from some of the regulatory issues in Europe or that creates a complete framework for crowdfunding initiatives. To achieve this goal however, it will take quite some time for Europe to get there.

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<sup>162</sup> Source: <http://www.europecrowdfunding.org/FAQ>

<sup>163</sup> Source: <http://www.europecrowdfunding.org/FAQ>

<sup>164</sup> Source: <http://www.europecrowdfunding.org/>

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CHAPTER 4 - THE POSSIBILITIES OF CROWDFUNDING FOR START-UPS

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### 4.1 Is Crowdfunding a Good Solution for a Start-up?

*“We must find new and modern means for capital formation to ignite our sputtering economy.”*

Representative McHenry for North Carolina’s 10<sup>th</sup> congressional district,  
Describing the U.S.’s poor economic environment on the Hearing Before the  
Subcommittee on TARP.

A typical problem with start-ups is that they typically face difficulties to attract outside capital. Mostly because of the lack of sufficient collateral, cash flows and the existence of information asymmetries with investors.<sup>165</sup>

The financing of start-ups nowadays can take different forms. On the one hand there is debt financing by a bank. This will offer the entrepreneur accounting monitoring but no help on the technological side. The risks involved with this type of financing are that the bank will demand that the assets of the company of the entrepreneur will serve as collateral for the bank. In case of a default, the entrepreneur will lose everything.

On the other hand, there is venture capital financing. This type of financing differs in important ways from debt financing by a bank. First of all, venture capital financing does offer the technological monitoring for the entrepreneur because these people have a high level of expertise and know-how. These people will actively manage the companies they invest in. Second, venture capital firms often use milestone financing. If the company reaches certain “milestones”, what actually means that the company grows to a certain level, then the VC fund can decide to invest an extra round to stimulate the growth of the company even more. Finally, VC funds demand extensive control rights as return for their investment. They also often put some of their people on the board of directors and demand special voting rights in order to influence the decision making of the company.<sup>166</sup>

This chapter will explain if there is room for another type of funding that entrepreneurs can use to finance their small business or start-up: crowdfunding.

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<sup>165</sup> Andy Cosh et al. (2009), *Outside Entrepreneurial Capital*, Economic Journal, vol. 119, p. 6-7.

<sup>166</sup> Steven N. Kaplan et al. (2001), *Venture Capitalists as Principals: Contracting, Screening, and Monitoring*, American Economic Review, p. 3.

As stated before, there is a significant funding gap of \$50 billion in the United States alone for start-ups and small companies.<sup>167</sup> Funding through the crowd however has some aspects that differ from the traditional way of securities trading.

- 1) Funding takes place through the “crowd”, in which there is no distinction between accredited and non-accredited investors.
- 2) The amounts that people invest through crowdfunding are relatively low.
- 3) The preferences of the crowd lean more towards projects and businesses that are focused on the “social good.”<sup>168</sup>

The crowdfunding method does not make a difference between accredited and non-accredited investors, which is not particularly a bad thing. Being an accredited investor does not necessarily mean that this person is more sophisticated than a non-accredited investor. If you have a minimum level of net worth and absolutely no investment knowledge, you can be an accredited investor but if you have quite some investment knowledge but you lack the minimum level of net worth, than you are non-accredited. There are also no tests of investment knowledge required from accredited investors to judge if they are able to make well thought investment decisions. The accredited investor rule just makes it harder for the people with less wealth to invest in private companies.<sup>169</sup>

Crowdfunding offers a solution to this problem because it allows non-accredited investors to invest in equity capital of a start-up or small business. Some of these non-accredited investors might even make large profits while others could lose everything but this is not different from accredited investors. These non-accredited investors should still think twice before they decide to invest their money into a crowdfunded enterprise because investing is never without risk.

Different from a VC fund or an angel investor that invests large amounts of money, crowdfunding will offer the entrepreneur small amounts of money from a large number of investors, the crowd, that pools the funds together into a specific business entity. The more money an entrepreneur needs, the more disclosure requirements the entrepreneur has to comply with.<sup>170</sup> Moreover, limits are put on the amount of money that people can invest in these crowdfunded businesses to make sure that people lose too much of their money.<sup>171</sup>

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<sup>167</sup> William K. Sjostrom Jr. (2001), *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, Florida Law Review, Vol. 53, p. 586.

<sup>168</sup> Thomas A. Martin (2012), *The JOBS Act of 2012: Balancing Fundamental Securities Law Principals with the Demands of the Crowd*, Willamette University College of Law, p. 25.

<sup>169</sup> Scott Shane (2011, July 20), *Scrap the Accredited Investor Rule*, The American Magazine.

<sup>170</sup> Section 4A(b)(1) of the “CROWDFUND” Act of H.R. 3606, p. 12.

<sup>171</sup> Section 302 of the “CROWDFUND” Act of H.R. 3606, p. 10.

Crowdfunding gives entrepreneurs the ability to get attention for their business or start-up via a crowdfunding platform. It gives them a unique possibility to validate their idea and business for a large audience: the crowd. This can give the entrepreneur very important and useful knowledge about the potential of his business. If the entrepreneur receives the initial amount very easily in a short period of time, it will say something about the potential of his business and the product or service he wishes to deliver to customers. The crowd has the ability to serve as a filter for products and services where nobody is interested in. The crowd invests in potentially interesting projects and the entrepreneur will know more about the potential of his product or service. This is beneficial in both ways.<sup>172</sup>

Small business and start-ups are the lifeblood of a nation's economy.<sup>173</sup> Crowdfunding can be the solution for these entrepreneurs that have failed to raise venture capital. These entrepreneurs did not receive VC funding because of the fact that they are not characterized as "high-growth" companies by a VC fund or that the business plan did not have the potential for a large IPO. Moreover, VC funds cannot finance any business simply because there are more entrepreneurs in need of money than there is VC funding to obtain. Crowdfunding therefore can offer a solution since there are more potential investors than there are entrepreneurs.<sup>174</sup>

Crowdfunding will generate capital for small businesses and start-ups. This will consequently create jobs so why have all these stringent regulatory requirements for these entrepreneurs. Tim Miller, the CEO of Rally Software, stated about this:

*"Before the JOBS Act, emerging growth companies were subject to the same stringent regulatory rules as multi-billion dollar corporations like Apple. The JOBS Act will loosen some of these requirements on emerging growth companies, creating a more vibrant and diverse IPO market and allowing companies like Rally to reinvest the money they would have spent on regulatory filings back into jobs."*<sup>175</sup>

That equity-crowdfunding is not just an Internet hype proves the UK crowdfunding platform Crowdcube. On the first birthday of the platform already £2.3 million was successfully invested in small businesses. Eleven businesses of the number of 211 published pitches have received the

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<sup>172</sup> Paul Belleflamme et al. (2011), *Crowdfunding: tapping the right crowd*, Core Discussion Paper 2011/32, p. 26

<sup>173</sup> William K. Sjostrom Jr. (2004), *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, Florida State University Law Review, Vol. 32, No. 1, p. 1-2.

<sup>174</sup> David Lavinsky (2010, August 27), *Funding Fathers*, SmartBusiness.

<sup>175</sup> Rip Empson (2012, April 5), *With JOBS Act Becoming Law, Crowdfunding Platforms Look to Create Self-Regulatory Body*, TechCrunch.

initial funding amount, including Crowdcube itself. These businesses are expected to create an estimated 246 new jobs within the next three years.<sup>176</sup>

Crowdfunding will offer entrepreneurs a new opportunity to finance their business. The crowd is potentially able to fill the financing gap that entrepreneurs face to get their business started. Potential investors, accredited and especially non-accredited, must be aware though of the risks that are involved when investing in these entities.

Web 2.0 can bring securities transactions to possibly everybody. By reducing the costs for entrepreneurs and by increasing the opportunities, the potential rewards will outweigh the risks. Information about risky investments and scams are nowadays also more freely available than in the 1930s.<sup>177</sup> The real winner of a crowdfunding exemption will be the economy.

## **4.2 The Advantages and Disadvantages of New Regulation**

Crowdfunding might offer a solution for the problems that entrepreneurs encounter in their search of capital. Crowdfunding can either offer a solution to an entrepreneur that is in need of start-up capital to get his business started but it can also offer a solution to an entrepreneur who has already started a business but is in need of further financing to maintain his business or to expand his business.

Small businesses will have problems acquiring capital from a bank because most of these firms will not have enough significant assets that can count as collateral. Venture capital financing might be the solution for these businesses but venture capital financing is not widely available and might be hard to receive because the rejection rates are quite high. A research by Andy Cosh et al. showed that among the 952 of 2520 firms that were looking for external financing in the 1996-1997 period, the rejection rates were the highest among the venture capital funds. 46% of these funds rejected businesses in need of financing.<sup>178</sup> Nowadays these numbers are even higher.<sup>179</sup>

Moreover, venture capital financing is also often geographically bound to a particular area. Studies found out that there is a strong correlation between the geographic area of the venture capital fund and the area of investment. Venture capitalists are more likely to invest in a promising

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<sup>176</sup> Source: <http://www.crowdcube.com/infographic>

<sup>177</sup> Sam Gustin (2012, March 13), *Will Crowdfunding Drive A New Wave of Startup Investing?*, Time Business.

<sup>178</sup> Andy Cosh et al. (2009), *Outside Entrepreneurial Capital*, Economic Journal, Vol. 119, p. 4 & 25.

<sup>179</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 60.

business if the geographical area more or less corresponds with that of its geographical investment scope.<sup>180</sup>

Crowdfunding does not have the problem of being bound to a geographical area. One of its main characteristics is the fact that it can have a broad geographic dispersion of investors. Data from Sellaband, a crowdfunding platform for music where one can donate money to one's favorite artist, showed that the mean distance between the investor and the musician was 3,000 miles.<sup>181</sup>

With the JOBS Act now in place in the United States, the barriers on crowdfunding have eased and this offers the crowd the possibility to fund new businesses. As stated in Chapter 3.2.1, the exemption applies only to crowdfunded offerings smaller than \$1 million over a twelve-month period, or higher if the issuer can provide financial statements.<sup>182</sup>

But what are the advantages and disadvantages of this new Act? First, the possible advantages of this crowdfunding exemption will be discussed. Second, the disadvantages shall be elaborated.

The JOBS Act is a good example of the pendulum balancing between the individual businesses and the regulators, and this new Act may be a sign that the pendulum is more in favor of the business interests in these times of crisis.

The most important possible benefit from crowdfunding is that it has the potential to kick-start the economy by closing the gap between start-ups and small businesses and their access to capital. As stated above, entrepreneurs have a hard time obtaining finance from banks and venture capitalists. Crowdfunding could solve this problem. It is said that by closing the finance gap in the early phases of a business' lifetime, equity crowdfunding could be able to create over 500,000 companies and over 1.5 million new jobs over the next five years.<sup>183</sup> If this astonishing number will be achieved, it would give the American economy a great boost.<sup>184</sup>

That there is a significant capital funding gap will emphasize the need of a crowdfunding exemption. The estimations indicate that financial markets face a shortage of \$60 billion each year in meeting the demand of start-ups and small companies for equity financing in the early stages.

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<sup>180</sup> Olav Sorenson et al. (2008), *The Evolution of Venture Capital Investment Networks*, Administrative Science Quarterly, p. 26.

<sup>181</sup> Ajay K. Agrawal (2011), *The Geography of Crowdfunding*, National Bureau of Economic Research, p. 1.

<sup>182</sup> Andrew C. Fink (2012), *Protecting the Crowd and Raising Capital Through the JOBS Act*, University of Connecticut School of Law, p. 21-27.

<sup>183</sup> Testimony on Crowdfunding and Capital Formation (2011), *Hearing Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the Hearing Committee on Oversight and Governmental Reform*, (statement of Mr. Neise 30:51-30:59).

<sup>184</sup> Zachary J. Griffin (2012), *Crowdfunding: Fleecing the American Masses*, Case Western Reserve Journal of Law, Technology & the Internet, p. 31-33.



This equity capital is also considered to be less accessible for these small players because it is more costly per dollar compared to equity financing to larger businesses on the market.<sup>185</sup>

The second benefit of raising funds via crowdfunding is that the use of the Internet implies that information is spread very fast and easily across the web. This allows the Internet community to quickly receive information about an issuer that tries to defraud investors on a crowdfunding platform. “It will take only hours before millions of people know about it.” Because of the rising popularity of social media platforms and blogs as an easy means of communication through the Internet, it is quite easy to expose someone to the rest of the world and revealing the crimes committed simply by posting a message on these platforms/blogs.<sup>186</sup> But the use of Internet can also lead to cases of “fraudfunding”. The Internet can be used by scammers and fraudsters to defraud investors on crowdfunding platforms. If there are no minimal and adequate disclosure requirements crowdfunding platforms can offer a good place for scammers to create fraudulent pitches and run away with the money before investors realize that they are victims of fraud.<sup>187</sup>

The third argument is that equity crowdfunding poses a relatively low risk on investors because the amount that each individual can invest in crowdfunded securities is capped at a certain amount. The reason behind this cap is that it prevents investors from having a larger loss than the investor can actually handle. Even if the business completely flops and investors lose all their money, it is not disastrous because investors cannot invest their complete life savings for instance.<sup>188</sup> The amount that may be sold to investors may not exceed \$2,000 or 5 percent of the annual income if the annual income of the investor is lower than \$100,000. If the investor earns more than \$100,000 a year, 10 percent of the annual income of the investor may be invested in crowdfunded securities.<sup>189</sup>

The final argument in favor of a crowdfunding exemption is that the crowdfunding platforms have an incentive to get the best business ideas pitched on their website and that fraudulent activities will be prevented. The crowdfunding platform makes money out of the best ideas on the website. By offering good business ideas on the platform and by banning out fraud the platform can build a good reputation for itself by protecting investors and punishing fraudulent

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<sup>185</sup> William K. Sjostrom Jr. (2001), *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, Florida Law Review, Vol. 53, p. 586.

<sup>186</sup> Testimony on Crowdfunding and Capital Formation (2011), *Hearing Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the Hearing Committee on Oversight and Governmental Reform*, (statement of Mr. Neise 1:27:53-1:27:57).

<sup>187</sup> Thomas Lee Hazen (2011), *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why The Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, North Carolina Law Review, p. 133-134.

<sup>188</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 72.

<sup>189</sup> Section 302 of the “CROWDFUND” Act of H.R. 3606, p. 10.

entrepreneurs. If it does not do so, it will go the opposite way. A bad reputation will develop for this platform. The Crowdfunding Accreditation by the Industry website “crowdsourcing.org” can be granted to platforms that offer good and most importantly fair pitches to the general public. The CAPS program can play an important role here.<sup>190</sup>

It is of utmost importance that fraudulent entrepreneurs will have no chance of defrauding unknowing investors on these crowdfunding platforms because the whole crowdfunding idea and its reputation are on the line. If fraud happens on a regular basis, this will spread very fast across the web and people will not invest anymore in start-ups and small businesses on these platforms because of the fear of being defrauded. If they know that crowdfunding platforms are full of fraudulent businesses, people will put their money elsewhere and will not invest anymore. Thus the crowdfunding platforms are incentivized to do anything to prevent these kind of fraudulent activities in order to keep and build their reputation and to make sure that crowdfunding becomes a big success.<sup>191</sup>

There are quite some advantages linked to the crowdfunding exemption, whereof the possibility of closing the funding gap is by far the most important advantage. If some of the small businesses grow into profitable companies while giving jobs to a considerable amount of employees, it will lead to more job creation for citizens in the United States, it will also lead to more innovative businesses that will offer groundbreaking, innovative products and services to the people and it can increase the general prosperity of the nation as a whole.

Next up are the disadvantages of a crowdfunding exemption. The most heard complaints about the new JOBS Act are the concerns regarding investor protection. People that are interested in investing in these new crowdfunded ventures should be protected because these unsophisticated investors are not able to fend for themselves.<sup>192</sup> The Chair of the Securities and Exchange Commission, Mary Schapiro, also strongly opposes the crowdfunding exemption adopted in the JOBS Act. She states that these new measures could mean:

*“a new era of fraudulent investment schemes. It could backfire to the point that investors lose confidence in the marketplace, which in turn would make it more difficult and expensive to raise capital”*<sup>193</sup>

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<sup>190</sup> <http://www.crowdsourcing.org/caps>

<sup>191</sup> Zachary J. Griffin (2012), *Crowdfunding: Fleecing the American Masses*, Case Western Reserve Journal of Law, Technology & the Internet, p. 37-38.

<sup>192</sup> Joan MacLeod Heminway et al. (2011), *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, University of Tennessee Legal Studies Research Paper #154, p. 68.

<sup>193</sup> Source: [http://articles.chicagotribune.com/2012-03-21/news/ct-edit-investors-20120321\\_1\\_jobs-act-growth-bill-red-tape](http://articles.chicagotribune.com/2012-03-21/news/ct-edit-investors-20120321_1_jobs-act-growth-bill-red-tape)

The crowdfunding exemption will increase fraud and cyber crime on the Internet and cyber criminals will be offered an opportunity to defraud innocent investors. This is mainly because the worldwide web lacks good regulation and established legal precedent. The newly adopted exemption will only open the door for fraud and will leave investors with very little protection.<sup>194</sup>

The crowdfunding exemption within the JOBS Act eliminates the most important factors of investor protection. In general, the securities regulatory framework in the United States protects investors in two ways:

- 1) through registration requirements that impose mandatory disclosures; and
- 2) through the anti-fraud laws.<sup>195</sup>

These registration laws have the goal to achieve full disclosure and verification of the most important information of the company in order to give investors adequate information on which they can rely to make their investment decisions.

Then there are the anti-fraud provisions. This is the second most important feature of the securities framework. This gives investors the opportunity to sue fraudulent issuers for damages after the fraud has occurred. The crowdfunding exemption removes the protection that the registration requirements offer to investors, thus this means that the only protection for investors will come from the anti-fraud provisions and they only offer a solution in ex-post cases. Thus this implies that there is no ex-ante protection for investors and that means that they have to depend on the crowdfunding platforms and the Internet community for protection and information on fraudulent issuers and entrepreneurs. Investor protection is thus limited to cases where it already went wrong.<sup>196</sup>

Even if there is quite a large possibility that fraudulent issuers get caught, then investors will encounter problems during the litigation process. The plaintiff and the government need to show in these cases that these fraudulent issuers had scienter. Scienter is “a mental state embracing intent to deceive, manipulate, or defraud.”<sup>197</sup> It needs to prove that the facts establish a “strong interference” that the defendant acted with “the required state of mind.”<sup>198</sup>

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<sup>194</sup> Zachary J. Griffin (2012), *Crowdfunding: Fleecing the American Masses*, Case Western Reserve Journal of Law, Technology & the Internet, p. 21-22.

<sup>195</sup> Louis Loss et al. (2004), *Fundamentals of Securities Regulation*, Aspen Publishers, 5<sup>th</sup> Edition, p. 28-30.

<sup>196</sup> Zachary J. Griffin (2012), *Crowdfunding: Fleecing the American Masses*, Case Western Reserve Journal of Law, Technology & the Internet, p. 25-27.

<sup>197</sup> Ernst and Ernst v. Hochfelder, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976).

<sup>198</sup> Paul Chalmers et al. (2004), *Recent Issues In the Pleading of Scienter in Securities Fraud Claims*, White Paper of Wilson Sonsini Goodrich & Rosati Corporation., p. 3.

Another problem that might occur is that the investment cap placed in the JOBS Act is too high for some individuals. Small business offerings can be very risky and losses are likely to incur. Therefore it might be better to implement a per-investor limit on a lower amount, for instance \$500 or two percent of his annual income.<sup>199</sup>

Furthermore, crowdfunding lacks one of the important features of financing by a venture capital fund and that is the mentoring and coaching abilities that will go hand in hand with Angel or VC investments. Crowdfunded ventures will lack this feature because they receive investments via a crowdfunding platform from unsophisticated investors that lack the necessary business knowledge and know-how of an angel investor or venture capitalist.<sup>200</sup>

The “wisdom of the crowd theory”, a theory that means that a group collectively will come to wise decisions in favor of the business they invested in. This sounds good in theory but in practice it will probably not work because of all the assumptions that is relied on.<sup>201</sup> In theory one assumes that everyone will participate in the decision making of this business and one assumes that everyone will try to come up with good solutions. In practice it will often turn out differently. People will only invest but after that moment they will not participate actively and people that lack the sufficient knowledge will often come up with ideas that are of no use for the entrepreneur. The assumptions made by the “wisdom of the crowd” theory will therefore often turn out differently.

Finally, venture capital funds or angel investors might be deterred from investing in some crowdfunded businesses because of the high level of unsophisticated investors that own equity in the company. These funds or investors have the ability to invest significant amounts of money into businesses in order to stimulate growth. The “potentially conflicting agendas” within the large number of unsophisticated investors might be a reason for the venture capitalists to refrain from investing in a potentially profitable company.<sup>202</sup> If there are many investors that invested in the crowdfunded entity, then there might be a problem. If the number of investors is relatively low, then it will not impair the participation of the VC funds in further rounds of financing.

Concluding the disadvantages of the crowdfunding exemption, one can state that the main disadvantage of this exemption is less investor protection when investing in a crowdfunded business. Cases of fraud and cyber crime may become more frequent and might take place on a larger scale than was the case before the adoption of the JOBS Act. Whether Crowdfunding is indeed “fraudfunding” is a question that will be discussed in the next chapter.

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<sup>199</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 72.

<sup>200</sup> Carl Esposito (2012), *Making it Legal: Crowdfunding Bills Navigate Critics*, Crowdsourcing.org.

<sup>201</sup> Zachary J. Griffin (2012), *Crowdfunding: Fleecing the American Masses*, Case Western Reserve Journal of Law, Technology & the Internet, p. 34-35.

<sup>202</sup> Carl Esposito (2012), *Making it Legal: Crowdfunding Bills Navigate Critics*, Crowdsourcing.org.

### 4.3 Is Crowdfunding “Fraudfunding”?

*“It’s the Wild West meets the Internet meets Las Vegas.”*

Jeff Stibel: CEO of Dun & Bradstreet Credibility, *Crowdfunding Sites Launch a Preemptive Strike on Fraud.*<sup>203</sup>

That is just one thought about the crowdfunding exemption in the new JOBS Act. Is it really the case that this new exemption that should open the market for crowdfunding “opens the door” for fraudulent issuers?

As stated in Chapter 4.2, the most important reason against a crowdfunding exemption is the fact that it will reduce the amount of protection the investors will have. The concerns are that this consequently will lead to more fraud cases within the crowdfunding environment.

The people that will invest in the new crowdfunded entities are most likely to be people that have no relationship with that particular company, and therefore will have almost no information about that particular company, except for the information that is provided on the webpage of that company on the crowdfunding platform where the securities are offered for sale. The solicitation of small amounts of investment will draw more unsophisticated investors to the table.<sup>204</sup>

Giving unsophisticated investors the opportunity to invest in these risky crowdfunded ventures without the need of full disclosure to these people will sacrifice the level of investor protection. A lower disclosure regime will reduce the costs that these crowdfunded ventures will have to make.<sup>205</sup>

That crowdfunding takes place through the Internet will make it easier for scammers and fraudsters. Adrienne Jeffries at Betabeat has made a report about two Kickstarter projects that drew allegations of fraud. The first one, a project called Tech-Sync Power System received \$27,637 from backers but then the project was mysteriously cancelled and the backers never saw their money back. The second example is the example of Vere Sandals. This project received \$56,618 from 1,091 backers but most of them never saw the final product that they gave money to. Even worse is

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<sup>203</sup> Karen E. Klein (2012, April 9), *Crowdfunding Sites Launch A Preemptive Strike on Fraud*, Bloomberg Businessweek.

<sup>204</sup> Thomas Lee Hazen (2011), *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why The Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, North Carolina Law Review, p. 131-132.

<sup>205</sup> Thomas Lee Hazen (2011), *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why The Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, North Carolina Law Review, p. 133.

the fact that those who pledged money into this project did not receive their product but the company did start with a retail operation, selling the shoes directly to merchants, before they even completed their commitment to the backers on Kickstarter.<sup>206</sup> These are two examples where scammers defrauded backers on the popular crowdfunding platform Kickstarter. It means that there indeed are cases where it can go wrong and where people abuse the platform for their own private use.

How can an investor make sure that the platform itself is reliable? Crowdsourcing.org started the so-called “Crowdfunding Accreditation for Platform Standards” (CAPS) program in order to promote the adoption of best practices for the operation of crowdfunding platforms. This program was developed to protect crowdfunders as well as the people raising capital. Crowdfunding platforms can receive an accreditation from crowdsourcing.org if they meet their criteria. The accreditation is based on an interview and a review process of their transactional processes.<sup>207</sup> A program like CAPS can be effective because of the financial incentive of the people involved.<sup>208</sup>

These platforms that will get the accreditation can be considered trustworthy according to the standards of crowdsourcing.org. If these trusted platforms could achieve that fraud is completely banned than they can emerge as market leaders within this business. But if they fail, people will put their money elsewhere. Most of these investors are already limited in the amount of money they can lose on an investment.<sup>209</sup>

As Thomas Lee Hazen states in his paper on the possibilities of fraud within the crowdfunding model:

*“If history teaches us anything, the lesson is that social media technologies increase rather than decrease the potential for fraud. As such, it makes no sense to sacrifice investor protection simply because there are dollar limits on the investments solicited via crowdfunding.”*<sup>210</sup>

But is investor protection really sacrificed? The disclosure requirements in Title III, the Crowdfund Act, state that an issuer who offers or sells securities shall:

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<sup>206</sup> Ben Popper (2012, April 5), *Jobs Act becomes law, but questions linger about potential for fraud*, Venturebeat.

<sup>207</sup> Source: <http://www.crowdsourcing.org/caps>

<sup>208</sup> Andrew C. Fink (2012), *Protecting the Crowd and Raising Capital Through the JOBS Act*, University of Connecticut School of Law, p. 34.

<sup>209</sup> Andrew C. Fink (2012), *Protecting the Crowd and Raising Capital Through the JOBS Act*, University of Connecticut School of Law, p. 34.

<sup>210</sup> Thomas Lee Hazen (2011), *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why The Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, North Carolina Law Review, p. 135.

*“file with the Commission and provide to investors and the relevant broker or funding portal, and make available to potential investors -*

- (A) the name, legal status, physical address, and website of the issuer;*
- (B) the names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20 percent of the shares of the issuer;*
- (C) a description of the business of the issuer and the anticipated business plan of the issuer;*
- (D) a description of the financial condition of the issuer ...*
- (E) a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;*
- (F) the target offering amount, the deadline ... and regular updates regarding the progress of the issuer in meeting the target offering amount;*
- (G) the price to the public of the securities ... and each investor shall be provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;*
- (H) a description of the ownership and capital structure of the issuer ... ”<sup>211</sup>*

In addition, there are also extra disclosure requirements for issuers that are in need of larger amounts of capital:

*“... \$100,000 or less –*

- (i)*
  - I. the income tax returns filed by the issuer for the most recently completed year (if any); and*
  - II. financial statements of the issuer, which shall be certified by the principal executive officer of the issuer to be true and complete in all material respects;*
- (ii) more than \$100,000, but not more than \$500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the Commission, by rule, for such purpose; and*

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<sup>211</sup> Section 4A(b)(1) of the “CROWDFUND” Act of H.R. 3606, p. 12-13.

(iii) *more than \$500,000 (or such other amount as the Commission may establish, by rule), audited financial statements;*" <sup>212</sup>

It can be concluded that the CROWDFUND Act will require significant disclosure of the issuers. In case more than \$100,000 is needed, the help of independent accountants and lawyers is necessary in order to comply with the requirements of this Act. This makes an important difference and chances are that once the SEC has made their changes, these rules might be even more stringent.<sup>213</sup> The rules that currently are in place will not make it easier for scammers to defraud investors. They have to disclose a lot of (personal) information and by disclosing this information, it will reveal them to the general public. The two fraud cases on Kickstarter that were mentioned on this paper, are all over the Internet and the people behind this company will have a hard time setting straight the scam they committed.<sup>214</sup>

Moreover, the openness on the crowdfunding platforms is also a factor that can reduce fraud. The shady entrepreneurs that might be looking for unknowing investors have to present their business plan and have to make a pitching video where they present themselves and their idea. This form of openness will lead to better monitoring after the investors pledged money into a project. For many investors, the financial return is not the most important aspect when pledging money. This can lead to the conclusion that crowdfunders are of the opinion that social reputation is more important than receiving the profits from the participation in a particular project.<sup>215</sup>

However there always is an opportunity for scammers and fraudsters to betray investors, the argument that fraud will occur on a regular basis because of the new crowdfunding exemption is probably overstated. The equity crowdfunding platform Crowdcube that is based in the United Kingdom reported zero claims of fraud after being in business for a year.<sup>216</sup> In the event that fraud does happen, the JOBS Act provides a safe harbor for the people that suffered from the scam. Section 302(c) of the JOBS Act provides a private right of action against a company that engages in crowdfunding based on material, written or oral misstatements or omissions in connection with an offering.<sup>217</sup> Of course the SEC and the federal government still have the possibility to pursue a scammer under the criminal and civil laws.

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<sup>212</sup> Section 4A(b)(1) of the "CROWDFUND" Act of H.R. 3606, p. 12.

<sup>213</sup> John A. Myer (2012, April 27), *Complying with the Crowdfund Act Won't Be Trivial*, Myer Law PLLC Seattle.

<sup>214</sup> Sources: <http://www.geardiary.com/2012/03/17/why-the-verre-sandal-company-kickstarter-project-needs-a-kick-in-the-pants/> & [http://www.noozhawk.com/article/040712\\_olivia\\_uribe/](http://www.noozhawk.com/article/040712_olivia_uribe/)

<sup>215</sup> Paul Belleflamme et al. (2011), *Crowdfunding: tapping the right crowd*, Core Discussion Paper 2011/32, p. 26.

<sup>216</sup> Source: <http://www.cictr.com/blog/2012/03/tim-rowe-testifies-before-the-senate-banking-committee/>

<sup>217</sup> Section 4A(c) of the "CROWDFUND" Act of H.R. 3606, p. 13.



Furthermore, unsophisticated investors now will have the opportunity to invest in crowdfunded ventures. Although these investors will have less know-how about investing than the institutional investors, the task of the government is to protect these unsophisticated investors from the fraudulent investments, not from the investment that are very likely to be considered as “bad investments.” It is not the job of the government to check the quality of the investment value of any security. The securities laws have to provide transparency, so investors will be able to separate the good investments from the junk.<sup>218</sup>

Concluding this chapter, it is not the case that the new crowdfunding exemption “opens the door” for fraudulent issuers. Scammers and fraudsters will always be there. The new exemption gives the opportunity to daring entrepreneurs to issue shares to investors via a crowdfunding platform. The requirements are eased but the fundamental safeguards are there as is stated on the previous page. It is possible that because of the new regulations more cases of fraud will arise but if the new regulations will spur economic growth and will create new jobs by slightly breaking down the regulatory wall, then the positive effects will definitely prevail. The JOBS Act created some sort of middle ground. It gave entrepreneurs the opportunity to use crowdfunding as a business model for the financing of their start-up or small business but it also imposed duties and responsibilities on the same entrepreneur and the crowdfunding platform.<sup>219</sup> To my opinion that is already a good start. Now time will tell us if it was the right choice.

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<sup>218</sup> Thomas A. Martin (2012), *The JOBS Act of 2012: Balancing Fundamental Securities Law Principals with the Demands of the Crowd*, Willamette University College of Law, p. 32-33.

<sup>219</sup> Thomas A. Martin (2012), *The JOBS Act of 2012: Balancing Fundamental Securities Law Principals with the Demands of the Crowd*, Willamette University College of Law, p. 34.

## CHAPTER 5 - CROWDFUNDING: PROPOSALS FOR REGULATORY CHANGES

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*“The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.”*

President Franklin D. Roosevelt.<sup>220</sup>

Crowdfunding has grown significantly the last couple of years. The economic crisis, growing unemployment rates and new social media platforms have all played a role in the development of the crowdfunding principle. Crowdfunding with regard to regulatory issues is still relatively new territory for regulators as well as issuers. The goal will be to spur economic growth and job creation and to reduce the instances of fraud to an absolute minimum. Rules and regulations should be adopted to make sure that this goal is achieved.<sup>221</sup>

This chapter will come up with regulatory proposals, mainly focused on Europe because of the fact that they lack the regulatory proposals regarding crowdfunding. These proposals should help to reach the goal that was just mentioned. I personally am in favor of a crowdfunding exemption and I believe that it can help to spur the growth of economies of developed nations and that it can create new jobs.

The problem with most of the regulations was that it focused on the people that can invest, the accredited investors, but not on how people invest. This had a distortive effect and significantly reduced the size of the “crowd”.<sup>222</sup> The regulatory proposals made in this chapter should allow everybody to invest in securities and not only the people that are considered to be “accredited investors”.

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<sup>220</sup> Thomas A. Martin (2012), *The JOBS Act of 2012: Balancing Fundamental Securities Law Principals with the Demands of the Crowd*, Willamette University College of Law, p. 31.

<sup>221</sup> Andrew C. Fink (2012), *Protecting the Crowd and Raising Capital Through the JOBS Act*, University of Connecticut School of Law, p. 35.

<sup>222</sup> Kevin Lawton et al. (2010), *The Crowdfunding Revolution: Social Networking meets Venture Financing*, Self-published, p. 92.

## The Regulatory Proposals

### 1) The Investment Amount

Every individual should be free to invest his money into a crowdfunded venture but the amount an individual can invest should be capped to a certain amount. Regulations should prevent that individuals that invest in start-ups via crowdfunding will lose too much of their money so that they might get financial problems. Therefore an investment cap should be adopted in order to prevent people from investing too much of their own money. If such a cap is adopted, relatively smaller amounts of money will be at stake and this will ensure that investors are protected against themselves while at the same time offering new possibilities to small businesses.<sup>223</sup>

The JOBS Act already implemented an aggregate cap to protect investors. If the investor earns less than \$100,000 a year, the amount he may invest is \$2,000 or 5 percent of the annual income. If the investor's annual income is above \$100,000 then it is 10 percent of the annual income.<sup>224</sup>

If the European Commission were to adopt a regulation regarding crowdfunding, I believe that the aggregate cap of €2,000 or 5% of the annual income would be a good middle-road solution for the average investor in crowdfunded enterprises. It offers the opportunity to fund businesses with relatively large amounts of money for middle-class people, between the €1,000 and €1,500 for instance. At the same time, it prevents people from investing too much of their own money. If people with an average salary (e.g. €30,000) are able to invest €10,000 in small businesses, then the naïve or risk-loving investor might invest more money than he or she could actually afford. Investors should invest according to their financial standards. The law should take care of that. You cannot expect from every investor in crowdfunded securities that he has made a well thought-out investment decision. Steven Dresner, founder of DealFlow Media, a research and database firm, quotes:

*“Unrealistic expectations may be a bigger issue for people who invest through crowdfunding rather than fraud. There will be far more instances where people invest in a crowdfunded project and then realize it is really hard to make a profit.”*<sup>225</sup>

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<sup>223</sup> Jenny Kassan (2010, July 1), *Letter To Elizabeth M. Murphy, Office of the Secretary of the SEC*, Petition for Rulemaking.

<sup>224</sup> Section 302(a)(B) of the “CROWDFUND” Act of H.R. 3606, p. 10.

<sup>225</sup> Margaret Collins (2012, April 23), *Investor risk rises as crowdfunding gets easier*, Delaware Online.

An aggregate cap can prevent people from losing all their money when having these unrealistic expectations. The European Commission therefore should adopt this investment cap for these unsophisticated investors.

## 2) The Aggregate Investment Amount

The aggregate investment amount in the United States is \$1,000,000 after the exemption adopted in the JOBS Act.<sup>226</sup> In Europe the amount that issuers can obtain without the need to publish a prospectus is €5 million.<sup>227</sup> Angel investors that invest in companies in the so-called seed-stage invested approximately \$300,000 based on Gust (former Angelsoft) data in the United States.<sup>228</sup> Now with the new JOBS Act in place entrepreneurs have the choice to raise funds through the relatively slow angel investment route versus the more diverse and faster crowdfunding route.<sup>229</sup>

The overall investment amount should not be too low in case of a crowdfunding exemption, for instance €250,000, because that would imply that entrepreneurs in need of more would have to fund the gap themselves or look for angel funding.<sup>230</sup> The European Commission could put the maximum offering amount at €1 million for early-stage investing in crowdfunded ventures for instance. This is a decent limit. Because the average seed-stage investment amount is \$300,000 on average in the US, also the businesses that are in need of more capital in the early-stage have the possibility to use crowdfunding as a source to fund their business. Promising early-stage companies then have the possibility to grow substantially and leave opportunities to angel investors and VC funds to invest at later-stage funding rounds.<sup>231</sup> The amount that VC funds invested in 2010 in seed-stage companies was already 15 times larger compared to the average investment amount of angel investors, \$4.5 million versus \$300,000. These funds can play on a whole different level.<sup>232</sup>

To get a small start-up off the ground, the maximum offering amount of €1 million should be more than enough. However, the Commission should also adopt specific disclosure requirements for entrepreneurs in order to protect investors. This will also be discussed in this chapter.

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<sup>226</sup> Section 302(a)(A) of the “CROWDFUND” Act of H.R. 3606, p. 10.

<sup>227</sup> Article 1(a)(h) Amendments to Prospectus Directive 2003/71, No. 2010/73.

<sup>228</sup> Source: <http://gust.com/angel-investing/startup-blogs/2011/12/13/trends-in-seed-stage-funding-for-entrepreneurs/>

<sup>229</sup> Mark Fidelman (2011, November 25), *If This Bill Passes, The Angel Investment Community is Dead and Companies Like Kickstarter Take Over*, Business Insider.

<sup>230</sup> Nikki D. Pope (2011), *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, University of Pennsylvania Journal of Business Law, Vol. 13, No. 4, p. 124.

<sup>231</sup> Taylor Davidson (2012, January 23), *How crowdfunding could impact the venture capital industry*, Taylor Davidson Blog.

<sup>232</sup> Source: <http://gust.com/angel-investing/startup-blogs/2011/12/13/trends-in-seed-stage-funding-for-entrepreneurs/>

Crowdfunding can be most useful in the provision of seed-stage capital for businesses and if the companies really gets off the ground after the first investment round, larger rounds of capital can be provided from the more traditional sources (angel and VC investments) who will also add more know-how and managerial skills to the table.<sup>233</sup>

### 3) Investor Requirements

A crowdfunding exemption will bring investment opportunities to relatively unsophisticated investors. The JOBS act for instance raised the cap on the number of shareholders a privately held company may have without going public from 500 to 2,000. No more than 500 of those 2,000 may be unaccredited. Unaccredited means not having the net income in excess of \$200,000 or net worth in excess of \$1 million.<sup>234</sup> So you can assume that by far the largest group that invests in crowdfunded entities will be unaccredited investors.

A study of lenders on prosper.com however showed that unsophisticated investors became more sophisticated over time. Investors on this platform learnt rapidly over time and moved to loans with lower returns to loans that offered higher returns to these investors.<sup>235</sup> So even really unsophisticated investors can become more experienced and better investors after a while.

The issue at stake here is the whether a crowdfunding exemption will lead to more investor losses? Then there might be a reason not to adopt such regulations that would allow this type of business financing. Crowdfunding has the ability to offer good returns to investors and thus the potential gains for investors will increase. Equity- and debt-crowdfunding can receive interest or a share of the profits the crowdfunded entity makes. Although investors should be aware of the fact that investing in these entities is very risky, the possibility that some of these entities will be successful and will offer returns is better than no returns at all. Thus a crowdfunding exemption could make investors better off.<sup>236</sup> Thierry Merquiol, co-founder of Wiseed, states about this: “We do not stop people from going to slot machines and spending €2,000 a night.” So why stop people from investing in crowdfunded entities?<sup>237</sup>

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<sup>233</sup> Dana Mauriello (2011), *Crowdfunding: Connecting Investors and Job Creators*, Written Testimony to the Committee on Oversight and Government Reform U.S. House of Representatives, Sub-Committee on TARP and Financial Services, p. 11.

<sup>234</sup> Section 501 of Title V Private Company Flexibility and Growth of H.R. 3606, p. 20.

<sup>235</sup> Seth Freedman et al. (2008), *Do Social Networks Solve Information Problems for Peer-to-Peer Lending? Evidence from Prosper.com*, Net Institute Working Paper No. 08-43, p. 25.

<sup>236</sup> C. Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 69.

<sup>237</sup> Natalie Huet (2012, May 28), *Crowdfunding raises excitement in Europe*, Reuters.

It is true that some people that are accredited investors and are considered to be “sophisticated” investors actually are not.<sup>238</sup> Therefore I propose that a crowdfunding exemption that focuses on the ability of the investor to cope with the loss he might have. If a cap is placed on the amount each investor can invest based on his annual income, this would ensure that an investor cannot lose all his money by betting on one horse. The approach that is mentioned in paragraph 1, the investment amount, is a good example of how this can be done.

I also would like to propose to the European Commission to allow investment opportunities in crowdfunded entities to the general public. Do not adopt a difference between the accredited and non-accredited investors in crowdfunded offerings like in the US. Crowdfunded offerings should be open to the general public and not only to the first 500 non-accredited investors. Because of the cap that is placed on the amount each individual can invest, I do not think it is necessary to also have a difference between accredited and non-accredited investors. And as is stated above, the differences in sophistication between these two types are not always clear. I also propose that the European Commission does not restrict the amount of investors that can invest in a crowdfunded entity because some entrepreneurs might have troubles obtaining the necessary amount. The 2,000 shareholders limit in the US will be enough to finance most start-ups but some entrepreneurs will require a larger sum and then this limit might be too low. Therefore the Commission should not adopt a shareholders limit. If an entrepreneur needs €500,000 for instance, he likely needs more than 2,000 investors to fill this gap.

#### 4) Disclosure Requirements

Disclosure requirements are a very important aspect for a crowdfunding exemption. Adequate disclosure is very important to be able to offer sufficient protection to potential investors but an “overkill” of disclosure requirements would mean that crowdfunding would become too expensive for most issuers seeking early-stage investments.<sup>239</sup> Therefore the goal of the European Commission should be to seek a balanced approach.

To my opinion, the Commission should adopt regulations that oblige entrepreneurs to disclose a balance sheet of the financials of the business. Expected financials over the next few years should be disclosed as well as balance sheets of the latter years. Also very important is to disclose the possible risks for investors. What are the relevant risks involved in this type of business? What are the risks related to the minority ownership of the investors? Moreover, personal

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<sup>238</sup> Stephen Choi (2000), *Regulating Investors, Not Issuers: A Market-Based Proposal*, California Law Review, Vol. 88, p. 311

<sup>239</sup> Source: <http://fundinglaunchpad.com/tag/equity-crowdfunding/>

information of the issuer should also be disclosed. Because crowdfunding will take place over the Internet, it is very important that the issuer discloses much information about himself, even personal financial information.

Moreover, the Commission should adopt more extensive disclosure requirements for entrepreneurs that solicit larger offerings. These larger offerings can incur bigger losses for investors than smaller offerings. Therefore more measures should be taken by the Commission to reduce the risks for investors.

Issuers should also disclose practical information on how the shares will be priced and updates on management changes between the time of their pledge and the closing date of the offering.<sup>240</sup>

It is important that the package of disclosure requirements created by the Commission will not be too expensive, time-consuming or too complicated because then the exemption will not be used by entrepreneurs.<sup>241</sup> Finding the right balance are the keywords here.

## 5) Intermediary Requirements

Intermediaries that present the crowdfunded offerings on the Internet should be open to the general public. Pitches published on the platform should also provide open communication possibilities for investors to communicate with the issuers of that particular pitch.

Intermediaries in the crowdfunding business should be exempted from the MiFID Regulations stated in Directive 2004/39 by the European Commission.<sup>242</sup> These intermediaries only facilitate a marketplace where crowdfunding deals can take place. This should not require licensing. The exemption should also be adopted because of the fact that broker-dealers have to conduct extensive due diligence on issuers and purchasers. It would be much more costly to facilitate such a marketplace if an intermediary has to comply with these requirements.<sup>243</sup>

To be exempt from the broker-dealer requirements however, these intermediaries must remain neutral. They should not offer investment advice and should not rate or recommend offerings on their webpage. If crowdfunding platforms do want to offer investment advice, they should comply with the MiFID regulations that were just mentioned. If this restriction is not

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<sup>240</sup> Margaret Collins (2012, April 23), *Investor risk rises as crowdfunding gets easier*, Delaware Online.

<sup>241</sup> Dana Mauriello (2011), *Crowdfunding: Connecting Investors and Job Creators*, Written Testimony to the Committee on Oversight and Government Reform U.S. House of Representatives, Sub-Committee on TARP and Financial Services, p. 12.

<sup>242</sup> Directive 2004/39 on markets in financial instruments Directive (MiFID).

<sup>243</sup> Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 82.

adopted, then crowdfunding platforms could circumvent the regulation applicable to ordinary brokers and investment advisers.<sup>244</sup>

To prevent possible conflicts of interests, the Commission should also adopt rules to prevent that the crowdfunding platform and its employees can invest in pitches offered on their website. A prohibition of this kind will prevent manipulation of the marketplace to promote or favor certain particular offerings.<sup>245</sup>

Moreover, the Commission should oblige intermediaries to transfer the offering amount to the entrepreneur only if the funding goal is reached. This will incentivize the entrepreneur to issue just the necessary amount to fund his business because asking too much could consequently lead to a failed offering. This will also prevent scams such as with the Tech-Sync Power System where the entrepreneur closed the project after receiving \$27,000 for his project. The investors did not see their money back.<sup>246</sup>

It would be wise for intermediaries to check on the pitches before they are published on the website of the intermediary. This is in order to prevent pitches like this from a Florida-based company called Rocketjet, which claims to be developing a “water atomic engine.”

The company claims that investors can make 100 times their investment in 1-3 years and 1,000 times by holding the shares for 3-10 years. Their pitch refers also to a Rocketjet website. There the company estimates its market value of the company’s engine and all related product “in excess of \$1 trillion.” That is twice the stock market value of Apple at the moment.<sup>247</sup> This is of course ridiculous but there might be people around who will actually believe this nonsense and invest in this company. Therefore intermediaries have to make sure that pitches of these kind will never make it to its website.

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<sup>244</sup> Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 82.

<sup>245</sup> Steven Bradford (2011), *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, p. 82-83.

<sup>246</sup> Source: <http://www.squarepenguin.com/wordpress/?p=116>

<sup>247</sup> Jonathan Weil (2012, April 23), *Crowdfunding and the Greatest Investment Opportunity EVER!!!*, Bloomberg.



CHAPTER 6 - CONCLUSION

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*“I believe that the power of any resource – especially funding – is magnified when it comes from a supportive community of people. Capital is no longer just capital, no longer just a means to an end. It is a fundamentally different thing: it is an expression of a community’s best intentions, their hopes for the future, their desire to participate in making that future a reality. It is a statement of their belief in the recipient of that capital to lead the way.”*

Jessica Jackley, Profounder.

Entrepreneurs often face difficulties when they try to acquire capital to fund their business or start-up. VC funds are moving more towards later-stage investments. According to VentureBeat, \$2.3 billion dollar was invested in later-stage businesses and only \$179 million was invested in start-up/seed businesses in the third quarter of 2011.<sup>248</sup> Jose M. Mendoza and Erik P.M. Vermeulen already made clear that VC funds have become more conservative because of a lack of profitable IPOs as an exit strategy for VC-backed businesses. Therefore these funds made a switch to mid- or later-stage businesses that are already profitable. However this has led to a funding gap in the early stages.<sup>249</sup> The estimations are that there is a funding gap of \$60 billion every year in the demand of start-ups and small businesses that are in need of equity financing.<sup>250</sup> Both angel financing and venture capital only represent a small portion of small business finance.<sup>251</sup>

The capital that a small business and start-up might need can grow rapidly if the business turns out to be very successful. If the company grows fast the funds from the entrepreneur and friends and family might turn out to be insufficient to cover the increasing costs of the company. Banks will not be eager to fund the business because of a lack of collateral so the business needs to issue shares to outsiders. But because of the large funding gap, many of these companies will not receive any capital.<sup>252</sup>

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<sup>248</sup> Grace Nasri (2011, December 20), *Venture capitalists focus on later stages, but Silicon Valley still rules*, VentureBeat.

<sup>249</sup> Jose M. Mendoza & Erik P.M. Vermeulen (2011), *The “New” Venture Capital Cycle (part I): The Importance of Private Secondary Market Liquidity*, Lex Research Topics in Corporate Law & Economics Working paper No. 1/2011, p. 9-10.

<sup>250</sup> William K. Sjostrom Jr. (2001), *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, Florida Law Review, Vol. 53, p. 586.

<sup>251</sup> Allen N. Berger et al. (1998), *The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle*, Journal of Banking and Finance, Vol. 22, p. 15.

<sup>252</sup> General Accounting Office, Report to the Chairman, Committee on Small Business, U.S. Senate (2000), *Small Business Efforts to Facilitate Equity Capital Formation*, p. 2-6.

The financing method of crowdfunding can offer a solution for these entrepreneurs that have difficulties obtaining financing. Crowdfunding platforms allow entrepreneurs to reach millions of potential investors. It is also a great way for the entrepreneur to pitch his idea to the general public. This will give valuable insights about the market potential of the product or service the entrepreneur wishes to offer. So crowdfunding has the ability to be more than just fundraising over the Internet.<sup>253</sup>

Governments should realize that crowdfunding is emerging and that it can be a viable alternative to finance small businesses next to the traditional forms (angel, VC, bootstrapping, bank debt). Investors on the popular crowdfunding platform kickstarter pledged around \$100 million in 2011 compared to the \$27.5 million in 2010. The amount invested increased by 4 within one year.<sup>254</sup> That more than \$100 million on a single platform is invested in 2011 shows the potential that crowdfunding has. Non-equity models have significantly grown over the past few years and now the task is up to the governments to come up with a regulatory environment to allow equity-based crowdfunding models to experience the same growth and development. The United States already made a good example and developed the JOBS act that should open the market to equity-based crowdfunding models. It is now up to the SEC to review this act and to define regulations that will deal with the implementation of the law.<sup>255</sup>

Crowdfunding is relatively uncharted territory for regulators and issuers,<sup>256</sup> but both parties must be aware that allowing small businesses to raise equity from unsophisticated investors will open new capital-raising possibilities that will lead to economic growth and more jobs. There are always people with brilliant business ideas that because of a lack of financing possibilities or regulatory hurdles never have the chance to do something with their great idea. A crowdfunding exemption could be the solution.

The gap between small businesses and unsophisticated investors will not be built in a day but it will require some time. If businesses and platforms can prove themselves as reliable, trustworthy and profit generating, then more and more possible investors will surely find their way to these opportunities.

It is clear that crowdfunding will imply certain risks for investors. There are no guarantees that investors will see their money back once they invested in a crowdfunded entity. Investors are not protected from these losses incurred by entrepreneurs in whom they invested. There will also be

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<sup>253</sup> Paul Belleflamme et al. (2011), *Crowdfunding: tapping the right crowd*, Core Discussion Paper 2011/32, p. 26.

<sup>254</sup> Source: <http://www.kickstarter.com/blog/2011-the-stats>

<sup>255</sup> Zack O'Malley Greenburg (2012, April 5), *The JOBS Act's Real Impact on Crowdfunding*, Forbes.

<sup>256</sup> Andrew C. Fink (2012), *Protecting the Crowd and Raising Capital Through the JOBS Act*, University of Connecticut School of Law, p. 35.

investors that will be victims of scammers and fraudsters on these crowdfunding platforms. These investment opportunities will undeniably carry significant risks for investors but it will not mean that the door is opened for scammers and fraudsters to enter this market. Governments therefore should create a regulatory environment in which small businesses can issue crowdfunded securities and in which they are obliged to disclose a limited, but concise set of disclosures. Fraud is of all times and will never go away. It is possible to create such tough regulations that it would kill all illegal financial activity but it would also put the financial markets to a hold.<sup>257</sup>

I propose that governments come up with middle ground solutions in which there is a flexible regulatory environment where entrepreneurs are free to sell their shares to the public to get their business off the ground and where investors are protected by providing them with accurate material information about these businesses and where investors are protected from market manipulation and fraud.<sup>258</sup> The CAPS program set up by [crowdsourcing.org](http://www.crowdsourcing.org) is already a good initiative to deal with these issues.<sup>259</sup> An efficient market relies on relevant and accurate material information.<sup>260</sup>

One of the most important tasks of governments is to spur economic growth and job-creation. Therefore they must make sure that start-ups and small businesses have the opportunity to use crowdfunding as a viable capital-raising mechanism. It is impossible to spur economic growth without innovation and a measure of risk. Crowdfunding can give a boost to start-ups and new businesses. Now it is up to the governments to realize this. The next Apple or Facebook might be amongst a crowdfunded entity.

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<sup>257</sup> Thomas A. Martin (2012), *The JOBS Act of 2012: Balancing Fundamental Securities Law Principals with the Demands of the Crowd*, Willamette University College of Law, p. 34.

<sup>258</sup> Edan Burkett (2011), *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, Tennessee Journal of Business Law, Vol. 13, p. 96-97.

<sup>259</sup> Source: <http://www.crowdsourcing.org/caps>

<sup>260</sup> Bernard S. Black (1998), *Information Asymmetry, The Internet, and Securities Offerings*, Journal of Small & Emerging Businesses, p. 93.

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