CROWDFOUNDING

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VELEUČILIŠTE U ŠIBENIKU

ODJEL MENADŽMENT

SPECIJALISTIČKI DIPLOMSKI STRUČNI STUDIJ MENADŽMENT

MATIJA BLAĆE

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Završni rad

Šibenik, 2017.

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Šibenik, ožujak 2017.

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TEMELJNA DOKUMENTACIJSKA KARTICA

Veleučilište u Šibeniku Završni rad

Odjel Menadžment

Diplomski stručni specijalistički studij Menadžment

CROWDFUNDING

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Crowdfunding je nov, atraktivan i inovativan izvor financiranja za mala i srednja poduzeća. Iako ne postoji općeprihvaćena međunarodna definicija, tipično se podrazumijeva da je crowdfunding otvoren poziv za financiranjem, obično preko Interneta. Investitori se nagrađuju proizvodom, simboličnom nagradom, ulaganjem ili posudbom. Pozivi za investicije, tipično nazvani crowdfunding kampanjama, se mogu koristiti za razne projekte – mala i srednja poduzeća, start-upove, umjetničke projekte, stvaranje posebnog proizvoda od strane već postojećeg poduzeća, ili za druge svrhe. To je brz i jednostavan način prikupljanja sredstava za tražitelja sredstava, kao i za ulagača, te se na taj način povećava mogući broj tražitelja investicije i pojednostavnjuje se proces ulaganja. Zbog nedavnog porasta broja takvih kampanja, one su u najvećem dijelu pravno neregulirane u većini zemalja EU, te predstavljaju stanovit rizik za ulagače. Započevši sa rezolucijom Europskog parlamenta od 9. srpnja 2015. godine o Stvaranju Unije Kapitala (2015/2634(RSP) i nastavljajući sa Akcijskim planom o Stvaranju Unije Kapitala, EU je obratila posebnu pažnju crowdfundingu, s namjerom da ga pravno regulira te da promiče upotrebu ovog inovativnog financijskog instrumenta. Financijski model crowdfundinga se prvi put pojavio u Kini 2011. godine. Početno kašnjenje je brzo nadoknađeno galopirajućim rastom, pošto je danas Kina treće najveće tržište crowdfundinga u svijetu nakon SAD i EU, s golemim potencijalom za rast. Naglo proširenje pristupa i veća prihvaćenost mrežnih tehnologija, mrežnih financijskih servisa i osobito pametnih telefona zajedno s porastom BDP-a per capita brojnog stanovništva u Kini je stvorilo savršeno ekonomsko okruženje za eksplozivan rast crowdfundinga. Crowdfunding sa stjecanjem udjela je najkompleksniji oblik crowdfundinga, te je još zabranjen u nizu država. One države koje su ga dopustile, poput UK i SAD, su dale svojim tvrtkama dodatne opcije za stjecanje kapitala.

(42 stranice / 0 slika / 7 tablica / 78 literaturna navoda / jezik izvornika: engleski)

Rad je pohranjen u: Knjižnici Veleučilišta u Šibeniku

Ključne riječi: crowdfunding, pravni okvir, inovacija, financiranje

Mentor: Anita Grubišić, mag. oec., v. pred.

Rad je prihvaćen za obranu:

BASIC DOCUMENTATION CARD

Polytechnic of Šibenik Final paper

Department of Management

Professional Graduate Specialist Studies of Management

CROWDFUNDING

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Crowdfunding is a new, attractive and innovative source of financing for SME`s. Although there is no established international definition, it typically refers to open calls for financing, often over internet. Monetary investors are rewarded with a product, symbolic reward, investment or lending. Calls for investment, typically called crowdfunding campaigns, can be used for various types of projects – SME's, start-ups, artistic project, creation of a specific product by an already established company, or other. It is an easy and quick fundraising option for investment seeker, and the same for investor, thus broadening the range of possible investors and greatly simplifying the investment. Due to the recent prominence of such campaigns, they remain largely unregulated in most countries of the EU, and thus present certain risks for the investors. Starting with the European parliament resolution of 9 July 2015 on Building a Capital Markets Union (2015/2634(RSP) and continuing with the Action Plan on building a Capital Markets Union, EU has given special attention to the crowdfunding, with a view on regulating and promoting use of this innovative financial instrument. The crowdfunding financing model first appeared in China in 2011. The starting delay was quickly caught up by the galloping growth, as today China is third biggest crowdfunding market in the world, after USA and EU, with incredible potential for growth. The sudden greater access to and wider acceptance of internet technologies, online financial services and especially smartphones combined with the rise of GDP per capita of the numerous Chinese population created a perfect economic environment for the explosive development of crowdfunding. Equity crowdfunding is the most complex of the various forms in which crowdfunding appears, and it is still illegal in many countries. Those countries which have allowed and regulated it, such as UK and USA, have provided their companies with additional options for financing.

(42 pages / 0 figures / 7 tables / 78 references / original in English language)

Paper deposited in: Library of Polytechnic of Šibenik

Keywords: crowdfunding, regulation, innovation, financing

Supervisor: Anita Grubišić, mag. oec., v. pred.

Paper accepted:

1. INTRODUCTION

Small and medium sized enterprises (SMEs) are the drivers of economy and job creation. In the EU, 23 million SMEs represent 99% of businesses[1]. For the non-financial sector, they account for 58% of value added in the EU in 2014. Their importance is evident in employment - they provide 67% of total employment and account for 71,4% of the increase in employment in 2014[2]. When looking at the job creation, start-up companies take an especially important place. Around 60% of companies manage to survive the challenge of the first three years of business[3]. However, once through, they greatly contribute to the job creation. On average, young companies provide 17% of employment, but are responsible for the generation of 42% of new jobs[4]. Among the many challenges the new companies face, access to financing is one of the key concerns. Large enterprises have access to capital markets that SMEs, especially start-ups, do not have. Obtaining enough capital is a necessary first step in almost any venture. However, the research results seem to show signs of improvement in EU. Some authors, focusing on developing countries worldwide, claim that access to finance is the single biggest barrier to starting a company[5]. In the euro area, access to finance seems a lesser concern lately. Its importance as an impediment is steadily coming down, after a long period of difficulty. “Access to finance” was considered the least important concern for euro area SMEs (10%) while “Finding customers” remained the dominant concern (27%), followed by lack of “Availability of skilled labour”, increases in “Costs of production and labour” and “Competitive pressures” and “Regulation”. There is still significant divergence across countries regarding the difficulties in accessing external sources of finance. Some 31% of SMEs in Greece, 13% in Italy and 12% in Ireland and the Netherlands mentioned that access to finance was the most significant problem, compared with around 6% of SMEs in Austria and Germany and 8% of SMEs in Finland[6]. Still, less than half of SMEs perceive no limitations in their access to future financing, namely 41% in the EU28. Those that do

[1] De Buysere, K., Gajda, O., Kleverlaan, R., Marom, D., & Klaes, M. (2012). A framework for European crowdfunding. *European Crowdfunding Network*.

[2] Muller, P., Caliandro, C., Peycheva, V., Gagliardi, D., Marzocchi, C., Ramlogan, R., & Cox, D. (2014). Annual Report on European SMEs. *Final Report-July*.

[3] OECD (2015), OECD Science, Technology and Industry Scoreboard 2015: Innovation for growth and society, OECD Publishing, Paris

[4] Calvino, F., Criscuolo, C., & Menon, C. (2016). *No Country for Young Firms?: Start-up Dynamics and National Policies* (No. 29). OECD Publishing.

[5] Wang, Y. (2016). What are the biggest obstacles to growth of SMEs in developing countries?–An empirical evidence from an enterprise survey. *Borsa Istanbul Review*, *16*(3), 167-176.

[6] ECB, June 2016, Survey on the Access to Finance of Enterprises in the Euro Area, October 2015 to March 2016

perceive such limitations most often cite insufficient collateral or guarantees, and interest rates and prices of financing being too high[7]. The results of the European Commission's Innobarometer survey confirm that access to funding is a key obstacle for spurring R&D and the commercialisation of innovative products or services (EC, 2016). The conclusion from this data can only be that SMEs in less developed countries, with the lowest rate of economic growth, are the ones having most trouble obtaining the necessary financing, especially in the area of R&D for start-ups.

After the financial crisis and the economic recession that started in 2007, European Commission has undertaken a number of initiatives and programmes to strengthen the economic growth and sustainability and resilience of economy. The Competitiveness and Innovation Framework Programme (CIP) was designed to provide SMEs with better access to finance, as well as support for innovation, and regional business support. CIP was active between 2007 and 2013, and it provided more than EUR 1 billion to help more than 340,000 SMEs get access to loans and equity finance[8]. CIP was superseded by COSME (Programme for the Competitiveness of enterprises and SMEs) in 2014. COSME will run until 2020 and it has a planned budget of EUR 2.3 billion[9]. In 2011, an Action plan to improve to access to finance for SMEs was communicated. This Action plan recognized the difficulties SMEs have in obtaining the financing they need in order to grow and innovate[10].

European Commission did not limit its actions to the direct support of SMEs. A comprehensive legal framework was initiated in order to provide SMEs with a stable and sustainable business environment. A number of workshops and public consultations led to the Green Paper (IP/13/274) consultation on the long-term financing of the European economy of March 2013 which initiated a broad debate and lead to replies from all segments of the economy. The paper, among other issues, called for changes in efficiency and effectiveness of the financial markets to provide long-term financing instruments and to ease the access of SMEs to the bank and non-bank financing[11]. This led to the European parliament resolution 2015/2634(RSP) of 9 July 2015 on Building a Capital Markets Union. On 30 September

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[7] European Commission, http://ec.europa.eu/growth/industry/innovation/facts_figures/ innobarometer/index_en .htm, accessed on 7. 9. 2016.
[8] ibid
[9] ibid
[10] Communication from the Commission, An action plan to improve access to finance for SMEs, COM (2011) 870/final, 7. 12. 2011.
[11] European Commission, Green Paper – Long term financing of the European Economy, COM (2013) 150 final, 25. 3. 2013.

2015, the Commission adopted an Action plan on building a Capital Markets Union (CMU), setting out a list of key measures to achieve a true single market for capital in Europe[12]. The three main objectives of the CMU are broadening the sources of financing in Europe towards non-bank financing; deepen the single market for financial services; and to help promote growth and financial stability. CMU focused on easing the access to financing for SMEs, including access to public markets for raising capital and providing a legal framework for the alternate source of financing, thus complementing the set of potential financing instruments which are complementary to bank financing. In the Economic Analysis, an accompanying document[13], it is stated that the overreliance on banking is an impediment for growth and a weakness of the whole system, which led to the economic downturn following the recent economic crisis.

In these documents crowdfunding is recognized by the European Commission as one of the most potent financial instruments to promote start-ups and innovative companies. In the Communication from 27 March 2014 titled "Unleashing the potential of Crowdfunding in the European Union", European Commission has highlighted crowdfunding as an important part of the previously mentioned plans for improved financing and long term development of SMEs[14]. On 25 June 2014, following a public call for applications to select the members, the "European Crowdfunding Stakeholders Forum" (ECSF), and expert group, was set up by the European Commission. The group should assist the Commission in developing policies for crowdfunding to flourish while taking into account the interest of contributors[15]. ECSF had 4 meetings so far, on providing assistance, guidance and data which were contributing factors for the Report on Crowdfunding in the EU Capital Markets Union, published on 3 May 2016. In the report, the importance of crowdfunding for reaching the CMU Action plan objectives were highlighted yet again (Commission staff working document, Crowdfunding in the EU Capital Markets Union, SWD (2016) 154 final, 3. 5. 2016.).

[12] European Commission, Action plan on building a Capital Markets Union, COM (2015) 468 final, 2015

[13] Commission staff working document, Economic analysis, Accompanying the document COM (2015) 468 final, SWD (2015) 183 final, 30. 9. 2015.

[14] Communication from the Commission, Unleashing the potential of Crowdfunding in the European Union, COM (2014) 172 final, 2014

[15] Call for applications for participation in a European Commission informal expert group „European crowdfunding stakeholder forum" (ECSF), 16. 4. 2014.

China is the second-largest economy in the world with an average rate of 9% GDP growth over the last 20 years and a rapidly growing domestic market for new products and services driven by its population of 1.3 billion[16]. Although the predictions are that this incredible growth will slow down to 6.1% by 2018[17], even at this rate the size of Chinese economy will ensure the dominant position of China in global economy in decades to come. These incredible statistics make China one of most popular investment destinations for venture capital and private equity firms from all over the world, but innovative world trends such as internet based capital raising are also making their way into Chinese capital market, in the form of crowdfunding.

Although it is hard to accurately define and measure crowdfunding, compiling various sources, the growth rates that the industry demonstrates are undeniable. In 2009, the world crowdfunding market was estimated to be $3.61 billion. In 2012, this figure increased to $17.3 billion[18]. In 2016, the initial reports place crowdfunding industry at $22 billion[19].

[16] Hu T., Yang D., The People's Funding of China: Legal Development of Equity Crowdfunding – Progress, Proposals, and Prospects (IMI Working Paper No. 1508 {EN}), International Monetary Institute, Beijing, China, 2015

[17] OECD (2016), OECD Economic Outlook, Volume 2016 Issue 2, OECD Publishing, Paris

[18] Hu T., Yang D., The People's Funding of China: Legal Development of Equity Crowdfunding – Progress, Proposals, and Prospects (IMI Working Paper No. 1508 {EN}), International Monetary Institute, Beijing, China, 2015

[19] Crowdsurfer (22.12.2016.), Crowd finance in 2016, retrieved on 08. 01. 2017. from https://www.crowdsurfer.com/blog/crowd-finance-in-2016/

2. CROWDFUNDING, BENEFITS, RISKS AND MAIN MARKETS

Crowdfunding is a recently introduced financial instrument, and still in development. In order to begin exploring it, firstly we have to look at it in general terms.

2.1. What is crowdfunding?

There is no single, universally accepted definition of crowdfunding.
One of the possible definitions is the one proposed by De Buysere et al. It states that crowdfunding can be defined as a collective effort of many individuals who network and pool their resources to support efforts initiated by other people or organizations. This is usually done via or with the help of the Internet. Individual projects and businesses are financed with small contributions from a large number of individuals, allowing innovators, entrepreneurs and business owners to utilise their social networks to raise capital. It proposes further division into four basic types of crowdfunding: donation (a donor contract without existential reward); reward (purchase contract for some type of product or service); lending (credit contract, credit is being repaid plus interest); and equity (shareholding contract, shares, equity-like instruments or revenue sharing in the project/business, potential up-side at exit)[20].

Lambert and Schwienbacher propose the following definition: "Crowdfunding involves an open call, essentially through the Internet, for the provision of financial resources either in form of donations (without rewards) or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes"[21]. Valenciene and Jegeleviciute describe crowdfunding as a method to establish the connection between entrepreneurs, who aim to raise capital, and novel investors, who form an emerging source of capital and are willing to invest small amounts, through internet-based intermediaries[22].

European Commission defines crowdfunding as an open call to the public to raise funds for a specific project[23], or alternatively, as an emerging alternative form of financing that connects

[20] De Buysere, K., Gajda, O., Kleverlaan, R., Marom, D., & Klaes, M., A framework for European crowdfunding. *European Crowdfunding Network*, 2012

[21] Belleflamme, P., Lambert, T., & Schwienbacher, A., Crowdfunding: An industrial organization perspective. In *Prepared for the workshop Digital Business Models: Understanding Strategies', held in Paris on June* (25-26), 2010

[22] Valanciene, L., & Jegeleviciute, S. (2013). Valuation of crowdfunding: benefits and drawbacks. *Economics and Management*, *18*(1), 39-48.

[23] Communication from the Commission, Unleashing the potential of Crowdfunding in the European Union, COM (2014) 172 final, 2014

directly those who can give, lend or invest money with those who need financing for a specific project[24]. European Commission offers two possible divisions of types of crowdfunding. The first one includes crowd sponsoring (donation, reward or pre-sales based crowdfunding), crowd investing (profit-sharing or securities-based) and crowd lending campaigns. It is stated, however, that crowdfunding is still in the early development stage so these main models can evolve in the future[25]. The second division is that on crowdfunding with non-financial returns (donations, rewards and pre-sales) and crowdfunding with financial returns (crowd investing and crowd lending)[26].

These definitions and divisions have a lot in common, even if some elements are defined slightly differently. There is also the issue of hybrid forms, which combine two or more aspects outlined above. As the crowdfunding increases in volume and importance, spreads outside of national borders in the EU area and before further regulation arrives which deals precisely with various appearances of crowdfunding, it will be necessary to find an international and universally accepted definition of crowdfunding.

2.2. Benefits of crowdfunding

Crowdfunding has always been around in human society. The act of pulling resources together is what enabled us to advance from the Stone Age to the level of technological advancement that we enjoy today. Yet, as capitalism developed, and business regulation encompassed every step and every aspect of running a business, it became a huge burden to actually engage in running or owning a business except on a professional basis, or with the help of other professionals. The prevalent model of owning a part of a business – stock exchange – has become so highly regulated that it is not possible to take part in it except through specialized companies and certified individuals. Similarly, setting up and running a company can be a huge challenge, given the enormous amount of regulation that needs to be followed, which regularly increases on the EU level. With the strict penalties for not doing so, it can be a discouraging experience.

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[24] European Commission Memo from 27 March 2014, retrieved on 07. 09. 2016. From http://europa.eu/rapid/press-release_MEMO-14-240_en.htm?locale=en

[25] Communication from the Commission, Unleashing the potential of Crowdfunding in the European Union, COM (2014) 172 final, 2014

[26] ibid

As stated, crowdfunding has always been there. Donations to various charity causes have always existed. Statue of Liberty has been constructed with the funds gathered from small private donors. Democracy is hard to imagine without donations to political parties (though the morality of it can be question in some cases). President of the United States of America (USA) Barack Obama made masterful use of crowdfunding in his 2008 campaign, collecting more than three quarter of a billion USD in crowdfunding. Around half of that amount was in contributions of less than 200 USD. Yet, crowdfunding in business is a novel feature, gaining prominence only in 2008 and beyond. Two aspects have benefitted the rise and spread of crowdfunding in mainstream business. The first one is Age of Internet, and the second is the economic crisis of 2008.

The economic crisis aspect is easy to explain. With the near-collapse of the financial system, the financing became much harder to obtain. Renewed and much more risk-assessment procedure and regulation (in the EU Basel III, Markets in Financial Instruments Directive (MiFID), Capital Requirements Directive (CRD) IV, Alternative Investment Fund Managers Directive (AIFMD), to mention a few), low liquidity of banks, lack of trust in financial institutions, reduced purchase power, low market demand, fragile partnering companies and fear of what tomorrow may bring made starting up a business a lot more difficult proposition. Some company managers adapted, and after a few successful crowdfunding campaigns, the model became more widespread.

Age of Internet enabled numerous business opportunities over the last two decades, and it was a matter of time when the new tools, especially Web 2.0, will be used in a creative manner for fundraising. Gaining public attention with the computer game and gadget projects through the platforms such as Kickstarter, it quickly spread to other business. Internet allows unprecedented level of communication between consumers and companies seeking capital, using videos, graphic material, text and social networks for promotion of their products and plans. With the ability to quickly provide small payments, suddenly everyone could become an investor, without any prior knowledge of the sector or stringent legal procedure. The freedom and speed of information that the Internet offers were therefore used to create a funding model before the regulators could take note of what was happening. This, of course, also presented new risks for the investors. We now have to find the right answer to this challenge of providing both safe and secure investment models while not impeding growth of the crowdfunding model.

2.3. Risks of crowdfunding

Unique risks and uncertainties exist for both the investors and project initiator in the crowdfunding system.

Due to the snapshot nature of crowdfunding platforms, and a lack of elaborate project and financial plans, the probability of the project finishing as planned is uncertain. For instance, backers may not receive the return as specified. In this regard, start-ups going bankrupt or delayed delivery of pre-sold products are among the most prevalent problems[27]. Advertising and advice by promoters can be misleading or even fraudulent[28]. Due to the small amounts of money pledged or raised, most crowdfunding campaigns fall outside of security instruments governing more traditional investment models (depending on national legislation). For example, United Kingdom Financial Conduct Authority considers crowdfunding, and especially the investment model, to be a high risk investment activity[29].

Crowdfunding can be risky for project initiators as well. Start-ups face problems as they grow invariably of the source of capital, but some issues are inherent to the crowdfunding. For instance, many project initiators who use crowdfunding as pre-sales mechanisms do not possess scalable production facilities. As a consequence, many products and other rewards are delivered with delay, potentially damaging the reputation of the project initiator. This may also decrease profitability of the project due to unforeseen extra costs[30].

2.4. Crowdfunding in the USA

Crowdfunding was a phenomenon first observed in the USA, and as of 2015, the size of the market was estimated to be € 33.58bn, coming up from the € 9.65bn in 2014 and € 3.24bn in 201331. The USA crowdfunding market is therefore substantially larger and with a far more explosive growth than that of the EU. This is no small part due to the timely regulation, namely the Jumpstart Our Business Startups Act (JOBS Act), signed by president Obama on

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[27] Brüntje, D., & Gajda, O., Crowdfunding in Europe, State of the Art in Theory and Practice. Springer International Publishing, 2016

[28] Communication on crowdfunding in the European Union, Frequently Asked Question, Brussels, 2014

[29] Financial Conduct Authority website, https://www.fca.org.uk/consumers/crowdfunding, accessed on 22. 9. 2016.

[30] Communication on crowdfunding in the European Union, Frequently Asked Question, Brussels, 2014

[31] Wardrop R., Rosenberg R, Zhang B., Ziegler T., Squire R, Burton J, Hernandez E., Garvey K., Breaking new ground: The Americas Alternative Finance Benchmarking Report, 2016, Cambridge Center for Alternative Finance, Cambridge, UK. Retrieved 07.01.2017. from https://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/publications/breaking-new-ground/#.WHvkEFxsxaQ

April 5, 2012. Especially important parts of this act are Title II (Access to capital for job creators, signed into effect on September 23, 2013) and Title III (Crowdfunding, signed into effect on May 16, 2016). This regulation allowed for tremendous change in ease of doing business. Previously, the cost for registration to advertise and sell securities was prohibitively high. It ranged from $ 300,000 to $ 500,000 for legal accounting, filing and other fees for an underwritten public offering under Securities Act. With the exemption under Regulation A (sub-$ 5 million offering), it still costed between $ 40,000 and $ 60,000, while offerings under Regulation D still had the limitation on the number of unaccredited investors to 35[32], (accredited investors are those individuals who earn more than $200,000 per year or have a net worth of over $ 1 million[33]. Donations or rewards models are not regulated.

Title II allowed for much easier registration, speeding up the process and lowering the cost of public offering, raising exemptions to $ 50 million, allowing for an unlimited number of accredited investors and raising restrictions on the advertisements on the sale of equity. These and other provisions of the Title II allowed for the explosive growth of crowdfunding the USA. Yet, the provisions of the Title III are providing the real change. Entrepreneurs can raise up to $ 1 million without registration with the SEC, though they have to provide disclosures (financial, business and risk) with regular updates, and funding portals are defined and regulated[34]. Investors can invest up to 5 or 10% of their annual income or net worth, with no need for accreditation (European Crowdfunding Network, Review of crowdfunding regulation, 2014). This regulatory framework allows for unprecedented freedom of investing, which is certain to help keep the impetus of growth of SMEs in USA.

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32 Stemler, A. R., The JOBS Act and crowdfunding: Harnessing the power—and money—of the masses. *Business Horizons*, *56*(3), 2013, 271-275.

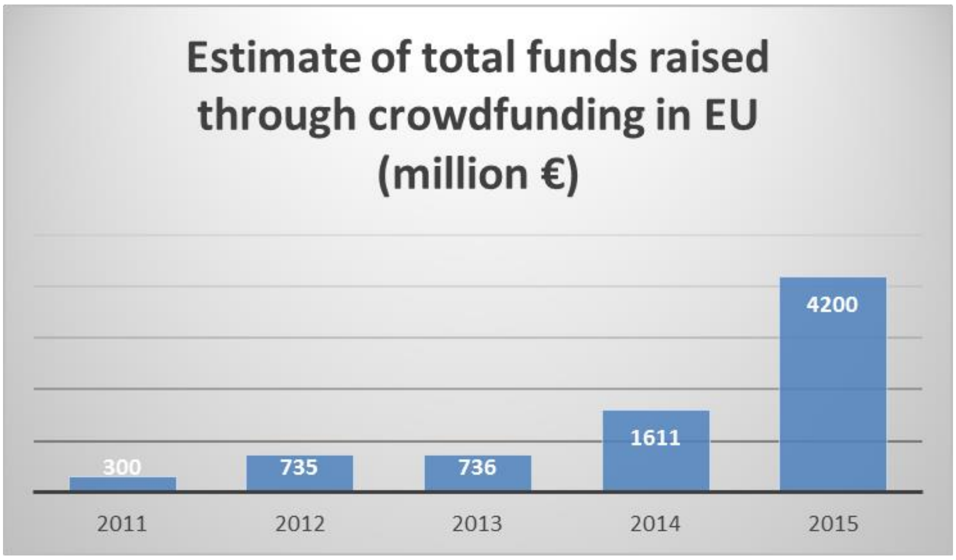
33 Barnett, C., Why Title III Of The JOBS Act Will Disappoint Entrepreneurs, Forbes, retrieved on 23. 09. 2016. from http://www.forbes.com/sites/chancebarnett/2016/05/13/why-title-iii-of-the-jobs-act-will-disappoint-entrepreneurs/2/#4082e7913a7f

34 Stemler, A. R., The JOBS Act and crowdfunding: Harnessing the power—and money—of the masses. *Business Horizons*, *56*(3), 2013, 271-275.

2.5. Size of the EU market

From the humble beginnings in mid-2000, crowdfunding has progressively increased in size and importance in EU. Although still small compared to the venture capital market, it is speed of expansion, the potential of growth and other previously outlined advantages will make it a decisive factor in the economic progress and long term sustainability of SMEs in EU.

Table 1. Total funds raised through crowdfunding in EU



Source: For 2011.: De Buysere et al. 2012 "A framework for European crowdfunding"; For 2012.: Communication from the Commission, Unleashing the potential of Crowdfunding in the European Union, COM (2014) 172 final, 27.3.2014.; For 2013. and 2014.: European Commission, Crowdfunding: Mapping EU markets and events study, 30.9.2015.; For: 2015. Commission staff working document, Crowdfunding in the EU Capital Markets Union, SWD (2016) 154 final, 3.5.2016.

Given the lack of a specific and universally accepted definition of crowdfunding and different legal solutions present today, it is not possible to correctly measure the size of the total funds raised. Therefore, the data present in Table 1. is only an estimate, gathered through the various sources, all of which varied in the market coverage and methods used. The inconsistency is especially obvious between 2012 and 2013, which in the graph indicate no growth, while in reality the growth was consistent. Until better data arrives, this table is useful not because it accurately depicts the amount of capital raised, but rather because it relatively accurately shows the trends in the crowdfunding model, and that is the incredible rate of growth which increases exponentially every year.

Table 2. Total amount of capital raised through crowdfunding by Member States in 2014

Country	Amount raised (€ 000)	Country	Amount raised (€ 000)
United Kingdom	1.397.611	Belgium	1.381
France	50.494	Slovakia	936
Germany	36.633	Romania	586
Netherlands	16.204	Portugal	511
Spain	13.929	Hungary	330
Estonia	11.281	Greece	226
Finland	6.489	Bulgaria	186
Sweden	5.058	Slovenia	152
Italy	4.504	Malta	125
Poland	4.111	Croatia	101
Austria	2.297	Lithuania	57
Denmark	2.271	Latvia	48
Ireland	2.010	Luxemburg	14
Czech Republic	1.511	Cyprus	2

Source: European Commission, Crowdfunding: Mapping EU markets and events study, 2015

Looking at the data in Table 2., we can notice that more than the 89% of crowdfunding market is carried by the United Kingdom. This disproportionality can be explained by the linguistic connection with the USA market, on which the crowdfunding expansion started first. This provided the United Kingdom market with an early start. Despite the different starting positions, the amount of capital raised through crowdfunding is increasing equally in almost all Member States. One indicator of the crowdfunding activity is the number of the active platforms. There are some 510 crowdfunding platforms active today in the EU, which is an average increase of 49% annually between 2009 and 2014[35].

2.6. Regulatory framework in the EU

There is no specific legal regulation of crowdfunding on the EU level. Following the initial assessment inside the Capital Market Union Action plan, the European Commission does not intend to come up with legislative measures, but remains committed to promotion of crowdfunding and regular assessments of possible issues requiring legislative action[36]. The diversity of the crowdfunding market makes it difficult to be singularly regulated. Many different appearances of crowdfunding require different approaches to the issue of regulatory

[35] European Commission, Action plan on building a Capital Markets Union, COM (2015) 468 final, 30. 9. 2015.

[36] European Commission Memo from 27 March 2014, retrieved on 07. 09. 2016. from http://europa.eu/rapid/press-release_MEMO-14-240_en.htm?locale=en

framework. This is further compounded by the different solutions in national legislation, due to the lack of the EU regulation in this specific area.

On the one hand, it is important that regulatory framework allows for unimpeded development of crowdfunding platforms and continues to provide easy access. Excessive requirements on capital requirements, conduct of business rules, conflicts of interest rules and organisation requirements can stifle the creativity offered in this sector and the impetus of growth. On the other hand, investors are entitled to a certain degree of protection, and harmonization is essential for the cross-border activities.

Some aspects, such as donation-based crowdfunding or pre-payment or rewards-based crowdfunding, deal with small amounts of money and don't require any further legislative actions. For example, UKs Financial Conduct Authority intentionally excludes such models from regulation[37].

It gets a lot more complex in the field of loan-based or investment-based crowdfunding. EU rules may apply to financial-return forms of crowdfunding, depending on the type of activity and the specific business model used. These include the Prospectus Directive, the Payment Services Directive, MiFID, CRD IV, AIFMD, the Consumer Credit Directive, the Distance Marketing of Financial Services and the Regulations on Capital Requirements, European Venture Capital, European Social Entrepreneurship Funds[38] and possibly some other, like the Unfair Commercial Practices Directive, Unfair Contract Terms Directive and Data Protection Directive. Only some of these instruments would apply to a given business model and only in specific cases, depending on the financial crowdfunding campaigns design (such as the amount of money being raised).

Today, seven EU Member States have introduced specific national regulatory frameworks on crowdfunding, with several others preparing to regulate said area[39]. This has a negative effect on the cross-border activities of crowdfunding platforms and projects. In 2015, 46% of crowdfunding platforms engaged in a comprehensive study indicated zero funding inflows

[37] Financial Conduct Authority website https://www.fca.org.uk/consumers/crowdfunding, accessed on 22. 9. 2016.

[38] European Commission Memo from 27 March 2014, retrieved on 07. 09. 2016. from http://europa.eu/rapid/press-release_MEMO-14-240_en.htm?locale=en

[39] Commission staff working document, Crowdfunding in the EU Capital Markets Union, SWD (2016) 154 final, 2016.

from outside of their country while 44% of firms had between 1-50%. 77% of surveyed firms had 10% or less of total funding coming from outside their country of operations. As in 2014, European alternative finance activity remains heavily domestic[40].

One of the areas that can be harmonized are the offerings under securities laws. Namely, the Prospectus directive doesn't regulate sub-€5 million public offerings, and Member States cannot require prospectus for offerings under 100,000 € threshold. The problem is that for offerings between 100,000 € and 5,000,000 € the choice is left to the individual Member States whether they grant an exemption on offerings up to 5,000,000 € or not[41]. Since most crowdfunding offers fall within this amount, the differing national legislation prevents start-ups from raising funds across the border.

Another unregulated issue is limitations in public offerings for limited companies by national company laws, given that start-ups usually choose simpler forms of company type, with all the limitations and restrictions. Investment type contracts might be seen as derivatives by one national legislation, and as securities by another, thus falling under either the Prospectus Directive or MiFID directive, and therefore either gain the permission to operate under European passport (in case of MiFID) or not. In order to evade such legal restrictions, crowdfunding platforms are sometimes set up on the eBay model, providing only technical means through which investor and project initiator can get in contact with each other[42].

European Union is putting a lot of effort (and funds) in the SMEs, in the attempt to improve the prospect of start-up companies and economy in general. The common market, so important for the member states, is still a project in development. Despite decades of integration, there are still important differences in the legal regulation of the different financial instruments, which is quite obvious in crowdfunding. The Capital Market Union, an important project of the current European Commission, seeks to alleviate those differences.

As stated before, the challenge is to balance excessive regulation offering more security for the investor, without limiting and discouraging the project initiators, and to allow them for

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[40] Sustaining momentum, The 2nd European alternative finance industry report, Cambridge Centre for Alternative finance, September 2016

[41] Brüntje, D., & Gajda, O. (2016). Crowdfunding in Europe, State of the Art in Theory and Practice. Springer International Publishing.

[42] ibid

cross-border operation with as few obstacles as possible. Given the plethora of national law regulation options currently in place, only the harmonized approach on a European level can break down the barriers, limits and restrictions investors and crowdfunding platforms face in cross-border activities. Therefore, the European Commission should, in due time and in harmony with other legislation being prepared, build a European legislative framework to facilitate crowdfunding.

3. CROWDFUNDING IN CHINA

Chinese crowdfunding market is unique in many ways, just like the country itself. The incredible speed by which the country has embraced the use of online financial services created a market that more easily embraces crowdfunding then any other. Although there is nothing ground breaking or innovative in the way crowdfunding was introduced to China, the size of the market provides environment different than the other advanced markets with higher individual purchase power. If we look at the BDP per capita, China is still far behind USA and more developed EU countries, especially the United Kingdom. Exploring Chinese crowdfunding market is therefore especially interesting because crowdfunding is inherently a way for a greater number of people to participate in a business endeavour. Huge population of China coupled with the lower individual purchase power is ideal background for the analysis which will give us the answer to the question – is crowdfunding appropriate for the developing markets? Such an important question deserves its own chapter.

3.1. Size and features of the crowdfunding market in China

China has had the benefit of coming late to the crowdfunding wagon. First online platform, Demohour, opened in 2011 as a response to the crisis of 2008[43]. After that modest start, the market soon erupted and has seen unprecedented rates of acceptance and growth. For example, crowdfunding for the movie titled “Happy Boys Movie” enlisted nearly 4 million Chinese participants, setting a new record for the number of investors in a single crowdfunding project[44]. Demohour has specialized for art projects, but soon, big companies realized the potential of the market and started their own platforms for crowdfunding. In December 2013, Aliababa launched crowdfunding on Taobao, creating Yulebao, which allows investors to support Chinese films. In July 2014, JD.com, one of China’s largest e-commerce websites, launched Coufenzi, a crowdfunding platform hosting a variety of projects. Shortly after, in 2015, JD.com launched JD Equity Crowdfunding, a platform devoted to entrepreneurs looking for early-stage investors. Baidu and Tencent also entered the

[43] The World Bank, Crowdfunding’s Potential for the Developing World. 2013. info Dev, Finance and Private Sector Development Department. Washington, DC.

[44] Hu T., Yang D. (December 2015), The People’s Funding of China: Legal Development of Equity Crowdfunding – Progress, Proposals, and Prospects (IMI Working Paper No. 1508 {EN}), International Monetary Institute, Beijing, China.

market by launching Baidu Crowdfunding and Tencent Succor, also known as Tengxun Lejuan[45].

Today, all sub-types of crowdfunding are flourishing in China, driven by high acceptance of internet and especially mobile technologies. There are 650 million internet users in China, and 86% of internet usage is through smartphones. The nature of the market is especially evident in the use of electronic money; Alipay consists of 350 million users, with WeChat Wallet, Baidu Wallet, and many others vying for market share[46]. These factors have combined to form a prognosis of forming a world's biggest crowdfunding market. Estimates by the The World Bank put China's crowdfunding market at $50 billion in 2025, more than half of the estimate of the total amount of funds raised through crowdfunding in the developing countries[47].

Still, the progress in the crowdfunding market didn't come without drawbacks. In 2016, Chinese police have arrested 21 people involved in the operation of peer-to-peer (P2P) lender Ezubao over an online scam. Ezubao was accused of operating a large Ponzi scheme. It took in some 50 billion yuan (approximately 7.6 billion USD) from about 900,000 investors[48]. This unfortunate development has highlighted the weak regulatory framework under which crowdfunding operates in China, which will be analysed in the next chapter in this paper.
User mentality of the Chinese users is interesting, described as "more accustomed to the role of buyer rather than investor. They tend to be more interested in the physical products and benefits such as early delivery of the good or discount prices, rather than showing support for the entrepreneurial and inventive spirit, which has been an important element for crowdfunding's popularity in the USA[49].

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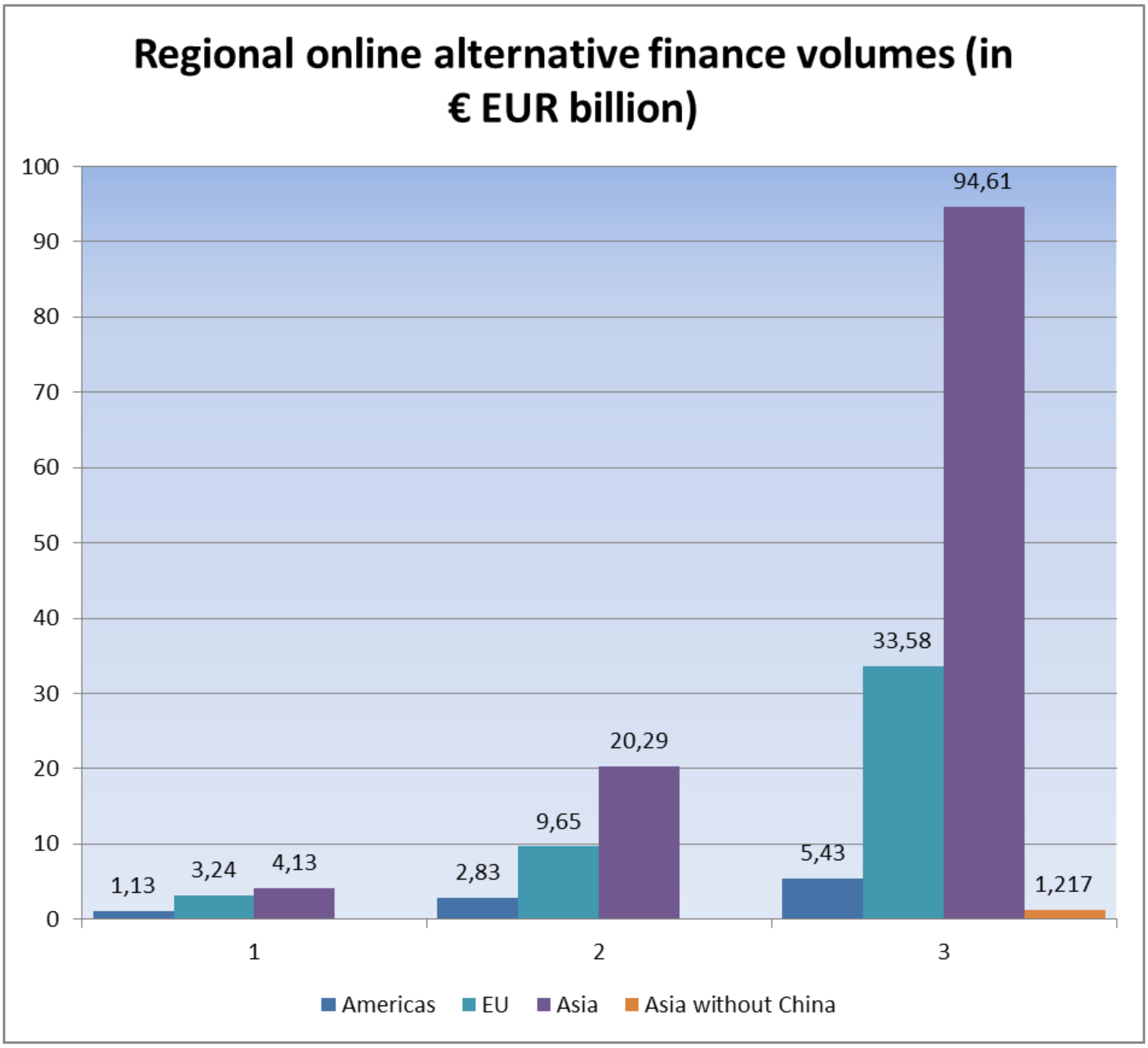
[45] China science and technology newsletter (30.06.2015), Special Issue: Popular Entrepreneurship and Mass Innovation in Full Swing, retrieved on 09. 01. 2017. from http://www.chinaembassy.org.nz/chn/zxgxs/kjhz/P020151123361006938250.pdf
[46] ibid
[47] The World Bank, Crowdfunding's Potential for the Developing World. 2013. info Dev, Finance and Private Sector Development Department. Washington, DC.
[48] Reuters (01.02.2016.), Chinese police bust $7.6B Ponzi scheme at P2P lender Ezubao. Retrieved 01. 08. 2017. from http://www.cnbc.com/2016/02/01/chinese-police-bust-76b-ponzi-scheme-at-p2p-lender-ezubao.html
[49] ibid 48

Table 3: Total regional online alternative finance volumes, in € EUR billion

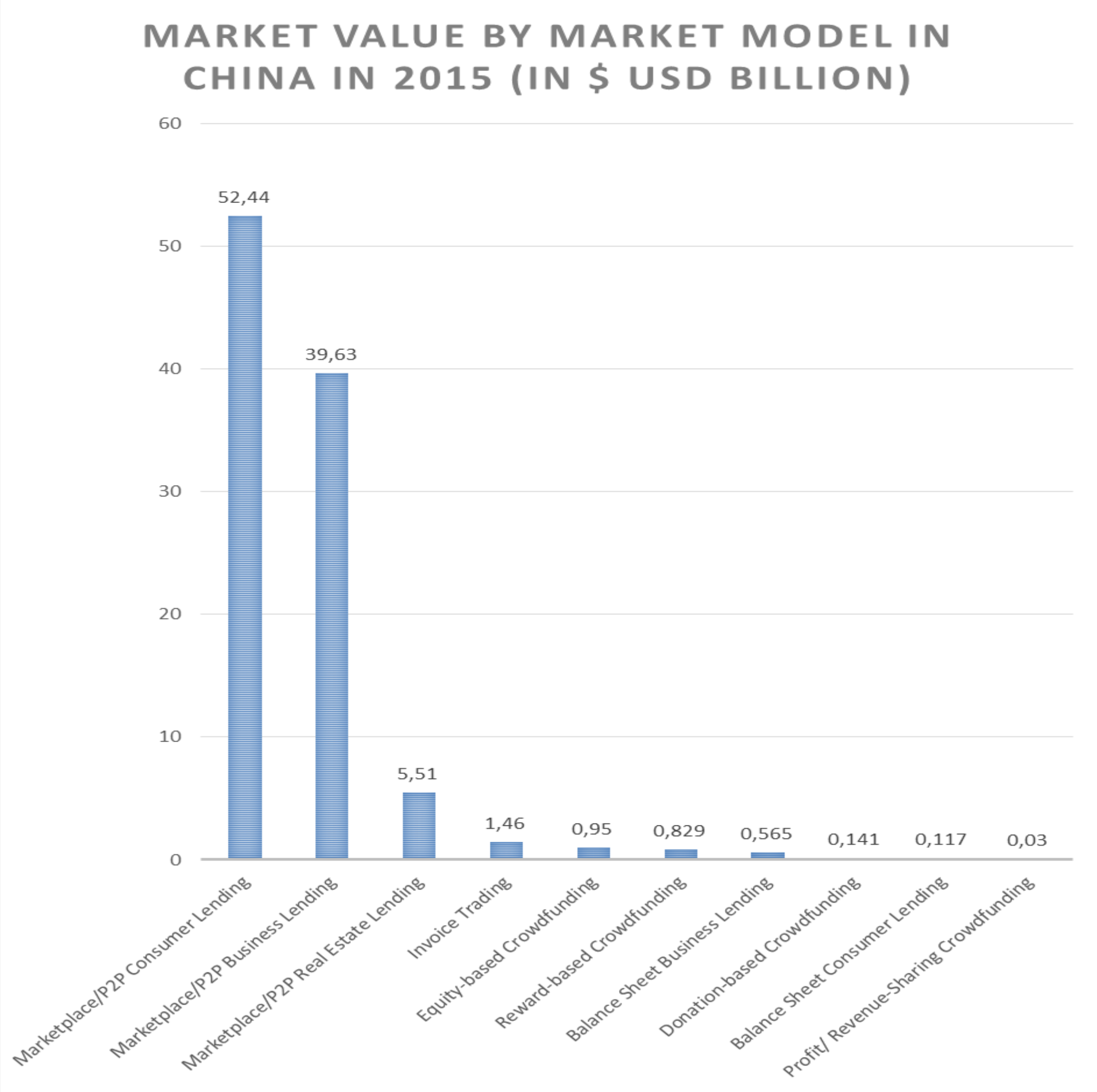


Source: Sustaining momentum, the 2nd European alternative finance industry report, Cambridge Centre for Alternative Finance, September 2016

Table 3. shows the incredible rate of growth in total online finance volumes in 2013-2015. While American market has grown 480% in these three years, and in EU the growth has been 1036%, Asia has grown for the incredible amount of 2290%. This figure looks even more impressive when we take into account that out of the 94.61 billion € in 2015 in Asia only 1.217 billion € was made outside of China. This number includes marketplace / P2P consumer lending, balance sheet consumer lending, marketplace / P2P business lending, balance sheet business lending, marketplace / P2P real-estate lending, invoice trading, equity-based crowdfunding, equity-based real estate crowdfunding, reward-based crowdfunding, donation-

based crowdfunding and revenue/profit-sharing crowdfunding[50]. While most of the above mentioned finance models do not fall into traditional definitions of crowdfunding, the incredible rate of expansion of online alternative financing models show the fertile ground for the development of crowdfunding, which happens practically exclusively online.

Table 4. Market value by market model in China in 2015, in $ USD billion



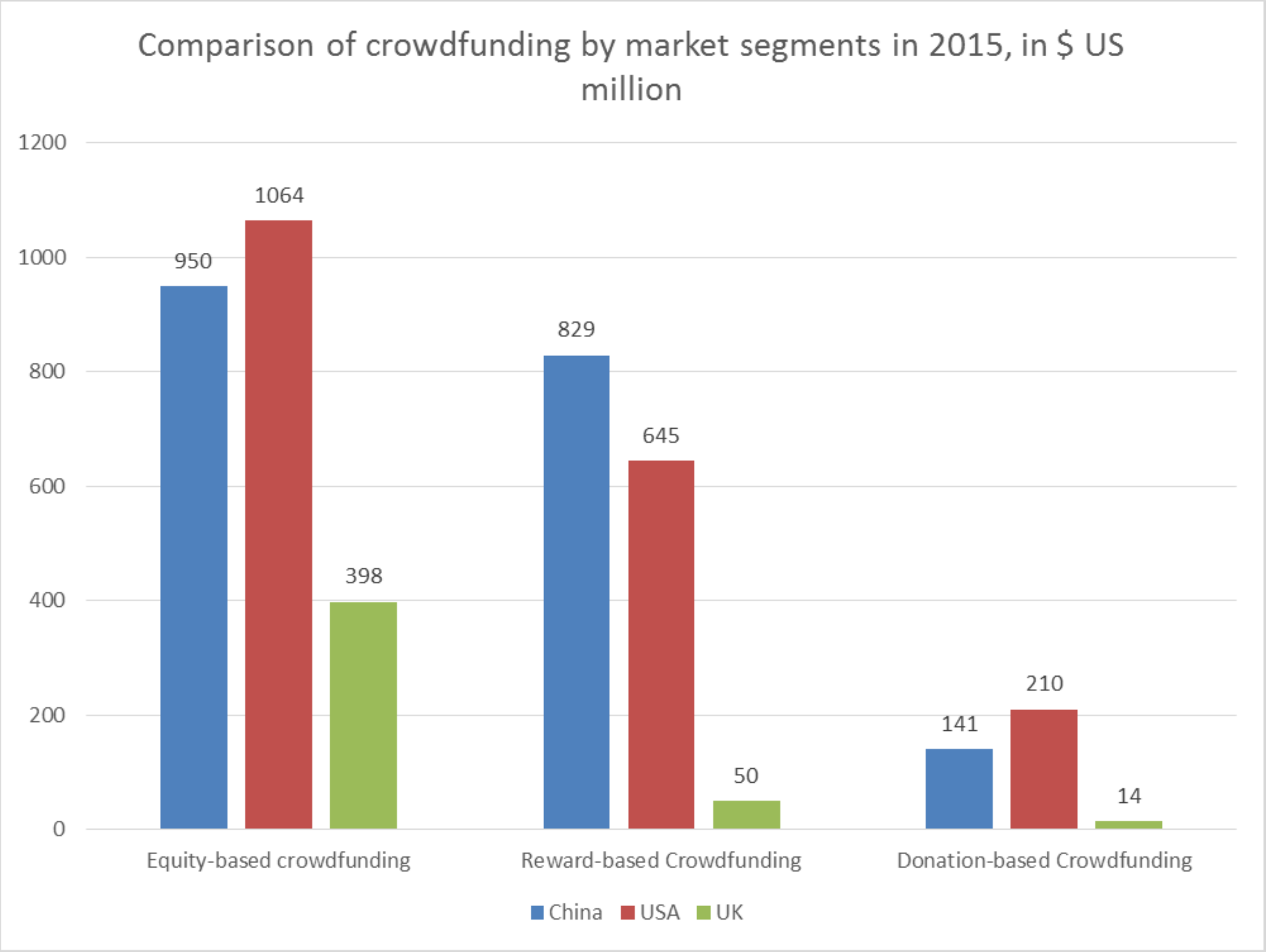
Source: Harnessing Potential: The Asia-Pacific Alternative Finance Benchmarking Report, Cambridge Centre for Alternative Finance, March 2016)

[50] Zhang B., Deer L., Wardrop R., Grant A., Garvey K., Thorp S., Ziegler T., Ying K., Xinwei Z, Huang E., Burton J., Chen H., Lui A., Gray Y., Harnessing Potential: The Asia-Pacific Alternative Finance Benchmarking Report, 2016, Cambridge Center for Alternative Finance, Cambridge, UK. Retrieved 07. 01. 2017. from https://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/ publications /harnessing-potential/#.WHvgjFxsxaQ

Table 4. shows us the distribution of market value by market model for online alternative finance in China in 2015. The four models of crowdfunding indicated (Equity-based crowdfunding, Reward-based Crowdfunding, Donation-based Crowdfunding and Revenue-based / Profit Sharing Crowdfunding) provide a market volume of $2 billion.

3.2. Comparison with United States of America and United Kingdom

Table 5. Comparison of crowdfunding by market segments in 2015, in $ US million



Source: Sustaining momentum, the 2nd European alternative finance industry report, Cambridge Centre for Alternative Finance, September 2016, Harnessing Potential: The Asia-Pacific Alternative Finance Benchmarking Report, Cambridge Centre for Alternative Finance, March 2016, Pushing boundaries: The 2015 UK Alternative Finance Industry Report, Cambridge Centre for Alternative Finance, February 2016). Note: USA includes data for Canada, however, given the small amounts of money raised through crowdfunding in Canada, the impact in negligible.

Table 5. shows the comparison of the amount of volume of transactions in three main models of crowdfunding for the three biggest crowdfunding markets in the world: China, USA and United Kingdom. While the crowdfunding market has been developing for quite a while in the

USA and United Kingdom has not lagged behind much, China has managed to pull ahead of the USA market in just 5 years (between 2011 and end of 2015).

In comparison of segments, the cultural differences between Chinese and other users can be easily viewed from the chart. As we gave previously said, a Chinese user tends to act more like a buyer, rather than the investor. Therefore, China is taking a large lead in reward-based crowdfunding. On the other hand, USA takes precedence in equity-based crowdfunding, highlighting the investor culture. This is especially evident for the users from the United Kingdom, whose preference for the equity-based crowdfunding take up the largest ratio of total amount of market volume. Such user behavior will probably change in the future given the changing nature of Chinese society.

3.3. Legal framework of crowdfunding in China

Chinese financial market is traditionally dominated by state-owned banks, and compared to the financing models such as direct loans, initial public offerings, or bond issuances, equity-based crowdfunding is still in its embryonic stage[51]. Conversely, there is no single legislative source regulation crowdfunding, such as JOBS Act in USA or the Financial Services and Markets Act in the United Kingdom. In the period between 2005 and 2013 China was regulating the banking sector, achieving greater stability and security, trying to achieve the ultimate goal of “full banking service coverage”[52]. However, the period also saw the emergence of microfinance services, such as P2P lending, microcredit companies, village banks, etc. At the same time, non-traditional forms of digital finance have grown very rapidly in a very short time in China, bringing major challenges to policymakers and regulators[53]. For example, a major hurdle for the development of equity-based crowdfunding in China is the strict distinction between public and private offerings. Generally, the definition of a public offering is quite crystallized, but crowdfunding invades the traditional supervisory arena of public offerings by encouraging online private offerings to the general public via an Internet

[51] Hu T., Yang D., The People’s Funding of China: Legal Development of Equity Crowdfunding – Progress, Proposals, and Prospects (IMI Working Paper No. 1508 {EN}), 2015, International Monetary Institute, Beijing, China.
[52] Weihuan T, Arner D., Buckley P. (September 2015), Regulation of digital financial services in China: Last mover advantage?, Tsinghua China Law Review (Vol. 8:25).
[53] ibid

platform[54]. The transfer of equity to non-specific persons and/or to more than 200 specific targets is deemed to be an issue of securities to the public and is subject to approval by state administration, in accordance with the Criminal Law. In China, the qualification requirements and approval standards for the public issue of securities are highly rigorous and thus, it is unlikely that small and medium-sized enterprises (SMEs) and start-up enterprises will be eligible for the public issue of securities. Furthermore, the cost of publicly issuing securities is far too high to be borne by SMEs and start-ups, and is too expensive compared with the amount of the capital raised. Thus, it is unrealistic for SMEs and start-ups, to conduct fundraising by strictly complying with the requirements for a public issue of securities because the approval standards required by the state administration are unlikely to be met[55].

Another issue is the definition of non-specified investor. This is usually circumvented by crowdfunding platforms by prior registration and approval of the investor by the platform, and by limiting the percentage of contribution so as to stay within the limits of 200 investors[56].

The Ezubao case and the issues mention above had led the Chinese government to act on regulating the crowdfunding, especially so after 2014 when the crowdfunding boom began to take place. In December 2014 The Securities Association of China has published the Consultation Draft called “Measures for the Administration of Private Equity Crowd Funding”, thus for the first time producing specific regulation for crowdfunding. The requirements for the investors were lowered, though by many, they have remained high. The draft regulations require investors to be accredited, meaning that anyone who wants to invest in equity crowdfunding projects must meet at least one of the following requirements: Invest at least RMB 1 million in a single project; Possess net assets of RMB 10 million; or Possess financial assets of RMB 3 million and having an annual income of at least RMB 500,000 for the past five years[57].

[54] Hu T., Yang D. (December 2015), The People’s Funding of China: Legal Development of Equity Crowdfunding – Progress, Proposals, and Prospects (IMI Working Paper No. 1508 {EN}), International Monetary Institute, Beijing, China.

[55] Peng W., Equity-based Crowd-funding and its Supervision in China Today, 2015, China Law Insight. Retrieved on 09. 01. 2017. from http://www.chinalawinsight.com/2015/04/articles/securities/equity-based-crowd-funding-and-its-supervision-in-china-today/

[56] Weihuan T, Arner D., Buckley P., Regulation of digital financial services in China: Last mover advantage?, 2015, Tsinghua China Law Review (Vol. 8:25).

[57] Zolzaya Erdenebileg (16. 11. 2016.), Better Together: The Potential of Crowdfunding in China, China Business review, retrieved 07. 01. 2017. from https://www.chinabusinessreview.com/better-together-the-potential-of-crowdfunding-in-china/

In March 2015, the General Office of the State Council released the Guiding Opinions on Expanding Maker Space to Promote Innovation and Business Startups by General Public.
More recently, in July 2015, China's central bank and several other relevant government departments issued guideline to regulate the general online finance industry. In August 2015, the China Securities Regulatory Commission (CSRC), the supervising government body for crowdfunding, announced that it would begin inspecting online equity financing platforms and assessing any possible illegal activities[58]. In December 2015, the China Banking Regulatory Commission (CBRC) issued the first draft for online lending, and in August 2016, announced the first official rules. This development indicates that crowdfunding will soon be subject to more specific regulatory requirements[59].

The requirements in other legal documents, such as the Criminal Law, PRC Securities Law, Offenses Against Company and Enterprise Management Order and Crimes of Undermining the Order of Financial Management were not changed at this time.

3.4. Proposals for the legal framework for crowdfunding

Chinese government has shown determination to strengthen the legislative framework for crowdfunding. It faces classical dilemmas in this area – whether to introduce stricter laws and therefore provide more security for the investors, or to reduce the criteria for crowdfunding participation, therefore opening more space for embezzlement and fraud. Hu and Yang (2015) argue that any such development has to be in line with the existing Chinese legislation and culture. Otherwise, it may "easily become descriptive, mechanical, and perfunctory elements with tenuous practical value or legislative significance"[60]. Although the Chinese government has voiced the complete dedication for the growth of economy based on mass innovation and entrepreneurship with a market orientation (China science and technology newsletter 2015), the rather non-flexible legislation does not follow those guidelines.

[58] Xinxua, China to regulate online equity financing platforms, 2015, retrieved 09. 01. 2017. from http://english.gov.cn/state_council/ministries/2015/08/08/content_281475163531038.htm
[59] ibid
[60] Hu T., Yang D., The People's Funding of China: Legal Development of Equity Crowdfunding – Progress, Proposals, and Prospects (IMI Working Paper No. 1508 {EN}), 2015, International Monetary Institute, Beijing, China

The proposals are:

1. To better define the illegal fundraising in PRC Criminal Law. This crime is most often linked with false advertising, but as it is not strictly defined, it may or may not be an obstacle for the development of crowdfunding[61]

2. Provide investor with more control over the investment. Current framework allows for only basic information and monitoring rights, which is not adequate protection for the investors right of return. Potential conflicts of interest should be announced up front, before the contract is made. This includes any financial interests of the fundraising portal and any and all relations between the portal and the fund-receiver, therefore ensuring full disclosure[62]

3. To lower the investor qualification and therefore truly allow the wider crowd to participate in crowdfunding[63]

4. Clarify the identity and function of the equity crowdfunding platform. At the moment, the Contract Law and Securities Law (virtually unchanged from 1992) do not provide for clearly delineated obligations that such platforms must adhere to. By better defining the contract obligations between the platform and the user, users will be provided more security for their investments without any perceived loss of effectiveness of the system[64]

Although China is a latecomer to the crowdfunding movement, it has quickly embraced the movement and by the metrics studied in this paper, taken the world lead in the amount of total volume of funds in both the online alternative finance and crowdfunding. The sudden development has caught government regulators unprepared, despite similar trends in other leading economies. The size and rate of growth of Chinese economy, number of potential

[61] China science and technology newsletter (30.06.2015), Special Issue: Popular Entrepreneurship and Mass Innovation in Full Swing, retrieved on 09. 01. 2017. from http://www.chinaembassy.org.nz/chn/zxgxs/kjhz/P020151123361006938250.pdf

[62] Li, J., Equity Crowdfunding in China: Current Practice and Important Legal Issues (September 19, 2016). Available at SSRN: https://ssrn.com/abstract=2842752 or http://dx.doi.org/10.2139/ssrn.2842752

[63] Hu T., Yang D. (December 2015), The People's Funding of China: Legal Development of Equity Crowdfunding – Progress, Proposals, and Prospects (IMI Working Paper No. 1508 {EN}), International Monetary Institute, Beijing, China

[64] ibid

users, unique combination of social and economic system, a specific legal system and many other factors complicate the development. In terms of development potential, it is enormous. Yet, a wish for harmonious and secure development is not quite as simple to fulfil. The legal framework is non-specific and undefined. Better, more concise regulation is desirable, though any regulation carries the risk of over norming the market, thus strangling its development. China has the unique advantage of being able to observe the rules already implemented in other economies and therefore pick and choose the most successful practices. The resoluteness of Chinese government to stop fraudulent practices such as the Ezubao case is commendable from every angle, unless it leads to the future regulation that is too strict, therefore preventing the even wider spread of the model, especially the equity crowdfunding. China has all the prerequisites to become world leader in crowdfunding - it will be most interesting to watch its development.

4. EQUITY CROWDFUNDING

Equity crowdfunding is a novel and especially interesting form of crowdfunding, providing many opportunities and dangers. In this chapter it will be explored in greater detail.

4.1. Definition and problems

When we mention crowdfunding, obtaining equity is not the first reference that comes to mind. The most common models used today, even though the definition of crowdfunding is not internationally established is the division to donation, reward, lending and equity crowdfunding. These models have the crowd aspect (usually defined as a limited or unlimited number of previously unattached persons), open call over internet and financing aspect in common (meaning that some type of financial exchange must have taken place). They differ wildly in other aspects, such as the expectance of return (non-existing in case of donation), type of return (material or financial), longevity (single action or permanent property in case of equity acquisition) and amount of finance pledged (typically lower in case of donation and higher in case of lending or equity). As such, they carry different levels of risk, yields and complexity of procedures for the receiver and the investor. Crowdfunding has the potential to become a 96B $ industry[65].

Equity-based crowdfunding (usually defined as crowdinvesting), in which funders receive compensation in the form of fundraiser's equity-based revenue or profit-share arrangements. In other words, the entrepreneur decides how much money he or she would like to raise in exchange for a percentage of equity and each crowdfunder receives a pro-rata share (usually ordinary shares) of the company depending on the fraction of the target amount they decide to commit. For example, if a start-up is trying to raise $50,000 in exchange for 20% of its equity and each crowdfunder provides $500 (1% of $50,000), the crowdfunder will receive 0.20% (1% of 20%) of the company's equity[66].

Equity capital can be seen as an alternative to traditional funding practices such as angels investment, venture capital, loan, own capital, or other. While there are some other advantages for the other forms of fundraising (for example, mentorship which comes with

[65] The World Bank, Crowdfunding's Potential for the Developing World. 2013. info Dev, Finance and Private Sector Development Department. Washington, DC.

[66] Wilson, K., Testoni, M. (August 2014), The role of equity crowdfunding in Europe's capital markets, Brueger Policy contribution Issue, 2014/9.

angel investing), equity crowdfunding is sometimes the only possibility for small and medium enterprises (SMEs) and start-ups which for any reason don't have access to other methods. Crowdfunders are typically first-time entrepreneurs. Unlike investors in other entrepreneurial finance settings, they cannot count on investment banks to stimulate demand[67]. When valuing to take an equity position in start-ups, venture capitalists and business angels rely heavily on face-to-face interactions and personal relationships. In the crowdfunding setting, personal communication tends to be replaced by pseudo-personal communication over the Internet. Also, often those looking for funding opportunities do not have sufficient information about potential sources of capital. This results in a problem of informational inefficiency that is fostered by the failure to match sources of capital with opportunities[68].

With the purchase of equity in a company, the investor shares the risk of the complete loss of the investment, if the company is not run successfully. They typically lack the experience and capability to evaluate different investment opportunities[69] and, due to fixed costs, have limited opportunity to perform due diligence[70]. For these reasons, a large information asymmetry exists between the entrepreneur and investor. This can be mitigated to some extent by more extensive regulation, but that comes with negative consequences - cost of registration and other administration increases, the process lengthens and therefore the entire point of crowdfunding as an easy access to capital and investment opportunities using small amounts of money is defeated.

Equity crowdfunding therefore caters an exponentially growing niche of alternative financial investment opportunities. It solves some of the problems with the classical fundraising methods. It is not limited in size - campaigns of up to several million $ have already been successfully finished. Rather, the risk of fraud because of the information asymmetry is the greatest threat to the inherently risky nature of placing an investment. To some degree, through introducing certain limitations, national legislations have remedied the risk to a

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[67] Wismara, S. (2014), Equity Retention and Social Network Theory in Equity Crowdfunding, Conference on National Systems of Enterpreneurship, Mannheim, Germany

[68] Mitra D. (2012), The role of crowdfunding in entrepreneurial finance, Delhi Business review, Vol.13.No.2 (July – December 2012)

[69] Ahlers, G. K., Cumming, D., Günther, C., & Schweizer, D. (2015). Signaling in equity crowdfunding. Entrepreneurship Theory and Practice, in press.

[70] Agrawal, A. K., Catalini, C., & Goldfarb, A. (2013). Some simple economics of crowdfunding, NBER working paper.

certain extent. In the next chapter, we shall see the legal options and solution employ on the four biggest crowdfunding markets in the world - United Kingdom, United States of America, China and European Union.

4.2. Legal frameworks for equity crowdfunding

Given that it is by nature more strictly regulated then the other forms of crowdfunding, there is greater divergence in crowdfunding regulation between different countries. This subchapter will therefore explore the main markets in greater detail.

4.2.1. United Kingdom

For a long time, UK was considered to have the most advanced crowdfunding market in the world, and the crown still hasn't been taken away. A strong IPO tradition, the relevance and size of the London Stock Exchange and the Alternative Investment Market create basis for further development. In addition to structural factors, regulatory reasons underlie the development of the equity crowdfunding market in the UK. The regulatory setting for alternative finance in the UK, defined by the Financial Conduct Authority (FCA), is perceived as a properly regulated market with a set of well-defined asset classes[71]. Among them, equity crowdfunding is the class with the highest growth rates over recent years. FCA regulates loan-based and investment-based crowdfunding, while donation-based and prepayment or rewards-based crowdfunding are exempt due to the lack of financial gain from these activities[72]. The FCA publically acknowledged the full authorisation of 24 firms for equity crowdfunding activities as of March 2016[73]. The FCA defines the instruments traded on investment-based crowdfunding as "non-readily realisable securities" that are not listed on regulated stock markets, and are distributed and sold over the internet. Given this definition, the key activities performed by investment-based crowdfunding, especially those in the equity crowdfunding space, already fell under the FCA's regulatory purview. As such, requirements around disclosure, client monies, and promotion were already in place for platforms in the space. New rules pertaining to investment-based crowdfunding-related primarily to marketing

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[71] Wismara, S. (2014), Equity Retention and Social Network Theory in Equity Crowdfunding, Conference on National Systems of Enterpreneurship, Mannheim, Germany.

[72] Financial Conduct Authority website https://www.fca.org.uk/consumers/crowdfunding, accessed on 22. 9. 2016.

[73] Crowdfund Insider, A case of regulatory evolution: a review of the UK Financial Conduct Authority's approach to crowdfunding, 2016, retrieved 13. 04. 2017. from https://www.crowdfundinsider.com/2016/07/88046-case-regulatory-evolution-review-uk-financial-conduct-authoritys-approach-crowdfunding/

restrictions, in the form of consumer protection rules, which dictate how firms can make direct offers to retail clients, and how said retail clients are defined[74].

Based upon their ability to meet certain criteria, the FCA divides retail consumers into three categories: the high-net worth individual, the sophisticated investor and the ordinary retail investor. Depending upon the categorisation of the individual investor, a platform may only direct offer promotions to retail consumers that meet the following criteria:

- Certified high net-worth or sophisticated investors;
- Ordinary retail investors who receive regulated advice;
- Ordinary retail investors who invest less than 10% of net assets.

In this instance, firms are required to check consumer understanding of risks if not receiving regulated advice. Platforms operating in the investment-based crowdfunding space must also verify that the retail investor is aware of the risks associated with their activity[75]. FCA regularly updates the rules and publishes reviews which are open to public comment on its website.

Of note is the especially high satisfaction with the existing regulation. 89% of alternative finance platforms consider existing regulation “adequate and appropriate”[76]. The equity crowdfunding rules in the UK are therefore considered to be the reference rules, successful application of which has allowed UKs equity crowdfunding industry to achieve substantial growth.

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[74] Crowdfund Insider, A case of regulatory evolution: a review of the UK Financial Conduct Authority’s approach to crowdfunding, 2016, retrieved on 13. 4. 2017. from https://www.crowdfundinsider.com /2016/07/88046-case-regulatory-evolution-review-uk-financial-conduct-authoritys-approach-crowdfunding/

[75] ibid

[76] Zhang B., Wardrop R., Ziegler T., Lui A., Burton J., James A., Garvey K., Sustaining Momentum: The 2nd European Alternative Finance Industry Report, 2016, Cambridge Center for Alternative Finance, Cambridge, UK, retrieved on 07. 01. 2017. from https://www.jbs.cam.ac.uk/faculty-research/ centres/alternative-finance/publications/sustaining-momentum/#.WHvjK1xsxaQ

4.2.2. United States of America

In the United States of America (USA), as a general rule, securities offered to the general public must be registered with the Securities and Exchange Commission (SEC). A notable exemption to this rule are offers made to accredited investors – individuals with a net worth of at least $1,000,000 or who have income of at least $200,000. Apart from this, USA legislation previously allowed for few exceptions, making equity crowdfunding practically inoperable[77].
The situation changed in 2012 with the Jumpstart Our Business Startups (JOBS) Act. Under this act, issuers are not required to file a registration statement with the SEC or at the state level if:

- the amount raised does not exceed $1,000,000 during a 12-month period;
- the transaction is conducted through a broker or funding portal registered with the SEC;
- the amount sold to a single investor does not exceed the greater of either $2,000 or 5% of the annual income or net worth of such investor if either the annual income or the net worth of the investor is less than $100,000, and 10% of the annual income or net worth of such investor if either the annual income or net worth of the investor is equal to or more than $100,000. In any case, the maximum aggregate amount sold to a single investor shall not exceed $100,000.

The issuer discloses the required information to potential investors. In particular, if the aggregate target offering amount is equal to or below $100,000, issuers must provide their most recent income tax returns and financial statements, which must be certified by the principal executive officer of the issuer. For issues of more than $100,000 but less than $500,000, financial statements must be provided and reviewed by a public accountant, who should be independent from the issuer. Furthermore, the accountant must use professional standards and procedures for the review. For issues of more than $500,000, audited financial statements must be provided by the issuer[78].

The final part of these rules, Tier III, entered into force on October 30, 2016, and therefore allowed for true equity crowdfunding. As part of the provision of the law, three new

[77] Griffin, Z. J., Crowdfunding: Fleecing the American Masses, 2012, available at SSRN: http://ssrn.com/abstract=2030001

[78] Wilson, K., Testoni, M., The role of equity crowdfunding in Europe's capital markets, 2014, Brueger Policy contribution Issue, 2014/9

institutions have been founded to provide education and advocacy: National Crowdfunding Association, Crowdfunding Professional Association and CrowdFund Intermediary Regulatory Advocates.

4.2.3. China

China has been a latecomer to the crowdfunding wagon, but has since benefited from the experience of the other countries. The unregulated market allowed for some major frauds to be committed, especially the Ezubao. Ezubao was accused of operating a large Ponzi scheme and losing about 50 billion CNY ($7.6 billion) from about 900,000 investors (Reuters 2016). Such happening encouraged Chinese government to start work on a stricter regulation. In December 2014 The Securities Association of China has published the Consultation Draft called "Measures for the Administration of Private Equity Crowd Funding", thus for the first time producing specific regulation for crowdfunding. The requirements for the investors were lowered, though by many, they have remained high. The draft regulations require investors to be accredited, meaning that anyone who wants to invest in equity crowdfunding projects must meet at least one of the following requirements:

- invest at least CNY 1 million in a single project
- possess net assets of CNY 10 million
- possess financial assets of CNY 3 million and having an annual income of at least CNY 500,000 for the past five years.

Limitations on "unknown investor" and a limit of 200 investors per company remained in place. Furthermore, with Guiding Opinions on Expanding Maker Space to Promote Innovation and Business Startups by General Public from March 2016 and new rules on online lending from August 2016, China has demonstrated the intention to regulate crowdfunding market more strictly then before, and seemingly in a less flexible way then the UK or USA. The impact of such actions remains to be seen.

4.2.4. European Union

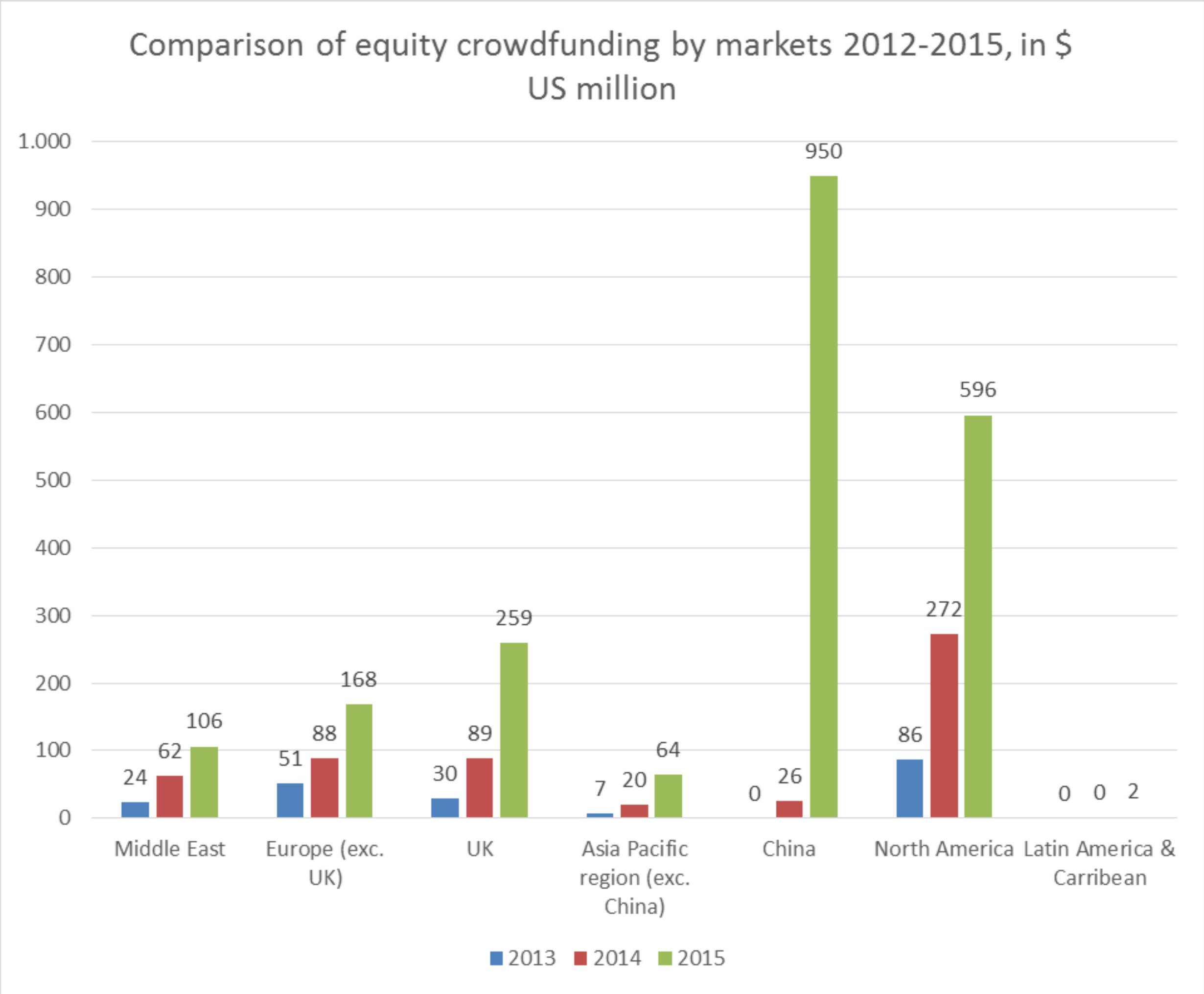
Although the European Union is not a single state, it does have unique regulatory authority on the market issues and its decisions impact the legislative of all 27 Member countries. After the Capital Market Union Action plan was defined, special working groups of the European Commission were founded. Several reports and communications were produced on the crowdfunding. For now, the European Commission declaratively supports and promotes crowdfunding, but hasn’t announced the intention to more closely regulates it. Still, some rules still apply for the crowdfunding actions, for example: the Prospectus Directive, the Payment Services Directive, MiFID, CRD IV, AIFMD, the Consumer Credit Directive, the Distance Marketing of Financial Services and the Regulations on Capital Requirements, Venture Capital, European Social Entrepreneurship Funds and possibly some other, like the Unfair Commercial Practices Directive, Unfair Contract Terms Directive and Data Protection Directive. Only some of these instruments would apply to a given business model and only in specific cases, depending on the financial crowdfunding campaigns design (such as the amount of money being raised).

Therefore, until the Commission deems that the action is necessary, the EU member states have the freedom to regulate crowdfunding as they see fit (which, indeed, seven states have already done).

4.2.5. Size of the equity crowdfunding market

Although not comparable with traditional financing instruments such as direct investments, bank loans and venture capital, the rate of growth of the equity crowdfunding is very high.

Table 6. Comparison of equity crowdfunding by markets 2012-2015, in $ million



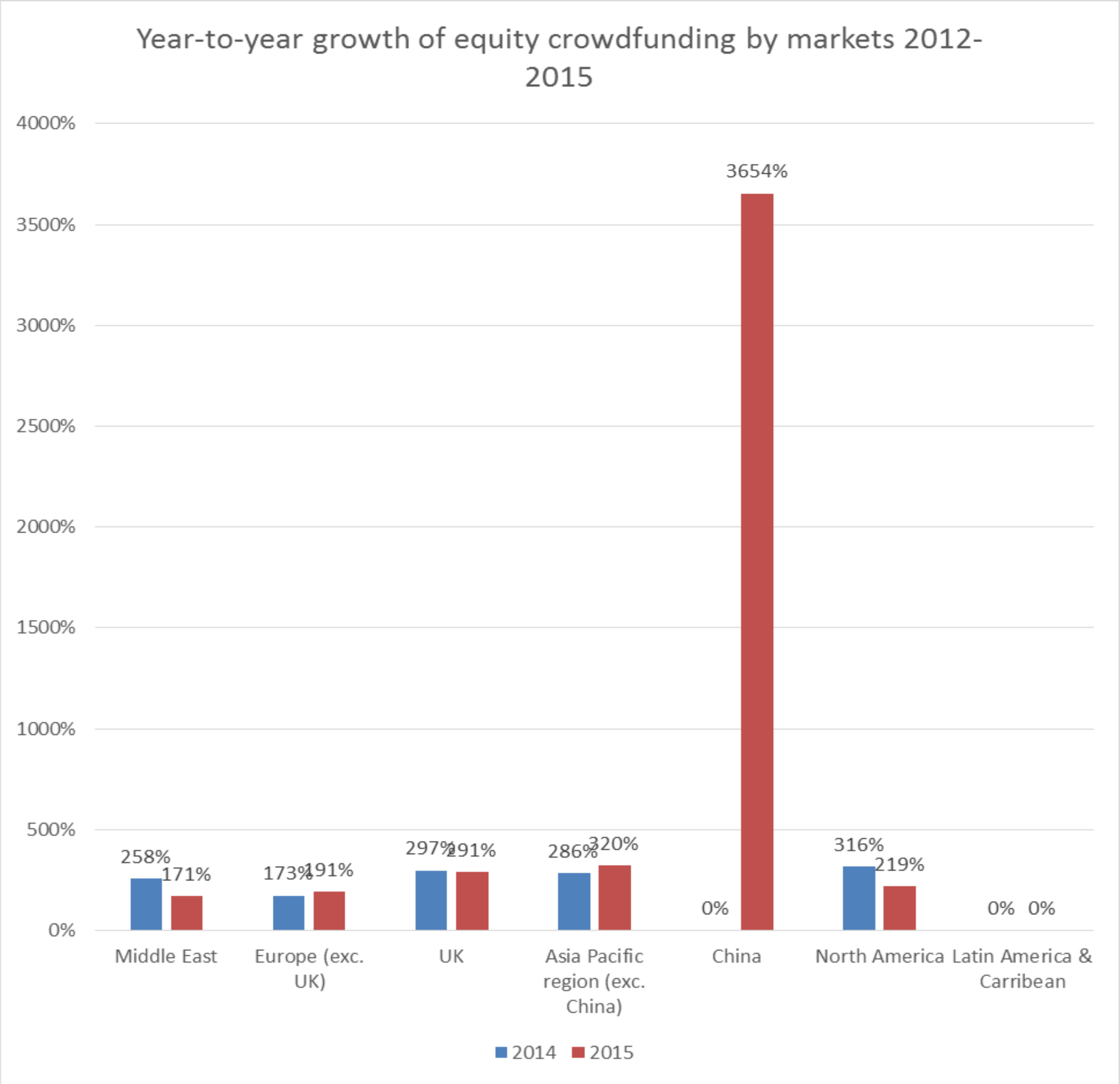
(Source: The Africa and Middle East, alternative finance Benchmarking report, Cambridge Centre for Alternative Finance, February 2017, Breaking New Ground, The Americas alternative finance benchmarking report, Cambridge Centre for Alternative Finance, April 2016, Sustaining momentum, the 2nd European alternative finance industry report, Cambridge Centre for Alternative Finance, September 2016, Harnessing Potential: The Asia-Pacific Alternative Finance Benchmarking Report, Cambridge Centre for Alternative Finance, March 2016, Pushing boundaries: The 2015 UK Alternative Finance Industry Report, Cambridge Centre for Alternative Finance, February 2016).

Note: USA includes data for Canada, however, given the small amounts of money raised through equity crowdfunding in Canada, the impact in negligible.

Looking at the data in Table 6, it is obvious that the China dominates the rest of the world in the total amount of financing secured through equity crowdfunding. The special circumstances of unregulated and unhindered market couplet with the explosive GDP growth, huge population and economy together with the technically savvy population have created fantastic opportunities which have been used by the Chinese. USA, where the crowdfunding originated from, is a strong second market, with UK in the third place with a very highest per capita amount of finance. The rest of European Union countries is trailing far behind the UK, probably because Germany, the strongest economy in EU, didn't yet regulate the equity crowdfunding. Also, perhaps even more important, investment in EU countries traditionally relies more on bank loans, with venture capital and other forms of investments being secondary sources of capital. Middle East is not far behind, thanks to the very strong start-up scene in Israel and some equity crowdfunding in Saudi Arabia and Qatar. The rest of Asian countries with the exception of Australia are behind, and equity crowdfunding in Africa, Latin America and Caribbean is almost non-existent.

The growth rate in China in 2015 has been an incredible 3650% in 2015, while no growth in 2014 symbolizes how late crowdfunding has started in that country. Although the regulatory framework is not yet completely set in place, it seems it will be difficult to stop the incredible growth. Rate of growth in USA seems to be slowing down in 2015, although the new Tier III of the JOBS act entered into force in 2016 so the USA market should accelerate growth in the future. UK and Asia Pacific region seems to have a steady increase, while the Middle East is slowing down. This is somewhat surprising, given that it is unknown if the Islamic banks gave been counted given that their operating model (no interests but rather ownership from the loans).

Table 7. Year-to-year growth of equity crowdfunding by markets



Source: The Africa and Middle East, alternative finance Benchmarking report, Cambridge Centre for Alternative Finance, February 2017, Breaking New Ground, The Americas alternative finance benchmarking report, Cambridge Centre for Alternative Finance, April 2016, Sustaining momentum, the 2nd European alternative finance industry report, Cambridge Centre for Alternative Finance, September 2016, Harnessing Potential: The Asia-Pacific Alternative Finance Benchmarking Report, Cambridge Centre for Alternative Finance, March 2016, Pushing boundaries: The 2015 UK Alternative Finance Industry Report, Cambridge Centre for Alternative Finance, February 2016).

Note: USA includes data for Canada, however, given the small amounts of money raised through equity crowdfunding in Canada, the impact in negligible.

5. CONCLUSION

Crowdfunding can be a powerful propellant of the SME financing, and therefore of the economic growth in the European Union. It allows for financing of companies which may otherwise not be able to get funded by the most traditional financing instrument in EU, bank loans, and it does so with lower costs for the entrepreneur. At the same time, it allows for a huge amount of capital stored in citizen bank deposit to be activated. The success of the crowdfunding in USA shows how good regulation can open up new possibilities for growth. Yet, the fragmentary nature of national legislation is limiting crowdfunding to national borders, with huge obstacles for cross-border operations, if appropriate regulation is available at all. The European Commission, which monitors the developments, should proceed and start building European regulatory framework in order to remove those obstacles and fully harness the power of crowdfunding.

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The forever changing legal and financial landscape which will shape the development of crowdfunding is impossible to exactly predict. However, without hesitation, it can be concluded that the growth will continue in the future. It is to be expected that great many countries, especially in the EU, will continue to develop their own legislative frameworks, even without the initiative from the European Commission.

The legislative model in place in the UK has proved itself to be successful, given that it has ensured the steady growth and a high user satisfaction. JOBS Act has entered into effect too recently to be accurately measured, and it will be most interesting to obtain the final number from the accurate reports for 2016 and thus further the conclusion that proper regulation is essential for the equity model to become both legal and providing sufficient freedom and security for further development. China will again benefit from not being first and thus buy itself more time to implement the optimal model. The caution with which it has implemented the legislative changes after the Ezubao case shows that the government is aware of the possible danger of fraud. The implications should be taken seriously, especially by those countries which don’t have a proper legal framework in place.

Although still in infancy, the equity crowdfunding is general gaining more traction in the world and will increase in importance. The more complex nature of this particular model provides great benefits, unlocking new opportunities for both entrepreneurs and investors, but unlike more basic crowdfunding models (more eminent donation and reward-based), lessons learned so far teach us that equity crowdfunding requires more protection for the investors. It is up to the national governments (or ideally supra-nation organizations to emphasize inherent international aspect) to respond appropriately.

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