

**REGULATORY CHALLENGES IN INVESTMENT-BASED CROWDFUNDING:
THE MODEL OF THE UNITED STATES AND LESSONS FOR HUNGARY**

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Abstract

This thesis examines what are the major issues that legal regulation has to address in connection with investment-based crowdfunding. In this type of crowdfunding investors receive some kind of security in return for their investments. The purpose of this thesis is to detect whether and under what conditions could Hungarian legal regulation introduce investment-based crowdfunding rules. The thesis provides a general discussion about the risks and advantages of investment-based crowdfunding in the context of startup finance, and provides a detailed evaluation of the regulatory issues in connection with this alternative financing instrument. As a comparative example of possible solutions, this thesis examines the regulatory model of the United States adopted on investment-based crowdfunding. Based on the general evaluation and on the conclusions of the model of the United States this thesis concludes that the current regulatory framework of Hungary is not suitable for a viable investment-based crowdfunding system. In this regard, the thesis provides certain recommendations on further steps to create appropriate pre-conditions for investment-based crowdfunding.

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Introduction

1. *The increased interest in crowdfunding*

In recent years, the success of Kickstarter, Indiegogo and similar crowdfunding websites has drawn attention to this innovative and evolving method of raising funds through the internet for a wide range of ideas and projects. This increasing interest may be attributed to a number of factors among which the most influential is also the most simple: money. Proponents of crowdfunding never fail to mention how significant is the amount of capital investment that has already been involved in this industry.¹ As of February 2016, the statistics of Kickstarter² show that it had alone successfully raised more than USD 2.2 billion for more than 100,000 project and the Massolution crowdfunding report for 2015 estimates that the global crowdfunding industry had reached almost USD 34.4 billion in that year.³ Specifically in Europe, statistical data on equity-crowdfunding also shows a notable growth. In 2014 equity-crowdfunding platforms of the United Kingdom alone raised EUR 111 million, while the rest of Europe also reached EUR 82.6 million in that year.⁴

Apart from its broad economic significance, crowdfunding is worthy of attention because it provides the entrepreneurial community with an innovative financing device that brings new investors, and therefore, additional capital into the investment sector. Also, it may serve as a marketing and market research tool exploiting new ways of advertising. Proponents of crowdfunding argue that the innovations that it brings to the capital markets are so unique that they cannot be replaced by other instruments, and therefore, they outweigh the disadvantages and risks that it are also inherent in crowdfunding. This thesis will later examine the drawbacks in detail

¹ David Mashburn, *The Anti-Crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies*, 63 EMORY LAW J. 127, 127 (2013). and Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption [article]*, UNIV. PA. J. BUS. LAW 973, 974 (2010).

² Kickstarter Stats — Kickstarter, <https://www.kickstarter.com/help/stats>. (Accessed on February 15, 2016).

³ *Global Crowdfunding Market to Reach \$34.4B in 2015, Predicts Massolution's 2015CF Industry Report*, <http://www.crowdsourcing.org/editorial/global-crowdfunding-market-to-reach-344b-in-2015-predicts-massolutions-2015cf-industry-report/45376>. (Accessed on February 15, 2016).

⁴ Sean Ennis, *Refining Regulation to Enable Major Innovations in Financial Markets*, Issues Paper DAF/COMP/WP2(2015)9 (OECD, Directorate for Financial and Enterprise Affairs Competition Committee 2015) 13.

but in order to understand the emerging support and enthusiasm around crowdfunding we have to take a glance at its unique benefits first.

As a general principle, crowdfunding is suitable for small and medium sized enterprises (SMEs) because size is a decisive factor for whether entrepreneurs are able to establish personal connection with the crowd to address and convince them to invest in the company. Crowdfunding may especially play an important role in the financing of SMEs at their early stages⁵, when they have no track record, reputation or customer base, they lack assets that could be used as collateral to receive credit⁶, and they only need a relatively small amount to launch their business.⁷ In connection with the special characteristics of startup companies crowdfunding presents several potential advantages over the traditional early stage financing instruments. Of course, these serve as another key reason for the increased interest surrounding crowdfunding in recent years.⁸

2. Advantages of crowdfunding over traditional financing

First of all, crowdfunding helps to fill the so-called *funding gap* in startup finance as traditional capital-raising methods are usually unavailable to startups at their earliest stage.⁹ Second, crowdfunding provides direct feedback from the targeted market in the very first phase of a project or product development.¹⁰ As a result of this early assessment of customer preferences a lack of market demand can already be detected when the crowd does not support a crowdfunding

⁵ Paul Belleflamme & Thomas Lambert, *Crowdfunding: Some Empirical Findings and Microeconomic Underpinnings*, SSRN Scholarly Paper ID 2437786, 3 (Social Science Research Network), Aug. 30, 2014.

⁶ Karen E. Wilson & Marco Testoni, *Improving the Role of Equity Crowdfunding in Europe's Capital Markets*, SSRN Scholarly Paper ID 2502280, 4 (Social Science Research Network), Aug. 29, 2014.

⁷ Strictly speaking *early stage* as a general term refers to all life stages of a company that takes place before the expansion stage. (At the expansion stage the firm is already operating as a going concern, i.e. produces and sells products, provides services, while it also seeks to expand its production and increase its revenues.) As opposed to this period the early stages include the *pre-seed* (when the idea and a tentative business plan is under development), *seed* (period of research, product development and market exploring), and *startup* (formation of the firm and its initial operation until expansion) stages of a business. Early stage is considered to be the first 3 to 5 years of the company's life during which the distinction of the above sub-categories is usually not clear. As a result there is no universally-accepted definition and duration of a startup period and the term early stage and startup stage is usually used interchangeably in related literature. See *Glossary of Key terms*, NEW APPROACHES TO SME AND ENTREPRENEURSHIP FINANCING 141–48 (OECD Publishing 2015).

⁸ Mashburn, *supra* note 1, at 139. Mashburn highlights four of these advantages (with regard to funding gap, market assessment, prelaunch community, and geographical barriers) but other authors add further characteristics to this examination.

⁹ C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SECUR. REGUL. LAW J. 195, 196 (2012). and Mashburn, *supra* note 1, at 139.

¹⁰ Virginia Robano, *Case Study on Crowdfunding*, CFE/SME(2013)7/ANN1/FINAL 1, 4 (OECD, Centre for Entrepreneurship, SMEs and Local Development), Jul. 8, 2015, at 1.

campaign, and therefore, the project does not even reach its launch.¹¹ Furthermore, as a third advantage, a successful campaign creates a supporting customer base around a product, even before actual manufacturing is started.¹² This prelaunch customer community may also generate a lasting attention¹³ that reduces marketing costs in later stages too, and therefore, mitigates a great burden for startups.¹⁴

Fourth, crowdfunding persuades new type of investors who are not solely guided by monetary motivations but are also attracted by the possibility to support a project for non-material reasons, for example, merely for the sake of the investment experience.¹⁵ Accordingly, crowdfunding may reach new investors who were not present at the capital market before because of limited financial resources or lack of interest in the traditional purposes of investing.¹⁶ Fifth, a crowdfunding campaign may reach a wider group of investors in a geographical sense too. It is conducted through an online platform that – at least in theory - makes it possible to collect funds from anywhere in the world.¹⁷ Last but not least, crowdfunding finally moves corporate financing to Web 2.0 in the sense of providing for a virtual community (interactivity and collaboration) for investors and entrepreneurs. This is an inevitable segment of economic development today when online social networking is part of everyone's life and part of the global society.¹⁸

3. Objectives and scope of this thesis

Encouraged by the innovative features and specific advantages of crowdfunding, a number of studies have been conducted to evaluate how it could promote economic growth and especially, advance the development of the startup and SME ecosystem.¹⁹ In addition to these

¹¹ Wilson & Testoni, *supra* note 6, at 7.

¹² Mashburn, *supra* note 1, at 139.

¹³ Peter J. Loughran et al., *The SEC Hands Out a Halloween Treat to Crowdfunding Supporters*, BUS. LAW TODAY 1 (2015).

¹⁴ Mónika Kuti & Gábor Madarász, *Crowdfunding*, 59 PUBLIC FINANCE Q. 355, 357 (2014).

¹⁵ Belleflamme & Lambert, *supra* note 5, at 4.

¹⁶ Kelly Mathews, *Crowdfunding, Everyone's Doing It: Why and How North Carolina Should Too*, 94 NC REV 276, 300 (2015). and Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. LAW REV. 561 (2015).

¹⁷ Belleflamme & Lambert, *supra* note 5, at 5.

¹⁸ Kevin Lawton & Dan Marom, *The Crowdfunding Revolution: Social Networking Meets Venture Financing*, 55 (Thecrowdfundingrevolution.com) (2010). and Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. LAW REV. 561 (2015).

¹⁹ OECD (2015), *New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments*, OECD Publishing, Paris. and *Unleashing the Potential of Crowdfunding in the European Union*, COM(2014) 172 final (European Commission), Mar. 27, 2014.

works, that mainly study the economy of crowdfunding, legal professionals have also examined the legislative requirements to introduce different types of crowdfunding in national legal systems and determined the necessary principles that should govern the regulation of crowdfunding. Such works mostly focus on a specific geographic area for example the European Union or compare the national legislation of European countries²⁰. In other cases the focus of research is the regulatory framework in the common law tradition, i.e. in the United Kingdom²¹ or the United States.²² However, it is hard to find research that would compare the general experiences of crowdfunding practices or that would deeply examine the regulatory models of the United States or the United Kingdom to draw conclusions for developing systems. The evaluation of their experiences is necessary and useful for any research on crowdfunding based on the simple fact that the first platforms started to operate in these countries²³

A research gap on crowdfunding especially exists with regard to Hungary even though the entrepreneurial community has already expressed interest towards this new instrument. In their view, the adoption of crowdfunding may help the development of a so-called startup-hub in Budapest, i.e. a capital for startup companies with facilitating regulatory and economic environment.²⁴ Unfortunately, no significant progress has been made to achieve this goal, not even on the level of professional debate. In light of the above, the purpose of this thesis is to promote a discussion about investment-based crowdfunding – in which investors receive some kind of security in return for their investments²⁵ – in Hungary. In order to evaluate whether and how

²⁰ Tanja Aschenbeck-Florange et al., *Regulation of Crowdfunding in Germany, the UK, Spain and Italy and the Impact of the European Single Market*, EUR. CROWDFUNDING NETW. JUNE (2013)., see also Kristof De Buysere et al., *A Framework for European Crowdfunding*, 61 EUR. CROWDFUNDING NETW. ECN (2012)., David Röthler & Karsten Wenzlaff, *Crowdfunding Schemes in Europe*, 2011 EENC REP. (2011). and Maria Staszkievicz et al., *Crowdfunding Visegrad: Analysis & Manual*, text Jan. 16, 2015.

²¹ Financial Conduct Authority, *The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-Readily Realisable Securities by Other media—Feedback back to CP13/3 and Final Rules*, 14 POLICY STATEMENT PS (2014).

²² Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN REV 879 (2010). and C. Steven Bradford, *Crowdfunding and the Federal Securities Laws [article]*, COLUMBIA BUS. LAW REV. 1 (2012).

²³ ArtistShare, an industry specific site was founded as early as 2003. See ArtistShare - Where the fans make it happen!, <http://www.artistshare.com/v4/>. Kiva, grew one of the leading crowdfunding sites in the US that since it was founded in 2005. See History | Kiva, <http://www.kiva.org/about/history#2004>.

²⁴ BudapestHUB working group, *Budapest 2.0.2.0 Runway - The Startup Credo*, Text (National Research, Development and Innovation Office), Nov. 18, 2013.

²⁵ See Section I.2 below.

investment-based crowdfunding could contribute to the development of the Hungarian startup ecosystem, this thesis will examine its regulatory challenges in the field of startup finance and evaluate the model of the United States as an example to address these challenges. Finally, this thesis will discuss the relevance of these issues in Hungary as well.

In this thesis the investment-based crowdfunding model of the United States will serve as a comparative example for two reasons. First, this regulation is an example of a highly advanced and detailed model, and based on a thorough legislative process that has been under way for several years. Consequently, the United States enacted a crowdfunding law (*Jumpstart Our Business Startups Act*²⁶) as early as 2012 and has already adopted the related implementing regulation (*Regulation Crowdfunding*²⁷). The second reason is the comprehensive public consultation that closely accompanied this legislative process involving lawyers, economists, non-equity based crowdfunding platforms and all other market participants that felt themselves concerned. This consultation process outlined both the practical and the legal issues concerning the equity crowdfunding regulation. The course of preparation and the statutory outcome (as answers to the questions raised) provide a perfect basis for a potential equity-crowdfunding system to learn from their experiences and their crafted solutions. In this regard, this thesis will show that investment-based crowdfunding is such a new instrument of legal engineering that borrowing from the United States is not excluded even by a civil law country, such as Hungary.

4. Outline of thesis structure

To accomplish the above objectives this thesis proceeds in four chapters. Chapter I provides an overview of crowdfunding within the general context of startup finance. It discusses the antecedents and the typology of crowdfunding and establishes the basic definition of investment-based crowdfunding that is used in this thesis. Subsequently, an outline about the general problems of startup finance is provided, with special regard on the funding gap that

²⁶ Pub. L. No 112-106, 126 Stat. 306 (to be codified in scattered sections of 15 U.S.C.) (2012).

²⁷ SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

concerns this field. The last section of Chapter I explains the solutions that crowdfunding offers with regard to these issues.

Chapter II discusses the regulatory challenges that investment-based crowdfunding regulation has to address. Accordingly, the questions of investor protection, due diligence, the “Lemons Problem”, securities regulation, exit opportunities in crowdfunding, and finally, the issues of regulating crowdfunding intermediaries are explained.

Chapter III examines the investment-based crowdfunding regulation of the United States. This part of the thesis outlines the development of investment-based crowdfunding in the U.S by introducing its early examples and the legislative gap that required regulation on this new capital-raising instrument. This is followed by a detailed presentation on the current regulatory framework on investment-based crowdfunding as adopted by the JOBS Act and Regulation Crowdfunding of the Securities Exchange Commission (SEC).

Chapter IV of this thesis summarizes the lessons of the previous chapters with regard to Hungary. This chapter explains the emerging attention towards startup finance and crowdfunding in Hungary, followed with a short summary of the European tendencies. Subsequently, the main rules of the Hungarian legal framework on investment-based crowdfunding offerings are presented with recommendations on the paths that Hungarian regulation should take. A few examples about the possible future of investment-based crowdfunding in Hungary is also provided.

Finally, this thesis ends with concluding remarks on the lessons for Hungary and about the research gaps that should be filled in the future with regard to investment-based crowdfunding.

Chapter I – Crowdfunding in the context of startup finance

1. *Antecedents of crowdfunding*

In order to understand the meaning and the special characteristics of different forms of crowdfunding, it is necessary first to take a closer look at their antecedents. It is common to all types of crowdfunding, that the basic idea finds its roots in crowdsourcing²⁸ and microlending²⁹ which themselves are relatively new concepts of corporate development and corporate finance. In crowdsourcing contributions are collected from the “crowd” in the form of ideas, feedback and solutions in order to develop corporate activities.³⁰ Of course, such cooperation requires a publicly accessible platform such as the internet, in which regard Wikipedia is a perfect example of internet crowdsourcing.

The other preceding concept of crowdfunding is microlending (or microfinance), which means the lending of very small amounts, typically to small entrepreneurial ventures. Crowdfunding constitutes a fusion of these two concepts (realized by digital technique) as they represent the core points of a crowdfunding transaction: microlending focuses on the contribution and the recipient (small amount of money provided to small enterprises), while in crowdsourcing the emphasis is on the contributors i.e. the crowd and on the platform in which they can be addressed.³¹ Complemented by the technical element, crowdfunding generally refers to an open call through the internet to collect small contributions from a large number of people for supporting small enterprises. Originally, this combination was used to fund charitable projects³², but the development of different types of crowdfunding gave way to its broader use in financing.

²⁸ Paul Belleflamme et al., *Crowdfunding: Tapping the Right Crowd*, 29 J. BUS. VENTUR. 585, 586 (2014).

²⁹ Bradford, *supra* note 22, at 28.

³⁰ Belleflamme et al., *supra* note 28, at 586.

³¹ Bradford, *supra* note 22, at 29.

³² Jean-Pascal Brun, *Crowdfunding: Placement Privé Ou Offre de Titres Au Public?*, 10 REV. TRIMEST. DROIT FINANC. 64, 64 (2013).

2. *Typology of crowdfunding*

As described above in Section I.1, crowdfunding is generally used as an umbrella term to describe a large group of fund-raising methods.³³ By synthesizing these activities we may distinguish four different models based on the type of compensation – if any – that investors receive in exchange for their investment. These are the *donation-based*, *reward-based*, *lending-based* and *equity-based crowdfunding* models.³⁴ In practice, even some hybrid forms of these types are used but one thing is common to all crowdfunding campaigns: the core is their clearly specified goal, i.e. the actual project that is to be carried out by the raised funds.³⁵

Donation-based crowdfunding is conducted for a project which the founders support for its specific cause without expecting (and receiving) any compensation. In case of *reward-based crowdfunding* the funders receive a non-financial, symbolic reward, such as a first or specific edition of the products (also referred to as the pre-purchase model³⁶) or even just the right to pre-order. *Lending-based crowdfunding* (*crowd-lending*) and *equity-crowdfunding* may be described together as the “financial return models”, since both of them offer some kind of monetary rewards to funders in exchange of their contribution.³⁷ In the case of *crowd-lending* the principal investment of the funders is returned to them in accordance with the specified terms of the campaign, with or without interest. Based on the fact that none of the participants are professionally engaged in lending activities this model is often called peer-to-peer lending.³⁸ From a legal point of view *equity-crowdfunding* is the most complex form of crowdfunding, as it involves profit-sharing with the investors, generally by way of issuing securities to them.³⁹ For this reason it is usually described as crowd-investing.⁴⁰ Strictly speaking, in case the crowdfunding offering exclusively involves debt

³³ Frank Vargas et al., *Understanding Crowdfunding: The SEC's New Crowdfunding Rules and the Universe of Public Fund-Raising*, 2015-DEC BUSINESS LAW TODAY 1 (2015).

³⁴ Wilson & Testoni, *supra* note 6, at 3.

³⁵ Proposed Rules on Regulation Crowdfunding, Release Nos. 33-9470; 34-70741, File No. S7-09-13, 6 (October 23, 2013) available at <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>.

³⁶ Bradford, *supra* note 22, at 16.

³⁷ *Unleashing the Potential of Crowdfunding in the European Union*, *supra* note 19, at 3. and Vargas et al., *supra* note 33.

³⁸ Bradford, *supra* note 22, at 20.

³⁹ *Id.* at 25.

⁴⁰ *Unleashing the Potential of Crowdfunding in the European Union*, *supra* note 19, at 3.

securities than no equity issuance takes place in the process, while on the other hand securities regulation identically applies to both of these types of crowdfunding. In view of this fact, the most accurate term to describe the type of crowdfunding which may involve either the purchase of debt or equity security is *investment-based crowdfunding*⁴¹ or *securities-based crowdfunding*.⁴²

2.1. Relevance of investment-based crowdfunding

In the course of its early development, crowdfunding did not involve the financing of commercial corporations. In this phase donation-based crowdfunding was especially conducted for philanthropic projects, while reward-based campaigns spread in the field of creative sector for funding artistic projects. Today, a wide range of sites still focus on these type of projects and industries, for example music or publishing⁴³. It can be observed from the bulk of crowdfunding campaigns are still carried out within the entertainment industry and do not involve the sale of securities. Accordingly, investment-based crowdfunding is still relatively new and it is usually stated that it covers the smallest part of the crowdfunding market.⁴⁴ However, the relevance of this crowdfunding type is constantly growing, especially in the field of startup finance for several reasons that will be discussed under Section II.4 below.

C. Steven Bradford argues that crowdfunding in the long run may only become a useful capital-formation tool if issuers are allowed to use its crowd-investing forms and provide financial returns (interest or securities) to investors.⁴⁵ In order to understand how can crowdfunding be a viable financing tool for startups it is first essential to know what are the inherent problems that need to be addressed in this field.

⁴¹ As recommended by the European Securities and Markets Authority (ESMA). *Opinion - Investment-Based Crowdfunding*, Opinion ESMA/2014/1378, 6 (European Securities and Markets Authority (ESMA)), Dec. 18, 2014.

⁴² The term generally used by the Securities Exchange Commission in SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

⁴³ Bradford, *supra* note 22, at 12. *See also Unbound | books are now in your hands*, UNBOUND, <https://unbound.co.uk/>. and ArtistShare - Where the fans make it happen!, *supra* note 23.

⁴⁴ Wilson & Testoni, *supra* note 6, at 2.

⁴⁵ Bradford, *supra* note 9, at 197.

3. *Special risks and problems arising in startup finance*

As Ronald J. Gilson argues, all kind of investments carry similar risks and raise similar problems but these present themselves in an extreme level where the financing of early stage companies is concerned. He refers to the three most challenging issues as the “trio of problems” which are namely uncertainty, information asymmetry, and agency costs.⁴⁶ From among these problems, uncertainty is the most obvious: it is unpredictable whether the company will still exist in a year and whether it will be successful. The failing rate of startups are essentially higher than of ongoing businesses⁴⁷ for two reasons: first, they have no track record (every challenge that a business has to overcome is yet unresolved), and second, they are often engaged in the high-technology sector which brings additional scientific uncertainty.⁴⁸

The problem of information asymmetry means that investors have significantly less knowledge about the business they fund than insiders who control or monitor the entire activity of the company, and who are therefore far better able to predict the future and the value of the company.⁴⁹ Such asymmetry is expanded in the case of startups due to the same factors mentioned regarding uncertainty: the company has no operational history and investors rarely have high-tech expertise (for example to read a software code).⁵⁰ This problem may be even more significant in the case of crowdfunding where outsider and unexperienced members of the “crowd”, usually with limited or no background knowledge at all, are involved in the financing process.⁵¹ Such specialty raises a further issue in relation to the problem of information asymmetry, namely that crowdfunding would only create a “market for lemons” in respect of investments.⁵² As this problem is especially related to crowdfunding, it will be explained below in Section I.6.2.

⁴⁶ Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, STANFORD LAW REV., no. 4, 2003, at 1067, 1076–77.

⁴⁷ Bradford, *supra* note 22, at 108.

⁴⁸ Gilson, *supra* note 46, at 1077.

⁴⁹ RICHARD PIKE ET AL., CORPORATE FINANCE AND INVESTMENT: DECISIONS AND STRATEGIES 435 (Pearson Financial Times / Prentice Hall, 7th ed ed. 2012).

⁵⁰ Andrew A. Schwartz, *The Digital Shareholder*, 100 MINN. LAW REV. 609, 631 (2015); Gilson, *supra* note 46, at 1077.

⁵¹ This might not be true under the amendments introduced by Title II of the JOBS Act in Rule 506(c) of Regulation D [17 CFR 230.501 - 230.508]. *See in this regard* Section III.2.2.

⁵² Ibrahim, *supra* note 16, at 591.

The costs of uncertainty and information asymmetry present themselves even before any investment is made (i.e. they may be described as *ex ante* or *pre-investment problems*), while agency costs arise later during the operation of the enterprise (as an *ex post* or *post-investment problem*).⁵³ Agency costs are the result of a conflict of interest between the investors and the entrepreneur, meaning that the latter is in the position to make managerial decisions for its own advantage rather than to the benefits of the investors. Again, it has to be mentioned that in crowdfunding such risk is even more inherent due to the limited expertise of “outsider” investors.

4. Funding gap left by traditional startup financing instruments

The main argument in favor of crowdfunding – as mentioned above in Section I.1 - is that it provides an alternative capital-raising tool to startup companies which otherwise have limited access to traditional financing methods, or in other words, it helps to fill the funding gap that startups usually have to face.⁵⁴ Entrepreneurs at the very first stage of their business– when they literally only have nothing but ideas – usually use their personal sources including credit card debts and mortgages, and borrow money from friends and family to begin their venture. However, these types of funds obviously may provide enough launching capital only to a very limited part of the society.⁵⁵ Apart from personal funds, the traditional sources that startups and other small enterprises use are bank lending, and two forms of private equity: venture capital and business angel investing. However, these financing tools still leave a gap where some companies at the early stage of their business do not have access to capital. The easiest to explain is the problem with bank loans: especially within the stricter lending framework applied following the credit crisis, banks simply consider startups too risky to provide them credit because they lack sufficient collateral or cash flow.⁵⁶ As regards to private equity financing, only two types of tools are fitting for startups from the broad range of financing instruments that this term refers to. Generally private equity means private sources that the firm obtains in exchange for an ownership stake

⁵³ *Id.* at 573.

⁵⁴ Mashburn, *supra* note 1, at 140.

⁵⁵ Bradford, *supra* note 22, at 101.

⁵⁶ Schwartz, *supra* note 50, at 621; Bradford, *supra* note 22, at 102.

provided to the investor.⁵⁷ Apart from venture capital and business angel funding, other private equity financing tools target mature businesses per definition, e.g. growth capital is provided for a company to expand or restructure its operation, or buyout is a method to acquire a going concern.⁵⁸

4.1. *Venture capital investments*

The most generally available financing instrument to startup companies are venture capital funds, however, in practice they tend to invest in more advanced companies for two reasons. First, their methods to tackle information asymmetry and uncertainty problems of startup investment may only be used when the company has already passed the initial startup phase. Against information asymmetry, venture capital investors carry out thorough due diligence investigation and intend to closely monitor the company's activities by retaining control rights which is not possible when the business idea is only under development. To secure their investment against uncertainty, venture capitalists usually apply staged financing, i.e. they provide the investment in instalments on the condition that the investee achieves the designated milestones. This, however, also requires a sufficiently developed business plan that is only available to more mature companies.⁵⁹ Second, venture capital funding typically involves investment at a higher amount than pre-seed and seed companies need, also because small investments are impractical for higher transaction cost⁶⁰ and in light of the pre-screening work that venture capitalists have carried out.

In addition to the fact that venture capital targets more mature businesses, it is also extremely selective and focuses on industrial sectors promising high growth and returns within a relatively short time.⁶¹ Accordingly, venture capital investments are mainly concentrated in the digital economy (e.g. internet, electronics) and healthcare sectors (e.g. biotech, medical devices)⁶² and they reject 99% of the investee applicants.⁶³ Such a high rejection rate is also attributable to the

⁵⁷ NEW APPROACHES TO SME AND ENTREPRENEURSHIP FINANCING, *supra* note 7, at 106.

⁵⁸ *Id.* at 107.

⁵⁹ See Schwartz, *supra* note 50, at 637–40.

⁶⁰ Bradford, *supra* note 22, at 102.

⁶¹ NEW APPROACHES TO SME AND ENTREPRENEURSHIP FINANCING, *supra* note 7, at 111.

⁶² *Id.*

⁶³ Bradford, *supra* note 22, at 103.

fact that the scope of such investments is limited in geographic terms as well⁶⁴ since venture capitalists closely monitor and actively participate in the operation of the investee companies and provide them with technical and managerial expertise.⁶⁵ As a result, venture capital funding does not cover the financing need of pre-seed and seed companies and leave a remarkable funding gap on the startup segment as well. It is mostly suitable for those companies that have already received one or more financing rounds from business angels.⁶⁶

4.2. *Business angel investing*

Business angels are wealthy individuals who usually have their own successful entrepreneurial history, therefore they support startup companies both with money investments and with their business experiences. They invest smaller amounts than venture capital firms and they turn to pre-seed and seed companies as well, therefore to some extent business angels fill the financing gap concerning early stages⁶⁷, however, it is generally agreed that they still do not cover it all.⁶⁸ Through their active participation in the business and due to the technical expertise and experience that they usually have in the field where the company operates, they successfully challenge the trio of problems in startup financing (i.e. uncertainty, information asymmetry and agency costs). On the other hand these characteristics require even closer geographical proximity than venture capital investments and also restrict the possible investment field of a business angel to that particular area where the angel has expertise. As a result, only a few percent of startup investors seeking for capital from business angels are actually get funding.⁶⁹

In recent years the appearance of Business Angel Networks, especially in Europe, have played an important role in connecting investors and entrepreneurs who would otherwise not meet due to above mentioned factors limiting the accessibility of business angels.⁷⁰ Such networks

⁶⁴ Schwartz, *supra* note 50, at 622.

⁶⁵ NEW APPROACHES TO SME AND ENTREPRENEURSHIP FINANCING, *supra* note 7, at 110.

⁶⁶ *Id.* at 109.

⁶⁷ *Id.* at 118.

⁶⁸ Bradford, *supra* note 22, at 103.

⁶⁹ Pope, *supra* note 1, at 995.

⁷⁰ NEW APPROACHES TO SME AND ENTREPRENEURSHIP FINANCING, *supra* note 7, at 118.

promote the angel activity in a wider region without actually disclosing the identity of the investors which is another usual hindrance of business angel visibility. This has led to the fact that while the financial crisis substantially declined angel investments in the US - especially in the field of more risky early stage companies⁷¹ -, in the same time the investments arranged by business angel networks in Europe showed a constant increase in these years.⁷² Such networks, however, still do not answer the financing needs of those industrial sectors where business angels are underrepresented or not represented at all. They do not solve the problem that business angel investment simply does not cover all the capital that early stage companies seek to launch their businesses. In conclusion, even if there is a growing tendency of business angel investment in Europe, there still remains a financing gap in the funding of startup enterprises.⁷³

4.3. Public Equity

Public equity, the other category of equity finance as opposed to private equity, may only be reached by companies who are listed on some form of stock exchange. Consequently, it is obviously unavailable in pre-seed and seed stages. However, recent trends show that it cannot be left out from a discussion on startup financing opportunities as it has become an emerging issue that regulation should endorse the accessibility of public equity for small scale companies.⁷⁴ Such a development would necessarily involve startups that are relatively close to their expansion stage as well. Currently the bureaucratic burdens, financial preconditions, registration fees and other related administrative and legal expenses, make it practically impossible for SMEs and especially startups to have access to public equity by offering their stock in public exchanges. These obstacles may only be removed by a separate legal framework applicable to SMEs (including startups) adopting specialized trading platforms for the exchange of specific ownership stock of smaller growing companies.

⁷¹ Mashburn, *supra* note 1, at 140.

⁷² NEW APPROACHES TO SME AND ENTREPRENEURSHIP FINANCING, *supra* note 7, at 123.

⁷³ Centre for Strategy & Evaluation Services LLP (CSES), *Evaluation of EU Member States' Business Angel Markets and Policies*, NB-02-14-160-EN-N (Directorate-General for Internal Market, Industry, Entrepreneurship and SMEs, European Commission 2012) 43.

⁷⁴ NEW APPROACHES TO SME AND ENTREPRENEURSHIP FINANCING, *supra* note 7, at 125.

The creation of such specific SME trading platform with less demanding registration requirements is not a remote hypothetical idea, for example AIM (Alternative Investment Market) of the London Stock Exchange operates as early as of 1995.⁷⁵ The success and worldwide spread⁷⁶ of these platforms clearly show the growing need toward alternative methods which enable smaller scale entrepreneurs to access public sources of funding, as an example, the introduction of KOSDAQ - the Korean counterpart of AIM – on its website expressly states that it has been established for the purpose to provide funding for startup companies.⁷⁷ These specialized exchange markets apply flexible rules and lenient disclosure obligations on the listed companies, which results in significantly reduced admission costs.⁷⁸ However, these requirements are still not possible to be met by companies at their pre-seed or seed stages who are literally only seeking for a small amount of startup capital to realize a business idea. For them investment-based crowdfunding could be a viable alternative to raise capital by accessing a wider range of public investors.

5. The answers of crowdfunding to the problems of startup finance

The special problems and risks associated with startup finance - as discussed above in Section I.3. - present themselves most significantly in the earliest stages of a company's life. Since the funding gap explained in Section I.4 mainly concerns the youngest companies, crowdfunding's importance is especially increased in this segment and its economic value is mainly attributed to the fact that it provides novel solutions to the difficulties of startup finance. Bradford argues that the funding gap problem is not only attributable to the unavailability of traditional financing but also to certain deficiencies in information accessibility, meaning that entrepreneurs and investors who otherwise might be potential business partners do not know about each other.⁷⁹ Crowdfunding answers this issue with a digital solution by simply connecting the demand and supply side of the

⁷⁵ AIM - London Stock Exchange, <http://www.londonstockexchange.com/companies-and-advisors/aim/aim/aim.htm>.

⁷⁶ Other startup and SME specific platforms are KOSDAQ in South Korea, Entry Standard of the Deutsche Börse, Spain's Mercado Alternativo Bursatil, Canada's TSX Venture or Poland's NewConnect operated by the Warsaw Stock Exchange. See Gert Wehinger & Iota Kaousar Nassr, *Opportunities and Limitations of Public Equity Markets for SMEs*, 2015 OECD J. FINANC. MARK. TRENDS 49, 9 (2016).

⁷⁷ KOSDAQ Market, <https://global.krx.co.kr/contents/GLB/02/0201/0201010301/GLB0201010301.jsp>.

⁷⁸ Wehinger & Kaousar Nassr, *supra* note 76, at 10.

⁷⁹ Bradford, *supra* note 22, at 101.

investment market in the internet through platforms that can be easily accessed and advertised. This simple online process is the core of the different advantages that crowdfunding offers and what is defined altogether by Andrew A. Schwartz as the “digital methods” to address the trio of problems in startup finance.⁸⁰

5.1. *Uncertainty tackled by the wisdom of the crowd*

The crowdsourcing roots of crowdfunding answers the problem of uncertainty with the “wisdom of the crowd” that eventually selects and supports only those crowdfunding initiations that have the best chance to succeed. This theory of the “wisdom of crowd” means that a sufficiently wide and heterogenic (in terms of skills, knowledge and experience) group of people together can come to a wise solution even if the individuals alone do not have special expertise in the field, simply as a result of the mathematical fact that averaging cancels errors.⁸¹ As Friedrich A. Hayek explained years ago, every member of the crowd may contribute to this collective knowledge with some unique information that is not possessed by others.⁸² Certain aspects of crowdfunding regulation may specifically enhance the beneficial effects of the wisdom of the crowd, for example, through a requirement providing that only those campaigns receive the funds that entirely reach a previously set target amount while investors are allowed to cancel their investments until this target is met.⁸³ In this way the risks inherent in the uncertainty of startups are mitigated both to the benefit of investors and entrepreneurs, who themselves are prevented from the launch of an undercapitalized business.⁸⁴

5.2. *Crowdsourced information against information asymmetry*

One other digital method of crowdfunding which reduces information asymmetry is also rooted in the crowdsourcing antecedent of crowdfunding: by sharing investment information

⁸⁰ Schwartz, *supra* note 50, at 658.

⁸¹ *Id.* at 660.

⁸² See generally F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

⁸³ Schwartz, *supra* note 50, at 662.

⁸⁴ Statistical data regarding the operational history of companies funded on Kickstarter show that more than 90% of the issuers of successful campaigns remained ongoing ventures, indicating that the wisdom of crowd may be indeed capable to select those projects that are viable and will survive the initial startup stages. See Venkat Kuppaswamy, *Crowdfunding Creative Ideas*, presented at Dissemination of the Sharing Economy: Issues and Solutions - 2015 International Forum on Service Sector Advancement (2015).

through the platform participants create a crowdsourced investment analysis. Opponents of crowdfunding, however, express their doubts about the professional value of such evaluation. They argue that sophisticated investors and other professionals who could really contribute to this crowdsourcing process with valuable information and expertise would simply not be incentivized to share their information.⁸⁵ However, these arguments do not take into account that potential investors themselves may benefit from the communication features of crowdfunding and, for example, use it as a market research tool⁸⁶, especially in certain areas where customers and users have a special understanding on the field, e.g. in the case of video games and other software.⁸⁷ In addition, crowdfunding is also useful to professional investors to attract further investment by investors who are not interested in acquiring control in the company which is another important economic motive for them to encourage the contribution of the crowd to the funding campaign.⁸⁸

The co-participation of sophisticated and unsophisticated investors in crowdfunding may also be easily induced by regulation if an investment cap is applicable to professional participants of the campaign as well.⁸⁹ However, in light of the above mentioned economic motives of professional investors to take part in crowdfunding campaigns, it is rather unnecessary to impose such restrictions. In case an investor is willing to invest in a business without disclosing such intention (and other related information) to the public in a crowdfunding campaign she may always provide funding through other channels. Therefore the existence of an investment cap is not decisive on whether sophisticated investors are willing to share their expertise in the campaign and help to decrease information asymmetry in crowdfunding.

5.3. *Online reputation and digital monitoring of crowdfunded businesses*

The risks and disadvantages presented by the agency cost problem of startup financing is generally mitigated by strict monitoring which in the course of the traditional financing methods

⁸⁵ Schwartz, *supra* note 50, at 666.

⁸⁶ Belleflamme & Lambert, *supra* note 5, at note 11.

⁸⁷ Ibrahim, *supra* note 16, at 597.

⁸⁸ *Id.* at 592.

⁸⁹ Schwartz, *supra* note 50, at 666–67.

require a close geographical proximity and personal contact. The online platform on which crowdfunding is carried out may also provide the possibility to closely supervise the activity of the entrepreneurs but in a different way. The idea is that entrepreneurs initiating crowdfunding shall put their online reputation at stake by connecting their social media profile to the campaign, which is also easily tracked even after the process.⁹⁰ They are of course free to decide to what extent they are willing to share the details about their personal background and business history but it is obviously in their interest as well to build up trust with the potential investors by reducing the information asymmetry that usually hinders funding.

This technique of digital monitoring is identically applicable and even more important after the crowdfunding campaign, i.e. during the operation of the business. Any relevant data and business information may be regularly disclosed on the entrepreneur's social media profile or on the website of the company and even on the crowdfunding platform. This also provides some kind of personal connection between the investors and the funded business in the sense that the related information is made available directly, which is a common feature of crowdfunding with microfinance.⁹¹ Digital monitoring of the ongoing business, however, is only truly efficient if it is accompanied with the continuing possibility of communication between the investors as well. This is because information asymmetry still remains if unsophisticated investors are not capable of understanding the disclosed data.⁹² However, crowdsourcing and the common evaluation of the data may solve this problem if sharing of information is made easily possible. Crowdsourced monitoring is also important because it reduces the monitoring burden of individual investors which itself may discourage them from supervising if their investment is relatively small.⁹³

⁹⁰ *Id.* at 670–71.

⁹¹ Ross S. Weinstein, *Crowdfunding in the US and Abroad: What to Expect When You're Expecting*, 46 CORNELL INTL LJ 427, 429–30 (2013).

⁹² Ibrahim, *supra* note 16, at 594.

⁹³ Schwartz, *supra* note 50, at 684.

5.4. *Staged financing and securities based compensation*

While risking the entrepreneurs' online reputation also works as a preventive measure against fraud, digital monitoring is only useful to tackle agency costs if entrepreneurs are incentivized to cooperate and retain the trust of investors. This may be ensured by similar techniques as used by venture capital firms, namely staged financing of the business and securities based compensation of the management. By a sufficiently set funding cap investors are still allowed to collect the necessary amount of capital that they need at the startup level or at a given financing round but they are also required to return to the crowdfunding field for additional funds. In this system of staged-financing prior-round investors shall be provided with the opportunity to comment about the entrepreneur's activities for the reasons explained under Section I.5.3.⁹⁴ Crowdfunding regulation may also benefit from the staged-financing technique if it allows for higher funding cap but require that over a certain threshold the collected amount is only provided to the company if it meets an annual benchmark or other requirements.⁹⁵

It is a usual technique against agency costs to link the compensation of the management to the success of the business itself. In the case of investment-based crowdfunding, the founders of the business may issue any kind of securities to the investors which exposes them to a further (information asymmetry) risk, namely that such specific securities could be designed in a way that their returns will be far lower than that of the owners or the management. Both agency costs and this information asymmetry risk may be reduced by providing to the founders and managers the same kind of securities that are issued to the public in crowdfunding.⁹⁶

5.5. *Supplementary services of intermediaries*

In the crowdfunding scheme there is one constantly present participant that is highly motivated to maintain the system successfully: the crowdfunding platform itself. For these intermediaries it is essential that both investors and issuers are satisfied so they will return to the

⁹⁴ Bradford, *supra* note 22, at 113.

⁹⁵ Schwartz, *supra* note 50, at 639.

⁹⁶ *Id.* at 679.

platform for further investment options or additional financing rounds.⁹⁷ It is therefore substantial to provide such intermediaries with the possibility to support the use of crowdfunding by providing supplementary services to both the investors and to the crowdfunding businesses as well. In relation to investors such services may include due diligence investigation of businesses⁹⁸, rating of the investment possibilities, as well as the facilitation of information crowdsourcing by maintaining communication channels with an online reputation feedback system that includes all the companies registered by the platform even after the closing of a crowdfunding campaign. These platforms may play an important role to address uncertainty and information security in startup financing by signaling the quality of investments if they are allowed to investigate and select the projects they offer to the crowd.⁹⁹ As an example, if these platforms become a part of the financial institutions system they may use credit history to evaluate the proposed project and the trustworthiness of the entrepreneur.¹⁰⁰ Even if they are not responsible for the behavior of entrepreneurs – which however would be quite advisable according to several authors¹⁰¹ - or for the success of a business in terms of civil liability, they will have great economic incentives to keep their good reputation by preventing fraud and poor quality projects to be carried out under their watch.

While intermediaries may provide valuable services to unsophisticated investors guiding them through the crowdfunding process they shall not be prohibited to assist the entrepreneurs in certain ways as well. The preliminary due diligence checks and the rating of the companies listed by the platform are already services that mainly concern the entrepreneurs but intermediaries may also be suitable to provide them further legal and accounting assistance in relation to the launch of their business. In addition, the online and digital platform of crowdfunding offers the possibility to collect and analyze a vast amount of data on investors, entrepreneurs, companies and to create

⁹⁷ *Id.* at 678.

⁹⁸ Joachim Hemer, *A Snapshot on Crowdfunding* (Working Papers Firms and Region, Fraunhofer Institute for Systems and Innovation Research ISI 2011) 10. and Wilson & Testoni, *supra* note 6, at 9.

⁹⁹ Ibrahim, *supra* note 16, at 598–99.

¹⁰⁰ NEW APPROACHES TO SME AND ENTREPRENEURSHIP FINANCING, *supra* note 7, at 86.

¹⁰¹ Weinstein, *supra* note 91, at 463. and Ibrahim, *supra* note 16, at 605.

a database by the intermediary to provide matching services between the demand and supply side of crowdfunding.¹⁰²

The multiple role played by the intermediaries in crowdfunding places them in the core of effective crowdfunding regulation, since the correct combination of rights and obligations imposed on them may address the most important challenges of the regime: how to minimize the risk of loss and fraud and maximize transparency at the lowest possible level of transaction costs.¹⁰³ However, the comprehensive understanding of the challenges that crowdfunding regulation have to face requires a more detailed analysis, as provided in Chapter II.

¹⁰² Wilson & Testoni, *supra* note 6, at 7.

¹⁰³ Weinstein, *supra* note 91, at 435.

Chapter II – Regulatory challenges posed by investment-based crowdfunding

Under Section I.5 several advantages of crowdfunding and the novel techniques that it may introduce into startup finance in order to mitigate the inherent problems of the system has been discussed. However, the novelties of this capital-raising tool also involve a number of issues that might not be resolved by practice but rather requires legal regulation, otherwise crowdfunding will not be able to develop into a viable corporate financing instrument.

1. *Protection of investors*

One of the major problems in crowdfunding derives exactly from its fundamental idea to involve unsophisticated investors in corporate finance by reaching them through the internet. This paradigm necessarily raises the issue that such investors are highly exposed to the risk of loss by making poor investment decisions or by becoming victims of fraud for which the internet commonly used vehicle.¹⁰⁴ Regulation of cybersecurity is already essential concern of securities law¹⁰⁵ but crowdfunding may also be a cause for the development of new types of cyber-crimes.¹⁰⁶ As an example, crowdfunding may provide a fitting new arena for Ponzi schemes, where new investors are solicited by the artificially high returns provided to the previous investors, which returns are however only covered by the new investments and the scheme collapses when the flow of money into the system stops.¹⁰⁷ While it cannot be a realistic regulatory goal to protect all investors from all kind of losses¹⁰⁸ – which is an inherent and unavoidable part of any kind of investment activities – the increased risks presented in crowdfunding may and shall be mitigated by certain techniques. The most simple way for this is to apply an individual investment cap that limits (for example annually) the amount of money that unsophisticated investors may “risk” in crowdfunding platforms. As mentioned above in Section I.5.2 the condition that only those

¹⁰⁴ Heminway & Hoffman, *supra* note 22, at 934–35.

¹⁰⁵ Loughran et al., *supra* note 13.

¹⁰⁶ See also *Questions and Answers: Investment-Based Crowdfunding: Money Laundering/terrorist Financing*, Questions and Answers ESMA/2015/1005 (European Securities and Markets Authority (ESMA)), Jul. 1, 2015.

¹⁰⁷ PONZI SCHEME, Black's Law Dictionary (10th ed. 2014)

¹⁰⁸ Heminway & Hoffman, *supra* note 22, at 934.

projects are funded that reach the pre-set target amount and the possibility to cancel their investment also offer protection to investors.¹⁰⁹

1.1. *Investor education*

Some authors point out that fraud in crowdfunding is relatively rare, while on the other hand the probability of unforeseeable complications and problems in startup investments is rather high.¹¹⁰ Even the unexpected success of a campaign might cause difficulties, for example in the case of the reward-based crowdfunding of the Pebble Smartwatch the products were shipped with 4 to 10 months delay since the demand in the campaign was more than 102 times higher than expected.¹¹¹ In light of this the investor protection – instead of over regulating the prevention of fraud – should focus on the education of unsophisticated investors to improve their understanding of the specific risks involved in startup investments and enable them – even if only on an elementary level – to evaluate the potential of the projects. In order to this investors should be provided reading materials or a presentation video, and required to pass a test before they may use a funding platform.¹¹² It remains to be decided by legislation whether such materials should be standardized and identical in all platforms or each has to fulfill this responsibility on its own way. This latter solution would of course increase the costs of intermediaries but it also creates a beneficial competition between the portals and endorses their compliance by imposing legal liability on them for appropriate education. Nevertheless, even if education materials are standardized, platforms should be allowed to supplement them to correspond to the business area in which the portal is specialized.¹¹³

1.2. *Transparency*

Investor education alone would not be enough to ensure the proper understanding of the investors if they are not provided with sufficient information on the business and on the actual

¹⁰⁹ Bradford, *supra* note 22, at 139–40. and Mathews, *supra* note 16, at 314–15.

¹¹⁰ Belleflamme & Lambert, *supra* note 5, at 6.

¹¹¹ Mashburn, *supra* note 1, at 129.

¹¹² Mathews, *supra* note 16, at 330.

¹¹³ *Id.* at 331.

project for which funding is required. However, the provided data should be carefully selected since in crowdfunding the requirement of lengthy documentation would not be beneficial either to the entrepreneurs because of its costly preparation, nor to the inexperienced investors who, on the other side, would not be able to understand a detailed investment prospectus. Accordingly, sufficient transparency in crowdfunding should not mean extensive disclosure obligations, but the presentation of the most important information in an easily accessible and understandable way, for which standardized disclosure might be a proper solution.¹¹⁴ Such standardization could include the adoption of uniform disclosure forms to be filled out by the entrepreneurs and submitted to the funding portal with any necessary supporting evidence. However, it is also important in this regard – as was in the case of investor educational materials – that standardization should only set the minimum safeguards and the intermediaries shall be permitted to require additional disclosure and even to create their own methods to present the information if the standardized forms are published as well. This way the competition between the platforms is not hindered and the concerned market is free to improve and develop the regulatory system in line with the experiences of the practice.

This special characteristic of crowdfunding that the core business idea has to be revealed to an extent that is sufficient to convince the crowd to contribute makes it rather unappealing to those types of businesses whose basic idea is particularly innovative or whose intellectual property rights are otherwise threatened by such disclosure.¹¹⁵ Conclusively, a viable crowdfunding regulation necessarily requires a proper legal framework for the protection of intellectual property rights, especially in light of the fact that transparency in crowdfunding includes ongoing disclosures about the businesses' activity, even if such further rounds of publications necessarily do not involve as much innovative information. The continuing disclosure obligations are essentially important for investor protection to provide for a digital monitoring possibility (as discussed under Section

¹¹⁴ Heminway & Hoffman, *supra* note 22, at 938–39.

¹¹⁵ Wilson & Testoni, *supra* note 6, at 5.

I.5.3) and to inform investors about risks that may especially occur later in time following the crowdfunding campaign, for example the risk with regard to the dilution of their shares by subsequent financing rounds.¹¹⁶

1.3. Due diligence of the offerings in crowdfunding

It is evident – with regard to all kind of investments - that financial due diligence is the core questions of investor protection, but crowdfunding raises the special concerns that who should conduct such investment analysis. This peculiarity arises because unexperienced crowdfunders cannot carry out such task – and due to the small amount of their individual investment they are not even incentivized to do so¹¹⁷ - while they cannot be left without any assessment either as it would possibly lead to the proliferation of fraud.¹¹⁸ In addition, in lack of appropriate evaluation projects that otherwise could be promising and worthy of attention may simply left unfunded.¹¹⁹ However, due diligence is especially problematic with regard to offerings in crowdfunding if the issuer has no track record or credit history, and even if some information is available it is quite hard to assess. As discussed in Section I.5.2 the digital methods of crowdfunding may serve innovative solutions for these problems, however, crowdfunding regulation has to provide a suitable framework to direct the crowdsourcing of investment information and provide for professional evaluation possibilities as well.

As mentioned above in Section I.5.2 due diligence investigations may be carried out by the crowdfunding platforms itself as part of the additional (financial) services provided by the portal. However, the question remains to be decided by regulation whether such investigation shall be mandatorily carried out by the platforms, and in that case, to what extent shall be offerings or the issuer company be examined by them. Furthermore, the point in time when due diligence shall take place is not evident either. In European platforms the general practice shows that vetting of the companies are conducted as a precondition for registration at the platforms, but there are also

¹¹⁶ Weinstein, *supra* note 91, at 452.

¹¹⁷ Gerrit K.C. Ahlers et al., *Signaling in Equity Crowdfunding*, 39 ENTREP. THEORY PRACT. 955, 956 (2015).

¹¹⁸ See Mashburn, *supra* note 1, at 158 and 164.

¹¹⁹ Belleflamme & Lambert, *supra* note 5, at 10, note 9.

examples where investigations are carried out only if the target amount is met before the actual release of the funds or both pre-registration and pre-issuance screening takes place.¹²⁰

The streamlined due diligence processes that platforms may develop may of course be especially useful to reduce the related transaction costs of crowdfunding, however, the platforms may still not be the most suitable to undertake due diligence responsibilities. As Mashburn argues the due diligence services provided by crowdfunding platforms are unlikely to reach the quality of professional investigations carried out for example by venture capital firms because that requires an amount of time and resources that is not available in crowdfunding.¹²¹ At the same time, inexperienced crowdfunders may assume that such services are conducted with the same expertise as other type of investment advices and over-estimate the quality of such due diligence reports.¹²² Accordingly, it may be desirable to leave due diligence in crowdfunding to professionals of the field, i.e. financial institutions and other organizations that are particularly specialized in investment assessment. Similarly to the crowdfunding platforms, these institutions would also become the repeat players of the system and therefore would be able to standardize and simplify the processes and reduce its costs, while they would also compete with each other in terms of reasonable fees and highest possible quality standards. Legal regulation shall facilitate the development of such service providers and their competition by introducing them into the existing framework on financial institutions in a way that does not hinder their formation and spread by over-regulation but provides for proper monitoring.

1.4. *Anti-dilution*

Generally, anti-dilution rules are governed – especially in Europe – by company law, but within the context of crowdfunding investments it is also an issue of investor protection, and might be addressed by crowdfunding regulation.¹²³ The risk of dilution in crowdfunding applies to equity holdings and means that the investors' shares may be watered down by further financing rounds

¹²⁰ Collins Liam & Yannis Pierrakis, *The Venture Crowd* | Nesta (NESTA 2012) 11 and 16.

¹²¹ Mashburn, *supra* note 1, at 165.

¹²² *Opinion - Investment-Based Crowdfunding*, *supra* note 41, at 11.

¹²³ *Opinion - Investment-Based Crowdfunding*, *supra* note 41, at 11.

because each additional equity holder makes the shares of previous investors weaker in terms of ownership percentage. In investment contracts such risk may be mitigated by related anti-dilution provisions, however - similarly to the issue of due diligence (explained above in Section II.1.3) - the negotiation of such provisions cannot be left to the unsophisticated crowdfunding investors.¹²⁴ The risk of dilution is clearly increased when investors hold equity with minor or no voting rights at all¹²⁵, which is especially problematic in light of the fact that these type of securities are exactly the ones suitable for crowdfunding as discussed below in Section II.3.2.

It is neither realistic nor desirable to solve the problem of dilution through mandatory provisions adopted by regulation and required to be applied in all offering in investment-based crowdfunding campaigns. It is rather likely that intermediaries could be the right entities to address this problem and afford appropriate anti-dilution rights because it is also in their interest to attract the participation of investors - and especially - professional investors as well who might be well aware of this risk and able to properly estimate whether the portal's solution is sufficient. In order to facilitate the implementation of anti-dilution measures by crowdfunding portals the responsibility of regulation might be to raise awareness of the problem among unexperienced investors and provide guidelines or minimum requirements to the platforms

2. The “Lemons Problem”

As mentioned above under Section I.3 information asymmetry in crowdfunding raises a special concern about this instrument, known as the “market for lemons” problem.¹²⁶ This means that in a market where customers (investors) do not have the necessary information to distinguish between good and bad products (profitable or unpromising investments) the former is placed on the same price level with their poor quality competitors, therefore quality suppliers cannot charge a premium. Consequently, they leave such “market for lemons” and eventually only bad products will be present there. In the case of investment-based crowdfunding this would mean, for example,

¹²⁴ In the case of professionals, i.e. venture capital and business angel investments this is of course a reasonable solution. Wilson & Testoni, *supra* note 6, at 8.

¹²⁵ Liam & Pierrakis, *supra* note 120, at 27.

¹²⁶ Schwartz, *supra* note 50, at 631.

that issuers with clearly promising business cannot benefit from this by providing inferior security at the same or even lower price for which other similar campaigns offer securities with more senior rights. As Mashburn argues this is a hidden cost that may possibly deter more experienced entrepreneurs - who are therefore more likely to succeed - from relying on crowdfunding.¹²⁷

Opponents of crowdfunding also highlight as another factor intensifying the lemons problem in crowdfunding, that expert investors will always find and fund the promising investments and leave only those projects to crowdfunding platforms that they consider unworthy.¹²⁸ As a possible solution, crowdfunding regulations shall be designed to encourage the participations of professional investors (most frequently business angels) in crowdfunding for example by exempting them from limitations and restrictions that would otherwise concern the members of the crowd. This “co-investment model” is used by the Belgian site MyMicroInvest¹²⁹. Other platforms such as SyndicateRoom¹³⁰ in the UK go even further and apply the so-called “investor-led” model that requires as precondition for registering the campaign that a lead investor already supports the project, and at the same time also provides help to entrepreneurs to find such lead investors.

In the future, the evolution of crowdfunding may lead to a number of different methods professional investors may cooperate with crowdfunding platforms and participate in offering which is a desirable solution for the “lemons problem”. For example – reversing the order of the “investor-led” crowdfunding model – platforms may also host venture capital firms that would co-invest in projects receiving great support from the crowd.¹³¹ This model would also reflect the preference of venture capital firms – as explained under Section I.4.1 – to invest in companies which already proved to be promising, as the outstanding attention of the crowd could be a proof of probable success. In this model not only the funds provided by the two financing tool would be

¹²⁷ Mashburn, *supra* note 1, at 147.

¹²⁸ Schwartz, *supra* note 50, at 632.

¹²⁹ Wilson & Testoni, *supra* note 6, at 9. See MyMicroInvest - Invest € 100 or more together with others in innovative companies, <https://www.mymicroinvest.com/en>.

¹³⁰ Equity Crowdfunding for Investors and Business Angels - SyndicateRoom, <https://www.syndicatoroom.com/>.

¹³¹ *Opinion - Investment-Based Crowdfunding*, *supra* note 41, at 7, note 3.

combined but also the marketing features of crowdfunding (and the early a creation of a customer base) would be supplemented by the managerial and technical expertise of venture capitalists helping the project to remain an ongoing business venture.

In light of the above, in order to prevent the “lemons problem” crowdfunding regulation shall be designed in a way to encourage professional co-investment in such platforms (e.g. by providing tax advantages) because otherwise they are disinterested in companies with a high number of shareholders. On the other hand, if crowdfunding results in a highly fragmented ownership of the company that may be harmful to the founders as well in the course of decision-making processes. In order to prevent such situation the issuer shall be allowed to offer securities with various rights and special features, and be able to design the control structure of the company in a way that is both desirable to the founders and professional co-investors - as discussed in the following section.

3. Securities regulation

The first question that arises with regard to the relation between investment-based crowdfunding and securities regulation in a certain legislative framework is that whether the transfer of equity or other instruments in crowdfunding campaigns would be covered by securities law on the first place. In this regard a key difference between the United States and the most of the European legal systems may be described as the contrast of the unitary or divided notion of shares. Under the unitary notion securities regulation of the U.S. applies in principle to (the issuance, transfer, etc. of) all shares, and only express exemptions release certain transactions from the general rules. In the civil law tradition the notion is divided, distinct terms describe the shares of closed and public corporations, and a different legal regime applies to them. Accordingly, securities regulation governs only shares that are exchanged in regulated market.¹³² This means in relation to crowdfunding that shares of companies that are not listed on an exchange cannot be traded as

¹³² TANJA BOSKOVIC ET AL., COMPARING EUROPEAN AND U.S. SECURITIES REGULATIONS: MIFID VERSUS CORRESPONDING U.S. REGULATIONS 7–8 (World Bank Working Paper, no. 184. 2010).

securities, and their offering in a crowdfunding campaign might be illegal. For example if the public solicitation of potential buyers of such shares is prohibited that entirely excludes the possibility of crowdfunding for these companies, while these are exactly those small sized and startup enterprises that crowdfunding is designed for.¹³³ This is clearly an issue that national legislation has to resolve and decide whether place crowdfunding offering under securities regulation or provide a different type of exempted position for it in company law.

3.1. Small equity issuance

Investment-based crowdfunding, and especially equity-crowdfunding brings up another well-known issue in securities regulation, namely the liberalization of small equity issuance i.e. how to provide small businesses with the possibility to issue securities in a simple and inexpensive way. In this regard the role of crowdfunding regulation shall be to exempt the issuer - who in the campaign provides equity usually in the form of securities - from certain otherwise applicable legal requirements. Consequently, the regulation has to find a delicate balance between the level of protection provided to investors against hazardous crowdfunding campaigns¹³⁴ and the exemptions provided to security issuers from registration or other administrative requirements in order to give them access to capital markets. Such exemptions are of course weakening investment protection, but on the other hand, the simplification of the procedure and the adoption of a simple and speedy way to issue securities by small and startup companies is an essential condition for a successful crowdfunding regime.

3.2. Type of securities to be issued in investment-based crowdfunding

It is an equally important question of such securities law and crowdfunding regulation what types of securities may be issued in order to prevent small and startup enterprises from collapsing under the burden that a large number of shareholders may cause.¹³⁵ Because debt securities – as opposed to common stock - would prevent the fragmentation of ownership and

¹³³ Wilson & Testoni, *supra* note 6, at 11.

¹³⁴ See the examples of Ponzi schemes in Section I.6.

¹³⁵ Liam & Pierrakis, *supra* note 120, at 9.

control in the company, they may be a quite attractive form of security to issuers, therefore it may be assumed that debt will play an important role in crowdfunding.¹³⁶ Schwartz supports this assumption with the argument that together similarly to common stock, preferred stock would not be suitable to issue in crowdfunding because since it is usually a complex instruments which cannot be understood and appreciated by unsophisticated investors.¹³⁷

The issuance of preferred stock, however, does not necessarily has to involve complicated technical terms, as for example it may simply provide for multiple dividends in exchange for absent voting rights, which would be perfectly in line with the goals of the issuers: attracting investors while retaining control over the company at the same time. This kind of preferred stock would also be suitable in crowdfunding for two additional reasons. First, crowd-investors usually lack both the interest and the expertise to actively participate in the operation of the company by exercising voting rights. Second, as opposed to debt securities, preferred stocks do not necessarily have to promise fixed dividends which is obviously an obligation that startup companies are usually not able to undertake.

As mentioned above under Section I.2 the proper term referring to all crowdfunding campaigns involving the issuance of security instruments regardless of the type of these instruments (equity, debt or other security) is investment-based crowdfunding. The use of such common terminology is necessary because in principle securities regulation does not treat these types differently, moreover it may allow the issuance of convertible debt securities as well. Especially in the case of crowdfunding issuers may benefit from the flexibility provided by convertible debt securities in a way that is extremely suitable for possible high-growth startups whose future on the other hand is yet uncertain. Such securities may encourage first round investments by promising lower risk and higher liquidity but also provide for the option of conversion at a premium in case the company reaches a certain benchmark (i.e. it shows the predicted success). In other cases

¹³⁶ Schwartz, *supra* note 50, at 618.

¹³⁷ *Id.* at 640.

conversion may be linked to the precondition of acquiring additional equity in the company, in which case the previously owned debt securities may be converted to equity as well. Such terms are otherwise quite peculiar in convertible debt securities, however, they make sense in case of startup capital investment in high-growth companies.

In light of the above, the various types of securities and the different rights and obligations that may be attached to them provide issuers the opportunity to design and apply the form of security that is the most suitable for their business plan. However, entrepreneurs are only able to make use of this benefit if small offerings are not over-regulated and therefore prevented from entering the securities market due to disproportionate costs or fees and other red tape burdens.¹³⁸

4. *Exit opportunities to investors*

The discussion in Section 1.4 and 1.5 presented why crowdfunding is a necessary alternative tool for the startup finance system which explains the entrepreneurs' motivations to call for the possibility to use crowdfunding. However, investment-based crowdfunding as a completely new phenomenon intends to address members of the crowd that so far have not been familiar with this instruments. In this regard crowdfunding regulation is also responsible to invite and incentivize new investors to participate in startup financing through this new method. Even if unsophisticated participants have non-monetary motives to participate in a campaign such as the social and emotional benefits linked to the consumption and investment experience in crowdfunding¹³⁹, the financial benefits that investment-based crowdfunding may offer to investors (and not just to the entrepreneurs) shall be ensured by regulation where possible. With other words, in order to allow investment-based crowdfunding to function as a viable investment tool crowdfunding regulation shall promote the creation of possible exit opportunities to investors.¹⁴⁰

4.1. Resale restrictions: desirable protection or unnecessary constraint

¹³⁸ Pope, *supra* note 1, at 985.

¹³⁹ Belleflamme & Lambert, *supra* note 5, at 4; Wilson & Testoni, *supra* note 6, at 5.

¹⁴⁰ Wilson & Testoni, *supra* note 6, at 9.

Several authors claim that the possibility to resale the securities (or the ownership stake) acquired in crowdfunding should be limited to protect the participants of such resale market where they would not be in the possession of the same accurate and complete information that is available during the crowdfunding campaign.¹⁴¹ In the U.S. the SEC in its proposal on Regulation Crowdfunding argues that restrictions on resale for a defined period are necessary to provide enough time for the crowdfunded project to be developed and show its perspective, while the related illiquidity costs might be mitigated by allowing a few exemptions from such restrictions e.g. with regard to professional investors.¹⁴² However, this solution is quite unsatisfactory in light of the significant discouraging effect it has on investor participation, therefore as Bradford and Mathews both argue a secondary market established by the crowdfunding platforms with the possibility of interportal transactions is highly desirable to incentivize the acquisition of crowdfunded securities.¹⁴³

4.2. *Initial public offerings*

In practice, after their launch startup companies usually remain to operate as small or medium sized enterprises for which it is quite rare to conduct an initial public offering (IPO) and become registered on a stock exchange. However, with the spread of specialized SME trading platforms mentioned above under Section I.4.3 the likelihood of a crowdfunded startup to go public is not that low anymore, as it happened in the case of Mill Residential REIT, a company funded by equity-crowdfunding on SyndicateRoom and became listed on AIM afterwards.¹⁴⁴ This shows that a legislative framework promoting other type of instruments specialized for startup and

¹⁴¹ Heminway & Hoffman, *supra* note 22, at 954.

¹⁴² Section III.B.3.h at 378, SEC Proposed Rules on Regulation Crowdfunding, Release Nos. 33-9470 ; 34 -70741 (2013).

¹⁴³ Mathews, *supra* note 16, at 340; Bradford, *supra* note 22, at 144.

¹⁴⁴ *First UK Crowdfunded Company Listed - AltFi News*, ALTFI, http://www.altfi.com/article/0638_first_uk_crowdfunded_company_listed. In exceptional cases an IPO may take place on a stock exchange not specifically assigned to SME, however, this requires that the funded company became sufficiently large due to the previous crowdfunding rounds. *See Updated: OurCrowd Portfolio Company ReWalk Lists on NASDAQ, Shares Rocket*, CROWDFUND INSID. (Sept. 14, 2014), <http://www.crowdfundinsider.com/2014/09/49550-ourcrowd-portfolio-company-rewalk-lists-nasdaq-shares-rocket/>.

SME financing shall be designed together with crowdfunding regulation to provide a coherent system and also supplement crowdfunding with accessible exit opportunities.

5. Regulation on crowdfunding intermediaries

The most significant characteristic of investment-based crowdfunding which also shapes and determines any related regulation is that it is conducted through an online platform. In theory it may be argued that the use of such platform is not always necessary even in case of investment-based crowdfunding, for example securities may be issued directly as non-intermediated ones. However, the development of the crowdfunding industry and the important role of platforms in investor protection have almost entirely abolished the practice of non-intermediated campaigns initiated through individual websites. On the other hand, the specific legal procedure (transfer of shares or issuance of securities) carried out in investment-based crowdfunding makes it inevitable for most issuers to resort to the help of intermediaries. Apart from this platforms may provide a number of supplementary services (see Section I.5.5), and the more complex role they carry out in the system, the more detailed regulation will be necessary. Accordingly, this section cannot intend to outline all the legislative issues related to the regulation of these financial intermediaries, only draws attention to the most important questions: their regulation as financial institutions, rules on liability and conflict of interest.

The biggest challenge with regard to intermediaries in investment-based crowdfunding is that as financial institutions they have to be properly introduced in the related regulatory system. The applicable authorization requirements and administrative procedures have to be established to provide for the registration and monitoring of such entities. This also requires the creation of their related legal definition that also takes into account the different sizes and the diverse range of services that such platforms provide. Such differences makes it rather hard to create a common framework which leaves the possibility to platforms to structure their businesses (at least on its face) in a way to avoid otherwise applicable requirements.¹⁴⁵

¹⁴⁵ *Opinion - Investment-Based Crowdfunding*, *supra* note 41, at 5.

To adopt rules for the daily operation of these platforms does not seem to be less complicated either. There are still ongoing debates in literature whether (and to what extent) crowdfunding platforms should bear liability for the legality of campaigns or the behavior of issuers (see Section I.5.5). Conflict of interest issues also arise with regard to the cooperation between the platforms and their listed companies.¹⁴⁶ Intermediaries of course shall not be prevented from charging a reasonable fee for the services they provide, while such service fees are predictable, transparent and does not increase disproportionately in case of successful campaigns. Otherwise, an inadequate remuneration system could lead to the practice that issuers urge intermediaries with financial rewards to promote and close their projects as soon as possible. Such short term monetary incentives could outweigh the reputational motives of platforms to carefully select the issuers they list and exclude poor investments from the portal.¹⁴⁷

Another conflict of interest question is whether the intermediaries' personnel and their affiliated entities or an intermediary itself should be permitted to invest in projects listed in the platform.¹⁴⁸ This issue is also related to whether the platform is allowed to provide investment advice, because permitting both their investment and their assistance services could definitely create the risk of abuses. As Bradford argues the cost of such restrictions seems to be relatively low in comparison to the possible harm that manipulations could cause to investors, while it would also improve the reputation of such intermediaries.¹⁴⁹ This is exactly the approach that is followed by the regulatory model of the United States, which model also provides a comprehensive answers to the challenges of crowdfunding regulation, as it will be examined in Chapter III.

¹⁴⁶ *Id.* at 11.

¹⁴⁷ Wilson & Testoni, *supra* note 6, at 10.

¹⁴⁸ Bradford, *supra* note 22, at 136–37.

¹⁴⁹ *Id.* at 137.

Chapter III – Crowdfunding in the United States

1. *Development of investment-based crowdfunding in the U.S.*

The basic conclusion that one might draw from the list of Chapter II on the regulatory challenges in investment-based crowdfunding is that they concern such a broad range of legal areas that the adoption of any related regulation would require comprehensive legal research and careful consideration. The economic development and regulatory process that has been under way in this field in the United States resulted in one of the most complete models for the adoption of such regulation, which example shall not be disregarded by any research on investment-based crowdfunding. The idea of raising money through small donations from a large number of sponsors has long existed in the U.S. The classical example is Joseph Pulitzer's campaign to fund a base for the Statue of Liberty through a newspaper campaign.¹⁵⁰ However, in the recent years both the economic and the legal system of the U.S has called for the digital version of crowdfunding to be used as a financing tool. As a result, parallel systems of investment-based crowdfunding have been developed in both federal and state level, however, this thesis below will focus on the federal regulation and only provide some vague references to state examples.

1.1. *Early examples of investment-based crowdfunding*

Although the earliest crowdfunding platforms of the U.S. appeared in the first half of the 2000s¹⁵¹, it has particularly become a focus of attention following the financial crisis in 2007 as a financing model that avoids banks or other financial institutions.¹⁵² This was also the period when the first attempts of equity-crowdfunding were carried out, however, two of the most successful examples had been ended in a similar way by the intervention of financial authorities - both in federal and state level.

In the Pabst Brewing campaign (the purpose of which was to acquire the brewery) investors were offered “crowdsourced certificates of ownership” as well as beer in proportion to

¹⁵⁰ Robano, *supra* note 10, at 7.

¹⁵¹ *See* note 23.

¹⁵² Weinstein, *supra* note 91, at 430.

the amount invested and eventually raised more than USD 200 million.¹⁵³ However, the Securities and Exchange Commission (“SEC”) of the U.S. found that such offering of securities was subject to registration with the authority and no applicable exemption released the campaigners from such obligation. Similarly, in the case of ProFounder which operated as an equity-crowdfunding site the California Department of Corporations found that the platform was not allowed to sale securities on the internet without first obtaining authorization to act as a securities broker-dealer in the state.¹⁵⁴ These attempts show, however, that upon the emergence of securities-based crowdfunding the question also aroused whether financial regulation and registration requirements apply to this new instrument.

1.2. Applicability of federal securities regulation – the Howey test

The core of question with regard to the applicability of securities law to investment-based crowdfunding was obvious: whether the investments involved in crowdfunding constitute securities or not. Federal securities statutes have their own definition on “security”¹⁵⁵ but they all include the rather broad category of “investment contract”.¹⁵⁶ The key to the interpretation of this term was provided by the U.S. Supreme Court as early as 1946 in the Howey case¹⁵⁷ by formulating a standard test for characterizing unusual financial arrangements as securities.¹⁵⁸ The Howey-test stated that “an investment contract for the purposes of the Securities Act means a contract, transaction or a scheme, whereby a person invests his money in a common enterprise, and is led to expect profits solely [later changed to predominantly¹⁵⁹] from the efforts of the promoter or a

¹⁵³ Matter of Michael Migliozi II and Brian William Flatow - Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8a of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, No. Administrative Proceeding, File No. 3–14415, Release No. 9216 (us Securities and Exchange Commission Jun. 8, 2011).

¹⁵⁴ ProFounder Financial, Inc. - Consent Order to Desist and Refrain, (us State of California - Business, Transportation and Housing Agency - Department of Corporations Aug. 31, 2011).

¹⁵⁵ However, the key acts, Securities Act of 1933 (15 U.S.C. § 77a) and the Securities Exchange Act of 1934 (15 U.S.C. § 78a) contain almost identical definition of security.

¹⁵⁶ Bradford, *supra* note 22, at 30.

¹⁵⁷ Securities and Exchange Commission v. W.J. Howey Co. et al., 328 U.S. 293 (1946).

¹⁵⁸ Tibor Tajti, *Central European Contribution to the American Debate on the Definition of Securities or Why Does the Definition of Security Matter: The Fiasco of the Hungarian Real Estate Investment Cooperatives, Pyramiding, and Why Emerging Capital Markets Should Be Equipped to Act Rather than React [notes]*, TRANSNATL. LAW CONTEMP. PROBL. 109, 120, note 21 (2005).

¹⁵⁹ See note 164.

third party...”¹⁶⁰ According to the comprehensive case law that the both the Supreme Court and lower courts have developed with regard to the interpretation of the elements of the Howey-test it is rather hard to deny that the offerings in investment-based crowdfunding would constitute investment contracts in the above sense.

The first three prongs of the definition is obviously met by investment-based crowdfunding: there is a transaction whereby a person invests his money in a common enterprise. The (horizontal) commonality of a business venture is clearly demonstrated by the pool of crowdinvestors¹⁶¹, and for an investment transaction to take place it is immaterial whether the shares in the enterprise are represented by formal certificates or any other nominal interests in the physical assets employed in the enterprise.¹⁶² With regard to the requirement that the investor shall be led to expect profits it may be argued that investors in crowdfunding are motivated by incentives other than the expectation of profits, however, in light of the relevant court practice this argument is rather weak whenever a crowdfunding campaign offers financial return or equity interest in exchange for the investment.¹⁶³ Finally, it follows from the high number and the unsophisticated nature of crowdinvestors that it would be technically impractical to involve all of them in the business and they also have little interest and insufficient expertise to do so. Accordingly, investors in crowdfunding clearly expect the profits solely from the efforts of the issuers (as well as the intermediary, as a third party), and this requirement would still be met in case some active – though marginal - contribution would be carried out by an investor, since court precedents have changed the condition “solely” to “predominantly”.¹⁶⁴ In light of the above the applicability of securities regulation (namely the Securities Act of 1933¹⁶⁵ and the Securities Exchange Act of 1934¹⁶⁶) is inevitable for investment-based crowdfunding, which means that – unless an exemption is available

¹⁶⁰ Securities and Exchange Commission v. W.J. Howey Co. et al., *supra* note 157, at 298-299.

¹⁶¹ Heminway & Hoffman, *supra* note 22, at 901–2.

¹⁶² Securities and Exchange Commission v. W.J. Howey Co. et al., *supra* note 157, at 299.

¹⁶³ Heminway & Hoffman, *supra* note 22, at 903.

¹⁶⁴ See Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc., et al., 474 F.2d 476, 482 (9th Cir. 1973), and Securities and Exchange Commission v. International Loan Network, Inc., et al., 968 F.2d 1304, 1308 (D.C. Cir. 1992).

¹⁶⁵ 15 U.S.C. § 77a hereinafter “Securities Act”.

¹⁶⁶ 15 U.S.C. § 78a hereinafter “Exchange Act”.

under these statutes - securities may not be offered in a campaign until a registration statement has been filed with the SEC and it becomes effective.¹⁶⁷

1.3. Legislative demand for a crowdfunding exemption

Early-stage or even more mature but small businesses are not in the position to bear the administrative burdens and costs posed by the general registration and disclosure requirements of the SEC and the applicable statutes. A detailed registration statement has to be filed with the authority containing a separate prospectus for the investors and also additional information provided exclusively to the SEC.¹⁶⁸ In most cases the final amount of legal, accounting and administrative fees related to the preparation and filing of such registration statement would exceed the amount that the business wanted to raise in the first place.¹⁶⁹ Compared to the total size of the offering the relative costs are disproportionately higher for smaller offerings due to the fixed elements of the expenses.¹⁷⁰ In addition, most of such fees and expenses have to be paid in advance while the entire duration of the registration process may be more than 6 months.¹⁷¹ Accordingly, in lack of an exemption from the costly and quite technical registration requirements that are designed to the initial public offerings (IPOs) of bigger scale companies addressing brokers and other professional investors small and startup businesses were precluded from the opportunity of issuing securities in crowdfunding campaigns.

In order to ease the administrative burdens of private and smaller scale offerings the SEC has established various safe harbor rules under which registration requirements may be avoided. However, initially none of these statutory exemptions were available for crowdfunding, mainly because of limitations on advertisement or on the number of unsophisticated investors who may

¹⁶⁷ Sections 5(a)(1) and 5(c) of the Securities Act of 1933. 15 U.S.C. § 77e(c) (2012), 15 U.S.C. § 77e(a)(1) (2012).

¹⁶⁸ SECURITIES WORLD: JURISDICTIONAL COMPARISONS 428 (Willem J. L. Calkoen ed., European Lawyer Reference Series, 4th ed. 2014).

¹⁶⁹ Bradford, *supra* note 22, at 42.

¹⁷⁰ Rutheford B. Campbell, *Proposed Crowdfunding Regulations Under the Jobs Act: Please, SEC, Revise Your Proposed Regulations in Order to Promote Small Business Capital Formation*, SSRN Scholarly Paper ID 2406214 4, note 1 (Social Science Research Network), Feb. 14, 2014.

¹⁷¹ Bradford, *supra* note 22, at 43.

be purchaser in the offerings. As an example, under the most frequently used regulation¹⁷² issuers may choose among three different set of rules to escape registration, however, a prohibition on general solicitation or general advertising¹⁷³ precludes each of them to be applied to crowdfunding. Before 2013 only one slight immunity was available from this general prohibition, but that merely intended to give room to the application of certain special state exemptions, with the condition that solicited purchaser are accredited investors, therefore not members of the crowd. In general, these exemptions were meant to facilitate offerings addressed to a restricted group of people¹⁷⁴ and not crowdfunding, of which the public solicitation of unsophisticated investors is the essential part by definition. This was exactly the legislative vacuum that brought about the development of crowdfunding regulation in the U.S.

1.4. The adoption of regulation on investment-based crowdfunding

By 2010 the SEC has received a number of petitions to create regulation on securities-based crowdfunding, which idea was also provided bipartisan support by the Congress in line with a common goal upon which both political sides could agree at that time: the promotion of small businesses in American economy.¹⁷⁵ Consequently, President Obama – who himself raised funds for his presidential campaign by crowdfunding through the internet¹⁷⁶ - introduced the first proposal of the act in 2011 and signed the final Jumpstart Our Business Startups Act¹⁷⁷ (“JOBS Act”) in April 5, 2012. The JOBS Act do not only concern the crowdfunding exemption: it is only Title III that is actually referred to as the CROWDFUND Act (Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act) of 2012.

However, this statute still failed to open the way before securities-based crowdfunding in the U.S. because in most issues it did not provide a firm regulation, rather mandated the SEC to

¹⁷² Regulation D, 17 C.F.R. §§ 230.501-230.508 (2012). Regulation D rules has been slightly amended by the JOBS Act which changes will be explained below.

¹⁷³ 17 C.F.R. § 230.502(c) (2012).

¹⁷⁴ Weinstein, *supra* note 91, at 431–34 (Part I, Section C).

¹⁷⁵ Mashburn, *supra* note 1, at 143.

¹⁷⁶ Ibrahim, *supra* note 16, at 567–68.

¹⁷⁷ Jumpstart Our Business Startups Act of 2012, Pub. L. No. 112-106, §§ 301-305, 126 Stat. 306, 315-23 (2012) (codified in scattered sections of 15 U.S.C.).

adopt rules for the implementation of the skeleton framework provided in the CROWDFUND Act. As a result, investment-based crowdfunding is still not legal under U.S. law, and will not be until the SEC regulation comes into effect. According to a broad categorization Title II of the JOBS Act also constitutes a crowdfunding exemption.¹⁷⁸ Under these rules the JOBS Act indeed eliminated the restrictions on general solicitation or advertising with regard to some offerings, but only so long as the targeted purchasers are accredited investors.¹⁷⁹ According to the definition of accredited investors they shall be sophisticated institutions or individuals who meet high income or net worth standards.¹⁸⁰ This exemption already entered into effect on September 23, 2013 and was obviously very important to enable the operation of sites applying internet based solicitation within the traditional business angel or venture capital investment models, which proved to be a great success ever since.¹⁸¹ Nevertheless, this model is very far from the original idea of crowdfunding, and does not serve the original purpose associated to investment-based crowdfunding with regard to startup finance.

The remaining demand for a regulatory exemption on investment-based crowdfunding – that was left even after Title II rules came into effect - was clearly showed by state legislations that took the initiative and passed their own crowdfunding regulations.¹⁸² Their right to do so is provided by the Securities Act exempting intrastate securities offerings from its scope provided that all participants of the transaction are incorporated in or residents of that state¹⁸³, and by 2015 fourteen states have made use of this possibility and adopted their own intrastate crowdfunding exemptions.¹⁸⁴ Nonetheless, in the meantime the SEC has also made progress on the preparation and adoption of the federal rules to finally enable securities-based crowdfunding across the country and to some extent also in cross-border dimensions.

¹⁷⁸ Ibrahim, *supra* note 16, at 570; Vargas et al., *supra* note 33.

¹⁷⁹ 17 C.F.R. § 230.504(b)(1) and § 230.506(c) (2013).

¹⁸⁰ 17 C.F.R. § 230.501(a) (2013). *See also* Bradford, *supra* note 22, at 45.

¹⁸¹ *See generally* Part III of Ibrahim, *supra* note 16.

¹⁸² Mathews, *supra* note 16, at 293.

¹⁸³ 15 U.S.C. § 77c(a)(11) (2012).

¹⁸⁴ Mathews, *supra* note 16, at 293–94.

The deadline for the SEC to issue the regulation was 270 days following the enactment of the JOBS Act¹⁸⁵ (i.e. January 5, 2013), however, in light of the comprehensive public consultation and economic research that it had to carry out to evaluate the economic impact and to justify the economic efficiency of its adopted rules such deadline was delusional. First, the SEC has published its Proposal¹⁸⁶ on October 23, 2013 and called for a public consultation regarding the proposed rules. After the SEC has processed and considered over 485 comment letters that it had received in response to the proposal it finally adopted Regulation Crowdfunding¹⁸⁷ on October 30, 2015.¹⁸⁸ The final release¹⁸⁹ of the SEC provides detailed reasoning for its policy choices with regard to each and every final rule along with a short description of the views of the commenters. Regulation Crowdfunding will come into effect on May 16, 2016, however the rules on the registration of funding portals are already effective since January 29, 2016 in order to enable the timely establishment of the portals before their launch.

2. Consolidated crowdfunding model of Regulation Crowdfunding

As already mentioned, the CROWDFUND Act only outlined the skeleton of the securities-based crowdfunding regulation that the Congress envisaged while it is Regulation Crowdfunding that provides a detailed system for this instrument. In fact, the CROWDFUND Act introduced a new exemption¹⁹⁰ into the Securities Act as well as some requirements with respect to the transactions¹⁹¹ and supplemented some provisions of the Exchange Act¹⁹² accordingly. However, the essence of the regulation is in the matters that the CROWDFUND Act listed for either required or optional SEC rulemaking¹⁹³. The wide description of these issues provided great discretion for the commission during such rulemaking. As a clear example, the act

¹⁸⁵ Sections 302(c), 303(b), and 304(a)(2) of the JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 315-23 (2012).

¹⁸⁶ Proposal on Crowdfunding, Release Nos. 33-9470; 34-70741 (2013).

¹⁸⁷ Regulation Crowdfunding, 17 C.F.R. §§ 227.100– 227.503 (2016).

¹⁸⁸ Regulation Crowdfunding, Securities and Exchange Commission, 80 Fed. Register, pages 71388-71615, November 16, 2015 (FR Doc No 2015-28220).

¹⁸⁹ SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

¹⁹⁰ Section 4(a)(6) of the Securities Act, 15 U.S.C. § 77d(a)(6) (2012).

¹⁹¹ Section 4A of the Securities Act, 15 U.S.C. § 77d-1 (2012).

¹⁹² Section 12(g)(6) of the Exchange Act, 15 U.S.C. § 78l(g)(6) (2012); Section 3(h) of the Exchange Act, 15 U.S.C. § 78c(h) (2012), Section 3(a)(80) of the Exchange Act, 15 U.S.C. § 78c(a)(80) (2012).

¹⁹³ For a comprehensive list see Bradford, *supra* note 9, at 231.

generally authorized the SEC to adopt any rules it may deem “necessary or appropriate for the protection of investors” to carry out the crowdfunding exemption.¹⁹⁴ Therefore, the SEC did not only supplement the CROWDFUND Act with additional rules but also refined and clarified its provisions and incorporated the entire system into one consolidated instrument, the Regulation Crowdfunding. Accordingly, this thesis below will discuss such consolidated rules and only mention the provisions of the act (which are now implemented into the Securities Act) where it is necessary.

2.1. Essential conditions of the crowdfunding exemption

The amended Securities Act currently lists four fundamental conditions to conduct securities-based crowdfunding that is exempted from registration requirements.¹⁹⁵ The first and the second, limitations on the capital raised by the issuer and an investment cap on the investor¹⁹⁶, are also the two most important prongs of the crowdfunding exemption to balance between investor protection and the surrender of stricter regulatory requirements on. The third condition relates to the intermediary: securities-based crowdfunding must be conducted through a registered broker or a funding portal that complies with the applicable requirements.¹⁹⁷ The fourth conditions emphasizes that issuers also has to comply with the specific conditions of the crowdfunding exemption.¹⁹⁸

(i) Limitation on raised capital

Under the Regulation an issuer may offer or sell securities in reliance of the crowdfunding exemption¹⁹⁹ (i.e. without satisfying the general registration requirements of the Securities Act) if the aggregate amount of the securities sold to all investors during the preceding 12-month period and including the transaction at issue do not exceed USD 1 million.²⁰⁰ For purposes of calculating

¹⁹⁴ Section 302(c) of the JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 315-23 (2012).

¹⁹⁵ Section 4(a)(6) of the Securities Act, 15 U.S.C. § 77d(a)(6) (2012).

¹⁹⁶ Section 4(a)(6)(A) and Section 4(a)(6)(B) of the Securities Act, U.S.C. § 77d(a)(6)(A) (2012) and U.S.C. § 77d(a)(6)(B) (2012).

¹⁹⁷ Section 4(a)(6)(C) of the Securities Act, 15 U.S.C. § 77d(a)(6)(C) (2012).

¹⁹⁸ Section 4(a)(6)(D) of the Securities Act, 15 U.S.C. § 77d(a)(6)(D) (2012).

¹⁹⁹ Section 4(a)(6) of the Securities Act, 15 U.S.C. § 77d(a)(6) (2012).

²⁰⁰ Rule 100(a)(1) of Regulation Crowdfunding, 17 C.F.R. §§ 227.100(a)(1) (2016).

of such aggregate amount the securities sold and offered by all affiliates of the issuer company in the concerned time period has to be taken into account.²⁰¹ The SEC explains that this general limitation on the capital raised is intended to serve investor protection “by reducing the potential loss from dilution or fraud in the securities-based crowdfunding market” while issuers may seek additional financing by another type of exempt offering.²⁰²

(ii) *Investment limitations*

In addition to the above, the most important rule on investor protection are the individual investment limitations: the aggregate amount of securities that may be sold to any investor across all issuers during the 12-months period preceding the date of the transaction depends on the annual income or net worth of the investor concerned. If the either of these is less than USD 100,000 than the investment limit will be the greater of USD 2,000 or 5% of the investor’s annual income or net worth (from which the lesser amount shall be taken into account).²⁰³ If both the investor’s annual income and net worth exceeds USD 100,000 than the investment limit will be 10% of the investor’s annual income or net worth, whichever is less.²⁰⁴

The SEC admits that such investment caps may limit the positive effects of crowdfunding on capital formation, however, it considers this cost inevitable in order to secure the protection of unexperienced investors by preventing them from exposing themselves to extreme amount of losses.²⁰⁵ Another issue raised by the SEC with regard to the investment caps is that it also prevents investors from diversifying their investments in the securities-based crowdfunding markets where this would be especially important since it is expected to involve early stage-financing with inherently high failure rates.²⁰⁶ However, it is unlikely that higher investment caps would in fact really encourage unsophisticated investors to use such diversification technique. On the other hand Regulation Crowdfunding allows investors to calculate their net worth or annual income jointly

²⁰¹ Rule 100(c) of Regulation Crowdfunding, 17 C.F.R. §§ 227.100(c) (2016).

²⁰² Section III.B.2.a. at 390, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁰³ Rule 100(a)(2)(i) of Regulation Crowdfunding, 17 C.F.R. § 227.100(a)(2)(i) (2016).

²⁰⁴ Rule 100(a)(2)(ii) of Regulation Crowdfunding, 17 C.F.R. § 227.100(a)(2)(ii) (2016).

²⁰⁵ Section III.B.2.b. at 398, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁰⁶ Section III.B.2.b. at 395, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

with their spouses to enable the investment of those wealthy individuals who can really afford such inherent risks.²⁰⁷

It is important to mention with regard to the individual investment caps issuers are not obligated to strictly monitor the investor compliance with the limitation – since it would be almost impossible for them to do so. Accordingly, they may rely on the efforts of the intermediary (mandated by the regulation) to ensure such compliance, provided that the issuer do not actually know that the investor has exceeded the limit.²⁰⁸ Apart from this relief provided to issuers they still have to comply with a number of obligations that requires a more detailed examination, therefore it will be discussed in a separate section.

2.2. *Issuers*

The rules of Regulation Crowdfunding governing issuers' participation in securities-based crowdfunding is quite detailed. It determines prior eligibility criteria for, both general and financial disclosure requirements and additional restrictions on the promotional activities that issuers are allowed to carry out in connection with the campaigns. It is questionable whether and how unexperienced startup entrepreneurs (who are the expressed targets of the Regulation in order to aggregate the level of capital formation in the U.S. economy²⁰⁹) will be able to get to know, comprehend and properly adapt to the rules at a reasonable cost. In order to evaluate the administrative constraints that the Regulation may constitute a closer look shall be taken to its actual requirements.

(iii) *Issuer eligibility*

The categories of issuers that are excluded from the possibility to rely on the crowdfunding exemptions are set forth by the Regulation in accordance with the mandate of the CROWDFUND Act. Excluded categories are foreign companies, investment companies or those subject to Exchange Act reporting requirements, and issuers who have already conducted securities-based

²⁰⁷ Instruction 2 to Rule 100(a)(2) of Regulation Crowdfunding, 17 C.F.R. § 227.100(a)(2) (2016).

²⁰⁸ Instruction 3 to Rule 100(a)(2) of Regulation Crowdfunding, 17 C.F.R. § 227.100(a)(2) (2016).

²⁰⁹ Section III.B.1. at 383, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

crowdfunding but failed to properly perform the related ongoing reporting requirements, as well as issuers without an appropriate business plan.²¹⁰ The last two categories are added to the list at the discretion of the SEC as it considered them necessary to prevent information asymmetry.²¹¹ Additionally, the final rules set forth a number of disqualification provisions²¹² that applies to natural persons affiliated with the issuer (managers, officers, etc. and even promoters) and disqualifies issuers if such persons have been convicted or were the subject of any order or judgment in connection to an illegal action or other misdemeanor conducted in relation to securities.²¹³

(iv) *Disclosure requirements: general and financial information*

Issuers who intend to rely on the crowdfunding exemptions will first have to file the required information with the SEC by using Form C adopted for this purpose in Regulation Crowdfunding.²¹⁴ The SEC was well aware that choosing the right amount and content of disclosed information with regard to an offering is the core question of regulating investment-based crowdfunding, however, eventually it decided to tackle information asymmetry by requiring a very detailed list of information to be disclosed.²¹⁵ This list includes simple data of the company or its owners but also requires a “description of the purpose and intended use of the offering proceeds²¹⁶” and “any material information necessary to make the statements made (...) not misleading²¹⁷”. These designations are quite vague and might be really hard to understand and properly filled out by startup entrepreneurs.

The disclosure requirements of the Regulation also include the filing of a discussion about the issuer’s financial condition²¹⁸ (liquidity, capital resources and historical results of operations)

²¹⁰ Rule 100(b) of Regulation Crowdfunding, 17 C.F.R. § 227.100(b) (2016).

²¹¹ Section III.B.2.c. at 399-400, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²¹² Rule 503(a) of Regulation Crowdfunding, 17 C.F.R. § 227.503(a) (2016).

²¹³ For a *comprehensive list* see Rule 503(a)(1)-(7) of Regulation Crowdfunding, 17 C.F.R. § 227.503(a)(1)-(7) (2016).

²¹⁴ See a sample of such Form C filing form on page 603 of SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²¹⁵ Rule 201(a)-(y) of Regulation Crowdfunding, 17 C.F.R. § 227.201(a)-(y) (2016).

²¹⁶ Rule 201(i) of Regulation Crowdfunding, 17 C.F.R. § 227.201(i) (2016).

²¹⁷ Rule 201(y) of Regulation Crowdfunding, 17 C.F.R. § 227.201(y) (2016).

²¹⁸ Rule 201(s) of Regulation Crowdfunding, 17 C.F.R. § 227.201(s) (2016).

and a detailed set of financial statements²¹⁹ (balance sheets, statements of income and cash flows, etc.). In this regard the final rules implement a tiered disclosure system which only requires the financial statements to be reviewed or audited by an independent public accountant if the target amount of the offering exceeds a certain threshold.²²⁰ In case the issuer conducts securities-based crowdfunding for the first time audited financial statements are not mandatory, unless such statements of the issuer are otherwise available.²²¹ The expected content of the financial disclosures are quite clear as opposed to some of the above mentioned general provisions, however, their technical nature requires the assistance of accounting expertise, which entails further administrative costs to be covered by issuers.

Apart from the above explained ex-ante disclosure requirements the SEC also established the obligation to provide ongoing reporting after the sale of securities through a crowdfunding exemption.²²² This means that the issuer has to file with the SEC and publish on its website annual reports including financial statements and an update on most of the information provided in the ex-ante disclosures. Such ongoing reporting has to only be continued until the occurrence of certain conditions²²³, for example until one annual report has already been published and the issuer has fewer than 300 holder of records.

The disclosure requirements of the final rules are even more detailed than the previous list of the SEC's Proposal which already received criticism from the commenters.²²⁴ The commission argues, however, that detailed disclosure is the most effective way to prevent the lemons problem²²⁵ in securities-based crowdfunding market because it improves price efficiency by facilitating well informed decision-making of investors.²²⁶ According to the SEC's analysis the ongoing reports also provide a liquidity benefit for the resale of crowdfunded securities since in lack of such disclosure

²¹⁹ Rule 201(t) of Regulation Crowdfunding, 17 C.F.R. § 227.201(t) (2016).

²²⁰ Rule 201(t)(1)-(3) of Regulation Crowdfunding, 17 C.F.R. § 227.201(t)(1)-(3) (2016). Reviewed statements are required over USD 100,000, audited statements are required over USD 500,000 target offering amounts.

²²¹ Rule 201(t)(3) of Regulation Crowdfunding, 17 C.F.R. § 227.201(t)(3) (2016).

²²² Rule 202 of Regulation Crowdfunding, 17 C.F.R. § 227.202 (2016).

²²³ Rule 202(b) of Regulation Crowdfunding, 17 C.F.R. § 227.202(b) (2016).

²²⁴ Campbell, *supra* note 168, at 4.

²²⁵ See Section II.2.

²²⁶ Section III.B.3.b. at 414, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

they could not be evaluated after the campaign and a secondary market would not be able to develop.²²⁷ In addition, the SEC also points out that and the comprehensive financial disclosures – which due to their technicality might not be of use for unexperienced investors – is a useful way to to attract the investment of professional and accredited investors because it will provide them with more information than they would obtain in private offerings.²²⁸ The involvement of these investors in securities-based crowdfunding is indeed essentially important to eliminate the lemons problem in this market, however, it remains to be seen whether the final rules' disclosure measures will in fact be useful to achieve this goal.

(v) *Rules on promotion of crowdfunding offerings*

The last two rules of the issuer requirements section of Regulation Crowdfunding applies to advertising and promotional compensation. In light of that other exemptions under the Securities Act do not provide for the general possibility to publicly invite investors these topics received a great attention during the SEC rulemaking process. With regard to advertising, the final rules prohibits the advertising of an offering, except for notices that direct investors to the intermediary's platform and include only basic information and the terms of the offering.²²⁹ Apart from these limitations on the content, the SEC did not regulate the medium through which the notice may be advertised. It argues that this will allow issuers to leverage the internet and the social media in terms of advertisement, while the rules also ensure that investors are directed to the required disclosures.²³⁰

Additionally, the final rules also permit issuers to communicate with investors through the communication channels on the intermediary's platform, given that the issuer identifies itself in all communications.²³¹ The SEC considers that the sharing of information is the crucial condition for

²²⁷ Section III.B.3.b. at 415, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²²⁸ Section III.B.3.c. at 416, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²²⁹ Rule 204 of Regulation Crowdfunding, 17 C.F.R. § 227.204 (2016). According to the instruction to Rule 204 terms of the offering means the amount, nature and price of the securities offered, and the closing date of the offering period.

²³⁰ Section II.B.4.c. at 140, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²³¹ Rule 204(c) of Regulation Crowdfunding, 17 C.F.R. § 227.204(c) (2016).

crowdfunding investors to make profitable business decisions, and this requires bilateral communication to enable investors to ask questions that may remain even beside the disclosures and also the entrepreneurs to react to those issues.²³² This is also the reason for the final rules allowing issuers to engage promoters that may only act through the platform's channels²³³ and has to disclose during its communications that it receives compensation from the issuers in relation to its activity.²³⁴ This requirement applies broadly, regardless of the actual title for which the promoter received such compensation²³⁵, but on the other hand the issuer's responsibilities are also quite vague: it has to "take reasonable steps to ensure" that the promoter discloses such relationship. According to the SEC this definition is appropriately requires issuers to contractually oblige their promoters' compliance and subsequently monitor their activity without being overly prescriptive.²³⁶ From a regulatory point of view such vague designation may indeed provide more room for the authorities to examine the compliance of issuers, but on the other hand it also carries uncertainty costs for market participants until a practice is established in the matter.

(vi) *Insignificant deviations*

Authors have criticized the applicability of detailed issuer requirements already after the enactment of the CROWDFUND Act before the Proposal of the SEC would have been published.²³⁷ They argued that since the condition to rely on the crowdfunding exemption is to comply with all the requirements it is practically undermined and rendered useless since the slightest incompliance would make it invalid, which could also occur solely from the failure of the intermediary.²³⁸ The SEC has shared the view of the commenters and agreed that without a safe harbor issuers may be reluctant to conduct offerings that may easily (even due to the intermediary's conduct that is beyond their control) become subject of securities registration and regulatory

²³² Section II.B.4.c. at 141, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²³³ Pursuant to Rule 205(b) promoters may also be engaged for advertising but only for activities in strict compliance with the limitations of Rule 204 of Regulation Crowdfunding.

²³⁴ Rule 205 of Regulation Crowdfunding, 17 C.F.R. § 227.205 (2016).

²³⁵ Instruction to Rule 205(a) of Regulation Crowdfunding, 17 C.F.R. § 227.205(a) (2016)..

²³⁶ Section II.B.5.c. at 145, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²³⁷ Bradford, *supra* note 9, at 218.

²³⁸ Campbell, *supra* note 168, at 9.

finer.²³⁹ Accordingly, the Regulation provides a safe harbor for issuers stating that a failure to comply with a requirement will not result in the loss of the exemption if the issuer shows that such failure was insignificant with respect to the whole offering; it made good faith attempt to comply with all the rules; and lastly, it did not know about such failure if it is attributable to an intermediary's fault.²⁴⁰ The Regulation also states that the insignificant deviation exception does not preclude the SEC from investigating any noncompliance and bringing an enforcement action.²⁴¹ In fact, this additional provision puts the safe harbor conditions into context in the sense that it clarifies to who the issuer must show the fulfillment of such conditions.

The third prong of the safe harbor on insignificant deviations, the one that exempts the issuer from liability for the intermediary's failures was actually added to the Regulation in the final rules. By doing so the SEC acknowledged the approach that intermediaries are entirely independent participants of a crowdfunding process and they shall not be treated any more connected to the issuers than to the investors. Accordingly, the Regulation includes a set of rules exclusively applying to the formation and operation of crowdfunding intermediaries, as discussed in the following section.

2.3. *Intermediaries*

The fourth of the fundamental conditions of the Securities Act to rely on a crowdfunding exemption is that the transactions have to be conducted through a registered broker or a funding portal.²⁴² Regulation Crowdfunding uses the common term "intermediary" which also refers to, where relevant, an associated person of the registered broker or funding portal.²⁴³ The final rules also clarify that a crowdfunding transaction shall be exclusively conducted through the intermediary's platform, and that the issuer may not conduct an offering or concurrent offerings using more than one intermediary.²⁴⁴ In this regard the SEC also emphasizes – as mentioned above

²³⁹ Section II.E.1.c. at 323-324, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁴⁰ Rule 502 of Regulation Crowdfunding, 17 C.F.R. § 227.502 (2016).

²⁴¹ Rule 502(b) of Regulation Crowdfunding, 17 C.F.R. § 227.502(b) (2016).

²⁴² Section 4(a)(6)(C) of the Securities Act, 15 U.S.C. § 77d(a)(6)(C) (2012).

²⁴³ Rule 300(c)(3) of Regulation Crowdfunding and the related instruction, 17 C.F.R. § 227.300(c)(3) (2016).

²⁴⁴ Rule 100(a)(3) of Regulation Crowdfunding and the related instruction, 17 C.F.R. § 227.100(c)(3) (2016).

in Section III.2.2 - that the core principle of crowdfunding is the sharing of information by the general public, while such crowdsourcing and the transparency that it requires would be diluted if campaigns by an issuer could be conducted on different platforms at the same time.²⁴⁵

(i) *Registration requirements of intermediaries*

Crowdfunding intermediaries shall be registered with the SEC either as a broker (in which case the Exchange Act applies to them) or as a funding portal, the new regulatory category designed especially for the crowdfunding exemption and governed by the rules of the Regulation.²⁴⁶ In addition, the intermediary also have to be a member of a national securities association (i.e. a self-regulatory organization “SRO”²⁴⁷) that is registered in accordance with the Exchange Act²⁴⁸. Currently there is only one such association, the Financial Industry Regulatory Authority (FINRA).²⁴⁹ The Regulation do not include further eligibility requirements on intermediaries as these are included in the applicable statutes and in the rules of the relevant SROs. With regard to funding portals and associated persons – as opposed to brokers - such rules were not previously available and had to be developed along with the regulation on crowdfunding itself. Accordingly, the Funding Portal Rules adopted by FINRA and approved by the SEC became effective on the same day (January 29, 2016) as those rules of Regulation Crowdfunding that are related to funding portal registration.²⁵⁰ Funding Portals are subject to the regulatory supervision of the FINRA and ongoing reporting requirements, therefore, these Funding Portal Rules regulate the related procedures as well as the admission to the association and subsequent obligations of members.²⁵¹

(ii) *Special rules on funding portals*

As Funding Portals are completely new instruments of the U.S. legal frameworks and their scope of activities shall be more restricted - as opposed to brokers - certain special compliance

²⁴⁵ Section II.3.c. at 31-32, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁴⁶ Rule 300(a)(1) of Regulation Crowdfunding, 17 C.F.R. § 227.300(a)(1) (2016).

²⁴⁷ Weinstein, *supra* note 91, at 449, note 196.

²⁴⁸ Rule 300(a)(2) of Regulation Crowdfunding, 17 C.F.R. § 227.300(a)(2) (2016).

²⁴⁹ For a list of registered SROs see <https://www.sec.gov/rules/sro.shtml>.

²⁵⁰ SEC Approval of FINRA Funding Portal Rules and Related Forms, Regulatory Notice 16-06 (2016) available at <http://www.finra.org/sites/default/files/Regulatory-Notice-16-06.pdf>

²⁵¹ FINRA Funding Portal Rules available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=12218.

requirements apply to them. First, the definition of funding portals includes limitations on the services and activities that funding portals are allowed to carry out.²⁵² Accordingly, they are not allowed to offer investment advice or recommendations, solicit purchases, sales or buying offers of securities or compensate its employees or others for such solicitation, and funding portals are also permitted to hold, manage or otherwise handle investor funds.²⁵³ Finally, they may not provide compensation for its employees or others based on the sale of securities carried out in the platform²⁵⁴, which means that persons associated with the portal shall not be financially encouraged to boost up the number of transactions in the platform because this should be exclusively driven by the economic viability of the offerings. This is also the reason behind the prevention on investment solicitation and consultancy: since funding portals do not required to be financial experts they shall not be allowed to influence investment decisions either.

Since the restrictions in the definition of funding portals are quite broad Regulation Crowdfunding also adopted a safe harbor to provide some clarity about what activities are consistent with the prohibitions.²⁵⁵ These conditions also provide an outline about what does the SEC consider as essential tasks of intermediaries to ensure a viable securities-based crowdfunding system. Accordingly, they may select which issuers it allows to register, highlight certain offerings based on objective criteria (type of securities offered, location of business, target amounts, etc.), provide search functions and categorize offering on similar objective criteria, provide communication channels on the platform.²⁵⁶ The most important of the safe harbor rules is that funding portals are allowed to advice issuers on the structure and content of their offering and also assist them to prepare the relevant documentation²⁵⁷. In light of the complicated disclosure

²⁵² Section 3(a)(80) of the Exchange Act, 15 U.S.C. § 78c(a)(80), Rule 300(2) of Regulation Crowdfunding, 17 C.F.R. § 227.300(2) (2016).

²⁵³ With regard to the transmission of funds Regulation Crowdfunding requires funding portals to deposit funds into an escrow account managed by a qualified third party (e.g. a bank or a registered broker) and subject to an escrow agreement. Rule 303(e)(2) of Regulation Crowdfunding, 17 C.F.R. § 227.303(e)(2) (2016). *See also* G. Philip Rutledge, *Overview of Crowdfunding in the US*, 36 COMP.LAW. 244, 244 (2015).

²⁵⁴ Section 3(a)(80)(C) of the Exchange Act, 15 U.S.C. § 78c(a)(80), Rule 300(2)(iii) of Regulation Crowdfunding, 17 C.F.R. § 227.300(2)(iii) (2016).

²⁵⁵ Rule 402 of Regulation Crowdfunding, 17 C.F.R. § 227.402 (2016).

²⁵⁶ Rule 402(1)-(4) of Regulation Crowdfunding, 17 C.F.R. § 227.402(1)-(4) (2016).

²⁵⁷ Rule 402(5) of Regulation Crowdfunding, 17 C.F.R. § 227.402(5) (2016).

requirements this service of funding portal may be essential to enhance the efficient use of the crowdfunding exemption. Similarly, all further safe harbor conditions²⁵⁸ are designed to allow platforms to advertise themselves and guide both issuers and investors through the technicalities of the crowdfunding procedure.

In light of the above, the purpose of the funding portal category is to facilitate the formation and the competition of crowdfunding intermediaries with a relatively simple way for their establishment, so long as they merely provide a technical platform for the offerings and does not interfere with the investment market. Such category was also essential to enable the transformation of already existing donation or reward-based platforms without requiring them to be registered as investment brokers.²⁵⁹ These platforms are experienced and well-known in the field and therefore may be the drivers to develop the investment-based crowdfunding market as well. Another technique of Regulation Crowdfunding to promote the establishment and competition of funding portals is that it gave way to the registration of nonresident funding portals.²⁶⁰ Accordingly, funding portals that are not incorporated under the laws of the United States may also be registered, provided that an information sharing arrangement - also known as “memoranda of understanding” - is in place between the SEC and the regulatory authority competent to such nonresident funding portal.²⁶¹

(iii) *Measures to reduce the risk of fraud*

Under the rules governing intermediaries the Regulation introduced a number of provisions designed to enhance investor protection and reduce the risk of fraud in crowdfunding offerings. It is obvious that in any system of investment-based crowdfunding some level of responsibility has to be imposed on the intermediary to prevent fraud and ensure the legality of the offerings, but the crucial question is what should be the principles of such liability. Regulation

²⁵⁸ Rule 402(6)-(13) of Regulation Crowdfunding, 17 C.F.R. § 227.402(6)-(13) (2016).

²⁵⁹ Section III.B.1. at 389, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁶⁰ Rule 400(f) of Regulation Crowdfunding, 17 C.F.R. § 227.400(f) (2016).

²⁶¹ Such arrangements are concluded with most of the European countries, including also Hungary. *See Cooperative Arrangements with Foreign Regulators (SEC Office of International Affairs)*, https://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml.

Crowdfunding tends to be rather vague (or flexible, in the SEC's point of view) on this matter and adopts the reasonable basis standard, meaning that the intermediaries must have a reasonable basis to believe that an issuer complies with all the applicable requirements²⁶², and it has to deny access to its platform to an issuer if the intermediary has a reasonable basis to believe that it is subject to disqualification or presents the potential of fraud.²⁶³ According to the SEC these rules provide intermediaries the possibility to decide the specific steps to take based on their experience and type of business (e.g. require regulatory history data or conduct background checks themselves).²⁶⁴

(iv) *Investor education*

Another essential pillar of investor protection in crowdfunding is the adequate education of investors – as already discussed in Section II.1.1. The SEC did not chose to adopt standardized education materials to be used by intermediaries mandatorily, but it determined the scope of information that has to be communicated to investors effectively and accurately in plain language when the investor opens an account on the platform.²⁶⁵ The SEC emphasized that such information has to be tailored to the particular offerings of the intermediaries who are therefore better positioned to shape these materials than the Commission.²⁶⁶ The minimum specified information shall contain for example the explanation about the entire process, the types of securities offered and the risks associated with each type, clarification on the investment cap, the restrictions on resale, and the possibilities to cancel an investment. In sum, the materials have to ensure that the investor is aware of the risks inherent in investing in startups and small enterprises, and understands what obligations the issuers would owe to them after the campaign. In addition to these standards the FINRA (or other national securities associations that might be registered in the future) are free

²⁶² Rule 301(a)-(b) of Regulation Crowdfunding, 17 C.F.R. § 227.301(a)-(b) (2016).

²⁶³ Rule 301(c) of Regulation Crowdfunding, 17 C.F.R. § 227.301(c) (2016).

²⁶⁴ Section II.C.3.c.(3) at 179 and Section III.B.4.b. at 458, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁶⁵ Rule 302(b) of Regulation Crowdfunding, 17 C.F.R. § 227.302(b) (2016).

²⁶⁶ Section II.C.4.b.(3) at 191, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

to implement additional requirements on educational materials²⁶⁷, however, FINRA in its currently effective rules did not take this opportunity.²⁶⁸

(v) *Investor qualification*

In addition to the supervisory measures that intermediaries has to carry out in connection with the issuers they are also responsible for investor qualification.²⁶⁹ The Regulation requires the intermediary in each time when it accepts an investment commitment to have a reasonable basis to believe that the investor does not exceed the applicable investment cap.²⁷⁰ Similarly, before each investment made, the intermediary has to obtain a representation from the investor that it has reviewed the educational materials and understands the risks explained, and also has to require the investor to complete a questionnaire about the most important issues of the process (i.e. cancellation of investment, restrictions on resale, warning that the investor should not invest any more amount that in can afford to lose).²⁷¹ With regard to the investment cap the intermediary may rely on the investor's statements unless it has reason to question such representation.²⁷² In its final analysis the SEC suggested that intermediaries will be allowed to create a centralized database of investor information containing such information, however, the SEC did not make it obligatory at this early point of development of the securities-based crowdfunding market.²⁷³

2.4. *Restrictions on resales*

Restrictions on resales may entirely undermine the viability of an investment-based crowdfunding model as it determines the development of a secondary market for crowdfunded securities. The final rules state that securities issued under the crowdfunding exemption may not be transferred by any purchaser for 1 year following their original issuance, except to the issuer, to an accredited investor, to a family member or as part of a registered offering.²⁷⁴ During this one-

²⁶⁷ Section II.C.4.b.(3) at 194, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁶⁸ FINRA Funding Portal Rules, *supra* note 249.

²⁶⁹ Rule 303(b) of Regulation Crowdfunding, 17 C.F.R. § 227.303(b) (2016).

²⁷⁰ Rule 303(b)(1) of Regulation Crowdfunding, 17 C.F.R. § 227.303(b)(1) (2016).

²⁷¹ Rule 303(b)(2) of Regulation Crowdfunding, 17 C.F.R. § 227.303(b)(2) (2016).

²⁷² Rule 303(b)(1) of Regulation Crowdfunding, 17 C.F.R. § 227.303(b)(1) (2016).

²⁷³ Section II.C.5.b.(1)(c) at 210, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁷⁴ Rule 501(1) of Regulation Crowdfunding, 17 C.F.R. § 227.501(1) (2016).

year period the restrictions apply to any purchaser not just the initial one, otherwise the provision could be easily circumvented and – for example - accredited purchaser could sell the securities to the public even during the one-year limitation period.²⁷⁵ As mentioned above in Section II.4.1 the SEC Proposal introduced the idea of the restriction period arguing that it provides enough time for investors to observe the performance of the business.²⁷⁶ In its final analysis the SEC reinforces these arguments and emphasizes that restrictions are important for investor protection also by incentivizing due diligence before the initial investment.²⁷⁷

However, in light of the small amount of their crowdfund investments, unsophisticated investors are still unlikely to conduct detailed investment analysis and the inducement effects of resale restrictions in this regard are rather minor. Such restrictions on the other hand might be useful to startup issuers who may really need a transitional period to show the value of their company. In case of their success the illiquidity costs that investors have to bear in this first year will be returned. In addition, the exemption provided to accredited investors from the restrictions also benefit issuers by inducing such professionals to the market. In fact, this advantage that accredited investors have during the first year of crowdfunding investments may become the main reason for them to be involved in the crowdfunding business which also beneficial to tackle the lemons problem. However, regardless of all these possibly positive effects, it is still difficult to predict whether and to what extent the illiquidity costs caused by resale restrictions will hinder the development of the entire securities-based crowdfunding market.

2.5. Scope of statutory liability

Similarly to resale restrictions the provisions on liability are also determinative with regard to the viability of an investment-based crowdfunding system. The basic rule on statutory liability in the U.S. framework is included in the Securities Act and not in Regulation Crowdfunding, while, the scope of liability is of course determined by the obligations imposed on issuers and

²⁷⁵ Section II.E.2.c. at 327, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁷⁶ Section III.B.3.h. at 378, SEC Proposed Rules on Regulation Crowdfunding, Release Nos. 33-9470 ; 34 -70741 (2013).

²⁷⁷ Section III.B.3.i. at 437-438, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

intermediaries by the Regulation. The Securities Act states that an issuer (that offers or sells a security under a crowdfunding exemption) shall be liable to purchasers if it makes an untrue statement of a material fact or omits to state a material fact that would be necessary not to mislead the purchase during such offering or sale.²⁷⁸ In light of the definition of issuer that is provided by the act exactly for the applicability of the liability rules (issuer constitutes anyone who offers or sells a security in the transaction) intermediaries are also captured by this provision, as they definitely offer securities during a crowdfunding campaign.²⁷⁹

The liability rules of the Securities Act received maybe the most serious criticism compared to any other provisions of the crowdfunding exemptions. All of these highlight that the terms are too broad and the conditions for escaping the liability²⁸⁰ are impossible to prove in most of the cases, which results in a trap for unexperienced and unsuspecting issuers.²⁸¹ In the course of the extremely detailed disclosure issuers may easily make mistaken statements.²⁸² Similarly, in light of the uncertain standards to carry out disqualification checks on issuers intermediaries are trapped in deciding what should be a reasonable care to avoid faulty omissions.²⁸³ In view of the SEC, however, these rules will properly induce intermediaries to establish appropriate due diligence procedures and review offerings before posting them on their platform.²⁸⁴

It is understandable that investor protection requires a quite broad liability provision which enables investors to bring claims for harmful acts or omissions, the forms of which may not be determined precisely at this point of the lawmaking procedure. However, this opportunity alone might just be useless to prevent the careless actions of issuers and intermediaries, because individual

²⁷⁸ Section 4A(c) of the Securities Act, 15 U.S.C. § 77d-1(c) (2012).

²⁷⁹ Section II.E.5. at 334, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁸⁰ The issuer or intermediary may only escape liability if the purchaser knew of the untruth or the omission, or the issuer proves that it did not know, and in the exercise of reasonable care could not have known, of such untruth or omission. Section 4A(c)(2)(A)-(B) of the Securities Act, 15 U.S.C. § 77d-1(c)(2)(A)-(B) (2012).

²⁸¹ Mashburn, *supra* note 1, at 173.

²⁸² Bradford, *supra* note 9, at 217.

²⁸³ C. Steven Bradford, *Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others* [article], UNIV. CINCINNATI LAW REV. 371, 376 (2014).

²⁸⁴ Section II.E.5. at 337, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

investors in crowdfunding will not have a sufficient amount of investment at stake to pursue litigation.²⁸⁵

3. Conclusions about the U.S. model

The above discussed model of the United States provides a complex and thorough example to address the regulatory challenges of investment-based crowdfunding and in most aspects its answers are quite deliberate and well-founded. First of all, the SEC had correctly recognized that the potential users of this new financing instrument will be startups and small enterprises at the earliest stages of the business venture where they are still developing their business plans and too young to attract venture capitalist or business angel investments.²⁸⁶ On the other hand, the main problems of the model are actually connected to this issue: in many aspect the rules do not facilitate the participation of startups businesses and the administrative burdens of the system precludes these ventures from benefitting from it.

Several calculations show that the overall costs to carry out a securities offering under the crowdfunding exemption could be still unbearable to small businesses. According to the SEC's own estimates offerings of USD 100,000 or less would entail approximately USD 10-12,500, and the costs for offerings of more than USD 500,000 would be definitely more than USD 50,000.²⁸⁷ These include fees of the intermediaries, and the costs to prepare the Form C required documentation and financial disclosures – for which professional assistance is inevitable –, meaning that they have to be covered by the entrepreneurs in advance. Consequently, even the SEC admits in its final analysis that the cost of compliance with the Regulation may be “significant” for some issuer²⁸⁸, in which case the adjective “critical” might be more appropriate.

Nevertheless, the creativity of startup entrepreneurs in the U.S. shall not be underestimated and they may be quite successful – also with the help of the three F's, family, friends

²⁸⁵ Mashburn, *supra* note 1, at 165–66.

²⁸⁶ Section III.A.5.a. at 375, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁸⁷ Section III.B.3.a. at 410 (Table on cost estimates), SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015).

²⁸⁸ Section III.B.3.a. at 411, SEC Release on Regulation Crowdfunding, Release. Nos. 33-9974; 34-76324 (2015)

and fools - to raise the necessary amounts for a crowdfunding offering. If this will be the case after Regulation Crowdfunding enters into effect in May 2016 many of its aspects may prove to be successful and worthy of attention to other regulators intending to introduce investment-based crowdfunding schemes. For example, the rules of the Regulation on investor education and the requirements imposed on intermediaries in this regard appropriately summarize the core topics that need to be clarified to unsophisticated investors and provide example for the proper measures to ensure their understanding. Similarly, the different techniques of the Regulation to attract accredited investors into the investment-based crowdfunding markets may also be successfully applied in other regulatory system.

The above examples of the Crowdfunding Regulation also show that investment-based crowdfunding is such a new phenomenon and so closely related to the economic side of corporate finance that differences between common law and civil law systems do not prevent comparative analysis and the possibility of cross-fertilization. Accordingly, borrowing from the above explained U.S. system of investment-based crowdfunding by a European legal system in order to develop its own regulation is not at all excluded, which leads us to the purpose of the last chapter of this thesis: to draw conclusions about the challenges of a crowdfunding regulation with regard to Hungary.

Chapter IV – Lessons for Hungary

1. Importance of startup finance in Hungary

Following the recognition of U.S. economy that entrepreneurialism is the key to innovation, growth, and employment²⁸⁹ Europe has long been aiming to develop its own Silicon Valley.²⁹⁰ In 2013 European entrepreneurs adopted a so-called Startup Manifesto calling for the promotion of a startup ecosystem by exploiting internet-driven economic growth.²⁹¹ In line with this movement and encouraged by the global success of startups like Prezi, Ustream or LogMeIn the Hungarian entrepreneurial community has also adopted its own Startup-Credo which envisaged Budapest as the start-up center of Central and Eastern Europe.²⁹² However, in light of the latest report evaluating the achievement of the Startup Manifesto's recommendations the Hungarian economy has a long way to go.²⁹³

One of the essential preconditions to develop a successful startup ecosystem is to facilitate access to finance for startups as well as SMEs to help them remain as ongoing business ventures. In the Hungarian economy the startup funding gap is especially affecting the pre-seed and seed segments. Due to the successful implementation of the JEREMIE²⁹⁴ program backed by European Union resources venture capital funding has increased in the recent years, however it still only covers a fraction of the SME financing market.²⁹⁵ In addition, venture capital - similarly to state funded SME loan programs - are only available to companies with a few years of operating history.²⁹⁶ The market of business angel investment, which could provide a solution for early-stage

²⁸⁹ Barack Obama, *Toward a 21st-Century Regulatory System*, WALL STR. J., Jan. 18, 2011, <http://www.wsj.com/articles/SB10001424052748703396604576088272112103698>.

²⁹⁰ David Osimo et al., *The Startup Nation Scoreboard 2016* (European Digital Forum 2016) 6.

²⁹¹ Startup Europe - A manifesto for entrepreneurship and innovation to power growth in the EU, <http://startupmanifesto.eu/>.

²⁹² BudapestHUB working group, *supra* note 24, at 4.

²⁹³ The Startup Nation Scoreboard 2016 listed Hungary as 24th out of the 28 European member states based on the adoption rate of the recommendations. David Osimo et al., *supra* note 291, at 11.

²⁹⁴ JEREMIE: Joint European Resources for Micro to Medium Enterprises, http://ec.europa.eu/regional_policy/en/funding/special-support-instruments/jeremie/#1.

²⁹⁵ The statistics of the Hungarian Private Equity and Venture Capital Association (HVCA) reported 109 companies in 2015 and 89 companies in 2014 receiving investments. EVCA Statistics | HVCA, <http://www.hvca.hu/statistics/>.

²⁹⁶ András Bethlendi & Richárd Végh, *Crowdfunding – Could It Become a Viable Option for Hungarian Small Businesses?*, 13 FINANC. ECON. REV. 100, 118 (2014).

financing, is still underdeveloped.²⁹⁷ In light of this existing funding gap – especially with regard to startups at the very beginning of their life-cycle - the need for a viable solution has become an important issue of Hungarian economic development.

1.1. Attention towards crowdfunding to solve the funding gap

The Hungarian startup society has already expressed interest towards crowdfunding as a possible answer to their financing needs. The first crowdfunding platforms were launched around the turn of 2011²⁹⁸, however, they have already been closed down. The currently operating sites are of non-profit, charitable character, and they only conduct donation (or sometimes reward) based campaigns.²⁹⁹ A recent research on the crowdfunding activity of Visegrád countries³⁰⁰ concluded that local platforms in the area are primarily used for artistic and social projects while entrepreneurs of technological startups use global platforms instead.³⁰¹ This tendency might be changed by an investment-based crowdfunding platform in the region that would attract professional investors to the market as well and therefore be more profitable for business ventures. In addition, investment-based crowdfunding may constitute competition for traditional financing instruments, improving the overall performance of the market.³⁰²

2. A glance at the European framework and tendencies

The European trends with regard to investment-based crowdfunding indicate that sooner or later the Hungarian economic and legal system will have to deal with this new instrument. Nine European countries³⁰³ have already introduced specific laws facilitating investment-based

²⁹⁷ Patrícia Becsky-Nagy & Zsuzsanna Noyák, *Formalization of the Informal Venture Capital Market*, 46 BP. MANAG. REV. 39, 46 (2015).

²⁹⁸ These were *indulj.be* and *kezdbeted.hu*. See *The First Hungarian Crowdfunding Sites Has Been Launched (Elindultak az Első Magyar Községi Szponzorációs Oldalak)*, INDEX.HU, Jan. 18, 2012, http://index.hu/tech/2012/01/18/elindultak_az_elso_magyar_kozossegi_szponzoracios_oldalak/.

²⁹⁹ Adjudokössze ("Let's add it up"), <http://www.adjudokossze.hu/>; CreativeSelector, <http://www.creativeselector.hu/>.

³⁰⁰ Czech Republic, Hungary, Poland and Slovakia-

³⁰¹ Staszkievicz et al., *supra* note 20, at 4.

³⁰² Bethlendi & Végh, *supra* note 297, at 102.

³⁰³ Austria, Belgium, France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom. David Osimo et al., *supra* note 291, at 33. In Italy the competent financial authority has already amended its regulation two times (the last updated being effective as of March 5, 2016). These rules were initially enacted in July 2013, based on Italy's crowdfunding law of 2012. See *New Rules for Equity Crowdfunding in Italy*, CROWD VAL., <http://news.crowdvalley.com/1/post/2016/03/new-rules-for-equity-crowdfunding-in-italy.html>.

crowdfunding, and it also received attention from European Union institutions. In 2013 the European Commission initiated public consultation³⁰⁴, which resulted in a detailed communication document³⁰⁵ and the establishment of the European Crowdfunding Stakeholders Forum in 2014. In the Commission's view premature regulation may cause more harm than benefits, and it decided that further monitoring of market activities and regulatory developments – both in Europe and in foreign jurisdictions – is required.³⁰⁶

In the meantime a number of investment-based crowdfunding platforms started to operate under a European legal framework which had been adopted without consideration of such businesses. In response to these tendencies the European Securities and Markets Authority (ESMA) have adopted its Opinion³⁰⁷ and Advice³⁰⁸ to provide clarity about the European Union regulation applicable to investment-based crowdfunding platforms. In these documents ESMA expressed concerns that while the current EU-regime provides an appropriate level of risk mitigation, platforms tend to design their activities to fall outside the scope of the applicable legislation, i.e. the rules of MiFID.³⁰⁹ These rules, however, have been updated and their implementation is currently under way.³¹⁰ In light of this ongoing process, the financial regulation of investment-based crowdfunding platforms in the European Union will definitely require further research in both European and national level.³¹¹ Accordingly, this thesis will not evaluate the legal framework of Hungary applicable to crowdfunding platforms as financial intermediaries, as it is

³⁰⁴ European Commission, Directorate General Internal Market and Services, Consultation Document: Crowdfunding in the EU? Exploring the Added Value of Potential EU Action (2013). All related documents available at http://ec.europa.eu/finance/general-policy/crowdfunding/index_en.htm.

³⁰⁵ *Unleashing the Potential of Crowdfunding in the European Union*, *supra* note 19.

³⁰⁶ *Id.* at 12. Accordingly, in 2015 the Commission conducted further market research. *See* Crowdsurfer Ltd. & Ernst & Young LLP, *Crowdfunding: Mapping EU Markets and Events Study* (European Commission), Sept. 30, 2015.

³⁰⁷ *Opinion - Investment-Based Crowdfunding*, *supra* note 41.

³⁰⁸ *Advice - Investment-Based Crowdfunding*, Advice ESMA/2014/1560 (European Securities and Markets Authority (ESMA)), Dec. 18, 2014.

³⁰⁹ Directive 2004/39/EC on markets in financial instruments (MiFID I)

³¹⁰ Directive 2014/65/EU on markets in financial instruments known (MiFID II) shall be implemented by January 3, 2017, however the Commission has proposed *See* European Commission Press release - Commission extends by one year the application date for the MiFID II package, http://europa.eu/rapid/press-release_IP-16-265_en.htm.

³¹¹ Despite the quite comprehensive harmonisation of the regulation of financial instrument markets most of the related legislation was adopted in the form of directives, which require the implementation of member states, and leave some room for discretion to national legislations.

currently taking shape in accordance with the European legislation.³¹² Instead, the next Section will draw attention to issues of investment-based crowdfunding offerings within the current Hungarian framework from the issuers' point of view.

3. Investment-based crowdfunding offerings under Hungarian law

Under the current Hungarian framework the possible forms for business enterprises to conduct securities-based crowdfunding offerings might be limited liability companies (*korlátolt felelősségű társaság*³¹³) or companies limited by share, that is either a private limited company (*zártkörűen működő részvénytársaság*³¹⁴) or a public limited company (*nyilvánosan működő részvénytársaság*³¹⁵). Pursuant to its definition shares of public limited companies are listed on a stock exchange as opposed to the ones of a private limited company. Due to the initial capital requirements, as well as the costs and administrative burdens related to their formation companies limited by shares are not suitable business forms for SMEs and especially not for startup ventures.³¹⁶

Furthermore, the legal opportunities to conduct investment-based crowdfunding offerings is not significantly different in the case of private limited companies and limited liability companies.³¹⁷ The public solicitation of shareholders and the public raising of funds of private limited companies is prohibited, which means that these companies could not be established as a result of an investment-based crowdfunding campaign.³¹⁸ In addition, the shares of a private limited company cannot be publicly offered, therefore, it would be prohibited for these companies to issue equity securities in an investment-based crowdfunding offering. The effect of these restrictions on

³¹² Nevertheless it has to be mentioned that Directive 2004/39/EC has been implemented by Act CXXXVIII of 2007 on Investment Firms and Commodity Dealers, and on the Regulations Governing their Activities.

³¹³ § 3:159 of Act V of 2013 on the Civil Code.

³¹⁴ § 3:211(2) of Act V of 2013 on the Civil Code.

³¹⁵ § 3:211(1) of Act V of 2013 on the Civil Code.

³¹⁶ The initial capital requirement of public limited companies is HUF 20 million (approximately EUR 64,000) and HUF 5 million (approximately EUR 16,000) in case of private limited companies. § 3:212(2) of Act V of 2013 on the Civil Code.

³¹⁷ However, it has to be mentioned, that the required initial capital in case of limited liability companies is HUF 3 million (approximately EUR 9,500) which could also be critical for SMEs and startup companies. 3:161 of Act V of 2013 on the Civil Code).

³¹⁸ § 3:249 of Act V of 2013 on the Civil Code

equity-crowdfunding possibilities of private limited companies is quite similar of those related to limited liability companies. According to the general rule, securities representing ownership rights may only be issued by companies limited by shares³¹⁹, which generally prevents limited liability companies from offering equity securities in crowdfunding.³²⁰ In addition, members of a limited liability company may not be solicited by public invitation³²¹, which means – similarly to the case of private limited companies – that such enterprises could not be established by a crowdfunding campaign that offers equity to investors. Consequently, under the Hungarian legal framework equity-crowdfunding in its strict terms are prohibited, and the only possible way to conduct an investment-based crowdfunding campaign could be to offer debt securities, basically bonds.

3.1. Debt securities based crowdfunding offerings

In the Hungarian framework debt securities based crowdfunding offerings would be governed by Act CXX of 2001 on the Capital Market which requires that any marketing of securities shall comply with the rules of public offerings unless it meets the criteria of private offerings. In order to avoid publication, registration and other requirements, as well as the approval procedure that public offerings are subject to³²² it is essential for crowdfunding campaigns whether they may qualify as private offerings. One of the relevant criteria provides that an offering may be construed as a private offering if the aggregate value of all the securities issued within the European Union does not exceed EUR 100,000 during a twelve-month period beginning from the announcement of the offering.³²³

With regard to the amount of the cap on the offering this exemption could be suitable to raise startup capital through crowdfunding, however, there are a number of hidden costs in the system of a private offerings as well. These include fees of the central securities depository, legal

³¹⁹ § 3:11 of Act V of 2013 on the Civil Code.

³²⁰ This rule demonstrates the divided notion of shares - mentioned in Section II.1 - that Hungarian law applies. Accordingly, ownership interests held in companies, other than companies limited by share (in other term, stock companies) cannot be represented by equity securities.

³²¹ § 3:160 of Act V of 2013 on the Civil Code.

³²² § 20-43 of Act CXX of 2001 as well as Article 31 of Commission Regulation (EC) No 809/2004.

³²³ § 14(e) of Act CXX of 2001.

costs and also fees that crowdfunding intermediaries may apply.³²⁴ The main problem with such costs is that they have to be covered in advance, before issuers would receive any returns from their campaign. The fundamental cause calling for crowdfunding in the first place would be to answer the financing needs of early stage entrepreneurs, but the inherent costs of the current crowdfunding possibilities in Hungary prevent its use by those who would actually need it.

4. Recommendations for future regulation

In light of the above analysis, it would be rather hard to adapt investment-based crowdfunding into the legal framework of Hungary, moreover, it is unlikely that under the current conditions it could operate as a viable financing tool for startup entrepreneurs. In order to take advantage of the economic benefits it may provide to a startup ecosystem, a separate regulation would be required providing exemptions from the restrictions on public fundraising of limited liability companies. This might be an outrageous idea in light of the Hungarian legal tradition, but clarifications of the rules – e.g. a clear definition on “startup companies” eligible for its use – may render such innovation possible. What is more important, however, that regulation should not start with the reform of company law or securities regulation, but it should first facilitate the creation of the entire startup ecosystem.

4.1. Missing conditions of a startup ecosystem

Accordingly, what may currently be the biggest obstacle in the way of a Hungarian investment-based crowdfunding system is not the absence of applicable regulation, but the lack of participants who would actually willing to use it, referring equally to entrepreneurs and investors. Small businesses generally suffer from an educational gap with regard to equity finance and they mostly rely on bank lending³²⁵, but in Hungary – as discussed in Section IV.1 – they do not have a wide range of alternative options to choose from either. Consequently, the Hungarian startup ecosystem should be established by simultaneous development of debt and equity financing instruments. This process shall be accompanied with improved business education starting from

³²⁴ Bethlendi & Végh, *supra* note 297, at 120.

³²⁵ Wehinger & Kaousar Nassr, *supra* note 76, at 51 and 54.

secondary school level.³²⁶ It is not only the awareness of entrepreneurs with regard to financing opportunities that has to be improved, but entrepreneurship within the entire Hungarian society need to be promoted. This is particularly essential with regard to crowdfunding which also requires enthusiasm and trust towards the investment experience from non-professional individuals. Without such investors and entrepreneurs who are aware and willing to take the risks of investment-based crowdfunding – also because they have a general trust in the financial system – no successful campaign would be conducted even if all the necessary rules would be in place.

Additionally, the creation of an accurate definition of startup companies is an essential precondition for any legal regulation concerning these companies. Some of these required regulations are not just proposals for the future – as crowdfunding may be in the eyes of the regulator – but rules that should have been already enacted, as a particular example, a specific startup tax regime.³²⁷ A startup definition should be adopted with regard to other categories of SMEs, and together with the legal determination of such categories. This is essentially important since SMEs constitute the vast majority of Hungarian enterprises including a wide range of businesses: hundreds of thousands of individual entrepreneurs and rapidly growing limited liability companies as well.³²⁸

4.2. Future possibilities of investment-based crowdfunding in Hungary

The latest news in Hungary with regard to investment-based crowdfunding derives from the Budapest Stock Exchange (BSE) which announced as part of its five-year (2016-2020) strategic plan the promotion of SME financing.³²⁹ This particularly includes the establishment of a specific SME multilateral trading platform and a private placement platform related to the stock exchange,

³²⁶ See in this regard Kåre Moberg, *Two Approaches to Entrepreneurship Education: The Different Effects of Education for and through Entrepreneurship at the Lower Secondary Level*, 12 INT. J. MANAG. EDUC. 512 (2014).

³²⁷ BudapestHUB working group, *supra* note 24, at 13.

³²⁸ *Characteristics of Small and Medium Sized Enterprises (A Kis- és Középvállalkozások Jellemzői)* (Hungarian Central Statistical Office), Nov. 2014. <https://www.ksh.hu/docs/hun/xftp/idoszakai/regioke/gyorkekv12.pdf>.

³²⁹ The main directions of the 2016-2020 strategic plan of the Budapest Stock Exchange (A Budapesti Értéktőzsde 2016-2020-as stratégiájának fő irányai) (Mar. 9, 2016), https://bet.hu/topmenu/tozsde/bemutakozas/strategia_fo_iranyai/strategia_fo_iranyai.html.

and, under a separate brand, a crowdfunding platform as well.³³⁰ As mentioned above in Section I.4.3 specific SME trading platforms may be a successful tool for public equity finance of smaller companies and even startups.³³¹ However, such ambitious goals of the Budapest Stock Exchange could only be useful if it forms part of a coherent financing system for startups and SMEs. Generally, private and public equity financing instruments (including investment-based crowdfunding as well) should be supported and developed in a way to complement each other, and quite importantly, bank lending as well.³³²

While the announcement of the Budapest Stock Exchange may be a promising sign for market participants that investment-based crowdfunding is on the agenda of Hungarian regulators, it should be bear in mind that the Hungarian market alone might not compete successfully with already established crowdfunding markets in the region, particularly, in Austria.³³³ The research on the market of the Visegrád countries - mentioned in Section IV.1.1 above – based its recommendation on this recognition and proposed the creation of a region-wide platform.³³⁴ Furthermore, the online methods of crowdfunding obviously suggest that this evolving industry should exploit the opportunities of international investment and boost capital formation by involving and matching new participants of the market. For Hungary, the creation of such cross-border platform should be a way to move forward in investment-based crowdfunding, provided that other preconditions of a viable startup ecosystem are already ensured.

³³⁰ The proposed innovations are put into a peculiar context by the fact that in December 2015 the Budapest Stock Exchange was acquired by the state, precisely, its current majority owner is the Hungarian National Bank.

³³¹ NEW APPROACHES TO SME AND ENTREPRENEURSHIP FINANCING, *supra* note 7, at 126.

³³² Wehinger & Kaousar Nassr, *supra* note 76, at 52.

³³³ In the summer of 2015 Austrian legislation passed the Alternative Finance Act providing for regulation on equity-crowdfunding. *Economic Report Austria 2015 - Executive Summary (Wirtschaftsbericht Österreich 2015)* (Federal Ministry of Science, Research and Economy of Austria (Bundesministerium für Wissenschaft, Forschung und Wirtschaft)), Jun. 2015.

³³⁴ Staszkiwicz et al., *supra* note 20, at 27.

Conclusion

Some authors conclude that it is the complex and innovative structure of crowdfunding that may impede its legal regulation³³⁵, however, the lessons for Hungary imply that economic obstacles precede regulatory challenges. That is because investment-based crowdfunding is not the panacea of startup finance, but it may only open new and unused sources of capital successfully as part of a well-functioning startup ecosystem. This requires a vital entrepreneurial community (supported in all sectors, starting with lower level education) and a financing system that is able to provide customized solutions for different type of businesses at all stages of their life-cycle. Where such pre-conditions exist crowdfunding may efficiently fit into the system and the related legal regime can also afford to focus on ex-post monitoring rather than over-regulating the market entrance. Accordingly, the first step that Hungarian legal regulation should take towards investment-based crowdfunding is to achieve these conditions of the ecosystem.

The growing numbers of the crowdfunding industry indicates that the importance of this new instrument will increase in the future.³³⁶ In order to exploit all the benefits that investment-based crowdfunding may bring to the field of corporate finance further research has to be conducted in several areas. Effective methods to tackle the different regulatory challenges presented in this thesis has to be clarified. Especially, the lemons problem (meaning that crowdfunding market may only consist of poor investments) have to be mitigated. In this regard, research should focus on the development of due diligence and investment analysis procedures, and examine how may these procedures be implemented or connected to the crowdfunding mechanism. Techniques to facilitate the development of a complementing industry of signaling services, and to induce the participation of professional investors is also very important.³³⁷

In addition, research should be conducted on the possible paths that the evolution of crowdfunding may take. The constant digitalization of the economy may couple crowdfunding

³³⁵ Brun, *supra* note 32, at 64.

³³⁶ Crowdsurfer Ltd. & Ernst & Young LLP, *supra* note 307, at 29; Staszkievicz et al., *supra* note 20, at 5.

³³⁷ Kuti & Madarász, *supra* note 14, at 363.

with other online lending techniques and grow it into a complex system of investment and financing services competing with banks.³³⁸ The evolution of virtual investment advice, digitalized due diligence and credit check processes indicates that such tools might be used by investment-based crowdfunding platforms in the future at low costs.³³⁹ In light of these opportunities and the rapid development of the digital industry the real potential of crowdfunding may not even be accurately predicted right now.

In order to supplement its digital evolution, legal research shall develop further techniques to simplify investment-based crowdfunding. For example, the “holding model” might reduce the entrepreneurs’ administrative burdens by requiring to issue shares only to a financial intermediary (a holding company) that would sell them to the crowd.³⁴⁰ As another possible path, research on non-intermediated securities could reveal the possibilities to leave out financial intermediaries from the issuance procedure of securities, which could significantly reduce costs.³⁴¹ However, the details of these legal techniques and other similar proposals require more research in the future to decide whether they are possible solutions for simplifying investment-based crowdfunding.

Last, but definitely not least crowdfunding (including all other types along with investment-based crowdfunding) will demand more attention as a marketing and advertisement tool, as well as a device for market research. The focus of this thesis was investment-based crowdfunding as a new capital-raising instrument of the financing system. However, it is possible and it remains to be seen in the future whether its importance will expand in the marketing sector rather than in corporate finance. The use of crowdfunding in marketing through its reward or donation based types is not dependent on the slow reaction of legal regulators, therefore it may show a rapid spread in this field.

³³⁸ Mårten Blix, *The Economy and Digitalization – Opportunities and Challenges* (Svenskt Näringsliv (Confederation of Swedish Enterprise)), Dec. 2015 97.

³³⁹ *Id.* at 102.

³⁴⁰ Hemer, *supra* note 98, at 16.

³⁴¹ TRANSNATIONAL SECURITIES LAW 2 (Thomas Keijser ed., Oxford University Press, First edition ed. 2014).

The numerous possible ways of its development indicates that crowdfunding will certainly remain on the agenda of economists, legal researchers and regulators. The example of the U.S. shows that the success of donation and reward-based sites do not exempt investment-based crowdfunding of the market, on the contrary, it expedited its regulation. European tendencies imply a similar progression that will sooner or later reach Hungary as well. Until that, in light of the above analysis, the task of the regulator is to facilitate economic development of a startup ecosystem and prepare the Hungarian legal system to be more welcoming for innovations.

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