EQUITY CROWDFUNDING REGULATION – INTERNATIONAL BEST PRACTICE OVERVIEW INNOVATION REFORM

JANUARY 29, 2021

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<th><strong>ACRONYMS</strong></th>
<th><strong>Description</strong></th>
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<tr>
<td><strong>API</strong></td>
<td>Application Programming Interface</td>
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<tr>
<td><strong>CAGR</strong></td>
<td>Compound Annual Growth Rate</td>
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<tr>
<td><strong>CCAF</strong></td>
<td>Cambridge Center of Alternative Finance</td>
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<tr>
<td><strong>CF</strong></td>
<td>Crowdfunding</td>
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<tr>
<td><strong>COBS</strong></td>
<td>Conduct of Business Sourcebook</td>
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<tr>
<td><strong>CONSOB</strong></td>
<td>Commissione Nazionale per le Società e la Borsa</td>
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<td></td>
<td>The government authority of Italy responsible for regulating the Italian securities market</td>
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<tr>
<td><strong>EC</strong></td>
<td>European Commission</td>
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<td><strong>ECN</strong></td>
<td>European Crowdfunding Network</td>
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<td><strong>FCA</strong></td>
<td>Financial Conduct Authority</td>
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<td>Financial Services and Markets Act</td>
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<td><strong>GBP</strong></td>
<td>Great Britain Pound</td>
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<td><strong>GEL</strong></td>
<td>Georgian Lari</td>
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<td><strong>GITA</strong></td>
<td>Georgian Innovation and Technology Agency</td>
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<td><strong>LS</strong></td>
<td>Law on Securities Market</td>
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<td><strong>MiFID</strong></td>
<td>Markets in Financial Instruments Directive</td>
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<td><strong>MOESD</strong></td>
<td>Ministry of Economy and Sustainable Development of Georgia</td>
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<td><strong>NBG</strong></td>
<td>National Bank of Georgia</td>
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<td><strong>OECD</strong></td>
<td>Organisation for Economic Co-operation and Development</td>
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<td><strong>P2P</strong></td>
<td>Peer-to-Peer</td>
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<tr>
<td><strong>RIA</strong></td>
<td>Regulatory Impact Assessment</td>
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<tr>
<td><strong>SEC</strong></td>
<td>U.S. Securities and Exchange Commission</td>
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<td><strong>SME</strong></td>
<td>Small and Medium Enterprise</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>SPV</td>
<td>Special Purpose Vehicle</td>
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<tr>
<td>UK</td>
<td>United Kingdom</td>
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<td>US</td>
<td>United States</td>
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<td>USD</td>
<td>US Dollar</td>
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<td>WB</td>
<td>World Bank</td>
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EXECUTIVE SUMMARY

Crowdfunding (CF) began quickly developing as an alternative source of financing following the 2007-2008 global financial crisis. The term is broadly defined as the process of funding different ideas, initiatives, or plans via online platforms by individuals and companies. The market defines four basic types of CF: debt, equity, reward, and donation-based models. The first two models are also known as investment types of CF, while the latter two have no financial incentives. Currently, the global CF market is worth almost $14 billion, and forecasts predict it has the potential to grow to $39 billion by 2026.

The USAID Economic Governance Program, in consultation with the National Bank of Georgia (NBG) and the Ministry of Economy and Sustainable Development (MOESD), aims to facilitate CF ecosystem development in Georgia. The Program’s research report is solely focused on equity-based CF, as requested by the NBG and the MOESD.

The study revealed that the CF ecosystem in Georgia remains underdeveloped. During the Program’s research, only a few CF platforms were identified as operational with updated websites.

Equity CF is a popular method of financing for small and medium enterprises (SMEs) and startups. The pool of investors in equity CF includes accredited and unaccredited investors as well as angel investors and venture capitalists. Although equity CF is a comparatively young industry with high growth opportunities, it still has the potential to positively impact venture financing as well as society and the business environment.

Both investors and borrowers are exposed to risks in the CF ecosystem. Risks are generally classified into two groups, direct and indirect. Direct risks for backers include project failure, closure of the platform, fraud, and the lack of an exit option. The World Bank (2013) emphasizes the risk of unsophisticated investors and money laundering as well. On the other hand, indirect risks imply cyberattack, stealing personal data, and a lack of transparency.

This report overviews international regulatory policy on CF. It discusses the global regulatory innovation environment and reviews the pan-European approach to regulations.

One of the most important parts of the report covers the best practice overview. Section 7 is dedicated to case studies from different countries that have proven records of equity CF activities and regulations in place, such as the USA, the UK, Italy, Germany, and Estonia.

Equity CF shares a market with traditional startup and SME financings like micro-lenders, angel investors, and venture capitalists. However, equity CF facilitates funding for projects that could otherwise be left out of the market. Section 8 of the report summarizes the main characteristics of various types of equity financing.

Finally, section 9 provides main policy recommendations for developing countries like Georgia on how to enable in the best possible CF environment. The four elements of a robust CF investing ecosystem are economic regulations, technology, community engagement, and entrepreneurial culture. It is also essential that the right balance is kept between the regulation and enabling environments. Beyond the analysis of the local CF context, it would also be beneficial to follow the path of successful examples from different countries and consider their experience and characteristics.
I. INTRODUCTION TO CROWDFUNDING

CF can broadly be defined as an alternative source of finance. The term “crowdfunding” can be traced back to 2006 when entrepreneur Michael Sullivan used it to raise capital for his project (which failed). In the literature, CF tends to be used to refer to the “method of collecting many small contributions, employing an online funding platform, to finance or capitalize a popular enterprise” (Freedman and Nutting, 2015). This definition is close to that of Shneor, Zhao, and Flaten (2020), who define CF as a pooling of contributions from multiple backers, which is done via the internet, and often without standard financial intermediaries. Shneor and Flaten (2015) also define a crowdfunding platform as “an internet application bringing together project owners and their potential backers, as well as facilitating exchanges between them, according to a variety of business models.” Through CF, a wide variety of project owners from different industries can be sourced from many individuals or companies.

The global financial crisis in 2008-2009 became the main trigger for the CF revolution. In the era of financial technologies, online-based platforms became an alternative source of financing for startups and SMEs.

1.1. TAXONOMY OF CROWDFUNDING

While considering CF as an alternative source of finance it is important to define its taxonomy. There are two basic approaches currently being adopted in research into CF. One is financial (debt and equity-based) and the other is non-financial types of CF (donation and reward-based), Figure 1.

Figure 1. A basic approach to CF. Source: Author 2020, adopted from Freedman and Nutting 2015

However, as CF evolved during the last decade, the terminology became clearer. Most academic literature refers to the taxonomy developed by the Cambridge Center of Alternative Finance (CCAF). According to the CCAF’s Global Alternative Finance Market Benchmarking report (2020), 14 different models have been adopted that are broadly grouped into three main categories: debt

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1 Startups 2018.
models, equity models, and non-investment models. This classification system helps distinguish types of alternative finance models as a form of capital raising, Figure 2.

Figure 2. Taxonomy of alternative finance. Source: Author 2020, adopted from CCAF 2020

<table>
<thead>
<tr>
<th>Alternative Finance</th>
<th>Debt models</th>
<th>Equity models</th>
<th>Non-investment Models</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>P2P/Marketplace lending</td>
<td>Balance sheet lending</td>
<td>Invoice trading</td>
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<td></td>
<td></td>
<td></td>
<td>Securities</td>
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<td></td>
<td></td>
<td></td>
<td>Equity based</td>
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<td></td>
<td></td>
<td></td>
<td>Real estate based</td>
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<td></td>
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<td>Profit sharing</td>
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<td></td>
<td></td>
<td></td>
<td>Reward based</td>
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<td>Donation based</td>
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<td></td>
<td>Consumer lending</td>
<td>Business lending</td>
<td>Invoice trading</td>
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<td></td>
<td>Business lending</td>
<td>Property lending</td>
<td>Debt based</td>
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<td></td>
<td></td>
<td>Consumer lending</td>
<td>Mini bonds</td>
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<td></td>
<td></td>
<td>Business lending</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Property lending</td>
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</table>

The system of debt-models classification is dominated by peer-to-peer (P2P)/marketplace lending activities, which do not include deposit-taking platforms and only provide loans to individuals and companies from institutional investors or individual lenders (CCAF 2020). Equity models that include equity CF are typically related to investing in unlisted shares or securities of SMEs. Finally, CCAF classifies reward-based and donation-based CF as non-investment models, where people provide financial means to an individual or business without any financial interest.

1.2. DEFINITION OF MAIN MODELS

- **Donation-based CF** refers to the funding of philanthropic and/or research projects where contributors do not expect any monetary return from the project initiators. Donation-based CF backers are not economically driven, rather their decisions are based on social
responsibility. Saxton and Wang (2014) argue that one of the most appealing financings in this type of platform are health-related causes. They revealed that most of the projects that meet their targets on the platform are funded by donors at the early stage of the platform placement. Donation-based CF has accelerated the funding of social purposes by using standardized platforms that include integrated data collection, fast transactions, and robust communication strategies (Zhao and Shneor 2020).

- **Reward-based CF** has been used to refer to the model in which “supporters can provide funding to individuals, projects, or organizations in exchange for non-monetary rewards such as products or services while accepting a certain degree of risk of non-delivery on campaign promises” (Shneor and Munim 2019). The most famous platforms include Kickstarter, Indiegogo, etc.

- **Debt-based CF** is also labeled as P2P lending. It is characterized by investors providing funds to individuals or SMEs through online platforms with the promise they will receive their money back plus the agreed-upon interest. It usually includes a loan contract or debt security between parties. P2PMarketData (2020)² asserts that debt-based CF accounts for more than 92 percent of the global crowdfunding market.

- **Equity CF** refers to situations in which project owners sell a stake in their business to several investors in return for investment. According to the definition provided by the European Commission (EC), the main difference between equity CF and traditional models is that investor-company matching is done through internet-based platforms.

### 1.3. GLOBAL SNAPSHOT

The first CF business can be traced back to 2007 in the UK, followed by rapid development in the US market. CF didn’t appear in China until 2013, however, thanks to the rapid technological development of its financial industry, China soon overtook the US, becoming the global crowdfunding leader in 2018 (Cumming and Hornuf 2018).

According to MarketWatch (2020)³ the global CF market size is $13.93 billion, and it is forecasted to surpass $39 billion by the end of 2026, with a compound average growth rate (CAGR) of 16.0 percent during 2021-2026. A recent study by P.R. Rau (2020) suggests that global market volume is generated by more than 2200 crowdfunding platforms.

It is also important to observe the global market of alternative finance that includes CF as one source of financing. A recent study from CCAF (2020) highlights that in 2018, the global market accumulated around $305 billion in 171 countries. Figure 3 depicts the total market volume of alternative finance from 2015 to 2018. What is striking in this chart is the difference between the volumes with and without China. It clearly demonstrates how massive the Chinese market is (3.4 times more in 2018) compared to the rest of the world.

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What can be clearly seen in this chart below (Figure 4) is the dominance of debt models (93 percent) over the equity and non-investment models, five percent and two percent respectively.

Figure 4. Worldwide crowdfunding volumes by category excl. China. Source: Author 2020, adopted from the CCAF 2020

1.4. CROWDFUNDING STAKEHOLDERS

At its core, CF seeks to create conditions that are “win-win” for all participants in the process. Generally, there are three main stakeholders in the process: 1) platform; 2) fundraiser; and 3) backer. The platform is an intermediary between the fundraiser and backer. It provides online services, including transactions through banks, due diligence, material uploads, etc. The fundraiser posts ideas, projects, or social campaigns to raise targeted financial means, while the backer provides funds to make those ideas or projects achievable. Figure 5 illustrates the win-win dynamics in crowdfunding.
Figure 5. Win-win dynamics in crowdfunding. Source: Shneor, Zhao and Flaten 2020
2. RATIONALE OF THE REFORM

Access to finance remains a major obstacle for SME development in Georgia. A well-organized and regulated crowdfunding platform could be one optimal source for startup financing. To enable the development of crowdfunding platforms in Georgia, the Program consulted with the NBG on possible models of crowdfunding and related regulatory framework. The NBG requested the Program’s support in exploring international best practices and conducting regulatory impact assessment (RIA) on equity-based crowdfunding models.

The NBG uses its regulatory sandbox framework to, among other things, test key risks before the introduction of regulations on innovative financial products and services. It believes this approach is appropriate for CF regulations. The regulation should reflect the outcomes and specific characteristics found in the testing process.

The Program also organized a meeting with the MOESD and discussed how to move forward with the equity CF model. MOESD representatives shared their views on CF reform implementation and provided meaningful insights.

The ultimate objective of the Program’s intervention is to support entrepreneurs, businesspeople, and companies, especially small, medium, and micro enterprises, to cultivate a community around their offerings to provide access to alternative funds.

For the purposes of this report, the Program’s research will be focused solely on equity CF as per the request of the NBG and MOESD. Currently, Georgia is in the process of creating a well-functioning and operational capital market, which requires significant regulatory, tax, technical and policy changes. Therefore, the CF model as an alternative funding model will be considered under the umbrella of the capital market reform.
3. BACKGROUND OF THE GEORGIAN CROWDFUNDING ECOSYSTEM

The CF ecosystem in Georgia remains underdeveloped. The Program’s research identified only a few CF platforms that are operational and maintain updated websites. The biggest in terms of Georgian Lari (GEL) volume is the donation-based platform wehelp.ge. The main goal of the platform is to provide help to socially vulnerable people who have either health or income-related issues. According to their platform, 128 projects have been financed with a total amount of GEL 591,036.\(^4\)

The second platform identified is investme.ge, which uses the reward-based crowdfunding model. The numbers do not seem to be promising, as one project was successful out of the two submitted. investme.ge has accumulated slightly more than GEL 2,800 so far.\(^5\)

The third and final investing model identified is crowdfund.ge. This platform is a hybrid of debt-based and equity-based models as well as a reward-based model. According to the platform, only one project has been registered and GEL 10 accumulated.\(^6\)

Another donation-based platform, charityconcept.ge, is run by one of the biggest banks in Georgia, TBC bank, however no statistics are available online.\(^7\)

To address the financing problems SMEs face in the early stage of development, the Georgian Innovation and Technology Agency (GITA) closely cooperates with technology startups. To meet market demand, GITA drafted amendments to the Law of Georgia “On Securities Market” where new mechanisms for loans and equity-based CF were introduced and regulated. Draft amendments were initially set to be adopted by Parliament in 2017, however, that has not occurred yet. It is worth mentioning that unlike equity or debt-based crowdfunding, donation and reward models do not require any regulations or legislative changes to operate.

In 2017, the USAID Governing for Growth in Georgia (G4G) project provided technical assistance to review the draft amendments to the Law on Securities Market (LS) to regulate the provision of crowdfunding investments. The main findings of international consultant M. Parnell (2017) suggested that “it is particularly important that the regulatory authority keeps pace with developments in this sector. While some crowdfunded businesses succeed, about one in five fails (data compiled by AltFi Data and Nabarro 2015) leaving investors out of pocket. The Financial Conduct Authority (FCA) is in the process of reviewing its crowdfunding regulations having ascertained through consultation that investors found it difficult to compare crowdfunding sites with each other or with other asset classes due to ‘complex and often unclear product offerings.’ The FCA also found that financial promotions were not always ‘clear, fair and not misleading,’ and that the complex structure of some investments created ‘operational risks that are not being managed sufficiently.’ Finally, the FCA found that regarding loan-based platforms stronger rules were needed in the event a crowdfunded business failed.”

\(^4\) http://wehelp.ge/?page=aboutus
\(^5\) https://investme.ge/ka
\(^6\) https://crowdfund.ge/add-project
\(^7\) https://charityconcept.ge/
4. EQUITY CROWDFUNDING

Equity CF quickly gained popularity following the 2008 financial crisis and became a popular method of financing for SMEs and startups. Although some SMEs failed to return on the investment, many ventures expanded and grew their presence on the market (Schwienbacher 2019). The pool of investors in equity CF represents accredited and unaccredited investors, as well as angel investors and venture capitalists.

The equity CF market significantly increased in the early 2010s, however, in some countries it experienced a steady decline due to uncertain regulations and constraints (Garvey et al. 2017; Ziegler et al. 2018), Figure 6.

![Figure 6. Equity CF volumes (million euros). Source: Shneor, Zhao and Flaten 2020](image)

Top countries are the United Kingdom with EUR 378 million in 2017 and the United States with EUR 209 million in 2017 (Ziegler et al. 2019).

Specific principles have become broadly recognized across platforms operating under the equity CF model, although there are differences among them. Figure 7 illustrates the typical process.

![Figure 7. Typical equity CF process. Source: Lukkarinen 2020](image)

Usually, the pre-selection process is highly selective, and platforms perform due diligence on each fundraiser. Ziegler (2019) asserts that six percent of ventures willing to run a campaign on platforms were qualified for onboarding. One similarity shared by most equity CF platforms is the all-or-
nothing model. That means that ventures only qualify for access to the funds allocated from investors if they reach their pre-determined campaign goal. If a minimum threshold is not met, then funds are paid back to investors (Tuomi and Harrison 2017).

Platforms generate revenue during different phases of the process: registration fees before ventures start a campaign; transaction fees during a campaign; and if the campaign reaches its target, the venture pays the platform a success fee in a range of 4-10 percent (ECN 2016). The comparatively low fees and transaction costs (compared to traditional investment forms) attract people and investors to CF, as does the low investment threshold. Small investors do not gain high bargaining power during each phase of a campaign because terms are pre-defined. Hornuf and Schmitt (2017) argue that investors cannot influence the terms of transactions or covenants because a platform provider and fundraiser have defined them in advance.

It has been suggested by Estrin et al. (2018) that investors describe the sums they invest via equity CF as “small” and a “small part” of their overall investment portfolios. Guenther et al. (2014) draw on an extensive range of sources to assess the average time spent by investors on each project evaluation. Survey results (Guenther et al. 2014) show that investors spend less than an hour assessing the business plan, less than an hour on the campaign page, and less than an hour studying the venture’s home page. On the other hand, equity CF platform providers dedicate much more time to each of those processes before they admit projects on their platforms.

Schwienbacher (2019) argues that the main challenges currently facing equity CF are connected to investor returns, platform profitability, and share liquidity. Although equity CF is a comparatively young industry with high growth opportunities, it still has the potential to positively impact venture financing, as well as society and business environment. CF offers startups and SMEs an alternative form of equity financing, while also providing investors financial instruments and an opportunity for portfolio diversification across geography and company lifecycle.
5. RISKS ASSOCIATED WITH CROWDFUNDING

Both investors and borrowers are exposed to risks when they enter the CF ecosystem. The Organisation for Economic Co-operation and Development (OECD) (2015) classifies those risks as direct and indirect. Direct risks for backers are related to project failure, closure of the platform, fraud, and the lack of an exit option. World Bank (2013) emphasizes the risks for unsophisticated investors and money laundering as well. Indirect risks imply cyberattacks, stealing personal data, and a lack of transparency.

- **Project failure** – experienced investors know that new companies are riskier than those with historical cash flow, a qualified management system, and robust structure. Available data shows that historically half of start-ups fail within five years (SBA 2018). The World Bank (2013) suggests that potential investors need disclosure documents to help them understand these risks, as well as the lack of guarantees, liquidity limitations, and other potential pitfalls. The report also stresses that equity CF portals and trusted third parties “should provide robust, easily understood investor educational tools.”

- **Platform closure** – Douw & Koren (2013) argue that many CF platform providers are startups themselves with a lack of finance and risk assessment capacity. As these types of platforms tend to be small companies, they could struggle with weaker control and governance frameworks.

- **Fraud** – unlike angel investors and venture capital, CF investors might not know anything about the borrower other than the information presented on the online platforms. Geographical distance adds to the likelihood that projects cannot be physically monitored (De Buysere et al. 2012). According to the World Bank (2013), the most likely scenario for successful fraud involves criminals creating fake crowdfunding platforms and fake companies to attract investors.

- **Unsophisticated investors** – equity crowdfunding mainly attracts unaccredited, amateur investors who may lack experience or education about prudent investment decisions. In response, platform providers should communicate clearly that this type of investment is not guaranteed.

- **Lack of an exit option** – crowd-investing opportunities take time to yield returns. In countries that lack a well-developed secondary equity market, investors are not able to sell their shares and exit the business.

- **Money laundering** – even though developed countries have strong regulations to address this risk, money laundering remains a legitimate concern.

World Bank (2013) has developed a set of risk mitigation techniques in its report *Crowdfunding’s Potential for the Developing World*. Figure 8 illustrates recommendations for governments to reduce fraud risks. Table 1 details the protective mechanisms that have been used internationally to protect CF investors.
Table 1. Protective mechanism against potential fraud. Source: World Bank 2013

<table>
<thead>
<tr>
<th>Type</th>
<th>Risk</th>
<th>Rationale</th>
<th>Mitigation tactic</th>
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<tbody>
<tr>
<td>Business</td>
<td>Fraud</td>
<td>The securities markets have examples of fraud.</td>
<td>• Background checks for issuers. • Mandatory auditing, financial disclosures, and business reviews. • Requiring all-or-nothing financing (prevents fraudsters from raising money and then disappearing when donors ask difficult questions). • Restricting or monitoring social media communication about offerings. • Requiring all crowdfund raising to take place on portals that are registered with a national regulatory body that oversees securities. • Providing investor education to learn how fraud has been perpetrated in the past so that investors can identify it in the future. • Mandatory holding periods to prevent pump-and-dump schemes.</td>
</tr>
<tr>
<td>Business</td>
<td>Failure</td>
<td>Crowdfund investments offer no guarantee of return.</td>
<td>Educating investors about portfolio diversification to prevent total loss of investment(s).</td>
</tr>
<tr>
<td>Business</td>
<td>Anti-money laundering</td>
<td>Using businesses as a cover for illegal money transfers.</td>
<td>•Placing caps on amounts that may be raised in specific periods. • A “cooling off period” between reaching the funding target and funds transfer to allow for further diligence by investors and regulators.</td>
</tr>
<tr>
<td>Business</td>
<td>Sector risk</td>
<td>Crowdfunding has had the most traction in consumer products and extensions of popular brands or games.</td>
<td>•Build on small successes in areas like science and energy. • Raise small amounts of capital to show market interest and customer validation. • Consider leveraging the crowd for only a small part of the overall capital raise to identify interest and de-risk the bigger investment.</td>
</tr>
<tr>
<td>Business</td>
<td>Subsequent funding failure</td>
<td>Bringing on crowdfunding investors creates a more complicated investor table that may deter subsequent investors.</td>
<td>•Consider the use of a Special Purpose Vehicle (SPV) to group all crowdfund investors into one voting group to ease communication and voice. • Offer to buy out crowdfund investors at subsequent rounds of financing at the current price.</td>
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<tr>
<td><strong>Investor</strong></td>
<td><strong>Entrepreneur</strong></td>
<td><strong>Regulatory</strong></td>
<td><strong>Industry</strong></td>
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<tr>
<td>Investor liquidity and losses</td>
<td>Lack of issuer experience</td>
<td>Regulatory and compliance risk</td>
<td>Market rejection</td>
</tr>
<tr>
<td>Crowdfunded stocks are not liquid, businesses do fail, and an investor can lose their investments.</td>
<td>Entrepreneurs do not always have all the experience needed to build, run, and raise capital for a business.</td>
<td>Regulatory bodies may resist or reject the argument that crowdfunding is an appropriate and effective method of financing early-stage companies.</td>
<td>The investor community might not have an appetite for this new emerging asset class.</td>
</tr>
</tbody>
</table>
| • Investment limits for nonaccredited investors.  
• Allowing for crowd vetting and crowd diligence to discuss the merits/risks of the offering in a public manner.  
• Promote the creation of secondary markets after a 12-month holding period where shares may be traded based on supply and demand. | • Create education programs about how to build a business.  
• Create education programs about how to raise money from the crowd and follow through with a plan once funded.  
• Requirements of either a securities broker/dealer, an attorney, or accountant. | • Work with local governments before offering crowdfunding investing.  
• Engage with local regulatory and policy constituents to build crowdfunding frameworks. | • Leverage the media to share success stories of businesses that have been successful with crowdfunding investing and jobs that have been created.  
• Share early financial engagement stories of investors who have backed crowdfunded companies and why.  
• Offer crowdfunding investments in tandem with more traditional investments to act as an honest broker. |
6. GENERAL REGULATORY OVERVIEW

A country’s legal and regulatory frameworks provide rules for participation and compliance standards. Regulation is an important tool to guide the development of new financing instruments (OECD 2015). The three crowdfunding actors (the backers, the CF platform, and the fundraiser) are subject to regulation, although the existence and scope of regulation vary within and across countries and regions (EC 2015).

A recent study by P. R. Rau (2020) suggests that online CF as a form of innovation is expected to have the same impact on economic development as mobile phone penetration or microcredit. Regulation has a serious impact on CF in middle-income and rich countries, however, its influence appears to be less in low-income countries.

CCAF - World Bank (WB) survey (2019) Regulating Alternative Finance: Results from a Global Regulator Survey, examines the global regulatory landscape as it affects the CF ecosystem as well as alternative finance systems as a whole. One of the focus areas of the survey was equity CF. Researchers targeted 209 regulators representing a total of 221 jurisdictions and received responses from 99 participants, representing 111 jurisdictions across six continents (CCAF 2019). Figure 9 visually maps regulatory approaches by countries.

Figure 9. Map of regulatory approaches to equity CF. Source: CCAF 2019

The survey showed that incorporated entities are allowed to invest in 97 percent of the jurisdictions where equity CF is regulated. That means those regulators allow the CF ecosystem to act as a funding space for startups and SMEs. Around 85 percent of regulators included in the survey confirmed that promotions (e.g. schemes to attract and retain investors and to benefit from their investments) for individual investors are also permitted. Figure 10 lists the most common activities allowed in regulated equity CF companies.
Every country that regulates equity CF requires that online platform owners provide customers with accurate and complete communication. Also, regulators oblige platforms to provide investors with standardized information, e.g., risk warnings, costs, incentives, etc., Figure 11. Many regulators also require that money received from investors before a campaign ends should be held in a separate account (CCAF 2019).
6.1. REGULATORY INNOVATION

Innovation drives crowdfunding and alternative finance. By using different technological solutions, regulators increase their efficiency and productivity while accelerating the development of the crowdfunding ecosystem.

The CCAF (2019) survey also focused on regulatory innovations. Results show that among a sample of 111 jurisdictions, 73 did not have any operational regulatory innovation initiatives. Table 2 depicts the prevalence of these regulatory innovation initiatives among respondents.

Table 2. Prevalence of regulatory innovation initiatives among respondents. Source: CCAF 2019

<table>
<thead>
<tr>
<th>Initiative</th>
<th>Innovation Office</th>
<th>Regulatory Sandbox</th>
<th>RegTech/SupTech</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes - Currently Operational</td>
<td>26%</td>
<td>22%</td>
<td>14%</td>
</tr>
<tr>
<td>Yes - Forthcoming (within the next 12 months)</td>
<td>3%</td>
<td>9%</td>
<td>2%</td>
</tr>
<tr>
<td>Currently Under Consideration</td>
<td>13%</td>
<td>14%</td>
<td>27%</td>
</tr>
<tr>
<td>Not in Place</td>
<td>48%</td>
<td>46%</td>
<td>42%</td>
</tr>
<tr>
<td>Not applicable</td>
<td>11%</td>
<td>9%</td>
<td>14%</td>
</tr>
</tbody>
</table>

RegTech (Regulatory Technology) and SupTech (Supervisory Technology) programs were the least common regulatory innovation initiatives: around 14 percent of surveyed regulators had such a program in place. Table 3 provides a list of technologies employed by regulators for RegTech/SupTech.

Table 3. Technologies employed by regulators for RegTech/SupTech. Source: CCAF 2019

<table>
<thead>
<tr>
<th>Technology</th>
<th>% of jurisdictions employing (conditional upon having operational RegTech/SupTech program)</th>
<th>% of all jurisdictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machine Learning (Supervised &amp; Unsupervised)</td>
<td>60%</td>
<td>18%</td>
</tr>
<tr>
<td>Blockchain/Distributed Ledger Technology</td>
<td>47%</td>
<td>14%</td>
</tr>
<tr>
<td>Natural Language Processing</td>
<td>40%</td>
<td>8%</td>
</tr>
<tr>
<td>Data transfer protocols (e.g. APIs)</td>
<td>40%</td>
<td>18%</td>
</tr>
<tr>
<td>Direct data pull or push systems</td>
<td>33%</td>
<td>15%</td>
</tr>
<tr>
<td>Machine-readable or executable regulation</td>
<td>33%</td>
<td>12%</td>
</tr>
<tr>
<td>Cloud Computing</td>
<td>33%</td>
<td>12%</td>
</tr>
<tr>
<td>Robotic Process Automation</td>
<td>20%</td>
<td>8%</td>
</tr>
<tr>
<td>Bio-metrics (e.g. Digital ID)</td>
<td>13%</td>
<td>10%</td>
</tr>
<tr>
<td>Other</td>
<td>13%</td>
<td>15%</td>
</tr>
</tbody>
</table>

According to the Global Innovation Index (2020), Georgia ranks 63rd among 131 countries. However, the NBG is very open to innovative solutions and technologies. It has created a special unit, the Financial and Supervisory Technology Development Department, to facilitate the RegTech

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and SupTech environment in the sector. In addition, the NBG has created a regulatory sandbox environment to support local fintech initiatives.

6.2. THE PAN EUROPEAN APPROACH TO REGULATIONS

The EC has said that the European Union (EU), as a single market for CF, remains underdeveloped compared to other developed countries across the globe. CF platforms in the EU mainly face challenges when it comes to cross-border activities. This is caused by the lack of common laws and governing regulations, which create compliance and operational costs that hinder the broader expansion of the platforms. In 2018, the EC introduced a proposal for regulating crowdfunding service providers under the umbrella of the Fintech Action Plan. The proposal only applies to crowdfunding platforms that use equity-based and debt-based mechanisms.9 The European Financial Institutions (2020)10 specifies that once common regulations are adopted for the EU single market, each country will have a total of 18 months to comply with the new rules.

In October 2020 the European Parliament adopted Regulation (EU) 2020/1503 of the European Parliament and of the Council.11 The EC suggests that the new rules will be beneficial for CF platforms as it will provide:

- Clear rules on information disclosures for project owners and crowdfunding platforms.
- Rules on governance and risk management.
- A coherent approach to supervision.

OECD (2015) detailed the current relevant EU directives governing CF-related operations:


Appendix 1 illustrates the introduction of explicit regulations for investment-based crowdfunding by countries over the course of several years. Based on the CCAF-WB (2019) survey, Rau (2020) suggests that “21 countries had explicit regulations on debt crowdfunding, while 31 countries had explicit regulations on equity crowdfunding.” The last column of the table shows the list of countries that have been benchmarked before the adoption of their own legal and regulatory frameworks. The CCAF (2019) survey argues that more than 90 percent of regulators have reviewed and analyzed the regulations of other countries when implementing within their jurisdictions and for over 66 percent of countries “the trigger for regulatory change in lending (equity) was the review of another jurisdiction’s approach to regulating alternative finance.”

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10 https://www.europeanfinancialinstitutions.blog/post/102g8yp/a-new-eu-crowdfunding-regulation
7. OVERVIEW OF CROWDFUNDING REGULATION BY COUNTRY

This section presents an overview of equity CF regulations in the United States, the United Kingdom, Germany, Italy, and Estonia. These countries were selected due to their experience regulating CF platforms and activities.

7.1. THE UNITED STATES (US)

The first US legislation that was applicable to CF was the 1993 Securities Act. It forbids entities from offering or selling securities to the public, with two exceptions: the offering is registered with the U.S. Securities and Exchange Commission (SEC) or there is an available exemption from registration. The exemption from registration applies to firms raising less than $1 million (with individual investments limited to $10 000 or 10 percent of investors’ annual income) and raising the cap on “mini-offerings” from $5 million to $50 million (OECD 2015).

Twelve years later, in 2015, Title III of the JOBS Act created a federal exemption under the securities laws that allowed CF to be used to offer and sell securities (SEC 2015).

Cumming and Hornuf (2018) states that currently there are several exemptions for crowdfunding in the US. The first two are federal Rules 506 (b) and 506(c), which limits sales to sophisticated or wealthy investors. Also, in 2015 the SEC finalized the Regulation Crowdfunding to implement an exemption in section 4(a)(6) of the Securities Act, which is specifically aimed at retail crowd investing by the general public.

Regulation Crowdfunding enables eligible companies to offer and sell securities through CF. The rules are:

- Require all transactions under Regulation Crowdfunding to take place online through a SEC-registered intermediary, either a broker-dealer or a funding portal.
- Permit a company to raise a maximum aggregate amount of $1,070,000 through CF offerings in 12 months.
- Limit the amount individual investors can invest across all CF offerings in 12 months and;
- Require disclosure of information in filings with the SEC and to investors and the intermediary facilitating the offering.

Regulation Crowdfunding applies to the issuer who sells securities; the intermediary who operates the platform through which these securities are sold; and investors who buy the securities. Cumming and Hornuf (2018) suggest that Regulation Crowdfunding imposes substantial regulatory requirements on issuers, intermediaries, and investors. They argue while the motivation to protect investors is worthwhile, the regulation cost may be too high for many small business offerings. Based on their findings, it is unclear if any US exemptions have found the appropriate balance between capital formation and investor protection.

13 https://www.ecfr.gov/cgi-bin/text-idx?SID=34e3261f2ed0101e23a49dd3ae21f087&mc=true&rtp=/ecfrbrowse/Title17/17cfr227_main_02.spl
According to Finra (2017)\textsuperscript{14} in reliance on JOBS Act crowdfunding, depending on the amount of money being raised in the prior 12 months, issuers are also required to make certain financial disclosures. (See Table 4)

<table>
<thead>
<tr>
<th>Amount Raised</th>
<th>Inflation-Adjusted Required Minimum Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>$107,000 or less</td>
<td>- Financial statements and specific line items from income tax returns, both of which are certified by the principal executive officer of the company.</td>
</tr>
<tr>
<td>$107,000.01 to $535,000</td>
<td>- Financial statements reviewed by an independent public accountant and the accountant’s review report. If audited statements are available, those must be provided</td>
</tr>
</tbody>
</table>
| $535,000.01 to $1.07 million | - For an issuer using crowdfunding for the first time, financial statements reviewed by an independent public accountant and the accountant’s review report. If audited statements are available, those must be provided.  
- For all other issuers, financial statements are audited by an independent public accountant and the accountant’s audit report. |

7.2. UNITED KINGDOM (UK)

As an advanced equity CF market, UK regulations on the market are frequently considered a significant factor in CF development and function as a model for other legislation (Haniff, Halim and Ismail 2019). According to the European Crowdfunding Network (2018), the UK dominates the CF landscape in Europe in terms of market volume per capita. The country’s overall market share in Europe reached 81 percent with EUR 4.412 million in 2015 of market volume per capita while equity CF itself was worth GBP 332 million, compared to GBP 84 million in 2014 (ECN 2018). The University of Cambridge (2017) further added that the equity CF market in the UK continued to the world leader in total new equity raised, amounting to GBP 272 million by 2016. As of July 2017, approximately 13 equity CF platforms were operating in the UK (Saul, et al, 2017).

Equity CF regulation in the UK is governed by several regulations: Companies Act 2006; Financial Services Market Act 2000 (FSMA); Prospectus Regulation; the Financial Conduct Authority Handbook; Markets in Financial Instruments Directive; and the Conduct of Business Sourcebook (COBS) (Haniff, Halim and Ismail 2019). According to Paragraph 4.20 FCA Policy Statement, these rules “complement each other and do not affect or limit the applicability of one another.”

Prospectus Requirement

The legislator of the FSMA is allowed to exempt all offerings of securities to the public from the prospectus requirement if the total consideration is less than EUR 5 million.\textsuperscript{15} Therefore, start-ups


can use CF to issue transferable securities such as stocks and bonds without a prospectus as long as they raise less than EUR 5 million within 12 months (Cumming and Hornuf 2018).

**Platform Regulation**

UK crowd investing platforms largely provide the receipt and transmission of orders, so they fall under the Markets in Financial Instruments Directive (MiFID). Specifically, CF is subject to the MiFID’s authorization requirement and the organizational and conduct of business requirements of FSMA 2000.

In 2014, the Financial Conduct Authority (FCA), the UK financial markets regulator, issued a policy statement to specify requirements for crowd investing platforms. A year later, in 2015, it published a review of the regulatory regime.16

Under the MiFID, platforms are obliged to ensure that the financial promotions they offer are fair, clear, and not misleading. Platforms must require clients to provide all information necessary to assess the securities on offer. This requirement reflects concerns that the low investment volumes create a risk for unsophisticated investors who may not fully understand the inherent risks to CF investment. In addition, platforms must require that investors take a simple automated test about the characteristics of equity CF investments (Armour and Enriques 2017).

Unlike in the US, the UK regulation does not set single-issuer limits but does limit how much an investor can invest in the entire crowd investing market. Under the law, the absolute amount a single retail investor can invest depends on the amount of their overall investible financial assets. Similar to US regulations, however, in the UK, platforms rely on the information provided by the investor in a “Restricted Investor Statement” (FCA 2020).17 That means that it is possible for investors to avoid investment limits by lying about the amount of their investible financial assets.18

**7.3. GERMANY**

As of 2015, Germany’s CF market ranked 3rd behind France (2nd place) and the UK (1st place). The rankings can be misleading however as there is a significant difference in the overall volume of emissions between Germany and the UK. In 2015, the total volume of the German equity CF market was 47 million EUR, compared to the UK’s equity CF market, worth 374 million EUR( Deloitte 2017).19 The German Federal Financial Supervisory Authority Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) is responsible for supervising the CF market in the country.20

**Prospectus Requirements**

Most German start-ups are limited liability companies (GmbH), not stock corporations. The shares of GmbH are not securities, so the EU prospectus regulation do not impact CF in Germany.

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The German Parliament adopted new and improved legal framework for crowd investment in 2019, according to the German Crowdfunding Association. The main changes in the expanded framework include:

- The fundraising limit for CF prospectus exemption increases from EUR 2.5 million to EUR 6 million.
- The range of instruments covered will include subordinated loans and profit participation rights.
- The crowdfunding exemption can be used every 12 months, instead of just once over the lifetime of the project.
- The individual investment limit is raised from EUR10,000 to EUR 25,000 per investor per year. This applies to securities as well as investment assets.
- Investors who invest through a special holding company (GmbH & Co KG) can invest beyond the EUR 25,000 limit.
- Non-issued and already repaid investments do not count toward the threshold for a prospectus requirement. Before, the prospectus threshold depended on the size of the offering.

**Platform Regulation**

German crowd investing platforms are governed by the Trade Regulation Act, not the German law implementing MiFID and the federal securities regulator BaFin. The Trade Regulation Act states that no capital regulatory requirements apply to CF platforms although they are required to obtain professional liability insurance (Cumming and Hornuf 2018).

Unlike UK regulations, German law includes a single-issuer limit, but does not regulate the amount that an investor may invest in the entire crowd investing market (Cumming and Hornuf 2018).

### 7.4. ITALY

Italy was the first European country to adopt CF-specific legislation (Adamo et al. 2020). In Italy, equity CF is mainly regulated by Law no. 221 (Law 221/2012) and by Commissione Nazionale per le Società e la Borsa (CONSOB) Regulation n. 18592.

The country allows innovative start-ups and SMEs that meet the legal requirements to use equity CF (Battaglia et al. 2020). It also allows collective investment undertakings and investment companies willing to invest primarily in innovative startups and SMEs (ECN 2018).

CONSOB only allows authorized entities (banks and investment companies) to perform CF activities. These types of companies, once registered in a special registry, can initiate their offerings through online platforms. While regulation limits the total offering of shares to EUR 5 million, there is no limitation on the number of investors. Under Italian law, a CF offering is only successful if at least five percent of securities are sold to professional investors, banks, or start-up incubators. The law also stipulates that if platforms due not start operations within six months of receiving their license, they may be closed.

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22 [https://www.intechopen.com/online-first/crowdfunding-the-case-of-italy](https://www.intechopen.com/online-first/crowdfunding-the-case-of-italy)

23 The government authority of Italy responsible for regulating the Italian securities market
Exemptions to the prospectus requirements are available through an authorized equity CF platform for public offers of shares or securities below EUR 5 million. Three other Italian laws could potentially be applied to CF activities: Money Laundering Law; Data Privacy Law; and Consumer Code.

European Crowdfunding Network (2018) has identified several regulatory barriers for foreign platforms interested in operating in Italy and for Italian platforms looking to expand to international markets:

- Foreign equity-based crowdfunding platforms require authorization to operate in the Italian market. An exception to the rule is if the platform has a MiFID EU license. That would allow it to operate in Italy under certain conditions.
- These rules are also applicable to the foreign projects published on foreign crowdfunding platforms as they are not allowed to engage with Italian investors.

Italian equity-based crowdfunding platforms seeking foreign investors face the following barriers:

- Authorized, Italian equity-based CF platforms cannot directly operate in other countries.
- Italian companies are allowed to publish a project on an EU equity CF platform, under the relevant EU country’s applicable laws and regulations.
- The EU equity CF platform is also open to Italian equity-based CF platforms seeking foreign companies/project initiators.24

7.5. ESTONIA

Estonia is one of the top countries in the European CF industry according to ECN (2018). The first CF platform (P2P consumer lending) appeared in 2009; by 2015 Estonia was in second place in Europe in total volume per capita. It is worth noting, however, that the equity CF market has a small share of the overall CF market in Estonia.

Estonian financial market legislation is based on European Union regulation, the Directive on Investment Services in the Securities Field (93/22/EC), and the Directive on Markets in Financial Instruments (2004/39 EC) (MiFID / MiFID II).25 The Ministry of Finance (Rahandusministeerium) oversees the alternative finance market.

In Estonia, the CF market is regulated by a guide (Annex 2), which was prepared by Finance Estonia and the Deloitte Legal law firm in Estonia. The guide aims to increase the transparency of CF platform providers’ activities for clients and investors. The guide defines best practices, which do not substitute the legal responsibility to adhere to applicable laws (Sadzius and Sadzius 2018).

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24 See more about Italian crowdfunding landscape - [https://euroccrowd.org/wp-content/blogs.dir/sites/85/2018/06/CF_FactSheet_Italy_June2018.pdf](https://euroccrowd.org/wp-content/blogs.dir/sites/85/2018/06/CF_FactSheet_Italy_June2018.pdf)

8. COMPARATIVE ANALYSIS

Equity CF covers the same market as traditional startup and SME financing, such as micro-lenders, angel investors, and venture capitalists. However, equity CF also facilitates funding for projects that could otherwise be ignored by traditional financers (Harrison and Mason 2019). Table 3 summarizes the main characteristics of various types of early-stage equity financing.

The investors who fund equity CF offers and micro funders share some traits: they both use their own funds to invest in high-risk ventures and investing is rarely their main profession. According to Tuomi and Harrison (2017), “they both expend very limited effort to evaluate the target, although the decision making of equity crowdfunding investors may also partly rely on their knowledge of the platform having already pre-evaluated the target.”

One clear difference is that CF’s online platforms allow investors and startups/campaigns to collaborate without meeting, erasing any geographical barriers that exist in more traditional markets. It is worth noting that startups can seek investment using CF platforms and traditional financing instruments.

Hornuf et al. (2018) suggest that startups that have successfully met their equity crowdfunding campaign goals are more attractive to other angel investors or venture capitalists in the next stage of development, while unsuccessful campaigns may lead to failures with traditional investors as well.

Table 5. Comparison of different forms of early-stage equity financing. Source: Lukkarinen 2019

<table>
<thead>
<tr>
<th>Features</th>
<th>Equity CF Investors</th>
<th>Micro Funders</th>
<th>Angel Investors</th>
<th>Venture Capitalists</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Funder characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Typical funder background</td>
<td>Often high education, many with no entrepreneurial background</td>
<td>Often high education, many with entrepreneurial background</td>
<td>High education, previous experience from entrepreneurship, consulting, and industry</td>
<td>Previous experience from finance, consulting, and industry</td>
</tr>
<tr>
<td>Heterogeneity of funder space</td>
<td>Very high: crowd composed of many different types of investors</td>
<td>High: varying demographic backgrounds, investment amounts, and skills</td>
<td>Relatively high: diversity in competence, motivations, and investment activity</td>
<td>Low (although categories exist): firms unified by an aim to earn profits and efforts to hire suitable staff</td>
</tr>
<tr>
<td>Source of funds</td>
<td>Investor’s own money</td>
<td>Investor’s own money</td>
<td>Investor’s own money</td>
<td>Others’ money pooled into venture capital fund</td>
</tr>
<tr>
<td>The centrality of investing activity for funder</td>
<td>Not central; limited contributions of time and money</td>
<td>Not central; limited contributions of time and money</td>
<td>Often central</td>
<td>Very central; the key purpose of venture capital firm</td>
</tr>
<tr>
<td><strong>Venture characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk level</td>
<td>Very high risk</td>
<td>Very high risk</td>
<td>High risk</td>
<td>Rather a high risk</td>
</tr>
<tr>
<td>Lifecycle stage</td>
<td>Very early-stage, early-stage, or advanced early-stage</td>
<td>Very early-stage; earlier than angel investors</td>
<td>Early-stage; earlier than venture capital</td>
<td>Advanced early stage, later than angel investors</td>
</tr>
<tr>
<td><strong>Investment decision process</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Motivations for investing</td>
<td>Various; including intrinsic and extrinsic</td>
<td>Various; including intrinsic and extrinsic</td>
<td>Financial returns important, but also intrinsic motivations</td>
<td>Financial returns highly important</td>
</tr>
<tr>
<td>The extent of target evaluation</td>
<td>Limited (conducted by individual)/medium (conducted by platform)</td>
<td>Limited; conducted by individual</td>
<td>Medium; conducted by individual, possibly with support from angel network</td>
<td>Extensive; involves staff and often external advisors</td>
</tr>
<tr>
<td>Key investment criteria</td>
<td>Rapid-to-observe venture and campaign</td>
<td>Financial, social, and</td>
<td>Entrepreneur, team, product, market,</td>
<td>Product, market, entrepreneur, team,</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Funding mechanism characteristics</th>
<th>Environmental venture and team features</th>
<th>business plan, exit opportunities</th>
<th>expected returns, exit opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Role of digitalization</strong></td>
<td>Central; all or most activity via an online platform, allowing for high volumes and visibility</td>
<td>Limited; in-person interactions via personal connections or organizations</td>
<td>Limited but emerging; face-to-face contacts important, some are starting to use platforms</td>
</tr>
<tr>
<td><strong>Transaction costs</strong></td>
<td>Very low due to standardized and automated processes and the online nature of communications</td>
<td>Low; close pre-investment connections contribute to low screening and monitoring requirements</td>
<td>Relatively low; administration costs are small</td>
</tr>
<tr>
<td><strong>Bargaining power of individual investors</strong></td>
<td>Very low; deal terms pre-determined by venture</td>
<td>Medium; small investments but opportunity to make information requests</td>
<td>Relatively high; personal negotiations before deal</td>
</tr>
<tr>
<td><strong>Connections between funders and the venture</strong></td>
<td>Often no relationship</td>
<td>Rather often a pre-existing family or friendship relationship</td>
<td>Only occasionally prior knowledge of the entrepreneur</td>
</tr>
<tr>
<td><strong>Pre-investment relationship</strong></td>
<td>Usually, no personal communication</td>
<td>Varying levels of social connection</td>
<td>Active, including face-to-face meetings</td>
</tr>
<tr>
<td><strong>Communication during the investment process</strong></td>
<td>Very limited, passive</td>
<td>Varied but often limited and light, sometimes passive</td>
<td>Active via board position or advisory roles</td>
</tr>
<tr>
<td><strong>Post-funding involvement of funders</strong></td>
<td>Often active via board position or advisory roles</td>
<td>Active via board position or advisory roles; control</td>
<td></td>
</tr>
</tbody>
</table>
9. GENERAL POLICY RECOMMENDATIONS

When crowdfunding started in the late 2000s, there were no regulations to guide it. Over the years, some countries have established laws and regulations to protect investors. Others have drafted guidelines on ethical or best practices. In both cases, the developing nature of CF requires smart policy intervention that promotes innovation and improves the financial environment.

In 2013, World Bank published *Crowdfunding's Potential for the Developing World*, a report based on research into the peculiarities of developing countries. The report provides very thorough policy recommendations for regulators and policymakers. The recommendations are specifically tailored to countries where the CF market is still developing and the enabling environment requires more support, including legal and regulatory frameworks and incentives as well as the promotion of innovations to drive crowdfunding. The recommendations developed by the WB for developing countries were instrumental for the Program as it developed robust recommendations for Georgian stakeholders.

WB (2013) identified several key enablers for a CF investing ecosystem to grow in a country, Figure 12.

Figure 12. Four elements of robust crowdfunding investing ecosystem. Source: Autor 2020, adapted from World Bank 2013.

9.1. DECISION FRAMEWORK TO EVALUATE THE OPPORTUNITY FOR CROWDFUND INVESTING

Not every country is ready to develop CF investing and, for some, the necessary infrastructure and financial environment will not be available in the near future. When considering regulation for a CF ecosystem, policymakers and regulators should consider a number of challenges and opportunities. The World Bank developed the following questions to encourage a discussion about necessary strategies and policies to establish and accelerate a crowdfunding investment ecosystem (World Bank 2013).26

I. Capital requirements to create an adequate market opportunity

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• How much do entrepreneurs need to be able to raise to enable most small businesses to benefit? The typical funding void for early-stage companies in the developed world is below $1 million.

II. Investment structures and necessary participants
• Create an initial list of commonly used equity and debt instruments that are best for early-stage companies. What are the typical arrangements and valuations? What are the standard terms? These must be evaluated according to cultural norms. Start with common stock and simple debt, and possibly continue with structures like revenue-based financing.
• An efficient crowdfund investment marketplace requires credible participants. Consider which market participants are allowed or disallowed from offering crowdfund investments. What bad actor provisions are currently in place to allow for transparency?

III. Evaluating and building investor sophistication
• Investors need a certain amount of information about a business to make an investment decision. They also need to understand the risks associated with such investments. What are the right risk-related disclosures and other information to provide to investors? What investor education can be created or replicated to educate about the high-risk nature of early-stage company investments?
• Investors need a minimum understanding of owning shares or loaning money. Such basic understanding can “qualify” them as prepared to invest. What is the right way to “qualify” crowdfund investors? Should there be a formal qualification requirement?
• Capping the number of individual investments in a crowdfunding campaign is one way to provide investor protection. What might be the limit each person could be allowed to invest? What is this based on—annual income and/or net worth?
• Paychecks, tax returns, and investment statements can certify that investors make a certain amount of money or have a certain amount of savings—but requiring disclosure of this information may deter investors from investing. What is the right blend? Can investors “self-certify” that they fall within an income or net worth bracket to qualify to make investments?
• What methods should be used to create and disseminate broad-based education to investors to teach them about risk and portfolio strategy, such as limiting their high-risk investments to less than 10 percent of their savings?
• Do any other investment protection mechanisms need to be included?

IV. Regulatory challenges to address in building a crowdfunding ecosystem
• Time, cost, and bureaucracy are the main reasons businesses operate outside of legal structures. Identify the laws, regulations, and/or processes governing business incorporation that must change or be adapted to streamline the process.
• Explore national or local rules that make it difficult for businesses to start or expand their operations. If there is a permission process, what changes can be enacted easily to improve its function?
• Controlling how individuals receive investment solicitations is critical to preventing fraud. Explore guidelines to consider how people will solicit other individuals to purchase shares in a company. How do you create an investment exemption that is big enough to allow businesses to have the opportunity to succeed, but not so large that it creates panic from regulators? The ideal mix is a large reach with low risk.
• Governments and/or institutions need to track which organizations are raising capital. Businesses need to be able to report without being overly burdened. Regular reporting requirements must be created for all companies that raise money from crowdfund investing. Institutions should consider and standardize the components of this reporting.
• How will the government and the securities regulatory authority control the purchase and sale of crowdfunding securities? Can simplified versions of systems used in public markets provide transparency without limiting speed or effectiveness? These presumably would be
online transactions, to achieve scale and cost efficiencies; what form of existing escrow or transfer agents can be used?

- Bankruptcy laws in which bankruptcy repercussions follow early-stage entrepreneurs around for life threaten to deter entrepreneurship. What policies can be put in place to ease the burden of bankruptcy, so that the possibility of failure is a risk but not an overriding reason to avoid entrepreneurship?

V. The role of disclosures in building transparency

- Investors need standardized and efficiently delivered information about business plans, use of proceeds, valuation, and other issues to make investment decisions. Consider what information an entrepreneur must provide to investors to seek to crowdfund investments, and how technologies such as online business planning software can facilitate this disclosure.

- Companies need laws protecting their intellectual property and reliable structures for enforcement. What is the right way to balance the need for disclosure and the ability for companies to maintain trade secrets and proprietary information? What intellectual property laws exist or need to be enacted to protect trade secrets?

Georgia is seeking to accelerate support for crowdfunding and foster its expansion. The policy recommendations outlined in this report will be key to achieving a robust and transparent equity crowdfunding market. It is also essential to establish a healthy balance between regulation and the enabling environment. In addition to an analysis of the local CF context, it would also be beneficial to study successful examples from different countries and consider their experience and peculiarities. Overall, pursuing equity CF development is a step toward increased access to finance for startups and SMEs, ultimately contributing to capital market development.
### ANNEX I: YEARS OF INTRODUCTION FOR EXPLICIT REGULATION ON CROWDFUNDING EQUITY MODELS, SOURCE: P.R. RAU 2020.

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**Notes:** The countries that governed crowdfunding equity models through existing (implicit) regulation were Austria, Canada, the Czech Republic, the Dominican Republic, Estonia, Germany, Greece, Kenya, Malta, Norway, Panama, Qatar, Singapore, South Africa, and the UK.
ANNEX II: REPORT FORM FOR BEST PRACTICE FOR CROWDFUNDING, DELOITTE LEGAL AND FINANCE ESTONIA

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www.deattle.ee

FinanceEstonia and Law Firm Deloitte Legal Estonia have created the Best Practice for the crowdfunding industry (hereinafter the Best Practice) in order to provide a code of conduct for all the internet-based crowdfunding platforms (hereinafter the crowdfunding platforms) in Estonia that have joined this Best Practice. Compliance with the Best Practice does not exempt a crowdfunding platform provider from following the requirements provided by law.

The Best Practice operates based on the principle of „comply or explain”, which means that a crowdfunding platform provider must notify the public on its website of whether or not the Best Practice principles are being complied with. In the case where a crowdfunding platform provider that has joined the Best Practice does not follow a principle provided for in the Best Practice, the platform provider must explain on its website which principles are not being followed and why.

The data on this form must be provided according to the type of crowdfunding (investment based and loan based models must be distinguished):

1. **Type of crowdfunding platform** (loan based, investment based, etc.)

2. **Results of the crowdfunding platform provider’s economic activities**

3. **Field, sector of investment objects** (general, IT sector, real estate, etc.; if possible, the relationship between different sectors)

4. **The total number of investment objects (investment campaigns) in the calendar year and the number of successfully completed investment campaigns out of these, as well as the size of the average investment object in the calendar year**
5. **Sum of money raised during successful investment campaigns in a calendar year for each investment object**, the size of the smallest and biggest successfully completed campaign

6. **The number of investors per each successfully completed investment campaign**

7. **Expected and actual return on successfully completed investment campaigns (comparison of forecasts and actual results)**

8. **Depositing investors’ funds (Section 1 of the Best Practice)**

9. **Processing and security of data (Section 2 of the Best Practice)**

10. **Due diligence measures of money laundering prevention and the implementation of international sanctions (Section 3 of the Best Practice)**
| 11. **Communication and the quality of information** (Section 4 of the Best Practice) |
| 12. **Risk warnings** (Section 5 of the Best Practice) |
| 13. **Consumer protection and advertising** (Section 6 of the Best Practice) |
| 14. **Avoiding conflicts of interests and the remuneration system** (Section 7 of the Best Practice) |
| 15. **Sustainability of the activities** (Section 8 of the Best Practice) |

16. **Reporting** (Section 9 of the Best Practice)

Within two (2) calendar months following the end of each calendar year, the crowdfunding platform provider is obligated to make available on its website an overview of the results of the platform provider’s economic activities over the previous calendar year, as well as information on the campaigns conducted during the same calendar year, the forecasts published regarding the investment objects and the comparison of such promises with actual results, including the promised and actual returns on investments.
17. Dispute resolution (Section 10 of the Best Practice)

Questions:
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FinanceEstonia and Law Firm Deloitte Legal do not guarantee nor are responsible for the accuracy of the data submitted to FinanceEstonia by the crowdfunding platform providers nor the accuracy of data that the crowdfunding platform providers have made available to the public.
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UK_Follow-up_Funding_and_Firm_Failure
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