

# ***A Comparative Study on the Regulatory Framework of Crowdfunding***

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*The whole world enters into the financial revolution called crowdfunding. The United States, Italy, the United Kingdom and Japan have already legally allowed equity crowdfunding. South Korea also enacted equity crowdfunding in July 2015 for the purpose of efficient financing for startups and SMEs. This study reviews their crowdfunding regulations in terms of offering and investment limitations, requirements for intermediaries and requirements for issuers. And then, we raise several points about Korean crowdfunding and suggest amendment of regulations to promote fund raising through crowdfunding.*

**Keywords :** *Crowdfunding, Startup, SMEs, JOBS Act, Growth Decree 2.0, Financial Investment Services and Capital Markets Act*

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## ***I. Introduction***

Small and Medium-sized Enterprises, otherwise known as SMEs, are the grassroots of the national economy because they represent the large majority of companies and jobs in every country. Therefore, many countries around the world have placed an emphasis on fostering SMEs in order to develop sustainable growth engines, create jobs, improve competitiveness and realize social integration. The same is true for South Korea. In order to overcome the limitations on imitating technologies developed by companies in advanced countries, South Korea has promoted new growth industries and has boosted

the job market by creating innovative companies.

However, SMEs and startup companies have difficulties for raising funds before any meaningful company revenue has been realized. In particular, it may be hard to use bank lending due to the low credit rating that comes with a young company. It also may be hard to attract external funds since it is not easy to judge whether a startup would succeed or innovative ideas could be easily converted into profitable business models. Moreover, there has been a reduction in capital available for new startups since the recent global financial crisis.

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Due to these circumstances, there has been a need to develop an alternative tool of financing for new businesses and ventures, and crowdfunding has since emerged. According to Belleflamme, Lambert and Schwienbacher (2014), the concept of crowdfunding finds its root in the broader concept of crowd-sourcing. They said that “*crowdfunding involves an open call, mostly through the internet, for the provision of financial resources either in form of donation or in exchange for the future product or some form of reward to support initiatives for specific purposes.*” In other words, crowdfunding uses platforms on the internet to collect funds from crowds, a group of unspecified individuals. In the end, funds raised through these methods go to individuals, companies and projects as a form of patronage, lending and investment. What stands out here is the use of so-called funding platforms or online intermediaries rather than traditional financial institutions.

The first use of crowdfunding over the internet was by the British rock band “Marillion” in 1997. Funds for their American tour (USD 60,000) were collected (BBC, 2013). For 10 years that followed from the mid-2000s, the crowdfunding industry has grown gradually along with the evolution of mobile services. In particular, the emergence of “Kickstarter” in 2009, an American crowdfunding platform, has been central in establishing the concept of crowdfunding using social media (The Verge, 2011).<sup>1)</sup>

The worldwide crowdfunding volume increased from USD 6.1 billion in 2013 to USD 16.2 billion in 2014, revealing an explosive 167% growth. It is expected that the size of the market will be close to USD 34.1 billion in 2015. North America accounts for 58.3% (USD 9.46 billion), Asian market makes up 20.9% (USD 3.4 billion) and Europe takes up 20.1% (USD 3.26 billion) of the total funding volume in 2014. A significant increase of Asian crowdfunding is attributed to exponential growth in Chinese lending-based crowdfunding. However, North America (30%) and Europe (48%) account for the majority

1) <http://www.theverge.com/2011/12/20/2644358/kickstarter-success-product-development-revolution>.

of active crowdfunding platforms as of December 2014. Asia is represented with 13.5% of worldwide total crowdfunding platforms (1,250) in 2014 (Massolution, 2015).

Crowdfunding can be distinguished as equity-based, lending-based, reward-based and donation-based depending on the investment method and purpose. Equity-based crowdfunding is to support new startups and small enterprises in the form of angel investment. The purpose is to gain equity on a proportion of the invested amounts. Lending-based crowdfunding is to finance individuals and businesses that need funds through a small loan over the internet. The purpose is for investors to earn through interest rates. Examples are: online micro-credit and P2P financing. Reward-based crowdfunding is to finance projects with a reward of non-monetary compensation. For example, tickets for performance, movie, record and prototype. Donation-based crowdfunding is similar with reward-based but there is no expectation of compensation. This is pure donation.

It was practically impossible to implement equity crowdfunding due to established public offering regulations under the Securities Act. A company must fully comply with the complex registration requirements to advertise and sell securities to the general public. Registration under the Act is quite expensive for most startups and small businesses. Thus, companies needing funds were tied to public offering regulations that were fastidious and required high expenses.

Therefore, each nation around the world is now abolishing public offering regulations to enable equity crowdfunding and taking complementary measures to protect investors and to develop a sound crowdfunding market. Important developments are the JOBS Act (Jumpstart Our Business Startups Act)<sup>2)</sup> in the United States and the Growth Decree 2.0<sup>3)</sup> in Italy. The United Kingdom anno-

2) The formal title is “An Act to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”

3) The formal title is “DECRETO-LEGGE 18 ottobre 2012, n. 179 Ulteriori misure urgenti per la crescita del Paese.”

united and initiated enforcement of rules allowing crowdfunding, including equity crowdfunding, and the Congress of Japan amended the Financial Instruments and Exchange Act allowing equity crowdfunding in May 2014. South Korea enacted crowdfunding by amending the Financial Investment Services and Capital Markets Act on 24 July 2015 for the purpose of efficient financing of startups or small-sized venture companies in their initial phase.

In this paper, we examine the legislation regarding crowdfunding in the United States, Italy, the United Kingdom and Japan. And then we compare and review these legislations with the enactment in South Korea. This exercise is relevant in order to examine the considerations upon revising the Financial Investment Services and Capital Markets Act and the Enforcement Decree of that Act, ultimately to vitalize crowdfunding in South Korea.

## *II. Equity Crowdfunding Abroad*

### **2.1 The United States**

The United States enacted the JOBS Act on 5 April 2012 to broaden funding opportunities for small businesses. Under the CROWDFUND Act<sup>4)</sup> in Title III of the JOBS Act small businesses are allowed to use equity crowdfunding by exempting control over public offerings under the Securities Act. On 23 October 2013 the Securities and Exchanges Commission (SEC) enacted the rules for the enforcement of the CROWDFUND Act under the JOBS Act i.e. the so-called Proposed Rules of Regulation Crowdfunding (hereinafter referred to as the “Regulation Crowdfunding”) (SEC, 2013).<sup>5)</sup>

More specifically, Section 302 of the JOBS Act newly added article 6 to Section 4 of the Securities Act of 1933 (hereinafter

referred to as the “SA”), which exempts the obligation to submit a registration statement when satisfying all four of the following elements. The four elements are (1) offering limit for issuer, (2) investment limit for investors, (3) requirements for broker or funding portal, and (4) requirements for issuer.

#### **2.1.1 Offering and Investment Limitations**

Under the Regulation Crowdfunding 227.100(a)(1), a company would be able to raise a maximum aggregate amount of USD 1 million through crowdfunding offerings in a 12-month period.

Under the Regulation Crowdfunding 227.100(a)(2), investors, over the course of 12-month period, would be permitted to invest up to USD 2,000 or 5% of the investor’s annual income or net worth, whichever is greater, if both the investor’s annual income or net worth is less than USD 100,000; and 10% of the investor’s annual income or net worth, whichever is greater, not to exceed USD 100,000, if either the investor’s annual income or net worth is equal to or greater than USD 100,000.

There has been some confusion regarding the interpretation of the calculation and application standard of net assets and annual income in relation to the investment limit under section 302(a)(6)(B) of the JOBS Act, however, SEC clarified these ambiguous parts under the JOBS Act. The Regulation Crowdfunding provides that annual income and net worth are to be calculated in the manner provided in Rule 501 of Regulation D and the investor’s annual income and net worth may be calculated jointly with that of investor’s spouse.

Concerning the verification of investor investment limit the Regulation Crowdfunding requires the intermediary to have a reasonable basis for believing that the investor’s investment does not exceed the above limitations prior to the acceptance of any investment commitment. An intermediary may rely on an investor’s representations concerning compliance with the investment limitation requirements unless the interme-

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4) CROWDFUND Act is the short title of “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012.”

5) <https://www.sec.gov/rules/proposed/proposedarchive/proposed2013.shtml>.

diary has reason to question the reliability of the representation (Regulation Crowdfunding §227.100(a), §227.303(b)).

An intermediary must provide the funds raised to the issuer only when the total amount of funds procured from investors reaches or exceeds the target amount (SA §4A(a)(7)). This shows that only all-or-nothing crowdfunding is allowed in the form of imposing obligation to the intermediary.

### **2.1.2 Requirements for Intermediaries**

The CROWDFUND Act demands intermediaries to perform the role of gatekeeper to prevent fraud and abuse, and to ensure that investors understand the risk of investing.

Regulation Crowdfunding Section 227.100(a)(3) demands crowdfunding transaction to be conducted exclusively through the platform (i.e. an internet website or similar electronic medium) overseen by an SEC registered and FINRA<sup>6</sup> regulated intermediary, either a broker-dealer or a funding portal. The Regulation Crowdfunding does not allow investors to deal directly with the issuer. Only one platform is allowed to be used for one crowdfunding campaign, and public offering through multiple platforms at the same time is prohibited.

Intermediaries must provide disclosures pursuant to the SEC regulations, including disclosures related to risks and other investor education materials (SA §4A(a)(3)). And intermediaries ensure that each investor (1) reviews investor-education information, (2) positively affirms that the investor understands that the investor is risking the loss of the entire investment and that the investor could bear such a loss, and (3) answers questions demonstrating an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers (SA §4A(a)(4)).

Relating to due diligence of an interme-

diary, the Regulation Crowdfunding imposes considerable due diligence on the broker-dealer and funding portal intermediaries. An intermediary must have a reasonable basis for believing that an issuer seeking to offer and sell securities through the intermediary's platform complies with the requirements in Section 4A(b) of the Securities Act and it must have reasonable trust that the issuer has established means to keep accurate records of the holders of the securities. However, an intermediary may rely on the representation of the issuer unless the intermediary has reason to question the reliability of those representations. In addition, an intermediary must deny access to its platform to the issuer when an intermediary has a reasonable cause to believe that issuer or any of its officers, directors, and 20% or more beneficial owners is subject to a disqualification under §227.503 of Regulation Crowdfunding. In satisfying this requirement, an intermediary must conduct a background and securities enforcement regulatory history check of the above parties. Access to the intermediary's platform must be denied if the intermediary believes that the issuer or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection (Regulation Crowdfunding §227.301).

In relation to opening accounts and managing subscription funds, an intermediary may only accept an investment commitment in a crowdfunding transaction after the investor has opened an account with the intermediary and the intermediary has obtained from the investor consent to electronic delivery of related documents. A broker or dealer that may directly handle subscription money must deposit and manage the money by using a bank account separated from his or her own account, as the agent or consignee of the investor. Since funding portals cannot directly handle subscription money, the funding portal must direct investors to transmit their funds directly to a bank that has agreed in writing (Regulation Crowdfunding §227.302(a), §227.303(e)).

A special requirement for intermediaries

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6) FINRA (Financial Industry Regulatory Authority) is a non-for-profit organization authorized by Congress to protect investors by making sure the securities industry operates fairly and honestly.

in the Regulation Crowdfunding is that intermediaries must provide on its platform communication channels by which persons can communicate with one another and with representatives of the issuer about offerings in order to make use of the collective intelligence feature of crowdfunding. Issuers are allowed to freely express their opinions and refute other opinions by participating in this communication channel. Funding portals, not brokers or dealers, are only allowed to establish communication channel guidelines or delete abusive or fraudulent communication, and are not allowed to actively participate in the communication channel. Communication channel must be disclosed to the public, however, posting of commentary are only allowed to investors that opened an account with the intermediary. Any person posting a comment in the communication channel must clearly and prominently disclose with each posting whether he or she has interests with the issuer (Regulation Crowdfunding §227.303(c)).

In relation to the prohibited activities of funding portals, the Regulation Crowdfunding prohibits funding portals from investment advice or recommendation, solicitation of purchases, sales of securities displayed on its website, imposing certain restrictions on compensating people for solicitations, and holding, possessing, or handling investor's funds or securities.

### 2.1.3 Requirements for Issuers

The fourth requirement to exempt to submit a registration statement regards the issuer, which is regulated by SA §4A(b), which was newly established by JOBS Act §302.

Certain corporate entities are designated as unqualified entities that are not able to use crowdfunding by the JOBS Act. Unqualified entities include foreign companies, publicly traded companies,<sup>7)</sup> investment companies defined in Section 3 of the Invest-

ment Company Act of 1940 or private funds that are not subject to the regulations under the Investment Company Act of 1940. An issuer that has been disqualified as a bad actor<sup>8)</sup> pursuant to Regulation Crowdfunding §503(a), entities not submitting an annual business report for the recent two years that is required under Regulation Crowdfunding after an existing crowdfunding offering, and companies in a blind check or blind pool type that have business plans having an objective of M&A with a company that is unspecified or does not have a detailed business plan are also excluded from eligibility by the Regulation Crowdfunding.

An issuer is exempted of submitting a registration statement, but instead, shall file specified information with the SEC and provide it to investors and relevant broker or funding portal, and make available to potential investors (SA §4A(b)(1)). However, the Regulation Crowdfunding specifies to submit more materials than the above to SEC through EDGAR,<sup>9)</sup> provide these additional materials to investors and relevant intermediary and make available to potential investors. Concerning the financial statements requirements, an issuer whose target offering amount is USD 100,000 or less files the income tax returns and financial statements which shall be certified by the principal executive officer of the issuer. An issuer whose target offering amount is USD 100,000–500,000 files financial statements reviewed by a public accountant, and an

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7) A publicly traded company means an issuer obligated to submit a file reports pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934.

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8) A bad actor means a party that received administrative sanctions or a party with varied criminal history, such as a party sentenced of a crime for securities fraud within the past ten years (including minor offenses) or a party receiving an order by the court of SEC or a prohibition order relating to securities within the past five years. Such disqualification requirement applies over parties, including issuers, directors and executing officers, unlimited liability employees, managing members, shareholders owning 20% or more of shares, promoters, and paid recommenders.

9) EDGAR is an abbreviation of “Electronic Data Gathering, Analysis, and Retrieval system.”

issuer whose target offering amount is more than USD 500,000 files financial statements audited by a public accountant. Following completion of the offering, the issuer must electronically file through EDGAR and post on its website an annual report no later than 120 days after the end of the fiscal year (Regulation Crowdfunding §227.201, §227.202).

An issuer may not advertise directly or indirectly the terms of an offering, except for notices that direct investors to the intermediary's platform. A notice is limited to the name of intermediary, link to the intermediary, the terms of the offering, issuer's legal identity and address, phone number, website, representative email, and brief description of business. Notwithstanding the prohibition on advertising, an issuer may communicate with investors and potential investors through communication channels on the intermediary's platform. In addition an issuer is prohibited to compensate any promoter but only if the issuer takes reasonable steps to clearly disclose the receipt of such compensation (Regulation Crowdfunding §227.204, §227.205).

Liability provision Section 4A(c) of the CROWDFUND Act borrows directly from the language of Securities Act 12(a)(2). Section 4A(c) of the CROWDFUND Act imposes liability on any issuer, including officers and directors, for any materially false or misleading statements or omissions made by any means of any written or oral communication, in the offering or sale of a security. Section 4A(c) of the CROWDFUND Act replaced "prospectus" in Section 12(a)(2) with "any written or oral communication," the reach of Section 4A(C) will cover all disclosure statements filed with the SEC and provided to investors, and it will likely cover all additional statements related to the offering or selling of the securities. In addition, the anti-fraud provision in Section 17 of the Securities Act of 1933 applies as well.

JOBS Act regulates that the purchaser of securities issued based on exemption of crowdfunding cannot transfer securities during the 1 year period beginning on the date of pur-

chase. However, the restriction on sale is removed regarding transfer to the issuer, transfer to an accredited investor, transfer as a part of offering registered with the SEC or transfer to relevant parties, such as the family of the purchaser (SA §4A(e)).

## 2.2 Italy

501 crowdfunding platforms were identified as active in the European Union (EU) on 31 December 2014, which was risen by 23.2% compared with its level in 2013. The United Kingdom had the largest number of live crowdfunding platforms (143 platforms), accounting for 28.0% of the EU total number of platforms. This was followed by France (77 platforms), Germany (65 platforms), the Netherlands (58 platforms) and Italy (42 platforms), which cumulatively accounted for a further 47.5% (European Commission, 2015).

While the number of crowdfunding platforms and the amount of crowdfunding investment are increasing in the EU, there is currently no regulation of crowdfunding at the European level although there is an expert group. The European Commission has set up an expert group (the European Crowdfunding Stakeholders Forum, ECSF) that assists the Commission in developing training modules, raising awareness, promoting transparency and exchange of best practices on 25 June 2014. The group members are 15 Member State representatives and 25 representatives of the civil society.<sup>10)</sup>

In terms of national regulatory changes, Italy, the United Kingdom and France are representative of the recent regulatory development for crowdfunding. Italy enacted the special law referred to as Growth Decree 2.0,<sup>11)</sup> which shows similar features to the JOBS Act of the United States in 18 October 2012 and implemented Regulation 18592 in June 2013, introducing specific

10) More information available at: [http://ec.europa.eu/finance/general-policy/crowdfunding/index\\_en.htm#maincontentSec6](http://ec.europa.eu/finance/general-policy/crowdfunding/index_en.htm#maincontentSec6).

11) It was converted to "Legge 17 dicembre 2012, n. 221."

measures to regulate equity crowdfunding. On 1 April 2014, the United Kingdom adopted a new regulatory framework for crowdfunding. On 30 May 2014, France adopted new crowdfunding regulation that became applicable from 1 October 2014.

Even though Italy has a lower portion in the EU crowdfunding than the United Kingdom and France, Italy shows the first instance of enacting and enforcing a special law allowing equity crowdfunding. It is significant to examine the case of Italy because the first legislation in the EU has influenced other countries.

Growth Decree 2.0 of Italy allows equity crowdfunding as an exclusion of general securities regulations in Article 30 through adding four provisions in the Consolidated Finance Act (CFA).<sup>12)</sup>

On 26 June 2013, Commissione Nazionale per le Società e la Borsa (CONSOB), which is the securities regulating authority, announced the “Regulation on the Collection of Risk Capital on the Part of Innovative Startups vis Online Portals” as the detailed enforcement rules for the enactment and execution of the delegated matters of the same law on equity crowdfunding (CONSOB, 2013).

### **2.2.1 Offering and Investment Limitations**

Italy allows innovative startups to raise funds up to EUR 5 million per single offer in a 12-month period, which is remarkably high when compared to the United States (USD 1 million). As a special feature, Italy, unlike the United States, does not have investment limits. However, Italy allows investment by general investors only after the 5% (or more) first shares are sold to specialized investors (professional investors or banking foundations or innovative startup incubators), to perform the role of a minimum verification device for the value of the company subject to investment.

The online funding portal must transmit the order of subscription received by each investor to the bank or investment company.

Banks and investment companies must treat and process the orders in compliance with all the applicable regulations on investment services along the lines of the MiFID (Markets in Financial Instruments Directive) regime, including evaluation. An exemption in this regard will apply if the value of a single subscription is less than EUR 500 (up to a maximum annual amount of EUR 1,000) for investments by individuals and the value of a single subscription is less than EUR 5,000 for each order (up to a maximum annual amount of EUR 10,000) for investments by legal entities. This is because, in case of small contributions, the need to protect non-professional investors from the risks connected to the investment is not that big.

The characteristics regarding the public offering method is that the application of an all-or-nothing method, which is introduced in the United States, is excluded. Thus, the concerned crowdfunding may be enforced even when the subscription amount falls short of the target amount. On the other hand, upon raising money, companies may engage in public offering by using multiple portals at the same time, which is another factor different from the United States.

### **2.2.2 Requirements for Intermediaries**

Equity crowdfunding may be carried out only through funding portals enrolled in the relevant register held by CONSOB. A company which carries out the business of online funding portal must apply for registration, provide detailed reports on their intended activity and meet the requisites of honorability and professionalism. Banks and investment companies intending to act as online funding portals will be automatically registered in a special section of the CONSOB register without submitting any documentation to CONSOB.

Control over the business activities of an intermediary is regulated through CONSOB Regulation §13~§21. The main points are as follows. The intermediary must work with diligence, fairness and transparency, avoid-

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12) It is “Testo Unico della Finanza (TUF)” in Italian.

ing any conflicts of interest which could arise in management of the portal that may affect the interests of the investors and the issuers. The intermediary must make available to investors all the information regarding the offer that is provided by the issuer in a detailed, correct and not misleading manner and without omissions so that investors may sufficiently perceive the nature of the investment and investment risk. Expressing recommendation regarding to the financial instruments are prohibited. In addition the intermediary must ensure that the information on the portal is updated, accessible for at least 12 months after the closure of the offers and make available to the interested parties upon request for five years from the date of the end of the offer (§13).

Portals must publicly announce the operator of the concerned portal, mediation procedure and method, costs, measures of reducing fraud, protecting personal data, preventing conflicts of interest, and dispute resolution devices in a summarized and easily comprehensible form (§14).

Portals must sufficiently provide to investors the information on the taxation benefits, the withdrawal right and the investment risks (risk of losing entire amount, limitation to liquidity, ban on distributing profit, etc.) in a brief and easily comprehensible form. In addition, portals must allow access to the portal only when non-professional investors understand the investment education materials, sufficiently perceive investment risks, and positively respond that they have the financial ability to take the risk (§15).

For each offer, portals must publish the offer itself, the details on the bank or investment company which treat and process the order and frequency of updates on the subscription campaign (§16).

### **2.2.3 Requirements for Issuers**

The Growth Decree of Italy only allows equity crowdfunding to innovative startup companies. Innovative startups must meet all of the following requirements. (1) The company must be involved in the develop-

ment, production or sale of innovative products or services having high technological value; (2) the company shall have existed for no more than 48 months; (3) the principal place of business of interests must be within Italy; (4) the total value of annual production may not exceed EUR 5 million from the second year of business; (5) the company cannot distribute profits; (6) the company shall not be the result of merger, de-merger or transfer of a business or a part of one. Subsequently, innovative startups must meet at least one of the following requirements. (1) The proportion of the research and development costs must occupy 15% or more among the gross production value and cost; (2) there must be one-third or more of people with experience in research, such as a doctorate degree in research; (3) the company must hold ownership of intellectual property right (Growth Decree §25).

On the other hand, the Italian government grants tax benefits to investors to vitalize investments. For the period 2013~2015, an individual investor is allowed to deduct from his gross income tax due an amount equal to 19% of the investment made through equity crowdfunding up to a maximum amount of EUR 500,000 per year, and corporate investors are allowed to receive income tax deduction by 20% of the investment within the limit of EUR 1,800,000 by the article 29 of Decree Law no.179 of 2012. In order to enjoy this tax benefit, there is a retention period requirement of two years. There is no separate regulation limiting the distribution of equity securities acquired through crowdfunding, however, the income tax reduced by the investment will be redeemed upon selling the investment shares, in part or in whole, within two years.

### **2.3 The United Kingdom and Japan**

The United Kingdom announced the final amended rules (FCA, 2014) in March 2014 after the Financial Conduct Authority (FCA) announced the Consultation Paper on 24 October 2013 (FCA, 2013) regarding



crowdfunding regulations and gathered opinions. These rules have been enforced from April 2014, by applying to both loan-based and equity-based crowdfunding.

The main content of the rules relating to equity crowdfunding is to restrict the type of investor to whom firms can send direct offer promotions for unlisted equity or debt securities. The investors that are allowed to participate in public offering through equity funding in the United Kingdom are professional clients; retail clients who confirm that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorized person; retail clients who are venture capital contacts or corporate finance contacts; retail clients who are certified or self-certified as sophisticated investors; retail clients who are certified as high net worth investors; and retail clients who clarify that they will not invest more than 10% of their net investible financial assets in unlisted equity and debt securities (FCA, 2014).

The final amended rules regarding equity crowdfunding are that, first, the investor type is now decided through general regulation instead of the method of restricting the type of investor upon each approval, and second, the FCA additionally acknowledged retail clients obtaining investment consultation and retail clients planning investment within 10% of the financial assets available for net investment, in addition to the crowdfunding investor types previously acknowledged.

In addition, public offering for funds on or under EUR 5 million annually is available without a prospectus. On the other hand, the firm operating the crowdfunding platform is required to obtain the approval of the FCA (FCA, 2014).

Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS), which are special tax benefit schemes relating to venture investment in the United Kingdom, are the main factors of vitalizing crowdfunding. EIS is a system introduced in 1994 for vitalization of investments to small-

sized companies, which provides an income tax relief of 30% of the cost of shares, on a maximum investment GBP 1,000,000 to the investors after 6 April 2012, and SEIS is a system additionally introduced to vitalize investments over small-sized ventures on 6 April 2012, which provides an income tax relief of 50% of the cost of shares, on a maximum investment of GBP 100,000 (HR Revenue and Customs, 2015).<sup>13)</sup>

Japan was influenced by the JOBS Act of the United States, thus, amended the Financial Instruments and Exchange Act allowing equity crowdfunding on 30 May 2014. The main contents of the amendment act are to exempt restrictions over the business activities of intermediaries of equity crowdfunding and to alleviate the requirements for the minimum capital (§29-4-2). The amendment act enables crowdfunding intermediaries that solely conduct public offerings or private placements through the internet only (or other designated electronic means) within certain subscription amount limits, to register as a Type 1 intermediary if equity interests are offered directly or as a Type 2 intermediary if fund interests are offered. Subscription amount limits will be determined by the cabinet order. The total subscription amount is expected to be less than JPY 100 million (approximately USD 1 million) and subscription amount per investor is expected to be JPY 500,000 or less (approximately USD 5,000) (Mori, 2015).<sup>14)</sup>

The amendment act exempts registered Type 1 and Type 2 crowdfunding operators from certain restrictions applicable to other financial business operators, including restrictions on conducting other types of business and regulations on capital to risk ratios. The minimum capital requirement is expected to be alleviated to JPY 10 million from JPY 50 million for Type 1 crowdfunding intermediaries and is expected to be lowered to

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13) <https://www.gov.uk/topic/business-tax/investment-schemes>.

14) <http://www.iflr.com/Article/3429725/Japan-Promoting-equity-crowdfunding.html>.

JPY 5 million from JPY 10 million for Type 2 crowdfunding intermediaries (Sibbit, 2014).<sup>15)</sup> In addition, the self-regulation of Japan Securities Dealers Association (JSDA) will be lifting prohibitions on handling public offers or private placements of unlisted securities so that current Type 1 Financial Instruments Business Operators can handle lower-priced securities over the internet.<sup>16)</sup>

In order to prevent fraudulent acts using online fund raising structures, the amendment act introduces new regulations. The amendment act imposes the obligation to provide certain disclosures, and the obligation to maintain certain internal control systems. Although the details of the obligations are scheduled to be decided by the cabinet order, it is expected to include due diligence on issuers and establishment of a system for providing proper information over the internet (DLA Piper, 2014).<sup>17)</sup> Moreover, since both Type 1 and Type 2 crowdfunding intermediaries are characterized as financial instruments business operators, the general conduct regulations are applied to them, such as duty of good faith, advertising regulation, the obligation of delivery of documents prior to the execution of contract and on execution.

### ***III. Comparative Review on the Main Contents of the Financial Investment Services and Capital Markets Act of Korea***

The Financial Services Commission of Korea (FSC) announced an introduction plan of crowdfunding on 26 September 2013, and enacted equity crowdfunding through partially

revising the Financial Investment Services and Capital Markets Act (hereinafter referred to as the “Capital Markets Act”) on 24 July 2015. The Capital Markets Act of 2015 reveals its reason for amendment as “to allow crowdfunding to safely settle as a reliable and sustainable means of financing for startup and venture companies.” For deregulation, Capital Markets Act of 2015 drastically alleviates the existing reporting regulations, accompanying the issuance of securities, for small amount securities public offerings. And it allows crowdfunding to be utilized as a means for financing by newly establishing intermediaries for online micro-investment. The Capital Markets Act of 2015 prepares controlling devices to prevent investors from injury through information asymmetry pursuant to the alleviation of controls over reporting, such as posting of business plan and the financial status of issuer, limitation on investment, imposing of compensation liability to issuer, prohibition on active recommendation to subscribe by the intermediary.

For this, a new provision specifying the definition of “intermediary for online micro-investment” (hereinafter referred to as the “intermediary”) has been included in Article 9 and a separate chapter 5 in part 2 relating to financial investment business has been newly established under the title of “Special Case on Intermediary for Online Micro-Investment.”

Meanwhile FSC revised the Enforcement Decree of the Capital Markets Act (hereinafter referred to as the “Enforcement”) on 25 January 2016, which regulates delegated matters of the Capital Markets Act of 2015, such as requirement of issuer, offering limit of issuer, investment limit of investor.

#### **3.1 Offering and Investment Limitations**

The Capital Markets Act of 2015 establishes a limit amount of public offering through the crowdfunding and the limit amount for investment by investors like the JOBS Act. The public offering limit amount through the crowdfunding is delegated to the Enforcement. And the Enforcement allows a company to raise a maximum aggregate amount

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15) <http://www.omm.com/japan-adopts-new-legislation-to-facilitate-equity-crowdfunding-for-start-up-companies>.

16) At present, JSDA prohibits handling public offerings or private placements of unlisted securities as a general rule.

17) <https://www.dlapiper.com/en/canada/insights/publications/2014/03/amendment-act-to-the-fieare-garding-encourage-of>.

of KRW 0.7 billion (approximately USD 0.6 million) through crowdfunding in a 12-month period, which is considering the fact that the small public offering limit is KRW 1 billion under the Capital Markets Act. However, the aggregate amount of crowdfunding offering could be expanded from the amount limit of KRW 0.7 billion by investment of expert investors, if they do not transfer their securities during 1 year (Enforcement §118-15).

The offering limit KRW 0.7 billion of Korea seems adequate considering enlargement of investment of expert investors, even though it looks small comparing with the offering limit of the United States (USD 1 million), the United Kingdom and Italy (EUR 5 million), and Japan (JPY 100 million).

Regarding the investment limit of investors, expert investors do not have investment limits. The investment limit of general investors has been set, primarily based on the income of investors. In addition, the Capital Markets Act sets the investment limit per issuer and per investor (Act §117-10⑥, Enforcement §118-17①~⑤). Table 1 summarizes the investment limits.

**Table 1**  
**Investment Limit for Crowdfunding**  
**in Capital Markets Act**  
**and Enforcement Decree**

(Unit: KRW)

Annual Investment Limit	General Investors Lacking Qualifications	General Investors Satisfying Qualifications	Expert Investors
	per Issuer	2 million	10 million
per Investor	5 million	20 million	No limit

As equity crowdfunding investment involves high investment risk due to the high information asymmetry compared to the existing securities investments and high probability of investment failure, establishing an annual investment limit is reasonable for the purpose of preventing investments that may incur difficulty in the daily lives of investors, at least when an investment failure has occurred.

However, investment limits per company, which are not applicable in other countries, seem unnecessary. Investors can invest all in one company within the gross annual investment limit, and may also engage in diversified investments to several companies through composing an adequate portfolio. In a situation where the annual investment limit is not high, establishing an investment limit per company shows a marginal effect of diversified investment while excessively limiting the self-determination right of investors and causing the financing of companies to become difficult.

### 3.2 Requirements for Intermediaries

A party that has not registered as an intermediary cannot engage in online micro-investment intermediary business (Act §117-3), and a party seeking to become an intermediary must register with the Financial Services Commission by satisfying certain qualifications (Act §117-4).

Similar to the JOBS Act of the United States, the Capital Markets Act of 2015 newly established business activity regulations to promote sound business of intermediaries and to protect investors. Intermediaries are prohibited from responding to consultation on management or investment and are prohibited from engaging in activities of arranging and acting as a proxy for the subscription of the issuance of securities or obtaining securities one mediates through making one's own calculation. In addition, intermediaries are prohibited from accepting investors' subscription unless the investor sufficiently checks the contents of subscription and risks involved. And also intermediaries must not subscribe randomly with investor's property before investor shows his intent to subscribe. Also the prohibition of unlawful discrimination and notification of subscription result has been imposed for the intermediaries. In addition, intermediaries are prohibited from all acts recommending subscription of securities, excluding the public announcement and transmission of information provided by issuers and invest-

ment advertisements in a limited scope (Act §117-7).

To protect investments, intermediaries are prohibited from receiving deposits and storing the assets of investors, and the subscription deposit of investors must be deposited or entrusted in institutions, such as banks or financial securities companies, without going through an intermediary (Act §117-8).

Issuer and intermediary are allowed to advertise only through internet website opened by an intermediary (Act §117-9).

Other methods of protecting investors specified by the Capital Markets Act of 2015 include granting the obligation to intermediaries to confirm facts of public announcement to prevent fraud (Act §117-11) and allowing investors to withdraw their intent to subscribe until the end date of the subscription period (Act §117-10⑥).

In relation to the verification of investment amounts, the biggest feature of the Capital Markets Act of 2015 is the installation of a central record management agency, thus, the Central Counterparty. The function of this central record management agency is to perform general office work, such as verification of offering and investment limits, subscription and payment, and distribution of stock certificates, on behalf of issuer or intermediary (Act §117-13). When considering the small size of issuers or intermediaries using crowdfunding, the existence of the Central Counterparty with high reliability can be seen as necessary infrastructure for the success of the crowdfunding system (Seong, 2014).

The Regulation Crowdfunding of the United States requires “an intermediary must provide on its platform communication channels by which persons can communicate with one another and with representatives of the issuer about offerings.” And it allows non-subscribers to access the communication channel, while allowing only subscribers the posting of opinions. Disclosure to non-subscribers seems as a proper measure not only because it can provide much information to potential investors but also because it could con-

tribute to social surveillance system.

The Capital Markets Act of 2015 places a similar devices as the above, which is the obligation that “an intermediary can allow the opinions of investors regarding securities and the issuer to be exchanged through his own internet website” (Act §117-7⑩). However, this regulation only specifies the opinion exchange between investors; thus, there is a need to supplement the system for the issuer to exchange opinions actively between all investors including potential investors.

It is extremely important to prevent the fraudulent use of crowdfunding. The capital Markets Act of 2015 states “the background of the representative and management of issuer” among the facts regarding the issuer that must be confirmed by an intermediary (Act §117-11⑬). In addition the Enforcement requires an intermediary to check the issuer’s business and financial plan, record of crime and suit of the issuer (including large shareholder and directors), etc. (Enforcement §118-18).

### 3.3 Requirements for Issuers

In relation to the scope of issuers, the Capital Markets Act of 2015 only allows equity crowdfunding to the company that has existed for no more than 7 years. And the Enforcement does not allow equity crowdfunding to listed company and business that the “Support for Small and Medium Enterprises Establishment Act” prohibits, such as financial, insurance, real estate, dance hall, golf course, ski resort, gambling and betting businesses. However, venture companies and technology innovation SMEs can use equity crowdfunding without restriction of the 7 business years (Act §9⑳, Enforcement §14-5㉑).

The Capital Markets Act of 2015 exempts the obligation to submit a registration for the equity crowdfunding (Act §117-10①). Therefore a separate disclosure requirement for the issuer is imposed. The Capital Markets Act of 2015 and the Enforcement require issuers raising securities through crowdfunding to publish the information concern-

ing offering on the intermediary's webpage, such as information of offering, issuer (including issuer's financial state), business plan and records of crime and suit of the issuer, directors and major shareholder (Act §117-10②, Enforcement §118-16①).

The Capital Markets Act of 2015 does not acknowledge the keep-in-all method, and compels the all-or-nothing method in a rather alleviated form. Article 117-10 Clause 3 regulates that, "when the issuer raises securities in a method of crowdfunding, the issuance must be cancelled if the subscription amount falls short of the amount multiplying the ratio (designated by the Enforcement) to the anticipated amount." And the Enforcement defines the ratio as 80% (Enforcement §118-16⑤).

The Capital Markets Act of 2015 requires an issuer or its representative to be responsible for compensation for investors' damages if there is an omission of records on important matters or there are false records on important matters in a business plan or document specifying the financial condition and issuance condition of the securities. However, when the party to be responsible for compensation proves that such matter could not be known even when taking reasonable care or the acquirer of such securities knew of such fact when subscribing for acquisition, the responsibility to compensate is exempted (Act §117-12①).

Just as the JOBS Act limits advertisements for crowdfunding, the Capital Markets Act of 2015 strictly limits subscription advertisements for crowdfunding to both the issuer and platform. Thus, investment advertisements through a means other than the platform website is not allowed, however, introducing the pertaining internet website address through another medium or providing a device allowing to access the pertaining website are allowed (Act §117-9①).

However, such restrictions on advertisements are only enforced in the United States. Italy, the United Kingdom, and Japan have not established new advertisement rules that apply only to crowdfunding. Controll-

ing advertisements in a phase where crowdfunding has not yet settled is an extreme measure to intermediary platform or companies making attempts for financing through crowdfunding. thus, it should be alleviated. It should be sufficient to leave such matter to Article 57 of the Capital Markets Act of 2015 regarding the advertisements of financial investment dealers.

On the other hand, the Capital Markets Act of 2015 requires issued securities to be mandatorily deposited or kept in security and prohibits the sale or withdrawal of securities, excluding exceptional circumstances, for one year from the deposit date (Act §117-10⑦). The Enforcement permits sale as an exception in case of selling to the issuer, special investors, and major shareholder (Enforcement §118-17⑤).

The Capital Markets Act of 2015 limits resale of securities for one year after the date of purchase in order to reduce investment risk through temporary pause of risk transfer and to raise prudent investment. However, asymmetric between investor in the platform and potential investor out of the platform is not dismissed or reduced with restriction of resale for one year. It could be accomplished through disclosure of the communication channel to the public and reinforcement of investor education to reduce investment risk and raise prudent investment. Therefore, it is reasonable to remove the restriction of resale and give tax benefits to the security holders for a certain period of time from the viewpoint of funding vitalization.

#### *IV. Conclusion*

Deregulation of securities offerings and introducing equity crowdfunding have been coming into the spotlight all over the world to vitalize the economy through improving financing conditions for startups and SMEs. Companies in the United States are able to raise a maximum aggregate amount of USD 1 million through crowdfunding without submitting a registration statement, and companies in Italy and the United Kingdom may procure up to EUR 5 million and companies

in Japan may raise up to JPY 100 million through an online platform, without also needing to file a registration statement. However, these countries have been enacting various measures to protect investors in parallel as the deregulation concerning public offerings of securities may weaken protection of investors. Instead of exempting submission of a registration statement, these countries impose issuers to disclose their business plans and the financial conditions and they establish a limit of investment amount. In addition they demand intermediaries to perform the role of gatekeeper to prevent fraud and abuse. In particular, the United States is further enhancing protection over investors by adding further restrictions, such as strict advertisement controls and restriction on resale.

South Korea has completed legislation regarding crowdfunding in July 2015, thus, startups and SMEs are able to procure up to KRW 700 million through an intermediary. Unlike requirements for general investors, the investment limit of expert investors has been eliminated in order to facilitate financing for companies, while measures to limit resales and control advertisements have been enacted, in addition a due diligence obligation to intermediaries has been imposed, just as the United States.

The United States amassed USD 1.6 billion in the amount financed through crowdfunding in 2012. However, in that same year in Korea, the amount of financing through crowdfunding only amounted to KRW 8,850 million (approximately USD 8 million), which reveals that there may be no need to apply the strict measures protecting investors as in the United States, which has successful crowdfunding platforms such as Kickstarter, Indiegogo, GoFundMe, EquityNet, and Fundable.

For sure, the deterioration of investor's confidence in the market, caused by issuer's fraud, abuse and investment damage resulting from indiscreet offerings, could lead to the failure of crowdfunding scheme. In South Korea protection of financial consumer has been a main concern especially after two financial scandals, the forced closures of 16 mutual saving banks in 2011 and the bankruptcy

of a conglomerate Tongyang group in 2013, which made numerous retail investors of subordinated bonds and commercial papers (CPs) suffer from massive financial losses.

However, those are issues to solve with financial supervision of the governmental authorities or private bodies and sufficient financial awareness of retail consumers. Moreover, Korean crowdfunding framework has high standard devices to prevent investors from injury, such as investment limitation, deposit or trust of subscription in financial institutions without going through an intermediary, obligation to intermediary to confirm facts, business activity regulations of intermediary, and existence of the central counterparty.

It would be appropriate to strictly maintain the core and strong instruments to protect investors, while regarding other instruments protecting investors considering more efficiency in control and drastically postponing the implementation of inefficient instruments.

Based on such perspective, the amendment to the Capital Markets Act and the Enforcement Decree would need to be revised as follows.

First, it would be unnecessary to place a separate investment limit per company, other than the total investment limit for general investors. Placing an investment limit per company in a situation where the total investment limit is not high would only become an obstacle for corporate financing and excessively interfere with the self-determination right of investors, while having a marginal effect on diversified investment.

Second, potential investors should be allowed to participate in the communication channels enabled by online platforms. By disclosing the communication channels to the public, potential investors would be able to obtain much more information, and the social surveillance function will be able to be strengthened.

Third, allowing only investment advertisements through the website of online platforms as in the United States would be unnecessary in the current situation where the crowdfunding industry has not even stabi-

lized. It would be advisable to leave this issue to Article 57 of the Capital Markets Act, which concerns advertisements of financial investment services.

Fourth, the measure that limits resale of securities for one year would be unnecessary. Crowdfunding is in its introductory stage and the reverse effect of intensifying the liquidity risk due to the absence of a divestment market is rather high in Korea. It would be more reasonable to lift the restriction on resale and to propose for possession of a certain period or more as a requirement for tax reduction.

In order to create new industries and new markets by improving the financing conditions for startups and SMEs, by escaping the economic growth trend focusing on large companies, a more decisive alleviation of regulations is needed. Now is the time to accumulate success stories in which companies and investors grow together through the investments in creative ideas. Now is the time to grow the pie known as crowdfunding.

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## 크라우드펀딩 법제에 관한 비교연구

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전 세계는 크라우드펀딩이라는 금융 혁명에 진입하고 있다. 미국, 이탈리아, 영국 및 일본은 이미 증권형 크라우드펀딩을 법제화하였고, 한국도 스타트업 기업 및 중소기업의 원활한 자금조달을 위하여 2015년 7월 증권형 크라우드펀딩을 법제화하였다. 이 연구는 공모 및 투자 한도, 중개업자 및 발행인의 요건 측면에서 미국, 이탈리아, 영국, 일본 및 한국의 크라우드펀딩 규제 체계를 살펴본다. 이를 통하여 한국의 크라우드펀딩에 관한 시사점을 도출하고, 크라우드펀딩을 통한 자금 조달을 촉진하기 위하여 자본시장과 금융투자업에 관한 법령의 개정 사항을 제안하고 있다.

**주제어** : 크라우드펀딩, 스타트업, 중소기업, 잡스법, 성장법 2.0, 자본시장과 금융투자업에 관한 법률

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