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TITLE

EQUITY-BASED CROWDFUNDING AND ARMENIAN START-UPS

**Whether the current regulatory framework of Armenia in relation to
legal entities and protection of investors engaged in public trading of shares
creates obstacles for startups to raise money via equity-based crowdfunding**

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Introduction

Back in 2014, the news about a deal caught the attention of the media and the business world. The social media giant, Facebook, announced its intention to acquire a start-up called Oculus VR for \$2 billion.¹ However, what made this start-up unique was its method of financing. Two years before this major deal, the founder of Oculus VR, Palmer Luckey, was only 19 years old when he launched a fundraising campaign on Kickstarter asking the public to donate money for the production of virtual reality goggles called Oculus Rift.² This innovative project with the promise of creating a breathtaking gaming environment attracted the virtual reality fanatics, and in a short period, Luckey was able to raise \$2.4 million.³ Despite the fact that the interest of the world's largest social network was pleasant for Luckey and his angel investors, the contributors who could not fathom how their contributions turned an independent project into a billion dollar business with them receiving nothing but a thank you note or an early prototype, criticized the deal.⁴ What Luckey did back in 2012 was crowdfunding.

Crowdfunding campaigns are not a novelty. One of the most remarkable products of a successful crowdfunding campaign is the pedestal of the Statue of Liberty in New York City. In 1885, Joseph Pulitzer, who commenced a fundraising campaign in his newspaper The New York World, was able to raise funds exceeding \$100,000 from more than 120,000 investors, an action that covered the costs of the much-needed substructure.⁵

Even though the above examples already suggest what crowdfunding represents, defining crowdfunding is not a hard task as the meaning can be found in the word itself; It is the process of gathering funds from the public. However, this definition is too simplistic and does not adequately demonstrate the nature and purpose of crowdfunding. Thus, the following definition seems to be more appropriate:

Crowdfunding is the process of obtaining small amounts of money from a large pool of investors through an intermediary to fund projects, businesses or other needs.⁶

¹ Victor Luckerson, *Facebook Buying Oculus Virtual-Reality Company for \$2 Billion* (March 25, 2014) <<http://time.com/37842/facebook-oculus-rift/>>

² David M. Ewalt, *Palmer Luckey: Defying Reality* (January 5, 2015) <<http://www.forbes.com/sites/davidewalt/2015/01/05/palmer-luckey-oculus-rift-vr/#1b66bd84fa09>>

³ *ibid.*

⁴ Victor Luckerson, *When Crowdfunding Goes Corporate: Kickstarter Backers Vent Over Facebook's Oculus Buy* (March 27, 2014) <<http://time.com/39271/oculus-facebook-kickstarter-backlash/>>

⁵ *The Statue of Liberty and America's Crowdfunding Pioneer* (April 25, 2013) <<http://www.bbc.com/news/magazine-21932675>>

⁶ Eleanor Kirby and Shane Worner, *Crowd-Funding: An Infant Industry Growing Fast*, IOSCO Staff Working Paper 3 (2014), p. 8 <<http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>>

This manner of financing has four different models that can be grouped into two major categories: “Community Crowdfunding” that contains donation-based and reward-based crowdfunding and “Financial Return Crowdfunding” that includes peer-to-peer lending and equity-based crowdfunding (“ECF”).⁷

The donation is perhaps the most well-known form of crowdfunding where the donors grant money to various charitable causes and do not receive anything but gratitude in return for their contributions.⁸ In the reward-based model, rewards are given out to all the persons contributing to the project.⁹ This model is different from other forms of crowdfunding in the sense that it cannot provide the contributors any financial return such as interest or return on investment.¹⁰ Conversely, in the peer-to-peer lending, the public poses as a bank for the company and receives interests on the loan that it gives, and finally ECF where the company sells shares to the contributing public.¹¹ If either Luckey or Pulitzer had offered shares to the public in return for their donations, their fundraising would have been labeled as an ECF.

Crowdfunding campaigns and particularly ECF have gained substantial attention both in the United States of America and the European Union in the last ten years. Two reasons can explain the increased interest. Firstly, technological innovations like Web 2.0 applications have made ECF viable.¹² Even if the crowdfunding itself is not the creation of today’s world, the channels through which the public and the project owners connect are not the same as 130 years ago. Technological advancements such as the Internet, smartphones, and social media have replaced the traditional intermediaries (e.g. the newspapers) and have created an environment where finding and financing interesting projects are just a matter of seconds. Secondly, the Global Financial Crisis of 2008-09 created a funding gap and limited the ability of not only the start-ups but also small and medium enterprises to receive loans from banks or have access to other sources of capital.¹³ The financing crisis has also reached to Armenia and finding capital for Armenian start-ups is not an easy task. According to Bagrat Yenbgibaryan, the Head of the Enterprise Incubator Foundation (EIF), the biggest problem Armenian start-ups face is financing.¹⁴ Hence, alternative sources such as ECF seem to offer a prospect of a solution to the funding issues of Armenian start-ups. Moreover, the ECF extends its benefits to

⁷ *ibid.*, 9.

⁸ Yannis Pierrakis and Liam Collins, *Nesta...Banking on Each Other: Peer-to-Peer Lending to Business: Evidence from Funding Circle* (2013), p. 11

<http://www.nesta.org.uk/sites/default/files/banking_on_each_other.pdf>

⁹ *ibid.*

¹⁰ *ibid.*

¹¹ *ibid.*

¹² Kirby and Worner, *supra* note 6, at 12.

¹³ *ibid.*, 12-14.

¹⁴ Arman Gasparyan, *Breaking Stereotypes: Challenges Armenian Start-ups Face* (February 16, 2016)

<<http://www.panarmenian.net/eng/details/205407/>>

the public and democratizes access to investment opportunities by allowing non-professional investors to invest in projects about which they are passionate.¹⁵

Notwithstanding the above mentioned, the emergence of ECF has sparked heated debates among the regulators around the world. Since the public offering of shares is regulated by the securities laws and due to the risks inherent to crowdfunding such as fraud, default, and liquidity the regulation of this sort of financing becomes inevitable. Consequently, various jurisdictions have adopted certain frameworks to regulate this new form of funding. These mechanisms usually focus on three sectors: 1) regulation of crowdfunding intermediaries through licensing, 2) limitation of investment opportunities for retail investors, and 3) restrictions imposed on crowdfunded firms.¹⁶

Nonetheless, the existence of regulations does not seem to be satisfactory for academics. The review of legal articles shows that many are skeptical about the created instruments stating that unreasonable restrictions such as limitations on the amount of money that crowdfunded firms are allowed to raise create unnecessary barriers for start-ups, and such protective measures make it almost impossible to use crowdfunding as an alternative source of financing. They criticize the regulations of being overly protective of investors and putting an extra burden on the companies. Thus, the main purpose of crowdfunding laws should be to maximize investor protection while keeping the costs of business low for small and medium enterprises and start-ups that wish to raise money via issuing stock.¹⁷

Armenian legislative framework has not introduced a regulation or a statute concerning the ECF. However, the question remains that whether the ECF can be successfully implemented under the current regulatory environment and whether the laws of the Republic of Armenia are protective enough of investors in capital markets and are positively affecting the growth and expansion of Armenian entrepreneurship.

This paper will research the global trends regarding ECF and will compare the various regulatory approaches in order to suggest amendments to Armenian legal framework. Chapter 1 will discuss the main regulatory issues concerning ECF in the context of start-ups and small and medium enterprises. In this part, legal articles will be reviewed to get a better understanding of the existing problems in this field and the analysis and solutions of legal scholars on them. This chapter will present the “Bridgefunding Theory” developed by Seth

¹⁵ Alma Pekmezovic and Gordon Walker, *The Global Significance Of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital*, William and Mary Business Law Review, Volume 7, Issue 2 (2016) pp. 351 -352
<<http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=1109&context=wmbllr>>

¹⁶ *ibid.*, 353.

¹⁷ Ross S. Weinstein, *Crowdfunding in the U.S. and Abroad: What to Expect When You're Expecting*, Cornell International Law Journal, Volume 46, Issue 2, Article 6 (2013), p. 435
<<http://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=1814&context=cilj>>

Oranburg which is one of a kind in proposing solutions to issues of start-up financing. Chapter 2 will examine different regimes of ECF in the USA, UK, and Greece and will show the benefits and drawbacks of each model. Chapter 3 will present the main issues of RA legislation and regulations that create hurdles for the expansion of Armenian entrepreneurship and will propose amendments that will help to introduce reforms into laws and regulations governing Armenian securities market.

This paper tries to argue that even though investor protection should be adequately addressed in public trading of shares, the regulators should consider that on the other side of the scale there are companies which because of regulatory hassles are unable to access to capital markets. Additionally, the goal of investor protection can be achieved through other means as well, and exemptions such as ECF are great tools that allow the regulators to structure a legislation that will both be protective of investors and will have positive effects on the country's economic growth and development.

Chapter 1. Regulatory Issues Related to Equity-Based Crowdfunding

Section 1. Risks of Crowdfunding

The emergence of ECF and its potential for start-ups and small and medium enterprises alleviated the funding gap created by traditional methods of business financing. However, risks and dangers inherent to this form of investment have alarmed the regulators around the world. The risks of this new model of funding are similar to those of a traditional IPO. However, these dangers are magnified in ECF due to two reasons: 1) The addressees of ECF are mainly unsophisticated investors as opposed to IPO where professional investors engage in public trading of shares, and 2) The main characteristic of ECF is the conduct of transactions through online platforms that are not as regulated as the traditional stock exchanges. Thus, even though the pitfalls associated with the ECF exist in various kinds of securities, the distinct nature of ECF requires a vigorous regulatory framework which would address the concerns of the governments.¹⁸ Hence, an understanding of the imminent dangers of online offer and sale of securities is essential for structuring legal and regulatory mechanisms which would allow crowdfunding to contribute to a country's economic growth.¹⁹

§1. Fraud

Fraud, one of the inherent risks of stock markets, is the primary concern of the regulators.²⁰ This issue is of more prominent importance in the ECF because the offer and sale of shares are done through online platforms, and the anonymity of the Internet can contribute to the growth of scammers.²¹ Professor Thomas Lee Hazen also cautions that the nature of Internet increases the magnitude of fraud and demands more regulations for the protection of investors.²²

Nonetheless, it seems that the impersonal nature of Internet is the only quality of cyberspace that serves as a basis for either dismissing or requiring an extensive regulation of this sort of financing. Despite this approach of regulators and legal scholars, one should also

¹⁸ World Bank, infoDev, Finance and Private Sector Development Department, *Crowdfunding's Potential for the Developing World*, Washington, DC (2013), p.45

<http://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf>

¹⁹ *ibid.*

²⁰ Michael Vignone, *Inside Equity-Based Crowdfunding: Online Financing Alternatives for Small Businesses*, Chicago-Kent Law Review, Volume 91, Issue 2, Article 17 (2016), p. 831

<<http://scholarship.kentlaw.iit.edu/cgi/viewcontent.cgi?article=4128&context=cklawreview>>

²¹ Kirby and Worner, *supra* note 6, at 26.

²² Thomas Lee Hazen, *Crowdfunding or Fraudfunding - Social Networks and the Securities Laws - Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, North Carolina Law Review, Volume 90, No. 5, Article 13 (2012), at 1766

<<http://scholarship.law.unc.edu/cgi/viewcontent.cgi?article=4584&context=nclr>>

consider the other aspects of Internet which might offer solutions to the same problems that is in the center of the attention of critics.

First, as Professor Seth Oranburg mentions, just because something occurs on the Internet does not make it automatically fraudulent.²³ On the contrary, the Internet gives the opportunity to investors to discuss their concerns and by collaborating with each other single out the deceitful players.²⁴ In other words, an online community of investors will be created that can review and share the information and warn each other about fraudulent offers or advise on good investment opportunities.

Secondly, the risk of fraud exists in all forms of investments and proper regulatory instruments such as personal liability can reduce fraud in crowdfunding platforms.²⁵ Professor Bradford also supports this line of argument. He finds that investors are already making investments in other models of crowdfunding and these investments carry the same risk with the difference that they do not promise the same benefits of ECF.²⁶ Therefore, allowing online offer and sale of securities through proper regulations will only increase the income of individuals without increasing the risk of fraud.²⁷

Alongside these arguments, the facts also seem to suggest that the worries of regulators are unfounded. Many successful ECF operating platforms such as the Australian Scale Offerings Board and the UK's Crowdcube have helped with large amounts of investments and have reported almost no cases of fraud.²⁸

Taking into consideration the above mentioned, it can be concluded that the Internet offers more than anonymity. It is true that the risk of fraud and Internet go hand in hand and this fact can be troubling in securities offerings where fraud is already a major concern. Despite this, the Internet is a space where the information is shared within seconds, and this quality will help to identify the fraudulent activities. Furthermore, the risk of fraud will decrease considerably, if the offers are made exclusively through regulated platforms.

²³ Seth C. Oranburg, *Bridgdfunding: Crowdfunding and the Market for Entrepreneurial Finance*, Cornell Journal of Law and Public Policy, Volume 25 (2015), p.426

<<http://www.lawschool.cornell.edu/research/JLPP/upload/Oranburg-final.pdf>>

²⁴ *ibid.*

²⁵ *ibid.*, 426-427.

²⁶ C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, Columbia Business Law Review, Volume 2012, No.1, p. 105

<<http://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=11118&context=lawfacpub>>

²⁷ *ibid.*

²⁸ World Bank, *supra* note 18, at 45-46.

§2. Risk of Default

Even though regulators around the world are more worried about the risk of fraud, protecting investors from start-up failure also represent a legitimate issue.²⁹ The data shows that almost 9 out of 10 start-ups are inclined to failure.³⁰ The lack of sophistication of investors also adds another layer to the problem as the primary addressees of ECF are non-professional investors, who do not have the same sophistication of experienced investors who can understand that start-ups are riskier than later-stage companies.³¹

There are two methods to address this issue. Even if one cannot protect investors from bearing losses due to the possible default of enterprises, proper disclosure of information including a statement informing the investors about the associated risks can minimize the potential losses of the investors.³² Besides, the portals conducting the crowdfunding and trusted third parties should engage in investor education ensuring that the public is well-informed.³³

§3. The Trio of Problems

According to Professor Ronald Gilson, there are three sets of problems that start-ups face. These “Trio of Problems” that are uncertainty, asymmetry of information and agency costs are more aggressive in early stage start-ups.³⁴ However, Andrew Schwartz in his work *The Digital Shareholder* proposes digital solutions to these issues.

(1) Uncertainty

The uncertainty of the business is the most obvious problem meaning that it is not possible to predict the future of the company.³⁵ This issue is magnified in early stage start-ups for several reasons.³⁶ First, almost all the important decisions which will have an enormous effect

²⁹ Oranburg, *supra* note 23, at 397.

³⁰ Erin Griffith, *Why Start-ups Fail, According to Their Founders* (September 25, 2014) <<http://fortune.com/2014/09/25/why-start-ups-fail-according-to-their-founders/>>

³¹ World Bank, *supra* note 18.

³² *ibid.*

³³ *ibid.*

³⁴ Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, *Stanford Law Review*, Volume 55 (2003), p. 13

<<https://ssrn.com/abstract=353380>>

³⁵ Csilla Orsolya Eötvös, *Regulatory Challenges in Investment-Based Crowdfunding: The Model of the United States and Lessons for Hungary*, Central European University (2016), p.10

<http://www.etd.ceu.hu/2016/eotvos_csilla.pdf>

³⁶ Gilson, *supra* note 34, at 14.

on the company's success are yet to be made, and there is uncertainty about the outcome of the company's efforts.³⁷ The second issue concerns the quality of the management of the corporation because the decisions of the managers will affect the value of the company's portfolio.³⁸ Besides, if the company is specialized in the technology sector of the economy, scientific uncertainty is also added to the general problems.³⁹

However, the most prominent solution that is suggested by many legal scholars is the "Theory of Wisdom of the Crowd." This theory suggests that when people with different backgrounds (i.e. ethnicity, age, gender, etc.) gather, on average, they can make better decisions.⁴⁰ On the other hand, with a homogenous crowd, there are higher chances that their answers on average would be wrong since all of them can make the same mistakes.⁴¹ Crowdfunding in this sense can be a solution because the Internet allows various groups of investors to be involved and consequently fund the projects they find the most promising based on the approach of the other investors.⁴² Despite the popularity of this theory, one should also consider its flaws. The crowd will not be able to make rational and accurate decisions if the participants are not independent.⁴³ The lack of independence will result in herding, a situation where the participants will follow each other without considering the consequences of their actions.⁴⁴

(2) Asymmetry of Information

The second concern for the issuers is the asymmetry of information. Asymmetry of information means that logically the issuers are more aware of their company and the value of their shares than the investors are.⁴⁵ If the investors are not provided with sufficient information, then they will face an adverse selection which can lead to a "Lemons Market."⁴⁶ This means that since the information does not show the good and the bad products and investors are not willing to risk, therefore, the good products will leave the market, and only the "lemons" will be present.⁴⁷ Besides, promising businesses are expected to have other

³⁷ *ibid.*

³⁸ *ibid.*

³⁹ *ibid.*

⁴⁰ Andrew Schwartz, *The Digital Shareholder*, Minnesota Law Review, Volume 100, No. 2 (2015), p. 660-663

<<https://ssrn.com/abstract=2707266>>

⁴¹ *ibid.*

⁴² *ibid.*

⁴³ Philip Ball, *Wisdom of the Crowd: The Myths and Realities* (July 8, 2014)

<<http://www.bbc.com/future/story/20140708-when-crowd-wisdom-goes-wrong>>

⁴⁴ *ibid.*

⁴⁵ John Armour and Others, *Principles of Financial Regulation*, Oxford University Press (2016), E-Book, 3.3.1 Asymmetric Information

⁴⁶ Eötvös, *supra* note 35, at 27-29.

⁴⁷ *ibid.*

sources of finance and leave the ECF to leftovers.⁴⁸ In other words, the asymmetry of information will cause troubles, no one will invest, and this will lead to a market failure.⁴⁹

Online platforms can propose a solution. The investors have the possibility of sharing information online which will reduce the asymmetry of information to some extent.⁵⁰ This together with mandatory disclosure of information will allow the injection of information into the market and will minimize the risk of a “Lemons Market.”

(3) Agency Costs

The third wheel of the problems is what economists call agency costs. Agency costs arise as a consequence of conflicts of interest between the investors and the companies.⁵¹ This means that the firm, which in this case is an agent, can make decisions for its benefit and harm the investors, the principals.⁵² This problem is magnified in the crowdfunding since the addresses of this form of financing are mainly retail investors who have limited expertise in this field.⁵³

One of the ways to mitigate the agency cost problem is through strict monitoring of the whole financing process.⁵⁴ Besides regulating the intermediaries that can bear some burden of this control, the firms should share information to the extent possible, and by doing so, they can build a relationship with their shareholders.⁵⁵ This digital monitoring is critical after the campaign reaches its target offering amount when regular and continuous disclosures should be provided.⁵⁶

(4) Solutions from Angel Investors and Venture Capitals

One of the debated issues in the legal literature is the protection of crowdfunding investors through contracts that will include protective clauses similar to contracts regulating the relationships between angel investors, venture capitals (“VCs”) and entrepreneurs.

⁴⁸ Schwartz, *supra* note 40, at 632.

⁴⁹ *ibid.*, 633.

⁵⁰ *ibid.*, 663.

⁵¹ Eötvös, *supra* note 35, at 11.

⁵² *ibid.*

⁵³ *ibid.*

⁵⁴ *ibid.*

⁵⁵ *ibid.*

⁵⁶ *ibid.*

Angel investors, ex-ante, invest in areas that are familiar to them.⁵⁷ This reduces the uncertainty and the asymmetry of information.⁵⁸ Furthermore, the angels have a trusted network of advisors who screen and monitor the start-ups and advice about the condition and investment opportunities in start-ups.⁵⁹ Ex post, the angels engage and guide the business rather actively and reduce the agency costs.⁶⁰ Angel investors perform the above-mentioned tasks through special covenants in contracts.⁶¹ It is naïve to assume that these protective measures will be effective for crowdfunders, as they do not have the same negotiating powers and expertise of angel investors.⁶² However, similar protective clauses can be provided if the transactions are conducted based on standardized contracts drafted by the regulators or the intermediaries.⁶³

In the case of VCs, the staged financing is one of the primary methods of mitigating the start-up investment risks. During a staged financing, VCs contract with the firms and promise to fund the business gradually.⁶⁴ This means that until the achievement of certain milestones the company will not receive any funding.⁶⁵ Staged financing not only reduces the information asymmetry but also by incentivizing the entrepreneurs to receive more funds reduces the agency costs.⁶⁶ Additionally, VCs purchase preferred stock that includes protective devices such as preemptive rights, anti-dilution provisions, liquidation preferences, tag-along rights and board representation.⁶⁷ These methods also cannot directly translate into crowdfunding. To achieve staged financing, the intermediaries should actively participate in the investment process, and this might create an unnecessary burden.⁶⁸ However, protective measures found in preferred stock might be a solution if just as suggested above they are included in standardized contracts.⁶⁹

⁵⁷ Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, Minnesota Law Review, Volume 100 (2015), p. 575
<http://www.minnesotalawreview.org/wp-content/uploads/2016/01/Ibrahim_4fmt.pdf>

⁵⁸ *ibid.*

⁵⁹ *ibid.*, 575-576.

⁶⁰ *ibid.*, 576.

⁶¹ Tadej Vrabc, *Crowdfunding - Regulatory Framework and Implications for Investors*, University of Ljubljana, Faculty of Economics, Master's Thesis (2015), p. 34

<<http://www.cek.ef.uni-lj.si/magister/vrabc1735-B.pdf>>

⁶² *ibid.*

⁶³ *ibid.*

⁶⁴ Ibrahim, *supra* note 57, at 574.

⁶⁵ *ibid.*

⁶⁶ *ibid.*

⁶⁷ Jack Wroldsen, *Crowdfunding Investment Contracts*, Virginia Law and Business Review (2016), p.16

<<https://ssrn.com/abstract=2844771>>

⁶⁸ *ibid.*

⁶⁹ *ibid.*

§4. Absence of Secondary Market

One of the major drawbacks of ECF is that secondary markets almost do not exist. One of the reasons that impedes the development of secondary markets is the magnitude of issued shares. The numbers of shares that are issued in an online offering are likely to be smaller than the shares that are traded on an organized exchange.⁷⁰ In regulated markets, since the number of investors is more, then it is also easier to find someone in the same market and sell the shares.⁷¹ Additionally, the market for online securities transactions is new. Therefore, there have not been too many exits.⁷²

The development of secondary markets is of utmost importance. Investors are interested in the liquidity of their shares meaning that they want to know how fast they can sell the shares and turn it into cash.⁷³ Therefore, the shares with more liquidity will incentivize the investors and will result in payment of higher prices for the issued shares.⁷⁴ In contrast, the absence of security market can deter investors who do not want their investment to be tied-up for long periods.⁷⁵

Nonetheless, the secondary markets will eventually emerge. The platforms conducting the ECF will grow enough and will allow the investors to trade shares bought from the very same platform.⁷⁶ In addition, specialized platforms will be launched that will oversee the transactions.⁷⁷ Until the emergence of such platforms, regulations can solve the issue to some extent by mandating the companies to buy back the shares within a specified period.

Section 2. Bridgefunding Theory: A Solution for Start-ups?

As outlined above, different solutions are proposed to address the issues related to online offer and sale of securities to unsophisticated investors. However, one theory stands out. Professor Seth Oranburg has tried to come up with a unique solution to start-up crowdfunding problems by the Theory of Bridgefunding. This approach suggests that the solution to the much-discussed problems of ECF lies in allowing the companies to use ECF only during a certain period of their financing cycle. Nonetheless, this proposal only focuses on start-ups.

⁷⁰ Ronald Kleverlaan and Flip de Jonge, *Equity Crowdfunding - Considering Potential Risks and Liabilities as the Industry Grows and Matures*, CrowdfundingHub (2016), p. 6

⁷¹ *ibid.*

⁷² Vrabec, *supra* note 61, at 43.

⁷³ <<http://www.cek.ef.uni-lj.si/magister/vrabec1735-B.pdf>>

⁷⁴ *ibid.*

⁷⁵ *ibid.*

⁷⁶ Kleverlaan and de Jonge, *supra* note 70.

⁷⁷ *ibid.*

Hence, before going into details of the Bridgdfunding Theory, a brief introduction to the nature of start-ups and their financing cycle seems appropriate.

§1. Start-up vs. Small Business

Even though in the modern day world, the terms start-up and small and medium business are often used interchangeably, however, the conflation of these terms is not acceptable.⁷⁸ These companies have significant differences, and central to structuring a proper exemption such as ECF is the basic knowledge of the distinct needs of these businesses.

Two factors contribute to the peculiar nature of these companies. The first difference lies in the speed of growth. Start-ups are considered as companies with the potential of growing quickly⁷⁹ and to maintain that growth they usually rely on outside capital.⁸⁰ On the contrary, established companies like small and medium enterprises grow sustainably.⁸¹ Secondly, the method of financing differs considerably. Angel investors and VCs are keener on funding start-ups.⁸² This enthusiasm can be explained by the investment model of private equity investors. The primary way to raise money for start-ups besides the personal assets of the owners is through the sale of preferred stock to angel investors and VCs.⁸³ The stock is held for a restricted number of years and cannot be easily transferred to another player in the market.⁸⁴ Since this investment is risky, these investors intend to obtain significant returns and are more curious about investment opportunities in start-ups because as already mentioned start-ups promise high-growth and high-rewards.⁸⁵ Conversely, even though small businesses are as risky as start-ups, they do not have the same exponential growth.⁸⁶ Therefore, private equity investors will bear the same risk as they do with start-ups but with far lower returns.⁸⁷ Thus, the chances that a small business will receive financing from angel investors and VCs are slim.⁸⁸

⁷⁸ Oranburg, *supra* note 23, at 405.

⁷⁹ *ibid.*

⁸⁰ *ibid.*, 399.

⁸¹ *ibid.*, 406.

⁸² *ibid.*, 405.

⁸³ *ibid.*, 403.

⁸⁴ *ibid.* 405. (Citing Jack S. Levin et Al., Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions, Paragraph 103 (2009))

⁸⁵ *ibid.*

⁸⁶ *ibid.*, 406.

⁸⁷ *ibid.*

⁸⁸ *ibid.*

§2. Start-up Financing Cycle

As already mentioned, the main providers of capital for start-ups are angel investors and VCs. However, these investors provide money in different stages of start-up evolution which creates the dynamic called the start-up financing cycle.⁸⁹

The first stage is the seedfunding when friends, family and angel investors provide capital.⁹⁰ Once the company starts its operations, it enters into seed valley of death where the company has almost no revenues, and a huge amount of money is needed.⁹¹ If the company produces enough revenues to cover the monthly costs of the business, then it exits the seed valley of death and enters into early stage financing where VCs show the interest of funding.⁹² The first early stage investment is called Series A, after which VCs frequently invest as Series B, C, D, etc.⁹³ This cycle ends well if the start-up is acquired by or merged with another company.⁹⁴ The cycle ends badly, if the start-up goes bankrupt, decides to liquidate or sells the company for pennies on the dollar to another corporation.⁹⁵

According to investors and legal scholars, there is a gap in this cycle and start-ups do not usually receive the investment as smoothly as it seems. This gap, which is named the Funding Gap, is estimated to be between 1\$ million and \$5 million.⁹⁶ This Funding Gap, commonly known as the Series A Gap, can lead to a phenomenon named the Series A Crunch.⁹⁷ This means that even if the start-ups receive the support of angel investors but are not successful in landing the attention of VCs are “crunched.”⁹⁸ However, if correctly regulated, the ECF can fill this gap by introducing the crowds into the private equity market.⁹⁹

§3. The Bridgefunding Proposal

What Professor Oranburg suggests is to introduce the crowdfunding during the Series A gap. It means that instead of having crowdfunding from the beginning of the start-up lifecycle (seed stage start-ups), the public should be allowed to invest in early stage start-ups that are

⁸⁹ *ibid.*, 410.

⁹⁰ *ibid.*

⁹¹ *ibid.*

⁹² *ibid.*

⁹³ *ibid.*

⁹⁴ *ibid.*, 411.

⁹⁵ *ibid.*

⁹⁶ *ibid.*, 412-414.

⁹⁷ *ibid.* 414.

⁹⁸ *ibid.*

⁹⁹ *ibid.*, 401.

already funded by a professional investor.¹⁰⁰ Professor Oranburg argues that the biggest mistake that the current ECF regulations make is placing the public and angel investors against each other.¹⁰¹ Angel investors are sophisticated players of the market and making the public to compete with them does not address the funding gap. Instead, it only creates another player at the same level of investment where there is no gap.¹⁰² Thus, the public should be allowed to invest after angels make their investments.¹⁰³

The structure of this theory is based on four components:

1. A \$1 Million Floor: The amount of money that companies are allowed to raise shall be calculated based on the needs of the start-ups. For instance, as the paper will show below, the limit on the companies in the U.S. is \$1 million. So, instead of having a maximum limit of \$1 million, the companies will be required to raise at least \$1 million before being able to use crowdfunding.¹⁰⁴ This will impede the low-quality start-ups from access to public's capital while allowing high-quality start-ups to seek the money they desperately need to reach to Series A financing.¹⁰⁵

2. A \$5 Million Ceiling: The limit on companies should be raised to \$5 million.¹⁰⁶ More mature start-ups who have already passed the Series A Gap are not under the risk of crunch, and there is no need for the public to finance them.¹⁰⁷

3. An Independent and Significant Investor: The start-ups shall be required to have at least one significant and independent investor before reaching to public.¹⁰⁸ The motive behind this requirement is that a professional investor will oversee the operations of the company; therefore, the investments of public will be more secure.¹⁰⁹

4. Mandatory Contractual Protection: Since the participants of the ECF are mostly unsophisticated investors, they could not know how to protect themselves through contractual means like VCs or angel investors do.¹¹⁰ Hence, the legislation should mandate the companies to have contracts with the investors that will give the same level of protection as they provide for VCs and angel investors.¹¹¹

¹⁰⁰ *ibid.*, 419.

¹⁰¹ *ibid.*, 423-425.

¹⁰² *ibid.*

¹⁰³ *ibid.*

¹⁰⁴ *ibid.*, 419.

¹⁰⁵ *ibid.*

¹⁰⁶ *ibid.*, 420-421.

¹⁰⁷ *ibid.*, 421.

¹⁰⁸ *ibid.*, 420.

¹⁰⁹ *ibid.*

¹¹⁰ *ibid.*

¹¹¹ *ibid.*

This theory has its advantages. It will reduce the risk of fraud and business failure as the firm is already vetted by a professional in the field.¹¹² Moreover, if the company gets the attention and support of the public, it can send a strong signal to venture capitals who will start to finance the company on the later stage preventing it from failing.¹¹³ However, it also has drawbacks. Limiting the start-ups from reaching out to the public might be considered an unnecessary restriction. Moreover, the implementation of the components of this theory requires an extensive research and these solutions are not as easy as they seem. Nonetheless, under existing regulations, this proposition offers the best prospect of a solution to the crowdfunding problems.

¹¹² *ibid.*, 401-402.

¹¹³ *ibid.*

Chapter 2. Regulation of Equity-Based Crowdfunding Abroad

Section 1. The Untied States of America

In the United States of America, access to capital has been troublesome for the start-ups and small businesses. Financial Crisis of 2008-09 decreased the number of small business loans, and the regulatory hurdles associated with the public offering of shares contributed to restraints on small business capital access.¹¹⁴ Hence, in 2012, President Obama signed the Jumpstart Our Business Start-ups (JOBS) Act to minimize the funding gap created by traditional methods of financing.¹¹⁵ The Securities and Exchange Commission (SEC) introduced the rules implementing the Act, and since 2016, the U.S. companies have more options of pursuing capital.¹¹⁶

The JOBS Act has five titles, and each of them amends a certain aspect of the securities laws. This section will present Title III of the JOBS Act, also named “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012” or “CROWDFUND Act” and the “Regulation Crowdfunding” implementing the said title.

§1. Regulation of the Companies

According to section 4(a)(6)(A) of the Securities Act of 1933 (the “Securities Act”) and the Regulation Crowdfunding, the aggregate amount of money that an issuer can raise on reliance on crowdfunding exemption during a 12-month period preceding the date of the securities transaction is limited to \$1 million.¹¹⁷ When calculating aggregate amounts of securities offered or sold online, the issuer shall calculate all the securities that are sold in reliance on Section 4(a)(6) by 1) all the entities that are controlled by the issuer or are under common control with the issuer, and 2) any predecessor of the issuer.¹¹⁸ Moreover, only the offerings using crowdfunding exemption are calculated toward the limit, and the capital raised through other exemptions of the Securities Act (e.g. Regulation D or Regulation A) is not included in

¹¹⁴ Thaya Brook Knight, *A Walk Through the JOBS Act of 2012: Deregulation in the Wake of Financial Crisis*, CATO Institute, Policy Analysis, N.790 (2016), pp. 1-6

<<https://object.cato.org/sites/cato.org/files/pubs/pdf/pa790.pdf>>

¹¹⁵ Alexandra Alper, *Obama signs bill to boost business start-ups* (April 5, 2012)

<<http://www.reuters.com/article/us-usa-jobsact-idUSBRE83414F20120405>>

¹¹⁶ The U.S. Securities and Exchange Commission (SEC), *SEC Adopts Rules To Permit Crowdfunding* (October 30, 2015)

<<https://www.sec.gov/news/pressrelease/2015-249.html>>

¹¹⁷ 17 CFR §227.100(a)(1)

¹¹⁸ 17 CFR §227.100(c)

the evaluations.¹¹⁹ Additionally, the companies shall conduct the transactions solely through the intermediary's platform and are not allowed to perform investment crowdfunding using more than one intermediary.¹²⁰

Besides the limitation on the amount that each company is allowed to raise, there are also certain requirements concerning the disclosure of information. Before an issuer can make an offer on an online platform, an extensive array of information should be filed with the SEC and provided to investors and intermediary. The required information can be grouped as the following:

1) General information on the issuer, including the name, position and business experience of the officers and directors, the names of the beneficial owners of 20 percent or more of the issuer's outstanding voting securities, a description of the business of the issuer and its business plan, and a description of all the circumstances that make the investment speculative or risky;

2) The amount of money that the issuer intends to raise, the deadline to reach the target and a detailed description of the purpose and intended use of the proceeds;

3) A description of the ownership and capital structure of the issuer, including information related to the securities of the issuer;

4) Information about the intermediary, including any financial interest of the latter in the transaction and the issuer;

5) Information about the transactions of the issuer, including any indebtedness of the issuer and transactions carried out based on the other exemptions of the securities laws; and

6) Financial information, including information about the financial condition of the company.¹²¹

§2. Limits on the Investors

Under section 4(a)(6)(B) of the Securities Act and the Regulation Crowdfunding, in a 12-month period, an investor is limited to invest: 1) the greater of \$2,000 or 5 percent of the lesser of annual income or net worth if the annual income or net worth is less than \$100,000; or 2) 10% of the lesser of either annual income or net worth in the case that the annual income or net worth is equal to or more than \$100,000 and the sale of securities to the investor shall not

¹¹⁹ 17 CFR §227.100(a)(1)

¹²⁰ 17 CFR §227.201(a)(3)

¹²¹ 17 CFR §227.201

exceed \$100,000.¹²² In addition, the spouses are allowed to calculate their net worth or annual income jointly, but the limitations on their investment would be the same as the restrictions applied to an individual investor.¹²³ These limitations concern all the offerings made under section 4(a)(6) across all issuers,¹²⁴ and the intermediary is obliged to ensure that the investor will not exceed these limitations, provided that the issuer does not know that investor has or could exceed the investor limits.¹²⁵

Incidentally, there are three other mechanisms aimed at the protection of investors. Firstly, if the investment commitments are not equal to or exceed the target offering amount, the issuer cannot sell any security, and the investments shall be returned.¹²⁶ Secondly, the investors may cancel an investment 48 hours before the deadline established by the issuer.¹²⁷ Failure to do so will release the funds to the issuer.¹²⁸ Third, if there is a material change made to the offering and the investor has not reconfirmed its commitment, then the investment will be canceled, and the investor will be returned his investment funds.¹²⁹

Conversely, the investors have almost no exit options. Investors are not allowed to transfer their securities during the one-year period, unless the securities are transferred to the issuer, an accredited investor, the SEC, or a member of the family in particular circumstances.¹³⁰

§3. Regulation of the Intermediary

Any person who is an intermediary in a transaction that relies on the crowdfunding exemption must be a registered broker or act as a funding portal and be a member of a national securities association.¹³¹

The notion of funding portal is one of the innovations of the JOBS Act. A funding portal is a broker that is prohibited from offering investment advice or recommendations, solicitation, compensations for such solicitation and handling investor funds or securities.¹³² Funding portals are required to only register with the SEC, and they do not have to follow the registration process of brokers under the Exchange Act.¹³³

¹²² 17 CFR §227.100(a)(2)

¹²³ 17 CFR §227.100(a)(2)

¹²⁴ 17 CFR §227.100(a)(2)

¹²⁵ 17 CFR §227.100(a)(2)

¹²⁶ 17 CFR §227.304(d)

¹²⁷ 17 CFR §227.304(a)

¹²⁸ 17 CFR §227.304(c)

¹²⁹ 17 CFR §227.201(k)

¹³⁰ 17 CFR §227.501(a)

¹³¹ 17 CFR §227.300 (a)

¹³² 17 CFR §227.300 (c)(2)

¹³³ 17 CFR §227.401

Certain investor protection measures are also entrusted to the intermediaries. They have to conduct investor protection tests where the investor should demonstrate that he/she understands the risks associated with this financing and that the entire amount of his investment could be lost.¹³⁴

In addition, the intermediary is required to provide communication channels where the investors can contact one another and the representatives of the issuer as long as it does not participate in the communications and parties who participate disclose their status fully.¹³⁵ The communications shall be public and available to everyone.¹³⁶

Section 2. The United Kingdom

The United Kingdom is considered as one of the pioneers in the field of crowdfunding. UK's equity market is one of the fast growing markets in the world, and as of 2016, it is considered as the second most active source for high growth companies.¹³⁷ Despite this fact, the UK regulatory framework does not address ECF directly. However, the crowdfunding is tolerated under the UK framework. Notably, the Financial Services Market Act of 2000 (the "FSMA") contains certain provisions on ECF and the Financial Service Authority (the "FCA") addresses the ECF through a set of regulations. Compared to the U.S. regulations, the UK's legislator has proposed lenient legislation on the ECF. However, in 2016 the FCA announced its intention of reviewing the rules and proposing stricter guidelines for the UK's companies and investors.¹³⁸

§1. Regulation of the Companies

The UK regulations do not contain any provision limiting the amount of money that the entrepreneurs are allowed to raise. However, when dealing with retail investors, they are obliged to disclose information. Any firm who offers or sells securities to retail clients is required to disclose the following information:

1. Information of general nature about the firm and the services that it provides;

¹³⁴ 17 CFR §227.300 (b)(2)

¹³⁵ 17 CFR §227.402 (4)

¹³⁶ 17 CFR §227.402 (4)

¹³⁷ Megan Dunsby, *Equity Crowdfunding Now the Second Most Active Funding Source in the UK* (May 19, 2016)

<<http://start-ups.co.uk/equity-crowdfunding-now-the-second-most-active-funding-source-in-the-uk/>>

¹³⁸ *Financial Conduct Authority, FCA publishes interim feedback following a call for input to the post-implementation review of the rules for crowdfunding* (December 9, 2016)

<<https://www.fca.org.uk/news/press-releases/fca-publishes-interim-feedback-following-call-input-post-implementation-review>>

2. Information about the protection of designated investments of clients and client money;
3. Information about all fees, charges and other costs and expenses that the investor shall bear;
4. Information about the risks and dangers associated with the investment;
5. Information about the prospectus published by the issuer and where the investor can find the prospectus;
6. If one element of the transaction constitutes a greater danger, then the information related to that elements; and
7. If the offer is guaranteed, the information about the guarantee and the guarantor.¹³⁹

§2. Limits on the Investors

The persons who are allowed to make investments are subject to some restrictions and only the following groups are allowed to be make investments in crowdfunding platforms:¹⁴⁰

1. Retail clients certified as high net worth investors: In order to qualify for the status of high net worth investor, the individual shall sign a statement stating that he/she has an annual income of 100,000 or more or a net worth of 250,000 or more.¹⁴¹ The annual income is calculated without considering the money withdrawn from pension savings.¹⁴² The net worth has also certain limitations. Net assets do not include the property that is the primary residence of the investor or money received as a loan that is secured on that property.¹⁴³ The net assets also do not include any rights under the contract of insurance and any benefits that should be paid in the future because of the death or retirement of the investor.¹⁴⁴

2. Retail clients certified as sophisticated investors: A certified sophisticated investor is an individual that has a written certificate signed by the firm within the last 36 months that confirm that the individual has been assessed by that firm and has enough knowledge to understand the risks of engaging in the business.¹⁴⁵

3. Retail clients self-certified as sophisticated investors: Retail clients can self-certify as sophisticated investors based on several grounds: 1) an individual who is a member of network of business angels for the last 6 months, 2) has made more than one investment in an unlisted company two years prior to self-certification, 3) has two years experience prior to self-

¹³⁹ COBS 14.3

¹⁴⁰ COBS 4.7.7 R

¹⁴¹ COBS 4.12.6

¹⁴² COBS 4.12.6

¹⁴³ COBS 4.12.6

¹⁴⁴ COBS 4.12.6

¹⁴⁵ COBS 4.12.7

certification in private equity sector in professional capacity or in the provision of finance for small and medium enterprises, 4) is currently or has been two years prior to self-certification the director of a company with annual turnover of at least £1 million.

4. Retail clients certified as restricted investors: Retail clients can be considered as restricted investors who state that they will not invest more than 10% of their net assets. The limitations for the net assets are the same as for high net worth investors.

§3. Regulation of the Intermediary

The intermediaries are also regulated. In the UK's securities market, there is a restriction on financial promotion. This means that any invitation or inducement to engage in an investment activity in the course of business is prohibited.¹⁴⁶ Engaging in the investment means to enter or offer to enter into an agreement that has a controlled activity.¹⁴⁷ Making arrangements to buy, sell, subscribe or underwrite shares is considered a controlled activity.¹⁴⁸ Hence, firms acting as an intermediary in an online offer and sale of securities will be regarded as performing a controlled activity and shall be authorized by the FCA.¹⁴⁹

Section 3. Greece

Greece is one of the latest countries that has adopted a concrete legislation to regulate ECF. This legislation was a solution to the ongoing financial crisis in Greece.¹⁵⁰ The financial issues that had their toll on the banking systems and subsequently on the financing options of Greek entrepreneurs, the Hellenic Capital Markets Committee ("HCMC") and the Bank of Greece came up with ECF as a solution. The Greek Parliament passed the legislation on 1st September 2016, and since then Greek start-ups have the opportunity to enter into capital markets.

¹⁴⁶ Financial Services and Markets Act of 2000 [hereinafter FSMA], Chapter 8, Section 21(1)

¹⁴⁷ FSMA, Chapter 8, Section 21(8)

¹⁴⁸ FSMA (Regulated Activities) Order 2001, Article 25(1)

¹⁴⁹ FSMA, Chapter 8, Section 21(2)

¹⁵⁰ Konstantinos Serdaris, *The Regulation of Crowdfunding under the Greek Securities Laws*, National and Kapodistrian University of Athens, Law School (2016), p. 11
<<https://ssrn.com/abstract=2913443>>

§1. Regulation of the Company

In Greece, there is a limitation on the amount of capital that the company may raise by online offer and sale of securities. In a 12-month-period an issuer can only raise up to €500.000.¹⁵¹

According to Greek regulations, the issuance of prospectus is not mandatory, if one of the following occurs:

1. If the offer is addressed only to qualified investors;
2. If the addressee of the offer are fewer than 150 natural or legal persons;
3. If the investors acquire securities for a total of at least € 100,000 for each separate offer;
4. If it is an offer of securities whose denomination per unit amounts to at least €100,000;
5. An offer of securities less than €100.000 over a period of 12 months.¹⁵² This amount can be raised up to € 5,000,000 at the discretion of national regulators.¹⁵³

The Greek legislator has taken a step further and provides that in the case of securities included in an offer where the total consideration for the offer in the Union is less than €5,000,000 instead of prospectus one can issue an information sheet.¹⁵⁴

The principal information in the information sheet can be grouped as the following:

1. Information on the issuer;
2. Information on the investment; and
3. Information about the possible connection between the crowdfunding platform and the issuer.¹⁵⁵

§2. Limits on the Investors

Investors are also subject to certain limitation. Particularly, the investor is allowed to invest up to 5,000 in a single issuer, and the aggregate amount of investment across all issuers shall not exceed 10% of the average income.¹⁵⁶ In addition, the amount invested on the same platform shall not be more than 30,000.¹⁵⁷

¹⁵¹ The Greek Law 4099/2012

¹⁵² The Greek Prospectus Act, Article 3, Paragraph 2

¹⁵³ Directive 2003/71/EC, Article 1(a)(i)

¹⁵⁴ The Greek Prospectus Act, Article 1, Paragraph 5

¹⁵⁵ Greek Markets in Financial Instruments Act, Article 25, Paragraph 11

¹⁵⁶ The Greek Prospectus Act, Article 1, Paragraph 6(c)

¹⁵⁷ The Greek Prospectus Act, Article 1, Paragraph 6(c)

§3. Regulation of the Intermediary

Intermediaries in Greece should be accredited by the HCMC or the Bank of Greece. This includes investment firms, AIFMs and credit institutions. Moreover, they shall notify the HCMC or the Bank of Greece about their intention to operate electronic platforms to offer securities to the public.¹⁵⁸

Section 4. Problematic Provisions

As shown above, the countries have different approaches when dealing with online offer and sale of securities, and three parties are in the center of attention of these regulators: 1) crowdfunded companies, 2) crowdfunding investors, and 3) intermediaries. However, the regulations that should balance the interests of both companies and investors fail to consider the realities of the market and consequently place too much of a burden on companies.

The first problematic provision is the limitation on the amount of money that a company is allowed to raise during a crowdfunding campaign. Even though this restriction is imposed on the firms to follow the investor protection goals, it seems that the regulators have overlooked two issues. Firstly, as mentioned in Chapter 1, the legislation should differentiate the needs of a small but established company and a start-up.¹⁵⁹ While seasoned companies need money to secure a continued growth, start-ups need considerable cash infusions to grow rapidly.¹⁶⁰ Secondly, due to the complexity of the provisions and associated costs, many issuers will just forgo the crowdfunding exemption finding other sources of financing more advantageous.¹⁶¹ Hence, the limit of \$1 million or €500.000 is simply not enough.

The second matter of concern is setting limitations on the amount of money that each investor can raise. Professor Hazen argues that this sort of constraints are not going to deter the scammers from deceiving the investors.¹⁶² However, one should not ignore the goal and rationale behind this regulation. Setting investor limitations does not intend to lessen the incentives of scammers. The fraudsters will attempt to deceive investors regardless of the amounts of money involved. Instead, this sort of restriction intends to limit the exposure of investors to potential losses. Notwithstanding, Professor Hazen states that fraud even in small amounts can

¹⁵⁸ Serdaris, *supra* note 150, at 14-15.

¹⁵⁹ Knight, *supra* note 114, at 3.

¹⁶⁰ *ibid.*, 17-18.

¹⁶¹ *ibid.*

¹⁶² Hazen, *supra* note 22, at 1765.

be damaging and some investors may not be able to bear even the smallest loss.¹⁶³ This argument has some validity, but this thinking can lead to a disastrous situation where either the market will be overregulated, and financing through other methods will be more beneficial, or the regulators will prohibit the public from participating and limit the financing options of start-ups even further.

Another factor contributing to the above-mentioned problem is that these restrictions are the same for all investors and there is no differentiation between a retail investor and a professional investor. This separation has been only introduced in the UK where only the restricted investors are limited to invest up to 10% of their net assets. The SEC justifies its approach based on two arguments. Firstly, the intention of the JOBS Act is to create equal opportunities for all investors regardless of their status.¹⁶⁴ Besides, if an issuer wants to offer more to accredited investors can rely on other exemptions of the Securities Act where the accredited investors are not under such limitations.¹⁶⁵ In the case of USA, these arguments might be well-founded. However, the approach of Greece with regard to this problem is questionable.

The final issue that raises concern is that the current regulatory frameworks instead of filling the gap of financing place the crowds in competition with the angel investors.¹⁶⁶ In other words, the regulations create a type of investor that occupies the same place as an angel investor does in a start-up financing cycle even though these two investors have different characteristics.¹⁶⁷ The regulations should be structured in a way that will place the crowdfunders in a phase that will fill the gap as suggested by Bridgefunding.

¹⁶³ *ibid.*, 1765-1766.

¹⁶⁴ The Securities and Exchange Commission (SEC), Rules Governing the Offer and Sale of Securities Through Crowdfunding Under Section 4(A)(6) of the Securities Act (2014), [hereinafter SEC, Final Rules] at 28 <<https://www.sec.gov/rules/final/2015/33-9974.pdf>>

¹⁶⁵ *ibid.*

¹⁶⁶ Oranburg, *supra* note 23, at 422.

¹⁶⁷ *ibid.*

Chapter 3. Implementing Equity-Based Crowdfunding in Armenia: Regulatory Issues

The securities market in Armenia is regulated through a series of laws of which the most prominent one is the RA Law on Securities Market. However, the laws are not the sole regulators, and the Central Bank of Armenia (“CBA”) has the authority to govern the market through its regulations. Despite the fact that almost ten years have passed since the adoption of Law on Securities Market, it seems that legislators have forgotten about the importance of capital markets and the new trends such as ECF that encourage and assist the entrepreneurs and reduce the costs of the conduct of business through the application of new technologies. The absence of ECF exposes the gaps in Armenian laws and regulations which as a result place an unnecessary burden on the entrepreneurs and fail to provide appropriate and standard protective structures that should exist in online commerce.

Section 1. Main Problem of Law on Securities Market

The offer and sale of securities in Armenia are conducted through the only stock exchange of Armenia; The exchange is operated by “NASDAQ OMX Armenia” OJSC and is solely available for open joint stock companies. The enterprises that intend to issue shares and offer them to the public shall spend extensive amounts of resources, money, and staff in order to raise funds through capital markets. The main issue that contributes to these complications is not the existence of provisions but rather the absence of them.

The conducted research on the legislation of other countries demonstrates the true nature and purpose of ECF. The intention of this new form of investment is not solely to allow the participation of unsophisticated investors in the capital markets, but its other goal is to deregulate the market to the extent that will incentivize the companies to offer shares and boost the economy. This objective is shared by other exemptions such as Regulation A or Regulation D of the USA that have lowered the cost of capital for small companies in the same manner as ECF promises to do. These exceptions have two characteristics in common.

First, there are separate regulations for different levels of offering. In other words, based on the amount of money that the corporation intends to raise the mandatory rules which should govern the activities of such companies are different. The Law on Securities Market does not contain any such provisions, and this unified approach can discourage companies from

participating in public trading of shares. A corporation that intends to raise a relatively small amount of capital will find other sources more favorable as going through the hassle of regulations does not worth nor the time nor the resources. If the company is a start-up, then the situation will be even more worrisome as the chances are higher that the start-up either will search other sources of money or will fail and default. Thus, the barriers to entry such as extensive disclosure of information should be reduced, and the regulations should gradually get stricter with the number of shares that the company issues.

The second element of these exemptions is the absence of differentiation of regulations based on the audience of the issuer. This means that regulations on companies will be different depending on whether the offer is made to a professional investor or an unsophisticated one. Armenian regulations do not allow the direct participation of unsophisticated investors, and this limits the financing opportunities of companies even further. As mentioned before, there is a gap in start-up financing; A gap that is responsible for the failure of businesses and could be filled through crowdfunders. If this provision is established in Armenia, then the chances of success are high. The reason is that Armenia has a large diaspora and the establishment mechanisms such as ECF would allow Armenians living abroad to invest in projects and support Armenian start-ups. This might also be a solution to the problem of corruption because instead of dealing with government agencies, the investors will be directly in touch with the owners of small companies and will have a better understanding of their needs. However, the regulations imposed on businesses shall be balanced and also consider the interests of issuers. The understanding of this balance is of utmost importance as there is always the risk of overregulation. These risks are significant in ECF where the participation of unsophisticated investors might force the regulators to provide for extreme protective measures that will unnecessarily impede the involvement of the public and the companies.

To sum up, it can be said that RA Law on Securities Market lacks one important principle which is well-established in other countries and that is the absence of differentiated approach of regulations towards the participants of capital markets. This gap in the regulatory framework of Armenia leads to a situation where companies are not interested in doing creative projects because the regulations are standing in front of their development. Of course, it does not mean that the market should be completely deregulated, but the introduction of carefully drafted legislation that will consider the interests of companies is of fundamental importance.

Section 2. Problems of Investor Protection

§1. Disclosure of Information

The disclosure of information has been in the center of attention of legislators and legal scholars for a long time and it appears that the Law on Securities Market also deems the disclosure of information as an important investor protection measure and the requirements for publication of a prospectus are regulated through the regulations of the CBA.

However, if ECF or other sorts of exemptions are to be introduced, then the Law on Securities Market should review the provisions of disclosure of information. Even though the ultimate goal of securities market regulation is investor protection, but it seems that regulators have forgotten that the intention is not to eliminate the possibility of investor losses, but to allow investors to make informed decisions.¹⁶⁸ Particularly in the case of ECF, it is less likely that an investor wishing to invest \$50 is not going to read 100 pages of information, and the issuers that need to raise a small amount of money to expand their business are not going to go through the hassle of publishing a prospectus.

It does not mean, however, that disclosure of information should be abandoned entirely. It is the major instrument that fights the asymmetry of information and creates a market where the investors will not face an adverse selection. Nonetheless, establishment of uniform disclosure regime in exempt offerings does not effectively address neither the goals of investor protection nor the promotion of business. Hence, as regulations should be based on the issued shares and sophistication of investors, they should also differentiate disclosure of information based on the mentioned elements of exempt offerings. Moreover, mandatory disclosure of information only puts extra-burden on the companies. However, if the regulations create online platforms where investors would be able to share the information about the participants of market, then the transfer of information would be faster and cheaper.

§2. Contractual Protections

As already mentioned, one of the suggested protection mechanisms is guarding the investors through contracts which in nature are similar to those signed by angel investors and VCs. Since the ECF is done through regulated online platforms, the contracts are also online.

¹⁶⁸ Louis Gullifer and Jennifer Payne, *Corporate Finance Law, Principles and Policy*, Hart Publishing (2015)[E-Book] 10.4.1. Objectives of Regulation

However, the protection of investors through online contracts will be challenging under Armenian regulations.

The first issue that will arise is the absence of proper regulations of online commerce. According to Article 470 of Civil Code, the purchase and sale of securities are done through a purchase and sales contract unless the legislation prescribes otherwise. In a standard purchase and sales contract, the seller has the obligation of transfer of goods to the buyer in return for which the latter shall pay a certain amount of price for the received products.¹⁶⁹ However, the legislation does not include any provision with respect to online purchase and sales contracts where there is also a third party, an intermediary creating the suitable environment for the conduct of such transactions. Even though some argue that online transactions can be regulated through the mentioned provisions of the civil code, these relations are unique and shall be regulated accordingly.¹⁷⁰ Specifically, the Civil Code does not include provisions regulating the meaning of online commerce, the participating subjects, the rights and obligations of the latter, and the format and conditions of online contracts.¹⁷¹

These gaps need to be addressed as soon as possible as this will be a serious problem for online trading of shares. The contracts are the largest arsenal of investors which allow them to gain certain leverage against the companies. In the absence of proper regulations, there can be a situation where the issuer will sign a contract with the investor but might later argue that the contract was not a securities purchase agreement and as a consequence, the investor will bear the losses.

The second issue related to online contracts is the problem of online signatures. Online contracts usually have four levels of protection. The first level which is probably the simplest form and many people encounter with it is when the terms of the offer are accepted as soon as the party to whom the offer is made click on an “I Agree” button.¹⁷² The second instance which is also popular gives protection through passwords or credit card number that help to identify the other party.¹⁷³ The third and probably the hardest to implement is the protection through biometrics such as face recognition,¹⁷⁴ and finally, the digital signature that is done through the codification of the contract.¹⁷⁵

¹⁶⁹ RA Civil Code, Article 470

¹⁷⁰ Vardan Khachatryan, *The Legal Regulation of E-Commerce in the Republic of Armenia*, Collection of Scientific Articles of YSU SSS (2015), p. 177

¹⁷¹ *ibid.*

¹⁷² Stephen E. Blythe, *Armenia's Electronic Document and Electronic Signature Law: Promotion of Growth in E-Commerce via Greater Cyber-Security*, p. 4

<<http://law.aua.am/files/2012/03/esignaturelaw.pdf>>

¹⁷³ *ibid.*

¹⁷⁴ *ibid.*, 4-5

¹⁷⁵ *ibid.*, 5.

Nonetheless, according to Article 1 of the Law on Electronic documents the sole form of signature that is recognized and regulated in the Republic of Armenia is the digital signature. This issue also needs consideration. There can be a situation where the contract will be signed through other measures that the digital signature and the investor will be unable to enforce a contract that contains a signature not regulated through Armenian regulations.¹⁷⁶

Section 3. Suggested Amendments

Considering the above mentioned, the following amendments are suggested:

1. The RA Law on Securities Markets needs to be amended and include exemptions such as ECF. The implementation of such instrument might be difficult, and a considerable research needs to be conducted to determine the risks and appropriate regulatory mechanisms. However, other forms of exemption that do not include online platforms can be introduced. In this case, the provisions governing such exempt offerings should be based on the amount of money that the company intends to raise and to whom the offering is addressed.

2. If the ECF is to be regulated, its foundation based on the following principles:

a. Limitations on the amount of money each issuer is allowed to raise should be introduced. The limitations will be placed on the company for a given period such as one year. In addition, it is essential that this restriction not to be arbitrary and be based on well-established factors. For instance, the amount of money that contributes to the gap in private equity market can be a good indicator in deciding such limitations.

b. Limitations on the amount of money each investor is allowed to raise should be introduced. The limitations can be calculated for a period such as one year. Moreover, these restrictions should take into consideration the status of investors and their investment knowledge and capabilities.

c. Independent intermediaries should be established. These intermediaries will play a major role in the online offer and sale of securities, and significant investor protective measures will be placed on them. These measures include but are not limited to educating the public about the risks of investment, conduct of testings to understand the level of knowledge and understanding of investors, creation of online forums for communication of investors and issuers, monitoring the transactions conducted on their platform, allowing the trade of shares that are bought from the issuers represented on their platform, etc.

¹⁷⁶ Khachatryan, *supra* note 170, at 178.

3. Online contracts should be drafted either by the intermediaries or the regulators. These contracts should include protective measures similar to contracts containing protective clauses provided for angel investors and VCs. For purposes of implementation of this form of contract, RA Civil Code needs to be revised and amended. In addition, the other concepts of online signatures should also be regulated.

Conclusion

The technological advancements and the historical concept of crowdfunding have found a solution to the problem of financing that start-ups and small and medium enterprises face during the course of the business. This new form of investment that introduces the public as a new participant in the market is a form of investment that connects investors and issuers through online platforms and tries to fill the gap in the private equity market left by traditional methods of financing. The ECF not only allows the start-ups and small and medium enterprises to have access to alternative sources of finance, but it also gives the opportunity to unsophisticated investors to invest in various projects and businesses. The risks and dangers which are inherent to start-ups did not make the regulators to ignore this new yet intriguing investment mechanism and instead they made their best effort to create legislative and regulatory structures that would balance the interests of the issuers and the investors. These regulations intend to lessen the burden of companies that wish to issue stock, but they are not doing this by sacrificing investor protection. On the contrary, they introduced measures for the intention of protecting the investors. Notwithstanding the arguments that these regulations maintain the balance between these two participants, certain provisions do not effectively address the issues that are in the center of attention of legal scholars. On the other hand, this is a relatively new form of investment vehicle, and it will take time for regulators to come up with better solutions.

Armenian regulatory framework also regulates the securities market, but it is distinguished from other legislations. The difference lies in the absence of exemptions such as ECF. The lack of such methods of financing shows a deeper problem in the legislation of capital markets. Firstly, the laws and regulatory framework of Armenia do not aid with the promotion of business and entrepreneurship as they provide restrictive measures and do not allow unsophisticated investors or small companies to participate in the public trading of shares. On the other hand, investors are also not protected adequately as not only the extensive disclosure of information is not enough but also contractual protections are not sufficient.

It can be concluded that the Armenian regulatory framework does not adequately address the balance between the company's interest and the investor's protection. The creation of mechanisms such as ECF would allow the regulators to review their approach on how they govern the securities market and adjust the regulations and consider the application of technological and legal innovations.

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