

# *Equity-Based Crowdfunding in China: Beginning with the First Crowdfunding Financing Case*

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## **Abstract**

Although the legality of equity-based crowdfunding was determined from a judicial point of view in the “first crowdfunding financing case” in 2015, there is no formal law, regulation, or rule released to regulate the crowdfunding financing. From a micro-perspective, determining the nature and workings of equity-based crowdfunding are two preconditions for determining the legal framework for and supervision of equity-based crowdfunding. The “Open, Public, Small-sum” characteristics defined the nature of public offering to the equity-based crowdfunding; therefore, it should be distinguished from private equity financing as a different category of online equity financing. Based on the original purpose of “financing facility” and the nature of “grassroots finance,” fundraisers shall enjoy exemptions on small sums, and the threshold of investors shall also be appropriately restricted, while the intermediary platform shall be the regulatory focus. From a macro point of view, the supervision of equity-based crowdfunding should seek a balance between “financial innovation” and “risk control.” Equity-based crowdfunding should not simply be considered a financing method. Rather, its positive effects on mass entrepreneurship and innovation should be emphasized so as to make it a particularly important “booster” to promote economic and social development.

**Keywords:** equity-based crowdfunding, private equity, financial innovation, social development

## 1. INTRODUCTION

### *1.1 The Global Scope of the Origins of Crowdfunding*

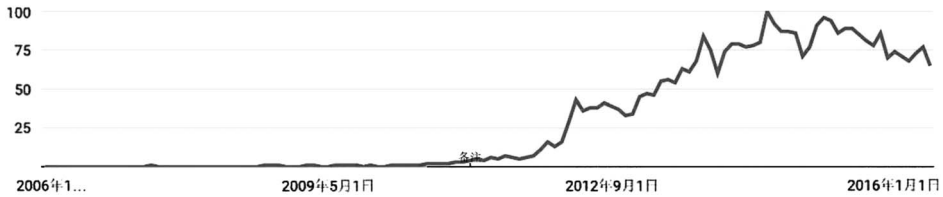
Dating to 1885, the Statue of Liberty could be considered the first crowdfunding financing case.<sup>1</sup> The German association “Anglizismus des Jahres” formally proposed the term “crowdfunding”—adopting it from English to German language in 2010—and in 2012

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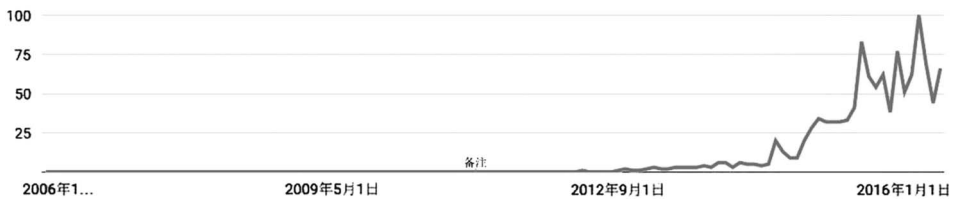
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1. After France shipped the statue to America in June 1885, it sat unassembled in a warehouse for a year because the American Committee of the Statue of Liberty ran out of money for the project. Pulitzer, the Hungarian-born publisher of the *New York World* newspaper, used the power of the press to urge New Yorkers to help fund the project. And he did some pay back for the donation. See Freedman & Nutting (2015).



**Figure 1.** Google trends search “crowdfunding” in the US  
Source: Google (2016)



**Figure 2.** Google trends search “crowdfunding” in China  
Source: Google (2016)

elected “*crowdfunding*” as the Anglicism of the year.<sup>2</sup> Before that, “crowdfunding” was regarded as the upgrade of “crowdsourcing.”<sup>3</sup>

“Google search trends” shows an increased interest in this term: in the US, weekly searches for “crowdfunding” began in 2008, showing an explosion of queries since 2009, while in China such queries began in 2012 and exploded in 2014 (see Figures 1 and 2).

Another indicator of increased awareness regarding crowdfunding is evident in market performance. According to the Crowdfunding Industry Statistics, the total global crowdfunding industry fundraising volume in 2015 was over USD34 billion, which is two times larger than the volume in 2014 and tenfold that of 2012. The Asia market has had the fastest growth rate, which was up to 210% in 2015 (Figure 3).<sup>4</sup>

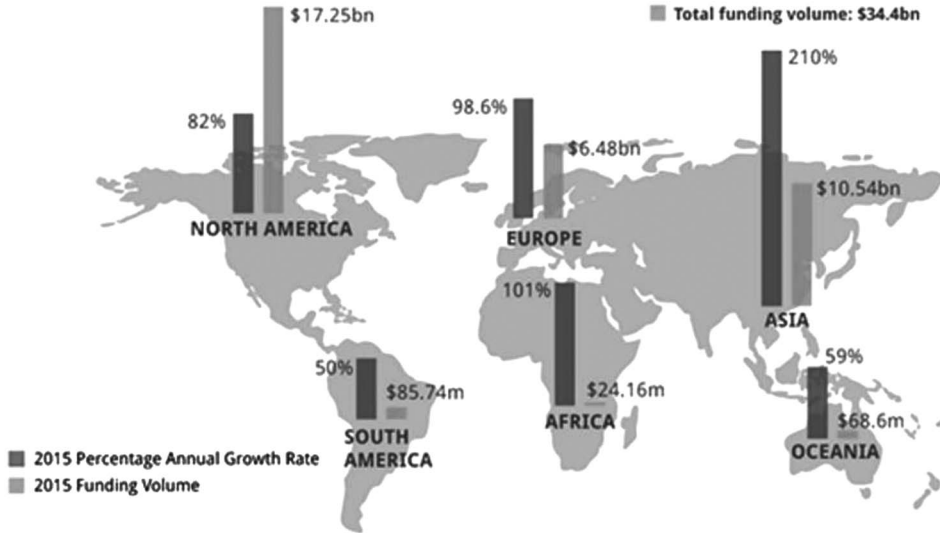
Before discussing the legal framework for and regulation of crowdfunding, however, further defining this term is necessary. Griffin defines crowdfunding as an evolving alternative financing method, putting an updated twist on a relatively old practice of raising money.<sup>5</sup> In the broadest sense, crowdfunding consists of accumulating money from a group of people, typically comprising very small individual contribution, to support another’s effort to achieve a specific goal. However, as the extension of this term is still far from clear, especially in China (the evolution progress of the equity-based crowdfunding’s concept is discussed later in this paper), it requires and deserves far more academic attention than it has received to date.

2. Stefanowitsch (2013).

3. Danmayr (2014).

4. Massolution (2015).

5. Griff (2013).



**Figure 3.** Global crowdfunding industry statistics

## 1.2 Types of Crowdfunding

There are different ways of categorizing types of crowdfunding in the relevant literature.<sup>6</sup> The following introduces three typical classifications:

1. Based on the findings of Lambert and Schwienbacher,<sup>7</sup> Larralde and Schwienbacher classify different crowdfunding approaches in terms of the types of rewards offered to the participating crowd members.<sup>8</sup> These give rise to the following distinct business models:
  - Donations: according to Lambert and Schwienbacher, 22% of a sample of crowdfunding initiatives rely on donations. Profit maximization often goes hand in hand with standardized, lower-quality products, whereas non-for-profit organizations are more inclined to produce high-quality products. This non-for-profit pattern meets the objectives of donors, thus potentially explaining the success of donation-based crowdfunding in the absence of rewards in physical or financial terms.
  - Passive investments: the highest stake of initiatives offer some form of rewards to attract investors. This does not automatically include opportunities for investors to become actively involved. Entrepreneurs choosing this type of crowdfunding focus solely on raising capital but not on using other potential sources of support from the crowd.
  - Active investments: offering the potential to become active in the projects and giving away rewards is seen as the active-investment business model. The entrepreneur benefits from not only collected money, but also feedback regarding the product or service.

6. *Ibid.*

7. Lambert & Schwienbacher (2010).

8. Larralde & Schwienbacher (2012).

2. To highlight important differences between types of crowdfunding, Hemer<sup>9</sup> suggests the use of delimiting terminology, in particular:
- Crowd donations: an altruistic act without an obligation of the recipient giving his backer almost anything in return.
  - Crowd sponsoring: initiator and sponsor agree on a defined reward, which the initiator is obliged to deliver.
  - Crowd pre-selling: this form of crowdfunding initially helps to produce something, and the promised return is the delivery of an early version or prototype of the outcome.
  - Crowd lending: this type is defined by the interest paid and the lending period. An alternative could be long-term lending based on a revenue-sharing principle. The creditor pledges a risk-bearing loan. Instead of frequent interest payments, he gets a predefined amount, including an agreed-upon share of the venture's earnings.
  - Crowd investing: this type comes with the highest burdens in administrative terms. Crowd funders invest equity, and the rewards they receive are shares, dividends, and/or voting rights.<sup>10</sup>
3. Massolution outlines a further taxonomy determined by the proposed exchange between creators and investors.<sup>11</sup> Similar to Hemer's contribution discussed above, the report states four established and one emerging model:
- Donations: investors donate money without expecting to receive tangible benefits.
  - Rewards: investors support campaigns in order to receive some kind of rewards.
  - Equity: investors receive equity shares in return for their investments.
  - Lending: investors lend money and expect future repayment. Interest payment is not mandatory in any setting.
  - (Royalty: investors support creators in order to get a share of revenue in return for their investments.)

Chinese scholars generally adopt Massolution's taxonomy, and the following discussion in this paper is based on such a classification.

### *1.3 Features and Motivations of Crowdfunding*

The extant literature consists mainly of describing different types of crowdfunding, highlighting its relevance by demonstrating the rise of the crowdfunding industry, and identifying involved parties and their properties.

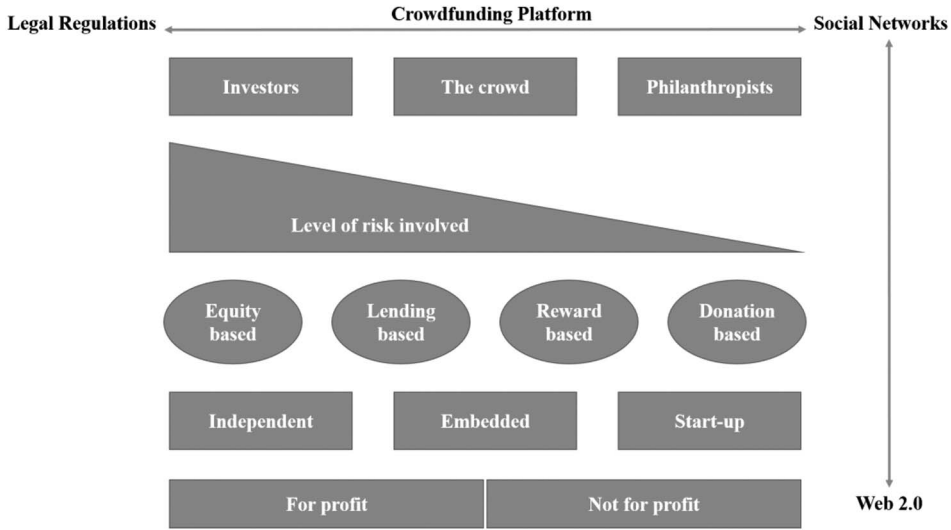
Up until now, however, the underlying web-based platforms that bring together participants by means of the Internet have not been addressed in a comprehensive fashion.

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9. Hemer (2011).

10. Kauffman Foundation (2013).

11. Massolution, *supra* note 4.



**Figure 4.** Main features of the crowdfunding phenomenon

To achieve a full and accurate picture of crowdfunding, examining the role of these platforms, as both amplifiers and mediators, as well as of large amounts of regulations and specific rules, is crucial.<sup>12</sup>

Based on the knowledge and opinions of other scholars,<sup>13</sup> Figure 4 shows the main features of crowdfunding in the context of Internet-driven developments.

As one of the only empirical analyses of crowdfunding, Lambert and Schwienbacher explain several factors motivating entrepreneurs to engage in crowdfunding initiatives.<sup>14</sup> As could be expected, raising money is a strong motivation for all participating entrepreneurs. Public attention (85%) and feedback for product/service (60%) were also relevant among respondents.

Not only possible future financial gains, but also sharing values and perceiving emotional rewards drive the success of crowdfunding. If the goal of profit maximization is now rare, then other factors have to be discovered,<sup>15</sup> such as: raising funds, establishing relationships, and receiving validation for creators; seeking rewards, supporting causes, and engaging in a trusting and creative community for funders.<sup>16</sup>

When considering influential factors concerning crowdfunding, the contributions of Ward and Ramachandran on peer effects should be taken into account.<sup>17</sup> They found that, due to information overload, limited individual information, and costly information acquisition, peer effects drive participants. As the funding decisions of others are more influenced by aggregating features, they represent a new kind of social information, thus playing an important role in the ultimate success of a crowdfunding project.<sup>18</sup>

12. Lehner (2013).

13. Steinberg et al. (2012).

14. Lambert & Schwienbacher, *supra* note 7.

15. De Buysere et al. (2012).

16. *Ibid.*

17. Ward & Ramachandran (2010).

18. Kuppaswamy & Bayus (2013).

The above considerations come mainly from scholars in Western countries. But what occurs in one of the biggest potential crowdfunding market, China, and how does China handle crowdfunding as a novel phenomenon in its capital market and Internet Finance area? The following attempts to answer these two questions. Specifically, since there are different classifications of crowdfunding, this thesis may focus on the equity-based crowdfunding, and the detailed reasons may be comprised in the following parts.

## 2. EQUITY-BASED CROWDFUNDING IN CHINA

### 2.1 *The Rise of Equity-Based Crowdfunding in China*

As mentioned above, crowdfunding is a way of raising funds, namely financing or refinancing, by individuals, organizations, or enterprises, including start-ups, through intermediary platforms for their specific activities.<sup>19</sup> Crowdfunding generally consists of:

... taking the Internet technology as the base, and using the public and the community's cognition to judge the extent of the market attention to an entrepreneurship project or a business plan, so as to provide financial support for the project at the starting stage.<sup>20</sup>

Based on the operating mode and return approach, Chinese scholars divide crowdfunding into the following categories: donation crowdfunding, reward crowdfunding, loan crowdfunding (i.e. P2P), and equity-based crowdfunding.<sup>21</sup> From the perspective of a legal relationship, donation crowdfunding, pre-sale crowdfunding, and loan crowdfunding are financing models based on a contractual relationship, where investors and financing enterprises (creators) establish their rights and obligations based on investment contracts. Equity-based crowdfunding is another financing model, based on an equity relationship (including equity trading, share issuance), so the rights and obligations of investors and financing enterprises should be governed by the investment contracts and relevant securities law and regulations, which reflects the particularity of asset securitization.<sup>22</sup> Based on its specificity, authors will focus on discussing the equity-based crowdfunding.

Considering that crowdfunding was formally included in the 13th Five-Year Plan,<sup>23</sup> crowdfunding is no longer a novelty. According to incomplete statistics, by the end of March 2016, there have been a total of 328 crowdfunding platforms of all types across the country, including 131 non-public equity financing platforms, 112 reward crowdfunding platforms, 73 integrated crowdfunding platforms, and 12 other charitable crowdfunding platforms.<sup>24</sup>

The World Bank expects that, by 2025, the global crowdfunding market size will reach USD300 billion, including over USD50 billion in China.<sup>25</sup> China offers a promising prospect

19. Fca.org (2014).

20. Worldbank.org (2013).

21. Fan (2015).

22. Yang & Liu (2015).

23. On 16 March, 2015, the fourth meeting of the 12th National People's Congress voted to pass the Program of the *13th Five-Year Plan for National Economic and Social Development (Draft)*. This Program proposed further promoting and incorporating mass entrepreneurship and innovation into all aspects and fields of development, encouraging various entities to develop new technologies, products, forms of business operations, and models, and to build new development engines. The Program also presented the construction of public service platforms for entrepreneurship and innovation, and the comprehensive promotion of mass innovation, crowdsourcing, crowd support, and crowdfunding.

24. Sohu.com (2016).

25. Roche (2014).

for the crowdfunding industry. Additionally, major Internet giants also regard equity-based crowdfunding as a strategic core of “Internet finance.” Chinese firms Jingdong, Qihoo360, and Suning have established equity-based crowdfunding platforms a little later than Ali’s Yu’eobao and Ant Financials’ “Antsdaq.”<sup>26</sup>

Compared to other relatively mature markets, crowdfunding in China is still in its infancy. In the US, for example, 5,600 projects raised USD215 million from 2.8 million investors in the first half of 2014. In China, 1,400 projects raised USD30 million from 0.11 million investors in the same period. According to the 35th report of the CNNIC (China Internet Network Information Centre), by December 2014, China’s Internet users had reached 649 million and Internet penetration rate was 47.9% of the population.<sup>27</sup> Mobile Internet usage was up to 85.8% of all Internet users, and 91.2% of Internet users used some form of instant messaging.<sup>28</sup> In addition, China’s total reported national savings was more than USD4.59 trillion by the end of 2013, up to 51% of national GDP.<sup>29</sup> Although there is a huge amount of private capital in China, it currently lacks formal investment channels—and if crowdfunding is officially supported and regulated, it could become a popular form of alternative investment for Chinese investors.<sup>30</sup> All of the above indicates that equity-based crowdfunding will become a new field of Internet finance in China.

## 2.2 *The Decentralized Regulatory System of Banking and the Financial Industry in China*

In September 1983, the State Council decided that the People’s Bank of China (hereinafter “PBC”) should exercise the functions of the Central Bank. In 1992, it set up the China Securities Regulatory Commission (hereinafter “CSRC”). In October 1998, the China Insurance Regulatory Commission (hereinafter “CIRC”) was established. Then, in April 2003, the China Banking Regulatory Commission (hereinafter “CBRC”) was established. These four functional departments comprise the decentralized regulatory system of banking and the financial industry in China, which is characterized by institutional supervision and focus on compliance supervision. Specifically:

- “PBC” carries out central banking operations, is mainly responsible for the formulation and implementation of monetary policy, maintaining financial stability, and providing financial services, which include financial risk prevention and resolution, statistical data, bank cards, financial regulations, anti-counterfeit currency work, bulletin boards, and so on.<sup>31</sup>
- “CSRC” is a department directly under the State Council, which is the supervisory department of the national securities and futures market. According to the authorization of the State Council, it performs the functions of administration and management, and carries out centralized and unified supervision over the securities and futures industry in accordance with laws and regulations, so as to protect their legitimate operations.<sup>32</sup>

26. China.org.cn (2015).

27. CNNIC (2015).

28. *Ibid.*

29. IMF (2014).

30. Liang (2015).

31. PBC.gov.cn (2016).

32. CSRC.gov.cn (2016).

- “CIRC” performs its administrative functions in accordance with the authorization of the State Council. It supervises and administers the national insurance market in accordance with laws and regulations, so as to safeguard the legal and stable operation of the insurance industry.<sup>33</sup>
- “CBRC” works as the banking supervision institution of the State Council. It uniformly supervises the management of banks, financial assets management companies, trust and investment companies, and other depository financial institutions in accordance with the authorization of the State Council. It also promulgates rules and regulations to administrate banking and financial institutions and their business activities in accordance with laws and administrative regulations.<sup>34</sup>

These four departments are collectively referred to as “One Bank and Three Commissions,” meaning supervision organizations with different functions for banking and the financial industry in China. The essence of PBC, as the Central Bank, is macro-prudential regulation. The main task of each financial regulatory authority, including CBRC, CSRC, and CIRC, is to maintain the stable operations and compliance of specific financial institutions, the essence of which falls within the scope of micro-prudential regulation.

Initially, the “One Bank and Three Commissions” arrangement worked well for supervisory purposes. With financial innovations, however, the market frequently gives rise to situations unsuited to this arrangement. Crowdfunding is an example of this. Based on the current regulatory system, CBRC would generally supervise P2P (lending-based crowdfunding), while CSRC would administer equity-based crowdfunding. If a funding portal (also called an intermediary platform) were to operate in terms of both of these crowdfunding styles, however, then which regulatory body would be responsible and hold ultimate power? Issues such as these, as well as those concerning consumer financial protection, remain to be solved. Hence, in the last part, we will discuss notions regarding a unified supervisory framework.

### 2.3 Review of the “First Crowdfunding Financing Case in China”

Although regulatory authorities, as well related laws, regulations, and policies, have not yet reached consensus regarding how to deal with crowdfunding in China, especially lending-based and equity-based crowdfunding, the judiciary has taken the first step in weighing in on its legitimacy.

A final judgment on the “first crowdfunding financing case in China” was made on 22 December 2015,<sup>35</sup> marking an official change concerning crowdfunding, from the “backstage to the stage”—the Court confirmed the validity of a crowdfunding financing agreement. In the case, the “intermediary platform” Fit Network Technology Co., Ltd. (hereinafter “FNT”) sued the “financing party” Beijing Nuomiduo Restaurant Management Co., Ltd. (hereinafter “NRM”), asking NRM to assume liability for terminating the contract due to NRM’s providing false information. Later, NRM appealed and filed a countersuit. The controversy between the two parties focused on the following: (1) the nature of the financing

33. Circ.gov.cn (2016).

34. Cbr.gov.cn (2016).

35. The “First Crowdfunding Financing Case in China” refers to the case of the intermediary contract dispute between Beijing Fit Network Technology Co., Ltd. and Beijing Nuomiduo Restaurant Management Co., Ltd.



agreement; (2) the determination of liability for the breach of contract. After hearing and ruling on the case, the Court offered explanations regarding the “legitimacy of the financing agreement,” “nature of the financing agreement,” and “determination of the liability for breach of the contract.”

First, with regard to the “legitimacy of the financing agreement,” a contract is generally held to be valid unless it is in breach of Article 52 and Article 54 of the Contract Law of the People’s Republic of China (hereinafter “Contract Law”).<sup>36</sup> All the investors in this case were members verified by “Renrentou” (the FNT’s crowdfunding platform), and the number of investors did not exceed the upper limit of 200 people. The Court determined that the crowdfunding-related transactions were not “public offering in securities” so that it did not violate the provisions of Article 10 in the Securities Law of the People’s Republic of China (hereinafter “Securities Law”),<sup>37</sup> and the crowdfunding transaction behaviour involved in the case neither prohibited nor gave negative evaluation to the existing administrative regulations, departmental rules, or other regulatory normative documents. Therefore, the “financing agreement in this case” had no legal circumstances as an invalid contract.<sup>38</sup> Also, in the interests of encouraging financial innovations, the Court thus positively evaluated the agreement.

Second, as to the “nature of the financing agreement,” the Court held that, although the two parties signed a contract that was called a “financing agreement,” entrustment financing was only part of the entire transaction between the two parties. FNT provided additional services such as: information auditing, risk control and design of the transaction structure, supervision of the transaction process, and so on. Therefore, the core of this contract was to facilitate transactions. After comparing the definitions of the entrustment contract<sup>39</sup> and the intermediation contract,<sup>40</sup> the Court determined that the main legal relationship between the two parties was an intermediary contractual relationship. Thus, the nature of the financing agreement was considered as an intermediation contract.

Third, concerning the “determination and assumption of the liability for breach of the contract,” the Court’s main point of view was that both parties should bear part of the liabilities for breach of contract. NRM should bear primary liability for providing false housing information, which resulted in the inability to conduct financing transactions. FNT, although it completed raising funds, did not finish the entire financing process, so it should bear secondary liability for its breach of contract.

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36. See Article 52 of the Contract Law: “A contract is invalid under any of the following circumstances”; and Article 54: “Either party has the right to request a people’s court or an arbitration institution to alter or rescind any of the following contracts.”

37. See Article 10 of the Securities Law: “Any one of the following circumstances shall constitute a public issuance: (1) issuing securities to non-specific persons; (2) issuing securities to more than 200 specific persons in the aggregate; and (3) such other issuing activities as may be so prescribed by laws or administrative regulations.”

38. Actually, the judge confirms that it was legal according to the Contract Law, although there are no explicit regulations at that time. See Article 52 (e) of the Contract Law and Article 14 of the *Interpretation of the Supreme People’s Court on Certain Issues Concerning the Application of the Contract Law (II)*: “The ‘mandatory provisions’ specified in Item 5 of Article 52 of the Contract Law refers to mandatory provisions concerning validity of contracts.”

39. See Article 396 of the Contract Law: “An entrustment contract is a contract whereby the principal and the agent agree that the agent shall handle the affairs of the principal.”

40. See Article 424 of the Contract Law: “An intermediation contract is a contract whereby the middleman reports to the trustee the opportunity for making a contract or provides intermediating services for the making of a contract, and the trustee pays remuneration therefor.”

Positively, this judgment confirms the legality of public financing from a civil legal perspective. But the problems are still obvious: (1) the ruling did not answer the question of what crowdfunding consists in (including its nature); (2) the current regulatory system remains unclear; (3) the civil legal structure fails to touch on the essence of crowdfunding, touching on the balance between financial innovation and assessing financial risk accurately and, therefore, fails to insure its beneficial social role.

#### 2.4 *The Legal Dilemma Equity-Based Crowdfunding Is Facing in China*

The development of crowdfunding will undoubtedly help solve the problems small- and medium-sized enterprises face in securing financing,<sup>41</sup> as it brings new opportunities for the Chinese economy and society. However, problems within the crowdfunding industry should still be addressed, especially the “inherent” problem in equity-based crowdfunding: equity-based crowdfunding cannot simply be considered an evolutionary upgrade<sup>42</sup> to existing financing method in China, and it seems difficult to orient crowdfunding within the current legal framework. As an innovative financial product, equity-based crowdfunding needs to strike a balance between “risk control and prevention” and “capital accumulation and activity.” Unfortunately, the existing legal system leaves a gap in the norms of equity-based crowdfunding.

On 18 December 2014, the Securities Association of China (SAC) drafted and issued the Private Equity-based Crowdfunding Management (Tentative) (Draft) (hereinafter “Measures”), preliminarily defining the nature of non-public offering of equity-based crowdfunding, crowdfunding platforms, qualified investors, and other aspects. The Measures failed to clarify the relationship between equity-based crowdfunding and private placement (private equity). It specified stringent requirements for qualified investors, which seemed to undermine the initial impetus for crowdfunding. Therefore, the Measures aroused extensive controversy in Chinese academic circles.<sup>43</sup>

On 18 July 2015, the Central Bank (The People’s Bank of China) and ten other ministries issued the *Guiding Opinions on Promoting the Healthy Development of Internet Finance* (hereinafter “Opinions”).<sup>44</sup> However, the Opinions were just a strategically advantageous framework, policy document, and this document did not directly affect the practical operations of equity-based crowdfunding.

In the “First Crowdfunding Financing Case in China,” the Court decided on the validity of the crowdfunding contract based on an attitude of encouragement and support, in terms of the existing legal framework. However, the judgment merely clarified the contractual

41. Liang (2014).

42. Some scholars argued that the creation of the private equity crowdfunding model improved the traditional private placement models; Liu (2015).

43. The controversy focused on restrictions on the qualifications of investors, in terms of which a high access threshold and limit on the number of investors are contrary to the essential characteristics of the crowd and microfinance nature of equity crowdfunding; Chen (2014).

44. The People’s Bank of China, the Ministry of Industry and Information Technology, the Ministry of Public Security, the Ministry of Finance, the State Administration for Industry and Commerce, the State Council Legislative Affairs Office, the China Banking Regulatory Commission, the China Securities Regulatory Commission, the China Insurance Regulatory Commission, and the State Internet Information Office jointly issued the *Guiding Opinions on Promoting the Healthy Development of Internet Finance* (Yin Fa (2015) No. 221), in order to encourage financial innovation, advance the healthy development of Internet finance, make clear regulatory responsibility, and standardize market order; Gov.cn (2015).

relationship between the intermediary platform and the financing party, and failed to consider more complex relationships between the financing party and investor, define what equity-based crowdfunding is, and answer (or perhaps avoided cleverly) the question of “how the existing legal framework should cover crowdfunding, especially equity-based crowdfunding.”

Based on the particularity of equity-based crowdfunding, if it is arbitrarily incorporated into the current regulatory rules and system, “Crowdfunding Chaos” could ensue, for example, confusion about the concept of equity-based crowdfunding, illegal offerings of shares, and other activities in the name of “equity-based crowdfunding,” and so on. That would not only distort the essence of crowdfunding development, but also run contrary to the spirit of encouraging market innovation. Failure to promptly standardize equity-based crowdfunding regulation is very likely to result in an inability to protect investors, provoking local or even systemic risk.<sup>45</sup>

Therefore, current attention should focus on two points related to equity-based crowdfunding norms: first, the connotations and denotations of this concept (equity-based crowdfunding). It is necessary to clarify the scope of equity-based crowdfunding, especially the relationship between “public equity-based crowdfunding” and “non-public equity financing” (such as private equity), thereby eliminating the “pseudo crowdfunding” of the “factual private equity financing” in the name of “crowdfunding.”<sup>46</sup>

Second, closing the combination of classified regulation and whole-course regulation in China. Classified regulatory measures should be taken for “equity-based crowdfunding” and “private equity financing.” Meanwhile, specific regulatory measures should be established according to the “open, public, small-sum” characteristics of the equity-based crowdfunding. In particular, the relationship between the rights and obligations of the financing party, intermediary platform, and investors should be dealt with properly, in order to achieve a balance between “financial innovation” and “investor protection.”

### 3. EQUITY-BASED CROWDFUNDING AND RELATED CONCEPTS IN CHINA

#### 3.1 *Equity-Based Crowdfunding and Online Equity Financing*

Although novel, the meaning of equity-based crowdfunding is uncontroversial, referring to a financing method that consists of raising funds from the public with equity as investment considerations by using Internet technology. For a long time, however, the public has been confused by equity-based crowdfunding and online equity financing, even those in authority, strong evidence of which are the above-mentioned Measures.

In the Measures issued by SAC at the end of 2014, equity-based crowdfunding was defined as an online non-public (private) equity financing method.<sup>47</sup> The reason for this was that the current Securities Law had not been amended, and the small- and medium-sized and micro enterprises engaged in crowdfunding often did not meet the “current approval

45. Liu (2014).

46. In practice, some private equity financing named as crowdfunding; thus, we call them pseudo crowdfunding; i.e. PE financing is not in the scope of crowdfunding.

47. See Article 2 of the *Private Equity Crowdfunding Financing Management (Tentative)*.

**Table 1.** Changes in the scope of the definition of equity-based crowdfunding

Issuer and document name	Definition and scope of equity-based crowdfunding
Securities Association of China, the Measures	Private equity-based crowdfunding refers to the equity financing activities of fundraisers in a non-public offering manner through online equity-based crowdfunding platforms (hereinafter “Equity-based crowdfunding platforms”)
The People’s Bank of China and ten Ministries, the Opinions China Securities Regulatory Commission, the Circular	Equity-based crowdfunding mainly refers to public small-sum equity financing activities through the Internet Equity-based crowdfunding specifically refers to the activities of publicly raising equity capital by innovators and entrepreneurs, or small and micro enterprises, through Internet platforms of equity-based crowdfunding intermediaries (Internet sites or other similar electronic media). The behaviour of non-public equity financing or raising private equity investment funds through the Internet does not belong to the scope of equity-based crowdfunding as stipulated in the Opinions
Securities Association of China, the Approach	“Private equity-based crowdfunding” was changed to “online non-public equity financing”

conditions for public offering.” Therefore, they “can only adopt the non-public offering method.”<sup>48</sup> Peng has pointed out that the definition in the Measures ran counter to the essentially open nature of crowdfunding.<sup>49</sup>

In July 2015, the Opinions issued by the Central Bank and ten other ministries offered an official definition of equity-based crowdfunding, making its “open, public, small-sum” characteristics clear.<sup>50</sup> In August, the *Circular on Special Inspection of Organizations Carrying out Equity Financing Activities over the Internet* (hereinafter “Circular”) issued by the CSRC echoed the scope of this definition in the Opinions, and explicitly excluded “non-public equity financing, private equity funds” from the scope of equity-based crowdfunding.<sup>51</sup> Three days later, in the Over-the-Counter Securities Business Record Management Approach (hereinafter “Approach”), SAC changed the language describing “private equity-based crowdfunding” to that of “online non-public equity financing.”<sup>52</sup>

As the Table 1 makes clear, both the Circular and the revised Approach provide a new definition of equity-based crowdfunding, referring specifically to public equity-based crowdfunding (online public equity financing). What was previously called “private equity-based crowdfunding” was renamed “online non-public equity financing” (also known as

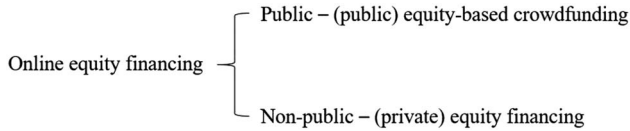
48. See the Sac.cn (2014).

49. Peng (2015a).

50. See Article 9 of the *Guiding Opinions on Promoting the Healthy Development of Internet Finance*: “Equity crowdfunding mainly refers to public equity financing in small amount through the Internet, and must be raised through equity crowd-funding intermediary platforms (Internet websites or other similar electronic media).”

51. See CSRC.gov.cn (2015): “Equity crowd-funding mainly refers to the activities of open equity financing in small amount via the Internet. Specifically, equity crowd-funding means innovative entrepreneurs or small and micro-sized enterprises publicly raise share capital via the Internet platforms of equity crowd-funding intermediaries (Internet websites or another similar electronic media).”

52. See the Sac.cn (2015).



**Figure 5.** Classification structure of online equity financing

private equity financing). This means that the actual behaviour of non-public equity financing, or of raising private equity investment funds via the Internet merely in the name of “equity-based crowdfunding,” falls outside the scope of equity-based crowdfunding.

Changes in the scope of the definition of equity-based crowdfunding indicate a cognitive shift in the mind of regulators, from a “vague concept” to an “attempt to regulate crowdfunding within the existing legal framework,” moving on to a “realization of the equity-based crowdfunding’s particularities and implementation of special regulation.” In terms of the promotion of the development of equity-based crowdfunding, these changes are desirable, since a balance of the interests of the involved parties in the formulation of a specific regulatory system can only be achieved on the basis of a full understanding of the “open, public, small-sum” particularities of equity-based crowdfunding.

We agree with the regulators’ current division system. On the one hand, the regulators acknowledge and encourage the existence of online equity financing as an innovative financing method. On the other hand, based on the crowd characteristics of crowdfunding, the system classifies online equity financing in terms of the categories of “public” and “non-public,” and defines the former as equity-based crowdfunding (or public equity-based crowdfunding) and the latter as private equity financing (or online non-public equity financing), as shown in Figure 5.

### 3.2 *Equity-Based Crowdfunding and Private Equity Financing*

Due to the longstanding absence of legal norms, some “crowdfunding chaos” has occurred in the development of equity-based crowdfunding. In addition to “illegal fundraising,” “illegal split,” and other issues that were clearly suspected of violating the law, many of the current equity financing platforms have carried out online equity financing in the name of “private equity-based crowdfunding.” In order to avoid legal risks, these platforms have often pre-defined qualified investor standards, limited the number of investors, and averted the red line of “non-specific public offering” through real-name authentication, acting as holders on behalf of others, and other methods. However, these practices do not comply with the original intention and inner spirit of equity-based crowdfunding.

To clarify the distinction between equity-based crowdfunding and private equity financing, and do away with “false equity-based crowdfunding,” we need to compare them, as has been done in Table 2.

In traditional areas of the Securities Law, the main distinctions between “public offering” and “private placement” consist of “whether the fundraising object is specific,” “whether the fundraising method is public,” and “investment restrictions.” These same distinctions are used to distinguish between “public offering” (i.e. equity-based crowdfunding) and “private offering” (i.e. private equity financing) in the field of online equity financing.

**Table 2.** Comparison between equity-based crowdfunding and private equity financing

Item category	Investors' requirements	Fundraising method	Amount of single investment	Financing limit
Equity-based crowdfunding	Almost none	Public offering	Max. amount limitations	Max. amount limitations
Private equity financing	Specific, qualified investors	Non-public offering, $\leq 200$ people	None	None

The “openness” of equity-based crowdfunding means it must be a “feast for the crowd.” According to Huang, it is difficult to call a practice equity-based crowdfunding in the absence of an enormous number of Internet users acting as investors.<sup>53</sup> Moreover, its “public” and “small-sum” characteristics also reflect the need for a balance between the popularity of people’s participation and control of group risk in equity-based crowdfunding.

Academia considers equity-based crowdfunding a new financing method typically representative of “grassroots finance,” because of its creative solution to the inclusive financial paradox<sup>54</sup> between “microfinance” and “low-cost financing.”<sup>55</sup> This determines the actual mode—“easy access and strict management”—of equity-based crowdfunding, which means the access threshold for investors should basically be within the range of “participation by ordinary people.” Since the involvement of large numbers of investors necessarily increases risks associated with equity-based crowdfunding (the problem of information asymmetry in the traditional issuance of securities has not really been resolved in equity-based crowdfunding, and there are more investors of a lower professional level), the “small-sum” characteristic of equity-based crowdfunding is a special financing need for start-ups or SMEs, and also an inevitable requirement for the control of group investment risks—specifically evident in limits on the total amount of financing and amount in one transaction.

In contrast, private equity financing operates in terms of “rigid access and slack management.” Since it is oriented towards particular investors and all intermediary platforms screen investors according to their own standards of “qualified investors,” private equity financing has fewer investors who can endure more risks, compared with equity-based crowdfunding. Therefore, private equity financing has relatively few investment restrictions.

The significance of distinguishing between equity-based crowdfunding and private equity financing lies in not only “conceptual discrimination,” but also the realization of differences in possibly applicable financing phases and financing project levels, which demonstrate the necessity for classified regulation.<sup>56</sup> Specifically, equity-based crowdfunding is mainly suited to the primary financing projects of small and medium enterprises or start-ups, while private equity financing does not have such restrictions. One could argue that the main

53. Huang (2015).

54. Zhang & Zhu (2014).

55. Sun & Yang (2014).

56. Peng (2015b).

difference among equity-based crowdfunding, venture capital, and private equity is reflected in their different modes of investment and financing. Private equity has the strength to compete with VC and PE for good financing projects. This also explains why some scholars in China are more optimistic about private equity financing.<sup>57</sup>

## 4. DESIGN OF EQUITY-BASED CROWDFUNDING REGULATION IN CHINA

### 4.1 Ideas Regarding Classified Regulation

As mentioned before, equity-based crowdfunding and private equity financing are two different ways of financing under the category of online equity financing. Therefore, the regulatory measures for these two should be designed according to different situations.<sup>58</sup> With respect to private equity financing, the authors feel further modifying and improving the provisions of “qualified investors” and “Investment limits” are workable, while other key provisions through field research and empirical analysis should on the basis of the existing Measures, in order to better suit China’s actual situation. Thus, private equity financing will be discussed in detail in another paper. The focus here will be on discussions regarding the design of equity-based crowdfunding regulation.

Scholars believe equity-based crowdfunding presents various challenges to the existing securities regulatory system:

- whether either the subject or behaviour should be regarded as the object of regulation;<sup>59</sup>
- how regulation can better protect investors, since equity-based crowdfunding is characterized by high investment risks (higher business uncertainties in SMEs and start-ups) and low professional levels (more serious information asymmetry) and the weak risk-bearing capacities of investors;<sup>60</sup>
- how to achieve a balance between two goals, namely protection of investors’ interests and encouragement of financial innovation.<sup>61</sup>

According to the Securities Law (Revised Draft) of 2015, the regulator intended to include equity-based crowdfunding within the regulatory system of the Securities Law, and to take special regulatory measures for equity-based crowdfunding, such as exemptions on small sums, and so on. The authors believe that the current regulatory system, with the Securities Law as the guiding principle, mainly adopts the mode of “focusing on subject regulation, supplemented by behaviour regulation,”<sup>62</sup> covering the norms of issuers, intermediaries, and listed companies. Therefore, equity-based crowdfunding regulation can also refer to this mode. As to the issues of “investor protection” and “how to achieve a balance between

57. *Ibid.*

58. *Ibid.*

59. Yue (2014).

60. Yang & Liu, *supra* note 22.

61. Xu (2015).

62. For example, as to the authorization to the securities regulation in the Securities Law, there are provisions regarding the formulation of specific rules in accordance with the regulatory object (such as securities companies) and the authorization of the regulatory department to regulate the issuance and underwriting of securities and other acts.



investor protection and financial innovation,” it is particularly necessary to use equity-based crowdfunding regulatory systems from other countries as a reference through horizontal comparison, whereas China’s current law leaves many gaps in such provisions.

#### 4.2 *Reference to and Enlightenment of Foreign Equity-Based Crowdfunding Regulations*

Equity-based crowdfunding usually involves three major subjects: the “financing party,” “intermediary platform” (also known as the funding portal), and “investors.” Foreign regulatory systems are mainly oriented around these subjects.

##### 4.2.1 *Regulation of the Financing Party (also Known as Creators)*

- Restrictions on the eligibility of the financing party. Most countries require financing enterprises to be established in their respective countries and, in some countries, financing enterprises should be public companies. In addition, fund companies are excluded from acting as equity-based crowdfunding issuers in some countries.<sup>63</sup> For example, in the US, crowdfunding provisions only apply to domestic issuers, and do not include investment fund companies. The SEC (the US Securities and Exchange Commission) has also suggested excluding companies without specific business plans, or those in which the business plan consists merely in mergers with or acquisitions of other organizations.<sup>64</sup> Britain does not have a limitation on the number of shareholders in a closed company, but prohibits closed companies from issuing public shares, so equity-based crowdfunding in Britain is actually limited to public companies.<sup>65</sup>
- Limitations on the maximum amount of financing. In order to avoid systemic risk, most countries set a ceiling on the annually raised funds of the financing party through equity-based crowdfunding. In the US, the amount of funds raised by companies through equity-based crowdfunding within 12 months should not exceed USD1 million.<sup>66</sup> In Britain, there is no restriction on the amount of funds raised by the financing party, but the financing party must disclose the prospectus or other relevant documents according to the amount of funds raised.<sup>67</sup>
- Requirements for information disclosure. Information disclosure of the financing party is the regulatory focus of equity-based crowdfunding in all countries. In the US, the financing party must complete two obligations of “information disclosure for the first issuance” and “continuous information disclosure.” The information disclosure for the first issuance includes the “basic information on the financing party,” “share issuance

63. See JOBS Act, §302 (a).

64. Powers (2013).

65. FCA, PS14/4—the FCA’s regulatory approach to crowdfunding over the Internet, and the promotion of non-readily realizable securities by another media, Article 1.5.

66. JOBS Act, §302(a)(6): “(A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than \$1,000,000.”

67. Fca.org, *supra* note 14.



information,” “capital structure information,” and “financial information.”<sup>68</sup> It is worth noting that the SEC has established a multi-level financial statement disclosure system differentiated according to the number of issued securities, in order to moderately reduce the costs of disclosure.<sup>69</sup> In addition, the SEC requires that financing companies submit the financing process to the SEC when funds raised have reached 50% and 100% of the planned amount, and must disclose the information to the intermediary platform and investors. If the disclosed information has changed substantially during the financing process, financing companies must report to the SEC, intermediary platform, and investors in a particular form. Continuous disclosure is required to refer to the listed company information disclosure system, and financing companies are required to submit to the SEC and give a public notice of annual reports and financial reports at least once a year.<sup>70</sup>

- Restrictions on financing promotion. Financing promotion for equity-based crowdfunding is an important channel through which the financing party provides information for investors. According to US regulations, financing companies should not carry out crowdfunding promotion through newspapers and other public media. Financing companies are only allowed to release a crowdfunding notice through an intermediary platform in a centralized manner. The notice should only publish the following information: the ongoing financing by financing companies; the name and address of the intermediary platform; financing provisions, including the number, price, type, and expiration date; the legal entity’s identity, telephone, address, website, and a brief introduction to the business activities of the financing company, the e-mail of the financing company’s representative, etc.<sup>71</sup>

#### 4.2.2 Regulation of Intermediary Platforms (Funding Portal) for Equity-Based Crowdfunding

- Qualification requirements for intermediary platforms for equity-based crowdfunding. Intermediary platforms are the core of crowdfunding activities, so, in all countries worldwide, intermediary platforms for equity-based crowdfunding must be registered in or licensed by the relevant regulatory authorities. For example, the US and Italy have adopted a registration system. In the US, intermediary platforms for equity-based crowdfunding must register as a broker-dealer or “financing portal” with the SEC.<sup>72</sup> Britain uses a licensing system, within which intermediary platforms must obtain permission from FCA (the British Financial Conduct Authority) to sell non-readily realizable securities to qualified investors.<sup>73</sup> However, except the relatively slack regulation in the US,<sup>74</sup> whether in the registration system or licensing system or not, intermediary platforms for equity-based crowdfunding are required to meet certain

68. See JOBS Act, §4A.

69. *Ibid.*, SEC. 4A.

70. Ellenoff (2013).

71. JOBS Act, §4A.

72. In the US, the registration obligations of intermediary platforms differ from the registration requirements for securities companies; see Ge (2016).

73. Fca.org (2016).

74. The SEC does not recommend setting too many conditions for a finance portal; Sec.gov (2015).

conditions, including, but not limited to, infrastructure operation, financial resources, governance structure, compensation insurance, and other aspects.

- Obligations and behavioural requirements for intermediary platforms for equity-based crowdfunding. Various countries impose obligations on intermediary platforms for equity-based crowdfunding, including, but not limited to, fraud prevention, restrictions on investment advice, investor education, prohibition of conflicts of interests, and so on.

In the US, intermediary platforms are required to take measures to reduce potential fraud risks in financing companies.<sup>75</sup> These specific measures include: intermediary platforms shall judge whether there are reasonable grounds for believing that a financing company meets the conditions stipulated by the American Securities Law, etc., and that a financing company has accurately recorded the information on stock holders, the refusal to release financing information for the financing companies which do not meet certain conditions, and so on. Concerning investment advice, intermediary platforms should neither provide investment advice for investors nor induce investors to buy the securities issued on their websites, unless they have provided disclosed objective information on issuance through their websites (platforms). Regarding investor education, intermediaries must provide investors with risk disclosure and other relevant investor education materials, to ensure that investors have an understanding of investment risks and their abilities to bear these risks. As to the prohibition of conflicts of interests, neither intermediary platforms nor their management personnel (directors, managers, partners, etc.) should have interests in financing companies, obtain extra remuneration for their services to financing companies, or carry out related transaction to the issuance and sale of securities for the benefit of enterprises.<sup>76</sup>

In addition, intermediary platforms must also assume the obligations of anti-money laundering, privacy protection, and acceptance of the supervision and inspection by the SEC and US Financial Industry Regulatory Authority, and other obligations similar to those of brokers.<sup>77</sup> Overall, with regard to equity-based crowdfunding, intermediary platforms must bear higher responsibilities and obligations than investors' and raisers', which is surely related to the characteristics and needs of public investment.

#### 4.2.3 Restrictions on Investors

Compared to intermediary platforms, all countries set relatively few restrictions on equity-based crowdfunding investors, generally focusing on whether the investment behaviour of investors matches their investment capacity. For example, the US sets a ceiling on the annual amount of investment according to the income or net assets of investors. If the investor's annual income or net assets are less than USD100,000, then the annual total investment in equity-based crowdfunding should not exceed USD2,000, or 5% of annual income or net assets (whichever is higher). If the investor's annual income or net assets are more than USD100,000, this annual total investment in equity-based crowdfunding should not be more

75. JOBS Act, §4A.

76. Powers, *supra* note 64.

77. JOBS Act.

than 10% of annual income, and the ceiling is USD100,000.<sup>78</sup> In Britain, time is not a consideration, and restrictions are only imposed on the investor's total investment in terms of equity-based crowdfunding. However, in Britain, equity-based crowdfunding is only open to sophisticated investors and several specific types of ordinary investors.<sup>79</sup>

Regarding investor requirements in the field of crowdfunding, Britain obviously has much higher requirements than the US. We think reasonable explanations for this are as follows. (1) FCA believes equity-based crowdfunding is a high-risk activity. The risks facing investors are close to those facing other financial institutions, whereas ordinary investors lack the same abilities to identify risk and protect themselves from it. Therefore, to ensure the sustainability of the system and limit damages to potential investors, FCA directly limits the targeted investor groups. (2) From the perspective of purpose, FCA is more inclined to regard investment-oriented crowdfunding as an investment behaviour, while the US is more inclined to consider crowdfunding a solution to financing difficulties facing SMEs. That is why the SEC takes a more relaxed stance on investor restrictions—in other words, basing policy on investment ability and the ability to take risks rather than the abilities to identify and protect themselves against risks.

### *4.3 Suggestions for Building an Equity-Based Crowdfunding Regulatory System in China*

Given that equity-based crowdfunding is still an emerging financing method in China, it could positively facilitate the financing of SMEs and start-ups, as well as promote employment and social development. In conjunction with the overall attitude towards equity-based crowdfunding regulations in foreign countries, we deem it appropriate to adopt the concept of “Moderate Regulation” at the current stage. Some scholars have suggested the use of “easy access and strict management” for equity-based crowdfunding regulation, placing regulatory focus on the code of conduct of financing parties and intermediary platforms.<sup>80</sup> We believe that this suggestion is, to some extent, informative.

#### *4.3.1 Focus on Risk Control with Regard to the Regulation of Financing Parties*

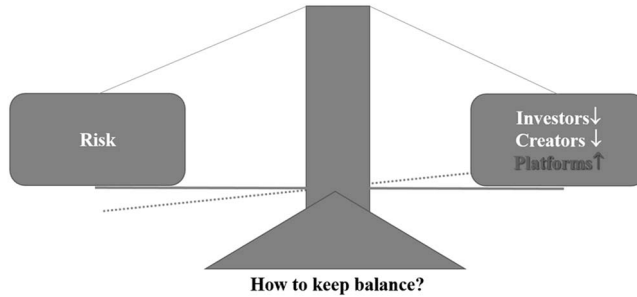
The Securities Law (Revised Draft) included equity-based crowdfunding as a special kind of securities for public offering, granting exemptions under certain circumstances. We believe that regulating the financing party can further improve its qualifications, responsibility, and limits of financing amounts.

Specifically, on the basis of the original intention and “open, public, small-sum” characteristics of equity-based crowdfunding, the financing party could be limited to start-ups or enterprises with smaller economic volume. In terms of responsibility, although the financing party issues securities through equity-based crowdfunding, it would not be necessary for it to undergo review by CSRC, assuming the financing party meets certain provisions. However, the

78. *Ibid.*, §302(a)(6)(B): “(i) the greater of \$2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; and (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000.”

79. Fan, *supra* note 21.

80. Yang (2014).



**Figure 6.** Schematic of how to maintain balance in controlling risk

financing party must raise funds through a licensed particular intermediary platform for equity-based crowdfunding. This proposal aims to promote a balance between “financing facility” and “risk control.” At the same time, special attention should be paid to information disclosure by the financing party. Concerning limits to financing amounts, a ceiling should be set on funds raised, to simplify the regulatory process of equity-based crowdfunding, reduce the crowdfunding costs of the issuer, and control equity financing risks, limiting them to a range within which they will not endanger the market economy.

#### 4.3.2 *The Regulatory Focus on Intermediary Platforms*

Since equity-based crowdfunding is exempt from the registration obligations of fundraisers and lessens restrictions on public participation in investment, intermediary platforms inevitably become a central link of equity-based crowdfunding—controlling risks and reducing the regulatory duties of CSRC (Figure 6). Therefore, special attention should be paid to the qualifications and duties of intermediary platforms.

- Qualification requirements for intermediary platforms. The special role of intermediary platforms means they should face higher qualification requirements for equity-based crowdfunding. From the specific requirements, the following should be met: first, anti-fraud capacities: the management personnel of intermediary platforms could be required to have considerable investment experience, and these platforms could also be required to pay a certain amount of registered capital, to protect the interests of investors under certain circumstances; second, the design of open, orderly investment procedures, including an information disclosure mechanism, linking the financing party and investors, the ability to pay online, etc.; third, the capacity to identify information, able to complete the formal review of the financing party’s information disclosure; fourth, technical safety-related capacities, to ensure the safety of investor information and funds. In terms of the form of qualification accreditation, we believe a licence or registration system (versus a record-keeping system) would be more appropriate, given the pivotal position of intermediary platforms for equity-based crowdfunding, as well as the tendency of CSRC to streamline administration and institute decentralization of equity-based crowdfunding regulation.<sup>81</sup>

81. Under the registration system, CSRC may supervise the entire equity crowdfunding business through intermediary platforms for equity crowdfunding, which helps to achieve the greatest degree of self-regulation of the equity

- Obligations and duties of intermediary platforms for equity-based crowdfunding. Since intermediary platforms for equity-based crowdfunding share some of the same regulatory duties as CSRC, these platforms fulfil some of the duties of regulating financing parties and investors, in addition to the fulfilment of their own obligations. By referring to foreign legislative experience and advice, intermediary platforms should fulfil the following main obligations: first, in terms of regulating fundraising parties, intermediary platforms must conduct due diligence of fundraising parties and their management within certain limits, urge fundraising parties to complete their obligations of information disclosure, and carry out the formal review of the authenticity of the information disclosed by fundraising parties; second, with regard to the regulation of investors, intermediary platforms must provide necessary crowdfunding risk warnings before public investors make investments, to ensure that investors can recognize and bear the associated investment risks. In addition, intermediary platforms need to assist investors in confirming investment limits, so that investors comply with restrictions on investment limits. Further, intermediary platforms should remain neutral, to avoid conflicts of interests, and may not have equities or other economic benefits in fundraising parties.

#### 4.3.3 *Appropriate Investor Restrictions*

The authors suggest that restrictions on equity-based crowdfunding investors shall take “Appropriate Principle.” On the one hand, the permission for public participation in equity-based crowdfunding is good to play its positive roles. The “public, small-sum” characteristics help to facilitate the role of equity-based crowdfunding, while at the same time reducing and dispersing risks associated with equity-based crowdfunding. In our view, regulations on investors should refer to experiences and practices from abroad—making the investment behaviour of investors match their capacity for assuming investment risks, to achieve a balance between the popularity and control the risk of equity-based crowdfunding. This means we shall focus on investment limits rather than limiting the number of investors.

On the other hand, in contemporary China, crowdfunding has a special meaning, especially given the background of “Mass entrepreneurship and innovation.”<sup>82</sup> Financing capacity lies at the foundation of the survival and development of innovative start-up enterprises. As a new way to raise funds, crowdfunding has been seen as one of the most innovative Internet financial formats.<sup>83</sup> *The Guidance on Accelerating the Construction of Mass Entrepreneurship and Innovation*, issued by the State Council, recognizes the positive significance of expanding the financial system to serve entrepreneurial innovation, by way of crowdfunding and other Internet financing methods.

It should be noted that the “the economic volume of SMEs,” “the investment capacity and investment limits of investors,” and other content as described in the above proposal should be further investigated and verified before any conclusion is drawn. Therefore, a separate

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(*F*'note continued)

crowdfunding industry and to facilitate equity crowdfunding business. Currently, Alibaba, Jingdong, and PingAn have met the qualifications to obtain a licence to operate as intermediary platforms for equity crowdfunding.

82. See the Government Work Report, published on the third session of the 12th National People's Congress, 5 March 2015.

83. Song (2015).

paper with this focus is required. On the occasion of comprehensively revising the Securities Law, the authors suggest that the relevant regulatory departments should carry out careful investigation and practical research before making a decision.

#### 4.4 *Planning of Upgrading the Financial Regulatory System in China*

##### 4.4.1 *The Problem of a Decentralized Supervision Framework*

An impeccable financial regulatory system should integrate macro-prudential regulation, micro-prudential regulation, and consumer protection regulation organically. Improvements to macro-prudential regulation, strengthening consumer protection, and rebuilding the financial regulatory system have been central trends of financial reform in the US and UK since the Subprime Crisis.<sup>84</sup>

With regard to financial consumer protection, China's current decentralized regulatory system does poorly. One reason for this is that the "One Bank and Three Commissions" framework involves four departments with different regulatory standards, responsibilities are not clear between each other, and a variety of other imperfections in co-ordination and co-operation.<sup>85</sup> For example, the PBC, CSRC, and CIRC established a joint meeting schedule in September 2000, but it has never played a substantive role in regulation.<sup>86</sup> Another reason is that current financial supervision is facing challenges from financial innovations, which defy traditional modes of supervision and blur the boundaries between banking, securities, and insurance.<sup>87</sup> The decentralized regulatory system has lost its market structure foundation, and causes trouble to financial consumers of integrated financial innovations—that is, facing either a duplication of supervision or a regulatory vacuum.<sup>88</sup> Scholars generally believe the traditional regulatory structure focuses more on the security and stability of financial institutions and ignores systematic risk and consumer protection, which is an important cause of the accumulation of systematic risks and financial crisis.<sup>89</sup>

In fact, in 2011, "One Bank and Three Commissions" set up their own separate Financial Consumer/Investor Protection Agency.<sup>90</sup> However, this arrangement is still not in essence different from the policy of "separated management and decentralized supervision." For this reason, it is easy to see why the above-mentioned problems persist and financial consumer protection is still a necessity.<sup>91</sup> Moreover, new problems have arisen regarding how the Financial Consumer Protection Agency in the Central Bank coordinates with other authorities. If the Central Bank's Financial Consumer Protection Agency only works as a protection co-ordinating body, its authority is clearly inadequate, and it would be difficult for this body to fulfil its roles of supervision and co-ordination; but, if it were given the power of protection, it will break the original "One Bank and Three Commissions" regulatory system. Given the above-mentioned problems, some scholars have proposed establishing a unified

84. Wen (2015).

85. Tu & Yang (2011).

86. Yu (2015).

87. Wang (2015).

88. Tu & Yang, *supra* note 85.

89. Wen, *supra* note 84.

90. Zhang (2012).

91. Yang (2013).

Financial Consumer Protection Bureau or take unified supervision to take specialized responsibilities for financial consumer protection.<sup>92</sup>

#### 4.4.2 *The Solution to Unified Supervision*

Concerning how to achieve a unified supervisory structure to actualize true financial consumer protection, there are two basic paths—mergers and new establishments:

1. Pu Yongxiang, the Director of the Financial Market Department of the China Central Bank Research Bureau, is representative of the mergers perspective. He has proposed the establishment of a single financial management system, entailing the dissolutions of the CBRC, CSRC, CIRC, and Foreign Exchange Bureau, and the integration of their organs, operations, personnel, and services into the Central Bank, after which point the Central Bank would collectively co-ordinate multiple functions.<sup>93</sup>
2. Zhang Chenghui, the Director of the Financial Research Institute of Development Research Centre of the State Council, is representative of the new establishments perspective. He has stated the following:

Currently we shouldn't make major adjustment on the existing "One Bank and Three Commissions", but upgrade the existing cross-functional coordination mechanism to a higher-level financial stability committee; and in the future, we should establish the model of "One Committee, One Bank, One Commission and One Bureau."<sup>94</sup>

which means the Central Bank, Financial Regulatory Committee, Medium and Small Investors, and Financial Consumers Protection Bureau would be placed under the leadership of the Financial Stability Committee.

Regardless of the approach adopted, the establishment of a regulatory system for financial consumer protection has become an important measure to enhance the international competitiveness of China's financial industry.<sup>95</sup> In the authors' view, although the specific implementation of the unified regulatory path remains to be discussed, achieving a unified regulatory and financial consumer protection framework is only a matter of time. At the moment, the authors suggest, as a first step, strengthening communication and co-ordination mechanisms among "One Bank and Three Commissions," in particular, between their Financial Consumer Protection Agencies,<sup>96</sup> so as to jointly safeguard financial stability and confidence in financial markets.

## 5. CONCLUSION: CROWDFUNDING AND THE GOOD SOCIETY

Crowdfunding is a bottom-up approach within financing innovation, combining economy (capitalism) and sociology (social aspects). At the bottom, making money should not be the primary business of private firms. Rather, they should justify their existence by solving

92. *Ibid.*

93. Pu (2015).

94. Cnr.cn (2016).

95. Yue & Zhang (2011).

96. Yu, *supra* note 86.



customer problems—individual needs such as nutrition, health, or transportation, or social and ecological issues facing the world. According to Freund,<sup>97</sup> crowdfunding could be the key to overcoming the barriers between economy and sociology, by applying powerful interactions between social and financial capital.<sup>98</sup> What's more, crowdfunding platforms provide virtual spaces for creators and investors to exchange resources to realize ideas. This approach allows individuals to expand their efforts, which had to formerly rely on personal or direct crowdfunding initiatives.<sup>99</sup>

Robert Shiller, the Nobel laureate in economics, once said: “The link between financial institutions and the people is the most basic relation to maintaining social operation ... innovation has to be accomplished in a way that supports the stewardship of society's assets.”<sup>100</sup>

Frankly speaking, from the “stocking-style” regulation of crowdfunding to the equity-based crowdfunding as “online public equity financing,” a large number of private equity financing platforms will face the challenge of “de-crowdfunding.” However, after a thorough-going reform, the “open, public, small-sum” characteristics of equity-based crowdfunding and the mission of “grassroots finance” should materialize. “Chinese-style crowdfunding” should not become a haven for “pseudo crowdfunding.” In the long run, the development of the crowdfunding industry in China will continue to face the challenges of connecting with the international crowdfunding industry. To do so, it is necessary to clarify the nature of crowdfunding, improve its regulatory system, and support and promote emerging financing projects with real potential. We should note that crowdfunding is essentially a reflection of the practice of communities' distributions on financial innovation, gathering the capital strength of the masses to support “grassroots projects,” to advance mass entrepreneurship and innovation. It embodies social assistance and endogenous dynamics. While we regard crowdfunding as a form of financial innovation and as a financing channel, we should be more concerned about the social values and social justice behind it, so as to better understand and develop crowdfunding.

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