The Institute of Public Accountants

Crowdfunding

Submission to the Treasury: Facilitating crowd sourced equity funding

August 2015

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Table of Contents

1. Introduction 4
2. Finance in the Entrepreneurial Ecosystem – the ‘financial escalator’ 6
3. Industry Actors and their Interest 6
4. Information and the Regulator’s Central Dilemma 9
5. Regulatory Oversight of ECF 11
6. Brief Illustrations of National ECF Regulation 12
7. Regulatory Constraints on ECF Investor Actions 20
8. A ‘Modest Proposal’ 21
9. And the Near Future.....? 21
10. References 23

Current Crowdfunding Legislation

1. Introduction

The purpose of this submission is to address contemporary issues related to the creation and maintenance of an efficient and effective regulatory environment for the promotion of a form of early-stage entrepreneurial finance termed 'crowdfunding' (CF). The submission will focus exclusively on Equity Crowdfunding (ECF is also termed 'crowdinvesting'). Investment-based crowdfunding is defined by the UK's Financial Conduct Authority (FCA) as "people invest directly or indirectly in new or established businesses by buying shares, debt securities or units in an unregulated investment scheme"[1]. Of the five main types of crowdfunding[2], only equity and loan based forms fall within the FCA's regulatory remit. In a legislative sense, ECF which exhibits a number of different structures and activities, is acknowledged to be legislatively more complex than other variants of CF[3].

Equity crowdfunding is one of the fastest growing types of CF. In Europe, ECF had a compound annual growth rate of 50% between 2010 and 2012[4]. In the UK, ECF was the fastest growing category of CF with an average growth rate of 410% between 2012 and 2014 and with a total of £84 million raised for investment by ECF platforms in 2014. However, business debt (£749 million) and consumer debt crowdfunding (£547 million) in the UK currently dominate profits-based CF (NESTA, op. cit.).

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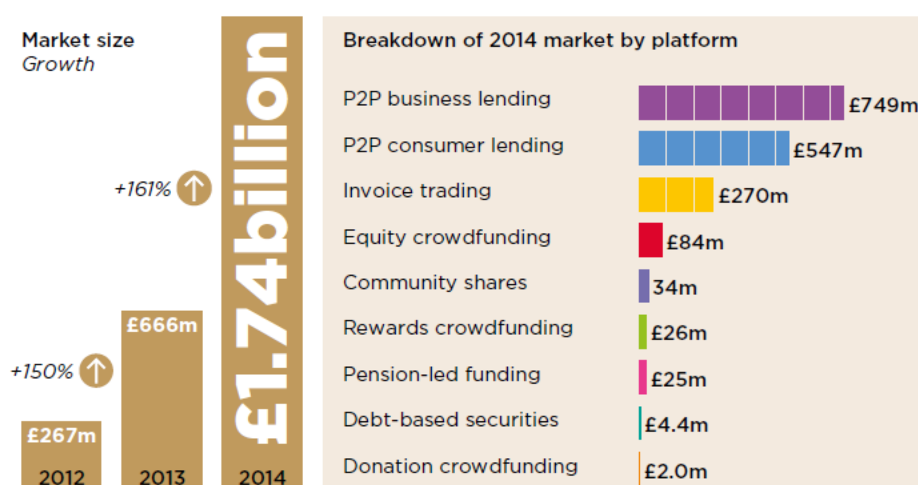
[1] Financial Conduct Authority (PS14/4), 2014

[2] Donation-based; prepayment or rewards-based; exempt (Enterprise Schemes or Industrial and Provident Societies)

[3] European Commission DG Communications Networks, Content & Technology, 2014

[4] Wilson and Testoni, 2014

Fig. 1 Size of Alternative Finance in the UK (NESTA, 2014)



Its importance to government, legislators and policymakers worldwide is that CF may augment and materially expand the financial resources available to start-ups and younger businesses thereby contributing to a supportive and proactive 'entrepreneurial environment'. Crowdfunding is also seen as highly relevant for supporting the developing world[5]. Since the Global Financial Crisis in 2008, banks have increasingly restricted their supply of loans for small & medium enterprises (SMEs), although this has been in parallel with a reduction in the demand for loans. While this situation is improving in Europe, researchers believe that the supply of bank debt to SMEs will continue to remain constrained[6]. Equity and debt variants of CF are both seen as a means of improving the supply side of finance to smaller and younger businesses, the so-called 'finance gap'. *The Economist* noted the present 'treasure hunt' by SMEs for new sources of finance with bank lending remaining subdued. However, this article expressed a necessary note of realism when it noted that the total raised by CF in Europe in 2014 was €1.5 billion compared to new external funding to European SMEs of €926 billion in the same year[7]. Most of this latter sum is provided by banks. Nonetheless, ECF is seen as particularly relevant to innovative and technology-focused new enterprises[8] which have greater problems in supporting loan servicing in their earlier years and thus usually need access to external sources of equity or risk capital in order to grow rapidly[9].

A caveat is necessary. CF as an industry is emergent and remains hugely immature[10]. There is as yet little consolidation of platforms, and while a number of CF platforms have exited, the industry is still characterised by a growth of new entrants, high levels of innovation and several experimental formats in their offerings to investors. The fact that the 'platform' market is still in its infancy is a particular issue

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[5] World Bank, 2013

[6] European Investment Fund, 2015

[7] *The Economist* June 27th, 2015

[8] European Commission, 2014

[9] Hall and Lerner, 2009

[10] Crowdcube organized the first successful equity crowdfunding in the UK in 2011

as many will exit the market and new entrants will arise. This creates uncertainty in the market for both investors and investees. Similarly the regulatory environment has been described as ‘a patchwork of legal frameworks’ with as yet little pan-European commonality or integration[11]. Accordingly, industry and academic analyses remain tentative in an often ‘over-hyped’ environment fuelled by statistics of frequently dubious provenance and authenticity. Industry data are best viewed as exploratory and speculative contributions, and should be treated with due caution. Industry immaturity is also a compelling argument for tentative intervention by policy makers and regulatory authorities in this early period of high uncertainty as to the industry’s future structure, conduct and performance.

2. Finance in the Entrepreneurial Ecosystem – the ‘financial escalator’

A considerable interest of government in both its enterprise and innovation policy frameworks is to create a series of complementary and interlinked sources of external finance available to young and potentially attractive, growth-oriented firms after the founders have committed and exhausted their own funds (aka ‘family & friends’ finance). Such finance may include debt provision but will at the earliest stages concentrate on the equity or risk capital needed by the young firm. This early-stage equity environment will include Business Angels (BA) and some Venture Capitalist (VC) providers. In an ideal world, such an environment will enable seamless ‘follow-on’ finance from a range of successive types of provider as the young firm grows, authenticates its commercial value, and requires more finance in order to realise its growth options. ECF providers, if classified by their ability to provide significant amounts of risk capital, are likely to sit between family & friends and BA individuals or syndicates, and well before the introduction of most VC finance. Indeed, one of the key policy issues is exactly how and where CF fits into the wider enterprise finance ecosystem. In clarifying this question, it is important that all parties interested in ECF also understand – and learn from - the relevant histories of VC and BA finance emergence in Western economies, particularly the USA and the UK.

Fig 2. ECF’s positioning in the Financial Escalator

Source: European Commission, 2014

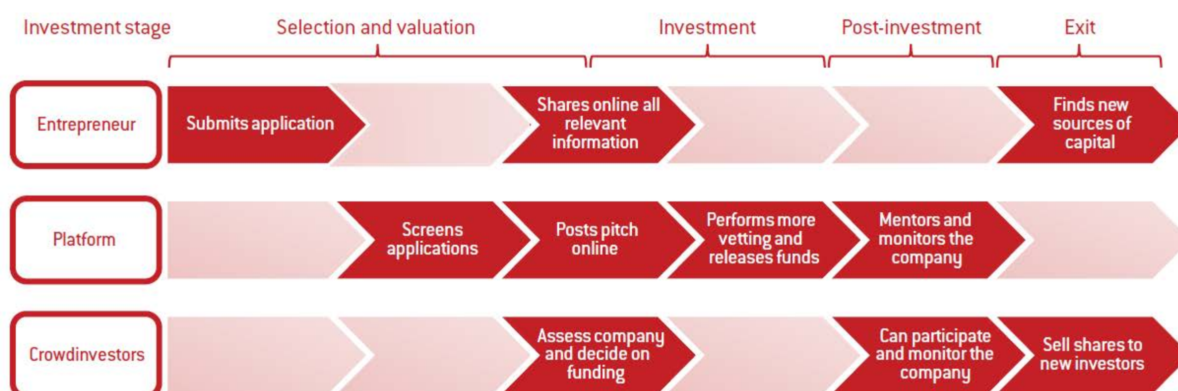
3. Industry Actors and their Interests

There are three key interest groups in ECF excluding government: the entrepreneurial *enterprises* or ‘issuers’ seeking external finance through the issuing of equity type instruments to support both start-up and growth phases; *investors* including both private individuals and increasingly professional BA and VC entities; and the intermediary ECF *platforms* facilitating the financial transaction. Each party is subject to a range of regulatory constraints (or exemptions) depending on the degree of sophistication of individual country legislative regimes. Freedom of action is also influenced by pan-European legislation in the European Union as well as state-based legislation in the USA. Wilson and Testoni

[11] DG Communication Networks, Content & Technology, 2014; ESMA, 2014

(2014) have summarised the activities of the three key actors and their relations to other risk capital providers in two useful diagrams (Figs. 3&4).

Fig. 3 Inter-related Funding Activities of ECF Actors



For entrepreneurs, the attraction of ECF can stem from investors' improved access to appropriate information allowing better matches which can result in an improvement in supply and possibly a lowered cost of capital. Entrepreneurs can also gain from more information or signals provided by interested investors which may allow them to make better forecasts of present and future market demand, product improvements etc. These advantages come at the cost of the greater levels of firm disclosure. Applicants for ECF have to communicate publicly and make detailed disclosures with little ability to control who receives this private intelligence. Such disclosure may encourage emulation from competitors and/or may imperil the security of the enterprise's key 'intellectual property rights'.

For investors, likewise, the widespread availability of information via digital communications can improve decision making and can also reduce the advantage of geographic proximity to the new venture[12] [13]. Investors, particularly 'early adopters', may gain greater access to innovative product and service offerings mediated through specialist network communities. There is also evidence that there are further non-economic benefits of preferential and voluntary participation of the crowd, as both users and co-owners, in an innovative and entrepreneurial community. However, these advantages each assume that the information is accurate, not overly optimistic and the entrepreneurs seeking external finance are competent, honest and not fraudulent. On occasions, each or all of these assumptions will not be met … to the cost of investors.

Indeed, ECF in its early development produces a *double information asymmetry.* Traditional models of financial markets focus on the relative information asymmetry between the firm (investee) and the financier (investor). Generally, these models predict that the firm knows more about the distribution of potential outcomes (the quality of the project) than the financier. But both equity and loan CF may give rise to a different type of market where asymmetric information exists but the asymmetry is apparent on *both* sides. The firm cannot make an accurate judgement on the quality of the investor (that is, ability to provide further rounds of finance, sector skills or networks, commercial expertise etc.) and, likewise, the investor cannot make a good judgement on the quality and future prospects of the firm.

[12] Agrawal, Catalini and Goldfarb, 2011

[13] Wiltbank, 2009

The potential for 'mismatches' increases exponentially in this situation. That is, the investor is poorly informed as to the quality and prospects of the issuing company. By the same token, the issuer knows very little about the true worth of the investor beyond the initial payment received via the platform.

Fig. 4 Characteristics of Risk Capital Providers relevant to High Potential/High Growth Enterprises

	Equity crowdfunders	Business angels	Venture capitalists
Background	Many different backgrounds, many have no investment experience	Former entrepreneurs	Finance, consulting, some from industry
Investment approach	Investing own money	Investing own money	Managing a fund and/or investing other people's money
Investment stage	Seed and early stage	Seed and early stage	Range of seed, early-stage and later-stage but increasingly later-stage
Investment instruments	Common shares	Common shares (often due regulatory restrictions)	Preferred shares
Deal flow	Through web platform	Through social networks and/or angel groups/networks	Through social networks as well as proactive outreach
Due diligence	Conducted by individual, if at all, and sometimes by the platform	Conducted by angel investors based on their own experience	Conducted by staff in VC firm sometimes with the assistance of outside firms (law firms, etc.)
Geographic proximity of investments	Investments made online: most investors are quite distant from the venture	Most investments are local (within a few hours' drive)	Invest nationally and increasingly internationally with local partners
Post investment role	Depends on the individual investor, but most remain passive. Some platforms represent the interests of the crowd	Active, hands-on	Board seat, strategic
Return on investment and motivations for investment	Financial return important but not the only reason for investing	Financial return important but not the main reason for angel investing	Financial return critical. The VC fund must provide decent returns to existing investors to enable them to raise a new fund (and therefore stay in business)

Source: adapted from Wilson (2011).

For platform managers, their income is primarily calculated as a percentage of the total value of successful fund raisings. Attracting more successful entrepreneurs and raising successively larger sums each contribute to their reputation as an intermediary, and to the potential for further business. In an emerging market with low barriers to entry, user recognition, media attention and market share are likely to be of far greater long term value to platform managers than immediate profitability – as Amazon has powerfully demonstrated. Platforms seek over time to widen the coverage and, critically, to enhance their reputation among advisers, funders and entrepreneurs in their selected market(s). Specialisation of platforms beyond the basic classification of CF activity is still rudimentary but is starting to occur. Platform managers' greater experience and ability to abort slow and unsuccessful fund raisings early helps address problems of adverse selection.

However, the dominant performance metrics presently communicated by the CF industry is the number, value (and speed) of successful fund raisings. While these measures are also of direct interest to the entrepreneurs, for the investors they are merely a means to the final goal of the realisation of an attractive, risk adjusted return on capital. By focusing only on 'money in', the success

of ECF platforms is problematically measured on half of the ‘objective function’. As the international VC industry learned painfully post 2000, total funds raised or ‘funds under management’ held by a VC’s general partnership is not ultimately a credible, *ex post* investment performance measure[14].

4. Information and the Regulator’s Central Dilemma

Government regulators have to address one central question that presently dominates the many debates as to the influence and role of CF. This dilemma, while also affecting ‘peer to peer lending’ as the other and larger category of profit-related CF activity, is most starkly observed in their choice as to how and to what degree ECF is to be regulated. Not surprisingly, US observers with their frequent ambivalence to government intervention articulate the two choices most emphatically:

i) ‘Government should recognise that CF is a game changing and disruptive *positive* phenomenon in the critical area of enterprise formation, financing and support. It should, accordingly, seek to ensure that artificial and bureaucratic barriers are not erected to impede the activities of CF actors. Investors are informed and can - and should - make their own commercial decisions without hindrance. Market evolution and innovation will eventually sort out inefficiencies at acceptable costs.’

The diametric view is that:

ii) ‘CF and particularly ECF is an open license to abuse, cheat and defraud the investing public outside those few persons with appropriate professional/business skills and/or access to expert advice. In these circumstances, regulatory constraints have to be applied in order to protect all parties (particularly, non-professional investors) and to ensure that the emerging CF industry remains honest and fit for purpose.[15]

The former position is most frequently espoused by interested commercial parties and particularly platform managers. It conforms to a strongly ideological view held by many entrepreneurs that the best course of action is to let markets discriminate and buyers should therefore beware. Government is seen as having little direct role given that intervention is seen to invariably produce excessive costs, restrictions in trade and other negative externalities. This essentially Darwinian view conflicts with a more interventionist regulatory view that public money raising schemes operating without clear legal definitions and transparent practices are likely to be abused. Uninformed and gullible retail investors will be particularly vulnerable and the state has a responsibility to pre-empt such threats. Of course, each position is essentially a parody and represents the pole opposites on a continuum. Such ideal types, if taken to extremes, would each incur costs that would endanger the future of the industry, whether from malfeasance or from the suffocating costs to a new industry of excessive regulatory burdens. The pragmatic question for regulators and policymakers is where along the continuum regulation should engage to ensure optimal outcomes of ECF activity and investor protection.

Central to this ongoing debate is the role of information in the transaction. That is, the degree to which information asymmetries exist; the ability of actors to access and use (that is, comprehend) the information needed; and how these market imperfections affect efficient industry behaviour. These

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[14] Fund raising by the VC industry collapsed worldwide after the technology bubble burst in Q1, 2000.

[15] These two statements have been written by the author and represent a composite summary of the views of each camp as expressed in the media.

questions essentially point to a key issue of what is the appropriate value of ECF as a financial component of the entrepreneurial ecosystem and how may this value be best realised[16].

By its very nature, the financing of new or young, growing enterprises – particularly if they are addressing novel markets with innovative products and services – is fraught with both Knightian risk and uncertainty (ie immeasurable and not possible to calculate). Regardless of the nature of enterprise funding employed, the transaction will typically involve high levels of market risk, technology risk and/or managerial risk. Eurostat data shows that by 2010 only 46% of businesses started five years before have survived. ECF is focused on early-stage enterprise - one of the most challenging marketplaces for finance. It is therefore sensible to use a meaningful benchmark of selection and governance to assess a platform's actions. Here, observers most readily reference ECF to its more established peers of BA and, perhaps most rigorously, VC finance. Such comparisons of the modes of investment selection and subsequent portfolio management tend to show ECF in a poor light compared to BA and VC investment activity. However, perhaps this comparison, while highly relevant, is as yet too early to make. Nonetheless, there is no question that ECF platforms can learn from these more established financiers of enterprise.

It is important to note that ECF platforms are rarely able to offer their investors advice on investee firm selection in order to retain their regulatory exemptions (see below). Rather, the platform recruits applicant firms against its own selection criteria and then makes the existence of such firms known to its investors. It is the latter who are responsible for their own decision whether or not to invest in a particular firm. Detailed information on the investment offering is typically rudimentary, and is at a level that would be unacceptable to experienced BA and VC investors. BAs, particularly operating in syndicates, and VC general partnerships invariably undertake considerable due-diligence on all aspects of any proposed investment. Professional investors are very aware of the information asymmetries existing between the owner of a young business and those that are approached as investors, and of the probability of adverse selection. This information discrepancy may also create a moral hazard which may adversely influence the behaviour of the funded entrepreneur with a now reduced ownership share.[17]

Commentators have frequently expressed concern over the poor level of scrutiny of applicant enterprises conducted by investors in ECF platforms and the organisation and structures of the deals offered[18]. Platforms have also been criticised for bias over reporting their activity levels; for the quality of enterprises selected; for the ambiguity and inflexibility of the legal and shareholding structures used; for the negative influence of ECF funding models on future fund raising (particularly from BA or VC investors); and for their inattention to investment realisation via profitable exit channels. Governments have similarly been criticised for their often uncritical support of ECF including both directing public financial support via platforms and making attractive tax breaks to investors available for eligible ECF activity[19]. Critics argue that the *imprimatur* of such public and official support to ECF activities gives an overly positive signal to non-professional investors, which is not warranted by ECF performance to-date. We believe that a greater level of scrutiny by policy makers is warranted.

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[16] Moritz and Block, 2014

[17] Hyytinen and Vaananen, 2006

[18] See Gray, 2014 for a particularly critical and informed analysis of the value of ECF to BA syndicates in the UK.

[19] The highly attractive Enterprise Investment Scheme and Seed Enterprise Investment Scheme are available to investors in ECFs in the UK. Belgium is also implementing tax breaks of relevance to ECF.

It is interesting that, while several of the observers' concerns about ECF are well founded, the same set of criticisms could be levelled at the BA community until very recently. Through the agency of Business Angel Networks (BANs) and more recently National BA Associations, often financially supported by government, BA financing has matured over the last decade into a more disciplined and collectively managed vehicle for enterprise finance. [20] One key indication of this greater professionalism is seen in the increasingly complementary co-investment and syndication between BAs and early-stage VCs. ECF platforms are already engaging with BAs[21] [22] and it is likely that these relationships (along with greater clarity of regulatory requirements on CF actors) will encourage rapid industry learning.

5. Regulatory Oversight of ECF

We have noted the patchwork diversity of regulation affecting CF that presently exists. In this section we will look exclusively at ECF which is acknowledged to be the most complex area of CF activity regarding legislation and regulation. We will look at the demands as they affect different actors. This will be referenced against individual country examples, albeit the USA and the UK will predominantly feature as the two biggest and most sophisticated markets for ECF. Given the importance of international activity in Europe and the influence of the European Union, we will also look briefly at both European regulation and the growing international dimension of ECF. (NB. In all cases, we are only introducing elements of relevant legislation and this summary is not intended to be read as any form of legal comment or opinion.)

It is important to recognise that crowdfunding regulation embraces all three major actors in ECF: namely, i) investors seeking to purchase equity, debentures or similar convertible instruments, ii) the company or enterprise seeking to raise finance by selling such securities to investors, and iii) the intermediary or ECF platforms that link all parties in order to complete a finance raising. Essentially, investors are seekers of appropriate information on new opportunities and the entrepreneurs seeking finance are the providers of information. The platform acts as an intermediary mandated by its two users to provide (ideally) full and unrestricted interchange of information between buyer and seller.

Regulators are interested to ensure that investors are appropriately protected. They need to decide if investors are consumers (and need protecting) or rational operators in the financial market and thus subject to the full requirements of the FCA. In ECF, the regulators have clearly seen retail investors as customers. Hence, there has been a bias towards imposing restrictions on investors' ability to access ECF platforms unless they can demonstrate that they are 'professional' investors or that they are 'retail' clients who can vouchsafe appropriate skill sets that will enable them to analyse the investment offering including the full range of risks that the proposed financing may incur. Eligible retail investors include those that receive regulated investment advice or are (self) certified as 'sophisticated investors'[23] or 'high net worth individuals'[24]. These statements must be provided in writing and signed

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[20] LINC Scotland is an example of a highly professional national BA association. See http://www.lincscot.co.uk/

[21] In January 2014, Crowdcube Ventures announced a collaboration with Braveheart Investment Group (a BA network) that would enable Crowdcube's ECF investors to build up a portfolio of investments by co-investing in ventures which have been screened by a professional fund manager.
[22] SyndicateRoom is a site which encourages ECF investors to invest in ventures assessed by experienced BAs.

[23] A sophisticated investor must meet at least one of the following criteria: has been a member of a network or syndicate of business angels for at least the six months preceding the date of the certificate; has made more than one investment in an unlisted company in the two years preceding that date; has worked, in the two years preceding that date, in a professional

by the investor.[25] Individual retail investors who cannot demonstrate sufficient (high) net worth or annual income and do not conform to the requirements of a sophisticated investor are frequently proscribed from investing as a condition of platform acceptance. That is, conditions of accreditation under the relevant financial acts are relaxed by the regulatory authority to allow ECF platforms to trade. A number of countries also require a 'cap' to be placed on the level or percentage of a retail investor's income or wealth that may be invested annually or by each project or platform. In the case of the USA, this cap changes depending on the annual income or net worth of the investor. It is the area of how much license should be given by regulators to retail investors not using an accredited financial adviser and without specialist skills or the diversification advantages of high income or wealth that appears to be one of the largest areas of debate. If ECF activity continues its rapid growth, unskilled and inexperienced retail investors may well become the numerical majority of retail investors.

For the entrepreneurial business or 'issuer' of equity type instruments to a retail public, the imposition is for the owners to be able to provide such information about the business, its financial condition and requirements, and its plans that will allow an experienced investor to make an informed decision on the information provided. The question of the validation of such information provided and the platform's responsibilities for the quality and quantity of information available to investors frequently remain unclear.

For the generic ECF platform, the arranging of deals and the financial promotions of securities including equity and debt instruments are regulated activities in most developed countries. Accordingly, the platform must be authorised unless an exemption is available. See Table 1 (below) for a summary of national regulation.

6. Brief Illustrations of National ECF Regulation

1) USA

An industry report launched on 31 March 2015 estimated the total crowdfunding market in the USA in 2014 to be $9.46 billion, and with an annual growth rate of 145%[26]. The central catalyst for this phenomenon occurred three years earlier. On 5 April 2012, the JOBS Act was approved by Congress and signed by President Obama into law. It gave private companies greater access to capital and made it easier for certain companies to go public on US exchanges. The Act created a new category of issuer called an emerging growth company (EGC) and provided regulatory relief to EGCs to encourage initial public offerings (IPOs). While passed by Congress and hailed by a myriad of entrepreneurial groups, lawyers and particularly the Securities Exchange Commission held several concerns as to the unregulated advertising of ECF fundraisings to the public. Accordingly, Title II of the JOBS Act, while allowing public advertising of fund raising, restricted ECF access to Accredited Investors (high net worth investors). Title III allowed companies to raise a maximum of $1 million a

capacity in the private equity sector, or in the provision of finance for small and medium enterprises; has been, in the two years preceding that date, a director of a company with an annual turnover of at least £1 million.

[24] A 'high net worth individual is one who had, during the financial year immediately preceding the date of the certificate, an annual income of £100,000 or more; and held, throughout the same year, net assets of £250,000 or more.

[25] It is important to note that by signing such documents, the investor waives important legal rights of consumer protection and compensation.

[26] Massolution 2015 Crowdfunding Report

year from the crowd without having to register these securities with the Securities and Exchange Commission. Under proposed rules, unaccredited investors are capped at a maximum investment of $2,000 per deal or 5% of their income if their annual income is less than $100,000 or 10% of their income if their income is greater than $100,000. However, finance raising campaigns had to go through a website hosted by an intermediary and disclosures including audited financial statements were required for campaigns of over $0.5 million. Title III has not yet been passed into law by the US authorities.

Table 1 Summary of ECF Regulation by Country

European Region

Country	Prospectus Limited	Requirements for Licence of Financial Authorities	Limits for Investors	Other
FR	EUR 1 Million	AMF (Regulation: Ordonnance n° 2014-559)	≤EUR 1 K (for crowdlending only)	
DE	EUR 1 Million (under new proposed regulation), but information document required	BaFin	≤EUR 10 K (under new proposed regulation)	Staff needs to demonstrate relevant skills; platforms need to produce an information document if they accept contributions more than EUR 250 (under new proposed regulation)
UK	EUR 5 Million per issuer within 12 months	FCA	≤10% of net assets per year	
ES	EUR 5 Million per issuer within 12 months	No	≤EUR 3 K per project ≤EUR 10 K in a platform (During a 12-month period)	Legal initiative propose: stricter regime should apply including accounting and auditing
IT	EUR 5 Million per issuer within 12 months	Only for professional online portal manager; if the portal manager is a financial intermediary no licence is required and the enrolment in the Consob register is automatic	5% of the equity offer should be taken by professional investors before offer completion	Under a Italian specific "crowdfunding law" Payment requires to be licensed by Bank of Italy
SE	EUR 1.5 Million within months	S-FSA or cooperation with licensed firm	Possible to offer investments in limited liability companies formed as "private", with limitations on the number of investors	Require a license when securities or investment products are sold; payment requires to be licensed by S-FSA
FI	EUR 1.5 Million per 12 months	No	No	Finnish Credit Institutions Act and Investment Services Act
SK	EUR 100 K in EU within 12 months	NBS	No	Financial Instruments Market Act; Payment Services and Systems Act
BG	EUR 100 K within 12 months	Bulgarian National Bank	No	Law on Credit Institutions & Law on Payment Services and Payment Systems
PL	EUR 5 Million per issuer within 12 months	No	No	National Law

Non-European Regions

US	Securities USD 1 Million (EUR 750 K) per 12 months	SEC, register as a broker or crowdfunding platform	USD 2 K (EUR 1.5 K) or 5 % of annual income for net worth less than USD 100K(EUR 75 K) per year; 10 % of annual income for net worth more than USD 100K(EUR 75 K) per year	
AU	AUD 5 Million (EUR 3.5 Million) per year	No	AUD 2.5 K (EUR 1.8 K) per issuer; AUD 10 K (EUR 7 K) in total per year	Corporations and Market Advisory Committee legal regulation
JP	JPY 100 Million (EUR 730 K) per campaign	No	JPY 500K (EUR 3.7 K) per investor	Under new proposed regulation, will come into effect in May 2015
SG	SGD 5 Million (EUR 3 Million) in a year	No	No	Singaporean Securities and Futures Act
KR	USD 500 K per year	No	USD 10 K per issuer for start-up; USD 10 K per issuer for Individual issuer	Capital Market Act Start-up Companies Support Act

Source: European Commission, 2014

In the USA, in 2015, the Title IV rules/Regulation A+ will allow for the first time non-accredited investors to invest in ECFs. In Regulation A+, there are two tiers of fund raisings and by implication two tiers of company issuers:

- Tier 1 allows companies to fund raise up to $20 million from both accredited and non-accredited investors. Tier I will not have state pre-emption (as under Title II 506(c)) offerings. While subject to formal review by state regulators, Tier I companies will not be required to perform formal audits and annual reporting as required from Tier II offerings.

- Companies fund raising under this latter Tier II category can raise up to $50 million. While the fund raising does not need to be registered in every state (a pre-emption on 'Blue Skies Laws'), offerings will require audited accounts and annual reporting requirements.

Accredited investors are defined as individuals who earn over $200,000 per year or have a net worth of over $1 million, or entities with over $5 million in assets. Under Tier I there is no restriction on individual investor limits. However, in Tier II, non-accredited investors are restricted to investing in ECF a maximum of 10% of the greater of their (self-reported) income or net worth per year.

Security regulators in December 2012 found 8,800 domains with crowdfunding in their name of which 6,800 had materialised after the JOBS Act was signed into law. Crowdfunding intermediaries can charge a commission to their investment seeking retail clients but they cannot offer investment advice. They can set criteria for the transactions their portal will list but they must allow every company that meets these standards to sign up if they so wish.

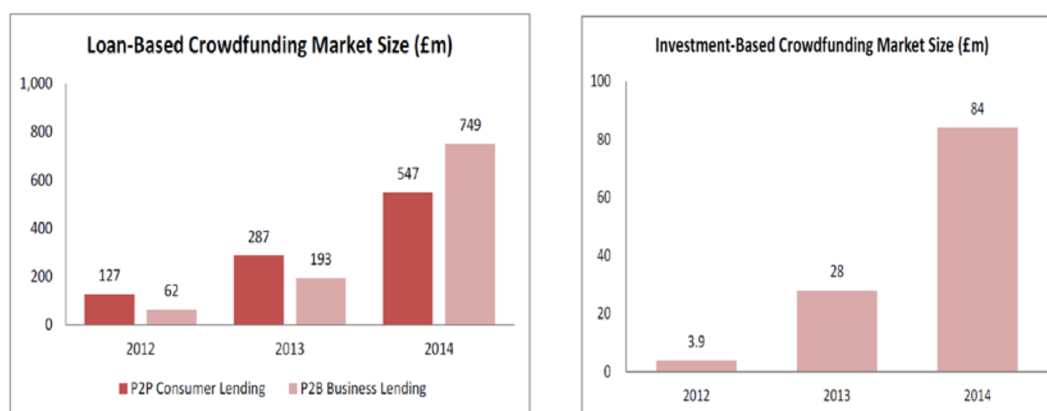
This legislative process is facilitating an internet-mediated equity investment market that will develop both in parallel with and alongside existing VC and BA infrastructures. Similar with current European efforts, while the USA remains the largest market for crowdfunding in all its variants at the present time, it is too early to say exactly how this rapidly developing market will react to current and recent legislation, and particularly the additional freedom of access to retail investors not classified as high net worth or as sophisticated investors. It is also too early to say at which stage of a company's lifecycle or which sectors will benefit most from ECF. Several observers have noted that CF

generically is significantly influenced by emotion and empathetic reaction from investors strongly linked to new social networking practices[27]. Whether such criteria will discriminate, for example, against supporting longer term and more technically complex projects, remains to be seen.

2) The United Kingdom[28]

The UK has the largest and most developed crowdfunding environment in Europe and is currently[29] second only to the USA in terms of the rapid evolution of this emergent industry. The annual growth in loan crowdfunding grew almost three times to nearly £1.3 billion in 2014. ECF demonstrated the same level of growth moving from £28 million to £84 million in the same period[30]. Regulation in the UK falls under the aegis of the Financial Conduct Authority. However, the FCA's responsibilities for regulating are limited only to loan-based[31] and investment-based crowdfunding activities. The UK regime is essentially restrictive and requires that a financial promotion to the public should be approved by a licensed authority. Similar to the USA, control is reduced for platforms that promote exclusively to professionally advised clients, high net worth individuals or self-certified professional investors.

Fig. 5 Profit-related Crowdfunding in the UK 2012-2-14



Source: NESTA, 2014

The average amount raised through ECFs in the UK in 2014 was £199,095. Almost 95% of funded deals were eligible for the Enterprise Investment Scheme (EIS) potentially reducing the net investment cost to eligible tax payers by 50%. According to the NESTA 2014 study, 38% of their respondents classified themselves as sophisticated or HNW investors. The average portfolio size for these investors was £8,000. For the remaining 65% of retail investors, their average portfolio was less than £4,000. The FCA noted that by April 2014 there were 14 portals authorised to conduct ECF, 10 sites in

[27] Agrawal et al, 2011; Belleflamme et al, 2013

[28] I am indebted to Sandy Finlayson, David Grahame, Nelson Gray for their expertise and wise counsel in alternative financing.

[29] Massolution 2015 notes the very rapid rise in Asia of for-profit crowdfunding (that is, equity and loan CF).

[30] NESTA, 2014

[31] On 1 April 2014 regulation of the consumer credit market transferred to the FCA including the regulation of loan-based crowdfunding platforms.

the process of application and a further 11 firms that act as appointed representatives and conduct regulated activities in ECF.[32]

In 2014, the FCA introduced new consumer protection rules for the sale of what was now to be collectively termed 'non-readily realised securities'. The rules came into force for all ECF firms on 1 October 2014. These marketing rules on the direct promotion of securities to the public restricted retail communications by ECF platforms to:

- Those who take regulated advice
- Those who qualify as HNW or sophisticated investors
- Those who confirm that they will invest less than 10% of their net assets in this type of security

ECF firms are required to check whether customers understand the risk if they do not take regulated advice. Most sites apply a self-certification process via their on-line portal which requires new applicants to the site to undertake a short questionnaire on the basis of which the person completing the survey may be deemed an eligible investor under the above criteria. The FCA will conduct a post-implementation review of the impact of the new rules in 2016.

In its February 2015 review, the FCA also noted that in its supervisory role it investigated the practices and communications of ECF sites. It expressed concerns with "most of the websites" in the review particularly with regard to: a lack of balance as to benefits and risks; insufficient, omitted or 'cherry-picking' of information; and the downplaying of important information especially on the risks of an investment. The CFA approached all the ECF providers who quickly amended their communications in order to meet the CFA's requirements of being fair, clear and not misleading. This regulatory watchdog role is likely to gain in importance as regional, national and international ECF and loan CF activities increase in size and frequency.

3) Other European Examples

a) Belgium[33]

Recent amendments in Belgium have included exemptions to CF sites issuing certain investment instruments under the public offering. For ECF sites, exemption is achieved if the fund raising is <€300,000 and includes a cap of €1,000 per investor. Belgian CF platforms operating under these ceilings do not need to test the experience, knowledge or expertise of their retail investor clients. ECF platforms would like to see this cap raised to €5,000 to encourage activity. The Belgian Federal High Council for Entrepreneurs and SMEs argues, as an interest group, for the complete removal of this cap. Government is currently looking at the logic of a 'light' investment services regulation including the introduction of appropriateness tests for retail investors in line with French regulation. At the same time, the government authorities are currently approving tax incentives for ECF. These include capital investments up to €7,500 via licensed platforms leading to a reduction in personal income tax for investors. The tax shelter proposed includes a reduction of 45% in personal income tax for new shares in an EU defined micro-firm SME and, secondly, a tax reduction of 30% on new shares to be issued by newly-formed SMEs if held for four years.

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[32] FCA, February 2015

[33] I am indebted to Xavier Walthoff-Borm and Professor Sophie Manigart for their guidance on Belgian activity.

b) Germany

The German government adopted the Small Investor Protection Act (SIPA) on 23 April 2015. For the first time, Germany now has specific legislation on the regulation of the German CF market. Before this initiative, ECF was subsumed within legislation governing banking, capital markets and trade/consumer trading. As in several other markets, the proposed legislation has engendered a debate among various interest groups including government policy makers and the academic community. At present, there are approximately 80 CF sites in Germany operating across the full spectrum of activities including real estate and social investing.[34] Excluding real estate and film financing, some 174 financing deals had been accomplished in Germany with a cumulative volume of approximately €41 million since its 2011 start.

German practice and the new Investment Act are closely following the precedent set by the JOBS Act given that the new German legislation establishes an exemption from the prospectus requirement. The conditions for exemption include[35]:

- The offering must be of investments within the meaning of the Investment Act as amended by the SIPA. That is, of profit-participating loans, subordinated loans or other similar financing forms and investments which are subject to a prospectus requirement for the first time because of the revisions in the SIPA.

- The investment must be offered exclusively by means of an investment consulting or investment brokerage via an internet platform.

- The ECF platform must make a legal obligation to monitor the agreed subscription limit imposed by the Act on ECF investors of a *single issuer limit* of :
  - €10,000 maximum in an issuer provided the investor has freely available assets of €100,000.
  - For investors not having available assets of €100,000 he/she can invest up to twice the investor's monthly net income but constrained to a limit of €10,000.
  - In all other cases, and particularly if the investor does not provide a statement of his/her assets and income, the investment cap is €1,000.

- Importantly, the investment limit is regulated by law to the amount that the investor can invest in a single issuer. It does not make any comment on the amount that the investor may invest in the entire CF market.

- Further, the legislation does not define or discriminate between types of investor and the limits apply only to investors who are not "corporate entities".

Klohn et al (2015) note that apart from observing the limits imposed on the investors, the CF portals remain almost entirely unregulated. The authors also note the potential for confusion in distinguishing the status in CF of profit participating loans from the (popular) German 'silent partnership'

[34] Klohn, Hornuf and Schilling, 2015

[35] Ibid, 2015

arrangement[36] which has extra investor protection and knowledge access rights via the German Commercial Code. These instruments are treated as a brokerage activity and trading CF platforms do not require a license.

c) Finland

The Finnish Ministry of Finance has recently circulated a draft for a Crowdfunding Act, that is, investment and business lending activities only; the consultation period ended on 12 June 2015 and the feedback is currently being appraised. In 2014, the Finnish Financial Supervisory Authority ruled that ECF is an investment service for which the provider must be authorised according to the Investment Services Act when the service includes the sale of financial instruments to the public. The activity may require authorisation and other regulations concerning investment activity need to be taken into account including the obligation to draw up a prospectus under the Securities Markets Act and any relevant disclosures relating to the offer of securities.

The current draft regulation includes raising the issuing threshold to €3.5 million and which currently stands at €1.5 million. The proposed legislation is also looking at how Finnish platforms can be more simply regulated under Markets in Financial Instruments Directive (MiFiD) I article 3 while conforming to the investor protection and disclosure aims of this European legislation. For example, the draft also looks at how non-transferable securities such as silent partnerships and promissory notes (mainly used by loan CF platforms) which are non-transferable can be used in the Finnish context without the platform requiring a full MiFiD license.

Given the current period of consultation and likely change, comments about future regulation concerning retail investors has to be no more than speculation. However, in communication with Finnish policy makers[37], the following points were made:

- The sophisticated/unsophisticated classification may well feature in future legislation.
- The classification between High Net Worth investors and other parties is not currently in the draft legislation.
- Similarly, professionally advised retail investors are also not currently in the proposed legislation.
- There are currently no controls (caps) put on the individual retail investor regarding either a fixed limit or a maximum percentage of net income or assets. Concern has been expressed as to how such caps are efficiently and cost effectively policed.

d) France

France had about €66 million invested in CF in 2014 with more than 60 platforms administering 55,000 projects. The importance of France as a source of CF finance is likely to grow given a clear commitment from the French President to promote all forms of CF. On 30 May 2014, France adopted

[36] Silent partnerships are economically similar to equity but legally meet the definition of a contractual instrument and not a security or equity instrument under company law.

[37] I am indebted to the detailed information and very helpful comments provided by Mr Aki Kallio of the Ministry of Finance, Helsinki.

new legislation (Ordinance n2014-559) enabling an exception to securities public offering rules and banking monopolies. It created two specific regulatory statuses for CF platforms:

- Conseil en investissement participative (crowdfunding investment advisers - CIP)
- Intermediaries en financement participative (crowdfunding intermediaries – IFP)

The first status allows ECF investment up to €1 million per company (previously €100,000) and gives an exemption from MiFiD. The second status allows loan crowdfunding projects beyond €1 million, and the investment can be promoted to investors across Europe using the MiFiD Passport system. The offering by the CIP of equity via an ECF platform is not construed as a public offering, and therefore not subject to a prospectus. This is on condition that the sum being raised is less than €1 million over a 12 month period. CIPs cannot receive funds from investors (other than platform fees) and are not authorised to receive securities from issuing companies. The limit on investors is <€1,000 per project but this only relates to loans and the IFP status. The French government believes that this limited and light regulation will enable France to become a European centre of CF activity in both equity and loan provisions to entrepreneurial businesses. However, the regulation also seeks to encourage disclosure given a recognition that most retail investors are likely to be unsophisticated.

e) European Union Legislation in Crowdfunding

It is impracticable to detail European legislation in this submission. However, we make reference to two recent and comprehensive reports on crowdfunding from i) the European Securities and Markets Authority (ESMA 2014) and ii) DG Communications Networks, Content and Technology (2014). What is clear from these reports is that the creation and functioning of a pan-European Crowdfunding legal and regulatory environment will be an extremely challenging, complex and time consuming task given the large number of national and European legislative rulings that will need to be revised, agreed and implemented across the full spectrum of financial services from money laundering to consumer protection. Positively, some European legislation already offers several elements of a workable framework; for example, the Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Directive (MiFiD) which have already been subject to extensive refinements by both national governmental and industry interests.

Nonetheless, the nascent status of the ECF industry, and its rapid growth and evolution would suggest that the regulatory changes need to be light and experimental while this emergent and volatile stage of industry development exists. However, while profit-related CF does not currently represent a systemic risk to financial markets, there will likely remain a need to review its potential impact over time.

7. Regulatory Constraints on ECF Investor Actions

As Table 1 and the accompanying text describe, governments have placed a number of restrictions on both platforms and retail investors in order to ensure that the general public, that is, retail investors – excluding professional, sophisticated and high net worth individuals – are protected from undertaking such volumes of excessively risky investments that could imperil their livelihoods. The balancing act that all regulators are seeking to achieve is a level of protection that is meaningful while not excessively hobbling the crowdfunding platforms in their raising of new funds for worthwhile and growing enterprises. Essentially, both parties are asked to moderate their actions in the light of self-reported information. Retail investors are asked to self-certify their discretionary income, wealth and/or their status as a sophisticated investor. Investors who wish to register with ECF websites are also frequently asked to undertake a questionnaire which will allow the platform to make a judgement on whether or not the potential investors should be treated as sophisticated investors. In both cases, the onus on reporting accurately is primarily the responsibility of the retail applicant. As part of a robust regulatory structure, this is highly problematic. The details of quantifying income and assets are complicated, especially for those who might need most protection. Likewise, the short questionnaires requiring completion prior to being treated as a sophisticated investor which are available on a number of ECF platforms, do little to test the analytical or judgmental skills of the applicant. For the naïve investor anxious to seize 'a part of the action', self-certification remains in danger of being on occasion little more than an online box ticking exercise. As ever, caveat emptor still rules.

This might not be a problem if, as Nelson (2014) suggests, the majority of crowdfunding investors will remain one-off exercises by the family and friends of the would-be entrepreneur. But the potential that several other credible observers see in CF would suggest that this modest impact might not remain the case. In the short-run at least, crowdfunding platforms are likely to know very little about the majority of their potential investors and vice versa. This is what we have termed the Double Information Asymmetry problem. As ECF expands, this knowledge disparity between issuers and investors is likely to become greater unless credible, and legally formalised, investor certification becomes a strict condition of engagement with the platform as an investor. Accordingly, beyond the earliest stages of a new industry, self-reported certification is not likely to offer sufficient investor protection. Similarly, there will likely be pressures to formalise the amount, type and quality of the information that potential firm applications provide to platforms and investors. Any well publicised incident where 'innocent' retail investors lose money in an ECF mediated deal either because of incompetence or corruption is likely to hasten public and government calls for greater regulation.

8. A 'Modest Proposal'

It is more likely that the ECF platform itself is in a better position of regulating or rationing the amount that individual investors are allowed to invest in a new issue. It is a relatively simple matter to cap the maximum individual investment for either a single fund raising or for a period across the total offerings of the ECF platform. Several country CF legislations impose such a cap (See Table 1).

A default position of the ability only to receive 'modest' individual commitments until such time as the investor was satisfactorily appraised by the platform would offer protection but at a greater initial onus (and cost) on the platform rather than the retail investor. We would suggest that the maximum retail investment should be around $5,000-$10,000 per investor per year regardless of the number of platforms or firms invested in. If both the investor and platform wished to increase the investment per named individual, then an independent certification of the status of the investor (that is, professionally advised, sophisticated, and/or high net worth) would have to be made. At or before that juncture, further generalised agreements as to industry investment limits and conditions would sensibly have to be made by regulators in consultation with all interested parties. This simple and pragmatic two-stage arrangement, is proposed at this stage of the industry's evolution in order to give some clarity and protection. It is believed that the regulation imposed should be relatively light until the ECF industry's growth and characteristics have evolved and are more easily understood. The ECF regime should be open to all companies and businesses wishing to raise funding, including small proprietary companies.

This simple two-stage arrangement would not protect the retail investor who was committed to joining and investing in several ECFs regardless of his/her competencies or wealth, and unless platforms could share investor identities. But, a regulatory system has to determine at what stage the retail investor must accept the consequences (good or bad) of his/her own actions. Policy makers would do well to study the evolution of the BA and VC industries in the gradual refinement and professionalization of the investment process and its governance.

9. And the near Future…?[38]

Over time, it is likely that ECF platforms will wish to professionalise in the same manner as BA and VC firms. This will be important to attract quality deal flow in a competitive environment. In these circumstances, the attraction of a large number of amateur investors will rapidly decline as credibility is sought with ECFs with established and well-financed professional co-investors. That minority of CF investors who will wish to participate in this transition are likely to wish to be seen – and act – as professional and sophisticated investors. In reality, this condition of investor selection will be imposed on ECF platforms by their co-investors. The realm of the small retail investor will regroup primarily around donation and reward-based funding categories.

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[38] It should be noted that this submission has focused exclusively on ECF. It has been observed that loan-based CF (aka peer to peer lending or P2P) is currently a considerably larger activity in profit-related CF than equity trading. Several observers see P2P as a more valuable innovation for enterprise finance than ECF. This author is rather sympathetic to this viewpoint.

In these circumstances, there is likely to be opportunity for platforms that can either assess ECF (as well as P2P) opportunities on behalf of interested but inexperienced investors. There is also likely to be opportunities for putting high net worth ECF investors in co-investment syndicates with BAs (see for example the SyndicateRoom model). In each case, the retail ECF investor is escorted by more experienced early-stage investors in traversing a steep learning curve. Such ‘investor-readiness’ activities, recommended by Nelson (2014) may also help attenuate the very likely over-pricing, which several BA industry participants believe will invariably occur, when optimism and inexperience meet in the disruptive industry that profit-related crowdfunding most certainly is.

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