

Chapter 19

Legal Aspects and Regulation in Crowdfunding: Comparisons across Countries

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ABSTRACT

Crowdfunding started with the donation-based and reward-based models, but soon its disruptive capacity to innovate the traditional approach to finance made it evolve into an alternative finance instrument, suitable to fund new business. Peer to peer lending and equity crowdfunding are investment instrument that can truly sustain the growth of businesses and generate profits. As any investment instrument, lending and equity crowdfunding are heavily regulated in order to protect investors and maintain a proper trust in the system. This chapter will go through the American and European main regulatory principles, offering a picture of the overall approach to this innovative and disruptive financing tool.

REGULATION

The crowd economy comprises a number of different forces, trends, and dynamics originating from the crowd. Many of them are connected with money; this is why a large part of the crowd economy is identified as crowdfunding. Indeed, crowdfunding is a very broad concept that includes several very different operations, each having its own logic and metrics.

“NON-INVESTMENT” CROWDFUNDING

Donation

Thanks to the explosion of social networks and the wide use of the web, fundraising easily moved from offline events and efforts to online crowdfunding platforms.

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Donation crowdfunding was the first crowdfunding model based on the web, and it is being used not only by charities and nonprofits to raise funds, but also by individuals to ask for help for their personal projects (business, entertainment, study, or any other purpose without limitation).

In donation crowdfunding, the crowd donates money to support a project with no expectation of financial return. In some cases, the crowd is offered some kind of rewards or incentives tied to their level of contribution, which have no significant intrinsic monetary value. In most jurisdictions, these perks do not influence the model, which remains a donation, and there is only a moral obligation to provide the promised reward.

However, in some civil law jurisdictions (originating with the “Napoleonic Code”), the eventual breach of promise might have consequences, like the obligation to give back the grant. In fact, a contractual obligation binds the donor and the project owner, simply because of the donation.

Reward

Donation-based crowdfunding quickly evolved to a model in which the value of the reward is comparable or substantially equivalent to the value of the donation: the project owner offers to produce and deliver an object to the donor, provided that a minimum number of orders are placed and therefore break-even is reached.

This model perfectly answers the need of financial coverage for those who create innovative products outside a well-established company: they can test the market without committing the upfront marketing, production, and distribution costs required to fully commercialize a new product.

Moreover, the customer validation arising from a successful pre-sale campaign grants project owners a valuable tool when negotiating with investors. Several studies have shown that a successful reward-based crowdfunding campaign influences the proclivity of professional investors to sustain the project with an equity investment. A well-known example is Pebble, a smart watch that interacts with every kind of smartphone. Pebble’s business model didn’t attract investors, so its founders launched a reward-based campaign on Kickstarter. The campaign was a real success—it’s still in the top 10 overall—and Pebble pre-sold enough smart watches to raise \$10 million. This scenario totally changed the approach of venture capital firms, and after a few months, Charles River Venture invested \$15 million in equity. One year later, a second crowdfunding round brought in \$20 million more. The Pebble case demonstrates the strength of the interaction between crowd validation and venture capital analysis and strategy.

In most jurisdictions, when the perk offered has a value comparable or close to the value of the financial contribution, reward-based crowdfunding is nothing but a sale or, better, a kind of e-commerce. As a consequence, consumer protection rules are applicable to each subscription, as well as regulations concerning guarantees, delivery, and breach of contract. From a tax point of view, some governments have made it clear that this is not a donation and therefore VAT and similar local taxes are applicable to these kinds of sale, and the European Commission is considering the possibility of uniform regulation.

Royalty

Using a different approach, a project owner might offer supporters a part of the profits that the project is going to generate. Without sharing in the ownership of the project, a funder could still share in part of the expected financial returns. This third and most complicated type of “non-investment” crowdfunding is the royalty-based model: funders are offered a return of a financial nature, calculated as a share of the

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