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# Revolution of securities law in the Internet Age: A review on equity crowd-funding

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## A B S T R A C T

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Along with the development and prevalence of Internet technology, a new financing model – equity crowd-funding – has been rising rapidly in recent years. Against this background, it becomes an important global topic in the field of securities law about how to balance both policy agendas of investor protection and capital formation. By referring to the JOBS Act in the US as a typical example, it is suggested in this article that modern securities law is making an active response to the demand of equity crowd-funding development. Besides expanding the application space of small issues exemption rules, securities law is also going beyond the traditional conceptual division between public and private offerings by introducing a brand-new system of equity crowd-funding exemption.

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## 1. Introduction

The Internet is changing not only our way of life, but also the way how the law develops. The rise of a new field of law – cyber law or Internet law<sup>1</sup> – can be seen as a good example of such an influence. And more importantly, the appearance of the Internet inspires us to review the functioning boundary of all relevant legal systems, and a series of brand-new legal issues and problems. These include but are not limited to digital signatures, cyber-crime, remedies to online invasion of privacy, constitutional

protection on freedom of online speech, etc. They lead us, however, to consider how the law may adjust itself to the Internet Age. In this article, the authors intend to refer to the prevalence of an innovative financial transaction model – equity crowd-funding – as an example to show the evolutionary influence of the Internet on the legal system of financial markets.<sup>2</sup>

As defined by the International Organization of Securities Commissions (IOSCO), crowd-funding refers to:

*An umbrella term describing the use of small amounts of money, obtained from a large number of individuals or organisations, to*

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<sup>1</sup> E.g. see Chris Reed, *Making Laws for Cyberspace* (Oxford University Press, 2012); Brian Craig, *Cyberlaw: The Law of the Internet and Information Technology* (Prentice Hall, 2012); Patricia Bellia, Paul Berman & Brett Frischmann, *Cyberlaw: Problems of Policy and Jurisprudence in the Information Age*, 4th ed. (West Academic Publishing, 2010).

<sup>2</sup> For some detailed review on the influence of Internet on financial law, please see Matthew Kien-Meng Ly, “Coining Bitcoin’s ‘Legal-Bits’: Examining the Regulatory Framework for Bitcoin and Virtual Currencies”, *Harvard Journal of Law & Technology*, Vol. 27, No. 2, 2014; Gönenc Gürkaynak and İlay Yılmaz, “Regulating Payment Services and Electronic Money: A comparative regulatory approach with a specific focus on Turkish legislation”, *Computer Law & Security Review* 31 (2015); Daniel C. Rowe, “Periodic Reporting in a Continuous World: The Correlating Evolution of Technology and Financial Reporting”, 13 *Duke Law & Technology Review* 248 (2015); Kevin C. Taylor, *FinTech Law: A Guide to Technology Law in the Financial Services Industry* (Bloomberg BNA, 2014).

fund a project, a business or personal loan, and other needs through an online web-based platform.<sup>3</sup>

In a broad sense, the term “crowd-funding” may embrace four types of fundraising acts: social lending/donation crowd-funding, reward crowd-funding, peer-to-peer lending and equity crowd-funding.<sup>4</sup> However, from a perspective of application of law, only the last two categories, i.e. peer-to-peer lending and equity crowd-funding, are caught by the radar of financial law (particularly securities law) around the world.<sup>5</sup> Furthermore, in some countries like China, since peer-to-peer lending has in practice “mutated” into shadow banking and then became an indirect financing model, it would “escape” the range of securities law which simply regulates direct financing.<sup>6</sup> Thus, this paper only focuses on equity crowd-funding, due to its clear securities law implication.

Since the first platform of equity crowd-funding went online in 2009,<sup>7</sup> we witness such new financing models springing up vigorously in almost all major countries around the world. As the leading country with the most developed financial market and information technology, the US has an industry of equity crowd-funding worth billion dollars, far exceeding the size of other countries.<sup>8</sup> In addition, China is certainly a “rising star” attracting attention in the global crowd-funding market. By the

end of 2015, there had been 121 equity crowd-funding platforms in China. According to a report of the World Bank, it is predicted that in 2025 this industry in China will reach a size of \$50 billion dollars.<sup>9</sup>

Therefore, in this article, by reviewing the rise of Internet-based equity crowd-funding, we will discuss the revolutionary impact of modern information technology to the system of securities law. Following the introduction in Section 1, this article now divides into four additional parts: Section 2 explains two primary objectives of securities law, i.e. protection of investors and facilitation of financing. Section 3 outlines the necessity of establishing the system of small issues exemption and expanding its application against the background of the Digital Age. Section 4 argues that regulation needs to go beyond the traditional division in the field of securities law between public and private offering, offering new theoretical and practical perspectives to support the introduction of a new category of “crowd-funding exemption”.

## 2. Two primary objectives of securities law: investor protection and facilitation of financing

### 2.1. Investor protection

It is widely accepted that the sustainable development of capital markets in one nation is to a large extent determined by the strength of investor protection offered by its legal system.<sup>10</sup> And when we talk about such protection, the first thing flashing into our mind is normally the securities law. Before the 1930s, in all jurisdictions, there did not exist any comprehensive legislation and regulatory body to keep an eye on the operation of the stock market, and investors were supposed to defend their interests through traditional litigation strategies – bringing a law suit before the courts on the basis of contract law or tort law. However, after the Securities Act of 1933 and Securities Exchange Act of 1934 came out in the US, the conception of a modern securities law started to take root on a global scale. The appearance of securities law means that the model of “private enforcement” – through court proceedings – is no longer the only way investors may seek to protect themselves. The model of “public enforcement” – through the authority of administrative or regulatory bodies – may open new forms of safeguard.<sup>11</sup> Since then, the securities issue and transactional activity are never purely “free trading” in the sense of *caveat emptor*, but facing more and more requirements or limitations from rules in the domain of public law. Among all these rules, the most typical example is the obligation that securities issuers shall normally register their issue with competent authorities (e.g.

<sup>3</sup> Eleanor Kirby and Shane Worner, “Crowd-funding: An Infant Industry Growing Fast”, Staff Working Paper of the IOSCO Research Department, Staff Working Paper: [SWP3/2014], p.8.

<sup>4</sup> Yannis Pierrakis and Liam Collins, “Banking on Each Other: Peer-to-Peer Lending to Business: Evidence from Funding Circle” (Project Report) London, UK: NESTA, 2013, p. 43.

<sup>5</sup> See *Ibid.*, p.11.

<sup>6</sup> In theory, peer-to-peer lending shall be regarded as a typical kind of direct financing as the person who intends to raise capital is attracting money directly from the public investors without reliance on a credit institution (e.g. a bank). So, in the US, the SEC requires those peer-to-peer lending platform to put their business under the regulatory system of registration of securities issuance. See Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 *UC Davis Law Review* 445 (2011). However, in China, many peer-to-peer lending platforms accept money saving from the public for the purpose of granting loans to borrowers, or provide guarantee to the investors for repayment through itself or its related companies. In other words, in this circumstances, those platform is no longer promoting direct financing, but actually get involved in credit service similar to the one provided by commercial banks. For the review on Chinese peer-to-peer lending market practice, see Bing Peng, “Review on P2P Online Lending Regulation Models” (P2P Wangdai Jianguan Moshi Yanjiu), *Financial Law Forum* [China], Vol. 2, 2014; Yuan Zhao, “Review on Legal Issues of P2P Online Lending from the Perspective of Direct Financing”, *SJTU Law Review* [China], Vol. 4, 2014.

<sup>7</sup> See “Venture Capital 2.0: Grow VC Launches Private Beta (We Have Invites)”, available at <http://www.arcticstartup.com/article/venture-capital-2-0-grow-vc-launches-private-beta-we-have-invites/>.

<sup>8</sup> In 2013, the size of investment of equity crowd-funding in the US has reached 3 billion dollars. See Deloitte, “Let’s Get Together: Crowdfunding Portals Bring in the Bucks”, 2013, available at [http://www.deloitte.com/assets/DcomShared%20Assets/Documents/TMT%20Predictions%202013%20PDFs/dttl\\_TMT\\_Predictions2013\\_LetsGetTogeaether.pdf](http://www.deloitte.com/assets/DcomShared%20Assets/Documents/TMT%20Predictions%202013%20PDFs/dttl_TMT_Predictions2013_LetsGetTogeaether.pdf). It is expected that the enactment of JOBS act would further stimulate the development of this new industry.

<sup>9</sup> See the World Bank, “Crowdfunding’s Potential for the Developing World”, 2013, available at [http://www.infodev.org/infodev-files/infodev\\_crowdfunding\\_study\\_0.pdf](http://www.infodev.org/infodev-files/infodev_crowdfunding_study_0.pdf).

<sup>10</sup> Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny, “Law and Finance”, *Journal of Political Economy*, Vol. 106, No. 6, 1998.

<sup>11</sup> As for the comparison between private and public enforcement, see William Landes & Richard Posner, “The Private Enforcement of Law”, 4 *Journal of Legal Studies* 1, 1975; Mitchell Polinsky, “Private versus Public Enforcement of Fines”, 9 *Journal of Legal Studies* 105, 1980.

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