I. Status Quo of Equity Crowdfunding in China

The development of equity crowdfunding in China presents a mixed picture. On one hand, the securities laws and criminal code hindered scope of equity crowdfunding; on the other hand, the small entrepreneurs desperately demand financial support. Because there is a dilemma that a incompatible conflict between the tight legal regulation and the big demand on the market, there are many equity crowdfunding portals are operating illegally.

During 2011, crowdfunding has sprung up in China. At the very beginning, there are only donation and reward crowdfunding. People put their money on these crowdfunding portals just for fun. Both of them meet no legal obstacles in China. However, Since 2012, equity crowdfunding emerged as an investment vehicle, the legal issues comes out. Here are three aspects of the legal issues involved in equity crowdfunding:

A. Public offering equity crowdfunding is defined as illegal capital-raising

Equity crowdfunding is regarded as securities offerings. Securities offerings, especially public offerings, are strictly regulated and supervised in China. Not only securities law regulates it, but also criminal law, contract law and trust law regulate and interpret it.

According to Securities Law of China, Article 10 Clause 1: A public issuance of securities shall meet the requirements of the relevant laws and administrative regulations, and shall be reported to the securities regulatory authority under the State Council or any department as authorized by the State Council for examination and approval according to law. Without any examination and approval according to law, no entity or individual may make a public issuance of any securities.” Article 10 is the general provision of the public offering securities, it clarifies that the issuance of public offering securities must follow the merit regulation. Article 13 of Securities Law of China shows the requirements an initial public offering of stocks of a company shall
According to this clause, China Securities Regulatory Commission (hereinafter “CSRC”) promulgate the Measures for the Administration of Initial Public Offering and Listing of Stocks, the Measures for the Administration of the Initial Public Offerings and Listing of Stocks on ChiNext, and the Measures for the Supervision and Administration of Unlisted Public Companies etc. these regulations made detailed requirements for public offering. If the issuer wants to exempt from this complicated and uncertain approvals process, or the issuer can not meet the requirements for public offering, he can only go through the private offering.

Article 10 Clause 2 of Securities Law of China, which is the definition of public offering, lists three requirements: 1) Making a public issuance of securities towards unspecified objects; (2) Making a public issuance of securities to accumulatively more than 200 specified objects; (3) Making a public issuance as prescribed by any law or administrative regulation. According to this definition, if the issuer wants to avoid the approval process, there is only one way: (1) make a public issuance of securities towards specified objects; (2) accumulatively no more than 200 specified objects; and (3) after the issuance, the shareholders should be accumulatively no more than 200 objects.

The Securities Law of China adopts the approval process instead of registration process, which aims to achieve two goals. One is that confine the scope of information disclosure; the other one is that run screen on the issuers so that to exclude the bad issuers. Although the starting point is good, the approval process indeed is complicated and high-cost, which blocks the small and start-up enterprises from raising capital from the stock market. Thus, many countries established the exemption rule for small enterprises. The idea of establishing exemption system is based on cost-benefit considerations: for the small enterprises, the capital raised from the public market is small scale, therefore ask them to pay expansive money to get approval is unreasonable. Moreover, because the capital is small scale and risks little to the society, the exempt system can simplify the information disclosure requirements and lower the cost of the

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1 Article 13 of Securities Law of China: An initial public offer (IPO) of stocks of a company shall meet the following requirements: (1) having a complete and well-operated organization; (2) having the capability of making profits continuously and a sound financial status; (3) having no false record in its financial statements over the latest 3 years and having no other major irregularity; and 4) Meeting any other requirements as prescribed by the securities regulatory authority under the State Council which have been approved by the State Council. A listed company that makes any initial non-public offer of stocks shall meet the requirements as prescribed by the securities regulatory authority under the State Council, which have been approved by the State Council and shall be reported to the securities regulatory authority under the State Council for examination and approval.
issuance.

The relaxed regulatory of small amount issuance brought more fraud problems. So how to balance between the efficiency and the protection of financial consumers is also a big question.

B. Private Offering is the only way to develop equity crowdfunding in China.

On the condition that there is no exempt clause under the Securities Law of China, small and start-up enterprises, which cannot afford the expensive public offering approach, the only way they could choose is the private offering approach. If strictly comply with the current laws and regulations, the private offering is that making a issuance of securities towards sophisticated objects and the investors should be accumulatively within 200.

The definition of sophisticated objects is ambiguous under the Securities Law of China, which leaves much debate in academic field. Theoretically, sophisticated objects refer to those investors who do not need special protection under law and regulations and who could protect themselves. Generally, sophisticated objects includes: (1) who remains special relationship with the issuer so that they are able to protect himself; (2) who has plentiful investment experience so that they could identify the risk and protect himself; (3) who is very wealthy so that they could protect himself. Practically, many countries adopt the third standard which is the wealth standards to define sophisticated objects. Such selection is because it is easy to standardize. On contrast, the special relationship standard and the investment experience standard are very subjective, it can only be used in the specified case, which is hard for the issuer and the regulator to identify who is sophisticated and who is not.

Therefore, to avoid illegal, the equity crowdfunding can only be private offering under the current exist law system. The two conditions are: (1) the investors must be sophisticated objects; (2) accumulatively within 200. In practical field, the number of investors is easy to control. As discussed above, it is hard to hold the standard of sophisticated objects because there is no clear and formal interpretation of it. Now, we could only conjecture. Another problem is that in China, there is no perfect property declaration system, neither the personal credit system, so that it is hard to determine investor’s wealth status and annual income. Therefore, practically the funding portals always set the minimum investment amount to ensure the investors can meet the wealth standards so that can be called sophisticated investor.
Follow this thinking way, the Securities Association of China (hereinafter SAC) published the Measures for Administration of Private Offering Equity Crowdfunding (for Trial Implementation) Consultation Paper (hereinafter Consultation Paper). In this draft, the SAC clarified that because the Securities Law of China has not been amended, the equity crowdfunding cannot match the public offering approval process, it can only be private offering. Also, SAC clarifies in the Consultation Paper that the sophisticated investors who participate in the equity crowdfunding shall meet one of the following requirements: (1) the sophisticated investors defined under the Interim Measures for the Supervision and Administration of Privately Offered Investment Funds; (2) the minimum amount invested in a single project must be more than ¥1,000,000; (3) pension funds, social welfare funds; (4) an institution whose net assets more than 10 million; (5) a person whose assets is more than 3 million or whose average annual income within recent 3 years is more than 5 hundred thousand. And, such person should acquire expertise knowledge to identify, judge, being able to undertake the investment risk; (6) other investors according to the rules of SAC.

This rule is very controversy, because the rule set up a very high standard for becoming a sophisticated investor. If strictly follow this rule, the funding portal should refresh its clients. On the other hand, the issuers of equity crowdfunding generally are small enterprises, they only have small demand of finance. The scale of one project cannot be huge. So if the minimum amount of investment is 1 million, there can only be a few investors in one project which is no good for risk diversification, therefore it is no good for the protection of investors.

The conclusion is that, under the current existing law, the equity crowdfunding could only go through the private offering approach. But it is also hard to go through. We still need to consider to return to its essence, that is small amount, public offering, openness.

II. The idea of equity crowdfunding exempt rule

Because of the strict legal requirements of public offering, the equity crowdfunding can only be private offering. However, the private offering itself cannot pool the risk, it obeys the equity crowdfunding’s essence. Also small amount and crowdsourcing is the key feature of equity crowdfunding, the private offering cannot show it.

Actually, considering the two features, small amount and crowdsourcing, many countries legislature has established a separate exempt rule for equity crowdfunding.
We can derive the good idea from other countries, and consider set up an equity crowdfunding exempt rule when the Securities Law of China is in the process of revising,

A. The meaning of crowdsourcing

The Securities Law aims to protect the investors and convenient financing channels. The two goals are mutual promotion, also conflicting. From the view of mutual promotion, the good protection of investors will encourage their willing to invest through equity crowdfunding and the small enterprises will be easy to get financed. From the view of conflicting, the protection of investors will raise the small enterprises’ finance cost, when the enterprises find the benefit cannot match the costs, they will give up this finance channel and the investors will lose an opportunity to invest. Therefore, it is a two headed snake, should keep a delicate balance between the protection of investors and the convenience of financing.

The exempt rule is based on benefit-cost analysis. Under the traditional exempt system, the legislator cares about 3 things for the protection of investors: (1) the acquirement of information; (2) fraud; (3) public damage. But the information offering is high-cost, so to balance between the protection of investors and the cost, legislator always simplify the information disclosure requirements to convenient the small enterprise to finance. However, they require all the investors must be sophisticated, have the ability to identify the risk and protect themselves. It is a tradeoff, based on the cost-benefit, both sides compromise a little.

But crowdfunding offers another way to think about it. Crowdfunding is not a brand new concept, it has existed for a long time in human history, that is lottery. Many people like to pay a very small amount of money to buy lottery. In most situations, they cannot be the lucky one and themselves know it, they will lose the money. But why they still buy the lottery in every week? This is because the amount of money is too small and they don't even care about it. But if they are lucky enough to win the prize, it is a huge fortune. Crowdfunding, in essence, has the similar meaning: a crowd of people, everyone invests just a small amount of money in the small enterprises. If the project failed, they don't feel too nervous, and the failure will not influence their lives too much. However, if the project is successful, they will get high profit. Crowdfunding offers a high risk investment opportunity to the public, which is usually offered to those sophisticated rich people. Moreover, the internet technology could lower the cost of
information dissemination, which will decrease the cost of information disclosure. Therefore, crowdfunding opens a door for ordinary person to invest in the high risk area. It is called Financial Democratization.

Because the theory of crowdfunding is different from the traditional exempt theory. It is necessary to set a new equity crowdfunding rule in the Securities Law.

B. The key features of equity crowdfunding exempt

When considering how to design the equity crowdfunding exempt, there are two key features we need pay attention to. One is crowdsourcing and small amount, the other one is open and public communication.

1. crowdsourcing and small amount: adapt to the risk of equity crowdfunding, the exempt rule should set an annual investment quota to limit investors’ investment. There is a problem: in order to avoid trouble with many investors linked, may be limited to the minimum investment amount, thereby limiting the number of investors in the system. China Angel sinks crowdfunding website, investors will adopt a collection of limited partnership, and then on behalf of the co-partners business investment issuer so that the issuer will place only the limited partnership registered as shareholders. This way you can reduce the number of shareholders of the issuer, but brought the principal-agent problem between investors and limited partnerships, and how in the end the pros and cons, but also worthy of further consideration.

After setting up investment limits, how to limit the amount of financing of the issuer and the investor's total investment is also a problem. In theory, it is the equity crowdfunding portal’s responsibility to carry it out. But considering there may be multiple crowdfunding website, issuers and investors are likely to invest in more than one funding portal, information sharing between these crowdfunding portals becomes very important.

2. open and public information communication: because of the web 2.0 era, the exchange of information via the Internet costs significantly reduced, and therefore, each investor is entirely possible to share their information to each other via the internet. The frequent exchange and pooling of information may constitute a "collective wisdom". Therefore, the law should require the crowdfunding site must open forum to promote and encourage investors to share and discuss relevant information in the discussion area.