LEGAL ASPECTS OF CROWDFUNDING

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LLM in Transnational and European Commercial Law, Mediation Arbitration, and Energy Law

2015-2016
Thessaloniki – Greece

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I hereby declare that the work submitted is mine and that where I have made use of another's work, I have attributed the source(s) according to the Regulations set in the Student's Handbook.

January 2017
Thessaloniki - Greece

Abstract

This dissertation was written as part of the LLM in Transnational and European Commercial Law, Mediation, Arbitration and Energy Law, at the International Hellenic University. I was engaged in researching and writing this thesis from September 2016 to January 2017.

This dissertation conducts a study around the crowdfunding focusing on its legal environment. Crowdfunding is a nascent and successful business of raising money through an online platform unlike the traditional sources of financing. Despite the large amounts spent by millions crowdfunding backers worldwide, there is a number of legal concerns that should be taken into consideration before running a crowdfunding campaign or before investing in a crowdfunded project. The aim of this study is to explore the legal gaps, discuss the legal issues that may be emerged and recommend ways that both parties should follow in order to avoid being caught in the toils of the law.

Acknowledgement

I wish to extend my heartfelt appreciation to the following people who have touched my life in various ways:

I would like to thank my supervisor, Dr. Thomas Papadopoulos, for his excellent guidance and support during this process. His mentorship was paramount in providing a well-rounded experience consistent my dissertation goals. I have been very lucky to have a supervisor who cared about my work and who responded to my questions and queries so promptly.

I would like to thank my mentor, Prof.Dr. Athanassios Kaisis, for the patient guidance encouragement and advice he was provided throughout all the period I was studying at the IHU University.

My mother deserves a particular note of thanks as she always stands by me and encourages me never to give up at bad times.

Last but not least my partner Christos and my friends contributed also to my work as they kept me calm and steadfast in pursuing my goals.

Keywords: crowdfunding, legal risks, entrepreneurship

Parthena Maria Malouta
30/01/2017

Preface

Since the economic crisis in 2008, banks have reduced giving loans to businesses, let alone funding start-ups and new entrepreneurs that have no collateral and credit history. The difficulties in financing of Small and Medium Enterprises (SMEs) are various. Many new ventures were let on the shelf due to the lack of efficient capital. Crowdfunding appeared in the financial realm giving a breath to million inventors that struggle to collect money in order to accomplish their business objectives.

In a nutshell, crowfunding nurtures and sustains entrepreneurial activities, boosts economy and forwards new investments. It is an innovative form of finance that initiated in US and recently made the first steps in Europe as well.

Through an explanatory study, author discusses the legal problems that might occur both in crowdfunders and potential investors and proposes solutions to reinforce this financial mechanism.

Contents

A. Introduction

In recent years, a relatively new phenomenon, called "crowdfunding", has attained a significant level of growth globally. Crowdfunding is based on the 'power and wisdom of the crowd'[1] and has been heralded as a revolutionary method of funding ventures as through this entrepreneurs raise capital via Internet from a large group of people around the world in order to convert their ideas into a project or business.[2] It has been characterized as an "engine of growth" as it promotes and nurtures entrepreneurial activities[3]. According to Crowdsourcing.org and the World Bank, crowdfunding will surpass $300 billion in funding transactions by 2025.[4]

The emergence of crowdfunding and its rapid expansion to the market is one of the results of the global financial crisis. During economic downturns such as the crisis that began in 2007-2008, it became even more challenging to find financial resources.[5] Crowdfunding appears as a solution, so as new entrepreneurs and firms to overcome the hurdles of credit crunch.

Turmoil on the financial market as the aftermath of the sub-prime crisis hindered many EU countries in refinancing their debts[6]. In order to achieve this goal, EU and IMF imposed austerity measures to the affected by the crisis countries until the resurgence of their economy. One of these measures was and the cuts in the public spending[7]. The banks became more "chary" of lending money not only to the individuals but also to the big and trustworthy companies. The lack of cash flow created a huge problem in the market. Small and medium sized businesses could not

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[1] James Surowiecki "*The Wisdom of Crowds: Why the Many are Smarter than the Few and How Collective", Wisdom Shapes Business, Economies, Societies and Nations* (2004)1.

[2] Steven Dresner, *Crowdfunding: A guide to Raising capital on the Internet* (2014) 3.

[3] Igor Micic, *Crowdfunding: Overview of the Industry, Regulation and Role of Crowdfunding in the venture startup* (2015) 12.

[4] Moriah Meyskens and Lacy Bird, *Crowdfunding and Value Creation* (2015) 157.

[5] Monica Williams Smith & Kimberly M. Green, *A Class Exercise to Explore Crowdfunding* (2015).

[6] Thomas Müllerleile, Dieter William Joenssen, Andreas Müllerleile, Crisis*, Co- Financing and Crowdfunding: Igniting Regional Development* (2014) 277.

[7] Andrea Pescatori, Dl Leigh, J .Guajardo, *Expansionary Austerity New International Evidence* (2011).

be based on traditional funding such as startup loans, angel investors or venture capital. Banks could not lend money to start–ups who have no collateral, credit history or track record[8] . As a result many new ventures remained unfunded due to the lack of sufficient value that could be pledged to investors because of unsuccessful attempts to find and convince them.[9] All these reasons, led new entrepreneurs to find alternative financial sources.

Crowdfunding creates new jobs and boosts economic recovery giving breath to the new entrepreneurs to start a business and at the same time giving motivations to investors. Abolishing the intermediaries, it brings closer the founder and the investor with only vehicle the internet usage.

Crowdfunding is available only in specific web platforms which provide security of transactions and constitute the basic tool for the campaign. The platforms should be reliable for the potential investors in order to attract more funders. Two of the most famous platforms are Kickstarter and Indiegogo, which seem to have offered huge amounts to entrepreneurs.

The structure of this dissertation is divided in five parts and proceeds as follows. The author at first part, makes an analytical understanding of crowdfunding, reviews the crowdfunding landscape, analyzes the models of crowdfunding and explains the reasons this phenomenon flourishes nowadays. The second part examines the legal environment of crowdfunding in Europe and in US. The third part explores the potential benefits and the hidden legal risks of crowdfunding. The fourth part describes author's opinion concerning legal matters of crowdfunding. Finally, the study concludes with a summary of crowdfunding legal aspects and recommends ways to overcome legal hurdles so as to make the mechanism more effective.

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[8] Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?* (1998) 60-61.

[9] Paul Belleflamme, Thomas Lambert and Armin Schwienbacher, *Crowdfunding: An industrial organization perspective* (2010) 2.

B. Crowdfunding and Its Variants

B.1 Definition of Crowdfunding

Nowadays, an innovative concept with the name "Crowdfunding" has come to the surface as a distinct form of finance, receiving much attention to the financial realm. Crowdfunding is a nascent business of pooling funds via web platforms in support of a cause, a creative entrepreneurial, cultural or social project, "for the provision of financial resources either in form of donation or in exchange for the future product or some form of reward"[10]. It is based on the idea that many interested people could offer small amounts covering the funding needs of a new business idea. Crowdfunding unlocks the power of the of social media[11] and helps entrepreneurs to raise capital from non–accredited investors with reduced formalities and costs.[12] In other words, crowdfunding can be considered as a process where non-profit or for-profit "projects are initiated in a public announcement by organizations or individuals to receive funding, assess the market potential and build customer relationships". [13]

It is being used in a wide array of fields from political fundraising to making movies,[14] ensuring high profits for entrepreneurs. For instance, the "Pebble", the smart-watch that is connected with the mobile phone and displays notifications from the phone, was pledged from a Kickstarter campaign and offered through crowdfunding to his entrepreneur almost $10 million from 70.000 backers.[15]

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[10] Frank Kleeman, G. Günter Voß and Kerstin Reider, *Un(der)paid Innovators: The Commercial Utilization of Consumer Work through Crowdsourcing* (2008) 6.

[11] Kevin Lawton & Dan Marom, *The Crowdfunding Revolution: How to raise venture capital using social media* (2014).

[12] Johana Diane Caytas, *Crowdfunding Venture Capital in Europe* (2016)1.

[13] Thomas Müllerleile, Dieter William Joenssen, *Key success-determinants of crowdfunded projects: an exploratory analysis* (2014).

[14] Jeff Howe, *Crowdsourcing: Why the power of the crowd is driving the future of business* (2008) 253.

[15] Alley Watch, *The Top 25 Crowdfunding Success Stories* (2013) 2.

Crowdfunding was divided in two basic forms: the pre-ordering and profit-sharing. In the first form, the entrepreneur calls consumers to pre-order the product (the most successful crowdfunding platforms, such as Kickstarter and Indiegogo, use this form) in order to raise the needed for his initial campaign capital while in the second solicits backers to provide money in exchange for a share of future profits or equity securities.[16] In both forms the contributors enjoy community benefits and privileges in comparison with "regular" customers, with the only difference that in the second form they are not consumers, as they did not have tasted the product, but just investors that believe in the product's success in the market and want to finance it.

Crowdfunding is assumed as an offshoot of "crowdsourcing", which is an online activity where an individual addresses via internet and proposes the crowd to contribute voluntarily ideas, solutions, feedback and expertise in a project. It possess a huge potential for bringing people together in way of achieving a common goal for an individual or a corporate need. The main difference between Crowdfunding and Crowdsourcing is that in the first the crowd is asked to contribute money to the project and not labor as in the second one[17] and also that in crowdfunding the investors often have interactive role and can participate in strategic decisions or even having voting rights in a business.[18]

Although crowdfunding is launched as a new phenomenon, in reality it was existed since 3000 BC, where there were not any financial institutions. At the old times, wealthy people used to lend money to individuals, in the aim of financing their businesses.[19] Another example in 1800's is the funds raised from Americans through crowdfunding to build the pedestal of the Statue of Liberty[20]. Joseseph Pulitzer when he realized that the budget for the completion of the project was

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[16] Paul Belleflamme, Thomas Lambert and Armin Schwienbacher, *Crowdfunding: Tapping the right crowd,* Journal of Business Venturing (2013) 4-5.

[17] Andrew A. Schwartz, *Crowdfunding Securities* (2013) 1459.

[18] Thomas Lambert and Armin Schwienbacher, *An empirical analysis of Crowdfunding* (2010).

[19] Steven Dresner, *Crowdfunding: A guide to Raising capital on the Internet (*2014) 3.

[20] Kevin Lawton & Dan Marom, *The Crowdfunding revolution: Social networking meets venture financing* (2010) 2.

insufficient, he made a crowdfunding campaign asking for donors and achieved to raise $150,000 by a large group of people. The most incredible aspect of his campaign is that the over 120,000 donations were in most cases less than a dollar![21]

Unlike other traditional ways of funding, such as bank loans, venture capital, where an entrepreneur has to meet with potential investors in order to convince them to invest in his project, crowdfunding offers the opportunity to the entrepreneur to collect money via internet without ever meeting his funder[22] and of course without having to spend money and time on expensive mistakes[23].

B.2 How Crowdfunding Operates

Figure 1: Crowdfunding process (the picture was found in: http://commandpartners.com/blog/how-much-does-it-cost-to-run-a-crowdfunding-campaign)

The concept and how it works is simple. The inventor who came up with an idea, formulates a business plan and uploads it in a crowdfunding platform proposing it and explaining his goals, presents the reasons investors should

[21] Julie Blair Pitts, *Pulitzer Crowdfunded the Statue of Liberty*, Daily Crowdsource, https://dailycrowdsource.com/content/crowdfunding/169-pulitzer-crowdfunded-the-statue-of-liberty

[22] Deborah A. Jacobs, *The Trouble with Crowdfunding,* FORBES (2013). http://www.forbes.com/sites/deborahljacobs/2013/04/17/the-trouble-with-crowdfunding/#5e90bad825f

[23] Steven Dresner, *Crowdfunding: A guide to Raising capital on the Internet (*2014) 21.

contribute to his venture and clarifies what they should expect from him, if there is any financial return. Contributors choose the project that attracts them, decide how much they want contribute and send the amount to the initial creator. The crowdfunding platform receives the contributions. If the projects raises the target capital, returns the financial contribution (if there is any) to the investor on behalf of the entrepreneur[24] and the idea becomes reality. If the founder does not reach the funding target, any amount will be returned, so investors lose out.

B.3 The Basic Actors in the Crowdfunding Landscape

Crowdfunding involves three parties: a) the campaign creator, b) the crowdfunding platform and c) the crowd. From the one hand, there are the founders (entrepreneurs) who seek through an online platform funders (investors) in order to "turn their promising ideas to actual business"[25] and from the other hand there are the investors who contribute a relatively small amounts of capital in return of a financial or non-financial reward.

The campaign creator is an individual or a company who has a promising plan for business project but lacks adequate capital and therefore tries to find through a crowdfunding platform, presenting his idea and its perspective, a funder to finance his venture. For achieving this, he should create a successful internet campaign. The ingredients for a crowdfunding success story in the media world is a creator: a) to make a video explaining who he is and why the investors should contribute to his project, b) to use social networks in order to be presented and be advertised, b) choose the right crowdfunding platform and c) to communicate often with his backers, informing them for the evolutional process of his project.[26]

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[24] Tomboc Gmeleen Faye B., *The lemons problem in crowdfunding* (2016) 260.

[25] Loreta Valanciene & Sima Jegeieviciute*, Valuation of Crowdfunding: Benefits and Drawbacks* (2013)1.

[26] http://www.excelixi.org/el/Knowledge-Base/Entrepreneurship/Crowdfunding

The platforms are the fulcrum player in the two-sided market.[27] They operate as intermediaries who facilitate transactions by linking founders with funders. Practically, web-platforms present the entrepreneurial project of the crowdfunding initiator and collect money from the crowd, keeping as a reward a small percentage from the profits or a fixed fee. Usually, the most known platforms cater for being reliable to the crowd and therefore "provide additional services, such as certification, due diligence or valuation".[28] As the scholar Yannis Bakos states: "A market has three functions: matching the buyers and sellers; facilitating the exchange of information, goods, services and payments associated with market transactions and providing an institutional infrastructure such as legal and regulatory framework that enables the efficient functioning of the market."[29]

The crowd (the public) is a large number of ordinary people from different origins but with the same interest, to invest in a new project contributing relatively small amounts, linked with each other through special online-platforms. Usually, the crowd is constituted by the founder's family, friends and familiars who want to invest in his new venture through the crowdfunding platform. Although, using the power of social media the circle of the investors can rapidly be expanded to more people who have any relation with the crowdfunding initiator. Some scholars, taking as criterion the reward received, made a distinction between campaign backers and crowdfunding investors who receive equity in exchange for funding, but eventually all the above are considered as crowd and included in this wide category, as the only thing that differs is the existing crowdfunding models.

B.4 Models of Crowdfunding

[27] Joan MacLeod Heminway, *Managing Third-Party Platform Litigation Risk in Crowdfunding: Terms, Pricing, and Reputation* (2016) 6.

[28] Igor Micic, *Crowdfunding: Overview of the Industry, Regulation and Role of Crowdfunding in the venture startup* (2015).

[29] Yannis Bakos, *The Emerging Role of Electronic Marketplaces on the Internet* (Aug. 1998) 35.

Depending on what the investors receive in return in exchange for their funding, crowdfunding is classified as: a) donation crowdfunding, b) reward crowdfunding, d) crowdfunded lending (peer to peer lending), e) invoice trading crowdfunding, f) equity-based crowdfunding g) royalty-based crowdfunding and h) hybrid models of crowdfunding.

- Donation crowdfunding focuses on altruistic activities and charities by individuals who are sensitive to vulnerable groups of people and are willing to provide voluntarily their financial aid. Participants finance the project without intending to make profit or receiving anything in return but only moral satisfaction. One characteristic example of this type of crowdfunding is The Red Cross and Medecins sans Frontiere where funders support people in need and cover their expenses (i.e for their medical care). GoFundMe is one famous donation crowdfunding platform.
  The donation-based model is the simplest as the legally transaction takes the form of a donation. The only risk in this model is that project may not achieve its promised goals.

- Reward crowdfunding is the most popular and successful crowdfunding model as it has gained 1.5 billion in the market in just a couple of years. Two of the largest and most famous in USA crowdfunding platforms are Kickstarter and Indiegogo. Participants receive non-financial rewards in exchange for donating to a project[30] but in return receive the fruits of the project. For example, an entrepreneur who is film director gives to his funder a role in the movie as a reward, or a writer gives the first copy of his book as a gift for his contribution.

- Crowdfunded lending (peer to peer lending) is a type of lending where individuals give loans to other individuals through a web platform with the

[30] Yannis Pierrakis & Liam Collins*, Crowdfunding: a new innovative model of providing funding to projects and businesses (2013) 1.*

motivation to take back their money usually with interest. This type of crowdfunding reminds the bank loans but the difference here is that contributors can refuse to make profit by asking only for the lending money and not for the interest. FundingCircle is one of the most known peer to peer lending business sites in UK which has offered £ 100m to approximately 1400 enterprises.[31]

- Invoice trading crowdfunding is a form of asset-based financing whereby businesses sell at a discount unpaid invoices or receivables to a pool of individuals through an online platform.[32]

- Equity-based crowdfunding due to its inherent complexity is the least common version of crowdfunding that now is in its infancy in Europe and recently accepted in US. It allows both accredited and non-accredited investors to take a proportion (share) in a new business, becoming part-owners, in exchange for funding, in the hope that the business will flourish and they will ultimately receive a share of the profits in the form of dividend[33].

  This model even it seemed promising it did not work in USA due to concerns regarding the securities laws. On April 2012, in order to assist start-ups and small businesses, Congress in USA enacted JOBS Act (Jumpstart Our Business Startups).[34] Although at the beginning it was prohibited, finally, the Securities and Exchange Commission (SEC) legalized equity crowdfunding, as on May 2016 adopted rules permitting companies to offer and sell securities.

  Equity-based model is the most complex model. From a legal perspective, the funder buys a stake in the company, the value of which must be estimated

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[31] Yannis Pierrakis & Liam Collins, *Crowdfunding: a new innovative model of providing funding to projects and businesses (2013) 7*.

[32] European Commission, *Crowdfunding in the EU Capital Markets Union* (2016).

[33] http://www.fundable.com/learn/resources/guides/crowdfunding-guide/what-is-crowdfunding

[34] Eric R. Smith and Parker B. Morrili, *Crowdfunding: The Real Thing Is Almost Here,* Business Law Today (November 2013).

while entrepreneurs should generate equity value in the company, which is extremely difficult to assess.[35]

EquityNet was the first crowdfunding platform that allowed businesses to publicly advertise their need for equity crowdfunding via internet.[36] Other equity-based crowdfunding platforms in Europe that have audience reach are Crowdcube and Seedrs.

- Royalty based crowdfunding is a less common than other models. It is based on investors receiving a percentage of revenue from the business once it starts generating revenue.[37] Under this model, potential gain is not limited, but neither is any particular gain certain.[38] According to the World Bank Report, the royalty model presents less risk or return than an equity investment, but more than a debt model.[39]

- Hybrid models of crowdfunding is a combination of different types of crowdfunding.

C. The Legal Framework of Crowdfunding in EU and US

Due to its novelty crowdfunding presents some deficiencies and gaps in regulation worldwide. The law around it is still evolving.

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[35] Karen E. Wilson and Marco Testoni, *Improving the role of equity crowdfunding in Europe's capital markets* (2014).

[36] Moriah Meyskens and Lacy Bird, *Crowdfunding and Value Creation* (2015)161.

[37] Brendan Galbraith*, Proceedings of the 9th European Conference on Innovation and Entrepreneurship* (2014) 248.

[38] Joseph J. Dehner and Jin Kong, *Equity-based crowdfunding outside the USA* (2014-2015) 417.

[39] World Bank Report, *Crowdfunding's Potential for the Developing World (*2013) 20.

C.1 European Regulatory Principles

In EU market crowdfunding implementation is small but has been growing at a fascinating rate. According to the released survey results that EU Commission brought to the light, it is estimated that in 2015 across EU were raised 4.2 billion euros through crowdfunding platforms.[40]

EU Commission is interested in exploring the potential of crowdfunding as an innovative method of raising money for new ventures.

In 2014, the European Commission published a paper explaining the potential benefits of crowdfunding in the economy and underlining its contribution to bridging the finance gap for small firms and innovative ventures.[41]

On 3 May 2016, the EU Commission published a report in which recognizes the development of crowdfunding in Europe and admits that EU should take measures in order to protect investors; however it postpones the establishment of a single framework for European crowdfunding declaring that still there is no emergency, so EU member states will implement national laws or EU legislative framework where appropriate, as the market is still relatively small. According to the report, Commission will monitor the cross-border business progress of crowdfunding and the national regulatory developments and afterwards it will assess if further policy intervention is needed by the EC.

C.1.1 Securities Laws in Europe

European crowdfunding law falls under the ambit of the current Prospectus Directive 2003/71 (amended by 2010/73/EC) that was enacted to harmonize rules for publishing prospectuses when companies seek to raise capital and also ensuring

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[40] https://www.crowdsurfer.com/info/

[41] European Commission, *"Communication from the Commission to the European Parliament, the Council, the European Economic Council and the Committee of the Regions. Unleashing the potential of Crowdfunding in the European Union (27 March 2014)".*

harmonized minimum protection for funders.[42] According to the Directive a prospectus must be published when an offer of securities is made to the public within the European Economic Area (EEA).[43] These rules were not designed exclusively for crowdfunding but addressed to any type of investment being associated with the public.

The general provision of Prospectus Directive (PD) is that any offer of "transferable securities" to the public must be made in a prospectus, unless certain exemptions apply. For instance, the (amended) PD does not apply if the minimum investment is more than €100,000 or if the size of the offer is less than €5 million or if the offer is directed by more than 100 people in each EU state.[44] But what if the offering exceeds for the amount of € 5 million? Who defines if any exemption occurs? The answer is the national authorities of each member state. In practice, this means a variety of different national legislations which implies an impediment to SMEs for broadening their funding researches outside the border of their country.

As understood the above exemptions do not serve the needs of crowdfunding because crowdfunding is based on small investments by a large group of people. Consequently, the number of investors that can use investment-based crowdfunding is very limited, but even if they are found and want to make business relying on a PD's exemption, they should be very careful in checking if this exemption actually applies or not. Here, match the words of a crowdfunding commentator: "while no innovative financial instruments were invented in Europe, its bureaucrats nonetheless stood by to regulate to death whatever appeared to flourish elsewhere if it showed any signs of meeting with so much as proof-of concept interest in the EU"[45].

In 2015, European Commission after a survey that has made concerning the function of Prospectus Directive, adopted a proposal for a new Prospectus

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[42] Gordon Walker, Alma Pekmezovic and Annabelle Walker, *Crowdfunding north and south: Australia and the European Union*, Journal of International Banking Law and Regulation (2016).

[43] Dennis Brüntje, Oliver Gajda, *Crowdfunding in Europe: State of the art in theory and practice* (2016) 137.

[44] https://www.city.ac.uk/__data/assets/pdf_file/0009/133965/Crowdfunding.pdf

[45] Joanna Diane Caytas, *Crowdfunding venture capital in Europe* (2015) 1.

Regulation which is intended to replace the Prospectus Directive. The aim of this proposal is to make easier and inexpensive for the small businesses the procedure of issuing shares on the market and gaining access to the general public, to expand offering securities throughout the Union, to unlock cross-border investments and at the same time to protect investors by addressing them to take right investment decisions. Already, on 20 December 2016 the European Parliament, Council and Commission formally came to a political compromise as to draft prospectus regulation and now the European Parliament is expected to approve the compromised text.[46]

C.1.2. MiFID

MiFID is the Markets in Financial Instruments Directive (2004/39/EC) that has been applicable across EU since November 2007. The aim of this regulation is to create a single market for the investment services, to facilitate cross-border investment and to establish a high degree of equity market transparency and protection for investors.[47] Where applicable, MiFID imposes to crowdfunding platforms to comply with certain requirements. "The benefit to a platform of being within the scope of MiFID is that it has a passport to carry on the services or activities for which it is authorized throughout the EU without any additional authorization being required, in accordance with a single set of rules".[48] For example, a company can provide investment services into the EU on a cross-border basis without obtaining separate authorization in each Member State in which they wish to do business.[49]

[46] http://www.consilium.europa.eu/en/policies/capital-markets-union/prospectus/

[47] http://ec.europa.eu/finance/securities/isd/mifid/index_en.htm

[48] Anne Choné, *EIFR Crowdfunding Seminar: ESMA's work on investment-based crowdfunding* (2015), http://www.eifr.eu/files/file5103556.pdf

[49] Helen Marshall, Christopher Leonard, Rosemarie Paul, Helen Strathearn, Chris Poon and Aileen Tse, *Annual review 2016* , Compliance Officer Bulletin *(*2017).

Nonetheless, national regulators are those who define whether or not an equity crowdfunding platform complies with MiFID investment activities or services, a fact that creates uncertainty to crowdfunders as there is not yet a legally stable opinion to rely on.

C.2 American Regulatory Principles and U.S Securities Laws

The federal Crowdfund Act in US signed into law in 2012 with the aim of assisting SMEs to flourish and providing investors' protection. The JOBS Act legalized equity crowdfunding by abrogating many restrictions in securities laws (adopt rules to exempt crowdfunding offerings from registration under the securities laws), on the basis of the Securities Act of 1933.[50] Specifically, the new rules permit entrepreneurs to channel funds from investors selling in return shares of their company without complying with the expensive, time-consuming process of registering with the SEC.[51] From the other hand, both accredited (those with annual income over $200.000) and non-accredited investors have the chance to participate in investment opportunities and buy equity in an early stage company as exchange of their investment.

Before the establishment of SEC's regulations in crowdfunding, the offering and sales of securities through internet (equity-based crowdfunding) were illegal under the federal securities laws. Consequently, companies wanted to raise capital through crowdfunding had two alternatives; the first was to implement donation-based crowdfunding where the second was to rely upon intrastate crowdfunding exemptions, which have been implemented by state jurisdictions which permit crowdfunding activities that are limited to a single state.[52]

The fact that JOB'S Act in the U.S legalized equity crowdfunding for SMEs and start-ups is a certain proof that governments becoming aware of the untapped

[50] Ajay Agrawal, Christian Catalini, Avi Goldfarb, *Some Simple Economics of Crowdfunding (*2013).

[51] Ramsey Y.A., *What the heck is crowdfunding?* Business people, (2012) 54-57.

[52] G. Philip Rutledge, *Overview of crowdfunding in U.S,* Company Lawyer (2015) 1.

potential of crowdfunding and are trying to reduce legal hurdles both for entrepreneurs and potential investors.[53]

D. <u>Benefits of Crowdfunding</u>

Crowdfunding is a new face of innovation that has been endorsed both by the new creators and the investors. Entrepreneurs can thrive and everyone can participate quickly and easily to a new venture from its very early stages. In this way, this alternative model of finance encourages the "ordinary" people to try a new business approach.

In general, crowdfunding is now assumed as a viable investment vehicle that fosters economic growth globally offering new jobs and opportunities to its parties.
The benefits of crowdfunding to the parties are numerous, but the most important are the following:

D.1 Accessibility and Low Cost Source of Capital

Crowdfunding has undoubtedly facilitated the access of SME's to funding and minimized the cost of raising small amounts of business capital from the crowd. It permits new entrepreneurs to interact with potential contributors and share their crowdfunding campaign online through social media (i.e facebook, twitter), emails or other tactics.

As for the cost, the crowdfunding campaign requires more time but less cost in comparison with traditional financial mechanisms. The cost of the campaign is quite less as structuring creator's profile (text, photos, and videos) and launching it to the crowd is not money consuming but time consuming procedure. What is more, using the crowdfunding as a fundraising method diminishes the cost of the expenses for meetings and contacts with potential investors in order to introduce a founder

[53] Othmar M. Lehner*, A Literature review and research agenda for crowdfunding of social ventures* (2012) 3.

his invention and convince the backer to contribute to it. Crowdfunding unlike other financial forms, it does not demand the physical presence and a manpower to operate.[54]

D.2 Market Validation

Crowdfunding offers the opportunity to new businesses to present their campaign and their promising business plan to the masses and test in this way the marketability of their project before proceeding with it. By setting up pre-orders for a new concept, an entrepreneur can test people's reaction and willingness for contributing, reducing at the same time the risk of failure. If many potential investors express their enthusiasm and ask for informations about the project, this is a positive sign that the creator's idea is worth investment and is more likely to succeed. Examining the results of the test and taking a taste about people's interests, the owners of an idea can improve and refine their business plan.

D.3 Consumer Feedback

Entrepreneurs can use the wide audience as target groups for feedback, to tap into their knowledge and advice, appeal to the circle of influence for additional support.[55] In this way, campaign owners become more famous, attracting more and more people, but at the same time they realize their "weaknesses" in order to avoid them in the future.

D.4 Democratization of Entrepreneurship

Before the appearance of crowdfunding, an individual who would have a creative idea but not the money or the personal connections, he should have

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[54] Eleanor Kirby and Shane Worner, *Crowd-funding: An infant industry growing fast* (2014) 22.

[55] http://www.crowdfundingfocus.com/

addressed exclusively to angel investors, to banks, to venture capitalists or to other wealthy sources of capital in order to get funded.

Nowadays, crowdfunding has diminished social and geographical classification by providing to everyone the chance to get financed through an online platform. It enhances the possibility that an aspiring entrepreneur from a modest background or geographically remote region would find financial backers for his version.[56] As for the investor's benefits, crowdfunding offers the opportunity also to "ordinary" people who are not professional investors to participate actively in it.

D.5 Investment in the community

As some commentators have stated crowdfunding gives incentives to the new founders and investors to remain in their community reinforcing the local community but to expand also internationally. Most entrepreneurs focus on a project within their geographical community but try to raise funds globally[57]. The online business model makes that easier and convenient for an entrepreneur to work his project in his area and at the same time to be addressed to an unknown international group of people.

E. Hidden risks and legal issues of Crowdfunding

Crowdfunding is an alluring alternative, both for an entrepreneur and for the investor, to nurture a new business activity, however due to the novelty of the crowdfunding concept, a number of problems have been arisen that might lead to an underestimation of the approach.[58]

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[56] John Elignon, *Tech Start-Ups Find a Home on the Prarie,* N.Y Times (2012).

[57] Clemens Bechter, S. Jentzsch, M. Frey, *From wisdom of the crowd to crowdfunding*, Journal of Communication and Computer, (2011) 951-957.

[58] Loreta Valanciene, Sima Jegeleviciute, *Valuation of Crowdfunding: Benefits and Drawbacks (*2013).

Therefore the parties, before considering getting in on what seems "golden opportunity"[59], should be aware of all the risks that this trend may hide and of the tricky legal waters they will encounter,[60] so as not to fall victims to crowdfunding potential legal issues.

E.1 Risks of Fraud

One of the main crowdfunding drawbacks is the risk of scams and fraud that investors take when accepting to finance an unknown through internet. As the crowdfunding lacks the proper regulatory framework, the likelihood of fraud is high.

The anonymity that the internet offers in combination with the reduced informations that crowdfunding requires, reinforces the fraud phenomenon. Funders lack any personal contact and the only knowledge they have for the project is the information they get from the platform. Furthermore, the geographical separation between the business/entrepreneur and funder can prohibit the funder from physically overseeing the business.[61]

Some companies try to conceal their financial status whereas others hush their real intentions, receive the money from the contributors and get disappeared or at least do not comply with their campaign's promises. This is a frequent phenomenon especially in donation crowdfunding where many individuals are represented as volunteers who try to raise money through online platforms for a good reason without revealing the final receiver.

A high percentage of fraud is met in investment-based crowdfunding models for investors as it cannot predicted in advance the success of a project or the appeal of a product to the audience. Equity crowdfunding hides an inherent risk because the investments cannot be classified as "good" or "bad" prior testing.

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[59] Kirsten Knipp, *Benefits and Drawbacks of Crowdfunding* (2014).

[60] Erik Weingold, *How to Navigate Crowdfunding Legal Issues* (2016).

[61] Kristof De Buysere, Oliver Gajda, Ronald Kleverlaan and Dan Marom, *A framework for European crowdfunding* (2012) 15.

The threat of fraud can lead many backers to lose their trust around crowdfunding model and hinge them to other forms of financing.

To mitigate this harm, amateur investors, who lack of experience, should always show due diligence in order to be sure about the receiver's real incentives before contributing to a crowdfunding campaign.

In some jurisdictions, the industry itself has taken the initiative for self-regulation in order to minimize the risk of a fraud.[62] Some platforms have taken measures to check the identity, the motivations and feedback/background of crowdfunding initiator before allowing him to "fish" for contributors through the platform.

E.2 Risks of Failure

The risk of failure is the risk of not succeeding the target; not only to deliver the crowdfunding goal but also to provide contributors with their reward in a timely manner.[63] The percentage of failure in crowdfunding projects is high, for example in equity-based model is estimated around 50%. According to Shikhar Ghosh, a senior lecturer at Harvard Business School, that analyzed data from more than 2000 US companies that received venture financing, about 30-40 percent of them fail, while more than 95 percent fail to generate the expected return on investment. [64]

If an entrepreneur does not reach the funding target, any finance should be returned unless the parties have signed contractual agreements with different terms.

A potential failure creates a bad past performance for a business and can cause reputational damage, a fact that can dissuade the contributors from financing a project that has once failed. However, the worst scenario is that disgruntled

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[62] Eleanor Kirby and Shane Worner, *Crowd-funding: An infant industry growing fast* (2014) 26.

[63]https://www.floship.com/7-potential-problems-with-crowdfunding/?ref=quuu&utm_content=buffer37464&utm_medium=social&utm_source=facebook.com&utm_campaign=buffer

[64] Deborah Gage, *The venture capital secret: 3 out of 4 start-ups fail*, The Wall Street Journal (2012), http://www.wsj.com/articles/SB10000872396390443720204578004980476429190

contributors can potentially band together to file a class-action-lawsuit for non-performance.[65] For this reason, the crowdfunding campaign owners should not overpromise earnings to investors by making unrealistic plans because the only thing that is achieved at the end is to alienate the backers and to set them against.

Investors, from the other side, should be protected in case of a failure not only by filing a legal action against the campaign initiator, because then it would be too late, but by platform provisions. Certain platforms have implemented provisions (mainly in lending model) that reimburse the investors in the event of a default. The "compensation" is created by borrowers who contribute a percentage of their overall loan to this fund.[66] If the investor knows that in case of a default he will be refunded, then he may choose to invest in riskier loans being sure that he will take back even a small amount of his contribution.

E.3 Lack of Transparency

Another weakness of crowdfunding model is the lack of transparency concerning the quality of launching product. This phenomenon is characterized as "lemons problem in crowdfunding" as the sellers know the quality of the offerings, but buyers do not.[67] Funders can only confirm the quality of a product or an investment after having invest on it. Taking only a foretaste of the products, buyers cannot distinguish through rich descriptions the good from the bad quality and as a result they are prepared to pay only a price for the product that "reflects the average quality of all units on the market".[68] Bearing this in mind, sellers of low quality products are benefited while others with high quality goods are damaged.

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[65] Assadi Djamchid, *Strategic approaches to successful crowdfunding* (2015) 144.

[66] Eleanor Kirby and Shane Worner, *Crowd-funding: An Infant Industry Growing Fast* (2014) 23.

[67] Tomboc Gmeleen Faye B., *The lemons problem in crowdfunding* (2016) 263.

[68] John Kwoka, *Jr., The Federal Trade Commission and the Professions: A Quarter Century of Accomplishment and Some New Challenges* (2005).

E.4 Managing Investor's Expectations

The crowdfunding procedure is constituted by two parts. The first part is an entrepreneur to find - through online platforms - contributors to finance his project and the second part is to give them a reward for their contribution or make them a shareholder of his business, depending on the crowdfunding model that is used. But imagine an entrepreneur who has a large number of small investors, what are their expectations? The contributors do not have only obligations but demands as well. According to the contributed amount, each of the investors has claims towards the creator.

Moreover, since they accept external financial aid, entrepreneurs are accountable to investors who want to be informed about how the project is going or for what reason their money have been spent. In some cases, mainly in equity crowdfunding model, funders become active members and have a determining role in taking important decisions. This point reminds venture capital and angel investors but the difference with traditional ways of financing is that the investor does not play a significant role in taking decisions.

From all the above, it is obvious that a founder is responsible not only to manage to gratify all the individuals that have contributed to his work but also to communicate with them, inform them about the process of the project and often comply with their illogical needs.

To circumvent this problem, an entrepreneur should manage how to deal with the investors' demands and clarify what they should expect by contributing in the project before the offerings take place.

E.5 Legal Uncertainty

As a relatively new phenomenon, the legislative policies around it are still being designed.[69] Since now there is not any pan-European legislation for this

[69] Igor Micic, *Crowdfunding: Overview of the Industry, Regulation and Role of Crowdfunding in the venture startup* (2015) 38.

financial model and as a result the parties are confused about which is the applicable law for their commercial exchanges. Each time the parties should check the national and the EU relevant laws otherwise they breach the laws.[70] The absence of any cross-border project funding indicates that crowdfunding remains a regional or a local phenomenon to a large extent.[71]

Therefore, as the European commissioner for the internal market, Michel Barnier, states there is a need for creating a single European legal framework to support those who develop crowdfunding platforms as well as to reduce risks for those who make use of such platforms to finance their projects[72] and for their investors. Affirming which is the applicable regulation would alleviate the above uncertainities,[73] but in order to make this happen, institutions should recognize and support the power of crowdfunding which is the key source of financing SMEs and start-ups.

E.6 Contract Law Issues

Although crowdfunding is an excellent way for an entrepreneur to generate money from backers promoting his idea through crowdfunding platforms, the true is that no one has considered the problems arisen with the contract law in the agreements with intermediaries (crowdfunding platforms) and investors.

Contracts are legally recognized forms of agreement between two or more individuals or entities, typically referred to as "parties"[74] that create an enforceable obligation. In order to be an agreement enforceable a party should make an offer

[70] https://ec.europa.eu/growth/tools-databases/crowdfunding-guide/what-is/risks_en

[71] European Commission - Press release, *Capital Markets Union: Commission supports crowdfunding as alternative source of finance for Europe's start-ups* (2016), http://europa.eu/rapid/press-release_IP-16-1647_en.htm?locale=en

[72] European Commission – Press release, *Crowdfunding in the EU - exploring the added value of potential EU action* (2013), http://europa.eu/rapid/press-release_IP-13-906_en.htm?locale=en

[73] Garry A. Gabison, *Equity Crowdfunding: All regulated but not equal* (2015) 400.

[74] Steven Dresner, *Crowdfunding: A guide to Raising capital on the Internet* (2014) 194.

and the other party (the offeree) should accept it. A contract starts to exist and is enforceable when the offeree accepts the offer in all its terms.[75]

One important thing that many entrepreneurs fail to consider when raise money through any crowdfunding platform in exchange of a product or an equity, is that they sign an enforceable contract. This has practical implementation when the entrepreneur does not fulfill his obligation towards his contributor, as the contributor has the right to file a lawsuit against him with the claim of a refund for undue debt. For this reason, an entrepreneur should be very specific in terms and the description of his offerings when entering into business and signing a contract with an unknown investor through an online platform. He should ensure that he can fulfill his promises (after having calculated the potential costs) before coming into an agreement with the backer.

Agreements between campaign initiators or intermediaries on the on hand and investors on the other hand may raise more contract law issues, as those agreements take place without the physical presence of the parties and many times emerge issues according the real assent of the parties.[76] For instance, there are two types of crowdfunding agreements, the browse-wrap (or click free) agreement and the click-wrap agreement. The first form is one where the terms and conditions of an agreement are posted on the website but they are connected to the main web page by a hyperlink to another web page that contains the contracts terms and conditions.[77] A browse-wrap agreement does not require the users to affirmatively interact with the site to show their consent to the terms and as a result the users may continue to use the website without visiting the page hosting the browse-wrap agreement or even knowing that these site exists.[78] The second form of agreement occurs when the user clicks on a link which states that it amounts to agreement- for example by clicking an "I Agree" or "I accept" or "OK".

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[75] Christopher Moores, Kickstart My Lawsuit: Fraud and Justice in Rewards-Based Crowdfunding (2015) 393.

[76] Steven Dresner, *Crowdfunding: A guide to Raising capital on the Internet* (2014) 196.

[77] http://www.dashfarrow.com/website-agreements-browse-wrap-vs-clickwrap-agreements/

[78] Suzanne L. Weakley, *California Law of contracts: 2016 Update* (2016) 72.

These two types of agreement arise a number of contract law claims as the investors often refuse the acceptance of the agreement's terms arguing that they inadvertently agreed, without awareness of what they have already signed.

Another problem that may occur and has to do with the nature of crowdfunding as internet-based way of raising money, is the participation of minors or people lacking the legal capacity to the crowdfunding procedure. One of the most significant disadvantages of the internet-based system is that the contracting parties are invisible and as a result this hides the risk of breaching the agreement with unexpected damages to the other contracting party.

E.7 Corporate Issues

Entrepreneurs who desire to use crowdfunding should take a formal action to organize their venture as a statutory form of legal entity before initiating their campaign.[79] Raising money from contributors is a business activity, so it is necessary for campaign owners to establish a company through which a business is conducted. Choosing the right legal entity for a business activity is very important as it can shield crowdfunding entrepreneurs from personal liability.[80] But which is the most profitable legal entity for entrepreneurs? Establishing a limited liability company (LLC) or a corporation is the best choice as their cost is low and their establishment procedure is very simple.

LLC is a relatively new legal entity that provides flexibility in its structures and tax advantages. The most important characteristic of LLC is the "veil" of liability protection that it offers to its members. The veil safeguards the personal assets of individuals from business risk.[81] LLC members are not personally liable for company's acts and debts, but only if they commit fraud in company's weight.

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[79] Steven Dresner, Crowdfunding: A guide to Raising capital on the Internet (2014) 192.

[80] Assadi Djamchid, *Strategic approaches to successful crowdfunding* (2015) 145.

[81] David M. Freedman and Matthew R. Nutting, *Limited Liability Company Basics for Crowdfunding Investors* (2015), https://www.financialpoise.com/accreditedinvestormarkets/article/limited-liability-company-basics-for-crowdfunding-investors/

Corporations offer a widely accepted corporate law, tax benefits and a limited protection to theirs owners (who are called shareholders). Like in LLC, corporation members are not personally responsible for the debts and liabilities stemmed from the business.

Crowdfunders can offer both in LLC and in corporation profit-sharing interests/ securities to the investors without making them partners in the business.

E.8 Equity Funding Issues

Among others, there is also a concern with an equity-based crowdfunding model.

Since now, the main problem with equity-based crowdfunding model was the strict regulation on equity issuance. National regulations typically were very strict concerning the offer and sales of security to the public, limiting it often to qualified investors and people with whom the entrepreneur had already clear links.[82] Characteristic example was the case of "Trampoline Systems" where the company was required to prepare a detailed mechanism in order to avoid any problems with the UK financial markets regulator.[83] Nowadays, EU Commission takes more lenient measures in order to circumvent this problem.

One other basic issue is the provision of financial payments, for example the calculation and value of shares amount given in return for a contribution and the percentage of business those shares constitute.[84]

Another problem is that equity investors want to get involved in the business management. They ask for informations concerning the project and frequent meetings in order to participate in the decision making process. Start-ups and small businesses do not have the experience in how to manage a large group of investors who have high demands.

[82] Armin Schwienbacher & Benjamin Larralde, *Crowdfunding of small entrepreneurial ventures*, (2010) 12.

[83] Paul Belleflamme, Thomas Lambert and Armin Schwienbacher, Crowdfunding: An industrial organization perspective (2010) 5.

[84] Claudia Gerrard, Law for small business for dummies (2016) 63.

Moreover, new entrepreneurs should valuate prior initiating a crowdfunding campaign how much equity to offer for the amount of capital they want to raise.[85] They should subtract administrative costs and the amount needed before, during and after the campaign and then calculate the remained amount for the investors. This may be difficult for an amateur entrepreneur as there are costs such as the legal expenses that cannot be estimated precisely. To overcome these hurdles, some crowdfunding websites are more flexible with the founders, as they allow them to freely define the equity offering amount. Another possible solution that is implemented is permitting the creator to predefine the equity offering amount and then try to find potential investors.

E.9 IP Legal Hazards

Although, crowdfunding has come to the market world as a boon both for the inventors and the investors, gaining increasingly growth and popularity, it was inevitable to avoid some pitfalls deriving from the legal regime.

One big part in the chapter of legal issues of crowdfunding is devoted to the intellectual property rights. Intellectual Property (IP) rights are essential business assets as they are considered as the identity of a business. IP rights are patents, trademarks, copyright, utility models, trade secrets and designs. They protect technical invention, artistic creations, identification signs, technical and business developments and processes. In other words, they protect and assure that an idea belongs to its creator so as no one to get free ride on the back of the innovator's creativity and inventiveness.

Since now, when an entrepreneur was looking for financing his new venture using traditional forms of funding such as 3F (family, friends and fools), banks, angel investors and venture capital funds, was asking potential contributor to sign a

[85] Kristof De Buysere, Oliver Gajda, Ronald Kleverlaan and Dan Marom, *A framework for European crowdfunding* (2012) 15.

confidential contract known as non-disclosure agreement (NDA).[86] Signing this agreement the investor was obliged not to reveal any information regarding the nascent business project without the permission of the founder and therefore the inventor was relieved that his innovative ideas would not be disclosed and his intellectual property rights would not be infringed.

Crowdfunding platforms have not this provision as it is extremely difficult to impose to each one who visit the platform to sign this kind of agreement. As a result the business plan of each entrepreneur, even if it is promoted via internet, is exposed to the wide crowd facing the risk of loss of IP rights.

From all the above it is obvious that crowdfunding can be challenging for those who do not have any IP portfolio because they are prey to the aggressive competitors who may steal, adopt, and launch in a more profitable way their ideas and (why not) getting benefit from them. Therefore, before initiating a crowdfunding procedure, entrepreneurs firstly need to take a legal advice, identify and protect intellectual property rights of their business project and then reveal their ideas to the wide audience in the hope of raising the target amount. Otherwise, the promising business plan can easily take wings with reversing for the inventor consequences.

E.9.1 From the Side of the Entrepreneur

Every day more and more inventors use crowdfunding in order to fund their ideas as they lack the efficient capital. Unfortunately, many of them, focusing on sales and failing to consider the importance of IP rights, do not protect their business idea prior to sharing it with the public. Often, this has the devastating result someone to destroy the value of his idea and undermine his own success.

As crowdfunding platforms are open to the crowd, everyone has access to them and may steal at any time innovative concepts and patents from oblivious

[86] Michael J. Allan & Tremayne M. Norris, *Crowdfunding: A guide to Raising capital on the Internet* (Chapter 6, Protecting your intellectual property) (2014).

inventors. Therefore, inventors confront problems such as loss of intellectual property rights.

To begin with, the excessive exposure to web platforms may have benefits for companies looking for funding, nevertheless it can often harm the unprotected by the law entrepreneur and put him into troubles. Uploading his promising idea to the platform without previously patenting it, the inventor shares it as well with his potential competitors. There are sophisticated IP predators, whose jobs are to search for unprotected ideas in crowdfunding platforms, grab the ownership of them and exploit them, destroying in a minute what the inventor has built devoting hours, months or years of hard work.

One characteristic example of IP theft is the Scott Willson's LunaTik watch kit that achieved to raise from the investors the amount of $ 942.578 in one month but due to the lack of protection of IP rights it was widely copied and sold in cheaper price offering benefits to the competitors. Now the inventors through their sites try to show to the audience how to recognize the imitation from the original.

As a result, creators fall easily into trap and disclose their ideas before protecting their IP rights. This means that projects will be unprotectable, eminently copyable, reducing any attraction for investors and prejudicing the survival of the business.[87] According to patent experts, IP coverage gives extra value (at least 20% more) to an idea in comparison with others that they lack of it, as it offers security and credibility to the investor and certifies that the founder is the real originator.

The truth is that is extremely difficult for an entrepreneur to safeguard his IP before promoting his crowdfunding campaign as launching demands disclosure of his professional plan and detailed explanation to the crowd of how it will operate so as to build trust with the backers. But revealing how his business will run in the market he faces the risk that another one may copy his plan and probably file the patent application on it before him.[88] The problem can be solved only by hiring a patent

[87] Roberts Gwilym & Mark Nowotarski, *The IP issues of Crowdfunding* (2013).

[88] Marry Juetten, *Intellectual property and Crowdfunding: Practice Safe Crowdfunding® (*2014), http://www.startuplawblog.com/2014/09/18/intellectual-property-and-crowdfunding-practice-safe-crowdfunding/

attorney. This means that it is crucial before making a step forward parties should seek at first legal protection, as it can save them time and money.

There are many founders who pinch their ideas to the crowd without securing a patent prior, as the patent process is time-consuming and expensive and also because they do not know in advance if the project will be successful at the end. They expect to raise the money for the patent attorney through crowdfunding platforms.[89] Others, they think that the online platforms will protect by themselves their legal rights but they finally make a terrible mistake as the crowdfunding platforms are responsible only for promoting the projects, taking for granted that users have already been legally protected (some platforms recommend the inventor to ensure before initiating his campaign that he is legally covered).

Another issue stems from the IP is that often the founders fail to check if there is already IP and initiate a project taking the risk that someone else may be the owner of the patent. In such a case an entrepreneur he may be accused by the first inventor who has already the patent rights for violating his intellectual property. This may result in a big loss of revenue and in damage of his business reputation, while investors that have supported him will be disappointed. As it is mentioned by the intellectual property expert and patent agent Mark Nowotarski, many successful projects have been shut down halfway through their funding campaigns for reported patent, copyright and trademark infringement, usually after being funded. This problem has faced Formlabs, a team of PHD students who raised in 30 days the amount of $ 3 million by selling on Kickstarter platform a professional 3D printer and afterwards they were sued by 3D System Corporation for patent infringement.[90] This could have been avoided if there was a due diligence and patent protection.

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[89] Shireen Smith, *Using Crowdfunding sites could destroy your nascent business idea* (2013), https://www.theguardian.com/media-network/media-network-blog/2013/jun/27/crowdfunding-sites-destroy-business-idea

[90] http://www.3dsystems.com/it/press-releases/3d-systems-announces-filing-patent-infringement-suit-against-formlabs-and-kickstarter

E.9.2.From the Side of the Investor

Although at first glance the intellectual property issues are focused to the entrepreneur, as he is the first who should take all the necessary measures to safeguard his identity, the truth is that investor faces also the same concerns.

Backers who want long-term investments are looking for security in the future, so IP coverage is necessary.[91] A potential violation of creator's intellectual property affects at the same time the rights of the funder as well, because the last invests in an insecure business project that finally will not thrive.

E.9.3 How to Deal with IP Risks

In order to run a successful crowdfunding campaign, a crowdfunding initiator should take into consideration all legal hazards including the intellectual property risks. As the practice has shown, protection of IP rights gives incentives to the individuals to continue to create new investment ideas while relieving their mind that the time and energy they have consumed, will not be wasted.[92]

It would be desirable if crowdfunding platforms could collect more extensive data on the background and the habits of the "crowd" that join in the platform.[93] Some platforms have special systems to reduce infringement and suggest creators to take preemptive measures in order to ward off a possible IP violation. Other platforms require investors to sign a non-disclosure agreement guaranteeing their discretion or provide data rooms where information can be uploaded but it will not be accessible to the wide audience. These data rooms preclude the anonymity of the user as they require password to enter and allow the campaign owner to see how

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[91] Marry Juetten, *Crowdfunding and Intellectual property: Tips from an entrepreneurial attorney (*2014),http://www.forbes.com/sites/maryjuetten/2014/07/10/crowdfunding-and-intellectual-property-tips-from-an-entrepreneurial-attorney/#1668c3367ef7

[92] Michael J. Allan & Tremayne M. Norris, *Crowdfunding: A guide to Raising capital on the Internet* (Chapter 6, Protecting your intellectual property) *(*2014) 98.

[93] Igor Micic, *Crowdfunding: Overview of the Industry, Regulation and Role of Crowdfunding in the venture startup* (2015) 22.

long the files were viewed and by whom.[94] However, online platforms in general do not provide sufficient IP coverage for the users. Therefore there are some steps that should be followed by the parties (creator and investor) so as to avoid IP troubles and ward-off litigation.

First and foremost, founders of an idea should identify and preserve all their valuable assets of IP, in advance of public disclosure. Entrepreneurs should decide if it is worth for their invention to file for any kind of IP protection.

If their idea is patentable they should file as early as possible (after having made a patent searching) for a provisional patent application because it excludes other persons from reproducing it without the consent of the patent holder. The protection lasts 20 years from the filing date of the application. A provisional patent application (less formal) is a low cost procedure and lasts for a year (in US). If after one year the entrepreneur has raised an efficient amount and his business plan is proved as a success story, he can then file for a non-provisional patent application (formal). In this way the creator saves money from legal expenses in case his project does not meet its goal.[95] By filling a patent application on time, the creator can safeguard his IP rights and avoid the infringement of others rights.

The other issue that an entrepreneur should consider related to intellectual property is trademarks. Trademarks indicate the source of product or services and distinguish them from those of other providers. Whoever files first for a trademark is presumed to be the trademark owner. The creator can apply for national, regional and international trademark. However, before starting his crowdfunding campaign, he should make a research if the name that he wants to use is already used by another competitor. A professional legal assistance would be helpful for trademark research and trademark application afterwards.

A creator should also take measures for his copyright protection that lasts the author' life plus an additional 70 years. Copyright protects the creations of an author for a limited time by granting exclusive rights for use and distribution of these works. Copyright infringement arises when the creator uses for his promotion pictures or

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[94] https://www.cleverism.com/14-potential-issues-with-crowdfunding-how-solve-them/

[95] http://www.crowdcrux.com/crowdfunding-legal-issues/

videos without asking before for the permission of the owner. Since there are some people who are looking through crowdfunding sites to steal the legally unprotected business ideas, to copy and create their owns based on them, it is vital for a creator to file for copyright registration if the work he may lose is associated with the business.

Last but not least, another important chapter to the IP rights protection is the trade secrets. Trade secrets is confidential information that has business and economic value (i.e Coca-cola's ingredients). If an aspect of founder's work is based on trade secrets, he should not reveal them, since once publicized, they cannot be protected.[96]

Additionally, the investor should take into account all the pre-referred intellectual property issues. He should conduct a due diligence assessment of any venture he seeks to invest in as the success or failure may be based on the strength and protection of those IP rights.[97]

E10. Tax issues

Many businesses have succeeded in attracting funding through crowdfunding platforms, although almost none of them have previously thought the ramifications for income taxes.[98] Since crowdfunding is still in its infancy terms, it is rational to raise many unanswered legal issues, one of them is the income tax consequences. Taxes are complicated and tricky for non-experts. Even the academies and experts fail to give a clear answer to the question whether the money raised through crowdfunding is counted as capital or income, creating as a result an accounting confusion. As an author once said "Taxing Crowdfunding pledges is one of policy considerations that government agencies must address in coming months as the

[96] Roman Zelichenko and Mark Levy, *The legal side of Crowdfunding* (2016).

[97] Camille A. Stewart, *Before you start crowdfunding, know the IP concerns!* (2014).

[98] Cheryl Metrejean and Britton McKay, *Crowdfunding and income taxes (*2015), http://www.journalofaccountancy.com/issues/2015/oct/crowdfunding-and-income-taxes.html

technique becomes increasingly popular and potentially hides questionable business dealings by both companies and investors."[99]

There are three tax categories for money raised in crowdfunding: Sales tax, Income and Gifts. The first category incorporates crowdfunders that raise money via reward-based model (receive money, give a salable product to the contributor as a reward).[100] The second category is the most common category and includes crowdfunders who raise money via peer to peer lending model, equity model and may be reward-based model in some cases. The last category addresses to the donation model, where gifts and donations (without returns) are exempted from taxable income.

However, all the above are theoretical thoughts since there is not yet definite guideline to clarify income and gift tax uncertainties regarding crowdfunding.[101] For this reason, it is safer for a crowdfunder in each case to consult a professional in order to define the nature of tax payments and to give answers to the parties' queries.

E.11 Bankruptcy

Insolvency is a basic risk that faces the investor when investing in crowdfunding. What happened in case the promising project fails and the entrepreneur files for bankruptcy? Is there any reorganizational plan in case the entrepreneur face some difficulties in fulfilling his obligation towards the investor? Characteristic example is the notorious "Rebus case" that has remained in the UK's history as the largest equity crowdfunding failure. Rebus was a company that raised through the crowdfunding platform "CrowdCube" £ 816,790 in 2015 and afterwards became insolvent leaving one hundred investors counting their losses.

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[99] Nat Rudarakanchana, *Crowdfunding: Income or gift? IRS Taxes and SEC Regulations could hurt startups and innovation on Kickstarter and Indiegogo (2013), http://www.ibtimes.com/crowdfunding-income-or-gift-irs-taxes-sec-regulations-could-hurt-startups-innovation-1350441*

[100] https://dailycrowdsource.com/content/crowdfunding/1005-understanding-crowdfunding-taxes

[101] Paul Battista, *The taxation of crowdfunding: Income tax uncertainties and a safe harbor test to claim gift tax exclusion* (2015) 145.

Although investing in a budding business has an intrinsic risk, investors should be mindful when choosing a crowdfunding site and a project. Before investing in any innovative project, the investor should ensure whether the site that he has chosen offers an insurance-type policy that covers the risk of bankruptcy and dissolution.[102]

However, has anyone wonder what happened if the crowdfunding platform goes bankrupt? The investors cannot predict this case, so they are really in danger of losing all their investments because as platform operates as an intermediary, a potential close of the platform will signal its impotence to return the money or the rewards to the contributors. For this reason, "in the event of insolvency of the platform-operator the continued existence of the incurred claims and their servicing (interest payments, dividends, redemption and information) must be guaranteed to the end of maturity"[103]. The retail investor should not rely on the success or failure of the crowdfunding platform.

F. <u>Commenting on the Legal Matters</u>

Based upon the findings, it is observed that crowdfunding is a phenomenon that can be examined from various and different angles. Because of the rapid development of crowdfunding, this alternative financial method remains poorly understood by entrepreneurs, funders, platform leaders, policymakers and researchers.[104] Individuals try to make profit using crowdfunding while investors positively respond, without really being aware of the legal concerns. The author depicts the two sides of crowdfunding, the bright and the dark, and centres on the potential pitfalls and legal matters that should be taken into consideration by both entrepreneurs and investors when getting involved in crowdfunding.

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[102] David M. Freedman, Matthew R. Nutting, *Equity crowdfunding for investors: A guide to risks, returns, regulations, funding portals, due diligence and deal terms* (2015) 157.

[103] Rainer Lenz, *"Take care of the crowd!" – Legal protection of retail investors in crowdfunding is long overdue* (2015).

[104] F. Xavier Olleros and Majlinda Zhegu, *Research handbook on digital transformations* (2016) 332.

Entrepreneurs have an intention to raise capital in order to make their business plans come true but often they are so focus on it that they do not pay attention to the legal parameters. For instance, in a hurry of pooling money from investors, creators of an idea do not take measures to safeguard their intellectual property rights and as a result their ideas get exposed to the public with the threat of a potential steal of the concept. Another example is that project initiators do not possess scalable production facilities and as a consequence the products or rewards are not delivered in fixed day to the contributors.[105] A wrong valuation may: a) put an entrepreneur into troubles as the unsatisfied investor can file a lawsuit for non-performance, b) destroy campaign owner's reputation and reliability and c) deter the profitability of the business as there are always unexpected costs that cannot be estimated till the completion of the project. To mitigate these problems, entrepreneurs should make a careful plan which will entail a need to rapidly execute a promised venture.[106]

Independently of their own due diligence that must be show and the knowledge around the legal hindrances, entrepreneurs who want to occupy actively with crowdfunding should definitely hire a business lawyer that specializes in crowdfunding issues. There are plenty of legal matters stemming from crowdfunding and only a professional can resolve them. To start with, before initiating a business activity an individual should structure a legal entity in order not only to be presented as more sophisticated and professional towards investors, but also to take advantage of tax benefits. This is lawyer's job; to establish a legal entity that is profitable for entrepreneur and do not bind him. Furthermore, a lawyer will draw up a contract between the creator and the funder adjusting all the parameters and adding the law gaps. Last but not least, lawyer can give an advice or add an extra provision in the contract concerning the event of a bankruptcy, protecting in this way both parties.

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[105] Miroslaw Przygoda, Mihaela Mikic and Petar Kurecic, *Economic and social development: 17th International Scientific Conference on Economic and Social Development – "Managerial Issues in Modern Business"* (2016) 419.

[106] Ethan Mollick, *The dynamics of crowdfunding: An explanatory study,* Journal of Business Venturing (2014) 14.

The most common problem from the side of investors is that they run the risk of losing their investment because the start-up failed to perform (on time) or even worst went bankrupt. As crowdfunding is an “open call” this means that can participate all types of investors even the inexperienced ones. An inexperienced investor cannot recognize easily which advertisings on the platform are fraudulent and tricky or they may invest in abortive projects. Therefore, there is dire necessity to take a legal opinion before making an investment in order to have in advance the right guidance and to avoid the pre-referred problems.

A special part is devoted to investors who choose investment crowdfunding (concrete equity-based crowdfunding). There is a lot of discussion around this model because in many countries there is not any regulatory provision or the national laws implemented this with many restrictions, making it very unfriendly and undesirable to investors. However, both in Europe and in US, have been established new, more lenient measures in order to appeal more investors.

G. <u>Conclusion</u>

This paper aims to shed light on the legal aspects of crowdfunding underlining the most fundamental legal issues that parties should take into account when getting involved in crowdfunding procedure.

In recent years, there is a growing movement to revolutionize banking, investing and giving by using technology to simplify the links between those who want to invest money and those who need it.[107] Crowdfunding is the new high dynamic in the financial realm that represents a disruptive change to the traditional method of financing. It is an innovative way for creators to pool funding for a wide variety of projects via internet platform. The concept of crowdfunding can take the body of capitalism (i.e equity-based) as well as altruism (i.e donation-based) using modern technologies to apply its particular marketing strategies.[108]

[107] Peter Baeck, Liam Collins &Bryan Zhang, *Understanding alternative finance: The UK alternative finance industry report 2014* (2014) 4.

[108] Sebastian Dehling, *Crowdfunding- A multifaceted phenomenon* (2013) 28.

Although crowdfunding seems as a panacea, as it presents numerous benefits for start-up founders and contributors, there are some legal pitfalls that parties may overlook and may intercept its success rate.

To conclude, crowdfunding seems to be here to stay as the statistics show that it is in the victory lane and continues to expand in a rapid pace globally. Nevertheless, the growing importance of this phenomenon calls for its regulation in order to uphold project initiators' and investors' protection and safety of the financial market as a whole.[109] The lack of uniform regulations of crowdfunding in EU disrupts EU harmonization, discourages investments, poses cross-border limitations and generally chokes off its growth. Therefore, European Commission which monitors the developments should proceed and build a concurrent of regulatory and supervisory framework in order to remove those obstacles and harness the power of crowdfunding.[110]

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[109] Fernando Zunzunegui, *The Spanish Crowdfunding Act,* Journal of International Banking Law and Regulation (2015) 496.

[110] Miroslaw Przygoda, Mihaela Mikic and Petar Kurecic, *Economic and social development: 17th International Scientific Conference on Economic and Social Development – "Managerial Issues in Modern Business"* (2016) 431.

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