Regulation of Equity Crowdfunding in China

Yong-tao CUI\textsuperscript{1,a,*}, Can ZENG\textsuperscript{2,b}

\textsuperscript{1}Xiamen University, Xiamen, China
\textsuperscript{2}Law School, Yunnan University, Yunnan, China
\textsuperscript{a}cytoo_198439@126.com, \textsuperscript{b}395647065@qq.com
\textsuperscript{*}Corresponding author

Keywords: Equity Crowdfunding, Platform, Regulatory Rules.

Abstract. Equity crowdfunding is a novel concept of using the strength of the Internet to raise business capital through the “crowd” and it is being developed well in China. Backed by government, entities and investors. Considering equity crowdfunding involves great risk, China has laid down some rules to regulate it in order to protect investors. Through the method of empirical analysis, the article analyzes the risks contained in equity crowdfunding and the deficiencies of China’s regulatory rules. At the end of the article, puts forward some suggestions to improve the level of equity crowdfunding regulation based on above analysis. The main purpose of this paper is to research how perfect the regulatory rules to protect investors who are interesting in equity crowdfunding and promote the healthy development of it in China.

Introduction

Equity crowdfunding is a novel concept of using the strength of the Internet to raise business capital through the “crowd”, where investors obtain the equity of an entity after they invested and share the future profits. Equity crowdfunding usually are implemented through funding portals where issuers publish projects and investors invest in them. Equity crowdfunding, based on the Internet, is a kind of financing instrument in essence, which has a positive significance for perfecting the multi-level capital market system and broadening financing channel of small and medium-sized enterprise. The article suggested that equity crowdfunding should be appropriately regulated through formulating some rules in order to play its positive role in facilitating the finance of small and medium businesses. Therefore, the aim of this research is to introduce China’s rules of regulating equity crowdfunding and consider whether the measures proposed by the CSRC are appropriate.

Equity Crowdfunding in China

Equity crowdfunding has developed rapidly since the first funding portal ANGEL CRUNCH appeared in 2011 and even grew faster than the United States and European developed countries. There are 113 equity crowdfunding portals as of the first half of 2015 in China which is the most in four kinds of crowdfunding portals. From the statistics, the financing of equity crowdfunding in China has already been more than 3.5 billion yuan in the first half of 2015 and the number is expected to grow by another 4.5 or 10 billion yuan in the second half of 2015.

The year of 2015 is the key point of development for equity crowdfunding and the government’s encouragement will provide the industry with more projects. Therefore, we can foresee that equity crowdfunding has a promise future in China.

Risks of Equity Crowdfunding

A. Issuer-related risks

At present, equity crowdfunding develops too rapid and there is no ripe experience that can be used as reference, so moral risks appeared one by one. Some issuers inflate the valuation of project...
and conceal the malpractices of enterprise; there are also some issuers who carried on related transactions under the name of the projected company for their own benefits; what’s worse, some issuers fabricated projects and cheated investors of trust and investment, but went off with all the money at last. The more risks from the issuers are that most of the issuers have no qualification and experience of equity crowdfunding and lack correct understanding of the feasibility of financing projects, so that investors have to bear the loss caused by the failure of the project.

**B. Investor-related risk**

In order to absorb the idle social funds, equity crowdfunding lowers the financing threshold and cost, so ordinary people can also take part in. However, ordinary public in China has not a higher educational background and a rational investment judgment, most of the time they invest in projects by virtue of the issuer’s business plan and their own intuitive feeling. They don’t have a taste of cruelty of the capital market and always choose the projects which are of high-risk and high-yield, so their investment behavior is irrational.

**C. Platform-related risks**

Currently, the equity crowdfunding portals are in a stage of barbaric growth, all portals develop in the dark and compete on the same starting line. Every portal has its own measures for the funds regulation. Some portals permit investors to submit crowdfunding intention online and transfer accounts offline, and other portals belong to the type of playing money directly online; there are also some portals which keep the money in the thirty party bank in order to ensure the safety of funds. However, transferring accounts offline leaves investors some time to think about the project which they want to invest, so to some extent it can avoid the irrational investment behavior, but investors don’t know clearly where the smart money is going and also have no idea whether the investment funds have truly been invested into the project truly; playing money directly online is irrational and increase the risk of fabricating projects and absconding with the funds.

**Regulatory Proposals of Securities Association of China**

Securities Association of China (SAC) published the Financing Regulation of Private Equity Crowdfunding (FRPEC) on December 18th 2015. The release of FRPEC has a milestone significance for the development of equity crowdfunding, it reflects that government regulators explicitly recognize the legitimacy of the new financing instrument and also show their positive attitude to pursue its advancement actively.

**A. The issuer’s qualification and responsibilities**

Issuers must be the users who register with their real names which have been verified by the equity crowdfunding portals. And also they must be small and medium-sized enterprises or its initiators. The issuers must perform the necessary information disclosure obligation and provide real, correct and complete user information to the portals. They should also guarantee that the project issued on the portals be real and legal, which means the information released to investors is true and accurate. The issuers should truthfully provide investors with the significant information which would affect or might affect their interests. Additionally, the issuers should not issue the project by deception or promise investors that the investment would not suffer from loss or they could receive the minimum profits. They also can not finance for the same project through two or more portals and release financing information in public forums beyond the equity crowdfunding portals.

**B. Equity crowdfunding portal · ·**

The FRPEC provides that the equity crowdfunding portal should be registered in the SAC and applies to be its member. The portal should be a company or a partnership which is legally established within the territory of China. It should have eligible professionals, legal Internet platform, and IT infrastructure which are adaptable to the finance on the equity crowdfunding portal. In addition, it should also have a sound business management system.
The portal should be diligent and responsible to urge both investors and financiers to carry out financing activities according to law and perform the contractual obligation. It should adopt the system of real-name authentication and examine the authenticity of users’ information, it should also verify the legitimacy of financing project and take precautions to prevent fraud, it should announce and stop the related financing activities when they find the fraud and other circumstances which harm the interests of investors. The portal should carry out the special account management on the funds during the period of raising, it should develop the literacy of crowdfunding finance and carry out the risk education activities continually, it should also sign the risk paper with investors to insure that they are fully aware of the investment risks. And it must protect the business secrets and the customer privacy, while it should not disclose the relevant information about issuers and investors unless due to legal reasons.

Meanwhile, the FRPEC also provides some negative obligations of the equity crowdfunding portals. For example, the equity crowdfunding portal can not fund itself or fund for the related parties through its own Internet platform, it should not provide any guaranty to other parties or could not sign any agreement of shares nomination. Also, it could not offer equities or other forms of transfer service of securities and gain the investment opportunities or mislead investors with its platform’s own advantages. The portal can not propagate or recommend financing project to non-real-name registration users and engage in the business of security institutions such as underwriting, investment consulting and asset management except that some institutions have the qualification of related business.

C. Investors

Like the issuers, investors should register with their real names on the equity crowdfunding platform. According to the FRPEC, investors who have the right to invest are mainly divided as follows:

(a) Qualified investors stipulated in Interim Measures for the Supervision and Administration of Privately-Raised Investment;
(b) An entity or a person who invest in a single project with the minimum amount not less than 1 million yuan;
(c) Pension funds such as Social Security Funds, Enterprise Annuity and so on, Social Benefit Funds such as Charity Foundations and Investment Programs which are legally established and have records in the China Securities Investment Fund Industry Association;
(d) An entity whose net assets are not less than 10 million yuan;
(e) A person whose financial assets are not less than 3 million yuan or a person whose annual income is not less than 5 billion yuan during the last three years, in addition to proof of income and property, the said individuals could identify, judge and bear the related investment risks.

Legal Barriers to Equity Crowdfunding

The supervision rules of China’s equity crowdfunding are formulated mainly by drawing lessons from the United States and European developed countries and combining with the specific situation in the country. However, equity crowdfunding of China is in preliminary development stage and the capital market is not yet well developed, so there are some shortcomings in supervisory rules of the FRPEC. To be specific, there are three aspects as follows:

A. Non-public offering (NPO)

The FRPEC makes it clear that equity crowdfunding should adopt non-public offering and it draws up a series of self-discipline management provisions to meet article 10. The first is that investors must be the real-name users conforming to the conditions in the FRPEC, and are verified by equity crowdfunding portal; the second is that the number of investors should not be more than 200 people; the third is that the equity crowdfunding portal could only recommend the project information to the users with the real-name registration. Both issuers and portals should not publicly advertise, recommend the project information to other people. These provisions could be hazardous
to the sound development of equity crowdfunding because they limit the expansion of potential investors and increase the degree of investors’ dependence on the platforms.

**B. Requirements for investors**

According to provisions of the FRPEC, investors who invest in the project on the Internet platform should be the persons who invest in a single project with the minimum amount of not less than 1 million yuan or the persons whose financial assets are not less than 3 million yuan or the person whose annual income is not less than 5 billion yuan during the last three years, in addition to proof of income and property, the said individuals could identify, judge and bear the related investment risks. It is not hard to find that the said individuals are the qualified investors stipulated in Interim Measures for the Supervision and Administration of Privately-Raised Investment if they meet the above requirements. The investor who meets the requirements should be more inclined to invest directly in private equity investment funds rather than equity crowdfunding. Currently, the investors who invest in the projects of equity crowdfunding are the holders of idle funds who have urgent demand for investment but not meet the above requirements, so equity crowdfunding certainly would be atrophy gradually rather than flourish if the authority insists on implementing the provisions.

**C. The Escrow**

According to the FRPEC, the portal should carry out the special account management on the funds during the period of raising. We have to say that it is the major shortcoming of the FRPEC. Due to the lack of the effective external supervision, even the platform sets up the special account to manage the investors’ funds, it has more control over the funds and can no promise its safety. In practice, circumstances such as embezzling or absconding investors’ fund happens from time to time.

**Recommendations**

The financing difficulties of small and medium enterprises has not been resolved because of the harsh requirements of bank loans, it becomes a major bottleneck which restrict their further development. Equity crowdfunding, as an effective financing instrument of small and medium enterprises, has a special significance in China. It can improve the efficiency of financing under the context of cutting down the cost of entities’ financing and also improve the financing system on that basis. So it has become the key channel of start-ups in early financing.

**A. Safe Harbor Rules**

To comprehensive consideration of securities laws and capital market in China, it would be a more appropriate choice to regulate the issuers’ financing behavior through establishing Safe Harbor Rules. Safe Harbor Rules of public propaganda can make the issuer breakthrough the subject scope of real-name users on crowdfunding platform and spread the financing information to the non-qualified majority of potential investors. Specifically, we can learn from the provisions of the United States law that the issuer performs the obligation of taking the appropriate measures to verify the investors’ subject qualification which is the essential condition of entering into Safe Harbor. Regulations on the public propaganda could include: first, only the qualified investors have the right to invest in the project of equity crowdfunding; second, propagandist should disclose the inherent risks of the project and the information of issuers and its recent operation status; third, the propagandists must tell the investors clearly that only through the platform of equity crowdfunding can they invest in the project.

**B. The Classification System of Investors**

At present, both experts and participants think that the provisions of qualified investors in the FRPEC are too rigorous and these limits violate the inclusive and popular characteristic of the Internet finance. Therefore it is necessary to learn from the experience of Jobs Act and set up the
classification system of investors. Besides the qualified investors stipulated in Interim Measures for the Supervision and Administration of Privately-Raised Investment, the general investors should be divided into several groups according to their annual income or their financial strength and then determine the specific limit or the specific percentage of investment that every group of investors could invest based on the above classification in order to meet the demands of different investors and reduce the risks of their potential loss as much as possible.

C. The Escrow System

Currently, the practice of investors’ funds management is that the platform distributes the funds to issuers after the funds were transferred directly to the special account of platform by investors. This method of management makes the investors’ funds face some risks and so the best way is to set up the Escrow System. It is stipulated in the law that the platform must find the Escrow Institution which completes the circulation of funds on behalf of itself in order to ensure the safety of funds and increase efficiency. So the financing process of equity crowdfunding transforms into that as follows: firstly, the issuer declare the project and the platform examine the necessary information; secondly, the investors select the project and complete the payment of funds through the platform of Escrow Institution after some necessary links such as information publication, then the issuer acquires the funds in installments from the third platform and only after the project is compete can the issuer receive the total amount.

Conclusion

Equity crowdfunding develops fast in China due to the great support of government because it can efficiently resolve the financing difficulties of small and medium-sized enterprises and provide funds for the personal pioneering. But this kind of financing instrument contains great risks and the harm to investors’ interests would not be avoided if there are no perfect supervisory rules. The SAC published the FRPEC of Private Equity Crowdfunding on December 18th, 2015. It provides some rules of regulating issuers, investors and the platforms respectively and has a great significance to protect the rights and interests of investors. However, the FRPEC mainly learn from some regulatory experience of foreign developed countries, additionally, the capital market in China is underdeveloped, so the regulatory rules have some shortcomings and should be gradually improved with the development of equity crowdfunding.

Reference


