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CROWDFUNDING AS FINANCING METHOD: POTENTIAL AND ASPECTS OF REGULATION

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Abstract

The present paper explores the aspects and practical issues of crowdfunding as one of the modern investment techniques supporting many social processes and business ideas. Amid the wide adoption of digital technologies in many areas of social life, crowdfunding progresses to a new level of consideration and the issues of regulation arise in the most advanced economies. The purpose of this study is to analyse the practical issues arising before the lawmakers and to develop recommendations on elaborating efficient organisational and legal solutions. The authors analyse potential applications of crowdfunding, international regulatory approaches and the projected legal norms of the Russian draft law on digital technologies in crowdfunding. The vast potential of innovative technologies in crowdfunding is outlined, as well as the risks involved. The outlook is analysed as to the development of legal regulation concerning digital technologies in crowdfunding and the problems arising in the area. It is observed that for now, there is yet no developed legal regulation of crowdfunding in the Russian Federation. However, one can already find successful examples of crowdfunding applications in global social and business practices. Conclusions are drawn and the outlook is described as to the development of crowdfunding regulation associated with the application of blockchain technology. The authors offer an assessment of legal regulatory options and propose to adopt the most plausible solutions for the Russian legal framework.

Keywords

Investment – Funding – Digital technologies – Tokens

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Introduction

Financing socioeconomic development, modernisation of educational institutions and healthcare and providing economic assistance for newly-established enterprises make top government priorities at the current stage. However, resource constraints limit the state's capabilities to ensure they are met properly¹. That is why alternative instruments have to be found for financing federal and especially regional projects of socioeconomic development and providing support to small enterprises².

One of the methods of collective project funding that involves attracting money for new product development from potential end consumers is crowdfunding. Apart from actual funding, this method provides an opportunity to evaluate potential investor interest, social profile and needs and to evaluate the viability of the investment idea. Moreover, it is also a way to generate publicity and engage those who may not be aware of the investment project³. Crowdfunding arranges task distribution in major groups via a public call⁴. The term is thought to date back to 2006 and is attributed to Jeff Howe, however, the phenomenon of collective funding had emerged long before that. A good case in point is the construction of the Statue of Liberty in New York for which money was raised in a collective public effort⁵. Apart from actual funding, the accompanying priorities in crowdfunding may include: marketing of a service or product; event management; assistance for the underprivileged; support of legal entities and individuals⁶.

Based on the objectives and expectations of investors, there are two models in the modern understanding of crowdfunding activities. The first group of crowdfunding types (models) is non-financial crowdfunding. In this case, investors might be driven by a variety of motives, e. g., contributing to a public cause or aspirations to complete the development of a product or service. The second group of crowdfunding types (models), also known as crowdfunding, is exclusively financially-driven and aims at gaining expected profits and assurance in the viability of the proposed business model.

¹ M. E. Kosov; S. P. Solyannikova; A. V. Sigarev; V. P. Karpenko y S. Y. Popkov, "Public Investment in Russia: Peculiarities of Implementation and Ways to Improve Efficiency", *Journal of Advanced Research in Law and Economics* Vol: 10 num 4 (2019): 1288-1295; E. V. Levkina; L. A. Sakharova y D. A. Edelev, "Comprehensive assessment of investment attractiveness of regions (Based on the example of the regions of the far east)", *Revista Inclusiones* Vol: 7 (2020): 546-555 y G. Serikbaeva Gaukhar; B. Bektanov y A. Bekturganova, "Sources of Attracting Investments in Technological Innovation Projects to Ensure the Sustainable Development of Rural Areas", *Journal of Environmental Management and Tourism* Vol: 10 num 4 (2019): 935-941.

² E. A. Kirillova; O. E. Blinkov; N. I. Ogneva; A. S. Vrazhnov y N. V. Sergeeva, "Artificial Intelligence as a New Category of Civil Law", *Journal of Advanced Research in Law and Economics* Vol: 11 num 1 (2020): 91 – 98 y E. Kirillova; O. Blinkov; T. Zulfugarzade; A. Bocharov y A. Avdalyan, "El estado legal de los tokens y su herencia", *JURÍDICAS CUC*, Vol: 16(1) (2020): 287–302.

³ C. K. Prahald y M. S. Krishnan, *Prostranstvo biznes-innovatsii: sozдание tsennosti sovместno s potrebitелеm* (Moscow: Alpina Publisher, 2012)

⁴ K. Eleanor y W. Shane, *Crowd-funding: an infant industry growing fast*. Staff working paper of the IOSCO Research Department. Retrieved from: <https://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>

⁵ Crowdfunding innovative ventures in Europe. The financial ecosystem and regulatory landscape. 2013. Retrieved from: <https://ec.europa.eu/digital-agenda/en/news/crowdfunding-innovative-ventures-europe-financial-ecosystem-and-regulatory-landscape-smart>

⁶ Kakim kraudfandingovym ploshchadkam možno doveryat v Rossii. Retrieved from: <http://svoedelo-kak.ru/finansy/kraudfanding.html>

The term "crowdfunding" refers to a model of funding of an investment project relying on the Internet to raise available cash from the public (individuals, microinvestors) pursuing their own interests to fund commercial projects with financial rewards for investors. Crowdfunding is a specific type of crowdfunding with financial rewards for investors⁷.

The most popular model of crowdfunding in Europe is reward-based crowdfunding (approximately a half of all projects), followed by donation-based and lending-based crowdfunding in the second place (approximately 25% each). There is a direct link between the amount of investment and the model used. On average, the respective amount is 1,054 EUR for the donation-based type; 1,732 EUR for the reward-based type; 3,540 EUR for the lending-based type and 143,085 EUR for the equity-based type⁸. Thus, crowdfunding allows attracting considerable funds for various projects. In areas such as real estate requiring significant financial resources from an investor, the participatory economic mechanism allows attracting retail investors, which considerably expands the potential of such investment⁹.

Of particular interest today are Initial Coin Offerings (ICO), an innovative form of crowdfunding targeting the development of a new cryptocurrency. This type of crowdfunding is arranged as follows: digital platform organisers attract funds in the form of fiat currencies, investors are issued tokens of the initial offering of the new cryptocurrency, which they get in their disposal, gaining the advantages of the initial offering¹⁰. E. g., TELEGRAM's TON project in 2018 raised 1.8 billion USD for a launch of the new GRAM cryptocurrency in a private ICO engaging 175 investors, with the minimum limit of 20 million USD. However, the project failed. The United States Securities and Exchange Commission (SEC) won a court ruling that the token of TON, GRAM, should be considered a security only transferable with prior registration, which meant investors could not receive tokens and it eventually led to project shutdown¹¹.

In May 2020, the project was announced to shut down, however, no further details were provided as to how the attracted funding would be repaid. The above example shows the high level of risks borne by those engaging in such ICO projects, which calls for the development of a strong legal framework to govern crowdfunding activities in general and, particularly, ICO platforms. Given that, the interest in crowdfunding and its innovative forms is quite strong in research circles in the areas of high technologies, economics and law. There are now many published works worth attention.

⁷ A. V. Kievich y D. A. Koipash, "Kraudininvesting kak alternativnaya model finansirovaniya investitsionnogo proekta", *Ekonomika i banki* Vol: 1 (2016) 58–64.

⁸ Consultation document: Crowdfunding in the EU – Exploring the added value of potential EU action. Brussels. 2013. Retrieved from: https://ec.europa.eu/finance/consultations/2013/crowdfunding/docs/consultation-document_en.pdf

⁹ R.M. Garcia-Teruel, "A legal approach to real estate crowdfunding platforms", *Computer Law & Security Review* Vol 35 num 3 (2019): 281-294.

¹⁰ N. Artemov; L. Arzumanova; A. Sitnik; Y. Smirnikova y S. Zenin, "El modelo de regulación legal de la circulación de monedas virtuales: La investigación sociológica y legal", *JURÍDICAS CUC* Vol: 16 num 1 (2020): 127–144.

¹¹ Sud SShA priznal kriptovalyutu Telegram tsennoi bumagoi. 2020. Retrieved from: <https://www.rbc.ru/crypto/news/5e7b02729a7947bafa0c48>

These include works by Iu. A. Tarasov, V. D. Khudo¹², A. V. Dergachev¹³, D. L. Panin¹⁴ and others. However, most papers available for review discuss individual aspects of crowdfunding, such as applications in specific economic sectors, risks involved or innovations (ICO). Complex studies are still rare, which is why the present paper addressing both the overall idea of crowdfunding and its digital constituent deserves a claim to scholarly novelty.

Research hypothesis. The widespread adoption of innovative technologies and high risks for investors suggest Russia urgently needs to develop legal regulation in the area of crowdfunding and ICO.

Methods

The research combines the dialectic method with the methods of theoretical generalisation, comparative analysis and synthesis and the statistical method to substantiate the need for developing legal acts needed to govern public relations around the use of crowdfunding in Russia and to select an appropriate model of state regulation. The formal legal method helped to isolate notions to be incorporated in the projected legal regulation. The information basis to prove the hypothesis of the study comprised papers by Russian and foreign researchers concerning the functioning and legal regulation of crowdfunding, statistics available online in the public domain and news published at specialised websites.

Results

The diverse scope of financial types of crowdfunding involving equity may pose a challenge not only for retail investors but even for experienced market participants, as investor rights may differ in different crowdfunding platforms and depending on the country, as national regulations governing this type of activities are not uniform. Another important issue for potential investors is the high risk of startup investments, particularly at the early stage, as project success in such cases is hard to forecast¹⁵. A major concern is how to settle the situations when a crowdfunding platform abruptly ceases operations, e. g., how loan repayment is to be arranged by the companies that receive financing (investments) in line with the signed agreements and without lost cash.

This suggests legal regulation should be prioritised in research concerning crowdfunding, as there are no clear legal foundations in the Russian Federation for this type of investment, meanwhile, international practice may provide the basis for further elaborations in this aspect.

¹² Iu. A. Tarasov y V. D. Khudo, "Perspektivy pravovogo regulirovaniya kraudfandinga i drugikh vidov kraudinvestinga v Rossii", *Izvestiya Yugo-Zapadnogo gosudarstvennogo universiteta. Series: History and Law. Vol: 9 num 3 (2019): 26–32.*

¹³ A. V. Dergachev, K voprosu pravovogo regulirovaniya ICO-proektov. In the book: *Sovremennye problemy pravotvorchestva i pravoprimeneniya. Baikal Student Legal Forum 2019: Proceedings of the All-Russian student research and practical conference (2019): 9-12.*

¹⁴ D. L. Panin, ICO kak sposob privlecheniya investitsii – rossiiskii i zarubezhnyi opyt. Collection of papers: *Traditsionnaya i innovatsionnaya nauka: istoriya, sovremennoe sostoyanie, perspektivy. International research and practical conference: in five parts (2018): 27-30.*

¹⁵ Iu. A. Tarasov, y V. D. Khudo, "Perspektivy pravovogo regulirovaniya...26–32

Further institutional development of crowdfunding involves the problem of selecting a model of its regulation. The following options of coordination are currently considered with regard to the analysed activities: ban; no specialised regulatory framework; banking regulation; intermediate option and American regulatory model. A study conducted by the Bank of Russia indicates that the first option implies an outright regulatory taboo, while the second one refers to an absolutely free market, though, potentially, with some statutes in place aimed at investor protection. The model of banking regulation, as the name shows, addresses the operation of P2P-platforms within the framework of the banking sector, i. e., crowdfunding sites are required to obtain banking licences, to file reports, etc. The study also describes the "intermediate" model as operating with regulations governing the functioning of P2P-platforms, with clearly stated licencing and advertising aspects in this area and defined mechanisms of calculating interest rates; meanwhile, the American model involves two levels of regulation administered by the SEC and each state¹⁶.

The Russian Federation is now among those countries where there is no regulation of crowdfunding. However, since 2015, the Bank of Russia has taken on monitoring the operation of P2P (crowdfunding) and P2B (crowdinvesting) sites, encouraging voluntary filings and hosting working meetings¹⁷. In one of his papers, V. A. Kuznetsov, member of the Expert Board for National Payment System Legislation under the State Duma Committee on Financial Market, proposed a range of approaches to financial market regulation with regard to new market players: – development and adoption of a special set of regulatory acts defining the scope of subjects under regulation, competent bodies administering oversight of their operations, requirements concerning anti-money laundering regulations and combating the financing of terrorism and security issues (in case of fraud or technical disruptions of IT-platforms) and so on; – institutionalising self-regulation; – adoption of licencing (as in Malaysia)¹⁸.

Crowdfunding ICO projects based on blockchain technology are now extremely popular. In many cases, the expected returns are calculated in hundreds or thousands per cent, which attracts crowds of investors and the market overheats. Investment risks multiply, too. This calls for the governments to take control of the situation by setting clear legal standards for organisers of ICO platforms.

In 2018, the Ministry of Finance and the Central Bank of the Russian Federation initiated draft laws "On Digital Financial Assets"¹⁹ and "On Alternative Investment Raising (Crowdfunding)"²⁰. The object of the latter is the relations around attracting investment by legal entities or individual entrepreneurs through investment platforms. The draft law also defines the legal foundations for investment platform operators in arranging retail funding (crowdfunding).

¹⁶ Ravnopravnoe kreditovanie: shag v ekonomiku sovmestnogo potrebleniya. Obzor regulirovaniya finansovykh rynkov Num 1 (2016): 12–17.

¹⁷ Obrashchenie k rukovoditelyam kraudfandingovykh (P2P) i kraudinvingovykh (P2B) ploshchadok. Bank of Russia. 2016. Retrieved from: http://cbr.ru/finmarkets/files/supervision/Inf_note_jun_0716.pdf

¹⁸ V. A. Kuznetsov, "Kraudfanding: aktualnye voprosy regulirovaniya", Dengi i kredit. News and analysis Vol: 1 (2017): 65–73.

¹⁹ Draft of the federal law "On Digital Financial Assets" (prepared by the Ministry of Finance of Russia) (not submitted to the State Duma of the Federal Assembly of the Russian Federation). February 16, 2018.

²⁰ V. A. Kuznetsov, "Kraudfanding: aktualnye voprosy regulirovaniya", Dengi i kredit. News and analysis Vol: 1 (2017): 65–73.

An important regulatory role, according to the draft law, is reserved to the Bank of Russia. E. g., Article 14 of the Draft law on crowdfunding assigns the following functions to the Bank of Russia: maintaining a register of investment platform operators; administering inspections of operators' business; issuing obligatory corrective instructions, etc. This kind of strict control and focused policies, presumably, would help to squeeze out shadow structures from the market and bring down the risks of losses associated with fraud^{21,22}.

The operator, on its part, is entitled by Article 4, clause 4 of the Draft law on crowdfunding to unilaterally adopt adjustments in the regulations of the investment platform. Relations between investment platform participants existing prior to such adjustments shall not be affected. Such flexible system would support the efficient and prompt achievement of investment project objectives and would help to clear the market of "dead" projects²³.

According to clause 3, part 1, Article 13 of the Draft law on crowdfunding, delivering an agreement for services at an investment platform, apart from the operator' details, would also require the identification of the subject attracting investment and its main objects. The lawmakers' intent is that it would help to prevent the financing of terrorism and other criminal groups and money laundering. A similar approach is already adopted by the tax authorities in Australia where investor identification for those attracting digital funds is used to levy taxes²⁴.

Discussion

Timely development of the legal regulatory base for ICOs is the determining factor of country attractiveness for companies opting for this method to attract investment. In turn, such companies provide clear benefits for the host country: tax revenues on attracted capital, capital inflows in the economy, job creation and attraction of foreign highly-skilled talent. The first country to adopt ICO regulations is the USA. In the summer of 2017, the SEC announced that initial token offerings represented risky investments and the US securities laws should apply to digital tokens having features typical of securities. This means, any company arranging an ICO should be prepared for regulatory oversight of the SEC or would have to prove that the tokens issued are not securities²⁵.

Neighboring Canada followed the lead of the USA; late in August, the Canadian Securities Administrators (CSA) announced the securities law would apply to ICOs if the token issue is proven to classify as securities. If tokens fall within this category, the issuer will be obliged to request regulatory recommendations on the token sale. Technologically advanced Asian economies followed the lead of North America, e. g., Hong Kong and

²¹ A. V. Dergachev, "K voprosu pravovogo regulirovaniya ICO-proektov. In the book: *Sovremennye problemy pravotvorchestva i pravoprimereniya*", Baikal Student Legal Forum 2019: Proceedings of the All-Russian student research and practical conference (2019): 9-12.

²² E. Kirillova; V. Bogdan; I. Lagutin y E. Gorevoy, "Estado legal de los contratos inteligentes: características, papel, significado", *JURÍDICAS CUC* Vol: 15 num 1 (2019): 285-300.

²³ A. V. Dergachev, "K voprosu pravovogo regulirovaniya ICO-proektov. In the book: *Sovremennye problemy pravotvorchestva i pravoprimereniya*", Baikal Student Legal Forum 2019: Proceedings of the All-Russian student research and practical conference (2019): 9-12.

²⁴ A. V. Dergachev, K voprosu pravovogo regulirovaniya ICO-proektov. In the book: *Sovremennye problemy pravotvorchestva i pravoprimereniya*. Baikal Student Legal Forum 2019: Proceedings of the All-Russian student research and practical conference (2019): 9-12.

²⁵ D. L. Panin, *ICO kak sposob...* 27-30

Singapore adopted similar regulations along the lines of those in the USA. However, not all Asian countries would take this stance. In China and South Korea, ICO was rejected as an illegal method of fundraising, which is prohibited in the countries. Notwithstanding their dogmatism, European countries would not forgo ICOs. The Swiss financial watchdog, Financial Market Supervisory Authority (FINMA), announced it would explore all ICOs taking place in the country to find out whether some ICO types may fall within the range of the applicable regulatory competences. Switzerland is now one of the best countries to arrange an ICO²⁶.

An important observation here concerns the obvious ambiguity of the legal foundations developed in ICO regulation in foreign countries. Based on the analysis of regulatory framework development for ICO operations in foreign countries, A. V. Tolokov classified countries in the following blocks²⁷:

- countries without a declared clear stance as to ICOs and cryptocurrencies (a majority of countries);
- countries where ICOs are banned (Bolivia, Bangladesh, Brazil, Afghanistan, etc.);
- countries where there is no official ban against ICOs but no regulation is currently administered pending the development of an official stance on ICOs (Greece, Denmark, France, etc.) or due to the ongoing preparation of the regulatory framework (Belgium, Italy, Russia, etc.);
- countries where the legal framework of ICOs is already integrated in the national legal framework and regulatory stance (Estonia, Lithuania, the UK, Germany, Canada, Luxembourg, Australia, Japan, etc.)²⁸.

Generally speaking, in most cases, specifically in the EU, national legislation with regard to ICOs is technologically neutral. In other words, new ICO-related developments are subject to traditional legal regulation. E. g., in Germany, the applicability of regulations with regard to an ICO depends on the type of tokens. If tokens are acquired by consumers, laws on consumer protection apply. In Estonia, if tokens issued in an ICO have features typical of securities, then securities laws will apply. A similar approach is applied in Lithuania and other countries. Some countries with aspirations to develop a national digital industry are creating a favourable environment by bringing down bureaucratic entry barriers for digital products and services and launching the so-called regulatory sandbox. E. g., the UK financial regulator has now progressed into the testing stage, as it practices the case-by-case approach in licencing the operations of ICO organisers and provides support and consultations in legal aspects. Meanwhile, some EU countries are only on their way to formulating regulatory approaches to address new phenomena. E. g., the conclusions of the public consultations concerning ICOs were released in France on February 22, 2018²⁹.

²⁶ D. L. Panin, ICO kak sposob privilecheniya investitsii – rossiiskii i zarubezhnyi opyt. Collection of papers: Traditsionnaya i innovatsionnaya nauka: istoriya, sovremennoe sostoyanie, perspektivy. International research and practical conference: in five parts (2018): 27-30.

²⁷ A. V. Tolokov, "Finansovo-pravovoe regulirovanie kriptovalyuty i ICO v zarubezhnykh stranakh", Vestnik Moskovskogo universiteta MVD Rossii Vol: 1 (2019): 7.

²⁸ A. V. Tolokov, "Finansovo-pravovoe regulirovanie...7

²⁹ Draft of the federal law No. 419090. March 20, 2018.

In particular, three propositions were put forth in the consultations initiated by the French financial regulator, Autorite des marches financiers, AMF, including adjustments to ICOs to avoid the need to revise applicable laws, while maintaining the best practices of technological neutrality; expansion of the existing legal base to approach ICOs as an initial public offering of securities (IPO); elaborating and adopting new legislation to regulate ICOs. The third option gained the most support at the public consultations, and the AMF decided to proceed with the development of the legal framework for ICOs, focusing specifically on guarantees for investors and compliance with the requirements concerning anti-money laundering regulations and combating the financing of terrorism³⁰.

That said, the EU member states should take into consideration not only national regulation, but also the supranational legislation of the EU. In particular, the European Securities and Markets Authority (ESMA) set out the requirements for ICOs in the EU member states in 2017³¹. ESMA does not prohibit ICOs in the EU. In addressing the possibility for ICO projects to be taken beyond the existing legal framework, there is the key indication that ICO projects should not contradict the EU laws, particularly, the EU Prospectus Directive, implying the requirement, where an ICO project meets the criteria of an IPO (initial public offering of securities), to publish a prospectus for the offering upon its approval by the regulator; the EU Markets in Financial Instruments Directive in case the markers have features typical of financial instruments; the EU Alternative Investment Fund Managers Directive in case the ICO qualifies as an alternative investment fund; and the Fourth Anti-Money Laundering Directive setting the requirement for obligatory customer identification³².

In the Russian Federation, initial token offerings are not regulated in any way and for that reason, many companies avoid conducting ICOs there³³. Meanwhile, 50% of ICOs are arranged by Russian citizens who have to go abroad, even though they might potentially accomplish it in Russia³⁴.

Conclusion

Crowdfunding is a high-tech and convenient instrument to modernise the financial and investment system. It provides certain clear advantages and represents a promising and potentially rewarding financing and investment technique. Firstly, an initial coin offering, ICO, represents one of the new forms of attracting investment through a sale of coins (tokens) to the public. On the one hand, decentralisation spurs the popularity of this approach to project financing, while, on the other hand, as observed above, it creates risks both for the traditional government institutions and for private individuals (potential investors). Other serious barriers for crowdfunding and particularly ICOs in Russia include fraud; faulty practices of borrowers failing to comply with loan agreements; unresolved tax issues; low confidence levels, etc.

³⁰ A. V. Tokolov, "Finansovo-pravovoe regulirovanie...7

³¹ Advise and publications for investors: Official website of the European Securities and Markets Authority. Retrieved from: <https://www.esma.europa.eu/search/site/ICO>

³² A. V. Tokolov, "Finansovo-pravovoe regulirovanie...7

³³ E. Kirillova; O. Blinkov; T. Zulfugarzade; A. Bocharov y A. Avdalyan, "Estado legal de los contratos inteligentes: características, papel, significado", JURÍDICAS CUC Vol: 15 num 1 (2019): 285-300.

³⁴ D. L. Panin, ICO kak sposob privilecheniya investitsii – rossiiskii i zarubezhnyi opyt. Collection of papers: Traditsionnaya i innovatsionnaya nauka: istoriya, sovremennoe sostoyanie, perspektivy. International research and practical conference: in five parts (2018): 27-30.

Such problems have to be analysed and resolved shortly primarily by way of development of a sound and adequate legal base. Therefore, the conducted analysis suggests that new phenomena such as crowdfunding and, particularly, its digital variety, ICOs, call for regulation, and one of the most relevant issues for investment is the issue of legal regulation of new applications of investment techniques. The research hypothesis is thus confirmed. Further research into crowdfunding regulation could be concerned with the elaboration of efficient mechanisms to ensure investor protection and guarantees of repayment of contributed funds in case the crowdfunding project fails.

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