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Unravelling China's Gradual Approach to Equity Crowdfunding Regulation

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UNRAVELLING CHINA’S GRADUAL APPROACH TO EQUITY CROWDFUNDING REGULATION

CHEN LI* AND YU QIANQIAN**

Crowdfunding is a phenomenon that has seen stunning growth since the early 2010s. With the advent of the Internet, it has become an increasingly commonplace method of fundraising, especially for startups and small and medium enterprises. Of the different types of crowdfunding, equity crowdfunding (“ECF”) carries the unique traits of securities offering, and thus poses significant risks for investors and market regulators alike. Various jurisdictions have taken a stride to implement specific laws and regulations that specifically target such activities, while the rest have made modifications to the existing regimes in bid to accommodate ECF. As one of the largest economies and the most populous country in the world, the potential for ECF activities in China is enormous. Yet, it appears that ECF activities remain an ambiguous fit within the present Chinese legal regime. As such activities continue to tread with care in the grey areas of law, they risk falling foul of both the Chinese Securities Law and the Criminal Law. This Article thus seeks to give a brief overview of the current ECF practices in China, discuss their legal implications, and rationalize the current regulatory approach to ECF.

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I. INTRODUCTION

The concept of crowdfunding goes way back in history. A well-known instance of this is when Joseph Pulitzer published an advertisement in the *New York World*, seeking contributions of a dollar or less from the public to fund the installation of the pedestal for the Statue of Liberty in New York Harbor.¹ Today, with the advent of the Internet and related technologies, the modern idea of crowdfunding has taken shape and is now often known to comprise of three key components: “(1) attracting many investors; (2) who [each] provide small monetary investments; (3) through the convenience and connectivity of the internet.”²

Equity Crowdfunding (“ECF”) refers to the use of the crowdfunding methodology as a substitute for traditional forms of formal venture financing, such that individual small investors receive an equity stake in the business venture.³ It is foremost different from charitable crowdfunding (gratuitous gifting) and rewards-based crowdfunding (funding in exchange of a non-financial token). It is also opposed to concepts such as crowdlending — i.e. debt crowdfunding, or an aggregated version of peer-to-peer lending — where the individual contributors (creditors) expect to have their contributions (loans) returned, often with interest. Hence, ECF is essentially a case where securities instruments are offered. It thus carries the usual risks of fraud, lack of transparency, and information asymmetry affecting the individual investor’s capability to assess the quality of the projects. Moreover, given that such transactions are performed over an online platform that is often less formal or reputable, ECF carries higher risks and necessitates specific regulatory response.⁴

In light of China’s Ministry of Commerce having recently published a

1. *Joseph Pulitzer*, NAT’L PARK SERV., <https://www.nps.gov/stli/learn/history/culture/joseph-pulitzer.htm> (last updated Feb. 26, 2015) (“The [advertisement’s] appeal was so popular that [within four months], the World collected over \$100,000 in donations — most donations being about \$1 or less. Roughly 125,000 people contributed to the completion of the pedestal thanks to Pulitzer’s crusade.”).

2. Alma Pekmezovic & Gordon Walker, *The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital*, 7 WM. & MARY BUS. L. REV. 347, 357–58 (2016); see also Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1, 2 (2014).

3. See James Chen, *Investment Crowdfunding*, INVESTOPEDIA, <https://www.investopedia.com/terms/i/investment-crowdfunding.asp> (last updated Apr. 23, 2018); *Equity Crowdfunding*, SYNDICATE ROOM, <https://www.syndicateroom.com/learn/glossary/equity-crowdfunding> (last visited May 8, 2019).

4. Pekmezovic & Walker, *supra* note 2, at 361.

draft Foreign Investment Law that seeks to significantly liberalize market entry for foreign investment,⁵ foreign investors' involvement in the Chinese market will only increase in the days to come. At present, ECF activities remain an ambiguous fit within the Chinese legal regime. The manner in which they are carried out today often risks falling foul to both Chinese securities law and criminal law. This Article thus aims to canvass the present regime and the prevalent practices adopted in China to help readers navigate the playing field insofar as ECF activities are concerned, for given the absence of foreseeable alterations to the regime in the near future, investors, both local and foreign alike, should necessarily stay apprised of the legal risks and implications, as well as the actual market practices.

II. POSSIBLE REGULATORY APPROACHES TOWARDS ECF

In the realm of ECF regulations around the world, jurisdictions have either imposed entirely new laws to specifically target the ECF industry or have merely adopted existing laws to regulate ECF.⁶

The United States ("U.S."), for instance, passed its Jumpstart Our Business Startups Act ("JOBS Act" or "JOBS") on April 5, 2012, with a stated goal of "improving access to the public capital markets for emerging growth companies."⁷ Essentially, it was to ease the difficulty of finding funds for startups and small-medium enterprises ("SMEs") and to revitalize the lull in the post-2008 Financial Crisis finance industry.⁸ Title III of the JOBS Act pertains to crowdfunding specifically, and the specific provisions thereunder make exemptions for qualifying issuers from federal securities law, namely the Securities Act of 1933. It further establishes a regulatory

5. See *China Consults Public Opinion on Draft Foreign Investment Law*, THE NAT'L PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA (Dec. 27, 2018), http://www.npc.gov.cn/englishnpc/news/Legislation/2018-12/27/content_2068862.htm ("China's top legislature on Wednesday published the full text of a draft foreign investment law to consult public opinion Necessary mechanisms on the facilitation, protection and management of foreign investment are written into the draft law, such as the pre-establishment national treatment and negative list management, equal supportive policies and equal participation in government procurement.").

6. See Eleanor Kirby & Shane Worner, *Crowdfunding: An Infant Industry Growing Fast* 30 (IOSCO Res. Dep't, Staff Working Paper SWP3/2014), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD459.pdf> (stating that three approaches are taken worldwide: an absolute ban, setting thresholds to be met by stakeholders before participation in ECF allowed, or to allow free market access to all).

7. Zachary Robock, Note, *The Risk of Money Laundering Through Crowdfunding: A Funding Portal's Guide to Compliance and Crime Fighting*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 113, 113 n.1 (2014).

8. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112–106, 26 Stat. 306 (2012).

framework for investors and intermediaries as well.⁹ It further requires the Securities Exchange Commission (“SEC”) to introduce rules and issue studies on capital formation, disclosure and registration requirements for participants of ECF activities. Accordingly, the SEC adopted Regulation Crowdfunding, which came into full force on May 16, 2016.

Unlike the U.S., jurisdictions such as the United Kingdom (“U.K.”) and Singapore do not have express legislative enactments that target the ECF regime. In the U.K., ECF activities fall within the jurisdiction of the Financial Services and Markets Act 2000.¹⁰ With the onslaught of ECF activities since the early 2010s, the Financial Conduct Authority conducted a two-month public consultation in 2013 and fine-tuned the existing securities framework to introduce regulations applicable to ECF activities.¹¹

Similarly in Singapore, the legislature did not introduce any new laws. The main applicable law remains as the Securities and Futures Act (“SFA”) 2001, though issuers participating in ECF could exploit the Small Offers Exemption under the SFA, under which they may be exempted from prospectus requirements.¹² As for the ECF platforms, these intermediaries may foremost be subject to the Financial Advisors Act (“FAA”), and licensing would be required before these intermediaries can lawfully commence operations.¹³ From the perspective of the investors, accredited and institutional investors would also fall under the regulation of the FAA, but for retail investors, the Monetary Authority of Singapore has proposed for intermediaries to impose ‘pre-qualifications’ prior to granting them access to the ECF projects.¹⁴ That said, these proposed ‘pre-qualifications’ require nothing more than that the retail investors sign a declaration that they acknowledge and accept the risks involved.¹⁵

9. Robock, *supra* note 7, at 114–15 (explaining that all three stakeholders — the issuer, investor and intermediary (platform) — fall within the purview of Title III of the JOBS Act).

10. Financial Services and Markets Act 2000, c. 8 (Gr. Brit.).

11. Pekmezovic & Walker, *supra* note 2, at 431–33.

12. Securities and Futures Act, Ch. 289 § 272A(1)(a)(i) (2002) (Sing.) (allowing offerors to make personal offers of securities up to SGD 5 million within any 12-month period, without a prospectus, subject to conditions).

13. Financial Advisors Act, Ch. 110 § 22(1) (2007).

14. *MAS Requires Intermediaries to Assess Investment Knowledge and Experience of Retail Customers*, MONETARY AUTHORITY OF SING., <http://www.mas.gov.sg/news-and-publications/media-releases/2011/mas-requires-intermediaries-to-assess-investment-knowledge-and-experience-of-retail-customers.aspx> (last modified Nov. 26, 2016).

15. See *Factsheet on MAS’ Proposals for Securities-Based Crowdfunding*, MONETARY AUTHORITY OF SING., http://www.mas.gov.sg/~media/resource/news_room/press_releases/2016/factsheet%20on%20mas%20proposals%20for%20securitiesbased

III. LEGAL REGIME IN CHINA

A. Securities Law

From the outset, since ECF is an exceptional instance in the offering equity, it bears noting that there are two general categorizations of securities offerings in China: public offering and private placement.¹⁶ Article 10 of Securities Law, which was last revised in 2014, distinguishes these two categories as follows:

The conditions set forth by laws or administrative regulations must be satisfied in the public issuance of securities, and such issuance must, pursuant to law, be submitted to the securities regulatory authority under the State Council or the departments authorized by the State Council for *examination and approval*. Without such examination and approval pursuant to law, no entities or individuals shall issue securities publicly. Any one of the following circumstances shall constitute a public issuance:

- (1) issuing securities to *non-specific persons*;
- (2) issuing securities to more than 200 specific persons in the aggregate; and
- (3) such other issuing activities as may be so prescribed by laws or administrative regulations.

Where securities are issued in non-public manners, no advertising, public solicitation or any other covert ways in disguised form shall be employed.¹⁷

The crux of Article 10 of the Securities Law is that where an offering fulfills the circumstances under Article 10(2), it would be considered a public offering, which must then be subject to examination and approval; otherwise, when an offering is deemed a non-public issuance of shares, the issuer is subject to publicity restrictions as imposed under Article 10(3).¹⁸ Notably, should ECF activities be found illegal in China, those involved would face severe sanctions, including criminal sanctions under Article 180 of the Criminal Law for offering securities without requisite approval.¹⁹ Since December 2006, the State Council's Notice on Several Issues about Rigorously Cracking Down on Illegal Issuance of Stocks and Illegal

[%20crowdfunding%20scf.pdf](#) (last visited Apr. 19, 2018).

16. See Law of the People's Republic of China on Securities (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, rev'd Oct. 27, 2005, effective Jan. 1, 2006), art. 10, 2006 P.R.C. LAWS 43, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (China).

17. See *id.* (stipulating the requirements for a prospective issuer, which is specified as a company listed by shares, to comply with it if it wishes to make a public offering of shares) (emphasis added).

18. *Id.*

19. *Id.* art. 180.

Operation of Securities Business has mandated the strict forbiddance of issuing of stocks to the public without authorization or in any disguised form, and the illegal operation of securities business, and an “entity or individual that violates any of [these three prohibitions] shall be clamped down firmly, and the legal responsibilities shall be investigated according to law.”²⁰

The 2014 revision of the Securities Law makes no mention of ECF activities. Clearly, even though the size of the ECF market in China is evidently substantial given the sheer size of its population,²¹ the government has taken a rather gradual and incremental regulatory approach in relation to the ECF industry in China. The earliest attempts at introducing some form of regulatory framework to the ECF industry was in the Securities Association of China’s publication of its Consultation Draft on the Measures for Managing Private Equity Crowdfunding (Trial) on December 18, 2014.²² The items considered in that Consultation Paper included the legal status of ECF, definition of ECF platforms, requirements for investors to participate, disclosure requirements by ECF platforms and issuers, prohibitions of ECF activities, many of which were largely repetitions of existing prohibitions under the Securities Law and Criminal Law.²³ Even though this document remains a draft document to date, official guidance has been introduced through the 2015 Guiding Opinions on Promoting the Sound Development of Internet Finance (“2015 Guiding Opinions”),²⁴ a normative regulatory document collectively issued by various governmental departments, paragraph 9 of which states:

9. Equity crowd financing. Equity crowd financing mainly means the

20. Circular of the General Office of the State Council Concerning Some Matter on Severely Cracking Down on Illegal Issuance of Stocks and Illegal Operation of Securities Business (promulgated by the Gen. Office of the State Council., Dec. 12, 2006, effective Dec. 12, 2006), Guo Ban Fa [2006] No. 99 (China).

21. Lin Lin, *Managing the Risks of Equity Crowdfunding: Lessons from China*, 17 J. CORP. L. STUD. 327, 328 (2017) (citing Shen Lingkun, *Qing Ke Observations: Publication of 2016 Equity Crowdfunding Report, Summary of 2015 Equity Crowdfunding Developments Spurred on by JD and Ali*, PE DAILY (Mar. 21, 2016)) (“2015 witnessed the establishment of 84 new platforms, with 1,175 projects successfully raising RMB 4.374 billion (about USD 660 million) from these platforms.”).

22. 关于就《私募股权众筹融资管理办法（试行）（征求意见稿）》 [Administrative Measures for Private Equity Crowdfunding (Draft for Comments)] (promulgated by Sec. Ass’n of China, Dec. 18, 2014), http://www.sac.net.cn/tzgg/201412/20141218_113326.html.

23. *See id.*

24. Para. 9, Guiding Opinions of the People’s Bank of China, the Ministry of Industry and Information Technology, the Ministry of Public Security, et al, on Promoting the Sound Development of Internet Finance, (promulgated by the People’s Bank of China et al., July 14, 2015, effective July 14, 2015) Yin Fa [2015] No. 221 (China).

public small-sum equity financing activities carried out through the Internet. Equity crowd financing shall be carried out through the platforms of the equity crowd financing intermediary institutions (Internet websites or other similar electronic media). *Equity crowd financing intermediary institutions* may, under the premise of complying with the laws and regulations, innovate on and explore the business types, maximize the role of equity crowd financing as an organic integral part of the multi-level capital market so as to better serve the innovation and business startup enterprises. *Equity crowd financing parties* shall be micro and small enterprises and truthfully disclose the business model, business operation management, finance, capital use and other key information to investors through the equity crowd financing intermediary institutions, and shall not mislead or cheat investors. *Investors* shall fully understand the risks of equity crowd financing activities, have corresponding risk tolerance, and make small-sum investment. The equity crowd financing business shall be subject to the supervision by the China Securities Regulatory Commission.²⁵

In addition to providing a definition, the 2015 Guiding Opinion also mandated the involvement of an intermediary in carrying out any ECF activity and further provided general guidelines as to the conduct of the ECF platform (intermediary), the financing parties as well as the investors.²⁶ Following the issuance of the 2015 Guiding Opinions, the China Securities Regulatory Commission (“CSRC”), which was tasked with supervising the ECF activities in China, soon issued its Notice on Conducting Special Inspections of Institutions Engaging in Equity Financing via the Internet on August 3, 2015 (“2015 CSRC Notice”).²⁷ This departmental regulatory document expressly sets out that these “financing activities are characterized as being ‘open, small-sum and public’ and concern the public interests and national financial security,” which warranted its regulation “according to the law.”²⁸ References were then made to the Company Law, Securities Law, and several related regulatory documents,²⁹ albeit none pertained exclusively to ECF activities. This 2015 CSRC Notice thus legitimized local offices of

25. *Id.* (emphasis added).

26. Guiding Opinions on Promoting the Healthy Development of Internet Finance (promulgated by State Admin. for Indus. & Commerce et al., July 18, 2015, effective July 18, 2015) Yin Fa [2015] No. 221 (China).

27. (promulgated by Gen. Off. of the China Sec. Reg. Comm’n, Aug. 3, 2015, effective Aug. 3, 2015) Zheng Jian Ban Fa [2015] No. 44 (China).

28. *Id.*

29. *Id.* These laws include the Interim Measures for the Supervision and Administration of Privately Offered Investment Funds, Order No. 105 of the CSRC with effect from August 21, 2014; and the Securities Investment Fund Law of the People’s Republic of China (2015 Amendment), Order No. 23 of the President of the People’s Republic of China with effect from April 24, 2015.

the CSRC to conduct inspection on equity financing platforms to determine “whether the financiers on platforms publicly propagandize, whether securities are issued to unspecific investors, whether the number of shareholders exceeds 200 cumulatively, and whether privately offered equity funds are offered in the name of equity crowdfunding.”³⁰

Following up on the 2015 CSRC Notice, the Implementation Plan for the Special Rectification of Risks in Equity Crowdfunding (“2016 Implementation Plan”) was issued on April 14, 2016.³¹ In particular, one of its main objectives was to conduct “centralized checking with full coverage,” where “problematic institutions and individuals” shall be ordered to “make rectification in accordance with laws and regulations,” failing which shall be “severely punished.”³² To that end, the 2016 Implementation Plan set out several “priority rectifications” to be made, including “internet equity financing platforms . . . that engage in equity financing business in the name of ‘equity crowdfunding[,]’ . . . platforms that raise private equity investment funds in the name of ‘equity crowdfunding[,]’ . . . platforms, real estate development enterprises, and real estate intermediaries that carry out illegal fund-raising activities in the name of ‘equity crowdfunding.’”³³

Rectifications were also aimed at the platforms that conduct false publicity and mislead investors by fabricating or exaggerating their strength, information on financing projects, returns, and other methods; money raisers on the platforms who publicly issue stocks directly or in disguise without approval; and securities companies, fund companies, futures companies, and other licensed financial institutions that cooperate with internet companies in carrying out business in violation of laws and regulations.³⁴

All in all, these rectifications show that even though the CSRC did not introduce any positive regulations targeted at ECF activities per se, the clear notion of the 2016 Implementation Rules was to prevent the misuse of this new ECF label to cause undesirable disruptions to the existing economic activities and to negate any mischief caused by the illegal financial activities that might have escaped regulation by disguising as ECF platforms.³⁵ In other words, this was an attempt to prevent the existing regulatory regime

30. *Id.* para. III.

31. Notice of Issuing the Implementation Plan for the Special Rectification of Risks in Equity Crowdfunding, (promulgated by China Sec. Reg. Comm’n, Apr. 14, 2016, effective Apr. 14, 2016) Zheng Jian Fa [2016] No. 29. Notably, this 2016 Implementation Plan was supposed to have been completed by January 2017. *Id.* para. IV.

32. *Id.* para. (I)(1).

33. *Id.* para. (II)(1).

34. *Id.*

35. *See id.* (insinuating that while the CSRC does not explicitly provide regulations for ECF, it is implied within the text).

and economic equilibrium from being destabilized by the introduction of ECF platforms.

Another objective of the 2016 Implementation Plan was to further improve the “laws, regulations, and rules . . . and the long-term regulatory mechanism” for the sound development of internet equity financing.³⁶ In line with this motivation, news released in mid-2016 disclosed that the CSRC was looking to include ECF regulations in the amendments to the Securities Law,³⁷ although to date, neither amendments to the Securities Law nor positive laws or regulations targeted at ECF activities have been introduced, leaving them subject to the existing regulatory framework. Besides national laws and departmental regulations, there are various provinces in China that have enacted local regulatory policies to supervise ECF activities conducted within their locality.³⁸ Besides the municipalities of Beijing, Shanghai and Tianjin, the other early adopters of ECF regulations include the provinces of Guangdong, Shandong, Jinan, Anhui, Shanxi, and Hunan.³⁹

B. Criminal Law

ECF is also susceptible to criminal sanctions in China, under what is generally known as “illegal fundraising.”⁴⁰ This term does not correspond with any specific offenses in the Criminal Law of China. Instead, the Supreme People’s Court (“SPC”) issued its Judicial Interpretation on Several Issues on the Specific Application of Law in the Handling of Criminal Cases about Illegal Fundraising in 2010 (“2010 SPC Judicial Interpretation”), which suggests that the ambit of “illegal fundraising” could cover the following six different types of crimes in the Criminal Law⁴¹:

Figure 1

36. *Id.* para. (I)(1).

37. See 证监会:积极推动出台私募基金监管条例 [CSRC: *Actively Promote the Introduction of Private Equity Fund Supervision Regulations*], CHINA SEC. NEWS: CHINA SEC. NETWORK (BEIJING) (Apr. 28, 2016, 12:33 PM), <http://money.163.com/16/0428/08/BLNNNT6K00251LDV.html>.

38. See FINANCING FROM MASSES CROWDFUNDING IN CHINA 121–30 (Jiazhuo G. Wang et al. eds., 2018) (listing “local regulatory policies of the crowdfunding industry”).

39. See *id.* (showing an extensive list of the local regulatory policies in place from 2015 to September 2016 and stating that policies relating to ECF activities were introduced in these municipalities and provinces by the end of 2015).

40. Interpretation of the Supreme People’s Court on Certain Issues Relating to Specific Application of Law with Respect to the Trial of Illegal Fund Raising Criminal Cases (promulgated by Sup. People’s Ct., Dec. 13, 2010, effective Jan. 4, 2011) Fa Shi [2010] No. 18 (China).

41. *Id.* at *1–4, 7–8, 11–12.

	Type of Offence	Category of Offence	Criminal Law
(1)	Illegal Procurement of Public Savings (or Procurement in Disguised Form)	Section 4, Criminal Law — Crimes of Undermining the Order of Financial Administration	Article 176 ⁴²
(2)	Illegal Fundraising by means of Fraud	Section 5, Criminal Law — Financial Fraud Crimes	Article 192 ⁴³
(3)	Illegal Offering of Securities without Approval ⁴⁴	Section 4, Criminal Law — Crimes of Undermining the Order of Financial Administration	Article 179 ⁴⁵
(4)	Illegal Offering of Securities by means of Fraud ⁴⁶	Section 3, Criminal Law — Crimes of Disrupting the Order of Administration of Companies and Enterprises	Article 160 ⁴⁷
(5)	Illegal Business Operation	Section 8, Criminal Law — Crimes of Disrupting Market Order	Article 225 ⁴⁸

42. Criminal Law of the People's Republic of China (promulgated by the Standing Comm. Nat'l People's Cong., July 1, 1979, rev'd Mar. 14, 1997, effective Mar. 14, 1997) art. 176, 1997 P.R.C. LAWS 83, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384075.htm (China).

43. *Id.* art. 192, 1997 P.R.C. LAWS 83.

44. *See also* Law of the People's Republic of China on Securities (promulgated by the Standing Comm. Nat'l People's Cong., Dec. 29, 1998, rev'd Oct. 27, 2005, effective Jan. 1, 2006) art. 188, 2006 P.R.C. LAWS 43, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (China) (regulating public issuance of securities).

45. Criminal Law of the People's Republic of China, art. 179, 1997 P.R.C. LAWS 83.

46. *See also id.* arts. 5, 69, 189 (regulating the public issuance of securities and illegal acts surrounding such action).

47. Criminal Law of the People's Republic of China, art. 160, 1997 P.R.C. LAWS 83.

48. *Id.* art. 225.

(6)	False Advertisement and Publicity	Section 8, Criminal Law — Crimes of Disrupting Market Order	Article 222 ⁴⁹
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Items three and four are the two offences directly related to illegal offering of securities and are therefore directly relevant to the very nature of ECF activities, whereas items five and six are the operational offences that ECF platforms could face, should there be lapses in their business processes. Due to the nature of these violations, the six offences listed above can be categorized into three types of illegality: those arising from the lack of approval from the relevant authorities (Items 3 and 5); those arising from the use of fraudulent or deceitful means (Items 2, 4, and 6); and the offence of Illegal Procurement of Public Savings or Procurement in Disguised Forms (Item 1).

The offence of Illegal Procurement of Public Savings or Procurement in Disguised Forms (“Illegal Procurement”) is a unique criminal offence in China that merits specific mention.⁵⁰ Its roots are found in the establishment of the central bank, i.e. the People’s Bank of China (“PBC”), where under Article 31 of the 1995 Law of the People’s Bank of China, the PBC was given the authority to “examine and approve the establishment, modification and termination of banking institutions, as well as the scope of their business operations.”⁵¹ Any private “commercial banks or any other banking institutions” formed without the approval of the PBC were thus illegal.⁵² This was first criminalized under Article 174 of the 1997 Criminal Law.⁵³ Some even take the opinion that this offence constitutes the seventh crime that falls under the umbrella of “illegal fundraising,”⁵⁴ albeit not at all being

49. *Id.* art. 222.

50. Based on the literature consulted for this Article, there does not appear to be any equivalent criminal offences constituted by the absorption of public funds in other jurisdictions; instead, usually these fell under the broad categories of swindling, cheating, or even corruption or embezzlement, but never as a crime on its own.

51. Laws of the People’s Republic of China on the People’s Bank of China (promulgated by the Standing Comm. Nat’l People’s Cong., Mar. 18, 1995, effective Mar. 18, 1995) art. 31, 1995 P.R.C. LAWS 4, <http://www.asianlii.org/cn/legis/cen/laws/pboc154/> (China).

52. Criminal Law of the People’s Republic of China (promulgated by the Standing Comm. Nat’l People’s Cong., July 1, 1979, rev’d Mar. 14, 1997, effective Mar. 14, 1997) art. 174, 1997 P.R.C. Laws 83, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384075.htm (China) (ordering that the PBC is the only entity with the power to create and provide the advantages of a commercial bank).

53. *See id.*

54. *See* LU QINZHONG, THE CRIMINAL LAW THEORY & PRACTICE OF ILLEGAL FUND-RAISING CRIMES 6 (Shanghai Renmin Press 2014).

referenced in the 2010 SPC Judicial Interpretation. In the same vein, any “illegal taking of deposits from the general public or . . . in disguised form thus disrupting financial order” was therefore criminalized as well, under Article 176 of the 1997 Criminal Law.⁵⁵ Today, the case law on Illegal Procurement largely pertains to criminals who procured public ‘savings’ with the intent to retain such illegally acquired funds,⁵⁶ as opposed to retaining the ‘savings’ due to a promise of return of principal with interests.

With the advent of ECF, it comes as no surprise that this fundraising vehicle could be used as a tool to conduct Illegal Procurement; analyzing actions for illegality thus boils down to a matter of characterization as to whether the monies were invested in exchange for equity with dividends or loaned in exchange for repayment with interests.⁵⁷ Pursuant to the 2010 SPC Judicial Interpretation, it was further qualified that Illegal Procurement pertained explicitly to illegal absorption from the “general public, i.e. unspecified persons” and does *not* apply to anyone who “absorbs funds from his relatives, friends or specific person within an entity without publicity in the society.”⁵⁸ In other words, the exception to this offence is rather wide, which inevitably greatly limits the scope of this provision’s reach. Indeed, at the enforcement level, there have been reports that forty-three ECF platforms were shut down in the first four months of 2016 due to illegal fundraising, misrepresentation, internal conflict, and lack of funding,⁵⁹ but none were prosecuted for the illegal procurement of public savings. As such, it can be said that this unique crime is hardly the main cause of worry for ECF platforms in China. Because of its relative novelty, the greatest source of doubt cast upon ECF is still in its potential for fraud.⁶⁰

IV. PREVALENT ECF PRACTICES IN CHINA

It is not difficult to see that the purported prohibitions under the present

55. Criminal Law of the People’s Republic of China, art. 174, 1997 P.R.C. Laws 83.

56. Fang Binwei, *Jizi Qipian yu Feifa Xishou Gongzhou Cunkuan Zui De Qufen*, 29 RENMIN SIFA ANLI 30 (2016).

57. See, e.g., Yang Jiao, 股权众筹4个月倒闭43家平台 生存环境仍艰难 [Equity Crowdfunding in Trouble, 43 Platforms Closed in 4 Months], YICAO GLOBAL (June 14, 2016), <http://finance.sina.com.cn/money/lczx/2016-06-14/details-ixszkzy5230708.shtml> (describing the unclear legal status of equity crowdfunding).

58. Interpretation of the Supreme People’s Court on Certain Issues Relating to Specific Application of Law with Respect to the Trial of Illegal Fund Raising Criminal Cases (promulgated by Sup. People’s Ct., Dec. 13, 2010, effective Jan. 4, 2011) art. 1, Fa Shi [2010] No. 18 (China).

59. Yang Jiao, *supra* note 57.

60. See Zhong Wei & Wang Yi-chun, *The Chinese Style Crowdfunding: Legal Regulation and Investors Protection*, 17(2) J. SW. UNIV. POL. SCI. & L. 23 (2015).

ECF regulatory regime result in a very awkward and superficial, if not artificial, regulatory exercise. Under the 2015 Guiding Opinion, ECF was defined as mainly referring to “*the public small-sum equity financing activities*” which shall be “*carried out through the platforms of the equity crowd financing intermediary institutions (Internet websites or other similar electronic media)*.”⁶¹ It mentions “small-sum equity” injections, but no concrete numbers are found in the text of the laws to quantify or benchmark this qualifier. Also, ECF shall not constitute “public issuances” under the Securities Law by issuing to unspecified persons or to an aggregate of more than 200 specific persons, unless they underwent requisite examination and obtained approval.⁶² Hence, entities that wish to raise funds from a large pool of individual contributors from the general mass are by default precluded from using this mechanism;⁶³ instead, they may turn to conduct project- or rewards-based crowdfunding. Moreover, if equity is privately offered, public solicitation, advertising, or the like in disguised forms, such as “in the name of equity crowdfunding,” should not be present.⁶⁴ In any case, once a fundraising activity finds itself within the four corners of this ECF category, the sourcing entity would be free from the CSRC’s strict scrutiny in its equity issuance⁶⁵ and be at liberty to look for investors from the “public,” albeit a limited pool therefrom.

61. Para. 9, Guiding Opinions of the People’s Bank of China, the Ministry of Industry and Information Technology, the Ministry of Public Security, et al, on Promoting the Sound Development of Internet Finance, (promulgated by the People’s Bank of China et al., July 14, 2015, effective July 18, 2015) Yin Fa [2015] No. 221 (China) (emphasis added).

62. Para. III, Notice of the General Office of the China Securities Regulatory Commission on Conducting Special Inspections of Institutions Engaging in Equity Financing via the Internet (promulgated by Gen. Off. of the China Sec. Reg. Comm’n, Aug. 3, 2015, effective Aug. 3, 2015) Zheng Jian Ban Fa [2015] No. 44 (China); Law of the People’s Republic of China on Securities (promulgated by the Standing Comm. Nat’l People’s Cong., Dec. 29, 1998, rev’d Oct. 27, 2005, effective Jan. 1, 2006), art. 10, 2006 P.R.C. LAWS 43, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (China).

63. See Law of the People’s Republic of China on Securities, art. 10, 2006 P.R.C. LAWS 43. On this note, the limitation on number of unspecified investors would already have been curtailed by the type of underlying vehicle seeking to raise funds through ECF. Companies Law of the People’s Republic of China (promulgated by the Standing Comm. Nat’l People’s Cong., Oct. 27, 2005, rev’d Jan. 1, 2006, effective Jan. 1, 2006) art. 24, 2006 P.R.C. LAWS 42, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384124.htm (China) (limiting the maximum number of shareholders to 50 for Limited Liability Companies); *id.* arts. 78–79 (limiting the maximum number of shareholders to 200 for privately-held Joint Stock Companies, also known as companies limited by shares).

64. Para. II, Zheng Jian Ban Fa [2015] No. 44; *id.*

65. Lin, *supra* note 21, at 335, 351–52 (stating CSRC’s involvement is in the approval of ECF platforms, a temporary measure that was put in place by the CSRC).

In spite of these regulatory red tapes and uncertainties, the Chinese market has nevertheless embraced this commercial financing vehicle.⁶⁶ Various creative ways have been adopted by ECF participants to survive and perhaps even prosper amidst the murky regulatory environment. The general trend today is that ECF platforms invite experienced investors who are high risk-takers to join the venture instead of targeting the general public. Amongst the ‘elite circle,’ some ECF projects adopt a ‘lead investor, plus follower investors’ method, where the bulk of the required capital is first contributed by an angel investor, who is usually more experienced and reputable within the investment circle, and who will then take the lead and pull in smaller investors.⁶⁷ Query whether the lead investor’s bulk investment would contravene the “small-sum equity” restriction in the 2015 Guiding Opinion. Sometimes, the lead angel investor would also form a limited partnership and draw in individual ‘partner’ investors before the entire enterprise takes on the final project together.⁶⁸ In this manner, the funding process would be cloaked as a private placement in a private enterprise, although these ‘partner’ investors were in fact largely gathered from the public through ECF platforms.⁶⁹ In such cases, the ‘lead investor’ takes on the important role of instituting trust to his fellow investors, whose ultimate decision to invest would often couch not upon their own individual confidence in the underlying project, but more upon their reliance on the lead investor’s assessment of the project’s viability.⁷⁰ However, because of the trust placed upon the lead investor, it magnifies the risks of fraud in an instance of collusion between the issuer and the lead investor.⁷¹

Another oft-used method is to have a membership arrangement, such that unspecified members of the public undergo detailed identity registration to become a named (specific) investor.⁷² Any such issuance to less than 200 of

66. See *id.* at 328 (explaining that startups and SMEs in China have long faced great difficulty in obtaining financing from traditional avenues, and ECF thus presents itself as a practical solution this difficulty).

67. See, e.g., Grant Thorton, *Raising Cornerstone Investment: Kicking Off Your Crowdfunding Campaign*, CROWDCUBE (Nov. 19, 2018), <https://www.crowdcube.com/explore/entrepreneur-articles/raising-cornerstone-investment-kicking-off-your-crowdfunding-campaign> (“A cornerstone [or, lead] investor is any investor that commits a significant portion of your funding round — usually 25-50% of the amount you are seeking. Securing cornerstone investment is becoming more and more instrumental in the success of crowdfunding campaigns as it demonstrates validity.”).

68. Lin, *supra* note 21, at 339–40.

69. Wei & Yi-chun, *supra* note 60, at 21.

70. See Lin, *supra* note 21, at 339–40.

71. See *id.* at 340 (discussing the issues with the lead-investor model).

72. There could be legal issues pertaining to privacy and data protection arising from such activities, but these matters are beyond the ambit of this Article.

these ‘club members’ would thus allow the issuer to avoid falling under the definition of ‘public issuance.’⁷³ However, the effectiveness of such ‘alteration’ of character of investors from non-specific to specific has not been tested in the Chinese courts. Even if these methodologies successfully enable such ECF activities to take on the characterisation of a private placement, care must be placed by the platforms to ensure their publicity of the ECF events does not fall foul of Article 10(3) of the Securities Law.⁷⁴ To that end, some ECF platforms not only take on a membership model, but also arrange physical meetings within their exclusive club to publicize and promote their ECF opportunities offline.⁷⁵ Such arrangements are sometimes termed as ‘speed dating,’ where large scale platforms such as AngelCrunch run roadshows for their potential investors.⁷⁶

More importantly, the manners in which the current practices are adopted are arguably in direct contravention of the 2015 CSRC Notice. These practices are precisely the kinds of mischief that the 2016 Implementation Plan sought to “rectify.” The manifest prevalence of such “ECF” activities nevertheless evidences a gaping gray area that continues to exist between black-letter law and law in action.

V. REGULATORY CHALLENGES

The architecture of ECF regulation should rest on the twin pillars of investor protection considerations and the ease of access for fund-seeking entities. Given that the concept of ECF boils down to the solicitation of funds from the public masses through the Internet, the modern arrangement of ECF presents a challenge to the traditional notion of regulation based on the public offering and private placement divide.⁷⁷ Since the main advantage of ECF lies in the relative ease and speed in which funds are supposed to be procured for SMEs, by reason of ECF’s low barriers to entry and lack of complicated procedures, requiring compliance with any such formal public

73. Law of the People’s Republic of China on Securities (promulgated by the Standing Comm. Nat’l People’s Cong., Dec. 29, 1998, rev’d Oct. 27, 2005, effective Jan. 1, 2006), art. 10, 2006 P.R.C. LAWS 43, http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm (China).

74. *See id.*

75. Ya Xian Sun, *Gu Quan Zhong Chou Ji Qi Yun Zuo Ping Tai De Fa lv Xing Zhi Fen Xi*, JING JI ZHONG HENG 128 (2018).

76. Lin, *supra* note 21, at 334 (“Most of the Chinese [ECF] platforms are VC firm-like investment service providers that provide fundraising, investment and exit services for the fundraisers and investors. They generally assume the role of selecting projects, determining valuation, publishing the project, facilitating negotiation between fundraiser and investors through providing road show service and offline ‘matchmaker’ meetings.”).

77. Wei & Yi-chun, *supra* note 60, at 20.

offering requirements of the Securities Law defeats the purpose of ECF entirely. On the other hand, ECF's method of soliciting funds from the masses through the Internet is another ingredient that does not sit well with the traditional notion of offline private placement activities. In effect, it is a hybrid vehicle that meets halfway between a public offering and a private placement.

The division between the law's treatment of public offering and private placement arises from the underlying differentiation of the public retail investors and the private individual actors. The U.S. Supreme Court reasoned this distinction on the basis that the former is in need of protection of the Securities Act, whilst a private group does not because they "are able to fend for themselves."⁷⁸ Hence, if this public-private distinction is blurred and the so-called 'private' individual investors of an ECF project are not afforded sufficient protection, the resulting agency and information asymmetry problems would undoubtedly be extreme. Investor protection is thus the key consideration in preventing the ECF industry from becoming a 'market for lemons' where only low-quality ventures would turn to ECF, while high-quality ventures would continue to rely upon the more matured methods of financing, such as through venture capital or private equity.⁷⁹ To that end, investor protection is the key thrust taken by a majority of the regulatory approaches across the world. For instance, in the U.S., there are even limits imposed on the amount of investment that the retail investor is allowed to partake in.⁸⁰ However, it must be recognized that a risk is a risk regardless of its quantum, and ECF by its very nature is an avenue for the masses to engage in a high-risk investment, even if each individual investment were minute in terms of absolute quantum.

Moreover, the notion of investor protection in public offering is often based upon the accurate and complete disclosure of information, incentivized by sanctions for non-compliance. There are foremost inherent limitations as to a disclosure-based regime for the protection of investors, for it presumes that investors have the capacity to process the disclosed information to make informed decisions.⁸¹ When put in the context of an economically and

78. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) ("Since exempt transactions are those as to which 'there is no practical need for . . . (the bill's) application,' the applicability of [Section 4(a)(2)] should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'").

79. Pekmezovic & Walker, *supra* note 2, at 451.

80. See 15 U.S.C. § 77d(a)(6)(B) (2018) (limiting the amount an investor can invest in crowdfunding based on their income and net worth).

81. Troy A. Paredes, *Blinded by the Light: Information Overload and Its*

socially diverse country like China, this premise founded upon full and frank disclosure becomes extremely shaky. In addition, such an extensive exercise necessarily leads to high costs in procuring funds, which goes against the second pillar of ECF regulation, which is to reduce the costs for SMEs to acquire funds. As such, under the ECF regime, the balance of the considerations of investor protection and access to funds naturally hinges upon the ECF platforms as intermediaries to not only bridge the information asymmetry, but also to perform a gatekeeping role. Various jurisdictions have thus imposed upon ECF platforms regulatory measures of registration as well as substantive positive obligations of conducting due diligence and procuring mandatory insurance.⁸²

Faced with the institutional deficiencies in the Chinese ECF regulatory regime, academics have long called for more proactive public intervention to fill the legislative gap and to strengthen investor-protection.⁸³ The general view is that guidance can be gleaned from other jurisdiction's approach to provide a small offer exemption, set minimum requirements for "qualifying" investors, and impose positive obligations upon ECF intermediaries.⁸⁴ In addition to positive regulatory intervention targeting ECF activities, there are also supplementary (or alternative) options that could assist in containing investment risks between ECF stakeholders, including the strengthening of corporate governance of the issuers and intermediaries,⁸⁵ or for individual stakeholders, the redistribution of risks among themselves through contractual design.⁸⁶ That said, the feasibility and effectiveness of these various mechanisms in managing the fledging ECF industry in the diverse Chinese market are similarly uncertain.

VI. CONCLUDING OBSERVATIONS

Whilst ECF is still in its developmental stages in China, the growth of the

Consequences for Securities Regulation, 81 WASH. U. L. Q. 417, 418 (2003) ("In short, if the users do not process information effectively, it is not clear what good mandating disclosure does."); Jason W. Parsont, *Crowdfunding: The Real and the Illusory Exemption*, 4 HARV. BUS. L. REV. 281, 321–22 (2014).

82. PENG BING, *TOUZIXING ZHONGCHOU DE FALV LUOJI* 244–48 (Peking Univ. Press 2017).

83. See Pekmezovic & Walker, *supra* note 2, at 398; Gan Qiang & Li Weinan, *Woguo Touzixing Zhongchou Falvzhidu de Chubu Jianguo*, HULIANWANG YU MINJIAN RONGZI FALVWENTI YANJIU 42–57, 50 (Law Press, China 2014).

84. See Lin, *supra* note 21, at 31 (arguing there ought to be positive due diligence duties on the intermediaries, requiring that they facilitate the information transfer as between issuers and investors, such that the latter can be assured of receiving timely, adequate and truthful information about the underlying investments).

85. Pekmezovic & Walker, *supra* note 2.

86. Lin, *supra* note 21, at 340.

industry — especially with the technological advances that have improved not only the market's connectivity, but also the fluidity of cashflow — has ventured far ahead of the existing legal regime, and it is high time that the law picks up speed to catch up with such advancements. Under the current Chinese legal regime, however, ECF remains dubious, with its legitimacy and the permitted ambits of activities being left largely to the determination of local authorities. However, the fact that the Chinese ECF industry is well active and thriving indicates that this degree of legal uncertainty and unpredictability is still acceptable to fund-sourcing SMEs, platforms, and investors alike. Yet, the commonplace reduction of the scale of fundraising and cautious publicity of ECF activities, while contributing to cloaking ECF activities with the appearance of legitimacy, does go against the spirit of crowdfunding to make use of the strength of the masses to offer financial support for a worthwhile endeavor. This deficient legal regime as to ECF regulation has even been argued to be a cause that hindered the Chinese ECF industry from realizing its full potential for growth.⁸⁷

If positive intervention were indeed the best recourse, it goes without saying that a combination of measures should be adopted, and sufficient flexibility must be given to allow the regulators to make necessary adjustments to suit their regulatory and administrative needs. The crux lies in the ability of the regulators to balance the spirit of crowdfunding (in allowing the masses to unite behind a common objective to provide funding with a low barrier or threshold for investment) and the need to protect the population from fraud or undesirable distortion of the financial market. In this regard, while it makes theoretical sense for a government to introduce a detailed set of regulations to ensure that all stakeholders' interests are protected, this postulation may be less defensible in light of how the consistent application of detailed rules is known to be a massive challenge for China, given the diverse judiciary standards across its vast territory.

Hence, it is understandable why regulators have taken a wait-and-see approach and have not introduced any ECF-specific legislation, but have, for the time being, left regulating as necessary largely to local authorities. This lack of regulation essentially means that the government is not dictating the rules for the market but is instead giving sufficient room to the stakeholders to forge forward in their trial-and-error attempts to arrive at the most efficient way of structuring an ECF project. Moreover, at the present stage, ECF is largely used by startups and SMEs for their seed and pre-A investments,

87. Qiang & Weinan, *supra* note 83 (asserting that the growth and development of the ECF industry in China have in fact been impeded by the skimpy legal regulatory framework, including the restrictions placed upon the eligibility of the issuer, the nature of the ECF platform and the number of investors).

which means that the scale of economic risks for ECF projects ought to be reasonably contained, and that there ought not to be any disproportionately substantial losses for an individual or community from ECF projects alone. If so, then it might not be a bad idea to allow market forces to let ECF practices mature and take shape first, before regulators take a reactive stance to impose positive rules. After all, economically unsustainable activities would eventually be driven out by competition, even without any positive regulatory intervention.

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