

LEGAL ASPECTS FOR LATVIAN ENTERPRISES, ATTRACTING FINANCE VIA CROWDFUNDING PLATFORMS

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Abstract: *When financial resources are decreasing, crowdfunding is an opportunity to deliver product and service to export markets, meet future buyers and attract financial resources. Latvian companies have considerably limited opportunities in crowdfunding markets, as some are not legally accessible. Therefore, it is an important research question to what extent Latvian companies can be using mainly international crowdfunding platforms to attract financial resources.*

Keywords: *Crowdfunding, financial resources, information technologies, investment, legal aspects*

Introduction

The global financial crisis in 2008 has been talked about as the second most devastating financial crisis, since the great depression in 1930s. In Eurozone crisis started in 2009, when Spain, Italy, Ireland, Greece and Portugal failed to provide economics that could meet needs of ability and banking system faced issues. Crisis have made a significant impact on the Unites States and Europe`s economics and investment trends. Within 2008 and onward we have been faced with bailouts to the banks and countries, financial market has changed drastically, credit and financing for start-ups and small medium enterprises (SME) have been insufficient and decreased significantly. Rising from these issues and as consequence, one of solutions that appeared in the market was a crowdfunding platforms. 510 live platforms are operating in the European Union (EU). 502 of these platforms were based in EU Member States, while eight were based outside the EU in countries such as the USA, Canada, New Zealand, Australia and China. Within the EU, the UK had the largest number of platforms, accounting for 28.0% of the EU total, followed by France, Germany, the Netherlands and Italy (which cumulatively account for 47.5%). By funding type, the three most common platform types in 2014 were rewards (30.4% of total), equity (22.9%) and loans (21.0%) [1, 4].

Principles of crowdfunding

Crowdfunding draws inspiration from concepts like micro-finance and crowdsourcing, but represents its own unique category of fundraising, facilitated by a growing number of Internet sites devoted to the topic [2, 9]. Crowdfunding at its most basic level is an open ask to the public for funds for a specific project or for a specific objective. Crowdfunding system has large number of supporters and small amount of funds from each supporter that are allocated for a project or cause. Within crowdfunding it is multi-sectional phenomena involving business, finance, funding, IT services, marketing activities, legal aspects and others. Crowdfunding is an e-commerce tool that can be used to implement financial needs of a company. Crowdfunding can entail legal uncertainty due to the lack of agreed definitions of the phenomenon, its complexity, financial and fee issues, the variety of national regulations concerned and the internet-linked risk of hacking, risk of fraud, platform closure or failure, project default, misleading advertising practices, legal uncertainty stemming from different legislation, liquidity risk. Conflicts over copyright may also emerge when creators, working in the context of a shared economy, disclose their ideas at an early stage of their work. The issue is complex at EU level too: a range of legislative acts can be relevant, including the Anti-money Laundering, Payment Services, Unfair Commercial Practices, Electronic Commerce and Copyright Directives, and the Capital

Requirements and Intellectual Property Regulations [3, 2]. Issue with crowdfunding gets more complex as nowadays crowdfunding platforms operate on international level, backers can be eligible worldwide for pre-ordering and involving with their financial resources, which is an aspect for national, international and global legal difficulties. Crowdfunding can be divided into two main categories, the non-financial return category: donation based, pre-payment or rewards based (people give money to receive a reward, service or product, which is tangible) and the financial return models (investment in return for the issuing of equity or debt securities or units in a collective investment scheme or the lending of money in return for a financial reward). Therefore, investment based crowd funding can provide capital to start ups and SMEs who might otherwise find it difficult to secure equity capital or loan funding from traditional sources as angel investors, banks or VC. It is important to mention that in Latvia there has been case as peer-to-peer landing platform *Mintos*, which started its activity December 2015 and in legal ways was asked to suspend their operation by government agency due to lack of legal regulation [4]. Within first company in peer-to-peer landing SMEs and start-ups had opportunity to access financial resources avoiding banks as traditional financing models. *Mintos* as an investment based crowdfunding platform is operating as other global platforms. Which means that there are at least three parties involved, the company seeking finance for a specific project (the project owner), the intermediary providing the internet crowd-funding specific platform (platform) and the investors (who are not typically professional investors) forming part of the crowd who fund the project through the platform, communicate through the intermediary and then invest. The intermediary may also provide assistance in developing the promotion for the platform, legal assistance with for example the preparation of the security issues or acting as register and watchdog for the issuer as to the ownership of securities. The project owner will pay a fee to the intermediary where the campaign is successful. Additional fees may also be payable to the intermediary for additional services. The most prominent United Kingdom (UK) equity based crowdfunding platform is *Crowdcube* entered the market in 2011, and got accredited in 2013 by the United Kingdom's Financial Conduct Authority (FCA), being the world's first equity-based platform. *Crowdcube* offers to United Kingdom enterprises an alternative way to approach the starting capital, by allowing individual investors to gather funds to support a project in return receiving an equity stack [5]. It is notable that UK is one of countries that have adopted legal action in regulating activity of crowdfunding, therefore it is more developed comparing to other EU countries.

Reward-based crowdfunding platforms

Reward-based crowdfunding, which, for many people, is synonymous with crowdfunding and online fundraising, has certainly captured the public imagination and media attention across Europe and USA in recent years. With 120,33 million euro raised in 2014 (compared with 63,18 million in 2013), reward-based crowdfunding is the second largest sector within the European online alternative finance market (excluding the UK), with an 127% average growth rate over the last three years [6, 8]. From aspiring entrepreneurs and creative artists to high-tech firms, SMEs and even multinational corporations, individuals and businesses can leverage this model to acquire early-stage investments, pre-sell products, obtain market validation and social proof, crowdsource creative ideas, engage customers, forge partnerships and build communities. Significant breakthrough and can be referred as a start point in reward-based crowdfunding occurred on April 28 2009, when reward-based crowdfunding platform Kickstarter was launched in United States [6]. The company's mission is to help creative people in funding their projects. Within a year Kickstarter obtained popularity and many entrepreneurs whose applications were rejected by the banks, angel capitalists or Venture Capitals (VC) used Kickstarter to pre-sell or reward crowdsource funds. Kickstarter has all-or-nothing model (campaigner gets money only when the fund goal is reached), which is recognizable by its

creative projects and is considered as crowd-funding culture. On the platform project has to be suitable in one of 15 categories (publishing, fashion, film and video, food, games, art, technology, theater, comics, dance, design, music, photography, journalism, crafts), and each project is approved before being launched. Comparing to other reward-based platforms Kickstarter is cost effective for the project authors - if fund is raised, Kickstarter will collect 5% and additionally 3-5% transaction fee. The main benefit of the platform is name recognition, Kickstarter platform does not permit non-profit campaigns, for example projects for raising money for a dream house or earthquake victims, it still remains the most preferred reward-based funding site. Disadvantages are that Kickstarter projects can be applied only from entities that are registered in Ireland, France, Germany, Spain, the Netherlands, Austria, Belgium, Italy, Luxembourg, United Kingdom, Canada and United States which means that Latvian companies don't have ability to participate and register a campaign, without registering in countries mentioned above [7]. The main competitor to Kickstarter is Indiegogo, which offers wider fundraising flexibility, for instance, on the all-or-nothing method, it charges 4% if the fund is raised and on the contrary to Kickstarter, Indiegogo offers the flexible funding plan, in the case of not reaching the goal, it takes 9%. For both methods there are additional transactional fees – 3%. The main advantage for platform is that there are no restrictions by application; it is available to every country. As payment method Indiegogo permits credit card and PayPal, however on the Kickstarter platform Stripe is used. For Indiegogo platform campaign duration is limited to 120 days, that means twice as long as on Kickstarter platform [8, 9]. There is discussion if that is a pro or con as majority of campaigns get funded in first and last days, some refer to longer campaign period as opportunity to promote product even more. The RocketHub was launched after Kickstarter and Indiegogo, offering wide range fundraising projects from movie making to philanthropy. In terms of charging of fees, RocketHub platform peculiarly does not differ from Indiegogo. For instance, for completed campaign, it charges 4% and if the fund has not met the target, 8% will be charged [8, 10]. However, the platform came in market adding several fresh ideas. They created RocketHub's Success school feature, providing instrument in helping to create a more valuable project. Also, RocketHub implemented Launched feature, which provides members with opportunity to collaborate with the industry professionals and public relation experts. RocketHub collaboration with Facebook led to a chance to support a project without involving in it financially. For instance, fans of the particular project can share or like project in the Facebook, giving the opportunity to spread it further, hoping to gather more funds. RocketHub platform dominates in the "customer support", besides, it is notable that RocketHub platform has lesser pledgers which opens up the possibility for them to get involved in each project [11]. Reward-based crowdfunding is one of popular crowdfunding methods, but there are also a lot of uncertainties. Companies have very limited duties to donators; actually the only duty is to thank them, by giving a reward. There is lack of transparency, no control mechanism in connection with the capital distribution and free riding. Currently there is no established a common crowdfunding regulation in Europe, but European Commission is working on it to develop the policy as crowdfunding in its many ways has a lot of legal aspects. Within Kickstarter it is company's responsibility to complete their project, it does not guarantee projects or investigate the ability of creators to complete their projects and backers are deciding the validity of the project by funding it, without receiving any guarantees. In Kickstarter platform when a company is submitting project they are granting Kickstarter, and others acting on Kickstarter behalf, the worldwide, non-exclusive, perpetual, irrevocable, royalty-free, sublicensable, transferable right to use, exercise, commercialize, and exploit the copyright, publicity, trademark, and database rights with respect to your submitted content. Additionally, Kickstarter jurisdiction is located in State of New York [7]. Indiegogo and The RocketHub operates within comparably similar terms of use, as platform takes no responsibility for company to deliver reward that was promised by backer in given time frame. Which leads to legal question about how relationships among

company delivering reward and backer can be resolved under international law. Out of legal research it is visible that there are no set and structured ways to resolve possible issues according to international law as each of countries, where backers and companies come from, have different laws and some does not have regulation at all. Therefore, it is an open question if company from Latvia can be misusing platforms services and therefore creating environment of mistrust. Starting of 2015 Latvian NGO has established Projektu Banka project that is an environment for crowdfunding with reward-based all-or-nothing structure [12]. Within this case companies, individuals and NGOs can submit their projects, products and participate in this platform.

Legal aspects for Latvian companies

Companies from Latvia have an ability to participate in many reward-based crowdfunding platforms, as it was case with AirDog [13]. It is important to note that in order to participate and launch campaign in Kickstarter, company has to be registered as an entity in US. It can be assumed that for AirDog this process was fostered by VC investment they attracted, future development of product and market specification. This example of AirDog case shows us that by starting as Latvian company and being in a country without legislation that would regulate crowdfunding initiatives, experience with suspended operations request from government agencies as in Mintos case, is forcing companies to register to countries where legislation is more clear and stated on issue as US and UK. For companies that are looking to attract crowdfunding in reward-based campaigns it is also a way to attract future VC and investors. One of aspects for Latvian companies who wants to develop and use international sites have to consider moving to another country that platform supports, if company is eligible for campaign in Kickstarter. Companies can choose other platforms that supports legal entity registered in Latvia, but it is notable, that it might be lower quality platform and harder to succeed. If looking at local Latvian platform *Projektu Banka*, then up to April 15 2016 it has 18 financed project total amount as 43 442 Euro [12]. Which is less than 1 project per month in approximate calculation. Secondly within this research there were no law regulations in Latvia found if there are any specific procedures how to declare incoming funds from international campaigns and if there might be any tax complications. There is also no public information available about legal regulations for companies joining *Projektu Banka*.

Conclusions

The research within this paper shows that Latvian companies have options to participate in crowdfunding platforms in order to raise funds, pre-sell product internationally and locally. It is complicated to participate in equity-crowdfunding and investment-based crowdfunding platforms outside country they operate because of difficulties in regulations. It is suggested that Latvian government should establish regulation and provide business environment with direct opinion if crowdfunding practices are approved and taken in account as safe and legal operation. It is expected that policy environment will continue to evolve at both a Member State level and at a European level, therefore it would be fair to expect that in Latvia legal environment develops as well. It is recommended for government of Latvia to establish legal procedures and to foster development of reward based crowdfunding platforms, state it as fair and secure tool for purchase, as that would be an important support element for start-ups and SMEs for validating their idea, product, having ability to pre-sell and acquire needed funding.

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