

The European Union Proposal for a Regulation on Cross-Border Crowdfunding Services: A Solemn or Pie-Crust Promise?

PANAGIOTIS K. STAIKOURAS^{*,**}

Abstract

In March 2018, the European Commission presented a Proposal for a Regulation on (financial return) crowdfunding service providers (CSPs) with a dual objective: to set up a single, EU-wide authorization regime for CSPs; and to ensure that duly authorized CSPs operate in a safe and sound manner. Over two years later, in July 2020, the Council of the European Union adopted its First Reading Position which reflects the compromise reached in negotiations with the European Parliament and brings about significant changes to the Commission Proposal. This study critically analyzes the objectives, economic rationales, and fundamental principles of the proposed EU Regulation on crowdfunding; highlights its weaknesses and inconsistencies; and offers proposals for refinement and improvement.

Keywords

Crowdfunding, fintech, authorization, supervision, suitability, KIIS, crowdfunding service providers

1. Introduction

Crowdfunding is an alternative form of microfinancing that uses the internet, particularly social media, to connect fundraisers/project owners with potential contributors/funders. Crowdfunding can be divided into two broad categories based on the kind of exchange the fundraisers and contributors have agreed upon: non-financial-return crowdfunding and financial-return crowdfunding. The former category encompasses

* Professor in Banking and Finance Law | Deputy Chair of the Department of Banking and Financial Management, University of Piraeus, Greece (e-mail address: pstaik@unipi.gr). Research Fellow, Institute of Global Law, Economics and Finance (IGLEF) – Queen Mary University of London (QMUL). Co-founder of the Institute of Finance and Financial Regulation (IFFR): <<http://www.iffr.gr>>.

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(i) donation-based crowdfunding, whereby funders are offered a non-tangible asset (e.g., recognition) in exchange for their contribution; (ii) crowd-sponsoring, whereby contributors receive advertising in return for financing; and (iii) pre-sales crowdfunding, whereby funders receive the product/service that was developed and produced with the funds raised at a value lower than the size of their contribution. Financial-return crowdfunding comprises: (i) investment-based crowdfunding, whereby equity, debt, or other security is issued to and purchased by the funders; and (ii) crowd-lending or peer-to-peer (P2P) lending, whereby fundraisers borrow money from funders with the promise to pay back the capital (with or without interest).

Crowdfunding first attracted the European Commission's attention in 2013, when the Entrepreneurship Action Plan urged Member States to assess the potential for amending national financial legislation to facilitate new alternative forms of financing for start-ups and small and medium-sized enterprises (SMEs), particularly crowdfunding platforms.¹ After few months, the European Commission promulgated the Green Paper on the "Long-term Financing of the European Economy" underlining the need to develop and promote "non-traditional" sources of finance for European Union (EU) SMEs.² The next year, the European Commission Communication on "Unleashing the Potential of Crowdfunding in the European Union" listed the key benefits and challenges of crowdfunding and committed to assessing whether regulatory intervention was necessary at the EU level.³ The European Parliament Resolution of July 9, 2015 on "Building a Capital Markets Union" (CMU) stressed that an appropriate regulatory environment should be established to promote the growth of non-bank, cross-border financing models, including investment-based crowdfunding and P2P lending.⁴ Three years later, the European Commission Action Plan on CMU confirmed that the EU would elaborate on the best means of enabling the development of crowdfunding across the region.⁵ Discussions culminated in the 2018 FinTech Action Plan, which presented the European Commission Proposal ("European Commission Proposal on Crowdfunding Regulation" or "European Commission Proposal" hereafter) for an EU Regulation on (investment- and lending-based) European Crowdfunding Service Providers—ECSPs.⁶ The European Parliament's first reading position of the Commission Proposal was adopted on 27 March 2019 ("European Parliament

¹ European Commission, *Entrepreneurship 2020 Action Plan: Reigniting the Entrepreneurial Spirit in Europe*, par. 3.1 (Brussels, 09.01.2013, COM(2012) 795 final).

² European Commission, *Green Paper: Long-term Financing of the European Economy*, par. 3.4 (Brussels, 25.03.2013, COM(2013) 150 final).

³ European Commission, *Communication: Unleashing the Potential of Crowdfunding in the European Union* (Brussels, 27.03.2014, COM(2014) 172 final) ["European Commission Communication on the Potential of Crowdfunding" hereafter].

⁴ European Parliament, *European Parliament Resolution of 9 July 2015 on Building a Capital Markets Union*, par. 47 (2015/2634(RSP)).

⁵ European Commission, *Action Plan on Building a Capital Markets Union*, par. 1.1 (Brussels, 30.09.2015, COM(2015) 468 final).

⁶ European Commission, *FinTech Action Plan: For a More Competitive and Innovative European Financial Sector* (Brussels, 08.03.2018, COM(2018) 109 final); European Commission, *Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service*

Position on Crowdfunding Regulation” or “European Parliament Position” hereafter).⁷ Following the promulgation of the Council of the European Union first reading position on 20 July 2020 (“Council First Reading Position on Crowdfunding Regulation” or “Council First Reading Position” hereafter),⁸ the European Parliament’s endorsement of the agreed text in second reading is expected to formally seal the political agreement reached in the inter-institutional procedure.⁹

The fundamental objective of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) is to establish a European label for financial-return (i.e., investment- and lending-based) crowdfunding platforms that would enable cross-border activity and facilitate the scaling up of crowdfunding services across the EU’s internal market, thereby increasing access to finance for entrepreneurs, start-ups, and scale-ups.¹⁰ To this end, the EU legislator seeks to address the core risks posed and the main uncertainties introduced by financial-return crowdfunding concerning investor protection and market integrity, including crowdfunding platforms’ credibility and funders’ lack of adequate information on and understanding of crowdfunding investment’s characteristics and risk profile.¹¹

This study assesses the objectives, economic rationales, and fundamental regulatory principles of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs). The study has two key aims: first, to employ the relevant empirical research and apply legal and finance analysis to critically examine whether the EU regulatory philosophy on crowdfunding is fine-tuned or misguided; and, second, to set out proposals for the refinement of the proposed EU regulatory regime on crowdfunding. To this end, the discussion is primarily focusing on the Council First

Providers (ECSP) for Business (COM/2018/0113 final – 2018/048 (COD)) [“European Commission Proposal on Crowdfunding Regulation” or “European Commission Proposal” hereafter].

⁷ European Parliament, *Legislative Resolution of 27 March 2019 on the Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP) for Business – Ordinary Legislative Procedure: First Reading (P8 TA-PROV(2019)0301)* [“European Parliament Position on Crowdfunding Regulation” or “European Parliament Position” hereafter].

⁸ Council of the European Union, *Position of the Council at First Reading With a View to the Adoption of a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers for Business and Amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937 – Adopted by the Council on 20 July 2020 (2018/0048 (COD), Brussels, 22 July 2020, 6800/1/20 REV 1)* [“Council First Reading Position on Crowdfunding Regulation on Crowdfunding Regulation” hereafter].

⁹ See also European Commission, *Communication to the European Parliament Pursuant to Article 294(6) of the Treaty on the Functioning of the European Union Concerning the Position of the Council on the Adoption of a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers for Business and Amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937 and a Directive Amending Directive 2014/65/EU on Markets in Financial Instruments (COM(2020) 356 final, 2018/0047 (COD), Brussels, 29.7.2020).*

¹⁰ European Commission Staff Working Document, *Impact Assessment Accompanying the Document: European Commission Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP) for Business*, s. 1.2 (Brussels, 08.03.2018, SWD(2018) 56 final) [“Impact Assessment of the European Commission Proposal on Crowdfunding Regulation” hereafter].

¹¹ *Ibid.*

Reading Position on Crowdfunding Regulation, not only because it reflects the latest version of the legislative text that is currently under consideration by the EU institutions but also and most importantly because it echoes the political agreement reached between the European Parliament and the Council on 18 December 2019. At an ancillary level, where deemed appropriate, the analysis also considers the initial European Commission Proposal as well as the suggestions that have been put forward by the European Parliament Position.

2. Towards a Common Regulatory Regime on Crowdfunding: A Primer on the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs)

2.1. Identifying and Prioritizing the Basic Utilities of Crowdfunding: Has the EU Legislator Got It Right?

One common misunderstanding concerning the rationale and scope of regulatory intervention in financial-return crowdfunding emanates from the lack of a coherent perception regarding the type of entrepreneurship that most needs, and could most benefit from, crowdfunding as an alternative financing vehicle. It is often claimed that financial-return crowdfunding is intended to fill the funding gap for SMEs as a whole. However, this premise is misguided for two fundamental reasons.

First, the EU definition of SMEs is wide-ranging and encompasses enterprises with differing profiles and financing needs. The definition comprises three categories of enterprises divided according to the firm's staff headcount and turnover or balance sheet total: *medium-sized enterprises* are enterprises employing fewer than 250 persons and that have an annual turnover not exceeding € 50 million and/or an annual balance sheet total not exceeding € 43 million; *small enterprises* are enterprises employing fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed € 10 million; and *microenterprises* are enterprises employing fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed € 2 million.¹² Differences in size and performance between the three SME sub-groups result in varying financial needs and diverse funding alternatives. The reality of this diversity is corroborated by the relevant data on SMEs' access to finance. For SMEs *as a whole*, the data reveal that access to financing is considered the least important challenge and that improvement in access to external financing has been greater than increases in their corresponding financing needs, resulting in a negative financing gap.¹³ Bank-related products (e.g., bank loans and credit lines) are more important sources of financing for SMEs than market-based instruments (e.g.,

¹² European Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, C(2003) 1422, OJ L 124/2003/36, Annex, art. 2.

¹³ European Central Bank, *Survey on the Access to Finance of Enterprises in the Euro Area: April to September 2019*, at ss. 2.2, 4.1.1, 4.1.2, (ECB, November 2019) ["ECB Survey" hereafter]. The most recent, 22nd round of the Survey on the Access to Finance of Enterprises, which was conducted between 2 March 2020 and 8 April 2020, is not considered here, because the results of the particular

equity and debt) and other sources of financing (e.g., leasing, hire-purchase, subsidized loans, trade credit).¹⁴ Moreover, *on average*, SMEs report an improved availability of external financing sources, especially bank loans, as well as an easing of credit standards for bank loans.¹⁵ At first glance, these findings seem to refute the popular but inaccurate perception that SMEs are, on balance, faced with severe financing impediments that not only constrain their development but also, and more importantly, threaten their survival. A closer and deeper look into the data tells a different and more compelling story.

The data reveal that concerns about access to financing decrease along with firm size, which suggests that access to financing is more of a problem for microenterprises than for small and medium-sized firms.¹⁶ The data suggest that noticeable differences persist in the availability of external financing (e.g., bank loans, trade credit, leasing and hire-purchase, credit lines, grants, subsidized loans, other loans, equity, debt) across firm sizes, with micro-firms reporting comparatively less access to external financing, particularly bank loans.¹⁷ Likewise, important variances persist across firm sizes concerning the type of financing instruments commonly used: about 18% of SMEs (mostly microenterprises) consider family, friends, and other companies – rather than bank loans and other forms of credit – to be the most important sources of financing for their business;¹⁸ banks also seem less willing to lend to microenterprises than to small and medium sized firms.¹⁹ These latter findings are consistent with, and can be explained by, the evidence that collateral requirements in the form of pledges over fixed assets for the repayment of bank loans have been increasing within the EU, particularly for microenterprises, thus dissuading a non-negligible portion of micro-firms from considering bank lending as an alternative source of financing.²⁰

Overall, surveys on SMEs' financing reveal that treating SMEs as a homogeneous group and addressing their financing needs and alternatives in terms of the "average" or "median" is flawed and leads to skewed inferences. The data show that financing sources and conditions vary significantly depending on SME sizes. While the data for SMEs considered *as a group and on an average basis* show that external financing

survey are driven by the extraordinary circumstances owing to the spread of the coronavirus (COVID-19) across Europe and the associated disruption in the business activity of many euro area companies.

¹⁴ ECB Survey, *supra* n. 13, at s. 3.1; European Commission, *Survey on the Access to Finance of Enterprises (SAFE) – Analytical Report 2019*, at paras. 1.2, 1.3, 3.4.1 (November 2019) ["SAFE" hereafter]; European Investment Fund, *EIF SME Access to Finance Index*, par. 2.2.2 (EIF Research & Market Analysis Working Paper No 2018/47).

¹⁵ ECB Survey, *supra* n. 13, at ss. 4.1.1, 4.1.3; European Central Bank, *The Euro Area Bank Lending Survey – Fourth Quarter of 2019*, at par. 2.1.1 (ECB, January 2020) ["ECB Lending Survey" hereafter]. Again, the ECB Euro Area Bank Lending Surveys covering the first and second quarter of 2020 have not been considered here due to the exceptional business environment that has been created as a result of coronavirus (COVID-19).

¹⁶ ECB Survey, *supra* n. 13, at s. 2.2.

¹⁷ ECB Survey, *supra* n. 13, at ss. 4.1.1, 4.1.3; ECB Lending Survey, *supra* n. 15, at par. 2.1.1; SAFE, *supra* n. 14, at paras 2.2.2, 2.3.1-2.3.3.

¹⁸ ECB Survey, *supra* n. 13, at s. 3.1; SAFE, *supra* n. 14, at par. 3.3.

¹⁹ ECB Survey, *supra* n. 13, at s. 4.1.3.

²⁰ SAFE, *supra* n. 14, at paras. 2.5, 2.5.2, 3.4.2.

availability corresponds to their financing needs, microenterprises (relative to SMEs) face constraints in financing their businesses, and are thus more likely to suffer funding gaps. Consequently, crowdfunding is a funding tool that should cater predominantly to the financing needs of microenterprises. For small and medium-sized firms, crowdfunding could play a supplementary role as an additional or/and alternative form of financing aside from more conventional funding sources, especially in economies where capital markets are underdeveloped and/or during times when bank financing is constrained. Though largely unnoticed, this latter function of crowdfunding as a complement to more established financing sources is particularly important for economic stability, because it spreads the project/investment risk across a larger pool of investors and allows firms to diversify their financing sources, thus reducing their vulnerability to changes in credit market conditions and increasing the resilience of the financial sector and the real economy in turbulent periods.²¹

Second, and most importantly, a firm's age and development phase, rather than its size, have the most important bearing on its financing needs and access to diverse financing sources.²² Consequently, the abovementioned inferences regarding the diverse financing needs among the different subclasses of firms comprising SMEs need refinement so that we may identify with more precision those firms – predominantly in the microenterprise class – that face the most significant financing barriers and that would thus most benefit from crowdfunding. The public consultation organized by the European Commission concerning the “Startup Initiative” revealed that access to finance has been the biggest barrier for start-up firms (i.e., newly established, growth-oriented firms up to five years old) searching for a scalable business model or an innovative product/service.²³ The primary cause of financing problems among start-up firms has been their lack of information (lack of business history) as

²¹ OECD, *G20/OECD High Level Principles on SME Financing*, at par. 3 (November 2015) [“OECD Principles” hereafter]; European Commission Staff Working Document, *Impact Assessment Accompanying the document European Commission Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 345/2013 on European Venture Capital funds and Regulation (EU) No 346/2013 on European Social Entrepreneurship Funds*, pp. 70-71 (Brussels, 14.07.2016, SWD(2016) 228 final) [“Impact Assessment of the Proposed Regulation on VCs and EuSEFs” hereafter]. See also Jess Cornaggia, Brian Wolfe, Woongsun Yoo, *Crowding Out Banks: Credit Substitution by Peer-To-Peer Lending* (30 March 2018), <<https://ssrn.com/abstract=3000593>>; Lynda De La Viña, Stephanie Lee Black, *US Equity Crowdfunding: A Review of Current Legislation and A Conceptual Model of the Implications for Equity Funding* 27 *Journal of Entrepreneurship* 83 (2017) [“De la Viña and Black (2017)” hereafter]; Saul Estrin, Daniel Gozman, Susanna Khavul, *Equity Crowdfunding and Early Stage Entrepreneurial Finance: Damaging or Disruptive?* Center for Economic Performance Discussion Paper No 1498/2017 (September 2017).

²² OECD Principles, *supra* n. 21, at par. 3. See also Seth Oranburg, *Bridgdfunding: Crowdfunding and the Market for Entrepreneurial Finance* 25 *Cornell Journal of Law and Public Policy* 397, 405-407 (2015) [“Oranburg (2015)” hereafter].

²³ European Commission, *Report on the Public Consultation under the Start-up Initiative*, pp. 7-10, 23 (Ref. Ares(2016)6544806 – 22/11/2016) [“European Commission Report on Start-ups” hereafter]. See also European Commission, *Communication: Europe's Next Leaders: The Start-up and Scale-up Initiative* (Brussels, 22.11.2016, COM/2016/0733 final).

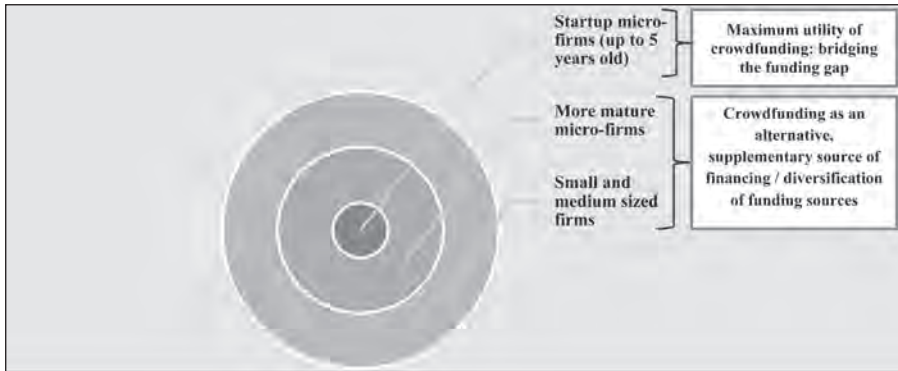


Figure 1

well as their undercollateralization.²⁴ Because information about these companies, their strategies, and prospects is more difficult to assess and as their assets are intangible, potential borrowers/investors face transaction costs that are higher than those for more mature companies.²⁵ Hence, start-up firms, in principle, risk facing a funding gap to a greater extent than do more mature and thus less opaque and better collateralized (micro) enterprises (see Figure 1).²⁶ Indeed, the finance and economics literature corroborates that the greater the information asymmetries surrounding a firm, the more difficult its external financing via conventional funding sources. Uncertainty is more acute for early-stage firms, with intangible assets and heavy reliance on R&D, because the value of and payoffs from firm-specific R&D are hard to estimate, the firms lack a credit history, and tangible collateral is unavailable.²⁷

Therefore, as reflected in the funding escalator (see Figure 2), the form of financing available to firms is strongly influenced by the firms' age and stage of development.²⁸ Crowdfunding should be designed to reach its full potential for and utility in helping start-ups bridge the "death valley" funding gap, which extends from the inception stage (when the firm is building its core team and developing an idea),

²⁴ Impact Assessment of the Proposed Regulation on VCs and EuSEFs, *supra* n. 21, Annex 8.

²⁵ Impact Assessment of the Proposed Regulation on VCs and EuSEFs, *supra* n. 21, Annex 8; OECD Principles, *supra* n. 21, at par. 3.

²⁶ European Commission Report on Start-ups, *supra* n. 23, at pp. 7-10, 16-18. Essentially, the group of start-ups intersects but does not fully coincide with the group of microenterprises: by definition and according to the relevant criteria, start-ups fall within the group of microenterprises, yet, not all microenterprises are by definition start-ups (i.e., firms may remain micro in terms of their size regardless of their age and stage of development).

²⁷ Andy Cosh, Douglas Cumming, Alan Hughes, *Outside Entrepreneurial Capital* 119 *The Economic Journal* 1494 (2009); Paul Gompers, Josh Lerner, *The Venture Capital Revolution* 15 *Journal of Economic Perspectives* 145 (2001); David Aboody, Baruch Lev, *Information Asymmetry, R&D, and Insider Gains* 55 *Journal of Finance* 2747 (2000); Michael Long, Ileen Malitz, *Investment Patterns and Financial Leverage* NBER Working Paper No 1145 (June 1983).

²⁸ Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 1.1.1.2.

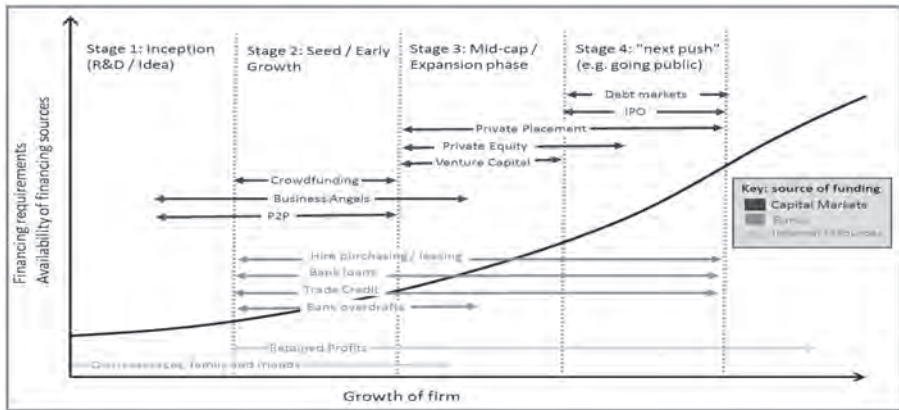


Figure 2

Source: Commission Staff Working Document, *Impact Assessment Accompanying the document Commission Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP) for Business*, p. 15 (Brussels, 08.03.2018, SWD(2018) 56 final).

continues into the early growth stage (when the firm develops the product/service and starts marketing), and extends into the expansion phase (when the firm is able to attract financing via sophisticated investors, such as venture capital providers, to scale up its activities via new offices, increased inventories, more staff, or increased capital investment to drive production, service delivery, and revenues).²⁹ Indeed, available data from the, more developed, U.S. crowdfunding market reveal that, for the period between May 16, 2016 and December 31, 2018: (i) the majority of issuers that sought financing via crowdfunding were relatively small and early in their lifecycle; (ii) the median offering was by an issuer that was incorporated approximately two years prior to the offering and employed about three people; and (iii) the median issuer had total assets of approximately \$ 30,000, cash holdings of approximately \$ 4,000, and no revenues (just over half of the offerings were by issuers with no revenues).³⁰

Consistent with the preceding analysis, and compared to Council First Reading Position on Crowdfunding Regulation, the European Commission Proposal has more accurately identified and prioritized the basic functions of crowdfunding; that is, to primarily play the role of financing tool for small and nascent firms, especially those

²⁹ *Ibid.* See also Bret Conkin, *The Crowdfunding Escalator: How to Pick the Right Crowdfunding Platform* (16 January 2015), <<https://www.crowdfundinsider.com/2015/01/16/1210-crowdfunding-escalator-pick-right-crowdfunding-platform/>>. Andrew Schwartz, *Crowdfunding Issuers in the United States* 61 *Journal of Law and Policy* 155 (2020), 164 corroborates that, in United States, almost all issuers that used crowdfunding from 2016 to 2018 were early-stage startups: 40% of issuers were under one year old and 80% were less than four years old; the median age of a crowdfunding issuer was 1.5 years and the average age was just under 3.

³⁰ U.S. Securities and Exchange Commission, *Report to the Commission: Regulation Crowdfunding* (June 18, 2019).

moving from the start-up into the expansion phase, and at a secondary/complementary level to constitute an established form of alternative finance for SMEs in general.³¹

2.2. *Underlying Rationales of the Proposed Regulation on European Crowdfunding Service Providers (ECSPs)*

A. *Addressing the Risks of Financial-Return Crowdfunding*

Financial-return crowdfunding brings several benefits: it facilitates access to finance and thus fosters entrepreneurship and contributes to growth and job creation; it also allows firms to diversify their financing sources and spread investment risk across a larger pool of investors, thus enhancing economic stability; finally, it offers an easier, quicker, and (most importantly) cheaper financing channel for potential fundraisers.³² The empirical research shows that financial-return crowdfunding enhances the geographic dispersion of investments and reduces distance-related economic frictions associated with early-stage entrepreneurial ventures (e.g., gathering information on and monitoring fundraisers and facilitating communication among contributors and information exchange). By alleviating geographic biases, financial-return crowdfunding significantly expands the pool of potential funders, allocates investment risk more efficiently to those more willing to undertake it, and reduces the cost of capital.³³ In addition, in cases where fundraising is combined with non-financial benefits, such as early access to products, project owners gain additional benefits in terms of market testing, reduced marketing costs, and wider reach that further contributes to lowering the cost of capital.³⁴ For contributors, financial-return crowdfunding augments the range of assets to which they have access and thus enhances portfolio diversification.³⁵

³¹ European Commission Proposal on Crowdfunding Regulation, *supra* n. 6, Explanatory Memorandum, at s. 1 and Recitals 1-2 of the Preamble. The Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 1, is less accurate, stating that crowdfunding is primarily intended to accommodate the needs of start-ups and small and medium-sized enterprises.

³² The Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 4, supplements that “crowdfunding [can] validate a business idea, give entrepreneurs access to a large number of people providing insights and information, and be a marketing tool”.

³³ European Commission Communication on the Potential of Crowdfunding, *supra* n. 3, at par. 2; European Commission, *Consultation Document: Crowdfunding in the EU – Exploring the Added Value of Potential EU Action*, p. 7 (Brussels, 3 October 2013) [“European Commission Consultation Document on Crowdfunding” hereafter]. See also De la Viña and Black (2017), *supra* n. 21, at p. 98; Ajay Agrawal, Christian Catalini, Avi Goldfarb, *Crowdfunding: Geography, Social Networks, and the Timing of Investment Decisions* 24 *Journal of Economics and Management Strategy* 253 (2015) [“Agrawal et al. (2015)” hereafter]; Ajay Agrawal, Christian Catalini, Avi Goldfarb, *Some Simple Economics of Crowdfunding* 14 *Journal of Policy and the Economy* 63, 71, 88-90 (2014) [“Agrawal et al. (2014)” hereafter]; Ethan Mollick, *Swept Away by the Crowd? Crowdfunding, Venture Capital, and the Selection of Entrepreneurs* (25 March 2013), <<https://ssrn.com/abstract=2239204>> [“Mollick (2013)” hereafter]; Andrew Fink, *Protecting the Crowd and Raising Capital Through the JOBS Act* 90 *University of Detroit Mercy Law Review* 1, 16-17 (2012) [“Fink (2012)” hereafter].

³⁴ European Commission Communication on the Potential of Crowdfunding, *supra* n. 3, par. 2; European Commission Consultation Document on Crowdfunding, *supra* n. 33, at p. 7. See also De la Viña and Black (2017), *supra* n. 21, at p. 99; Agrawal et al. (2014), *supra* n. 33, at pp. 71-72.

³⁵ House of Lords / House of Commons, *Changing Banking for Good*, at par. 350 (Report of the Parliamentary Commission on Banking Standards, First Report of Session 2013–14, HL Paper 27-II,

Furthermore, it offers the potential for more intense interaction and engagement with fundraisers, which can create a sense of community and social cohesion.³⁶

On the other hand, financial-return crowdfunding carries serious risks. Modern information economics suggests that information asymmetries between fundraisers and contributors constitute the most important challenge of financial-return crowdfunding. As capital-raisers are start-up companies with little or no credit and business history, capital-providers lack information on the quality of both the fundraisers and the project, as well as on the fundraisers' intentions.³⁷ Information asymmetries and uncertainty are inherent in financial contracts but become more acute in financial-return crowdfunding because of two fundamental and idiosyncratic features: first, fundraisers are at an early (start-up) stage of development and all decisions concerning future success, including the quality of the management, remain to be made; and, second, contributors include (or consist of) small investors (the "crowd") who lack sophistication and analytical skills.³⁸ The 2017 OECD Report on financial literacy within G20 countries is telling in this respect. The Report confirms that the overall level of financial literacy is quite low, with an average score across the G20 countries of just 12.7 out of a possible 21 (a total of seven points were possible for "knowledge," nine were possible for "behavior," and five were possible for "attitudes"). On average, fewer than half of adults (48%) in G20 countries could answer 70% of the financial knowledge questions correctly (the minimum target score), and only three in five households were using a budget (60%). Moreover, a quarter of people did not agree with the statement "Before I buy something I carefully consider whether I can afford it" and did not always pay bills on time, and over a third had faced a situation where their income did not cover their living costs in the last 12 months. Finally, only a small minority (15%) of people had used independent sources to compare across products and providers.³⁹

HC 175-II). See also Agrawal et al. (2014), *supra* n. 33, at p. 73.

³⁶ Ronald Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience* 55 *Stanford Law Review* 1068, 1076-1077 (2003) ["Gilson (2003)" hereafter]; European Commission Communication on the Potential of Crowdfunding, *supra* n. 3, at par. 2; European Commission Consultation Document on Crowdfunding, *supra* n. 33, at p. 7. See also Agrawal et al. (2014), *supra* n. 33, at pp. 73-74.

³⁷ Silvio Vismara, *Information Cascades among Investors in Equity Crowdfunding* 42 *Entrepreneurship Theory and Practice* 467 (2018); Silvio Vismara, *Signaling to Overcome Inefficiencies in Crowdfunding Markets*, in *The Economics of Crowdfunding*, 29-58 (Cumming D., Hornuf L. (eds), Palgrave Macmillan, Cham, 2018) ["Vismara (2018b)" hereafter].

³⁸ Thomas James, *Far from the Madding Crowd: Does the Jobs Act Provide Meaningful Redress to Small Investors for Securities Fraud in Connection with Crowdfunding Operations* 54 *Boston College Law Review* 1767, 1783-1787 (2013) ["James (2013)" hereafter]; Benjamin Seigel, *Title III of the JOBS Act: Using Unsophisticated Wealth to Crowdfund Small Business Capital of Fraudsters' Bank Accounts?* 41 *Hofstra Law Review* 777, 794-796 (2013); Steven Bradford, *Crowdfunding and the Federal Securities Laws* 1 *Columbia Business Law Review* 1, 109-112 (2012) ["Bradford (2012a)" hereafter].

³⁹ OECD, *G20/OECD INFE Report on Adult Financial Literacy in G20 Countries*, at pp. 7-9 (OECD, 2017).

Moreover, information asymmetry gives rise to adverse selection and moral hazard situations before the investment and after it occurs.⁴⁰ Pre-investment, information asymmetries prevent potential funders from distinguishing between high- and low-quality firms, thus causing them to discount the value of all fundraisers; as a result, high-quality ventures are prevented from raising via crowdfunding the required capital because they are undervalued and the market is dominated by lower-quality, lower-potential ventures (i.e., adverse selection).⁴¹ The three most important sources of ex ante information asymmetry between fundraisers and contributors in financial-return crowdfunding are uncertainty over fundraisers' competence and the risk/return profile of the project (investment risk), the risk of misleading advertising and advice, and ambiguity regarding the fitness of the mediating crowdfunding platform.⁴² The adverse selection problem is exacerbated due to two aggravating factors: first, due diligence of fundraisers is both complex and time consuming, while contributors are usually retail investors/lenders with limited understanding of the risks posed by crowdfunding projects and inadequate analytical ability; and, second, crowdfunding may be, more often than not, used by riskier firms that have been unable to attract financing from banks.⁴³

Post-investment, fundraisers are free to assume additional risks or/and behave opportunistically, thus negatively affecting capital providers' interests (i.e., moral hazard).⁴⁴ Moral hazard generates significant agency costs in the case of start-ups'

⁴⁰ For the origins of moral hazard and adverse selection theories, respectively, see Kenneth Arrow, *Uncertainty and the Welfare Economics of Medical Care* 53 *American Economic Review* 941 (1963) and George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism* 84 *Quarterly Journal of Economics* 488 (1970).

⁴¹ Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 1.1.1.2; European Commission, *Final Report: Identifying Market and Regulatory Obstacles to Cross-border Development of Crowdfunding in the EU*, at s. 6.2.2 (December 2017) ["European Commission Report on Crowdfunding Obstacles" hereafter]. See also Agrawal et al. (2014), *supra* n. 33, at pp. 78-79; Paul Belleflamme, Thomas Lambert, Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd* 29 *Journal of Business Venturing* 585 (2014).

⁴² European Commission Consultation Document on Crowdfunding, *supra* n. 33, at pp. 7-8. See also Semen Turan, *Financial Innovation – Crowdfunding: Friend or Foe?* 195 *Procedia-Social and Behavioral Sciences* 353, 359-360 (2015) ["Turan (2015)" hereafter]; Agrawal et al (2014), *supra* n. 33, at pp. 76-78; James (2013), *supra* n. 38, at pp. 1785-1787; Bradford (2012a), *supra* n. 38, at pp. 106-109.

⁴³ Olena Havrylchyk, *Regulatory Framework for the Loan-Based Crowdfunding Platforms* OECD Economics Department Working Paper 61/2018; Guido Ferrarini, *Regulating FinTech: Crowdfunding and Beyond* 2 *European Economy* 121, 126 (2017) ["Ferrarini (2017) hereafter]. See, also, James (2013), *supra* n. 38, at pp. 1785-1786, making two critical comments: first, that "[u]nlike large public companies, whose periodic SEC reports are scrutinized by professional analysts, small startups possess limited hard information [because they] are unlikely to have generated enough business to provide sufficient information for potential investors to make a meaningful investment decision"; and second, that "the risk of failure inherent to business startups is substantially greater than that of established companies, [because] startups lack the larger capitalization of more established companies and are thus less likely to survive downturns, competition, and other market pressures".

⁴⁴ Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 1.1.1.2; European Commission Report on Crowdfunding Obstacles, *supra* n. 41, at s. 6.2.2. See also Agrawal et al. (2014), *supra* n. 33, pp. 78-79; Paul Belleflamme, Thomas Lambert, *Crowdfunding:*

financing via crowdfunding. Due to the fact that the entrepreneur's human capital and input is critical for the future success of the company, it is common for entrepreneurs to maintain a controlling stake after the crowdfunding campaign.⁴⁵ In this context, the founder of a start-up may place weight on increasing his private benefits at the expense of outside shareholders.⁴⁶ This diversion between the entrepreneurs' and the contributors' interests may take many different forms, including: entrepreneurs' disloyalty (i.e., misuse of corporate opportunities and abuse of corporate information—such as trade secrets—for personal benefit); self-dealing; and excessive compensation.⁴⁷ Other, residual post-investment challenges include the risk of investment dilution (in equity-based crowdfunding), the protection of fundraisers' intellectual property rights, difficulties faced by investors/lenders in exercising their rights, and liquidity risk due to the lack of a secondary trading market for crowdfunding securities and/or because loan repayments do not follow the agreed plan.⁴⁸

Both adverse selection and moral hazard can lead to market collapse. Adverse selection can prevent the crowdfunding market from matching the most value-creating projects with funders, as higher-quality projects will self-select away from the market. Moral hazard can deter potential funders from entering the market from fear of being exploited by fundraisers post-investment.⁴⁹

Information asymmetries also persist and undermine trust in the relationships between fundraisers and platforms and between funders and platforms, thus producing additional transaction frictions. Fundraisers and contributors are uncertain about the quality, credibility, and organizational efficiency of crowdfunding platforms; they are concerned about issues such as document handling policies, the treatment of conflicts of interest, the treatment of contributors' funds, the platforms' risk-assessment skills regarding project monitoring, and the platforms' backup systems.⁵⁰ Such uncertainty reduces confidence in the platforms and fractures the efficient matching of value-generating projects with willing funders.

Consequently, bespoke regulatory intervention is needed to address the distinctive challenges posed by financial-return crowdfunding, particularly those arising from

Some Empirical Findings and Microeconomic Underpinnings (30 August 2014), <<https://ssrn.com/abstract=2437786>> ["Belleflamme and Lambert (2014)" hereafter].

⁴⁵ Gilson (2003), *supra* n. 36, at p. 1077; Paul Gompers, *Ownership and Control in Entrepreneurial Firms: An Examination of Convertible Securities in Venture Capital Investment* (January 1999, unpublished working paper) ["Gompers (1999)" hereafter].

⁴⁶ Gilson (2003), *supra* n. 36, at p. 1077; Gompers (1999), *supra* n. 45.

⁴⁷ European Commission Consultation Document on Crowdfunding, *supra* n. 33, at pp. 7-8. See also Turan (2015), *supra* n. 42, at pp. 359-360; Agrawal et al. (2014), *supra* n. 33, at pp. 76-78; Bradford (2012a), *supra* note 38, at pp. 106-109; George Dent, *Venture Capital and the Future of Corporate Finance* 70 *Washington University Law Review* 1029, 1052-1055 (1992).

⁴⁸ European Commission Consultation Document on Crowdfunding, *supra* n. 33, at pp. 7-8. See also Turan (2015), *supra* n. 42, at pp. 359-360; Agrawal et al. (2014), *supra* n. 33, at pp. 74-76. See finally European Banking Authority (EBA), *Opinion on Lending-based Crowdfunding*, at pp. 15-16 (EBA/Op/2015/03) ["EBA Opinion" hereafter].

⁴⁹ Agrawal et al. (2014), *supra* n. 33, at pp. 78-79.

⁵⁰ EBA Opinion, *supra* n. 48, at pp. 14-18.

the idiosyncratic information asymmetries between entrepreneurs and potential contributors, and to thereby facilitate entrepreneurs' financing.⁵¹ The empirical research corroborates that capital is, on balance, more likely to flow to better-regulated crowdfunding markets that appropriately protect capital providers while at the same time facilitating entrepreneurs' capital-raising (i.e., "race to the top" theory).⁵² At this point, the key question is: Why does regulatory intervention need to be taken centrally, at the EU level?

B. *Scaling-up Crowdfunding on an EU Cross-Border Basis*

The EU's online alternative finance market has been growing since 2013. In 2017, the overall volume of the online alternative finance market was increasing by 36% annually, from € 7.67 billion in 2016 to € 10.44 billion in 2017.⁵³ According to the 2019 Cambridge Center for Alternative Finance Report (2019 CCAF Report), the United Kingdom is the leading country in terms of volume generated via alternative financing (€ 7,066.80 million), followed by France (€ 661.37 million), Germany (€ 596.81 million), the Netherlands (€ 281.19 million), Italy (€ 240.66 million), Finland (€ 196.76 million), and Sweden (€ 196.38 million).⁵⁴ Domestic crowdfunding markets within the EU have been developing rapidly, and national regulatory regimes have been tailored to the characteristics and needs of local-national markets and market participants.⁵⁵ As indicated by a survey (see Figure 3) of the European Securities and Markets Authority ("ESMA" hereafter), about 46 nationally regulated investment-based crowdfunding platforms were operating within the EU by the end of 2014.⁵⁶

However, the diverse regulatory frameworks and licensing requirements for crowdfunding platforms have caused the crowdfunding sector to fragment along national borders and have obstructed the cross-border provision of crowdfunding services within the EU.⁵⁷ Most notably, while crowdfunding platforms need to expand their business across borders to reach a sufficient pipeline of project owners and investors to grow their business and become economically viable, and despite the fact that fundraisers seek to grow their funding sources beyond their legal origins, cross border

⁵¹ Nir Kshetri, *Informal Institutions and Internet-based Equity Crowdfunding* 24 *Journal of International Management* 33 (2018); Lars Hornuf, Armin Schwiendbacher, *Should Securities Regulation Promote Equity Crowdfunding?* 49 *Small Business Economics* 579 (2017).

⁵² Douglas Cumming, Sofia Johan, *Demand Driven Securities Regulation: Evidence from Crowdfunding* 15 *Venture Capital* 361 (2013).

⁵³ Cambridge Center for Alternative Finance (CCAF), *Shifting Paradigms: The 4th European Alternative Finance Industry Report* (2019), at p. 22 ["CCAF Report (2019)" hereafter].

⁵⁴ CCAF Report (2019), *supra* n. 53, at p. 142.

⁵⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 5; Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 1.2.1.

⁵⁶ European Securities and Markets Authority (ESMA), *Investment-based Crowdfunding: Insights from Regulators in the EU*, at p. 2 (ESMA/2015/856 Ann 1) ["ESMA Survey" hereafter].

⁵⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 6; Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 1.2.1.

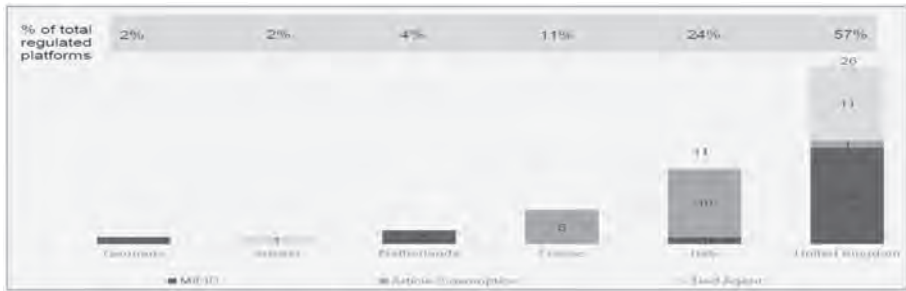


Figure 3: Regulated (investment-based) crowdfunding entities per country and regulatory status (December 2014)

Notes: (a) “MiFID” means that the platform has been authorized as an investment firm, that is, as a legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis (Directive 2004/39/EC [2004] OJ L 145/1, art. 4(1)(point 1)); (b) “Tied agent” means that the platform has been authorized as a natural or legal person who, under the full and unconditional responsibility of only one investment firm on whose behalf it acts, promotes investment and/or ancillary services to clients or prospective clients, receives and transmits instructions or orders from the client in respect of investment services or financial instruments, places financial instruments and/or provides advice to clients or prospective clients in respect of those financial instruments or services (Directive 2004/39/EC, art. 4(1)(point 25)); (c) ‘Article 3 firms’ are legal persons that: (i) are not allowed to hold clients’ funds or securities and which for that reason are not allowed at any time to place themselves in debit with their clients, and (ii) are not allowed to provide any investment service except the reception and transmission of orders in transferable securities and units in collective investment undertakings and the provision of investment advice in relation to such financial instruments, and (iii) in the course of providing that service, are allowed to transmit orders only to investment firms, credit institutions, branches of investment firms or of credit institutions, collective investment undertakings, and investment companies with fixed capital as defined in Article 15(4) of Second Council Directive 77/91/EEC (Directive 2004/39/EC, art. 3(1))

Source: ESMA, *Investment-based Crowdfunding: Insights from Regulators in the EU*, p. 2 (ESMA/2015/856 Ann 1).

accessibility and demand on crowdfunding platforms is fairly limited due to the divergences in the design and implementation of the relevant, domestic regulatory frameworks.⁵⁸ Absent a dedicated and coherent EU-wide regulatory and supervisory regime

⁵⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 6; Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 1.2; Antonella Cicchiello, *Harmonizing the Crowdfunding Regulation in Europe: Need, Challenges, and Risks*, *Journal of Small Business & Entrepreneurship* (forthcoming, 2019 DOI: 10.1080/08276331.2019.1603945); Rainer Lenz, *Peer-to-Peer Lending – Opportunities and Risks* 7 *European Journal of Risk and Regulation* 688, 703 (2016); EBA Opinion, *supra* n. 48, at p. 2 (“[T]he convergence of practices across the EU for the supervision of crowdfunding is desirable in order to avoid regulatory arbitrage, create a level-playing field, ensure that market participants can have confidence in this market innovation, and contribute to the single European market”). See also European Commission, *Commission Staff Working Document: Crowdfunding in the EU Capital Markets Union*, at pp. 29-30 (Brussels, SWD(2016) 154 final) [“Commission Staff Working Document” hereafter], noticing that fragmentation of national crowdfunding markets is a source of “inequality of opportunity

on crowdfunding, a solid pool of early-stage financing across Europe that would serve young businesses to attract the necessary start-up financing and scale up is doomed to failure and crowdfunding cannot reap the benefits of the internal market.⁵⁹ The underlying rationale of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) is to create a single set of rules on the provision of crowdfunding services within the EU to offer crowdfunding service providers (“CSPs” hereafter) the option to apply for a single EU-wide authorization; this would facilitate crowdfunding platforms’ activities on a cross-border basis, thereby increasing entrepreneurs’ access to finance across the internal market.⁶⁰

The reasoning of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) is sound. The 2017 European Commission Report on the “Market and Regulatory Obstacles to Cross-border Development of Crowdfunding in the EU” demonstrates that regulatory fragmentation constitutes a significant impediment to the development of cross-border crowdfunding because it increases legal uncertainty and compliance costs for both potential contributors and crowdfunding platforms intending to operate cross-border.⁶¹ The regulatory heterogeneity problem becomes even more acute considering that existing bespoke national rules develop myopically and are not well-adapted (or even intended) to support crowdfunding, as they were designed to address cross-border challenges involving more mainstream financial instruments and dimensions.⁶²

Niemand et al. (2018) use a sample of 217 participants-respondents and empirically confirm that capital providers in investment-based crowdfunding clearly prefer a European crowdfunding framework and that regulatory heterogeneity among Member States contributes to home-based investments.⁶³ In turn, regulatory fragmentation results in lower profitability for crowdfunding platforms, less funding opportunities for EU start-ups and fewer choices for investors.⁶⁴ The 2019 AFME Report on “Capital Markets Union” not only corroborates that fragmented crowdfunding regulation poses barriers to innovation and limits the EU’s capacity to encourage FinTech

to develop” between platforms in smaller and bigger countries (“*The platforms from smaller countries are more likely to look out for cross-border opportunities to achieve scale, as opposed to those operating in the large markets and having enough opportunities to grow domestically*”). The same argument, i.e. the “inequality of opportunity to develop” also applies in relation to growth prospects of start-ups that are established in countries with relative limited funding sources in comparison to other countries with more developed banking and capital markets.

⁵⁹ European Commission Proposal on Crowdfunding Regulation, *supra* n. 6, Explanatory Memorandum, at s. 2; Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 1.2.

⁶⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 7.

⁶¹ European Commission Report on Crowdfunding Obstacles, *supra* n. 41, at s. 6.3.

⁶² *Ibid.*

⁶³ Thomas Niemand, Martin Angerer, Ferdinand Thies, Sascha Kraus, René Hebenstreit, *Equity Crowdfunding Across Borders: A Conjoint Experiment* 24 International Journal of Entrepreneurial Behavior & Research 911 (2018).

⁶⁴ Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 1.2.1.

innovation,⁶⁵ but also notices that, in the absence of a deep EU liquid market for new companies to raise finance, innovative entrepreneurs have sought to access finance outside the EU.⁶⁶ The 2019 AFME Report also stresses that diverging national practices and disharmonised regulation on crowdfunding makes the cost of raising capital higher in some Member States than in others, and concludes that a common, EU-wide framework for crowdfunding services is central to providing the conditions needed to maximise the level of competition, choice and economies of scale for the benefit of consumers and market participants.⁶⁷ On the same line, Boitan (2016) observes that “*regulation of crowdfunding is characterized by heterogeneity, lack of coordinated actions at the European level [and] fragmentation among individual jurisdictions*” thus hampering the development of “*a European single market for this method of financing, or [...] the entrance of crowdfunding platforms from abroad into the European market*”.⁶⁸ What is more, the analysis of Boitan (2016) indicates that a common, EU crowdfunding framework would alleviate the problem of financial exclusion by offering entrepreneurs wishing to launch a start-up an alternative source of financing.⁶⁹ Finally, Cicchiello (2019) infers that a pan-EU crowdfunding regime is necessary to build a level playing field for all market actors in Europe, remove legal uncertainty and create an integrated crowdfunding ecosystem which fosters transparency and healthy competition among market participants.⁷⁰

Responses to the public consultation on the creation of an EU crowdfunding market also corroborate the thesis that regulatory heterogeneity across Member States prevents crowdfunding from reaching its full potential. About 82% of (actual or potential) contributors participating in the consultation stated that they would be willing to contribute to campaigns from another EU country, either without any further thinking (38%) or for projects that they really believe in (44%);⁷¹ one-third of the crowdfunding platforms that responded to the consultation also indicated a willingness to operate abroad.⁷² Most importantly, 44% of financial-return crowdfunding platforms cited the lack of information about legal requirements as an obstacle to their cross-border expansion, and 27% cited the high costs of authorization in another Member State, which implies that the EU market does not work efficiently for financial-return crowdfunding models.⁷³

The 2019 CCAF Report provides additional evidence corroborating the result of the analysis above. About 88% of crowdfunding platforms in 2017 reported some

⁶⁵ Association for Financial Markets in Europe (AFME), *Capital Markets Union: Key Performance Indicators*, at p. 33 (AFME, October 2019).

⁶⁶ *Ibid.*, at p. 43.

⁶⁷ *Ibid.*, at pp. 45, 56.

⁶⁸ Iustina Boitan, *Crowdfunding and Financial Inclusion Evidence from EU Countries* 4 Economic Alternatives 418, 425-426 (2016).

⁶⁹ *Ibid.*, at pp. 427-430.

⁷⁰ Cicchiello, *supra* n. 58.

⁷¹ European Commission, *Responses to the Public Consultation on Crowdfunding in the EU*, at p. 3 (March 2014) [“Responses to the European Commission Consultation on Crowdfunding” hereafter].

⁷² *Ibid.*, at p. 4.

⁷³ *Ibid.*

level of cross-border inflows in support of local campaigns, and 61% reported outflows of local users' support for crowdfunding campaigns abroad. The dark side of the data is that the majority of these cross-border transactions represents a comparatively modest total transaction volume: 61% of the platforms that reported cross-border inflows during 2016 stated that these transactions account for up to 10% of their total transaction volume, whereas 50% of the platforms reporting outflows for the same year (2016) stated that these constitute up to 10% of their total volume.⁷⁴ Thus, while platforms are recording increasing cross-border activity, domestic regulatory regimes seem to be imposing considerable constraints, as evidenced by the relatively low transaction volume of cross-border flows.

3. Demarkating the Scope of the Proposed EU Regulation on European Crowdfunding Service Providers (ECSPs)

3.1. *Subject Matter and Regulatory Reach*

A. *Setting Up an EU "Passport" for CSPs*

In order to facilitate the exercise of the freedom to provide and receive (financial-return) crowdfunding services in the EU internal market, the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) seeks to create a level playing field by laying down a harmonized regulatory framework at Union level for CSPs' authorization and funders' protection.⁷⁵ Hence, any legal person that intends to provide (financial-return) crowdfunding services, is required to comply with a harmonised set of requirements and receive a single Union-wide authorization by the Member State where it is established.⁷⁶ Moreover, to enable CSPs to operate on a cross-border basis without facing divergent rules and to thereby facilitate the funding of projects across the EU by contributors from different Member States, national gold-plating is not allowed.⁷⁷

Cross-border provision of crowdfunding services within the EU is facilitated more efficiently by placing CSPs, rather than fundraisers-entrepreneurs, at the focus of regulatory harmonization efforts. Startups seeking to raise capital via crowdfunding are thinly capitalized, financially inexperienced, and legally unsophisticated; thus, imposing a layer of admissibility requirements on fundraisers would substantially increase their cost of raising capital and, as a result, would be more likely to under-

⁷⁴ Cambridge Center for Alternative Finance (CCAF), *Expanding Horizons: The 3rd European Alternative Finance Industry Report* (2018), at p. 45 ["CCAF Report (2018)" hereafter]. According to the CCAF Report (2019), *supra* n. 53, at p. 45, the share of funds coming from cross-border inflows and outflows during 2017 increased, indicating that platforms are striving to become diversified outside their headquarters country to cater to investors and fundraisers abroad.

⁷⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recitals 7-8.

⁷⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 12(1).

⁷⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 33 and art. 12(12). For the definition of financial-return crowdfunding services see *infra* section 3.1.B

mine rather than promote the objective of scaling-up crowdfunding services across the EU market.⁷⁸ By contrast, CSPs are repeat players in the market and can spread regulatory costs over a large number of offerings.⁷⁹ In addition, crowdfunding platforms are, as hubs of crowdfunding activities, more visible to supervisors for supervisory enforcement purposes;⁸⁰ thus, ensuring CSPs' compliance with authorization and market conduct requirements would help build market confidence.⁸¹ Finally, CSPs are better placed to monitor the regulatory requirements imposed on the offerings, or the entrepreneurs making the offerings, and can thus play a key role as "gatekeepers" in reducing information asymmetries and promoting trust between market participants.⁸²

Moreover, determining with the necessary certainty when crowdfunding services are provided on an EU cross-border basis is particularly difficult and ambiguous, mostly due to lack of clear, harmonized criteria or guidance. In order to avoid the uncertainty concerning the identification of the place of the provision of crowdfunding services and aiming at avoiding the confusion that would be created by the parallel application of national and EU crowdfunding rules,⁸³ the Council of the European Union has wisely opted for the replacement of all national rules by the rules of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs). As a result, all providers of investment- and lending-based crowdfunding services – as these services are defined by the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) –, whether they operate on a cross-border or national-only basis, shall be covered and regulated by a common, single set of rules.⁸⁴ In light of the replacement of national rules by the rules of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs), transitional arrangements are introduced allowing persons providing such crowdfunding services in accordance

⁷⁸ Bradford (2012a), *supra* note 38, at p. 117.

⁷⁹ *Ibid.*

⁸⁰ Dirk Zetzsche, Christina Preiner, *Cross-Border Crowdfunding: Towards a Single Crowdlending and Crowdinvesting Market for Europe*, 27, at pp. 29-30 (European Banking Institute Working Paper No 8/2017) ["Zetzche and Preiner (2017)" hereafter]; Bradford (2012a), *supra* note 38, at p. 117.

⁸¹ Fink (2012), *supra* n. 33, at p. 32.

⁸² Ferrarini (2017), *supra* n. 43, at p. 125; Agrawal et al. (2014), *supra* n. 33, at p. 81; Bradford (2012a), *supra* note 38, at pp. 117-118; Stuart Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution* 64 Florida Law Review 1433, 1439 (2012).

⁸³ Failure to adopt harmonized guidelines regarding when a crowdfunding service is deemed to be offered in a country other than the home country of the platform (i.e., cross-border) blurs the boundaries between domestic and EU-authorized crowdfunding service providers ("CSPs" hereafter) and is an invitation to confusion and arbitrage, thus undermining the effectiveness of the CSPs' single-license regime. The European Crowdfunding Network (see European Crowdfunding Network, *Review of Crowdfunding Regulation* (ECN, 2017)) reveals a mosaic of diverse national approaches to identifying where crowdfunding services are being supplied and thus corroborates the abovementioned concerns.

⁸⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 76 and art. 1(1) and 1(2)(b). Essentially, the replacement of national rules by the rules of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) only covers types of crowdfunding services included within the scope of this Regulation.

with national law preceding the proposed EU rules to adapt their business activities and to have sufficient time to apply for an authorisation thereunder.⁸⁵

B. Defining Financial-Return Crowdfunding Services

According to the description of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs), financial-return crowdfunding matches the business funding interests of funders or contributors (i.e., lenders and investors)⁸⁶ and project owners⁸⁷ through an electronic information system operated or managed by a crowdfunding platform, and can consist of any of the following: (i) the facilitation of the granting of loans (crowd-lending or P2P lending);⁸⁸ or (ii) the placing without firm commitment of transferable securities or “admitted instruments” issued by project owners or special purpose vehicles *and* the reception and transmission of client orders⁸⁹ with regard to those transferable securities or “admitted instruments” (investment-based crowdfunding).⁹⁰

Crowd-lending may be facilitated via several business models, such as presenting crowdfunding offers⁹¹ to clients and pricing or rating the project owners’ creditworthiness.⁹² In order to avoid any confusion between crowd-lending and the traditional,

⁸⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 48: “Crowdfunding service providers may continue in accordance with the applicable national law to provide crowdfunding services which are included within the scope of this Regulation until ... [24 months after the date of entry into force of this Regulation] or until they are granted an authorisation referred to in Article 12, whichever is sooner.”

⁸⁶ Funders or contributors include both lenders and investors, that is, persons who, through a crowdfunding platform, grant loans or acquire transferable securities or admitted instruments for crowdfunding purposes. The Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(i) has adopted the term ‘investor’ instead of the term ‘funder’; for present purposes, the term ‘funder’ or ‘contributor’ shall be used interchangeably with the term ‘investor’.

⁸⁷ Project owners are natural or legal persons who seek funding through a crowdfunding platform, i.e., a publicly accessible internet-based information system operated or managed by a crowdfunding service provider (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(d) and (h)).

⁸⁸ ‘Loan’ means an agreement whereby a funder makes available to a project owner an agreed amount of money for an agreed period of time and whereby the project owner assumes an unconditional obligation to repay that amount to the funder, together with the accrued interest, in accordance with the installment payment schedule (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(b)).

⁸⁹ Clients (of a CSP) include any prospective or actual funder or project owner to whom a CSP provides, or intends to provide, crowdfunding services (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(g)).

⁹⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(a) and Preamble, Recital 10.

⁹¹ ‘Crowdfunding offer’ means any communication by a CSP, in any form and by any means, presenting sufficient information on the terms of the offer and the crowdfunding project being offered, so as to enable a funder to invest in the crowdfunding project. In turn, a “crowdfunding project” includes the business activity or activities for which a project owner seeks funding through the crowdfunding offer. See Council First Reading Position on Crowdfunding Regulation, *supra* n. 8., art. 2(1)(f) and 2(1)(l).

⁹² Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 11.

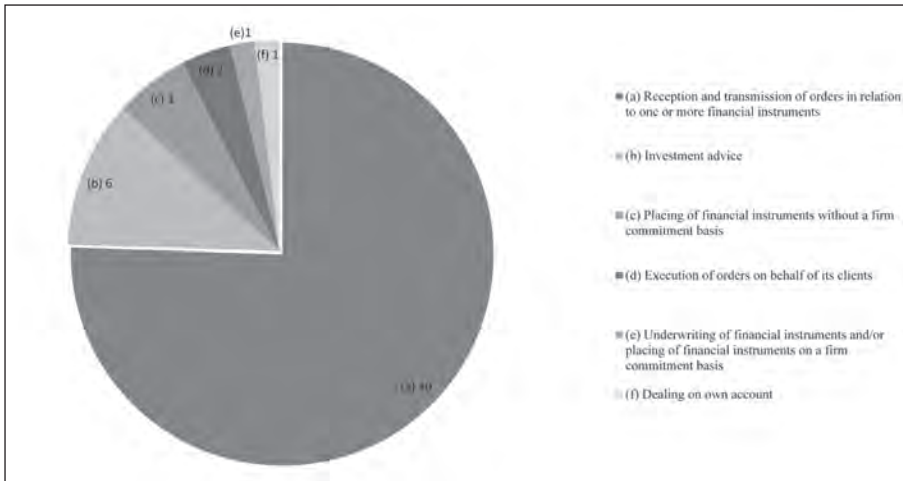


Figure 4: Services/activities carried out by (nationally-domestically) regulated crowdfunding entities within EU (as of December 2014)

Source: ESMA, *Investment-based Crowdfunding: Insights from Regulators in the EU* (ESMA/2015/856 Ann 1)

credit-extension and deposit-taking business of credit institutions, the Council of the European Union also clarifies that CSPs shall not, at any moment, act as creditors of project owners;⁹³ on the same line, project owners or investors accepting funds or granting loans for the purposes of offering or investing into crowdfunding projects should not be required to apply for a credit institution license or any other individual exemption, authorization or dispensation.⁹⁴

For investment-based crowdfunding, the EU legislator draws on the ESMA Advice and Survey concerning regulated investment-based crowdfunding platforms in the EU and attempts to reflect the basic activities most likely to be carried out by mainstream investment-based crowdfunding platforms.⁹⁵ Figure 4 presents a breakdown of the investment services/activities – as defined in Directive 2014/65/EU (“MiFID II” hereafter) – that (nationally-domestically) regulated crowdfunding entities have carried out as of December 2014. The figure shows that the most common MiFID II investment service/activity offered/undertaken by these entities has been the “reception and transmission of orders” whereas “placing of securities” ranks third. The reception and transmission of orders involves not only the reception of orders from investors and their transmission to the fundraiser, but also the bringing together of two or more parties (i.e., the fundraiser with contributors), thereby enabling a trans-

⁹³ *Ibid.*

⁹⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8., Preamble, Recital 9, and art. 1(3).

⁹⁵ See ESMA Survey, *supra* n. 56; European Securities Markets Authority (ESMA), *Advice: Investment-based Crowdfunding* (ESMA/2014/1560) [“ESMA Advice” hereafter].

action.⁹⁶ Placing is the service provided by the crowdfunding platform to a fundraiser, whereby the platform undertakes to place transferable financial instruments with investors on behalf of the issuer; it is a service provided by the platform related to primary market activities associated with the issuance of new instruments.⁹⁷

3.2. *Exemptions from the Perimeter of the Proposed EU Regulation on European Crowdfunding Service Providers (ECSPs)*

A. *Non-Financial-Return Crowdfunding*

As discussed, the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) covers financial-return crowdfunding only – that is, investment-based crowdfunding and crowd-lending. Excluding non-financial-return crowdfunding (i.e., donation-based crowdfunding, crowd-sponsoring, pre-sales crowdfunding) is consistent with the fundamental rationale of the EU legislator, which is to increase entrepreneurs' access to finance through the creation of a harmonized framework for crowdfunding and the scaling-up of crowdfunding services across the internal market.⁹⁸ Moreover, the evidence suggests that cross-border financial-return crowdfunding is much less developed than crowdfunding activities with no financial return. According to the responses to the consultation on EU crowdfunding, 81% of non-financial-return platforms operated cross-border, whereas only 38% of lending- or investment-based platforms accepted projects and contributions from outside the Member State of their establishment; by contrast, 48% of the lending- or investment-based crowdfunding platforms stated that they would like to operate abroad in the future, compared to 14% of non-financial-return platforms.⁹⁹ Along the same lines, the 2018 CCAF Report finds that P2P business lending and equity-based crowdfunding have lower cross-border transaction flows than other crowdfunding models: only 7% of the P2P business lending transaction volume is associated with cross-border inflows, and only 3% is associated with cross-border outflows, whereas just 8% of the equity-based crowdfunding transaction volume is associated with cross-border inflows, and 7% is associated with cross-border outflows.¹⁰⁰ It is thus logical to prioritize the goal of enhancing the cross-border activities of financial-return crowdfunding in the regulatory agenda.

⁹⁶ Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [2014] OJ L 173/349 (“MiFID II” hereafter), Preamble, Recital 44.

⁹⁷ See Questions and Answers published by the European Commission, available at <https://ec.europa.eu/info/law/markets-financial-instruments-mifid-directive-2014-39-ec/implementation/guidance-implementation-and-interpretation-law_en>.

⁹⁸ See European Commission Proposal on Crowdfunding Regulation, *supra* n. 6, Explanatory Memorandum, s. 1.

⁹⁹ Responses to the European Commission Consultation on Crowdfunding, *supra* n. 71, at p. 4.

¹⁰⁰ CCAF Report (2018), *supra* n. 74, at p. 46. Comparison with the data of the CCAF Report (2019), *supra* n. 53, is not possible due to the change of classification of ‘P2P Business Lending’ and ‘P2P Property Lending’.

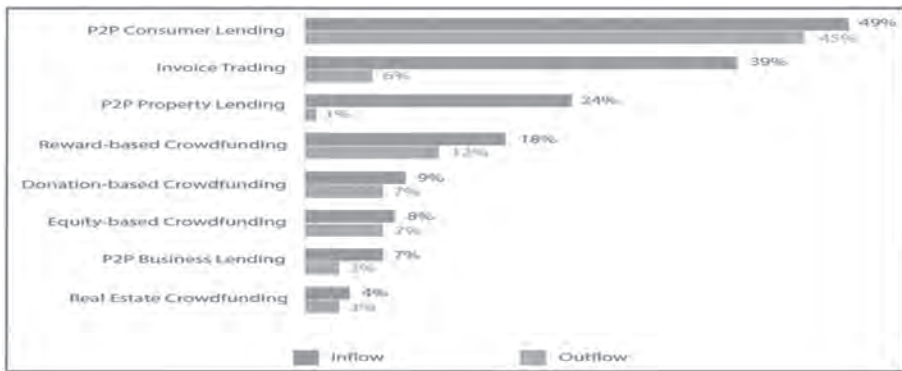


Figure 5: Crowdfunding cross-border inflows and outflows by proportion of volume (by crowdfunding model)

Source: Cambridge Center for Alternative Finance (CCAF), *Expanding Horizons: The 3rd European Alternative Finance Industry Report*, 46 (2018) [CCAF Report (2018)]. For the relevant definitions, see CCAF Report 2018, *ibid.*, at p. 28: P2P Consumer Lending: individuals or institutional funders provide a loan to a consumer borrower / P2P Business Lending: individuals or institutional funders provide a loan to a business / Invoice trading: individuals or institutional funders purchase invoices or receivable notes from a business at a discount / Equity-based crowdfunding: individuals or institutional funders purchase equity issued by a company / Reward-based crowdfunding: backers provide finance to individuals, projects or companies in exchange for non-monetary rewards or products / Real estate crowdfunding: individuals or institutional funders provide equity or subordinated-debt financing for real estate / P2P property lending: individuals or institutional funders provide a loan secured against a property to a consumer or business borrower.

Moreover, regulating non-financial-return crowdfunding models would be disproportionate because such models do not involve financial products and reflect information asymmetries of a type and magnitude different from those arising in financial-return crowdfunding.¹⁰¹ Indeed, financial-return crowdfunding offers contributors a product with a financial-return that depends on future cash flows.¹⁰² Inevitably, therefore, distinct and serious information asymmetries emerge, which, combined with the limited monitoring incentives of the small and dispersed contributors, poses serious and distinctive investor protection concerns.¹⁰³

B. Consumer Crowd-Lending

The proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) covers business, as opposed to consumer, crowd-lending. Crowd-lending to project owners who are consumers, as defined in Article 3(a) of Directive 2008/48/EC, is

¹⁰¹ European Commission Proposal on Crowdfunding Regulation, *supra* n. 6, Explanatory Memorandum, at s. 1.

¹⁰² Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 4.1.1.

¹⁰³ *Ibid.*

excluded, because such lending partially falls within the scope of existing EU legislation: (i) the Consumer Credit Directive (Directive 2008/48/EC) applies where a consumer is receiving a loan for personal consumption and operating outside of his/her professional capacity; and (ii) the Mortgage Credit Directive 2014/17/EU applies when a consumer receives a loan to purchase an immovable property.¹⁰⁴ Potential inefficiencies in consumer credit via new forms of lending such as on-line lending and P2P lending platforms (i.e., increased risk of irresponsible lending and borrowing causing over-indebtedness) have been discussed in the recent Consumer Financial Services Action Plan and will be dealt with during the evaluation of Directive 2008/48/EC.¹⁰⁵

C. *Non-Transferable Securities*

Investments in non-transferable securities are excluded from the scope of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) concerning investment-based crowdfunding. For the EU legislator, the transferability of a security is an important safeguard for investors because it provides them with the legal option of disposing of their interest on the capital markets and, thus, allows them to exit their investment.¹⁰⁶

At first glance, the exemption of non-transferable securities from the scope of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) seems to encompass investments in partnerships and private limited companies, which are the company structures most commonly used to accommodate the needs of startups. Nonetheless, a more thorough analysis suggests otherwise. First, according to the definition provided under Directive 2014/65/EU (MiFID II), “transferable securities” encompass those classes of securities that are negotiable on the capital market (with the exception of instruments of payment), such as shares in companies and other securities equivalent to shares in companies, partnerships or other entities.¹⁰⁷ By definition, therefore, participations in partnerships and other entities (e.g., private limited companies) may well be transferable securities, provided they are negotiable on capital markets. The notion of “capital market” is not explicitly defined, but it should be interpreted broadly to include all contexts where the buying and selling of interest in securities meet.¹⁰⁸ In this sense, the phrase “negotiable on the capital mar-

¹⁰⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 8 and art. 1(2)(a). See also Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 4.1.1, clarifying that “[t]o preserve consistency among the European legislative frameworks, the existing consumer protection regime would still apply to [non financial-return crowdfunding models]”.

¹⁰⁵ Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 4.1.1; European Commission, *Communication: Consumer Financial Services Action Plan – Better Products, More Choice* (Brussels, 23.03.2017, COM(2017) 139 final), par. 2.6.

¹⁰⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 13.

¹⁰⁷ MiFID II, *supra* n. 96, art. 4(1)(44). Cf. Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(m).

¹⁰⁸ See Questions and Answers published by the European Commission, available at <<https://ec.europa.eu/info/law/markets-financial-instruments-mifid-directive-2004-39-ec/implementation/>

ket” includes shares that are unlisted and not traded on any exchange but are still transferable in contexts where buying and selling interest meet and in accordance with certain rules (which usually relate to private companies); if, on the other hand, transfer restrictions prevent those instruments from being tradable in such contexts, they are not transferable securities.¹⁰⁹ In line with the above analysis, the Council of the European Union has made clear that shares of a private limited liability company that are not subject to restrictions that would effectively prevent them from being transferred, including restrictions to the way in which those shares are offered or advertised to the public incorporated under the national law of Member States, are also freely transferable on the capital markets and should therefore be included within the scope of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs).¹¹⁰ The problem is that it has not been clarified what kind of restrictions have the effect of prohibiting the transferability of securities; it could be argued, for example, that, where a breach of transferability restrictions does not result in the (in rem) nullification of the securities’ transfer, those securities may still be considered transferable securities.¹¹¹ The lack of clear guidance on the scope of the “transferable securities” concept is a source of ambiguity, leading to diverse national interpretations, which are in turn likely to increase uncertainty and undermine a consistent application of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) across Member States.¹¹²

Uncertainty as to the exact ambit of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) is likely to become even more marked in the case of investments in hybrid instruments – that is, participation in partnerships and private limited companies that are structured as loans, such as profit participation rights and silent partnerships.¹¹³ The proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) is silent on the issue. The Working Document on

guidance-implementation-and-interpretation-law_en>.

¹⁰⁹ See Questions and Answers published by the European Commission, available at <https://ec.europa.eu/info/law/markets-financial-instruments-mifid-directive-2004-39-ec/implementation/guidance-implementation-and-interpretation-law_en>.

¹¹⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 13, as well as art. 2(1)(a), 2(1)(n), 2(2)-(4). National supervisory authorities shall, on an annual basis, inform ESMA about the types of private limited liability companies and their shares that are offered and which fall within the scope of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs), with reference to the applicable national law.

¹¹¹ Central Bank of Ireland, *Investment Firms: Questions and Answers* (5th Edition – 8 October 2018), pp. 3-4.

¹¹² Zetzche and Preiner (2017), *supra* n. 80, at pp. 19-20. See also Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 14: “*Certain admitted instruments for crowdfunding purposes are in some Member States subject to national law governing their transferability, such as the requirement for the transfer to be authenticated by a notary. This Regulation should apply without prejudice to national law governing the transfer of such instruments.*”

¹¹³ See ESMA Advice, *supra* n. 95, at p. 15:

“*Many Member States, including Austria, Belgium, Germany and Sweden, have had experience of investment-based crowdfunding using forms of participation which are not considered to be transferable securities or to otherwise qualify as MiFID financial instruments, meaning that*

the Impact Assessment of the initial European Commission Proposal, however, seems to opt for a rather lax interpretation, noting that

*“[i]t is important to adopt a sufficiently comprehensive approach towards instruments in order to ensure both scalability of operations and mitigation of circumvention risks [hence, the] definition of products that are intermediated on crowdfunding platforms (e.g. business loans, securities, royalties, among others) is fairly broad in order to cover a sufficient number of business models.”*¹¹⁴

This more comprehensive interpretation is justified for another important yet seemingly neglected reason: it would accommodate bespoke contractual arrangements that have been developed and commonly used to protect crowdfunding investors in the context of staged financing while also facilitating the management of project owners' capitalization tables.¹¹⁵ Successful start-ups commonly receive several rounds of financing after the completion of the crowdfunding offering, including financing by business angels, venture capitals, and private equities. Considering that these latter-round, professional investors negotiate special rights to shelter their preferences, previous-round, retail crowdfunding investors may be disadvantaged and thus be

the platforms do not have to be authorized under MiFID to intermediate in relation to those securities.”

See also European Commission Staff Working Document, *Impact Assessment Accompanying the document European Commission Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds*, p. 133 (Brussels, 07.12.2011, SEC(2011) 1515 final).

¹¹⁴ Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 4.1.4. The definition of “securities” in the context of the U.S. crowdfunding regime is extremely wide, also encompassing “certificates of interest or participation in any profit-sharing agreement” as well as “investment contracts” (i.e., “contract or transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise”): see *SEC v. Howey Co.*, 328 U.S. 293 (1946), 298-301. See also 15 U.S. Code § 77b (a)(1):

“The term ‘security’ means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

See, finally, Joan MacLeod Heminway, *What is a Security in the Crowdfunding Era?* 7 Ohio State Entrepreneurial Business Law Journal 335, 353-370 (2012); Joan MacLeod Heminway, Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933* 78 Tennessee Law Review 879, 885-886 (2011) [“Heminway and Hoffman (2011)” hereafter].

¹¹⁵ Jack Wroldsen, *Crowdfunding Investment Contracts* 11 Virginia Law & Business Review 543, 552-553 (2017) [“Wroldsen (2017)” hereafter]; Zetzche and Preiner (2017), *supra* n. 80, at p. 35.

dissuaded from investing.¹¹⁶ Essentially, project owners face a puzzle concerning the structure of their financing: on the one hand, crowdfunding provides them with the opportunity to receive micro-financing at the critical start-up phase; on the other hand, maintaining a widely dispersed shareholding structure with many micro shareholders who enjoy the right to vote and influence business operations and strategy is likely to dissuade latter-stage investing by professional investors, thus impeding the realization of future financing rounds.¹¹⁷ “Unequity” securities, like the profit-sharing agreements mentioned above, offer a workable option for maintaining a clean capitalization table for future financing while also providing small investors with adequate incentives to participate in a crowdfunding offer.¹¹⁸ Attractive alternative solutions include future equity securities, whereby crowdfunding contributors receive the rights (not equities) to acquire stock upon the occurrence of predetermined events (e.g., IPOs or future financing by professional investors), and bespoke convertible debt contracts, whereby the project-owner commits to repaying crowdfunding investors’ funds at a certain interest rate or to convert these contracts into equity upon the occurrence of events like those mentioned above.¹¹⁹

All in all, ‘hybrid’ and ‘unequity’ investment instruments provide the opportunity to strike a delicate balance between the interests and investment incentives of first-round retail contributors and latter-round professional investors, thus expanding and easing the financing of start-ups. Unless the scope of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) is interpreted and applied flexibly to cover these (and similar) contractual arrangements, CSPs are likely to be less attractive for prospective (especially high-quality) project owners. It is, therefore, unfortunate that both the European Parliament and the Council of the European Union missed the opportunity to clarify and streamline the scope of “financial instruments” when revising the European Commission Proposal.

D. *Investment Advice*

The European Parliament had proposed that investment advice (i.e., the provision of personal recommendations to a client, either upon its request or at the initiative of the CSP) should also be included within the scope of the EU crowdfunding regime.¹²⁰ This suggestion was inspired by the available data presented in Figure 4 showing that the

¹¹⁶ Wroldsen (2017), *supra* n. 115, at p. 552.

¹¹⁷ Wroldsen (2017), *ibid.*, at p. 553; Ross Weinstein, *Crowdfunding in the U.S. and Abroad: What to Expect When You’re Expecting* 46 Cornell International Law Journal 427, 452-453 (2013) [“Weinstein (2013)” hereafter]; Gregory Deshler, *Wisdom of the Intermediary Crowd: What the Proposed Rules Mean for Ambitious Crowdfunding Intermediaries* 58 Saint Louis University Law Journal 1145, 1184-1185 (2014) [“Deshler (2014)” hereafter].

¹¹⁸ Wroldsen (2017), *supra* n. 115, at p. 555.

¹¹⁹ Wroldsen (2017), *ibid.*, at pp. 555-557; Jack Wroldsen, *Proactive Law as Competitive Advantage in Crowdfunding* in D. Assadi ed., *Strategic Approaches to Successful Crowdfunding*, pp. 138-139, 129-149 (IGI Global 2016). See also SEC, *Investor Bulletin: Be Cautious of SAFEs in Crowdfunding* (9 May 2017).

¹²⁰ European Parliament Position on Crowdfunding Regulation, *supra* n. 7, art. 4a. See, also, MiFID II, *supra* n. 96, art. 4(1)(4).

service of “investment advice” has been the second most popular service/activity that EU investment-based crowdfunding platforms offered to/undertook for their clients. However, the Council of the European Union rejected the idea of including investment advice within the scope of permissible activities of CSPs.¹²¹

E. Duplication of CSPs’ Authorization

CSPs intending to accept deposits or other repayable funds from the public should also apply for authorization as credit institutions in accordance with Article 8 of Directive 2013/36/EU.¹²² This requirement for the supplementary authorization of CSPs as credit institutions, wherein they act under a deposit-taking capacity, is necessary to avoid regulatory arbitrage and ensure effective supervision of CSPs.¹²³ On the same line, since only payment service providers (PSPs) are permitted to provide payment services, CSPs that intend to provide such payment services in connection with their crowdfunding services, also need to apply for authorization as PSPs under Directive (EU) 2015/2366.¹²⁴ From the opposite direction, too, in order to ensure proper supervision and to avoid disproportionate administrative burdens, entities that have been authorised as electronic money institutions, or credit institutions, or investment firms, or PSPs, and that intend to provide crowdfunding services, need to also apply and receive authorization as CSPs.¹²⁵

¹²¹ See also Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 21:

“The existence of filtering tools on a crowdfunding platform under this Regulation should not be regarded as investment advice under Directive 2014/65/EU as long as those tools provide information to clients in a neutral manner that does not constitute a recommendation. Such tools should include those that display results based on criteria relating to purely objective product features. Objective product features in the context of a crowdfunding platform could be pre-defined project criteria such as the economic sector, the instrument used and the interest rate, or the risk category where sufficient information regarding the calculation method is disclosed. Similarly, key financial figures calculated without any scope for discretion should also be considered to be objective criteria.”

Excluding investment advice from the scope of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) seems a wise decision: first, by limiting the scope of permissible services, CSPs’ sources of liability are curbed; and, second, the inherently risky character of investment advice – considering, in particular, that such advice would, more often than not, relate to non-listed securities, with scant trading activity / history and scarce information sources – would call for the imposition of more advanced internal organization and capital requirements (similar to those applicable to investment firms and credit institutions), which, in turn, would increase disproportionately the cost of authorization and doing business for CSPs.

¹²² Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 9. See also Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L 176/338.

¹²³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 9.

¹²⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 29 and art. 12(15). In order to facilitate the authorization procedure, the supervisory authorities shall require that the information and documents to be submitted under each application are submitted only once.

¹²⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 35 and art. 12(14). In such cases, a simplified authorisation procedure applies and the supervisory

F. Crowdfunding Offers over €5 Million (or over €8 Million)?

According to Regulation (EU) 2017/1129 (“EU Prospectus Regulation” hereafter), offers of securities to the public with a total consideration in the Union of less than € 1 million are considered small-scale offers and are thus exempt from the obligation to draw up a Prospectus.¹²⁶ Furthermore, in view of the varying sizes of the EU’s financial markets, Member States *enjoy the discretion* to exempt offers of securities to the public not exceeding €8 million from the obligation to publish a Prospectus.¹²⁷ Thus, Member States are free to set out in their national law a threshold ranging between € 1 million and € 8 million (expressed as the total consideration of the offer in the Union over a period of 12 months) within which the exemption from the obligation to publish a Prospectus shall also apply.¹²⁸

Considering the risks associated with crowdfunding investments and in order to ensure investor protection and enhance the mechanism of market discipline, the Council of the European Union has introduced a threshold for a total consideration for crowdfunding offers *made by a particular project* owner through a crowdfunding platform.¹²⁹ Very interestingly, however, the EU legislator has not adopted the € 1 million nor the € 8 million threshold of the EU Prospectus Regulation; instead, the EU legislator has opted for an “intermediate-tailored made” € 5 million threshold, calculated over a 12-months period, because this “*is the threshold used [emphasis added] by most Member States to exempt offers of securities to the public from the obligation to publish a prospectus in accordance with Regulation (EU) 2017/1129*”.¹³⁰ However, for those Member States that have set the threshold to exempt offers of securities to the public from the obligation to publish a prospectus under Regulation (EU) 2017/1129 at below € 5 million (i.e., € 4 million or € 3 million), a non-renewable temporary derogation is introduced according to which the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) shall apply in that Member States only to crowdfunding offers with a total consideration up to the amount of that threshold (i.e., € 4 million or € 3 million).¹³¹ Notably, the cap on crowdfunding offers

authorities should not require submission of documents or proof that are already at their disposal.

¹²⁶ Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC [2017] OJ L 168/12 [“EU Prospectus Regulation” hereafter], art. 1(3) and Preamble, Recital 12.

¹²⁷ *Ibid.*, art. 3(2) and Preamble, Recital 13.

¹²⁸ *Ibid.*, Preamble, Recital 13.

¹²⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 16.

¹³⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 16 and art. 1(2)(c). A crowdfunding offer within the threshold that is set out by the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) is exempted from the requirement to publish a prospectus under Regulation (EU) 2017/1129 (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 46).

¹³¹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 17 and art. 49. The underlying rationale for the provision of this temporary derogation is “*the special effort that might be sustained by those Member States [that have set the threshold to exempt offers of securities to the public from the obligation to publish a prospectus at below € 5 million] in terms of adjusting their national law and ensuring the application of the single threshold under this Regulation.*”

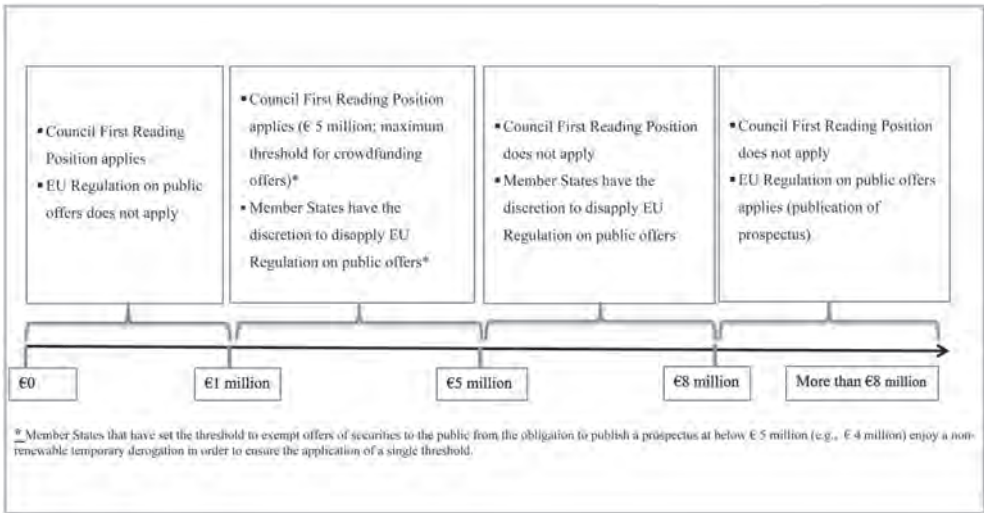


Figure 6: “Offering threshold”: mapping of the interrelation between crowdfunding and public offers

(i.e., € 5 million) is calculated on a “per project-owner” basis (as opposed to each single crowdfunding offer related to a particular crowdfunding project), by adding up the consideration of *all crowdfunding offers* (including both crowd-lending offers and investment-based crowdfunding offers as well as certain types of offers to the public according to Regulation (EU) 2017/1129) made by a particular project-owner within a twelve months period.¹³²

Figure 6 graphically illustrates the “offering threshold” for crowdfunding offers, on the one hand, and public offers, on the other hand.

i. Key Issues for Discussion

A more thorough assessment of the cap on the maximum amount raised via crowdfunding offers reveals several issues worth discussing. First, it could be argued, from a more theoretical perspective, that a cap on the maximum amount collected by project owners via crowdfunding prevents the raising of all the capital needed to make a project viable, which, in turn, results in lost opportunities or inefficiencies in the

¹³² The € 5 million threshold is calculated as the sum of: (a) the total consideration of offers conducted via crowd-investing and crowd-lending through a crowdfunding platform by a particular project owner; and (b) the total consideration of public offers of transferable securities made by the project owner in its capacity as an offeror: (i) of less than €1 million (calculated over a period of 12 months; or (ii) where such public offers are not subject to notification in accordance with article 25 of Regulation (EU) 2017/1129; or (c) of less than € 8 million (but exceeding € 1 million). See Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 1(2)(c)).

channeling of resources to their most productive use.¹³³ However, this concern is more than outweighed by two crucial considerations: first, crowdfunding is primarily suited to accommodate the financing of *start-ups' small-scale projects*, which essentially alleviates the “lost opportunity” concern; and second, the limitation on the amount that may be raised by project owners benefits investors by reducing the potential for dilution or fraud.¹³⁴

Another, and probably more, interesting issue associated with the ceiling on fundraising via crowdfunding is how the setting of the threshold fits the financing needs of EU start-ups. The available data show that most of the pre-seed and seed financing of EU entrepreneurs is derived from business angels, with the average deal ranging between € 100,000 and € 200,000.¹³⁵ In the next financing rounds (start-up and early-stage phases), venture capital funds come into play, with the average deal in the EU market fluctuating around € 1,500,000 to € 2,000,000.¹³⁶ For crowdfunding, preliminary data reveal that the average crowdfunding deal ranges around € 75,000, yet, this average deal size varies significantly across the various crowdfunding models, with the average deal size for equity crowdfunding reaching approximately € 200,000–€ 300,000 and that for P2P lending amounting to approximately € 65,000–€ 110,000 (see also Figure 7).¹³⁷ Available data from the U.S. crowdfunding market, between May 16, 2016 and December 31, 2018, corroborate that: (i) the typical crowdfunding offer was small and raised less than the 12-month offering limit; (ii) the median target amount sought was \$ 25,000 and the median maximum amount sought was \$ 500,000; and (c) of the offerings that were reported completed, the average offering sought a target amount of approximately \$ 52,428 and a maximum amount of approximately \$577,385.¹³⁸ It follows that, from a market or economic perspective, the € 5 million threshold that has been set out by the Council of the European Union for crowdfunding offers is rather ambitious given the current development of the EU crowdfunding market: crowdfunding under the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) not only intends to sit side-by-side with business angels' financing to start-ups in the pre-seed/seed phase of development and to cover the funding gap until venture investment and IPOs come into play,¹³⁹ but also

¹³³ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66519-66520.

¹³⁴ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66519.

¹³⁵ Helmut Kraemer-Eis, Antonia Botsari, Salome Gvetadze, Frank Lang, Wouter Torfs, *European Small Business Finance Outlook*, 42 (EIF, June 2018) [“Kraemer-Eis, et al. (2018)” hereafter]; European Business Angels Network (EBAN), *Statistics Compendium: European Early Stage Market Statistics 2017*, at p.12 (EBAN, 2017). Financing from family and friends is excluded due to lack of reliable data.

¹³⁶ Invest Europe, *2017 European Private Equity Activity*, 30-31 (May 2018); Dow Jones VentureSource, *Venture Capital Report*, 8 (Europe/4Q/2017).

¹³⁷ Kraemer-Eis, et al. (2018), *supra* n. 135, at pp. 104-105; Helmut Kraemer-Eis, Antonia Botsari, Salome Gvetadze, Frank Lang, Wouter Torfs, *European Small Business Finance Outlook Working Paper 2019/57*, 113 (EIF, June 2019); Massolution, *The 2015 Crowdfunding Report Industry Report*, 61 (Massolution, 2015).

¹³⁸ U.S. Securities and Exchange Commission, *supra* n. 30.

¹³⁹ See Darian Ibrahim, *Equity Crowdfunding: A Market for Lemons?* 100 *Minnesota Law Review* 561, 589 (2015) [“Ibrahim (2015)” hereafter]. See also Fabio Bertoni, Massimo Colombo, Anita Quas,



Figure 7: Average campaign size in 2014 in USD across crowdfunding models
 Source: Massolution, *The 2015 Crowdfunding Report Industry Report*, 61 (Massolution, 2015).

extends its financing boundaries within the scope of venture capital and private equity financing.¹⁴⁰

Most importantly, the Council of the European Union First Reading Position fails to clarify whether project owners are allowed to conduct an offering *via* multiple platforms or conduct concurrent offerings – based on either crowd-investing or crowd-lending models or on a combination of the two models – in several platforms. A negative answer is more appropriate in either circumstance.¹⁴¹ As correctly noted by the U.S. Securities and Exchange Commission, requiring a project-owner *to use*

The Patterns of Venture Capital Investments in Europe 45 Small Business Economics 543 (2015) (on the average, EU venture capital funds do not invest in young companies); Bradford (2012a), *supra* note 38, at pp. 102-110 (US venture capitalists tend to focus on companies that have passed the initial startup phase and are seeking to grow further, while US angel investors often invest on a smaller scale and are more willing to invest in startups). On the other hand, Oranburg (2015), *supra* n. 22, at pp. 419-435 infers that, in the U.S. startup ecosystem, business angels typically invest less than \$ 1 million at the Series Seed stage and venture firms typically invest more than \$ 5 million at the Series A stage, thus creating a funding gap between \$ 1 million and \$ 5 million; as a result, he proposes that crowdfunding should play the role of bridge-financing for startups seeking to raise at least \$ 1 million and up to \$ 5 million.

¹⁴⁰ The counter-argument could be that the € 5 million threshold includes not only crowdfunding offers but also public offers by project owners. However, considering the “funding escalator” presented in Figure 2 of the Annex (and the preceding discussion, *supra*, section 2.1), crowdfunding is primarily intended to fill in startups’ funding gap that extends from the inception stage and continues until the growth and expansion phases; typically, therefore, financing via capital markets and public offers is reserved for more mature firms.

¹⁴¹ Cf., U.S. 17 CFR § 227.100(a)(3)[Instruction to paragraph (a)(3)].

only one crowdfunding intermediary to conduct an offering or concurrent offerings would help foster the creation of a crowd and take advantage of its collective wisdom.¹⁴² Specifically, “[a]llowing an issuer to conduct a single offering or simultaneous offerings... through more than one intermediary would diminish the ability of the members of the crowd to effectively share information, because essentially, there would be multiple ‘crowds’.”¹⁴³ In addition, considering that practices among crowdfunding intermediaries may differ, allowing multiple intermediaries to conduct a single offering or simultaneous offerings could result in significant differences among such offerings.¹⁴⁴ Finally, permitting a project-owner to conduct an offering using more than one intermediary would make it more difficult for intermediaries to determine whether the project-owner has exceeded the aggregate limit on the total volume of capital that can be raised via crowdfunding.¹⁴⁵

G. Initial Coin Offerings (ICOs)

The European Commission did not concern itself with the possibility of including initial coin offerings (ICOs) within the scope of the proposed Regulation on crowdfunding. The issue of ICOs and their relation with crowdfunding was heavily debated by the European Parliament. The Parliament acknowledged that ICOs “*have potential in funding SMEs, innovative start-ups and scale-ups, can accelerate technology transfer, and can be an essential part of the capital markets union,*”¹⁴⁶ but it decided that ICOs should be excluded from the scope of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) because the “*characteristics of [ICOs] differ considerably from crowdfunding... [as] ICOs typically do not use intermediaries, such as crowdfunding platforms, and often raise funds in excess of €1 000 000... [thus] the inclusion of ICOs in this Regulation would not tackle the problems associated with ICOs as a whole.*”¹⁴⁷ The same approach has been adopted by Council of the European Union First Reading Position, concluding that “[w]hilst initial coin offerings have the potential to fund SMEs, innovative start-ups and scale-ups, and can accelerate technology transfer, their characteristics differ considerably from crowdfunding services regulated under this Regulation.”¹⁴⁸

¹⁴² U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66435.

¹⁴³ *Ibid.*

¹⁴⁴ *Ibid.*

¹⁴⁵ *Ibid.*

¹⁴⁶ European Parliament Position on Crowdfunding Regulation, *supra* n. 7, Preamble, Recital 15b.

¹⁴⁷ European Parliament Position on Crowdfunding Regulation, *supra* n. 7, Preamble, Recital 11a.

¹⁴⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 15. Another and probably more direct and convincing reason for not including (at least for the time being) ICOs in the scope of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) is that ICOs: (i) do not amount to financial instruments, hence, they fall outside the scope of securities-based crowdfunding (for a proposal to add virtual currencies to the list of financial instruments in Annex I – Section C of MiFID II (*supra* n. 96), see European Parliament/Committee on Economic and Monetary Affairs, *Draft Report: Amendments 2-10: Markets in Financial Instruments – Proposal for a directive 2018/0047 (COD)*, 12.9.2018, Amendments 9-10); and (ii) do not constitute fiat money, are not legal tender and are not backed by a central bank (hence, they are excluded from the scope of

4. Authorization, Supervision, and Market Conduct of CSPs: Critical Reflections

The authorization and market conduct requirements for CSPs are set out in Article 3-18 and 19-28 of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs), respectively.¹⁴⁹ An interesting initial question is whether the authorization and market conduct requirements constitute minimum or maximum harmonization rules. The wording of the Council of the European Union First Reading Position supports a maximum harmonization approach: “*To enable crowdfunding service providers to operate cross-border without facing divergent rules and to thereby facilitate the funding of projects across the Union by investors from different Member States, Member States should not be allowed to impose additional requirements on those crowdfunding service providers that are authorized* [emphasis added]” under the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs).¹⁵⁰

4.1. CSPs’ Authorization and the “Single Passport” for the Provision of Crowdfunding Services across the EU

A. A Primer on CSPs’ Authorization Requirements and the Key Principles of a Single EU-Wide Market for Crowdfunding Services

Designating the competent authority for the authorization and supervision of CSPs has been the cause of the most important disagreement between the European Commission and the European Parliament. The European Commission has been in favor of the concentration and monopolization of CSPs’ authorization and supervision, proposing that the relevant responsibility should rest with ESMA.¹⁵¹ However, the European Parliament rejected the Commission’s proposition for the assignment of CSPs’ supervision to a central, supranational supervisor and recommended instead that supervision should be disintegrated and allocated to the national competent authorities of the Member States where the CSPs are established, with ESMA retain-

crowd-lending, at least where such lending involves fiat currency). In order to clarify that ICOs are excluded from the scope of crowd-lending, the definition of “loan” (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(b)) should be supplemented with a reference that the medium/money involved should have the status of legal tender. See also Yves Mersch, *Virtual or Virtueless? The Evolution of Money in the Digital Age*, Official Monetary and Financial Institutions Forum-London (8 February 2018), <<https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180208.en.html>>.

¹⁴⁹ The provisions of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) that cover the powers and cooperation of supervisory authorities (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 29-38) as well as the administrative sanctions and measures in case of non-compliance (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 39-43) fall outside the scope of the present analysis.

¹⁵⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 33.

¹⁵¹ European Commission Proposal on Crowdfunding Regulation, *supra* n. 6, art. 10, 12 and 13.

ing a coordinating role.¹⁵² The European Parliament recommendation has been gaining significant ground and is now reflected in the Council of the European Union First Reading Position.¹⁵³ In the remainder of the text, the neutral term “supervisory authority” or “supervisor” shall be used to indicate the entity responsible for CSPs’ authorization and supervision.

Authorization is granted to CSPs upon the fulfillment of certain organizational requirements set out in Articles 3-10 of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs). In brief, these include: efficient governance arrangements to ensure prudent management; due diligence requirements to safeguard that project owners satisfy minimum fitness conditions; transparent complaint-handling procedures; requirements for the detection and resolution of conflicts of interest; effective outsourcing procedures to avoid additional operational risk; prudential safeguards; appropriate internal governance mechanisms, including risk-management and accounting procedures; requirements on outsourcing, asset safekeeping and payment services; and effective data-processing systems and business continuity arrangements.¹⁵⁴ All of these requirements must be complied with by CSPs throughout their operation; otherwise, their authorization can be withdrawn by the competent supervisory authority.¹⁵⁵

¹⁵² European Parliament Position on Crowdfunding Regulation, *supra* n. 7, art. 10, 12, 12a and 13.

¹⁵³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 3(1) in conjunction with art. 12(1). As bodies with highly specialised expertise, ESMA and the European Banking Authority (EBA) are entrusted with the development of draft regulatory technical standards which do not involve policy choices to detail several areas of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs).

¹⁵⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 3-4, 7-12. The due diligence safeguards (art. 5), in particular, mandate CSPs to exercise at least a minimum level of scrutiny in respect of project owners; such a minimum level of due diligence includes obtaining all of the following evidence: (i) that the project owner has no criminal record in respect of infringements of national rules in fields of commercial law, insolvency law, financial services law, anti-money laundering law, fraud law or professional liability obligations; and (ii) that the project owner is not established in a non-cooperative jurisdiction, or in a high-risk third country as recognised by the relevant EU policy on money laundering.

¹⁵⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 12(1)-(4), (11). According to the Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 17(1), the following situations justify the withdrawal of CSPs’ license: (i) CSPs have not used their authorization within 18 months after the authorization has been granted; (ii) CSPs’ have expressly renounced their authorization; (iii) CSPs have not provided crowdfunding services for 9 successive months and are no longer involved in the administration of existing contracts that have been matched through their platform; (iv) CSPs have obtained their authorization by irregular means; (v) CSPs no longer meet the conditions under which the authorization was granted; (vi) CSPs have seriously infringed the provisions of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs); (vii) CSPs or a third party acting on CSPs’ behalf have lost their authorization for the provision of payments services or investment services and those CSPs or third party have failed to remedy the situation within 40 calendar days; and (viii) CSPs that are also payment services providers (or their managers, employees or third parties acting on their behalf) have infringed the provisions of national law implementing the relevant EU Directive on money laundering and terrorism financing.

Authorization of a CSP established in a Member State (home country) constitutes a “single passport” that provides the CSP with the right to establish a branch or provide crowdfunding services in any other EU Member State (host country) without the need to seek further authorization or another license.¹⁵⁶ The single passport for the provision of crowdfunding services across the EU is founded on two crucial inter-related principles: (i) coordination of the rules for CSPs’ authorization (maximum harmonization) and (ii) mutual recognition of CSPs’ authorization license by Member States so that duly authorized CSPs are allowed to provide their services across borders without having to maintain a physical presence in the territory of the Member States where such services are offered (host Member States) and without having to obtain another authorization/license.¹⁵⁷

Among the organizational requirements set out by the Council of the European Union First Reading Position for the authorization of CSPs, two warrant more detailed discussion.

First, special attention should be paid to the introduction of mechanisms for identifying, preventing, and addressing conflicts of interest. Conflicts of interest can seriously undermine the vital but delicate function of CSPs as neutral intermediaries between contributors and fundraisers, thus disrupting the essence of crowdfunding intermediation.¹⁵⁸ CSPs must comply with four basic requirements to prevent and manage conflicts of interest efficiently:

- (a) CSPs are required to adopt and implement effective internal mechanisms and rules to prevent, identify, manage, and disclose conflicts of interest between themselves, their shareholders, their managers and employees, or any person linked to them by control and their clients, or between one client and another client.¹⁵⁹
- (b) CSPs are prohibited from maintaining any financial participation in any crowdfunding offer on their platform.¹⁶⁰
- (c) CSPs are barred from accepting as *project owners* in relation to crowdfunding services on their platform any “*associated persons*”, that is, any of their share-

¹⁵⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 30 and art. 18. See also European Commission, *Completing the Internal Market – White Paper from the Commission to the European Council* (COM(85) 310 final, 14.6.1985). See also Marcin Szczepański and European Parliamentary Research Service (EPRS), *Understanding Equivalence and the Single Passport in Financial Services: Third-Country Access to the Single Market* (European Union, Briefing, 2017).

¹⁵⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 12(12).

¹⁵⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 26.

¹⁵⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 8(4). “Control” means the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 22(1) and (2) of Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings [2013] OJ L 182/19, or a similar relationship between any natural or legal person and an undertaking, any subsidiary undertaking of a subsidiary undertaking also being considered to be a subsidiary of the parent undertaking which is at the head of those undertakings (see MiFID II, *supra* n. 96, art. 4(1)(35)(b)).

¹⁶⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 8(1).

holders holding 20% or more of share capital or voting rights, any of their managers or employees, or any person linked to those shareholders, managers and employees by control.¹⁶¹ By contrast, *such “associated persons” are not barred from acting as contributors* in the projects offered on CSPs provided that the CSPs (i) fully disclose this on their website, including the specific offers invested in, and (ii) ensure that these investments are made under the same conditions as those of other investors and that these investors do not enjoy any preferential treatment or privileged access to information.¹⁶²

- (d) CSPs are required to disclose in sufficient detail to their clients and potential clients the general nature and sources of conflicts of interest and the steps taken to mitigate those risks – for example, if the structuring of a compensation agreement leads to a conflict of interest, such as where the fundraiser is not obliged to pay any fees to the CSP if the target amount is not collected.¹⁶³

Second, due care should be taken in the transfer and safekeeping of client assets. CSPs should inform their clients about: (i) the nature and terms and conditions for asset safekeeping services, including references to applicable national law; and (ii) whether asset safekeeping services are provided by them directly or by a third party.¹⁶⁴ Turning to the provision of payment services, CSPs may themselves or through a third-party provide such services provided that they or the third-party provider is a payment service provider in accordance with Directive (EU) 2015/2366.¹⁶⁵

¹⁶¹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 8(2).

¹⁶² Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 8(2)(second indent). See also European Crowdfunding Network (ECN), *Position Paper on the Proposed Regulation on European Crowdfunding Service Providers (ECSP) for Business*, point ‘f’ (ECN, October 9, 2018) [“ECN Comments” hereafter].

¹⁶³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 8(5). Such disclosure shall be made on the website of the CSP in a prominent place and also (i) be made on a durable medium (i.e., an instrument which enables the storage of information in a way that is accessible for future reference and for a period of time that is adequate for the purposes of the information, and which allows for the unchanged reproduction of the information stored); and (b) include sufficient detail, taking into account the nature of each client, to enable each client to take an informed decision about the service in the context of which the conflict of interest arises (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 8(5)-(6)). See, also, EBA Opinion, *supra* n. 48, at p. 21.

¹⁶⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 10(1).

¹⁶⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 10(4). Where a CSP: (a) *carries out payment transactions* related to transferable securities and admitted instruments for crowdfunding purposes, it shall deposit the funds with a central bank or a credit institution; (b) *does not provide payment services* in relation to the crowdfunding services either itself or through a third party, such a CSP shall put in place and maintain arrangements to ensure that project owners accept funding of crowdfunding offers or provide any payment services only by means of a payment service provider operating in accordance with Directive (EU) 2015/2366 (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 10(2) and (5)). Transferable securities or admitted instruments for crowdfunding purposes offered on a crowdfunding platform, and which can be registered in a financial instruments account opened in the name of an investor or which can be physically delivered to a custodian, shall be held in custody by the CSP or by a third party (provided it is authorised to provide custody services in accordance with Directive 2013/36/EU or 2014/65/EU). See Council First

B. Critical Reflections on CSPs' Authorization Requirements

The CSPs' authorisation requirements under the initial European Commission Proposal focused on non-financial resources only and did not include any capital adequacy (prudential) conditions. Considering the acute information asymmetries between fundraisers and platforms as well as between contributors and platforms,¹⁶⁶ it would be more prudent to introduce a light-touch, proportionate capital regulation regime; such a regulation would bolster confidence among participating parties without unduly encumbering CSPs. To this end, two basic alternatives, or a combination of them, are envisaged. First, CSPs could be required to hold capital equal to a percentage of loaned/invested funds.¹⁶⁷ Second, CSPs could be required to either establish and be covered by a compensation scheme or to hold professional indemnity insurance that corresponds to the activities undertaken.¹⁶⁸ Both the European Parliament and the Council of the European Union have identified the gap in the European Commission Proposal and recommended the adoption of prudential requirements (i.e., a capital or insurance coverage requirements) as a prerequisite for the authorization of CSPs.¹⁶⁹

Moreover, the blanket prohibition on CSPs concerning the maintenance of any financial participation in crowdfunding offers hosted on their platform is ill-defined. CSPs should indeed be barred from having any financial interest in project owners using the CSPs' services because the "*existence of a financial interest in an issuer may create an incentive to advance the issuer's fundraising efforts over those of other issuers, which could potentially adversely affect investors,*"¹⁷⁰ albeit with one carefully crafted exemption: CSPs should be allowed to receive a financial interest from project owners on their platform *as compensation* for the crowdfunding services offered to them, *provided that the financial interest consists of securities of the same class and having the same terms, conditions and rights as the securities being offered to investors through the CSPs' platform and on condition that such financial interests*

Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 10(3). See finally Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 28:

"Depending on the type of assets to be safe-kept, assets are either to be held in custody, as with transferable securities which can be registered in a financial instruments account or which can be physically delivered, or to be subject to ownership verification and record-keeping. Safekeeping of transferable securities or admitted instruments for crowdfunding purposes that in accordance with national law are only registered with the project owner or its agent, such as investments in non-listed companies, or are held on an individually segregated account that a client could open directly with a central securities depository, is considered equivalent to asset safekeeping by qualified custodians."

¹⁶⁶ On the risks of financial-return crowdfunding, see *supra* section 2.2.A.

¹⁶⁷ See, for example, the FCA Handbook, IPRU-INV 12.2-3. A variation of this solution would be to require the holding of capital equal to either a percentage of loaned funds or a fixed minimum (e.g. € 50,000) – whichever is higher.

¹⁶⁸ See MiFID II, *supra* n. 96, art. 3. See also EBA Opinion, *supra* n. 48, at p. 21. See also Zetzche and Preiner (2017), *supra* n. 80, at pp. 31-32.

¹⁶⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 11. See also European Parliament Position on Crowdfunding Regulation, *supra* n. 7, art. 10(2)(ma).

¹⁷⁰ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66461.

are disclosed in the offering material (i.e., the key investment information sheet).¹⁷¹ This exemption would align CSPs' interests with those of potential contributors and incentivize CSPs to monitor project owners more diligently.¹⁷² Inspired by the U.S. paradigm and to align CSPs' incentives with those of issuers-clients, the European Parliament Position has proposed that CSPs should be allowed to participate in the funding of a project on their platform, provided that (i) the financial participation shall not exceed 2% of the capital accumulated for the project and (ii) information on that participation is made clearly available to clients through the publication of clear and transparent selection procedures.¹⁷³ Unfortunately, however, the aforesaid recommendation of the European Parliament has not been endorsed by the Council of the European Union First Reading Position.

It is even more unfortunate that the European Union does not follow the U.S. example by requiring CSPs to provide on their platform a communication channel through which contributors can communicate with each other and with representatives of the fundraiser about offerings made available on those CSPs' platforms.¹⁷⁴ The establishment of communication channels operated by CSPs provide a "*centralized and transparent means for members of the public that have opened an account with an intermediary to share their views about investment opportunities and to communicate with representatives of the issuer to better assess the issuer and investment opportunity.*"¹⁷⁵ As such, communication channels constitute a valuable tool for mitigating information asymmetries and combating fraud.¹⁷⁶ To exploit and enhance the

¹⁷¹ Cf. U.S. CFR 227.300(b)(1) and (2). Cf. U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66460-66461. On the Key Investment Information Sheet see *infra* section 4.2.C. An equivalent exemption could be drawn up for crowd-lending.

¹⁷² U.S. CFR 227.300(b)(1) and (2). Cf. U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66460-66461. See also Darian Ibrahim, *Crowdfunding Without the Crowd* 95 North Carolina Law Review 1481, 1498 (2015) ["Ibrahim (2017)" hereafter] (where funding portals have some 'skin in the game' they may use their expertise to screen startups based on their chances for success, not just on whether or not the startups are businesses free from fraud). See also ESMA Survey, *supra* n. 56, at p. 8:

"The fee structure does not in most cases seem to be aligned to investor objectives. Only where the platform benefits from a share of the investor's profits is there an incentive for the platform to promote the success of the investment, rather than of the initial fundraising. Where the platform co-invests there may also be an alignment of interests, but also the potential for conflicts of interests between groups of investors (i.e., the platform vs the investors) depending on how the co-investment is carried out."

¹⁷³ European Parliament Position on Crowdfunding Regulation, *supra* n. 7, art. 7(1)(second indent) and 7a(2). Moreover, CSPs are permitted to receive a success fee (carry) whenever the project exits successfully from the crowdfunding platform (European Parliament Position on Crowdfunding Regulation, *supra* n. 7, art. 7a(3)).

¹⁷⁴ Cf. U.S. CFR 227.303(c).

¹⁷⁵ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66472. See also Bradford (2012a), *supra* n. 38, at pp. 133-136; Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled* 40 Securities Regulation Law Journal 195, 209 (2012) ["Bradford (2012b)" hereafter].

¹⁷⁶ Liam Collins, Yannis Pierrakis, *The Venture Crowd: Crowdfunding Equity Investment into Business* (Nesta, 2012) 24 ["Collins and Pierrakis (2012)" hereafter]; Fink (2012), *supra* n. 33, at pp. 31-32; Bradford (2012b), *supra* n. 175, at p. 209. See also Massimo Colombo, Cristina Rossi-Lamastra, Chiara Franzoni, *Internal Social Capital and the Attraction of Early Contributions in Crowdfunding* 39 Entrepreneurship Theory and Practice 75, 95 (2015) ["Colombo et al. (2015)" hereafter].

“wisdom of the crowd” without sacrificing the integrity of the communications among investors, regulatory fine-tuning is required concerning the operation of communication channels. In particular, CSPs should permit the public to view the discussions occurring in the communication channels but restrict the posting of comments to those who have opened an account with the CSPs on their platform.¹⁷⁷ This would increase transparency about potential investment opportunities while safeguarding accountability for the comments posted on the communication channels.¹⁷⁸

Moreover, though communication among investors would still take place on other fora, outside the CSPs’ platforms, communication with the project owners or their representatives about the offerings should be restricted to the CSPs’ communication channels.¹⁷⁹ This requirement would further increase transparency and protect crowdfunding investors but, most importantly, would also advance the gradual concentration of all communications within CSPs’ communication channels.¹⁸⁰ Furthermore, to prevent biased, unfounded, or abusive statements, any person posting a comment in the communication channels should be required to clearly and prominently disclose along with each post whether he or she is a founder or an employee of a project-owner engaging in promotional activities on behalf of the project-owner, or is being or may be otherwise compensated to promote the project-owner’s offering. Likewise, CSPs should be prohibited from participating in any communication in these channels, other than establishing guidelines for communication and removing abusive or potentially fraudulent communications.¹⁸¹

One potential drawback of communication channels is that they may induce investors to passively rely on the judgment of other investors, thus causing information cascades and herding effects. In such a case, communication channels could facilitate “crowd foolishness” rather than crowd wisdom. Though one cannot absolutely rule out the potential for some degree of herding, there are strong arguments suggesting that the “information cascade” contention is exaggerated. First, the potential for herding is inherent in crowdfunding and is not a risk produced by the communication channels of CSPs per se; on the contrary, as mentioned, such channels operating under

¹⁷⁷ Cf. U.S. CFR 227.303(c)(2)-(3).

¹⁷⁸ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66472.

¹⁷⁹ Cf. U.S. CFR 227.204(c); U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66472. According to U.S. CFR 227.204(c), the project-owner’s communication with investors via CSPs’ communication channels is limited to issues concerning the amount of securities offered, the nature of securities, the price of securities and the closing date of the offering period. However, with the aim of increasing transparency and helping investors to make informed decisions, communications of the project-owner should be expanded to include, for example, information that seeks to clarify investors’ queries or comments about the risk or the prospects of the project.

¹⁸⁰ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66472. See also, Deshler (2014), *supra* n. 117, at pp. 1169-1173.

¹⁸¹ Cf. U.S. CFR 227.204(c). See also U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66472:

“Among other things, the records required to be kept by intermediaries should help to track the origins of any abusive or potentially fraudulent comments made through the communication channels. Without this measure, we believe there could be greater risk of the communications including unfounded, potentially abusive, biased statements aimed unjustifiably to promote or discredit the issuer and improperly influence the investment decisions of members of the crowd.”

rules promoting transparency and user accountability are likely to centralize communication and reduce the flood of biased or unreliable information in other fora.¹⁸² Second, crowdfunding contributors are, on average, sufficiently diverse and independent and their decision making sufficiently decentralized to make group thinking and herding less likely.¹⁸³ Finally, there is ample empirical evidence that herding, where it occurs, is likely to be “rational” due to observational learning among contributors: online comments and communications serve as private signals of the project owners’ quality, which enhance openness and both supplement and improve the total mix of information available to contributors, thus increasing the probability of a crowdfunding campaign’s success.¹⁸⁴

4.2. *Market Conduct and Client Protection Rules*

A. *General Overarching Conditions for the Provision of Crowdfunding Services*

The general overarching conditions underlying the provision of crowdfunding services under the proposed EU Regulation on European Crowdfunding Service Provid-

¹⁸² Moreover, as argued by Ibrahim (2017), *supra* n. 172, at p. 1501, the incentives to spread false or misleading information about a crowdfunding offer are relatively limited (“*promoting a startup that does not warrant it will not be a successful technique in crowdfunding as resale restrictions and other liquidity issues prevent making a quick back this way*”). See also U.S. Securities Act of 1933, at s. 4A(b)(3) and U.S. CFR 227.205 requiring project owners and any person acting on their behalf to disclose, with each communication, the receipt, past or presence, of any compensation to promote the project owners’ offerings.

¹⁸³ Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the ‘Crowd’* 38 *Vermont Law Review* 827, 841-847 (2014).

¹⁸⁴ Vismara (2018), *supra* n. 37; Vismara (2018b), *supra* n. 37; Paolo Crosetto, Tobias Regner, *It’s Never Too Late: Funding Dynamics and Self Pledges in Reward-Based Crowdfunding* 47 *Research Policy* 1463 (2018); Thomas Clauss, Robert Breitenecker, Sascha Kraus, Alexander Brem, Chris Richter, *Directing the Wisdom of the Crowd: The Importance of Social Interaction Among Founders and the Crowd During Crowdfunding Campaigns* 27 *Economics of Innovation and New Technology* 709 (2018) [“Clauss et al. (2018)” hereafter]; Vladimir Ivanov, Anzhela Knyazeva, *Soft and Hard Information and Signal Extraction in Securities Crowdfunding*, 2nd Emerging Trends in Entrepreneurial Finance Conference, 17 November 2017, <<http://dx.doi.org/10.2139/ssrn.3051380>> [“Ivanov and Knyazeva (2017)” hereafter]; Anna Lukkarinen, Jeffrey Teich, Hannele Wallenius, Jyrki Wallenius, *Success Drivers of Online Equity Crowdfunding Campaigns* 87 *Decision Support Systems* 26 (2016); P. Belleflamme, N. Omrani, and M. Peitz, *The Economics of Crowdfunding Platforms* (2015) Center of Operations Research and Econometrics Discussion Paper No 15 [“Belleflamme et al. (2015)” hereafter], pp. 37-39; Colombo et al. (2015), *supra* n. 176; Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study* 29 *Journal of Business Venturing* 1 (2014) [“Mollick (2014)” hereafter]; Ferdinand Thies, Michael Wessel, Alexander Benlian, *Understanding the Dynamic Interplay of Social Buzz and Contribution Behavior within and between Online Platforms – Evidence from Crowdfunding*, Proceedings of the Thirty Fifth International Conference on Information Systems: Social Media and Digital Collaborations, Auckland 2014; Mollick (2013), *supra* n. 33; Juanjuan Zhang, Peng Liu, *Rational Herding in Microloan Markets* 58 *Management Science* 892 (2012); Michal Herzenstein, Utpal Dholakia, Rick Andrews, *Strategic Herding Behavior in Peer-to-Peer Loan Auctions* 25 *Journal of Interactive Marketing* 27 (2011); Seth Freedman, Ginger Zhe Jin, *Do Social Networks Solve Information Problems for Peer-to-Peer Lending? Evidence from Prosper.com*, NET Institute Working Paper No. 08-43, <<https://ssrn.com/abstract=1936057>>.

ers (ECSPs) are threefold: the “due care” principle, the payout mode rule, and the rule on the use of special-purpose vehicles (SPVs).

i. The Due Care Principle

Article 3(2) of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) sets out the general, overarching principle that CSPs should act honestly, fairly, professionally, and in accordance with the best interests of their *clients*.¹⁸⁵ However, as already stressed, the term “client” includes both the contributors (investors or lenders) and project owners-fundraisers,¹⁸⁶ which implies that CSPs are required to serve two masters whose interests may well diverge or/and conflict in certain cases.

Although one may be tempted to argue that priority should be given to the interests of contributors because they are the ones who suffer the most from information asymmetries concerning the assessment and verification of fundraisers’ quality,¹⁸⁷ the interpretation of the Council of the European Union First Reading Position suggests that CSPs are required to promote the interests of contributors and project owners on an equal basis. Such an inference is founded on three pillars. First, Article 3 on the “due care principle” is placed under Chapter II of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs), which sets out the main principles that should guide the “provision of crowdfunding services,” rather than under a special chapter or provision concerning the protection of contributors. Second, where the intention of the EU legislator has been to confine the scope of regulatory requirements to “contributors” only, the term “investors” is used vis-à-vis the term “client” (e.g., Articles 21-24). Finally, the relevant Preamble explains that the due care principle is intended to “ensure fair treatment of *all clients* [emphasis added],” not just contributors.¹⁸⁸

In order to improve the quality of services to prospective contributors, the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) allows CSPs to recommend crowdfunding projects to individual funders based on one or more specific parameters (e.g., the type or sector of business activity or a credit rating)

¹⁸⁵ The Preamble of the Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 18, supplements that the due care principle should also guide CSPs selection of projects. The duty of care principle is further elucidated and reflected in the requirements set out in Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Article 3(3): more specifically, in order to ensure that prospective contributors are offered investment opportunities on a neutral basis, CSPs are barred from paying or receiving any remuneration, discount or non-monetary benefit for routing funders’ orders to a particular offer provided on their platform or to a particular offer provided on a third party platform (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 19).

¹⁸⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(i).

¹⁸⁷ See *supra* section 2.2.A.

¹⁸⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 18: “In order [...] to ensure *fair treatment of all clients* [emphasis added], crowdfunding service providers should have in place a policy designed to ensure that projects on their platforms are selected in a professional, fair and transparent way and that crowdfunding services are provided in the same manner.”

which have been communicated to CSPs by contributors in advance. However, considering that CSPs are not authorized to carry out individual or collective asset management services, contributors exclusively bear responsibility to review and take the investment decision concerning each crowdfunding project.¹⁸⁹

ii. *The Payout Mode*

There are two main and competing, payout models for the provision of crowdfunding services. According to the “all-or-nothing” or “threshold pledge” model, project owners agree with their CSPs and set a cutoff date (“pledging period”) at the beginning of the campaign by which a targeted amount of money should be collected by contributors (“threshold”) before funds are released to project owners; if the threshold is not reached within the predetermined deadline, all funds are returned to the contributors.¹⁹⁰ In the “keep-it-all” model, project owners can keep the funds raised by contributors regardless of whether the crowdfunding offer has reached the fundraising goal.¹⁹¹ The EU legislator seems to opt – albeit half-heartedly and hesitantly, as discussed below –¹⁹² for the all-or-nothing model: project owners and CSPs are required to set a minimum, target offering amount and also inform potential contributors of the consequences if the threshold is not met.¹⁹³ Though CSPs are allowed to charge both the end-users of the crowdfunding services (i.e., both project owners and contributors), they are inclined to price project owners only (e.g., charging a percentage fee on the amount of the funds raised), while allowing contributors to use their platform for free. This is so because charging a fee to contributors is very likely to backfire on CSPs, as contributors’ participation would be discouraged, thus reducing the platform’s attractiveness for potential project owners and seriously undermining the CSP’s profitability.¹⁹⁴

¹⁸⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 3(4) and Preamble, Recital 19.

¹⁹⁰ Alan Tomczak, Alexander Brem, *A Conceptualized Investment Model of Crowdfunding* 15 *Venture Capital* 335, 345 (2013) [Tomczak and Brem (2013)]; Collins and Pierrakis (2012), *supra* n. 176, at p. 15.

¹⁹¹ Tomczak and Brem (2013), *supra* n. 190, at p. 346.

¹⁹² See *infra* section 4.2.A.(iv).

¹⁹³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part B(a)-(c). The relevant information is provided via the Key Investment Information Sheet – KIIS (*infra*, section 4.2.C.(i)).

¹⁹⁴ See Belleflamme and Lambert (2014), *supra* n. 44, at p. 10 also inferring that:

“Subsidizing the participation on one side is often the only way for multisided platforms to solve the so-called ‘chicken-and-egg’ problem: as each group’s participation is conditioned on the other group’s participation, the intermediary has no choice but to let one group use the platform for free so as to initiate a positive feedback loop.”

See also Jonas Löher, *The Interaction of Equity Crowdfunding Platforms and Ventures: An Analysis of the Preselection Process* 19 *Venture Capital* 51, 66 (2017).

iii. *Conditions for Indirect Crowdfunding Investments*

As mentioned, the prime objective of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) is to facilitate *direct* investments in project owners. Article 3(6) sets out specific conditions for the use of legal structures other than duly authorized crowdfunding platforms to interpose between funders and fund-raisers.¹⁹⁵ Specifically, to prevent crowdfunding being used to package complex projects into combined SPVs¹⁹⁶ that are then accessible by contributors, CSPs are allowed to transfer only *one (illiquid or indivisible) asset* to an SPV to enable funders to gain exposure to that asset by acquiring securities.¹⁹⁷ Stated differently, CSPs may adopt models based on indirect investment by using vehicles (i.e., SPVs) that invest in a single, specific project to allow contributors to choose among individual projects for their investment.¹⁹⁸ Indirect investment structures can yield several benefits for crowdfunding contributors and project owners. In their simpler mode, the intermediating SPVs are the sole shareholders of project owners, while micro crowdfunding investors hold shares or units in the SPVs. As a result, project owners' ownership structure is kept clean and simple, thus facilitating future financing rounds.¹⁹⁹

As noted by an ESMA survey, indirect crowdfunding models are popular in EU national crowdfunding markets.²⁰⁰ In France, crowdfunding platforms use a "holding company", which is established specifically to obtain ownership of the shares in a specific project; investors hold shares in the holding company, which may be chaired by the platform or an experienced investor.²⁰¹ In the UK, the crowdfunding platform is often the legal owner of the equity in the project, with investors serving as the beneficial owners (i.e., by retaining a legal right to the benefits accrued from owning

¹⁹⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 22.

¹⁹⁶ 'Special purpose vehicle' or 'SPV' means an entity created solely for, or which solely serves the purpose of, a securitisation within the meaning of point (2) of Article 1 of Regulation (EU) No 1075/2013 of the European Central Bank concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions [2013] OJ L 297/107. See Council First Reading Position on Crowdfunding Regulation, *supra* n. 8., art. 2(1)(q)). As a result, the definition of an 'SPV' does not include Alternative Investment Funds (AIFs) of the Directive 2011/61/EU on Alternative Investment Fund Managers [2011] OJ L 174/1.

¹⁹⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 3(6). Indirect crowdfunding investments are allowed only on a look-through basis to the underlying illiquid or indivisible asset held by financial or legal structures fully or partially owned or controlled by the SPV, and the decision to take exposure to that underlying asset shall exclusively lie with contributors. The Council First Reading Position on Crowdfunding Regulation avoided introducing the distinction (which had been proposed by the European Parliament Position on Crowdfunding Regulation, *supra* n. 7, art. 4(5)) between retail clients and eligible counterparties as far as eligibility to participate in indirect crowdfunding investments is concerned; consequently, all contributors (whether retail, professional or eligible) have access to indirect crowdfunding services involving the transfer of only one asset to a SPV. See also ECN Comments, *supra* n. 162, at point 'd'.

¹⁹⁸ ESMA Advice, *supra* n. 95, at p. 21.

¹⁹⁹ Wroldsen (2017), *supra* n. 115, at pp. 596-597; Adrian Camara, *Anonymous Capital: Managing Shareholder Volume for Equity Crowdfunded Companies in Canada* 31 Banking and Finance Law Review 259, 275-276 (2016); Deshler (2014), *supra* n. 117, at pp. 1184-1185.

²⁰⁰ ESMA Survey, *supra* n. 56, at p. 5.

²⁰¹ *Ibid.*

the security).²⁰² In both the French and UK (indirect) crowdfunding models, project owners are enabled to deal with only one counterparty and investors to act as a single block.²⁰³

In more advanced indirect investment structures, an SPV could be set up to facilitate investment by wealthier and more sophisticated investors up to a certain percentage in a specific project (e.g., 20%); the investment interest of micro contributors could then be collected via another vehicle/SPV. In this model, micro investors essentially co-invest alongside more experienced investors and thus benefit from the latter's superior monitoring abilities.²⁰⁴

iv. *Closing, Critical Remarks*

Two points concerning the general overarching conditions for the provision of crowdfunding services are worth further consideration.

First, commencing from the payout model for crowdfunding services, the theoretical and empirical research confirms that the all-or-nothing mode offers noteworthy added value in both disciplining project owners and protecting contributors, thus developing trust among the parties involved. In the all-or-nothing model, contributors are provided with the time needed to network, communicate, and discuss with each other regarding the suitability of the proposed project and to withdraw their pledge before the threshold is reached.²⁰⁵ Moreover, over-confident, impulsive, and reckless contributors are protected because their pledges are reversible unless more prudent and vigilant contributors join the crowdfunding offer.²⁰⁶ Finally, project owners are compelled to assess their financing needs more carefully, which results in more accurate budgeting and planning.²⁰⁷ The empirical research also confirms that the all-or-nothing model is associated with higher-quality project owners, reduced information asymmetry, and more successful fundraising.²⁰⁸

²⁰² *Ibid.*

²⁰³ *Ibid.*

²⁰⁴ Maximilian Goethner, Lars Hornuf, Tobias Regner, *Crowdfunding: An Empirical Analysis of the Small Investor Protection Act*, CESifo Working Paper 8351/2020; Ibrahim (2017), *supra* n. 172, at pp. 1502-1503; Jason Parsont, *Crowdfunding: The Real and the Illusory Exemption* 4 Harvard Business Law Review 281, 326-328 (2014) ["Parsont (2014)" hereafter]; Belleflamme and Lambert (2014), *supra* n. 44, at p. 11; Karen Wilson, Marco Testoni, *Improving the Role of Equity Crowdfunding in Europe's Capital Markets* 9 Brugel Policy Contribution 1, 9-10 (2014). See also SEC No-Action Letter on AngelList LLC and AngelList Advisors LLC (March 28, 2013).

²⁰⁵ Tomczak and Brem (2013), *supra* n. 190, at p. 346; Bradford (2012a), *supra* note 38, at pp. 139-140.

²⁰⁶ Tomczak and Brem (2013), *supra* n. 190, at p. 346; Bradford (2012a), *supra* note 38, at p. 140. Collins and Pierrakis (2012), *supra* n. 176, at p. 24 also infer that the 'all or nothing' model offers protection against fraud because "the more people that have performed checks for fraud, the more likely a potentially fraudulent proposal will be identified as such."

²⁰⁷ Tomczak and Brem (2013), *supra* n. 190, at p. 346; Bradford (2012a), *supra* note 38, at p. 140.

²⁰⁸ Ivanov and Knyazeva (2017), *supra* n. 184; Mark Fenwick, Joseph McCahery, Erik Vermeulen, *Fintech and the Financing of Entrepreneurs: From Crowdfunding to Marketplace Lending*, European Corporate Governance Institute Law Working Paper No 369/2017; Nathan Marwell, *Competing Fundraising Models in Crowdfunding Markets* (November 13, 2015), <<https://ssrn.com/>

On the other hand, the terms of operation of the all-or-nothing model should be clarified and streamlined. Specifically, the requirement that contributors be informed of the consequences if the target offering amount is not reached is ambiguous and thus needs refinement to make clear, right from the start of the offering, that the funds shall be released to the project owners only on the condition that the predetermined threshold is reached; otherwise, all contributors are allowed to cancel their commitments and retrieve their funds.²⁰⁹ Along the same lines, the provision that project owners and CSPs be allowed to set a “*maximum offer amount [that is] different from the [minimum], target capital or the target funds*” is extremely confusing and thus needs to be streamlined.²¹⁰ If the wedge between the minimum and maximum offering amounts is made to be wide, we end up with nothing less than a masked keep-it-all model, thus negating the benefits of the all-or-nothing approach.²¹¹ Regardless of whether the EU legislator actually intended to offer project owners the discretion to use either of the two models or whether the wording is the outcome of careless writing, the latitude given for setting a spread between the minimum and maximum offering amounts should be eliminated.²¹² Finally, to allow for more flexibility without undermining the interests of contributors, the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) should be supplemented to allow for an extension of the deadline for fundraising provided certain conditions designed to ensure efficient transparency and accountability are met (e.g., the option for an extension should be included in the offering material, and the decision to extend should be clearly and fully justified).

Second, project owners should be required to split the funding for a specific project into smaller sub-projects or “stages” so that the release of contributors’ funds is contingent upon the completion of each sub-project or milestone.²¹³ This staggered

abstract=2777020>; Douglas Cumming, Gaël Leboeuf, Armin Schwienbacher, *Crowdfunding Models: Keep-It-All vs. All-Or-Nothing* 49 *Financial Management* 331 (2020).

²⁰⁹ Cf. U.S. Securities Act of 1933, at s. 4A(a)(7). In addition, it should be clarified whether and under what conditions the deadline for the raising of funds can be extended (see Bradford (2012b), *supra* n. 175, at p. 207).

²¹⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part B(d).

²¹¹ Ivanov and Knyazeva (2017), *supra* n. 184, at p. 18.

²¹² The “all-or-nothing” model is flexible enough to accommodate diverse situations; for example, project owners may set the minimum amount relatively low (e.g., where they are primarily interested in the success of the campaign) and/or allow oversubscriptions (e.g., where they are interested in retaining the option to keep additional funds exceeding the target offering amount). See also ECN Comments, *supra* n. 162, at point ‘k’:

“[The] requirement to state the maximum offering amount if different from the target [should be removed]. In our experience, many businesses do not want to define a maximum amount ahead of time, for two reasons. One is that, if they do not raise the maximum, they worry they may be perceived as having ‘failed’, notwithstanding that they hit or exceeded their target. The other is that, as in any fundraising round, circumstances may change while the round is ongoing: a business that intends to raise a particular amount may find that, due to new opportunities arising or a desire to accept investments from certain investors or groups of investors, it ultimately is willing to accept more. This happens all the time in a traditional, or offline, fundraising context, and it is equally common in crowdfunding.”

²¹³ An alternative, but less workable, solution to address information asymmetry would be to provide that the crowdfunding offer shall be valid only upon the condition that professional investors (e.g.,

release of funds addresses information asymmetry problems: the achievement of milestones provides contributors with new information on the quality of the project and the reliability of the fundraiser, and also mitigates the risk of fraud, especially if contributors are able to discuss and exchange views about the project owners' behavior and entrepreneurial skills.²¹⁴ Platforms would be given the task of monitoring, or at least disclosing information on, the completion of milestones, yet this cost would be more than outweighed by the benefits gained by addressing the risks of adverse selection and moral hazard.

B. *Information about CSPs*

To address the information asymmetry problem between CSPs and their clients (i.e., project owners and contributors) and in order to ensure that CSPs' clients have a clear understanding of the nature of crowdfunding services and the risks, costs and charges related to such services, CSPs are required to provide their clients with fair, clear and not misleading information,²¹⁵ including:

- (a) All marketing communications as well as information about: the financial risks and charges related to CSPs' services or investments; the crowdfunding project selection criteria; and the risks associated with crowdfunding services.²¹⁶
- (b) Information that the CSPs' crowdfunding services are not covered by the deposit guarantee scheme and that transferable securities or admitted instruments for crowdfunding purposes acquired through their crowdfunding platform are not covered by the investor compensation scheme.²¹⁷
- (c) Information about the reflection period for non-sophisticated contributors.²¹⁸

business angels, venture capitals, banks) have a significant participation (e.g., 5%). See the Italian Regolamento sulla raccolta di capitali di rischio tramite portali on-line Adottato con delibera n. 18592 del 26 giugno 2013, art. 24(2). See also Marina Nehme, *The Rise of Crowd Equity Funding: Where to Now?* 13 International Journal of Law in Context 253, 263-264 (2017) ["Nehme (2017)" hereafter]; Oranburg (2015), *supra* n. 22, at pp. 419-422. For more discussion on the monitoring role of professional investors in the context of crowdfunding, see *supra* section 4.2.A.(iii) and *infra* section 4.2.C.(ii).

²¹⁴ Clauss et al. (2018), *supra* n. 184; Nehme (2017), *supra* n. 213, at p. 269; Ibrahim (2015), *supra* n. 139, at p. 574; Bradford (2012a), *supra* note 38, at p. 113; Collins and Pierrakis (2012), *supra* n. 176, at p. 24; Armin Schwienbacher, Benjamin Larralde, *Crowdfunding of Small Entrepreneurial Ventures*, (28 September 2010), <<https://ssrn.com/abstract=1699183>> or <<http://dx.doi.org/10.2139/ssrn.1699183>>; Dirk Bergemann, Ulrich Hege, *Venture Capital Financing, Moral Hazard and Learning* 22 Journal of Banking and Finance 703 (1998). Dividing the projects in sub-projects/milestones also helps to augment the usefulness of social networking/communication channels (see *supra* section 4.1.B) as crowdfunding acquires a 'repeat game' character and project owners are monitored and assessed multiple times by the crowd (see Weinstein (2013), *supra* n. 117, at pp. 436-437).

²¹⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 39 and art. 19(1).

²¹⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 19(1).

²¹⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 19(2).

²¹⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 19(3). Whenever a crowdfunding offer is made, the CSP shall provide that information in a prominent place of the medium, including on every mobile application and webpage where such an offer is made. On the reflection

All this information is to be communicated to CSPs' clients whenever appropriate, *but at least prior to entering into a crowdfunding transaction.*²¹⁹

C. *Information about Project Owners and Their Offer*

i. *Key Investment Information Sheet*

As mentioned, the most acute information asymmetries leading to serious adverse selection and moral hazard risk arise between project owners and potential contributors.²²⁰ To close this information gap, project owners are required to draw up a Key Investment Information Sheet ("KIIS" hereafter) for each crowdfunding offer, containing material information about themselves, the project, the contributors' rights and fees, and the offer.²²¹ The KIIS should consist of a maximum of six sides of A4-sized paper if printed; it should also be clear, fair and not misleading and be presented in a standalone, durable medium that is clearly distinguishable from marketing communications.²²² CSPs are responsible for providing the KIIS to prospective contributors.²²³

The information contained in the KIIS can be divided into two sections. The first comprises information about:

- (a) the project-owner and the crowdfunding project (e.g., identity of the project-owner and description of the crowdfunding offer),²²⁴
- (b) the crowdfunding process and the conditions for the capital-raising or fund-borrowing (e.g., minimum target capital in a single offering, number of offerings already competed for the specific project, information on the consequences if the target capital is not raised, funds committed to the crowdfunding project by the project owner),²²⁵
- (c) the risk factors (presentation of the main risks associated with funding the crowdfunding project, with the sector, the project, the project owner and the transferable securities, admitted instruments for crowdfunding purposes or loans, including, where relevant, geographic risks),²²⁶

period and the definition of non-sophisticated contributors, see *infra* section 4.2.E and Figure 8 of the Annex, respectively.

²¹⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 19(4). Concerning the timing of information disclosure, a more accommodating version would mandate that information disclosure takes place *before* clients enter into a crowdfunding transaction *and be supplemented* by a provision offering CSPs the flexibility to delay disclosure on the condition that potential clients are promptly informed and detailed reasons are offered for such a delay.

²²⁰ See *supra* section 2.2.A.

²²¹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 50 and art. 20(2).

²²² Council First Reading Position on Crowdfunding Regulation, *supra* n. 8., art. 23(7).

²²³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8., art. 23(1)-(2).

²²⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part A.

²²⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part B.

²²⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part C.

- (d) the offering of transferable securities and admitted instruments (e.g., subscription price, treatment of oversubscriptions, information on the custody and delivery of securities/instruments),²²⁷
- (e) the issuer, where the issuer is different from the project-owner (i.e., an SPV),²²⁸
- (f) the rights of investors (e.g., key rights attached to securities, restrictions to which the securities are subject, exit opportunities),²²⁹ and
- (g) the fees and complaint procedure.²³⁰

Where the crowdfunding offer involves credit intermediation (i.e., the facilitation of granting loans), the KIIS shall, instead of the information described above under points (d) to (f), contain information about: the nature, duration and terms of the loan agreement; the applicable interest rates; the potential risk-mitigation measures; the amortization schedule of the principal and interest repayments; any default on credit agreements by the project owner within the past five years; and the servicing of the loan (including in situations where the project owner does not meet its obligations).²³¹

The second section is the “risk warning” part of the KIIS and comprises:

- (a) a warning that investment in crowdfunding entails risks, including the risk that the money invested may be partially or entirely lost; that the investment is not covered by the deposit guarantee and investor compensation schemes; that contributors may not receive any return on their investment, may not be able to sell their investment instruments when they wish (and may incur losses if they are able to sell them); that contributors *should not invest more than 10% of their net wealth in crowdfunding projects*; and that the investment in the crowdfunding offer is not a saving product,²³²
- (b) a statement that the crowdfunding offer has been neither verified nor approved by a supervisory authority or ESMA and that the appropriateness of the contributors’ education and knowledge has not necessarily been assessed before they were granted access to crowdfunding investment, hence they assume the full risk of participating in the crowdfunding offer, including the risk of partial or entire loss of the money invested,²³³ and
- (c) a responsibility statement of the project owner that “*to the best of its knowledge, no information has been omitted or is materially misleading or inaccurate*”, and that “*it [i.e., the project owner] is responsible for the preparation of [the] key investment information sheet*”.²³⁴

²²⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part D.

²²⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part E.

²²⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part F.

²³⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part H.

²³¹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part G.

²³² Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 23(6)(c).

²³³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 23(6)(b).

²³⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part A(b).

ii. *Assessing the Informational Content of the KIIS*

The informational content of the KIIS is lacking in certain respects and is extremely vague in others. Specifically, the KIIS should be supplemented to comprise additional information that prospective contributors require to make informed investment decisions, including:

- (a) Details about the entrepreneurs' human capital – that is, information on the formal and industry-related education of the founding team's executive directors. Empirical research confirms that the educational background of entrepreneurs serves as a signal of their managerial ability and thus reduces information asymmetry and increases the probability of campaign success.²³⁵
- (b) Details about how to cancel an investment commitment (e.g., certain time period prior to a deadline identified in the offering material), about the completion of the offering (e.g., contributors should be notified when the target amount has been reached) and about the discretion the project-owner has to extend the offering period prior to the deadline indicated in the offering material.²³⁶
- (c) Information concerning the ownership and capital structure of the project-owner (e.g., identity of major shareholders) and the treatment of contributors' investment commitment where the project-owner makes a material change in the KIIS.²³⁷

Moreover, the KIIS contains ambiguous and deficient information requirements concerning project owners' financial condition. In particular, the only requirement is that the KIIS should contain the key annual financial figures and ratios for the project owner for the last three years, if available.²³⁸ The information content of the KIIS should be enhanced along three directions. First, considering that crowdfunding is intended to constitute an alternative financing mechanism for young, start-up companies, project owners with no information history should also be covered. To this end, such project owners could be required to discuss the financial milestones and the operational, liquidity, and other challenges they face.²³⁹ Second, project owners

²³⁵ Evila Piva, Cristina Rossi-Lamastra, *Human Capital Signals and Entrepreneurs' Success in Equity Crowdfunding* 51 *Small Business Economics* 667 (2018); Gerrit Ahlers, Douglas Cumming, Christina Günther, Denis Schweizer, *Signaling in Equity Crowdfunding* 39 *Entrepreneurship Theory and Practice* 955 (2015); Jan Brinckmann, Soeren Salomo, Hans Georg Gemuenden, *Financial Management Competence of Founding Teams and Growth of New Technology-Based Firms* 35 *Entrepreneurship Theory and Practice* 217 (2011).

²³⁶ Cf., 17 CFR § 227.201(j).

²³⁷ Cf., 17 CFR § 227.201(k) and (m). The Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art., art. 23(8) provides that clients who have put forward interest for a crowdfunding offer shall be immediately informed about any material change in the KIIS, but falls short of explaining how contributors' investments should be treated – in contrast to art. 23(12) whereby investors are explicitly offered the option to withdraw their contribution in case that the KIIS contains irregularities.

²³⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part A(e).

²³⁹ Cf., 17 CFR § 227.201(s). See also ECN Comments, *supra* n. 162, at point 'k':

"[The] requirement [concerning the provision of financial information about the project owner should be amended, because], in many Member States, business below a certain threshold of turnover do not have the obligation to publish their financial statements. Where this is the case,

(with and without an operating history) should be required to discuss their financial condition more extensively; for example, they should discuss how the proceeds of the offering will affect their liquidity, whether the funds received are necessary for the viability of the business, how soon they plan to use the funds, and whether other sources of capital are available.²⁴⁰ Third (and this is a striking omission of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs)), project owners should be required to post on their website and/or file with their CSPs an annual report along with their financial statements describing their financing condition and explaining their progress in the use of the offering proceeds, both on an ongoing basis and for a specific period of time following the close of the offering; such post-campaign, ongoing disclosure requirements would encourage contributors' participation in the crowdfunding market and also lay the groundwork for the development of a "quasi" secondary market for crowdfunding products.²⁴¹

Finally, the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) should require project owners and/or CSPs to regularly provide updates via posts on their websites, both throughout the crowdfunding campaign and for a certain period following the conclusion of the campaign, on the progress of the capital-raising and on the largest investments made once a specific threshold is reached (e.g., a percentage of the target amount).²⁴² Consistent with the preceding discussion on the benefits of indirect investment structures in terms of reducing information asymmetries,²⁴³ ongoing disclosure of the largest investments could serve as a signal to micro-contributors that the project's quality has been assessed meticulously by other, wealthier (potentially professional or/and more experienced) investors with a greater stake in the business and thus stronger due diligence incentives. In line with this premise, the empirical research suggests that the backing of professional investors such as venture capitalists and business angels is a key contributor to crowdfunding success.²⁴⁴

and financial statements are not otherwise in the public domain, many businesses consider them highly confidential. We therefore recommend that platforms have the option to provide key financial figures and ratios in lieu of financial statements if they so choose."

²⁴⁰ Cf., 17 CFR § 227.201(s). See also Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure* 90 North Carolina Law Review 1735, 1753 (2012) (arguing that more disclosure on the nature of the project-owners' business is needed to enable investors to evaluate the merits of the securities being offered).

²⁴¹ Cf., 17 CFR § 227.202. On the potential for creating a quasi-secondary market, see *infra* section 4.2.G.

²⁴² Cf. 17 CFR § 227.201(v). An alternative would be to disclose the funders' name and the funds raised without any constraint or condition. However, the option discussed in the text is more balanced because it addresses herding by micro-contributors at the first stages of the campaign. See John Armour, Luca Enriques, *The Promise and Perils of Crowdfunding: Between Corporate Finance and Consumer Contracts* 81 Modern Law Review 51, 59, 61, 73-74 (2018); Belleflamme et al. (2015), *supra* n. 184, at pp. 32-33; Agrawal et al. (2015), *supra* n. 33; Agrawal et al. (2014), *supra* n. 33, at p. 85.

²⁴³ See *supra* section 4.2.A.(iii).

²⁴⁴ Stanislav Mamonov, Ross Malaga, *Success Factors in Title II Equity Crowdfunding in the United States* 27 Electronic Commerce Research and Applications 65 (2018); Keongtae Kim, Siva Viswanathan, *The 'Experts' in the Crowd: The Role of Experienced Investors in a Crowdfunding Market*

D. CSPs' Role as Gatekeepers

i. Verification of KIIS

In order to avoid delays and costs for CSPs and, most importantly, to ensure fundraisers' seamless and expedient access to capital markets and reduce their costs of financing, the KIIS is not approved by the competent supervisory authorities.²⁴⁵ Consistent with the empirical evidence that updates on the progress of the crowdfunding offers and on the offering materials provide new signals of a project's quality, thus reducing information asymmetry and increasing the likelihood of success of crowdfunding campaigns,²⁴⁶ the Council of the European Union First Reading Position clarifies that CSPs shall request project owners to notify them of any change in information in order to keep the KIIS updated at all times, and also that clients who have put forward interest for a crowdfunding offer shall be immediately informed by CSPs about any such change in the KIIS.²⁴⁷ Moreover, when a CSP identifies a material omission, mistake, or inaccuracy in the KIIS, that CSP is required to signal such an omission, mistake or inaccuracy promptly to the project owner, who shall promptly complete or correct that information.²⁴⁸ The crowdfunding offer should be suspended until the KIIS is complemented or amended, for a period no longer than thirty (30) calendar days; if, after the passage of the thirty-days suspension period, the KIIS has not been complemented or amended to rectify irregularities, the crowdfunding offer should be cancelled.²⁴⁹

Although the Council of the European Union First Reading Position strengthened the verification mechanisms concerning the substantive content of the KIIS, several inconsistencies persisted thus posing non-negligible risks for the protection of contributors. More specifically, the Council of the European Union First Reading Position

43 MIS Quarterly 347 (2019); Lars Hornuf, Matthias Schmitt, Eliza Stenzhorn, *Equity Crowdfunding in Germany and the UK: Follow-Up Funding and Firm Failure*, MaxPlanck Institute for Innovation and Competition Research Paper No 09/2017; Aleksandrina Ralcheva, Peter Roosenboom, *On the Road to Success in Equity Crowdfunding* (1 November 2016), <<https://ssrn.com/abstract=2727742>>; Lars Hornuf, Matthias Schmitt, *Success and Failure in Equity Crowdfunding* 14 CESifo DICE Report 16 (2016); Ibrahim (2015), *supra* n. 139, at pp. 597-598; Lars Hornuf, Armin Schwienbacher, *Market Mechanisms and Funding Dynamics in Equity Crowdfunding* 50 Journal of Corporate Finance 556 (2014) ["Hornuf and Schwienbacher (2014)" hereafter].

²⁴⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 23(14) and Preamble, Recital 54. However, competent authorities of the Member State where the authorisation was granted to the CSP may require an ex ante notification of a KIIS at least seven working days before making it available to prospective contributors.

²⁴⁶ Jörn Block, Lars Hornuf, Alexandra Moritz, *Which Updates During an Equity Crowdfunding Campaign Increase Crowd Participation* 50 Small Business Economics 3 (2018); Clauss et al. (2018), *supra* n. 184; Mollick (2014), *supra* n. 184; Hornuf and Schwienbacher (2014), *supra* n. 244.

²⁴⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 23(8).

²⁴⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 23(12) and Preamble, Recital 53.

²⁴⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 23(12). The contributors who have put forward interest for the crowdfunding offer shall be immediately informed about the identified irregularities, the steps taken and further to be taken by the CSP and the option to withdraw their interest for the crowdfunding offer.

complemented that CSPs need to have in place and apply *adequate procedures* to verify not only the completeness and clarity but also, and most importantly, the **correctness** of information contained in the KIIS.²⁵⁰ This wording suggests that CSP's verification responsibility is significantly enhanced as the assessment of KIIS *accuracy* falls within the scope of CSPs' duties. On the other hand, however, the CSPs' verification duty is only confined to establish *adequate certification procedures*; thus, CSPs' verification duty is not defined as an absolute duty to *ensure* KIIS completeness, clarity and **correctness**, but rather as a procedural duty to simply set up *adequate internal processes*. However, this interpretation is inconsistent with the Preamble and Article 23(12). The Preamble of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) explains that CSPs should *ensure* – not simply maintain adequate internal arrangements – that the KIIS is clear, **correct** and complete.²⁵¹ Moreover, Article 23(12) of the Council of the European Union First Reading Position confers certain duties on project owners in cases where CSPs identify not only material omissions but also material *mistakes* or *inaccuracies* in the KIIS. The inconsistent and careless wording creates confusion as to the exact scope of CSPs' verification duties concerning the KIIS.²⁵² It is necessary, therefore, that the ambit of CSPs' verification duties is streamlined along the following lines to ensure consistency and clarity.

To the extent that supervisory authorities are not involved in the assessment of the KIIS, more weight should be placed on CSPs' gatekeeping role. Considering that the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) envisages CSPs as the KIIS' only monitoring mechanism, it follows that their verification duties should be strengthened to include the duty to *ensure* (as opposed to the duty to merely maintain 'adequate internal procedures') both the completeness and clarity of the KIIS as well as the *accuracy* of information contained in the KIIS. On the other hand, considering the limitations that are inherent in assessing the accuracy of information originating from another party (i.e., the project owners) and taking into account the need to create a proportionate liability regime for CSPs, the latter's duty to assess the KIIS' accuracy should be considered to have been discharged as soon as there is *no reasonable basis* for questioning the inerrancy of the KIIS' information.²⁵³

²⁵⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 23(11).

²⁵¹ The Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 51 explains that enhancing the verification duties of CSPs is reasonable considering that it is the CSPs that are responsible for providing the KIIS to prospective contributors.

²⁵² The Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 23(9) augments ambiguity, as it requires responsibility for the information contained in the KIIS to attach *at least* (not *exclusively*) to project owners or their administrative, management or supervisory bodies.

²⁵³ Cf., U.S. 17 CFR § 227.301. It has been argued that permitting CSPs to rely on project owners' representations unless there is reason to question their reliability could mitigate CSPs' incentives to conduct a more thorough investigation of the projects and project owners and thus could increase the probability of fraud; however, such an outcome could be alleviated by the operation of communications channels (see *supra* section 4.1.B) that would facilitate the exchange of information and the exposure of fraud (see U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66531). Moreover, the "reasonable

Thus, the CSPs' verification duty concerning the KIIS should be elucidated and streamlined in two directions: first, it should be made clear that CSPs have a positive duty to *ensure* not only the completeness and clarity but also the correctness of the KIIS; and second, as far as the delineation of CSPs' duty to certify the KIIS correctness is concerned, it should be explicitly provided that CSPs' responsibility is to deny a project-owner access to their platform if they have a *reasonable basis* for believing that the KIIS is inaccurate or fraudulent.²⁵⁴

ii. *Suitability Assessment and Simulation Testing*

To ensure adequate protection of different categories of contributors participating in crowdfunding projects while facilitating investment flows, the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) distinguishes between sophisticated and non-sophisticated contributors, and introduces different levels of protection safeguards (i.e. suitability assessment and simulation testing), appropriate for each of those categories.²⁵⁵ The distinction between sophisticated and non-sophisticated investors draws on the distinction between professional clients and retail clients established in MiFID II but also takes into account the characteristics of the crowdfunding market.²⁵⁶ For a graphical representation of the distinction between the two classes (sophisticated v. non-sophisticated contributors), see Figure 8.

Considering that financial products marketed on crowdfunding platforms are not the same as traditional investment products or savings products, CSPs are required—before giving prospective *non-sophisticated contributors* full access to invest in crowdfunding projects on their crowdfunding platform—to assess whether and which crowdfunding services offered are appropriate for such *non-sophisticated contributors* and ascertain their understanding of such investments.²⁵⁷ To this end, CSPs shall

basis” test ensures that CSPs with no actual knowledge of the inaccuracies and no reason for suspicions (no “red flags”) are off the hook (see Steven Bradford, *Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others* 83 *University of Cincinnati Law Review* 371, 379-381 (2014) [“Bradford (2014)” hereafter]). Bradford (2014), *ibid.*, at p. 380, also notices that imposing more onerous due diligence/liability requirements on CSPs would excessively increase the cost of doing business for CSPs who, in turn, would pass that cost on to all project owners, thus making crowdfunding services significantly more expensive to use.

²⁵⁴ Darian Ibrahim, *Underwriting Crowdfunding* 25 *Stanford Journal of Law Business and Finance* (2020) (forthcoming), suggests—rather unrealistically—that crowdfunding offerings could employ the “firm commitment” underwriting mechanism (whereby underwriters in IPOs buy all of the shares a company is offering to the public, and then immediately resell them): crowdfunding offerings, like IPOs, could use CSPs/funding portals or angel investors as underwriters to serve as reputational intermediaries between startups and investors.

²⁵⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 42.

²⁵⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 42. For each non-sophisticated contributor, CSPs are required to review the appropriateness assessment every two years after the initial assessment (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 21(3)).

²⁵⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 21(1) and Preamble, Recital 43. Considering that sophisticated investors are, by definition, aware of the risks associated with investments in crowdfunding projects, there is no merit in applying the “appropriateness assessment”

request information about the prospective non-sophisticated contributor's *experience, investment objectives, financial situation and basic understanding of risks* involved in investing in general and in participating in the types of investments offered on the crowdfunding platform, including information about: (i) the prospective non-sophisticated contributor's past investments in transferable securities or past acquisitions of admitted instruments for crowdfunding purposes or loans, including in early or expansion stage businesses; and (ii) the prospective non-sophisticated contributor's understanding of the risks involved in granting loans, investing in transferable securities or acquiring admitted instruments for crowdfunding purposes through a crowdfunding platform, and professional experience in relation to crowdfunding investments.²⁵⁸ Where prospective contributors do not provide the information required, or where CSPs consider, on the basis of the information received, that the prospective contributors have insufficient knowledge, skills or experience, CSPs should inform those potential contributors that the services offered on their platforms may be inappropriate for them and give them a risk warning clearly stating the risk of losing the entirety of the money invested; if prospective contributors decide to proceed with the investment despite the risk warning, CSPs *may* accept their investment provided that contributors have expressly acknowledged that they have received and understood the warning.²⁵⁹

The EU suitability mechanism in the context of crowdfunding services goes beyond the U.S. crowdfunding regime, whereby potential contributors are required to consider on their own, based on the information provided by project owners and intermediaries, whether a particular crowdfunding investment is appropriate for them.²⁶⁰ Under the more light-touch U.S. rules, funding portals do not perform a suitability assessment but instead are required to

(a) deliver educational materials to potential contributors that explain how the offering process works and the risks associated with crowdfunding,²⁶¹

(b) obtain from potential contributors (i) a representation that they have reviewed the educational materials, understand that their entire investment can be lost and are in a position to bear the loss of the investment;²⁶² and (ii) a questionnaire demonstrating contributors' understanding that cancelling an investment commitment has certain restrictions, that reselling a crowdfunding investment may be difficult, and that a crowdfunding investment involves risk that should not be taken if one would be unable to withstand a total loss.²⁶³

or issuing a risk warning to them (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 44).

²⁵⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 21(2).

²⁵⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 21(4) and Preamble, Recital 45. A complementary, useful requirement is to provide that, in receiving the necessary information, CSPs should consider asking multiple-choice questions that avoid binary (yes/no) answers (cf. UK FCA Conduct of Business Sourcebook ("COBS" hereafter), at s. 10.2.9G).

²⁶⁰ Cf., U.S. 17 CFR § 227.302(b)(vii). See also Deshler (2014), *supra* n. 117, at pp. 1177-1178.

²⁶¹ Cf., U.S. 17 CFR § 227.302(a) and (b).

²⁶² Cf., U.S. 17 CFR § 227.303(b)(2)(i).

²⁶³ Cf., U.S. 17 CFR § 227.303(b)(2)(ii).

<p>Directive 2004/65/EU (MiFID II) Art. 4(1)(10), 4(1)(11) and Annex II, section I, points (1)-(4)</p>	<p>Council of the European Union First Reading Position on Crowdfunding Regulation Annex II(d)</p>
<p style="text-align: center;">CLIENTS</p> <p>Professional client is a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs. In order to be considered to be professional client, the client must comply with the following criteria:</p> <p>I. Categories of clients who are considered to be professionals</p> <p>The following shall all be regarded as professionals in all investment services and activities and financial instruments for the purposes of the Directive.</p> <p>(1) Entities which are required to be authorized or regulated to operate in the financial markets. The list below shall be understood as including all authorized entities carrying out the characteristic activities of the entities mentioned: entities authorized by a Member State under a Directive, entities authorized or regulated by a Member State without reference to a Directive, and entities authorized or regulated by a third country; Credit institutions; (b) Investment firms; (c) Other authorized or regulated financial institutions; (d) Insurance companies; (e) Collective investment schemes and management companies of such schemes; (f) Pension funds and management companies of such funds; (g) Commodity and commodity derivatives dealers; (h) Locals; (i) Other institutional investors;</p> <p>(2) Large undertakings meeting two of the following size requirements on a company basis: (i) balance sheet total: € 20,000,000, (ii) net turnover: € 40,000,000, (iii) own funds: € 2,000,000</p> <p>(3) National and regional governments, including public bodies that manage public debt at national or regional level, Central Banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.</p> <p>(4) Other institutional investors whose main activity is to invest in financial instruments, including entities dedicated to the securitisation of assets or other financing transactions.</p> <p>“Retail client” means a client who is not a “professional” client</p>	<p style="text-align: center;">CONTRIBUTORS</p> <p style="text-align: center;">SOPHISTICATED CONTRIBUTORS</p> <p>(1) All “professionals” clients by virtue of MiFID II (Annex II, section 1, points 1–4) are also considered “sophisticated” contributors.</p> <p style="text-align: center;">AND</p> <p>(2) Contributors who possess the awareness of the risks associated with investing in capital markets and adequate resources to undertake those risks without exposing themselves to excessive financial consequences. Sophisticated contributors may be categorised as such if they meet the following identification criteria and if the procedure set out below under point 3 is followed: A. Legal persons meeting at least one of the following criteria: (i) own funds of at least € 100,000, (ii) net turnover of at least EUR 2,000,000, (iii) balance sheet of at least € 1,000,000. B. Natural persons meeting at least two of the following criteria: (i) personal gross income of at least € 60,000 per fiscal year, or a financial instrument portfolio, defined as including cash deposits and financial assets, that exceeds € 100,000; (ii) the investor works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged, or the investor has held an executive position for at least twelve months in a legal person referred to in point A above; (iii) the investor has carried out transactions, in significant size, on the capital markets at an average frequency of 10 per quarter, over the previous four quarters.</p> <p>(3) CSPs shall provide contributors with a template that they may use to submit a request to be treated as sophisticated contributors. The template shall contain the identification criteria set out above under points (1)-(2) and a clear warning specifying the protection that a sophisticated investor will lose as a consequence of being classified as such. The CSP shall (i) take reasonable steps to ensure that the contributor qualifies as a sophisticated contributor; and (ii) approve the request unless it has reasonable doubts that the information provided in the request is correct.</p> <p>“Non-sophisticated” contributors are those who are not “sophisticated” contributors</p>

Figure 8: Classification of crowdfunding contributors according to the Council of the European Union First Reading Position and comparison with the definition of Directive 2004/65/EU for “clients”

The suitability assessment under the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) also encompasses a simulation test. The simulation test comprises two legs and refers to *non-sophisticated contributors* only.²⁶⁴

The first leg of the simulation test seeks to ensure that *non-sophisticated contributors* are not overexposed to crowdfunding projects.²⁶⁵ To this end, CSPs should require prospective non-sophisticated contributors to simulate their ability to bear loss, calculated as 10 % of their net worth, based on the following information: (i) regular income and total income, and whether the income is earned on a permanent or temporary basis; (ii) assets, including financial investments and any cash deposits, but excluding personal and investment property and pension funds; and (iii) financial commitments, including regular, existing or future commitments.²⁶⁶ The loss-tolerance threshold of 10% corresponds to the maximum amount of capital each contributor can invest in crowdfunding projects.²⁶⁷ Again, the results of the simulation test shall not prevent investing in crowdfunding projects provided that non-sophisticated contributors have acknowledged that they have received the results of the test.²⁶⁸

The second leg of the simulation test sets out a maximum amount that non-sophisticated contributors can, without further safeguards, invest in an individual project (“investment limitation”)—the underlying rationale being to offer protection against the risk of losing large amounts of the initially invested sums or even of experiencing total loss.²⁶⁹ More specifically, each time before a non-sophisticated contributor accepts an individual crowdfunding offer thereby investing an amount that exceeds the higher of either € 1,000 or 5 % of that contributor’s net worth, the CSP shall ensure that such contributor (i) receives a risk warning; (ii) provides explicit consent to the CSP; and (iii) proves to the CSP that he/she understands the investment and its risks.²⁷⁰

The suitability test, as set out by the Council of the European Union First Reading Position, could be criticized on several grounds.

First, requiring CSPs to assess non-sophisticated contributors’ experience may prove fruitless in practice, as the overwhelming majority of EU investors lack any experience with crowdfunding projects.²⁷¹

Second, the suitability assessment mechanism (including the simulation test) could be attacked on the ground that it allows CSPs to accept investors’ and lenders’ participation in crowdfunding projects, even if the result of the assessment indicates

²⁶⁴ See Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 46, noticing that sophisticated contributors have the necessary experience, knowledge or financial capacity, or a combination thereof, and thus should not be subjected to a simulation test.

²⁶⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 46.

²⁶⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 21(5). CSPs shall, for each non-sophisticated investor, review the simulation referred every year after the initial simulation (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 21(6)).

²⁶⁷ See also *supra* section 4.2.C.(i).

²⁶⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 21(6).

²⁶⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 46.

²⁷⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 21(7).

²⁷¹ See ECN Comments, *supra* n. 162, at point ‘i’, also noticing that a suitability test “*may have the effect of excluding many of the investors whom this Regulation is specifically intended to reach*”.

otherwise; all and any risk emanating from the participation in crowdfunding projects is borne exclusively by the contributors. However, introducing a type of rule that requires CSPs to thoroughly analyze the information provided by contributors and to abstain from providing crowdfunding services/products unless the contributors' profile is considered suitable-compatible would unduly expand the scope of duties and the concomitant liability of CSPs and, as a result, it would excessively increase the CSPs' cost of doing business.²⁷² The Council of the European Union First Reading Position offers a more fine-tuned and effective solution: CSPs are required to issue a risk-warning if they consider that the crowdfunding services/products are not suitable for a particular non-sophisticated contributor and those contributors should expressly acknowledge that they have received and understood the warning..

Third, and most importantly, the investment limitation of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) suffers from a fundamental drawback: considering that the ceiling applies on a per-project basis, it would not effectively curtail contributors' *overall or aggregate exposure* to crowdfunding. An alternative would be to adopt an *aggregate-overall investment cap* – that is, to set a *total, nominal value of capital* that contributors are allowed to invest in crowdfunding projects (e.g., crowdfunding investment should never exceed € 100,000).²⁷³ Such a *nominal-unadjusted investment cap* would establish a rigorous “stop loss” mechanism for inexperienced, less-wealthy, and less-sophisticated contributors.²⁷⁴ On the other hand, however, such a cap would impose significantly more stringent diversification constraints on contributors, thus potentially driving away wealthier and more experienced investors, impeding capital formation, and undermining informational efficiency.²⁷⁵ A different option would be to introduce a *legally binding investment limitation* that is calculated either as a *percentage of contributors' net wealth* or as a

²⁷² However, a different approach may be more appropriate when CSPs provide services that involve the exercise of a higher degree of discretion (e.g., portfolio management of loans): see *infra* section 5.

²⁷³ Such caps could be structured to allow for some flexibility (e.g., they could apply for a specific period of time, for instance, one year). Cf., U.S. Securities Act of 1933, at s. 4a(6) and U.S. 17 CFR § 227.100(a).

²⁷⁴ The European Parliament/Committee on Economic and Monetary Affairs, *Draft Report: Amendments 137-234: Markets in Financial Instruments – Proposal for a directive 2018/0048 (COD)*, Amendment 298, had proposed a variation of such a cap (“Investors may not invest more than € 4 000 per crowdfunding project and € 12,000 per annum per crowdfunding platform”).

²⁷⁵ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66520:

“[Investment limitations] might particularly affect the decisions of those with large portfolios who might be able to absorb losses and understand the risks associated with risky investments. For these investors, the \$100,000 aggregate cap might limit their incentive to participate in the securities-based crowdfunding market, compared to other types of investments, potentially depriving the securities-based crowdfunding market of more experienced and knowledgeable investors and possibly impeding capital formation. Limiting the participation of such investors would be likely to negatively affect the informational efficiency of the securities-based crowdfunding market because sophisticated investors are better able to accurately price such offerings. These investors also could add value to the discussions taking place through an intermediary's communication channels about a potential offering by providing their views on financial viability.”

ratio of contributors' participation in crowdfunding projects (or as a combination of both). It is true that such a limitation would place constraints on the development of a fully autonomous portfolio diversification policy within the crowdfunding market and would also confine the potential upside for contributors, yet, it would also provide a more balanced cap on potential losses.²⁷⁶ To ensure consistent implementation of the investment cap proposed above, two clarifications are needed: the investment cap should apply to, and be calculated after taking into account, *all* types of financial-return crowdfunding (i.e., both P2P lending and investment-based crowdfunding) *conducted via CSPs*,²⁷⁷ and the investment limit should also cover indirect investment models.²⁷⁸ Such a *legally binding investment limitation* – i.e., calculated as a *percentage of contributors' net wealth* or as a *ratio of contributors' participation* in all crowdfunding projects – could achieve the necessary equilibrium between the mandate to protect retail contributors and the need to facilitate participation of wealthier, more experienced and sophisticated investors.

Regarding the mechanism through which CSPs could monitor compliance with the proposed investment limitations (or any other investment cap), the most effective—but currently unworkable—solution would be to create a centralized database with information on, inter alia, CSPs, contributors, offerings, and transactions.²⁷⁹ In the absence of such a database, a more feasible but imperfect option is to propose that CSPs rely on contributors' representations to monitor compliance with the investment limits concerning the contributors' net wealth or other benchmarks, as proposed above, including the amount of the contributors' other crowdfunding investments through different CSPs. A CSP should not be allowed to rely on contributors' representations only if it has reason to question the reliability of the representations (e.g., where investments have been made by a contributor through that CSP or where other information or facts about a contributor have come into the possession of that CSP).²⁸⁰

E. Outcomes Statement

CSPs which facilitate the granting of loans are required to:

- (a) disclose annually the default rates of the crowdfunding projects offered on their platform over at least the preceding 36 months; and
- (b) publish an outcome statement within four months of the end of each financial year indicating, as applicable: (i) the expected and actual default rate of all loans the CSP has facilitated, by risk category and by reference to the risk categories

See also ECN Comments, *supra* n. 162, at point 'j'. See finally Dimitry Chervyakov, Jörg Rocholl, *How to Make Crowdfunding Work in Europe* 6 Bruegel Policy Contribution 1, 10 (2019).

²⁷⁶ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66520.

²⁷⁷ The limitation could be relaxed to apply to all crowdfunding investments conducted through an individual CSP (and not to the total exposure to crowdfunding projects conducted via all CSPs).

²⁷⁸ In the case of indirect investment-crowdfunding models, the investment cap could apply either to the contribution of participants to the SPV or to the investment made by the SPV to crowdfunding projects or to both. See also U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66520.

²⁷⁹ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66470.

²⁸⁰ *Ibid.*

set out in the risk-management framework, (ii) a summary of the assumptions used in determining expected default rates; and (iii) where the CSP offered a target rate in relation to individual portfolio management of loans, the actual return achieved.²⁸¹

The particular requirement is more than welcomed because it offers significant support to contributors' understanding of whether the CSP delivers on its promises, thus also enhancing market transparency. In addition, the comparability of the performance of CSPs' closed projects is facilitated and CSPs' self-discipline and the marketing of their reputation is strengthened.²⁸²

F. Reflection Period

The proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) makes provision for a reflection period during which the prospective *non-sophisticated contributor* can revoke an expression of interest to invest into a particular crowdfunding offer without penalty and with no obligation to provide a justification.²⁸³

The underlying rationale for introducing a reflection period is straightforward: to strengthen the protection for *non-sophisticated contributors* and to avoid that such contributors, by accepting a crowdfunding offer, bind themselves to a contract without any possibility of retraction during an adequate period of time.²⁸⁴ The reflection period commences at the moment of the offer to invest or the expression of interest by the prospective non-sophisticated contributors and expires four calendar days later.²⁸⁵ The reflection period *is not* necessary when a prospective non-sophisticated investor can express an interest in a particular crowdfunding offer without also thereby binding him/herself to a contract, except in the situation when such an offer to invest is made or such an expression of interest is expressed at a moment *close to the scheduled expiry date of the offer or to the date of reaching the target funding goal*.²⁸⁶

²⁸¹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art 20(1). The default rates shall be published in a prominent place on the website of the CSP.

²⁸² See European Parliament Position on Crowdfunding Regulation, *supra* n. 7, Preamble, Recital 37.

²⁸³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art 22(2) and Preamble, Recital 47.

²⁸⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 47.

²⁸⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art 22(3). The CSP shall provide accurate, clear and timely information to the prospective non-sophisticated investor about the reflection period and the modalities to revoke an offer to invest or an expression of interest, including at least the following: (a) immediately before the prospective non-sophisticated investor can communicate his or her offer to invest or expression of interest, the CSP is to inform the prospective non-sophisticated investor of (i) the fact that the offer to invest or the expression of interest is subject to a reflection period, (ii) the duration of the reflection period, (iii) the modalities to revoke the offer to invest or the expression of interest; and (b) immediately after receipt of the offer to invest or of the expression of interest, the CSP, through its crowdfunding platform, is to inform the prospective non-sophisticated investor that the reflection period has started (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art 22(6)).

²⁸⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 47.

The drafting of the “reflection period” rule should be reconsidered in order to strike the appropriate balance between, on the one hand, protecting less sophisticated investors and, on the other hand, avoid generating uncertainty and confusion that would seriously undermine the success of crowdfunding offers. As currently drafted, the duration of the “reflection period” rule is not pre-determined or fixed and common for all contributors, but, on the contrary, it varies depending on the time that each one of the contributors expresses interest to participate in the offering (i.e., it starts when a participant expresses interest). As a result, those non-sophisticated contributors that happen to express their interest at a relatively early stage of the offer shall not gain the full benefit of the views of other contributors that decide to participate at a later stage; and the revocation right of those contributors that happen to express their interest close to the expiry of the offer shall generate ambiguity as to whether the target offering amount has been met.²⁸⁷ It is even more unfortunate that the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) does not even require CSPs to inform project owners and contributors in cases where the revocation of an expression of interest during the reflection period leads to a situation where the crowdfunding offer no longer meets the target funding goal, or in the case of a funding range, no longer meets the minimum target funding goal.²⁸⁸ To strike the appropriate balance, contributors should be offered the right to cancel their participation in a crowdfunding offer until a predetermined period of time (e.g., ten days) prior to the closing of the offer as identified in the project owners’ KIIS. Under this approach, “an investor could reconsider his or her investment decision with the benefit of the views of the crowd and other information, until the final [stage] of the offering”²⁸⁹ without, at the same time, distorting the closing of the offers. In other words, the alternative offered above strikes the appropriate balance

*“between giving investors the continuing benefit of the collective views of the crowd and then, if desired, to cancel their investment commitments, while providing issuers with certainty about their ability to close an offering at the end of the offering period.”*²⁹⁰

G. Secondary Markets

A CSP may allow contributors who have made investments through its platform to advertise on a bulletin board operating on the platform their interest in buying or selling loans, transferable securities or admitted instruments for crowdfunding purposes which were originally offered on that platform, provided that the bulletin board does not bring together multiple third-party buying and selling interests in a way that results

²⁸⁷ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66476.

²⁸⁸ Cf. Council of the European Union, *Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP) for Business and amending Regulation (EU) 2017/1129* (2018/0048 (COD), Brussels, 24.06.2019), art. 15b(2aa).

²⁸⁹ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66476.

²⁹⁰ *Ibid.*

in a contract in relation to such advertisements.²⁹¹ Essentially, therefore, the bulletin board does not consist of an internal matching system which executes client orders on a multilateral basis unless, *in relation to transferable securities only*, the CSP also has a separate authorisation as an investment firm in accordance with Article 5 of MiFID II, or as a regulated market in accordance with Article 44 of MiFID II.²⁹² CSPs that do not hold the aforementioned authorisation in relation to transferable securities should clearly inform contributors that: (i) they do not accept the reception of orders for the purposes of buying or selling contracts in relation to investments originally made on the crowdfunding platform, (ii) that any buying and selling activity on their crowdfunding platform is at the investor's discretion and responsibility, and (iii) that they do not operate a trading venue in accordance with MiFID II.²⁹³ Along the same lines, where CSPs suggest a reference price for the buying and selling referred to above, they shall: (i) inform their clients that the suggested reference price is non-binding and substantiate the suggested reference price, and (ii) disclose key elements of the methodology used to calculate such price.²⁹⁴

The creation of a secondary market for crowdfunded products (i.e., loan agreements and securities) is a controversial issue that warrants close attention and cautious regulatory treatment. Unfortunately, the European Union addresses the development of secondary markets for crowdfunding products rather carelessly and somehow superficially; the vacuous and futile explanation offered in the Preamble of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) that post-campaign buying/selling of crowdfunding products is justified "*in the interest of transparency and flow of information*" is a case in point.²⁹⁵ As mentioned, crowdfunding products' illiquidity constitutes one of the most important risks for potential contributors, thus *ex ante* discouraging participation in the crowdfunding market and

²⁹¹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art 25(1)-(2) and Preamble, Recital 55.

²⁹² Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 55.

²⁹³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 55.

²⁹⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 25(5). Moreover, to ensure an appropriate level of contributors' protection, the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) introduces supplementary conditions concerning the operation of bulletin boards: (i) CSPs should inform contributors about the nature of the bulletin board and should require contributors advertising a sale of crowdfunding products to make available the KIIS; (ii) CSPs should provide contributors intending to buy loans advertised on the bulletin board with information on the performance of loans facilitated by the CSPs; (iii) CSPs should ensure that contributors advertising an interest to purchase a crowdfunding product and qualifying as non-sophisticated have received a warning stating the risk of losing the entirety of the money invested and are aware that crowdfunding products are not covered by a depositor/investor protection scheme; and (iv) CSPs that allow the advertisement of buying/selling interest through a bulletin board and that provide asset safekeeping services should require their contributors advertising such an interest to notify them of any changes in ownership for the purposes of conducting ownership verification and record-keeping. See also Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 25(3) and Preamble, Recital 55 ("*Where so permitted by national law, a crowdfunding service provider should be able to transfer the ownership of shares in an investment-based crowdfunding project by updating its information system.*").

²⁹⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 55.

raising capital costs for project owners.²⁹⁶ Providing for or allowing the development of a secondary market for crowdfunding products would offer an attractive exit option for potential contributors, increase participation in the crowdfunding market, and enhance the probability of crowdfunding success.²⁹⁷ On the other hand, buying and selling crowdfunding products in the secondary market poses serious investor protection concerns: the thin capitalization of project owners, the lack of continuous monitoring by analysts and by (many) professional investors, and the absence of ongoing disclosure requirements provide the ingredients of a perfect recipe for fraud, speculation, manipulation, and inefficient pricing in the secondary market.²⁹⁸

In this context, the solution adopted by the U.S. crowdfunding regime seems more fine-tuned and thus merits closer attention. Rule 4A(e) of the Securities Act of 1933 and the SEC Rules (U.S. 17 CFR § 227.501) restrict the transfer of crowdfunded securities for one year, with limited exceptions (e.g., for transfers to the project-owner in a registered offering, to an accredited investor, or to certain family members). By restricting the transfer of securities for a one-year period, investors and potential investors are offered “*a defined period to observe the performance of the business and to potentially obtain more information about the potential success or failure of the business before trading occurs.*”²⁹⁹ Moreover, by enhancing ongoing, post-campaign disclosure requirements for project owners and CSPs along the lines suggested above,³⁰⁰ transparency and information efficiency are improved, due diligence and monitoring are facilitated, and pricing efficiency is enhanced.³⁰¹ The U.S. paradigm strikes a delicate balance between the need to, on the one hand, improve the liquidity of crowdfunding products and increase contributors’ participation in the crowdfunding market and to guard against fraud and manipulation in the secondary market for such products on the other.

²⁹⁶ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66526. See, also, *supra* section 2.2.A.

²⁹⁷ See Alice Rossi, Silvio Vismara, *What Do Crowdfunding Platforms Do? A Comparison Between Investment-Based Platforms in Europe* 8 Eurasian Business Review 93 (2018) (a higher number of post-campaign services – i.e., helping successful campaign grow and deal with potential exits and expansions – offered by the platforms increase the annual number of successful campaigns).

²⁹⁸ Janet Austin, *How Do I Sell My Crowdfunded Shares? Developing Exchanges and Markets to Trade Securities Issued by Start-Ups and Small Companies* 8 Harvard Business Law Review Online 8, 21-35 (2018) [“Austin (2018)”]; Parsont (2014), *supra* n. 204, at pp. 330-332; Heminway and Hoffman (2011), *supra* n. 114, at p. 954.

²⁹⁹ U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66526.

³⁰⁰ See, *inter alia*, *supra* section 4.1.B (*inter alia*, on the introduction of ‘communication channels’ by CSPs) as well as *supra* section 4.2.C.

³⁰¹ Admittedly, the one-year restriction on resales could impede price discovery; yet, this type of illiquidity cost “*would be mitigated, in part, by provisions that allow investors to transfer the securities within one year of issuance by reselling the securities to accredited investors, back to the issuer or in a registered offering or transferring them to certain family members or trusts of those family members*” and, in another part, by the on-going disclosure requirements: see U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66526. A complementary – but more costly – proposal is create an effective vetting process in the secondary market by requiring project owners to pay CSPs for conducting due diligence (see Austin (2018), *supra* n. 298, at pp. 31-32).

H. *Marketing Communications*

The fundamental rationale underlying the marketing requirements is to direct potential contributors to the offering material (KIIS) and the relevant crowdfunding intermediary to obtain full information about a crowdfunding offer and thus make informed investment decisions.³⁰² To this end, the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) requires CSPs to ensure that all marketing communications to contributors are clearly identifiable as such.³⁰³ Moreover, prior to the closure of raising funds for a project, no marketing communications shall disproportionately target any individual planned, pending or current crowdfunding project or offer.³⁰⁴ Marketing communication requirements should be supplemented to ensure the non-discriminatory treatment of project owners.³⁰⁵ To this end, it should be made clear that marketing communications are prohibited from *discriminating* between different projects, that is, CSPs should not treat any particular project more favourably by signaling it out from other projects offered on their platform.³⁰⁶

5. Towards a Tailored-Made Regulatory Framework to Address P2P Lending Unique Challenges?

The EU regulatory framework on crowdfunding has been developing based on the fundamental premise that the type of reward contributors receive is the key distin-

³⁰² U.S. Federal Register 78 (Crowdfunding; Proposed Rule), 66455.

³⁰³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 27(1). A necessary complement to the requirements on marketing communication is that the information contained in such communications should be fair, clear and not misleading and should be consistent with the information contained in the KIIS (see Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 27(2)).

³⁰⁴ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 27(2). For their marketing communications, CSPs shall use one or more of the official languages of the Member State in which CSPs are active or a language accepted by the competent authorities of that Member State (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 27(3)). National competent authorities are prohibited from requiring an *ex ante* notification and approval of marketing communications (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 27(5)).

³⁰⁵ On the other hand, see ECN Comments, *supra* n. 162, point ‘n’, concluding that

“the risk of platforms unfairly discriminating between campaigns is very low. It is in the interest of all platforms to maximize the likelihood that each campaign it hosts will get funded, and so no platform is likely to engage in activities that would hurt or other reduce the funding chances of any of its campaigns or the trust it has worked to build with its investors.”

A useful clarification proposed by the ECN is that the term “marketing communications” should be separated into two concepts, that is, “marketing” and “communications”. Such a distinction is plausible because

“[t]o the extent that ‘marketing’ is defined as actively promoting and encouraging investment in a particular project, whereas a ‘communication’ about the project merely announces its existence and contains information about (and link to) it, it could make sense to apply a set of restrictions to ‘marketing’ but not to ‘communications’ ”.

³⁰⁶ See European Commission Proposal on Crowdfunding Regulation, *supra* n. 6, Preamble, Recital 37.

guishing feature between the different crowdfunding models.³⁰⁷ Specifically, the European Commission has noted that investment- and lending-based crowdfunding models offer a product with a financial return, which relies on a future cash flow stream.³⁰⁸ For the European Commission, this common feature produces additional and unique information gaps that call for a special regulatory intervention at the EU level: the combination of a dispersed investment/lending structure (and small ticket size that offers limited incentives to engage in monitoring) with the provision of a financial product in investment and lending-based crowdfunding models calls for targeted intervention to address the risks for cross-border market stability and investor protection, which may not be sufficiently (or may be too aggressively) addressed under current national regimes.³⁰⁹

The Council of the European Union First Reading Position further refines and reorients the analysis of the European Commission. In line with the perspective that has been adopted by the UK Financial Conduct Authority (FCA),³¹⁰ the Council of the European Union recognizes – even if not with the essential clarity – the distinctive features of the different financial-return crowdfunding models and the need for tailor-made regulatory responses. More specifically, while investment based crowdfunding is treated as a separate-individual or homogeneous model, crowd-lending is considered to be more heterogeneous comprising three, distinctive models:

- (a) *facilitation of granting of loans*, whereby, CSPs operate as “conduits” merely presenting on their platform crowdfunding offers to prospective clients;³¹¹
- (b) *facilitation of granting of loans according to point (a) and pricing or assessing the credit risk of crowdfunding projects or project owners*;³¹² and
- (c) *individual portfolio management of loans*, that is, allocation by the CSP of a pre-determined amount of funds of a contributor, which is an original lender, to one or multiple crowdfunding projects on its crowdfunding platform in accordance with an individual mandate given by the contributor on a discretionary lender-by-lender basis.³¹³

³⁰⁷ Impact Assessment of the European Commission Proposal on Crowdfunding Regulation, *supra* n. 10, at s. 1.1.1.1

³⁰⁸ *Ibid.*, at s. 4.1.1.

³⁰⁹ *Ibid.*

³¹⁰ See Financial Conduct Authority (FCA), *Loan-based ('peer-to-peer') and Investment-based Crowdfunding Platforms: Feedback on our Post-implementation Review and Proposed Changes to the Regulatory Framework* (Consultation Paper (CP) 18/20, July 2018) [“FCA CP 2018” hereafter].

³¹¹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(a)(i) and Preamble, Recital 11.

³¹² Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(a)(i) and Preamble, Recital 11.

³¹³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(a)(i) and (2)(c). Individual portfolio management of loans also includes business models “*using automated processes whereby funds are automatically allocated by the crowdfunding service provider to crowdfunding projects in accordance with parameters and risk indicators predetermined by the [contributor], so called*

This EU definition and classification of “crowdfunding services” could be mapped onto the corresponding description and categorization of “crowdfunding services” offered by the UK FCA:

- (a) Investment-based crowdfunding³¹⁴ and the mere *facilitation* of granting of loans (i.e., presentation on CSPs’ platform of crowdfunding offers to prospective lenders) are relative simple or direct crowdfunding models that involve services offered by “conduit platforms”, according to the FCA definition. In conduit platforms, investors pick the investment opportunities, and the platform administers the loan or investment arrangements.³¹⁵
- (b) More complex, loan-based crowdfunding services also comprising the pricing of crowdfunding projects’ or/and project owners’ credit risk as well as the individual portfolio management of loans (“intermediated crowdfunding services”, hereafter) mirror the services provided by “pricing” and “discretionary” platforms, following the FCA classification. In pricing platforms, the platform sets the price/rate, but the investor/lender picks the underlying investment or loan. The pricing platform model mirrors intermediated crowdfunding, where the latter comprises the service of “*pricing or assessing the credit risk of crowdfunding projects or project owners*” (“intermediated-pricing model” hereafter). In discretionary-crowdfunding, the platform sets the price and chooses the lender’s portfolio of loans to generate a target rate. The discretionary platform model corresponds to intermediated crowdfunding, where the latter takes the form of the “*individual portfolio management of loans*” (or “intermediated-managing model” hereafter).

Figure 9 graphically presents a mapping of crowdfunding services (as contemplated by the Council of the European Union First Reading Position) into the FCA crowdfunding structure.

Interestingly, the UK FCA has also concluded that conduit crowdfunding is the dominant business model in investment-based crowdfunding, whereas pricing and discretionary models appear to dominate in the P2P lending market.³¹⁶ This dichotomization of crowdfunding models and services is more clearly depicted in Figure 10.

Different types of underlying financing (i.e., investment-based vs. lending based) expose contributors to very different types of risk, thus requiring a more granular regulatory approach. Investment-based crowdfunding models tend to be relatively simple: platforms predominantly act as conduits, providing investors with an online route by which to obtain and assess information about underlying investment opportunities, while investors choose what they want to invest in.³¹⁷ By contrast, P2P plat-

auto-investing” (Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Preamble, Recital 20).

³¹⁴ Investment-based crowdfunding includes the placing or the reception and transmission of contributors’ orders in relation to securities or instruments issued by project owners or a special purpose vehicle (see Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 2(1)(a)(ii)).

³¹⁵ FCA CP 2018, *supra* n. 310, at s. 3.9.

³¹⁶ *Ibid.* at ss. 3.2, 4.24.

³¹⁷ *Ibid.* at ss. 1.8, 3.2.

Core business models of investment-based and peer-to-peer crowdfunding platforms in the UK*	Investment-based and peer-to-peer crowdfunding platforms according to the Council of the European Union First Reading Position
<p>MODEL & FEATURES</p> <p><u>Conduit platforms</u></p> <p>The investor picks the investment opportunities and the platform administers the loan or investment arrangements</p>	<p>MODEL & FEATURES</p> <p><u>Simple or direct crowdfunding</u></p> <p>Investment-based crowdfunding (i.e., the placing or the reception and transmission of contributors' orders in relation to securities or instruments issued by project owners or a special purpose vehicle) as well as the mere facilitation of granting of loans (i.e., presentation on CSPs' platform of crowdfunding offers to prospective lenders)</p>
<p><u>Pricing platforms</u></p> <p>The platform sets the price, but the investor/lender picks the underlying investment/loan</p>	<p><u>Intermediated crowdfunding</u></p> <p>Pricing of crowdfunding projects' or/and project owners' credit risk</p>
<p><u>Discretionary platforms</u></p> <p>The platform sets the price and chooses the investor's portfolio of loans to generate a target rate – this is only seen in the P2P sector</p>	<p>Individual portfolio management of loans</p>

*Financial Conduct Authority (FCA), *Loan-based ('peer-to-peer') and Investment-based Crowdfunding Platforms: Feedback on our Post-implementation Review and Proposed Changes to the Regulatory Framework*, s. 3.9 (Consultation Paper – CP18/20, July 2018) ["FCA CP 2018"]; FCA CP 2018, *ibid.*, at ss. 3.10-3.11: "The three platform types are not exclusive or exhaustive [...] A single platform can operate in more than one way (for example, adopting a different model for different categories of client). In the case of P2P platforms, all three models administer loan arrangements, and we have observed that platforms that allocate loans to investors are also inevitably involved in pricing these."

Figure 9

Model	Predominant Platform Type	Features and implicit expectations
Conduit	P2P	Platform undertakes due diligence on person/business seeking investment and decides whether to offer them on the platform.
	Investment-based	Investor is responsible for choices made about the prospect of a good return on individual loans/investments.
Pricing	P2P	Platform undertakes due diligence on person/business seeking investment and decides whether to offer them on the platform.
		Platform is responsible for accurately pricing loan (i.e. calculates the contractual return for an individual loan).
Discretionary	P2P	Platform undertakes due diligence on person/business seeking investment and decides whether to offer them on the platform.
		Platform is responsible for accurately pricing loan (i.e. calculates the target rate of return across a portfolio of loans).

Figure 10: Summary of main, crowdfunding business models and their core features

Source: Financial Conduct Authority (FCA), *Loan-based ('peer-to-peer') and Investment-based Crowdfunding Platforms: Feedback on our Post-implementation Review and Proposed Changes to the Regulatory Framework*, s. 3.9 (Consultation Paper – CP18/20, July 2018), Table 1, at p. 19.

forms tend to be more complex: they not only facilitate lending but also price loans (i.e., set loans’ interest rates) as well as spread contributors’ capital over many different projects and manage contributors’ portfolios to achieve a specific target (“mixed”) return, thus taking a more active role by exercising discretionary management on behalf of contributors.³¹⁸

In discretionary models, in particular, contributors neither choose the investment nor do they know to whom they are lending (this is, in effect, managed by the platforms) within the pool of crowdfunding projects the platform has chosen.³¹⁹ The interest rate received by contributors is “mixed” because it consists of the interest rate paid across a number of different loans allocated to each contributor, with potentially diverse interest rates.³²⁰ Essentially, the main objective of the platform is to produce

³¹⁸ *Ibid.*, at ss. 1.9, 3.3.

³¹⁹ *Ibid.* at s. 3.16. See also FCA CP 2018, *ibid.* at ss. 3.19 and 3.22:

“The platform effectively acts akin to a discretionary manager for the investor as it selects the loans that an investor is exposed to. Some, but not all, platforms give the investor a choice of what level of risk they wish to be exposed to. Platforms will typically have an automated process for selecting loans in line with any risk criteria built into their algorithms. [...] Some platforms invest an investor’s money in loans once it is received (or fairly soon thereafter), and the investor remains invested in those loans until the loans reach maturity. Other platforms adjust an investor’s portfolio of loans over time, for example replacing loans that have matured with new loans. In this case, the platform also determines the price at which a loan is transferred in or out of the investor’s portfolio.”

³²⁰ *Ibid.* at s. 3.18.

and effectively manage different loan portfolios so that contributors receive the mixed interest rate that was advertised to them.³²¹

In conclusion, P2P platforms offer a much more structured financial service and operate more complex business models; as a result distinctive risks emerge that call for more sophisticated, tailor-made regulatory responses.³²² Indeed, intermediated crowdfunding models are relatively more complicated and, as a result, information asymmetries are more severe: contributors-lenders are likely to know and understand significantly less both about role of CSPs and the type of services they provide as well as about the nature and the risk of the underlying crowdfunding product.³²³ Moreover, CSPs operating intermediated crowdfunding models are inherently more likely to develop perverse incentives: for example, market practice suggests that some CSPs may expose lenders to riskier loans in order to either benefit from hidden commissions or “dump on contributors” loans that have been pre-funded by the CSPs or a related company.³²⁴ Finally, behavioral biases in intermediated crowdfunding models are more acute, thus undermining contributors’ decision-making process: for example, contributors may decide to act on the basis of headline returns without due consideration to risks, or may believe that past satisfactory returns indicate low risk in relation to future investments.³²⁵

All in all, and without ignoring the similarities between investment- and lending-based crowdfunding models (e.g., they are both financial-return models), the market reality suggests that intermediated crowdfunding models bear special characteristics and introduce unique risks that justify, if not mandate, the introduction of custom-made, top-up regulatory responses.

i. Intermediated Pricing Crowdfunding Models

With respect to intermediated-pricing models, the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) places emphasis in ensuring that the pricing of projects’ credit risk corresponds to the interest paid by project owners and reflects the risk that contributors are willing to take.³²⁶ To this end, CSPs are required: (i) to undertake a reasonable assessment of the credit risk of the crowdfunding project or project owner before the crowdfunding offer is made, including by considering the risk that repayments are not made by the due date;³²⁷ (ii) to base the credit risk assess-

³²¹ *Ibid.*

³²² *Ibid.* at s. 3.3.

³²³ *Ibid.* at Annex 2, paras 5-9.

³²⁴ *Ibid.* at Annex 2, paras 10-12.

³²⁵ *Ibid.* at Annex 2, par. 13.

³²⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 4(4). Cf. FCA CP 2018, *supra* n. 310, at s. 4.36.

³²⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 4(4)(a). Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.5R. See also Financial Conduct Authority (FCA), *Loan-based ('peer-to-peer') and Investment-based Crowdfunding Platforms: Feedback to CP18/20 and Final Rules* (Policy Statement (PS) 19/14, June 2019) [“FCA PS 2019” hereafter], at p. 10 (Although CSPs are not explicitly required to conduct scenario analysis or stress-testing, it is expected that “depending on the business model of a platform, [some CSPs] will nevertheless consider that conducting scenario analysis

ment referred to in point (i) on sufficient information;³²⁸ (iii) to establish, implement and maintain clear and effective policies and procedures to enable them to carry out credit risk assessments, and publish those policies and procedures;³²⁹ (iv) to ensure that the price is fair and appropriate, including in situations where CSPs that determine the price of loans are also facilitating an exit for a lender before the maturity date of a loan;³³⁰ (v) to conduct a valuation of each loan, not only when the loan is originated and following a default, but also where the CSPs consider that the project owner is unlikely to fulfil its obligations to repay the loan in full (without the CSPs enforcing any relevant security interest or taking other steps with analogous effect) or where the CSPs is facilitating an exit for a lender before the maturity date of the loan;³³¹ (vi) to have and use a risk-management framework that is designed to achieve compliance with the requirements set out in points (i) to (v) above;³³² (vi) to maintain a record of each facilitated crowdfunding offer sufficient to demonstrate that a credit risk assessment was carried out when required and that the price of the crowdfunding offer was fair and appropriate in line with the risk-management framework.³³³

ii. *Intermediated Managing Crowdfunding Models*

For CSPs that act as decision makers enjoying the discretion to select and manage a loan portfolio for each contributor, more stringent requirements are introduced.³³⁴ More specifically, in order to ensure that contributors are exposed to loans that meet their own risk/return preferences, CSPs are required to receive from contributors a mandate specifying the parameters for providing the service, which shall include at

or stress-testing is appropriate [to] support [CSPs'] wider risk management framework and [their] compliance with the rules around portfolio composition").

³²⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 4(4)(b). Relevant information to conduct the credit risk assessment includes the following: (i) where available, audited accounts covering the two latest financial years; (ii) information of which the CSP is aware at the time the credit risk assessment is carried out; (iii) information which has been obtained, where appropriate, from the project owner; and (iv) information which enables the CSPs to carry out a reasonable credit risk assessment. CSPs should also make available a description of the method used to calculate credit scores or prices and, if the calculation is based on accounts that are not audited, that should be clearly disclosed in the description of the method; however, the requirement concerning disclosure of methods to calculate credit scores, or to determine the price or the interest rate, should not be construed as requiring the disclosure of sensitive business information or in a manner that impedes innovation (see Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 19(6) and Recital, Preamble 41). Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.6R.

³²⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 4(4)(c). Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.10R.

³³⁰ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 4(4)(d). Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.11R.

³³¹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 4(4)(e). Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.16R.

³³² Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 4(4)(f).

³³³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 4(4)(g). Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.10R.

³³⁴ FCA CP 2018, *supra* n. 310, at s. 5.15.

least two of the following criteria that every loan in the portfolio will have to comply with: (i) the minimum and maximum interest rate payable under any loan facilitated for the lender; (ii) the minimum and maximum maturity date of any loan facilitated for the lender; (iii) the range and distribution of any risk categories applicable to the loans; and (iv) if an annual target rate of return on investment is offered, the likelihood that the selected loans will enable the lender to achieve the target rate with reasonable certainty.³³⁵ Moreover, with a view to securing that the calculation of the loan portfolio risk and the assessment of the advertised target rate are based on a reasonable and transparent risk assessment process, CSPs should adopt sound and well-defined risk assessment criteria, and also implement a risk management policy that takes into account all the relevant factors that may have unfavourable effects on the performance of the loans.³³⁶ On the basis of the aforementioned risk assessment criteria and risk management policy, CSPs are required to assess (i) the credit risk of individual crowdfunding projects selected for the lender's portfolio; (ii) the credit risk at the lender's portfolio level; and (iii) the credit risk of the project owners selected for the lender's portfolio.³³⁷

In addition, custom-made (*ex ante*) disclosure requirements are introduced for CSPs that provide the service of individual portfolio management of loans, thus ensuring that contributors are provided with all information that is necessary to make an informed investment decision. More specifically, a modified KIIS ("KIIS at platform level" hereafter) should be made available to prospective contributors containing the following information: (i) the identity, legal form, ownership, management and contact details of the CSP; (ii) the minimum and maximum interest rate of loans that may be available to investors' individual portfolios; (iii) the minimum and maximum maturity date of loans that may be available to investors' individual portfolios; (iv) where used, the range and distribution of risk categories that loans fall into, as well as the default rates and a weighted average interest rate per risk category with a further break down by the year in which the loans were granted through the CSP; (v) the key elements of the internal methodology for credit risk assessment of the individual crowdfunding projects and for defining the risk categories; (vi) if a target rate of return on investment is offered, an annualised target rate and the confidence interval of this annualised target rate over the investment period, taking into account fees and default rates; (vii) the procedures, internal methodologies and criteria for the selection of the crowdfunding projects to the individual portfolio of loans for the contributor; (viii) the coverage and conditions of any applicable capital guarantees; (ix) the servicing of portfolio loans, including in situations where a project owner does not meet its obligations; (x) the risk diversification strategies; and (xi) the fees to be paid by the

³³⁵ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 6(1). In complying with the relevant requirement under art. 6(1), CSPs should adopt and operate robust internal processes and methodologies and use appropriate data (CSPs may use their own data or data sourced from third parties). See Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 6(2)). Cf. UK FCA COBS, *supra* n. 259, at ss. 18.12.13R, 18.12.14R, 18.12.27R.

³³⁶ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 6(2).

³³⁷ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 6(2).

project owner or the contributor, including any deduction from the interest to be paid by the project owner.³³⁸

Providing contributors with updated (ex post) information on critical (risk/return) parameters affecting the performance of their portfolio is vital not only to ensure an adequate level of understanding and protection for lenders but also to facilitate lenders' monitoring over CSPs and to enhance market discipline. To this end, CSPs are required, on a continuous basis and upon the request of a contributor, to provide, via electronic means, at least the following information on each individual portfolio: (i) the list of individual loans of which a portfolio is composed; (ii) the weighted average annual interest rate on loans in a portfolio; (iii) the distribution of loans according to risk category, in percentage and absolute numbers; (iv) for every loan of which a portfolio is composed, key information, including at least an interest rate or other compensation to the investor, maturity date, risk category, schedule for the repayment of the principal and payment of interest, compliance of the project owner with that instalment payment schedule; (v) for every loan of which a portfolio is composed, risk mitigation measures including collateral providers or guarantors or other types of guarantees; (vi) any default on credit agreements by the project owner within the past five years; (vii) any fees paid in respect of the loan by the lender, the CSP or the project owner; (viii) if the CSP has carried out a valuation of the loan, the most recent valuation, the valuation date, an explanation as to why the CSP conducted the valuation, and a fair description of the likely actual return, taking into account fees and default rates.³³⁹

iii. Contingency Funds

Contingency funds which compensate payments to investors in the event of a borrower default are also subject to bespoke transparency requirements. The underlying rationale of the new requirements is to introduce transparency about the role of contingency funds and, thus, to protect contributors from falsely perceiving that such funds offer a guaranteed rate of return.³⁴⁰ Where a CSP operates a contingency fund for its activity related to the individual portfolio management of loans, it shall provide

³³⁸ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 24(1) in conjunction with Annex I, Part I. Responsibility shall rest *exclusively* with the CSP for: (i) keeping the “KIIS at platform level” updated at all times and for the duration of the crowdfunding offer; (ii) informing the contributors who have made an offer to invest in the crowdfunding offer about any material change to the information in the “KIIS at platform level”; and (iii) identifying and rectifying any material omission, mistake or inaccuracy in the “KIIS at platform level” (see Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 24(2), (4)-(7)).

³³⁹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 6(4). Cf. UK FCA COBS, *supra* n. 259, at ss. 18.12.27R(3)-(5), 18.12.31(2)-(10) and (12), 18.12.26(3)-(11). Particular emphasis needs to be placed on the requirement to disclose “*any default on credit agreements* by the project owner within the past five years [emphasis added]”; the wording suggests that disclosure is all encompassing thus also covering borrowers' default on *all and every crowdfunding credit agreement*. The same requirement also applies to all crowd-lending offers (see Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, Annex I-Part G, point (e)).

³⁴⁰ FCA CP 2018, *supra* n. 310, at s. 4.66.

the following information to the contributors: (i) a risk warning specifying that: ‘*The contingency fund we offer does not give you a right to a payment so it may happen that you do not receive a pay-out even if you suffer loss. The contingency fund operator has absolute discretion as to the amount that may be paid, including making no payment at all. Therefore, investors should not rely on possible pay-outs from the contingency fund when considering whether or how much to invest;*’³⁴¹ (ii) a description of the policy of the contingency fund;³⁴² and (iii) on a quarterly basis, the size of the contingency fund compared to the total amounts outstanding on loans relevant to the contingency fund, and the ratio between payments made out of the contingency fund to the total amounts outstanding on loans relevant to the contingency fund.³⁴³

iv. Evaluation of the Regime for Intermediated Crowdfunding Services

The introduction of bespoke rules to address the peculiarities of intermediated pricing and managing crowdfunding models has certainly been a very much welcomed development. However, the new regime falls short in a number of critical areas.

First, considering the diverse services that P2P platforms may offer, it is important that relevant information on the exact role that CSPs play in facilitating P2P agreements should be provided to potential contributors.³⁴⁴ Moreover, to enhance contributors understanding of the risks emanating from the intermediating role of CSPs, information should be disclosed on the particular risks to the management and administration of P2P agreements in the event of CSPs’ failure.³⁴⁵

Second, new rules should be introduced to ensure the continuity of P2P agreements where the intermediating CSPs’ solvency is threatened. To this end, CSPs’ should be required to adopt appropriate wind-down arrangements in order to ensure that P2P agreements facilitated by them will have a reasonable likelihood of being managed

³⁴¹ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 6(5)(a). Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.33R(1). The risk warning improves contributors understanding of the role of contingency funds and, most importantly, clarifies that CSPs operating contingency funds are not authorized as insurance companies (see FCA CP 2018, *supra* n. 310, at s. 5.87).

³⁴² Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 6(5)(b). Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.35R(2).

³⁴³ Council First Reading Position on Crowdfunding Regulation, *supra* n. 8, art. 6(6). Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.38R.

³⁴⁴ FCA CP 2018, *supra* n. 310, at s. 5.67. For example, such information may include a description of: the nature and extent of due diligence the CSP undertakes in respect of borrowers; a description of role the CSP will play in determining the price of a P2P agreement; an explanation of the role the CSP will play in assembling or managing a P2P portfolio (if the CSP offers a P2P portfolio to lenders); a description of the CSP’s procedure for dealing with a loan in late payment or default (see UK FCA COBS, *supra* n. 259, at s. 18.12.24R).

³⁴⁵ Such information may include information on: (i) the possibility that P2P agreements may cease to be managed and administered before they mature; (ii) the possibility that any person involved in the continued management and administration of P2P agreements after the CSP fails may not be subject to the same regulatory regime; and (iii) the likelihood that the majority of balances due to the lender are repayments yet to be made by borrowers rather than from the CSP itself (so if the CSP fails, a lender’s entitlement to any client money held by the CSP would not include those balances that the CSP has not yet received from borrowers). See UK FCA COBS, *supra* n. 259, at s. 18.12.28R(4).

and administered, in accordance with the contract terms if, at any time, the CSPs cease to manage and administer those P2P agreements.³⁴⁶ With a view to improve the effectiveness of wind-down arrangements CSPs should also adopt and keep up-to-date a manual containing information about their operations that would assist in resolving the platform in the event of its insolvency (resolution manual).³⁴⁷ Essentially, the arrangements on CSPs' wind-down and resolution would provide an even more advanced protection framework for contributors and would also enhance confidence in the crowdfunding market.

Third, the regulatory requirements that have been introduced for intermediated-pricing models should be enhanced along the following directions. To begin with, CSPs' risk management policy should set out the principal factors that will be taken into account in performing credit risk assessments.³⁴⁸ In addition, CSPs should classify project owners (borrowers) by their credit risk, taking into account the probability of default and the loss given default and set out the specific circumstances under which they will review the valuation of P2P agreements.³⁴⁹ Moreover, it should be explicitly stated that, to determine a fair and appropriate price for a P2P agreement, CSPs must *at least ensure* that the price is reflective of the risk profile of the loan and that time value of money and the credit spread of the P2P agreement have been considered.³⁵⁰

Fourth, in *intermediated pricing and managing crowdfunding models*, an early warning mechanism concerning borrowers' *forthcoming* default should be established. Clients/lenders should, at any point in time, receive relevant information where their CSP considers that the borrower *is unlikely to pay its obligations under the P2P agreement in full*. Such a disclosure on the *likelihood of borrowers' default* would serve as an advance note to contributors of the intensification of project owners' default risk.³⁵¹

Finally, the informational content of disclosures on contingency funds' operation should be heightened. More specifically, considering that CSPs enjoy the *discretion* to pay out from the contingency fund, they should also bear the responsibility for notifying contributors: (i) of the activation of the fund, (ii) if they receive payment from the fund, and (iii) for the exact amount paid to them.³⁵² Moreover, market practice reveals that CSPs may be inclined to use the existence of contingency funds in advertisements of past performance of P2P agreements, which is essentially mislead-

³⁴⁶ See UK FCA Senior Management Arrangements, Systems and Controls ("SYSC" hereafter), at ss. 4.1.8AR-4.1.8DAR.

³⁴⁷ See UK FCA SYSC, *supra* n. 346, at ss. 4.1.8DBR-4.1.8DDR. See also FCA CP 2018, *supra* n. 310, at ss. 5.61-5.63.

³⁴⁸ UK FCA COBS, *supra* n. 259, at ss. 18.12.10R.

³⁴⁹ UK FCA COBS, *supra* n. 259, at ss. 18.12.18R(2)(c) and (d).

³⁵⁰ UK FCA COBS, *supra* n. 259, at ss. 18.12.12R.

³⁵¹ Cf. FCA COBS, *supra* n. 259, at ss. 18.12.31R(11). See also FCA PS 2019/14, *supra* n. 327, at p. 28 ("*there is value in early disclosure of P2P loans that, while not contractually in default, are either non-performing or unlikely to be repaid without recourse by the firm to actions such as realising security. [...] Providing this disclosure [...] will give investors a clear picture of likely additional defaults, which could lead to losses.*").

³⁵² Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.37R(1)-(2).

ing and creates a false sense of security for potential contributors. It is necessary, therefore, to ensure that any information containing an indication of past performance is reflective of the *actual payments* received by lenders from borrowers under P2P agreements, excluding any payments made to lenders by contingency funds.³⁵³

6. Conclusion

In March 2018, the European Commission presented its Proposal for an EU Regulation on investment- and lending-based CSPs. Two years later, in July 2020, the Council of the European Union adopted its First Reading Position that fully reflects the political agreement reached with the European Parliament on 18 December 2019. The text that has been adopted by the Council of the European Union sets out an ambitious plan aiming at introducing a comprehensive regulatory regime concerning the provision of investment- and loan-based crowdfunding services both across the EU and at a purely national level, that is, regardless of whether such services are provided on a cross-border, EU basis or at a purely national-domestic level.

Building on a legal and economic analysis of the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs), this study critically discusses the new EU rules on crowdfunding and recommends workable solutions to improve their effectiveness and consistency. More specifically, the study reviews the Council of the European Union First Reading Position and contends that, while several weaknesses of the initial European Commission Proposal are efficiently addressed, certain regulatory requirements remain vague, ill-considered, and hasty. Notwithstanding the limitations of the Council of the European Union First Reading Position it should be recognised that it constitutes a much more thorough and at the same time balanced text than the original European Commission Proposal. Whether one could even go as far to say with confidence that the proposed EU Regulation on European Crowdfunding Service Providers (ECSPs) shall “*fulfil the objective of promoting the proper functioning of the internal market in crowdfunding services, enhancing investor protection as well as market efficiency, and contributing to establishing the Capital Markets Union*” remains to be seen.³⁵⁴ Considering, in particular, that a number of technical standards detailing several regulatory requirements of the proposed Regulation (most notably, with regard to individual portfolio management of loans, conflicts of interest, authorisation of CSPs, information to clients, default rate disclosure, the entry knowledge test and simulation of the ability to bear loss, and the KIIS) are to

³⁵³ Cf. UK FCA COBS, *supra* n. 259, at s. 18.12.39-18.12.40. See also FCA CP 2018, *supra* n. 310, at s. 4.66-4.71.

³⁵⁴ Council of the European Union, *Draft Statement of the Council’s Reasons – Position of the Council at First Reading With A View To The Adoption Of A Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers for Business, and Amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937* (6800/20 ADD 1, ECOFIN 188, Brussels, 13 July 2020), s. IV.

be developed by the ESMA and the European Banking Authority (EBA), it seems much wiser and accurate to state that there is still some way to go before fulfilling the dual objective of improving start-ups' and scale-ups' access to finance while maintaining an appropriate level of protection for funders.