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Dirk A. Zetsche/Christina D. Preiner

**Cross-Border Crowdfunding – Towards a
Single Crowdfunding Market for Europe**

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Cross-Border Crowdfunding
Towards a Single Crowdfunding Market for
Europe

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Cross-Border Crowdfunding
- Towards a Single Crowdfunding Market for Europe[◇]

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Abstract: Crowdfunding has experienced rapid growth in some EU Member States. However, home bias by investors and regulatory barriers prevent the crowd and the project from moving freely across borders. Crowdfunding has, for the most part, remained a phenomenon of those larger Member States that ‘draw a crowd’, with a population large enough to make a crowdfunding website an economically feasible undertaking. In turn, crowdfunding has remained a mainly national issue, prompting the European Commission to conclude that there is no need for a harmonization of crowdfunding rules in Europe.

In contrast to the European Commission’s Capital Market Action Plan, this paper takes the view that national limitations on crowd investing and crowd lending *de facto* are the result of limits *de iure*. Given that no European passport is tailor made or fits crowdfunding, this source of financing is doomed to remain national. Moreover, with different legal requirements in Member States, European law hinders the development of cross-border crowdfunding within the region. This is particularly true for smaller Member States whose populations are too small to constitute ‘a crowd’. This paper details how European regulators could facilitate a Single European Crowdfunding Market while limiting both the risks for investors and the regulatory burden for crowdfunding platforms and recipients. In light of the regulatory experience with other financial products and the segregating effect of product-based approaches, many of which exist in the EU/EEA Member States, we believe existing product regulation is insufficient to enable a European cross-border crowdfunding market. Instead, regulation based on the ‘MiFID light’ framework could function as basis for a cross-border

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crowdfunding manager passport, given the minimum protection it affords both investors and the financial system, and the low costs it imposes on the platform. Following the (1) too-small-to-care, (2) too-large-to-ignore, and (3) too-big-to-fail development path of FinTech business models, we suggest adding a relevance threshold of EUR250,000 in transaction volume to the MiFID light framework and imposing regulation to address systemic risk concerns for very large crowdfunding platforms that may arise in the future.

Keywords: Financial Regulation, Crowdfunding, FinTech, Crowdlending, Equity based Crowdfunding, Crowdinvesting, CRD IV, CRR, MiFID, MiFIR, UCITSD, AIFMD.

Overview

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I. Introduction

Crowdfunding - an outcome of the modern sharing economy¹ - has experienced rapid growth in *some* EU Member States, notably the UK, France, Germany, Italy and the Netherlands.² However, home bias by investors and regulatory barriers including different approaches by several Member States prevent crowd-funded projects and ‘the crowd’ from moving freely across borders. In turn, crowdfunding has remained a mainly national issue.³ For the most part, crowdfunding has remained a phenomenon of the larger Member States that can ‘draw a crowd’, specifically those with a large enough population to make a crowdfunding venture an economically feasible undertaking. There is a valid concern that cross-border crowdfunding –already being low in volume⁴ – is going to

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- ¹ See Vassilis Hatzopoulos & Sofia Roma, *Caring for Sharing? The Collaborative Economy under EU Law*, 54 COMMON MKT. L. REV. 81 (2017).
- ² See the summary of European Parliament — Crowdfunding in Europe - Introduction and State of Play (January 2017); European Commission, Crowdfunding in the EU Capital Markets Union, at 14, SWD 154 final (2016) (holding that “most platforms were located in the United Kingdom (143), followed by France (77) and Germany (65)”); Lars Klöhn, Lars Hornuf & Tobias Schilling, *The Regulation of Crowdfunding in the German Small Investor Protection Act: Content, Consequences, Critique, Suggestions*, 13:2 EUR. COMP. L. 57 (2016) (detailing growth for Germany).
- ³ The related concerns have been addressed by European and international policy bodies, see the review by ESMA, Opinion: Investment Based Crowdfunding, ESMA/2014/1378 (Dec.18, 2014) *available at* https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1378_opinion_on_investment-based_crowdfunding.pdf (last visited Oct.11, 2016); European Commission, Crowdfunding in the EU Capital Markets Union, SWD 154 final (2016), *supra* note 2, *available at* http://ec.europa.eu/finance/general-policy/docs/crowdfunding/160428-crowdfunding-study_en.pdf (last visited Oct.11, 2016) and EC, Crowdfunding: Mapping EU Markets and Events Study (30.9.2015) *available at* http://ec.europa.eu/finance/general-policy/docs/crowdfunding/20150930-crowdfunding-study_en.pdf (last visited Jul.8, 2016), on regulatory frameworks for CF; as well as IOSCO, Statement on Addressing Regulation of Crowdfunding (December 2015), *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD521.pdf> (last visited Oct.11, 2016); and IOSCO, Crowdfunding 2015 Survey Responses Report (December 2015), *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD520.pdf> (last visited Oct.11, 2016); IOSCO, Research Report on Financial Technologies (Fintech) (February 2017), *available at* <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf> (last visited May 14, 2017).
- ⁴ See European Parliament — Crowdfunding in Europe - Introduction and State of Play, at 5 (January 2017). Amount raised cross-border in 2013 represented 8,5% and 7,3%, cross-border being defined as location of the platform being in a different Member State than location of the project. We are not aware of data with regard to cross-border funding raising, i.e.

decline even further, in line with increased national legislation being put into place. Regulatory attention has thus shifted from initial curiosity to ensuring ‘that crowdfunding can be done seamlessly across borders.’⁵

We support that view. Drawing on the experience of other financial products, such as the early days of Undertakings for Collective Investment in Transferable Securities (UCITS), we take the view that Crowdfunding (‘CF’) can only reach its full potential if national regulatory regimes within the EU and EEA do not inhibit the use of crowdfunding platforms.

This paper focuses on commercial approaches to crowdfunding as investment, reward or peer-to-peer lending schemes.⁶ Donation-based or charitable crowdfunding is out of scope. While the literature has focused on crowdfunding economics,⁷ its benefits for financing small innovative ventures and the associated risks for investors,⁸ this paper takes up the mission of

location of the platform being located in different Member States than location of investors.

- ⁵ See European Parliament — Resolution of 26 May 2016 on the Single Market Strategy ([2015/2354\(INI\)](#)), at 21. In turn, the European Commission has initiated a study on cross-border crowdfunding in Europe.
- ⁶ Other forms include donation-based crowdfunding, where people donate for a specific charitable project, rewards-based models, where investors provide funding in form of a donation and expect to receive non-financial rewards or goods in exchange.
- ⁷ Lars Hornuf & Armin Schwienbacher, *Funding Dynamics in Crowdfunding* 5 (2015), available at <http://ssrn.com/abstract=2612998>; Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons*, 100 MINN. L. REV. 561, 569 (2015); Gmeleen Faye B. Tomboc, *The Lemons Problem in Crowdfunding*, 30 J. MARSHALL J. INFO. TECH. & PRIVACY L. 253, 256 (2013-2014); A. Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, U. ILL. L. REV. 217, 224 (2015); Ajay Agrawal, Christian Catalini & Avi Goldfarb, *Some Simple Economics of Crowdfunding*, 14 INNOV. POL. & ECON. 63, 74 (2014); See Klöhn, Hornuf & Schilling, *supra* note 2 at 56–66; C. Steven Bradford, *Regulating Investment Crowdfunding: Small Business Capital Formation and Investor Protection*, ZBB, 376, 377 (2015); See also Ricarda B. Bouncken, Malvine Komorek & Sascha Kraus, *Crowdfunding: The Current State Of Research*, 14 INT’L. BUS. & ECON. RES. J. 3, 407 (2015).
- ⁸ Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the Crowd*, 38 VT. L. REV. 827, 831 (2014); Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws - Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N. C. L. REV. 1735, 1737 (2011-12); Jorge Pesok, *Crowdfunding: A New Form of Investing Requires a New Form of Investor Protection*, 12 DARTMOUTH L.J. 146, 149 et seq. (2014); Andrew C. Fink, *Protecting the Crowd and Raising Capital through the Crowdfund Act*, 90 U. DET. MERCY L. REV. 1, 8, 31 (2012-2013).

the EC's Capital Market Union action plan⁹ and reviews the steps that are necessary to develop a true cross-border market for crowdfunding in Europe. A true cross-border crowdfunding market has two dimensions: projects in one Member State may be funded via platforms located in different Member States, and investors will also examine platforms and projects in other Member States. If this occurs, risk for funding innovative businesses may be spread across Europe while potential demand may be maximized.

The paper is structured as follows: Part two will summarise the discussion to date and will highlight the importance of cross-border crowdfunding, unlocking its potential to close the seed funding gap for European enterprises. Part three outlines options for regulation implementation, regulation of the product, sales and distribution, and manager regulation. We argue that manager regulation is most suited to facilitating a Crowdfunding Capital Markets Union as it retains an open approach to innovation while mitigating the agency risks imposed on investors and funded enterprises when using a crowdfunding platform. Taking into account that European financial law underwent a significant expansion over the last ten years, part four proposes a pan-European crowdfunding regime based on Article 4 (1) No. 2 (c) CRR, an often overlooked exemption for small financial intermediaries based on the MiFID framework. With small modifications, a European passport based on the 'MiFiD light' rules referred to in Article 4 (1) No. 2 (c) CRR could close the circle (or more precisely: the triangle) in furthering a single European capital market, protecting investors and keeping down costs for intermediaries, funded firms and investors.

II. Regulating crowdfunding

The market for crowdfunding across Europe is fragmented and diverse and includes more than 500 platforms. The crowd may donate, invest, lend or buy, or they may expect non-financial rewards.¹⁰ The common denominator in the investment, reward or peer-to-peer lending schemes that this paper focuses on is the participation of a large number of funders who grant modest individual contributions gathered via the internet and who expect

⁹ European Commission, Action Plan on Building a Capital Markets Union, at 7, COM (2015) 468 final (Sept. 30, 2015). The CMU action plan builds on the Commission's previous work, in particular European Commission, Consultation Document: Crowdfunding in the EU- Exploring the Added Value of Potential EU Action (Oct. 3, 2013), *available at* http://ec.europa.eu/finance/consultations/2013/crowdfunding/docs/consultation-document_en.pdf (last visited Oct. 11, 2016) leading to the EC, Communication: Unleashing the Potential of Crowdfunding in the European Union, COM (2014) 172 final (March 27, 2014).

¹⁰ European Commission on Crowdfunding in the EU Capital Markets Union, *supra* note 2, at 8 et seq. (identifying 8 different categories); see also Simone Baumann, *Crowdinvesting im Finanzmarktrecht*, 8 et seq. (2014).

a return on their investment.¹¹ A platform that, as a minimum, provides the online infrastructure and some basic information on the activities to be funded, mediates between the project and the crowd. Although a platform is not necessary for collecting capital via crowdfunding, its use is common.¹²

The concept is driven by the idea of collective intelligence.¹³ Crowdfunding promises to democratise financing processes and create a level playing field for competing ideas. The judgement of the ‘swarm’ is deemed to be as wise as that of professional asset managers, investors or creditors. While collecting funds from a large number of people is not innovative per se – we find the same approach has been used by honest entrepreneurs, fraudsters and creators of Ponzi schemes for hundreds of years¹⁴ –, the innovative aspect of crowdfunding is the use of the internet, essentially social media, as a marketing and communication tool.

In this section, we argue that crowdfunding creates certain benefits. These benefits, however, do not justify an exemption from financial law altogether given that all established objectives of European financial law¹⁵ apply: investor protection, systemic risk prevention, stakeholder protection and facilitation of a single European market for financial services.

1. Benefits of crowdfunding

Europe is in desperate need of growth, and SMEs are at the core of economic growth and employment. Although SME access to finance has improved significantly, it remains one of the most pressing challenges in furthering economic growth and innovation.¹⁶ Between 54%-75% of external SME finance is

¹¹ Fink, *supra* note 8, at 9; Sharon Yamen & Yoel Goldfeder, *Equity Crowdfunding – A Wolf in Sheep’s Clothing: The Implication of Crowdfunding Legislation under the JOBS Act*, 11 INT’L L. & MGMT. REV. 41, 57 (2015).

¹² Baumann, *supra* note 10, at 21 et seq.

¹³ See most prominently James Surowiecki, *The Wisdom of Crowds: Why the Many Are Smarter Than the Few and How Collective Wisdom Shapes Business, Economies, Societies and Nations* (2005).

¹⁴ See Dirk A. Zetsche, *Prinzipien der kollektiven Vermoegensanlage* (transl. Principles of Collective Investments) 275-431 (2015).

¹⁵ For a discussion see Dirk A. Zetsche, *Anatomy of European Investment Funds Law* at III, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2951681; Dirk A. Zetsche, *Investment Law as Financial Law: From Fund Governance over Market Governance to Stakeholder Governance?*, 339, in THE EUROPEAN FINANCIAL MARKET IN TRANSITION, (S. Birkmose, M. Neville & K.E. Sørensen eds., 2012).

¹⁶ See ECB — Survey on the Access to Finance of Enterprises in the Euro Area, at 6 (October 2015 to March 2016, June 2016), available at

sourced from bank loans, while market-based finance is under-represented.¹⁷ Market-based finance finds itself in the midst of the EU Plans for establishing a European Capital Markets Union.¹⁸

Crowdfunding's focus is on financing of SMEs and emerging Start-ups. Financing of innovative ideas is difficult. Bank financing is barely accessible due to high information asymmetries and typically a lack of collateral.¹⁹ Financing by angel investors or seed venture capital financing is scarce. Venture capitalists turn down as much as 99% of the projects proposed to them.²⁰ Often the entrepreneur's family and friends step in. Rather than the quality of the business concept, successful seed financing often depends on geography, networks or gender.²¹

Crowdfunding, in particular peer-to-peer lending and equity funding, effectively channels funds from households to those parts of the economy that are not served by traditional financiers, providing funding for projects that may otherwise not be financed.²² Compared to other forms of market-based finance,

<https://www.ecb.europa.eu/stats/money/surveys/sme/html/index.en.html>,
(last visited Oct.19, 2016).

- ¹⁷ For 54% see ECB Survey, *supra* note 16, at 13. See also SWD 154 final (2016), *supra* note 2, at 3 (“Access to finance for young, innovative firms is a problem even in countries where access to bank finance has remained stable throughout the crisis. Thanks to their strong local networks and relationships, banks will continue to provide the majority of funding to SMEs. However, only 41% of all SMEs in the EU perceive no limitations in their access to future financing. To complement bank financing, the CMU Action Plan seeks to strengthen the different sources of alternative finance, including crowdfunding”); for 75 %, see European Commission (EC), Action Plan on Building a Capital Markets Union, *supra* note 9, at 7.
- ¹⁸ See European Commission (EC) — Action Plan on Building a Capital Markets Union, *supra* note 9; Capital Markets Union: First Status Report, SWD 147 final (April 25, 2016) and subsequently SWD 154 final (2016), *supra* note 2.
- ¹⁹ Tomboc, *supra* note 7, at 256 et seq.
- ²⁰ *Id.* at 256.
- ²¹ Hurt, *supra* note 7, at 224; Ibrahim, *supra* note 7, at 561 et seq.; Heminway *supra* note 8, at 832.
- ²² Eleanor Kirby & Shane Worner, *Crowd-funding: An Infant Industry Growing Fast* (IOSCO Research Department, Staff Working Paper, SWP 3/2014), 21 et seq. available at <http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>; Baumann, *supra* note 10, at 44 et seq.; Tomboc, *supra* note 7, at 259-260; Michael Nietsch & Nicolas Eberle, *Bankaufsichts- und prospektrechtliche Fragen typischer Crowdfunding-Modelle*, 1788, 1789, DB (2014); EC, Action Plan on Building a Capital Markets Union, *supra* note 9, at 4, 5 and 7; Report A8-0222/2016 of the European Parliament on Access to Finance for SMEs and Increasing the Diversity of SME Funding in a Capital Markets Union, at 14 (June 29, 2016).

crowdfunding creates new investment opportunities while at the same time spreading the risk among a target group of investors that may otherwise have been reluctant to invest. The bridging of these financing gaps is in the interest of the overall economy. Given that small- and medium-sized enterprises provide the majority of jobs and innovation, crowdfunding may foster growth in the European economy.²³

Crowdfunding subjects the business concept to a ‘crowd test’. An entrepreneur needs to ‘sell’ their idea to a crowd of financiers. Certain intuitive ideas that may be hard to sell to professional investors may find support from the crowd. This is particularly true for consumer-related projects with a strong emotional appeal, or for those whose appeal is limited to particular peer groups.

From an investor’s point of view, crowdfunding may serve as a new tool for diversification. If the administration costs of a virtual platform are lower than those of traditional forms of financing, crowdfunding may also reduce the financing costs of the borrower. If the crowdfunding investor is shareholder in the crowdfunded entity, they may receive increased investment returns. Further, higher competition among crowdfunding providers may unlock innovation and lower costs, and may also promote increased efficiency among traditional finance providers.²⁴

With regard to new business, we note a divide between private and public returns: Most start-ups fail, leaving seed financiers out of pocket. However, even businesses that fail provide some benefit to society, through the knowledge generated, jobs created and social security levies paid for a certain period of time. Regulators around the world thus seek to promote the establishment of new businesses.

2. Objectives of financial law

The imposition of financial law, in general, is justified by investor protection, market function and stakeholder concerns.²⁵

²³ EC, Action Plan on Building a Capital Markets Union, *supra* note 9, at Introduction, 4 and 7; Also fostering economy in general, see Kirby & Worner, *supra* note 22, at 21 et seq.

²⁴ Kirby & Worner, *supra* note 22, at 22; EC, Action Plan on Building a Capital Markets Union, *supra* note 9, at Introduction and 4.

²⁵ Zetzsche, in THE EUROPEAN FINANCIAL MARKET IN TRANSITION, *supra* note 15, at 343.

a) *Investor protection*

If investor protection concerns justify regulation of crowdfunding, this could increase the attraction of a particular location for FinTech operations.²⁶

(1) Investment, information and agency risk

While all investors hope that crowdfunding might kick-start a significant innovation, in most cases it will lead to a financial loss for the crowdfunders.²⁷ From an investor's or funder's perspective, all financial contracts suffer from inherent uncertainty, potential opportunism and agency costs.²⁸ Funders expecting rewards and returns face investment risk, information asymmetries²⁹ and agency risk in the form of possible fraud,³⁰ negligence or incompetence on the part of both the platform provider and the entrepreneur. Many crowdfunded investments to date lack liquidity³¹; investors may not necessarily be able to sell them in liquid secondary markets.³² This is in addition to any risk created by the investment's legal structure. For instance, crowdfunding investors could find their investment and influence on the entrepreneur becomes diluted by the entry of

²⁶ See, from a bird's eye perspective Mark Fendrick, Joseph A McCahery, Erik P.M. Vermeulen, *Fintech and the Financing of Entrepreneurs: From Crowdfunding to Marketplace Lending* 31-34 (May 12, 2017). Available at SSRN: <https://ssrn.com/abstract=2967891> (last accessed 29 May 2017).

²⁷ Klöhn, Hornuf & Schilling, *supra* note 2, at 58 (listing 22 insolvency cases while only in 4 cases investors were offered a premature exit at a premium to their entry price for the German Market). See SWD 154 final (2016), *supra* note 2 at 15-16.

²⁸ Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076 (2003).

²⁹ Aurélie Sannajust, Fabien Roux & Anissa Chaibi, *Crowdfunding In France: A New Revolution?*, 30 J. APP. BUS. RES. 6, 1919, 1923 (2014).

³⁰ See Ajay Agrawal, Christian Catalini & Avi Goldfarb, *supra* note 7 at 76 et seq (2014).

³¹ See also Anja Hagedorn and Andreas Pinkwart, *The Financing Process of Equity-Based Crowdfunding: An Empirical Analysis*, in CROWDFUNDING IN EUROPE: STATE OF THE ART IN THEORY AND PRACTICE 71 (Brüntje and Gajda, eds., 2016).

³² See also ESMA, *supra* note 3, at 11; The European Commission, *Crowdfunding in the EU Capital Markets Union*, *supra* note 2, at 14 (describing some concepts of emerging yet illiquid secondary markets).

additional investors.³³ Also, platforms³⁴ or entrepreneurs³⁵ may prove economically unviable and may file for insolvency.

The risks are exacerbated by the fact that crowdfunding is used by start-ups and emerging SME businesses.³⁶ The associated investment risk, level of information asymmetry and uncertainty regarding the viability of a project (for example an emerging technology) are all significant.³⁷ Also, the most promising start-ups may receive funding from other sources, such as venture capital funds or corporate incubators, leaving second-best investments for crowdfunders.³⁸ Finally, transferability of acquired rights is limited.³⁹ These risks are nevertheless not unique to crowdfunding, and have justified regulatory

³³ See also EC, Consultation Document — Crowdfunding in the EU- Exploring the Added Value of Potential EU Action, at 7 et seq. (Oct. 3, 2013); See also ESMA, *supra* note 3, at 11 and Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 J. CORP. L. 493, 516 (2013-2014).

³⁴ Examples of platforms that went insolvent include Emphas.is with a debt load exceeding 300,000 BPD *available at* <https://insolvencyguardian.com.au/blog-view/crowdfunding-platform-emphasis-goes-insolvent-490580/>.

³⁵ See for instance the list of insolvencies of crowd-funded German businesses *available at* <http://crowd-investment.de/crowd-pleiten/> (last visited May 14, 2017); A series of high profile insolvencies has prompted the call for adequate regulation in England, see the letter by the Chairman of the Treasury Committee Andrew Thierry to Tracey Mc Dermott, head of the Financial Conduct Authority ('FCA'), of 1 June 2016, *available at* <http://www.parliament.uk/documents/commons-committees/treasury/01062016-Chairman-to%20FCA.pdf> (last visited May 14, 2017); In turn, the FCA warns on its website "Due to the potential for capital losses, we regard investment-based crowdfunding in particular to be a high-risk investment activity. ... It is very likely that you will lose all your money. Most investments are in shares or debt securities in start-up companies and will often result in a 100% loss of capital as most start-up businesses fail." *available at* <https://www.fca.org.uk/consumers/crowdfunding> pdf (last visited May 14, 2017); More and more regulators worldwide recognize the necessity to require intermediaries to pursue bankruptcy checks on issuers, see ASIC, *Crowd Sourced Equity Funding Report May 2014*, *available at* http://www.tresscox.com.au/icms_docs/266454_crowd-sourced-equity-funding-report-2014.pdf (last visited May 14, 2017).

³⁶ International Organization of Securities Commissions on IOSCO Research Report on Financial Technologies (Fintech), at 11, (Feb. 2017), *available at* <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf>.

³⁷ See also ESMA, *supra* note 3, at 8, ¶18 et seq.; Hornuf & Schwienbacher, *supra* note 7, at 6; Nietsch & Eberle, *supra* note 22, at 1789; Fink, *supra* note 8, at 16; Kirby & Worner, *supra* note 22, at 45 et seq.; Ibrahim, *supra* note 7, at 573; on information asymmetry in the SME context, see Gilson, *supra* note 26, at 1077.

³⁸ Nietsch & Eberle, *supra* note 22, at 1789.

³⁹ ESMA, *supra* note 3, at 8, ¶19; Hornuf & Schwienbacher, *supra* note 7, at 6; Agrawal, Catalini & Goldfarb, *supra* note 7, at 68.

intervention in other cases. So why not regulate crowdfunding in a similar manner?

(2) The 'crowd' as false friend

Promoters of unregulated crowdfunding refer to the mechanics of the internet: Social media elements in the funding process should facilitate the flow of information between the respective sources of supply and demand. A greater sense of engagement and participation⁴⁰ may reduce transaction costs. Social media may also facilitate funder education, and exchanges of information regarding lessons learned could take place rapidly. In turn, the theory of collective intelligence suggests that regulators should not 'police the crowd,' the crowd is able to fend for itself.⁴¹

However, a closer look reveals the crowd to be a false friend. Insights from behavioural finance contradict the notion of the crowd's wisdom: Crowds may act irrationally, exhibiting 'lemming-like' behaviour⁴². Evidence from existing platforms indicates the incidence of herding.⁴³ Specifically, investors are found to be overoptimistic.⁴⁴ The quality of social media information is also uncertain, as its impact value can be watered down by biased comments, and its distribution is for the most part erratic. The same is true for comments and discussion as innovative features of a crowdfunding platform. Investors seem to be influenced by supposed fellow investors, who comment positively on the platform.⁴⁵ Funders are more likely to invest in projects that have reached a high percentage of the funding goal.⁴⁶ Crowdfunders may fund projects based on emotion or personal preferences; with the profitability and success

⁴⁰ European Commission on Consultation Document: Crowdfunding in the EU- Exploring the Added Value of Potential EU Action, at 7 (Oct. 3, 2013) available at http://ec.europa.eu/finance/consultations/2013/crowdfunding/docs/consultation-document_en.pdf.

⁴¹ Fink, *supra* note 8, at 31.

⁴² Heminway, *supra* note 8, at 837.

⁴³ The later funders' decision may rely on the decision and characteristics of early funders, See Paul Belleflamme, Nessrine Omrani & Martin Peitz, *The Economics of Crowdfunding Platforms*, at 32 et seq. (Center for Operations Research and Econometrics (CORE), 15 Discussion Paper, 2015) available at https://www.researchgate.net/profile/Paul_Belleflamme/publication/273850822_The_Economics_of_Crowdfunding_Platforms/links/5513f4270cf283ee08349a36.pdf.

⁴⁴ Agrawal, Catalini & Goldfarb, *supra* note 7, at 66.

⁴⁵ Hornuf & Schwienbacher, *supra* note 7, at 11 et seq.; Fink, *supra* note 8, at 31.

⁴⁶ Agrawal, Catalini & Goldfarb, *supra* note 7, at 66; also Hornuf & Schwienbacher, *supra* note 7, at 12; Tomboc, *supra* note 7, at 269.

probability of the funded project relegated to secondary importance.⁴⁷ Also, funders may overestimate the level of due diligence conducted by the platform. The platform's appearance may instil an unwarranted level of trust by investors.⁴⁸

Data suggest that the use of information by funders is most likely irrational. The crowd is constituted by what financial regulation refers to as 'the public': a high number of non-professional retail investors. Via online channels, platforms are able to reach a new clientele not tapped by the financial services industry thus far, namely young professionals with a high affinity towards technology and generally limited investment experience.⁴⁹ Investors usually do not leave their homes to invest and tend to receive no advice prior to investment. It is doubtful that this crowd of 'couchfunders' is able to undertake the neutral processing and valuation of information that a diligent credit or investment decision requires.⁵⁰ For the most part, funders lack basic experience with venture capital financing and the funded technologies.⁵¹ Even with neutral information in their hands, few will be able to draw correct conclusions. Even if they are, lock-in effects could force them to readjust their preferences. Some of these effects may be instilled by the crowd (or some of its members). Investors finding themselves locked into an unviable investment may try to maintain its value by talking it up on social media so that other crowdfunders inject further funds at unjustified pricing levels.

With regard to the traditional distribution of financial instruments, the phenomenon of talking up investments is well known within, and is addressed by, financial law. For instance, for publicly traded assets, Article 14 and Annex I Market Abuse Regulation 2014/596/EU prohibit market manipulation by virtue of inadequate information being distributed to the public. Conflict of interest rules imposed by the Market in Financial Instruments Directive (MiFID), the Directive on Alternative Investment Fund Managers (AIFMD) and the Directive on Undertakings for Collective Investment in Transferable Securities (UCITD) prevent asset and fund managers from talking up, front running, and dumping assets into funds they

⁴⁷ Agrawal, Catalini & Goldfarb, *supra* note 7, at 68; Nietsch & Eberle, *supra* note 22 at 1789.

⁴⁸ See also ESMA, *supra* note 3, at 11; discussing the potential civil law consequences; see Nietsch & Eberle, *supra* note 22 at 1792 et seq.

⁴⁹ Heminway, *supra* note 8, at 832; Hazen, *supra* note 8, at 1766; also Fink, *supra* note 8, at 8, 31 (finding that crowdfunders stem from various social groups, are very heterogeneous and not necessarily acquainted to the world of venture capital and risky investments).

⁵⁰ Sceptical also Tomboc, *supra* note 7, at 268; Hazen, *supra* note 8, at 1737; Nietsch & Eberle, *supra* note 22 at 1789.

⁵¹ Ibrahim, *supra* note 7, at 574 et seq.

manage⁵² – an action which is similar to the fund platform selling unsuccessful business models to the crowd. If crowdfunding is out of scope of financial law, potential funders are left vulnerable.

In short, the ‘wisdom of the crowd’ proposition is similar to libertarian theory, which holds that markets are most effective without any regulatory intervention. From an investor protection perspective, the call for unregulated crowdfunding based on the intelligence of the crowd sounds like a proposed revival of the *laissez faire* approach of the 1920s. If the libertarian theory held true, we could forego all financial regulation. However, regulators have taken a different view as almost 100 years of financial regulation demonstrate.⁵³

b) Systemic risk prevention

Presently, the overall financing volume of crowdfunding platforms is low.⁵⁴ Applying the ‘too-big-to-fail’ (TBTF) rationale, we have little reason to regulate. Further, if primarily retail investors participate in crowdfunding, the ‘too-connected-to-fail’ rationale does not justify regulation of crowdfunding.

However, the institutionalisation of crowdfunding is an emerging trend. Data gathered by the European Commission indicates increasing professional investment in crowdfunded assets.⁵⁵ Over the past few years, crowdfunding has attracted a rising number of institutional investors, either as funders or as direct investors in crowdfunding platforms.⁵⁶ Under the

⁵² See Article 23 MiFID II, Article 12.1(b) UCITS as well as Article 12.1(d) AIFMD.

⁵³ For example the peer-to-peer lending, where crowdfunding provides only 0,02 % of the bank originated credit, see Kirby & Worner, *supra* note 22, at 33.

⁵⁴ We only state here that the rationale of financial law applies. This does not exclude that some rules are superfluous or too burdensome, but this is a question of which financial law applies to which conduct.

⁵⁵ See European Commission, *Crowdfunding in the EU Capital Markets Union*, *supra* note 2, at 13 (“A growing trend that is expected to become more prominent in the future is the institutionalisation of crowdfunding, notably in terms of the investors. This trend is supported by a recent study which found that 45% of platforms in the United Kingdom reported institutional involvement, compared to 28% in 2014 and just 11% in 2013. Institutional involvement is particularly strong in consumer loans crowdfunding, while in equity-based crowdfunding a growing number of venture capital and angel investors are co-investing alongside or in parallel with ‘crowd investors’. The ‘institutional investor’ category is quite broad and includes banks, mutual funds, hedge funds, pension funds, asset management companies, but also local authorities and national development banks.”).

⁵⁶ See Report of Cambridge Centre for Alternative Finance in partnership with KPMG and CME Group Foundation on *Sustaining Momentum*, The 2nd European Alternative Finance Industry Report, at 20 and 41 (September 2016) *available at*

assumption of transparency, these investors may be able to protect themselves. However, the more active professional investors become in this market, the more the TCTF rationale justifies regulation.

In addition, given the current growth rate of crowdfunding⁵⁷ the TBTF objective may justify regulation in the near future.

Finally, crowdfunding platforms compete with heavily regulated intermediaries. Regulation imposes costs. Intermediaries without regulation can grow faster than regulated ones, as they have a larger share of their returns available for growth rather for maintenance of their businesses. At the same time, the level of protection provided to retail funders is low. All in all, the position of regulated ‘well-governed’ intermediaries and their regulators is weakened as business is shifted to unregulated entities.⁵⁸ Even worse, without any regulation in place, regulators are unable to observe transaction volumes and the trading conduct of crowdfunding platforms.⁵⁹ Money laundering

<https://assets.kpmg.com/content/dam/kpmg/nl/pdf/2016/sector/financial-services/sustaining-momentum-the-2nd-european-alternative-finance-industry-report.pdf> (“Institutionalisation took off in mainland Europe in 2015 with 26% of peer-to-peer consumer lending and 24% of peer-to-peer business lending funded by institutions such as pension funds, mutual funds, asset management firms and banks. 8% of the investment in equity-based crowdfunding was also funded by institutional investors such as venture capital firms, angels, family offices or funds. Excluding the UK, 44% of the surveyed European platforms reported some level of institutional funding in 2015 and just under 30% of peer-to-peer consumer lending platforms reported having a majority institutional shareholder (e.g. a VC, corporate or a bank)”).

⁵⁷ *Id.* at 20 (finding that in 2015 the European online alternative finance market - including inter alia crowdfunding and peer-to-peer lending -, grew by 92%); Kirby & Worner, *supra* note 22, at 35 et seq. (estimating that peer-to-peer lending could reach up to \$70 billion until 2019); European Commission, *Crowdfunding: Mapping EU Markets and Events Study*, at 75 (Sept. 30, 2015) (speaking of a rapidly evolving crowdfunding market in the EU).

⁵⁸ The same argument applies to other ‘digital’ business models that target financial services markets. See Dirk A. Zetsche, Ross P. Buckley, Douglas W. Arner & Janos Nathan Barberis, *From FinTech to TechFin: The Regulatory Challenges of Data-Driven Finance* (European Banking Institute Working Paper Series No. 6, 2017) available at <https://ssrn.com/abstract=2959925>.

⁵⁹ This is the difference between debt funds and crowdfunding platforms. Debt funds are subject to European regulation (Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers, hereafter “AIFMD”). European regulators and ESMA in particular have insight into and may interfere in the debt fund market. They cannot interfere in the crowdfunding markets.

may also be a concern,⁶⁰ as crowdfunding could well be a form of ‘shadow funding.’

c) Stakeholder protection

In European financial law, stakeholder concerns relating to the protection of SMEs have been used as a justification for regulation.⁶¹ These concerns apply to crowdfunding as well. For instance, several target companies have had to share their intellectual property with a platform provider as a pre-condition for funding, or have had to enter into onerous contracts that potentially hamper the SME’s future growth.⁶² Upon the platform provider’s insolvency, entrepreneurs could find themselves in a difficult position if the platform has diverted investors’ funds⁶³ or if the start-up is otherwise entangled in the platform’s insolvency. Disentangling the relationship between an insolvent platform and an SME may be costlier than the SME may be able to afford.

An SME’s dependency on a platform may also be a reason for concern. In essence, the platform functions as the SME’s sole investment bank. The platform provider may impose its own fee-driven interests upon the firm. For instance, it could press the SME to acquire another firm funded by the platform, or forego business opportunities taken up by other platform-funded firms, or make additional funding dependent on egregious fees. Again, all of this is not new. Financial law deals with these issues in various ways, including takeover, fair dealing and conflict of interest rules. Conflict of interest rules require intermediaries to avoid conflicts in the first place, or to manage conflicting interests with regard to the interests of all parties concerned. While some regulators have imposed mandatory rules on crowdfunding platforms⁶⁴ with these objectives in mind, we are

⁶⁰ See European Commission, *Unleashing the Potential of Crowdfunding in the European Union*, *supra* note 9, at 5.

⁶¹ See on the stakeholder orientation of European financial law, Dirk A. Zetzsche, in *THE EUROPEAN FINANCIAL MARKET IN TRANSITION*, *supra* note 15, at 339 (citing arts 25 et seq. AIFMD as example).

⁶² See Garry. A Gabison, *Understanding Crowdfunding and Its Regulation: How Can Crowdfunding Help ICT Innovation?* (European Commission, Joint Research Centre Institute for Prospective Technological Studies, JRC Science and Policy Report 16, 2015), *available at* <http://publications.jrc.ec.europa.eu/repository/bitstream/JRC92482/lbna26992enn.pdf>; Tomboc, *supra* note 7, at 268.

⁶³ Tomboc, *supra* note 7, at 268 et seq.

⁶⁴ See ASIC, *supra* note 33, at 21 et seq. (detailing the approaches of the UK, New Zealand, Canada and the U.S. on conflicts of interests). Under the Australian Corporations Act 2001, as amended by the Australian Corporations Amendment (Crowd-sourced Funding) Act 2017 (No 17/2017), the conflicts rules applicable to financial intermediaries apply to crowdfunding responsible intermediaries.; IOSCO, *Research Report on Financial Technologies (Fintech)*, *supra* note 34, at 31 § 3.4.(i) 2. IOSCO

not aware of a similar *market* standard in the crowdfunding world.

3. Promoting a Single Market for crowdfunding

The European Union was established as an economic union under the premise of a free, borderless, single market. The Treaty of the Functioning of the European Union (one pillar of the EU's 'constitution') defines integration into a single market as the main goal of EU policy.⁶⁵ In contrast, although the internet is international in nature and crowdfunding platforms may be accessed from all around the world, crowdfunding platforms operate for the most part from the UK, followed by France and Germany,⁶⁶ and most of the time focus on projects located in their home country. Cross-border crowdfunding where a platform and funded project each reside in different EU/EEA Member States is rare, amounting to just 7.3% of the amount raised in 2014.⁶⁷ Cross-border equity crowdfunding is even more limited, accounting for only EUR1.8m out of a total EUR104.8m in 2014 (< 1,3%).⁶⁸ However, in a truly European crowdfunding market, not only shall the investment side of crowdfunding, but the investors as well shall be spread across borders. Due to the nature of crowdfunding as an internet phenomenon, this should be the easiest of exercises. And yet, cross-border fund raising is still hampered by additional legal⁶⁹ and tax barriers. In particular, crowdfunding takes different legal forms and is subject to different regulation in various EU/EEA member states.

Platform providers are burdened with a plethora of additional rules when crossing borders. Divergent rules on crowdfunding in member states unsurprisingly hamper rather than promote cross border activity.⁷⁰ While a lot of market participants wish to cross borders, they are being deterred by a lack of information about applicable rules and high costs of multiple authorisations

emphasizes risks regarding to retail trading over investment platforms, in particular risks resulting from conflicts of interest and insufficient cost and fee transparency.

⁶⁵ Cf. Art. 26 TFEU, O.J. (C326) 1-390 of 26 October 2012.

⁶⁶ 510 crowdfunding platforms were active in the EU in 2014, 8 of them being non-EU platforms, see European Commission (EC) on Crowdfunding: Mapping EU Markets and Events Study, *supra* note 54, at 21 et seq.

⁶⁷ European Commission (EC) on Crowdfunding: Mapping EU Markets and Events Study, *supra* note 54, at 29.

⁶⁸ *Id.* at 40.

⁶⁹ See European Commission, Communication, *supra* note 57, at 5 et seq. 9 (mentioning the Directive on Unfair Contract Terms, IP law and the Anti-Money Laundering legislation).

⁷⁰ See European Commission, Crowdfunding: Mapping EU Markets and Events Study, *supra* note 54, at 75.

in different member states.⁷¹ In particular for platforms from smaller countries, cross-border access is vital, both in terms of projects and funding. In order to establish a truly European capital market and strengthen alternative sources of finance for SMEs⁷², facilitation of cross-border SME financing is crucial.

The regulatory objective in facilitating a single market is different from the respective perspective of investors, the financial system and stakeholder protection. While the former justifies restrictions, the promotion of a single crowdfunding market justifies some liberation. The prevailing method of facilitating single market access in financial law is, however, the European passport. The European passporting system is built on the presumption that the passported activity is at its core a regulated activity, which means a license is necessary *prior* to taking up the activity in the entity's home market. The license is issued subject to several preconditions, which we discuss in the next section. However, one aspect is noteworthy. Without regulation, the Member States where the financial services are distributed (i.e. where the funders reside) bear the risks while the benefits accrue to the intermediary's home Member State. Risk asymmetry over time is unbearable for the distribution states. In turn, minimum harmonization aimed at a suitable level of protection for the host Member States' investors, financial systems and stakeholders is a precondition for providing any financial services across borders.⁷³ This rationale applies in particular to the regulation of crowdfunding.

III. Towards platform regulation

Several policy bodies have promoted crowdfunding regulation in Europe. In particular, the ESMA has identified six key components of a suitable regulatory approach to crowdfunding.⁷⁴ These components are:

- Safeguards to ensure operational continuity, such as a minimum capital level proportionate to the platform's business model;
- A mechanism to ensure the appropriateness of the instruments offered to investors;

⁷¹ European Commission, Communication, *supra* note 57, at 8.

⁷² European Commission, Communication on Action Plan on Building a Capital Markets Union, *supra* note 9.

⁷³ For a detailed discussion see Dirk A. Zetsche, *Competitiveness of Financial Centers in Light of Financial and Tax Law Equivalence Requirements*, in RETHINKING GLOBAL FINANCIAL LAW AND ITS REGULATION 390-418 (R. Buckley, D. Arner & E. Avgouleas eds., 2016); Dirk A. Zetsche, *The Anatomy of European Investment Fund Law*, *supra* note 15, at III.2; Douglas W. Arner & Dirk A. Zetsche, *Cross-Border Financial Services – The Example of Investment Funds* – forthcoming.

⁷⁴ ESMA, *supra* note 3, at 11 et seq.

- A mechanism to ensure that investors are aware of the associated risks;
- Segregation of client assets in case of platform insolvency;
- Rules concerning the governance of the platform, inter alia business continuity provisions and safeguards against conflict of interests; and
- Clear rules, and perhaps communication requirements, regarding the platform's responsibilities and accountability to the client.

Particularly geared to the needs of the industry are the proposals of the European Parliament's Committee on Economic and Monetary Affairs (ECON). Regarding the exclusion of offerings less than EUR 1 million from the prospectus requirements, the ECON states that "a minimum level of consumer protection" should be granted through risk warnings and basic disclosure, "basic organisational requirements", cancellation rights and caps on the investment amount.⁷⁵

Given the plethora of financial legislation since the GFC, both wish lists prompt the question of whether special legislation for crowdfunding is warranted, or whether we can deal with crowdfunding using the established tools of financial law. We find the answer in the legal diversity of crowdfunding. Crowdfunding is a real-world phenomenon that can take on different legal forms. For instance, crowd-sourced equity platforms⁷⁶ facilitate investors acquiring stakes in small businesses with innovative business ideas. These stakes can have any legal form, ranging from simple contractual return promises of an unspecified kind, to securities, limited partnerships, debt instruments or a combination of the these.⁷⁷

From a regulatory perspective, the variety is difficult to handle. European financial law⁷⁸ draws on 'boxes' such as securities

⁷⁵ Report A8-0238/2016 of the European Parliament on the Proposal for a Regulation of the European Parliament and of the Council on the Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading, Amendment 5, Article 15 (July 19, 2016).

⁷⁶ European Commission, Crowdfunding: Mapping EU Markets and Events Study, *supra* note 54, at 23 (Sept. 30, 2015); Hornuf & Schwienbacher, *supra* note 7, at 5; Ibrahim, *supra* note 7, at 569.

⁷⁷ See on the use of mezzanine for Germany, Hornuf & Schwienbacher, *supra* note 7, at 6.

⁷⁸ In addition to financial markets law rules on the digital single market may apply, which are not subject to our considerations, see Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on Certain Legal Aspects of Information Society Services, in Particular Electronic Commerce, in the Internal Market. Also Anti-money laundering provisions may apply see Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on The Prevention of the Use of the Financial System for the Purposes of Money Laundering or Terrorist Financing

(Prospectus Directive⁷⁹), financial instruments (MiFID II/MiFIR⁸⁰), undertakings for collective investments (UCITSD, AIFMD)⁸¹ and the provision of credit (CRD IV/CRR⁸²). For legal certainty, these boxes are narrowly defined. If one of the defining characteristics is missing, European financial law will not apply. For instance, the provider of a peer-to-peer-lending platform will not provide credit as this necessitates lending against the entity's balance sheet. Accordingly, the platform is not a credit institution for the purposes of European banking law. Since the platform does not pool the capital provided by lenders it is out of scope for European collective investment law. The provider of an investment platform that avoids the investment characteristics of financial instruments is out of scope of MiFID II/MiFIR, etc.

This situation gives cause for concern. Funders, either investors or lenders, typically expect a return on their investment. Hence, investor protection concerns are paramount. Moreover, the regulatory provisions are sometimes applied differently between Member States. For instance, the traditional German view deemed long established participation in limited partnerships to be out of scope of MiFID, while these arrangements were deemed financial instruments in Luxembourg. The resulting ambiguity leads to frictions in a cross-border setting. If the regulatory status is uncertain, crowdfunding platforms are

⁷⁹ See Art. 3 and 14 Directive 2003/71/EC on The Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading and amending Directive 2001/34/EC, O.J. (L345) 64, as amended.

⁸⁰ See Art. 4.1(8) Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on Markets in Financial Instruments (...) ('MiFID II'): 'portfolio management' means managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments.

⁸¹ Cf. Art. 1(1) Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on The Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITSD); Art. 4(1)(a) AIFMD; Art. 4(1) Regulation (EU) 2015/760 on European Long-term Investment Funds (ELTIFR); Art. 3(a) of the Regulation (EU) No 345/2013 of the European Parliament and of the Council of on European Venture Capital Funds (EuVECAR), and Art. 3(a) of the Regulation (EU) No 346/2013 of the European Parliament and of the Council on European Social Entrepreneurship Funds (EuSEFR). For a detailed discussion see Zetzsche, *Anatomy of European Investment Funds Law*, *supra* note 15, at V.1.

⁸² See Art. 2 and 3 Council Directive 2013/36 of the European Parliament and of the Council of 26 June 2013 on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms (CRD IV), 2013 O.J. (L176) 338; Art. 4(1) No. 1 Commission Regulation 575/2013 of the European Parliament and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms (CRR), O.J. (L176) 1.

reluctant to take on the costs and risks of going across the border.⁸³

In the following section, we discuss the options available for a cross-border crowdfunding passport, following the traditional regulatory categories of product, sales and manager/intermediary regulation.

1. Product regulation

a) Definition

Product regulation is predicated on a tight product definition. The law prescribes the legal characteristics of the investment product which is subject to authorisation. These characteristics together make sure that the risks for investors from the financial product are mitigated to an extent that investors are willingly ready to bear. Product regulation seeks to abolish all risks other than investment risk, for which investors are compensated. In practice, product rules rarely achieve this objective.

b) Example

The UCITSD is the most successful example of product regulation. Pursuant to Art. 5 (1) UCITSD, “[n]o UCITS shall pursue activities as such unless it has been authorised in accordance with” the UCITSD. The authorisation is contingent on the fund document’s compliance with the UCITS investment restrictions, transparency requirements and general obligations, the appointment of a licensed UCITS fund management company, the appointment of a licensed depository and the directors of the depository being of sufficiently good repute and experience in relation to the type of UCITS.⁸⁴

The UCITS investment restrictions relate to the core of the UCITS product. The UCITS investment strategy specified in Art. 50 – 57 UCITSD focuses on liquid assets due to its open-ended nature, i.e. investors can redeem their investment at any time during the life of the UCITS. The UCITSD seeks to achieve liquidity of the UCITS assets with an extensive list of underlying assets in Article 50 (1) UCITSD, which by their nature are deemed liquid. These underlying assets range from transferable securities issued in respect of money market funds traded on capital markets, to more exotic assets such as untraded money market instruments backed by (1) public institutions, (2) listed companies, (3) prudentially regulated institutions, or entities

⁸³ European Commission Summary on Responses to the Public Consultation on Crowdfunding in the EU, at 4 (March 2014) *available at* http://ec.europa.eu/finance/consultations/2013/crowdfunding/docs/summary-of-responses_en.pdf (mentioning lack of information about foreign legal requirements and high costs of authorisation on other EU member states as barriers to cross-border crowdfunding).

⁸⁴ Art. 5(2) and (4) UCITSD.

with a minimum capital of EUR10m, including the financing divisions of listed companies or banks, that provide a minimum level of investor protection subject to approval by national authorities (Art. 50 (1)(h) UCITSD). Further, Article 50 (2) UCITSD prohibits the acquisition of precious metals, or certificates representing them, and real estate for investment purposes.⁸⁵

c) Discussion

An advantage of production regulation is the legal certainty stemming from stringent product rules. Investors know what risks they are taking on, and can manage these accordingly. On the downside, product regulation is not open to innovation but is particularly open to circumvention. By slightly altering the product range and definition, intermediaries find themselves out of scope. For these reasons, the UCITSD I, Europe's most successful investment product, has been supplemented with regulation of the fund management company. Also, its rigid product rules relating to securities traded in public markets have been widened and deepened down to include investment strategies such as ETFs, 130:30 portfolios and complex UCITS.

The example of the UCITSD is a strong argument that product rules may function as signal to investors, but may need to be supplemented by manager regulation. However, in the case of crowdfunding, the product is not clearly defined. Crowdfunding could refer to a donation, a debt, an investment, or a combination of each.⁸⁶ More importantly than the form of the investment, the underlying business model is far from uniform. Business ideas range from simple to sophisticated technology. The only common denominator is that investors encounter the business via internet. This is insufficient to draft product regulation for crowdfunding.

2. Sales / Distribution regulation

a) Definition

The legal focus of sales regulation is the point of sale or distribution, i.e. contact with the client. Sales regulation can take one of two forms. Either it may seek to ensure that investors are informed in a standardised way via a prospectus or key investor document (type 1 rules, or disclosure approach), or it may seek to ensure that investors have access only to products suitable for them. In the latter case, the financial intermediary functions as a gatekeeper. Rather than offering all products to the investor, the intermediary filters the investment universe and distinguishes

⁸⁵ For a detailed overview see Zetzsche, *The Anatomy of European Investment Fund Law*, *supra* note 15, at VI.

⁸⁶ See EC, *Crowdfunding in the EU Capital Markets Union*, *supra* note 2, at 8 et seq.

between suitable from unsuitable products (type 2 rules, or KYC approach). Type 1 or type 2 rules may be supplemented by type 3 rules that restrict the nominal amounts investors may invest.

b) Examples

Type 1 (disclosure): PD and PRIIPSR

The PD⁸⁷ facilitates the raising of capital in a cross-border context. It does so by imposing a common standard, in return providing a single passport for cross-border offerings. Whenever securities are offered to the public or traded on a regulated market, a prospectus must be drawn up and published after being approved by the NCA.⁸⁸ Based on this approval, the securities may be offered publicly in all member states. The PD determines the content and form of the prospectus and regulates what information investors need in order to make a sound investment decision. The PD thus provides reliable minimum standards for investors, as well as legal certainty and a level-playing field for issuers.

The regulatory goal is investor protection through the provision of information, as well as protection of the proper functioning of the financial markets by maintaining investor confidence. A prospectus should enable investors to understand their rights and to assess the risks associated with a security and thus make informed decisions.⁸⁹ The issuer, guarantor or party seeking admission to trading is responsible for the information that must be specified in the prospectus.⁹⁰

The PD covers all kinds of transferable securities under Art. 1 (1) and 2 (1) (a) MiFiD. It was not designed to apply in the crowdfunding context: (1) Publishing a PD-compliant prospectus drawn up for the professional trading of a security in capital markets is costly. Including drafting costs, fees of external advisers, translation, regulatory fees and auditing fees, estimates range between EUR200,000 to EUR300,000.⁹¹ (2) The complexity of the prospectus is high and seems out of place in

⁸⁷ Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC; see also Proposal for a Regulation on the prospectus to be published when securities are offered to the public or admitted to trading, COM (2015) 583 final (draft PD 2015).

⁸⁸ Art. 3 PD.

⁸⁹ PD, recital 18 et seq.; Art. 5 PD.

⁹⁰ Art. 6 PD.

⁹¹ Report of Center for Strategy and Evaluation Services (CSES), Study on the Impact of the Prospectus Regime on EU Financial Markets Final Report, 47 et seq. (June 2008), available at http://ec.europa.eu/finance/securities/docs/prospectus/cses_report_en.pdf (last visited July 14, 2015).

the social media influenced crowdfunding. Given the high costs and complexity, PD-based regulation is unattractive for crowdfunding platforms.⁹²

Crowdfunding platforms can avoid the application of the PD by several means. First, they can tailor the investment such that it does not meet the definition of ‘security’. Notably in Germany, various methods were developed to an extent that prompted the German parliament to add additional prospectus requirements for investments that do not meet the securities definition.⁹³ Second, the obligation to publish a prospectus does not apply if the offer is sufficiently small that the drawing up of a costly prospectus is disproportionate to the proceeds of the offer. For instance, Art. 1 (1) h) exempts a PD from the prospectus requirement if the total consideration for the offer stays below EUR5m for 12 months.⁹⁴ In this case the offer is excluded from the scope of the PD. However, the EU/EEA Member States may impose additional national requirements for offers between EUR100,000 and EUR5m for 12 months.⁹⁵ Currently 17 Member States make use of that option.⁹⁶ The recast of the PD will raise the respective thresholds even further in order to create a safe harbour for crowdfunding initiatives.⁹⁷

While one could question the desirability of the prospectus exemptions due to the cost-benefit ratio of the PD, we believe the non-application of the PD to be of greater importance for the viability of a well-functioning crowdfunding market: The EUR200,000 to EUR300,000 prospectus cost exceeds the average crowdfunding offer size in Europe.⁹⁸ Such a cost burden would make crowdfunding unviable. Further, significant data disclosures in a prospectus concern the past while crowdfunding

⁹² They try to tailor their business such as to maneuver under and around, see ESMA, *supra* note 3, at 9, ¶22; Klöhn, Hornuf & Schilling, *supra* note 2 at 61 et seq.

⁹³ Those are detailed in the Gesetz über Vermögensanlagen (Vermögensanlagengesetz - VermAnlG).

⁹⁴ According to Art. 1(3) d) draft PD 2015 this threshold will be raised to 10 mio.

⁹⁵ See however Opinion of Advocate General Sharpston in ECJ case C-441/12, No. 38 et seq. (June 19, 2014). According to Art. 3(2) draft PD 2015 this threshold will be raised to 500 TEUR.

⁹⁶ See draft PD 2015, at 13.

⁹⁷ EC, Commission Staff Working Paper, at 20, SWD 0255 final (2015); Draft PD 2015, at 13; European Commission, Crowdfunding: Mapping EU Markets and Events Study, *supra* note 54, at 40; Report on the Proposal for a Regulation of the European Parliament and of the Council on the Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading, *supra* note 72.

⁹⁸ See European Parliament on Crowdfunding in Europe - Introduction and State of Play, at 5 (January 2017) (detailing that average size of investment in 2014 amounted to EUR 260,000).

is all about the future: Emerging enterprises lack the sophistication and history to draw up meaningful disclosure, including data for back testing and peer group considerations. It does not come as a surprise that inside⁹⁹ and outside¹⁰⁰ Europe lighter touch offer documents substitute for heavy-handed prospectus requirements. We believe the same holds true for Europe.

Type 2 (KYC): MiFID

Under the type 2 approach, the regulator seeks to ensure that investors have access only to products and information suitable for them. There are two ways to ensure suitability, either through defining suitability in a general and abstract manner and banning inexperienced investors from certain products, or through delegating the suitability test to the financial intermediary to filter the investment universe and single out suitable and unsuitable products. For example, a MiFID investment firm must conduct a client investigation (know your customer) and may only recommend or offer financial instruments that fit the specific needs and interests of the client.¹⁰¹ To fulfil the KYC rules, the investment firm must obtain information about the client's financial situation, risk tolerance, knowledge and investment experience with respect to the targeted product type or service and the potential loss associated with the product.¹⁰²

Type 3 (investment limits)

Type 3 rules that set a maximum investment limit *per investor* constitute such a less expensive regulatory tool. Examples of type 3 rules include the German Small Investor Protection Act

⁹⁹ German law requires a short form document pursuant to ss. 13, 14 VermAnlG. On details see Klöhn, Hornuf & Schilling, *supra* note 2 at 61 et seq. (with a technical critique).

¹⁰⁰ See ASIC, *supra* note 33, at 21 et seq. (detailing the approaches in New Zealand, Canada, and the US.) as well as § 738J et seq. of the Australian Corporations Act 2001, as amended by the Australian Corporations Amendment (Crowd-sourced Funding) Act 2017 (No 17/2017). IOSCO, Research Report on Financial Technologies (Fintech), *supra* note 34, at 65 et seq., about FinTech growth in emerging markets/ Asia. The regulatory environment for P2P lending platforms and ECF varies considerably across emerging markets. Some countries have implemented regulation, while others have no tailored regulatory framework due to the still nascent nature of these business models and the fact that the full benefits and opportunities, as well as the risks and challenges, are not yet fully understood (at 67-68).

¹⁰¹ Art. 24 et seq. MiFID II; see Dirk A. Zetsche & Thomas Marte, *AIFMD versus MiFIDII/MiFIR: Similarities and Differences*, 120 et seq. in THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS (Dirk A. Zetsche ed., 2nd ed. 2015).

¹⁰² Art. 25(2) MiFID II.

(2015)¹⁰³ that limits the amount investors may invest into crowdfunding schemes at EUR1,000 per *issuer*. The amount is EUR10,000 if the investors declare total fungible assets of at least EUR100,000 or do not invest more than double their monthly net income. Type 3 rules apply also in Austria, where single investors may invest up to EUR5,000 per *issue* in any twelve-month period, unless they declare that they are not investing more than twice their monthly net income or ten percent of their financial assets.¹⁰⁴ Similar rules are common elsewhere within and beyond European borders.¹⁰⁵

c) Discussion

None of the rules governing distribution are fit for crowdfunding. As to type 1 (disclosure) rules, the costs of drawing up mandatory disclosure are significant, while the willingness of ‘the crowd’ to read and apply the information provided to them is cast in doubt. Crowdfunding is characterized by a certain degree of irrationality, which is both a weakness and a strength. It is a weakness, since disclosure-based investor protection does not work in that many crowdfunding investors do not regard themselves as investors, but as supporters and business angels of innovation. It is a strength, as irrationality, or perhaps defiance of convention, creates new business ideas that reveal sales potential by catering to people’s emotions. Third, foregoing disclosure obligations altogether does not resolve the issue of cross-border crowdfunding. This is because without a prospectus we lack the basis on which to grant a prospectus passport.

Type 2 (KYC) rules are associated with two issues: cost and expertise. Due to cost, most legislators seeking to enable low-cost crowdfunding have scaled back on KYC requirements. Type 2 rules require the platform provider to inquire into the knowledge, skills and experience of all retail individuals that together constitute ‘the crowd’, even though each funder invests

¹⁰³ See § 2a Gesetz über Vermögensanlagen (Vermögensanlagengesetz - VermAnlG).

¹⁰⁴ See § 3 Bundesgesetz über alternative Finanzierungsformen (Alternativfinanzierungsgesetz – AltFG), see Roman Rericha & Raphael Toman, *Neuer Rechtsrahmen für Crowdfunding - Ausbruch aus dem Regelungsdickicht des Kapitalmarkts?*, ZFR 218, 403 (2015).

¹⁰⁵ See, for instance, s. 738ZC of the Australian Corporations Act 2001, as amended by the Australian Corporations Amendment (Crowd-sourced Funding) Act 2017 (No 17/2017) (“The responsible intermediary for a CSF offer must reject an application made by a person pursuant to the offer if: (a) the person is a retail client in relation to the offer; and (b) having regard only to CSF offers for which the intermediary is the responsible intermediary, the application would result in the total amount paid or payable by the person in respect of applications made by the person, in any period of 12 months, pursuant to CSF offers made by the same company, exceeding: (i) \$10,000 ...”).

very little at one time. From a cost/benefit perspective, such a ‘per client’ approach is uneconomical and risks foreclosing crowdfunding altogether. Regulators who apply KYC checks in principle, provide exemptions from appropriateness and suitability tests if investors are protected by less expensive regulatory tools.¹⁰⁶ In Italy, which to our knowledge is the only country that has fully applied MiFID-style KYC rules to crowdfunding¹⁰⁷, a reform is in the making. While costs are certain, expertise on the side of platform providers to assess the appropriateness of investors is uncertain. Using non-experts as gatekeepers makes things worse rather than better.

As to type 3 (investment limits), any strict investment limit is either too high or too low. For poor people, even small amounts are too high as these could include all their savings, while at the same time restrict the ability of wealthy individuals to support innovative enterprises¹⁰⁸ and diversify their portfolios. We also observe an enforcement issue. Investors can participate in multiple platforms. Limiting losses on a possibly well governed platform may have a harmful effect if the same investors participate in other less well governed platforms. In fact, a smaller investment amount per platform could reduce investor due diligence and exacerbate the collective action problems inherent in crowdfunding.¹⁰⁹ Finally, type 3 regulation does not

¹⁰⁶ For instance, while in the UK FCA Policy Statement PS14/4 in theory requires an appropriateness assessment of retail clients intermediaries do not need to ensure that individuals continue to qualify under that appropriateness test on an ongoing basis. In particular, the appropriateness test does not apply where retail clients certify that they will not invest more than 10% of their net investible assets in non-readily realisable securities; further an appropriateness test of the past is valid for 12 months.

¹⁰⁷ See Legislative Decree No. 179 of 19 Oct. 2012, subsequently converted into Law No. 221 of 17 Dec. 2012, was implemented by Consob Regulation No. 18592 of 26 June 2013 (drawing on MiFID on MiFID for equity based crowdfunding models); on details Casimiro A. Nigro & Vittorio Santoro, *The Quest for Innovative Entrepreneurship and the Italian Regime for Equity Crowdfunding*, 11 EUR. COMP. L. 229 et seq. (2014); Edoardo d’Ippolito, Matteo Musitelli, Antonella Sciarrone Alibrandi, *Protecting Crowdfunders: Is a MiFID-Mimicking Approach Appropriate?* 13:1 EUR. COMP. L. 27–37 (2016) (referring to the MiFID suitability test as main hindrance for the Italian crowdfunding scheme and mentioning reform initiatives); IOSCO, Research Report on Financial Technologies (Fintech), *supra* note 34, at 74.

¹⁰⁸ ESMA states that invested sums can “be substantial”, see ESMA, *supra* note 3, at 8, ¶20.

¹⁰⁹ Consequently, the danger to be defrauded may be higher, see Agrawal, Catalini & Goldfarb, *supra* note 7, at 77; similar consideration with respect to US securities regulation, also providing examples see Pesok, *supra* note 8, at 149 et seq.

prevent fraud which is most harmful to investor confidence, irrespective of whether it involves small or large sums.¹¹⁰

3. ‘Manager’ or Intermediary Approach

None of the product and sales regulation types of regulation provide the basis for a European passport for crowdfunding platforms engaged in low-volume SME investments. There are two reasons for this. First, cross-border notification *per product* or *per sales effort* over time is more expensive than one notification *per platform* where the platform has multiple products to fund and where funding periods for each product are limited to several weeks or months. Second, if European regulation focuses on products, Member States could retain jurisdiction over manager regulation. There is currently a patchwork of harmonised European law in the field of financial markets. National gold plating in the case of minimum harmonisation as well as national regulation in un-harmonised areas of law could prevail. A clear-cut European legal framework is of the utmost importance.

Crowdfunding platforms are intermediaries that bring together the supply and demand of capital by providing the infrastructure necessary to present the projects, the legal framework for investment, as well as ongoing support for both supply and demand. Most crowdfunding platforms provide services to protect investors, such as screening of projects, information on applicable fees, identity checks of project owners, facilitation of communication between funders and project owners, and information to funders regarding associated risks.¹¹¹

At the same time, crowdfunding platforms operate on a for-profit basis. While fee structures are not uniform, we find fees are similar to the asset management world. Crowdfunding platforms charge (1) an initial investment fee, taken prior to channelling the investment to meet demand once the overall funding amount has reached the minimum investment threshold, (2) an ongoing annual ‘management’ fee charged to the user of funds, and /or (3) a performance fee dependent on the user’s successful growth and exit.¹¹² This may incentivise platforms to increase the number of potential entrepreneurs, establish trust amongst

¹¹⁰ See Hazen, *supra* note 8 at 1765 (stating that “fraud can come in small packages too”). European Commission, Summary, *supra* note 80, at 6 (stating that one in four respondents considers the risks of fraud or misleading advertising in crowdfunding as too high to even participate); ESMA, *supra* note 3, at 11.

¹¹¹ European Commission, Summary, *supra* note 80, at 4.

¹¹² See Agrawal, Catalini & Goldfarb, *supra* note 7, at 74 (finding that crowdfunding platforms charge an initial fee of 4-5%); a LL.M. master thesis at the University of Liechtenstein revealed a larger variety, and overall higher costs than Agrawal/Catalini/Goldfarb, see *Steib*, Costs of Crowdfunding and European Law, 2016 (unpublished, on file with authors).

investors and limit fraudulent use of the platform.¹¹³ On the downside, we may see excessive fees similar to those in the asset management and fund distribution chain. In the latter case, fiduciary risk has materialised. European financial law has implemented ‘manager’ regulation to counter the risk that intermediaries abuse their fiduciary capacity at a cost to investors.

a) Licensing requirements

Asset managers and investment advisers are subject to a general prohibition under all investment legislation, but which is lifted when the manager is authorised by the national competent authority.¹¹⁴ The most important licensing requirements¹¹⁵ include a fit-and-proper test for senior management; minimum capital requirements (details vary); a review of the business plan; adequate risk controls; an adequate business organisation; reliable significant shareholders; reliable third-country relationships, if any, and provision for a mandatory withdrawal of the license if the intermediary no longer meets the requirements of the applicable legislation.¹¹⁶

The standardisation of operating conditions has gained momentum with the European Commission’s statements on the governance of financial institutions.¹¹⁷ The most important are rules governing managers’ operations¹¹⁸ including commitments to fairness, honesty and investors’ best interests; conflicts of interest; best execution; the intermediary’s remuneration; the prohibition of letter-box entities or shell companies; valuations;

¹¹³ Agrawal, Catalini & Goldfarb, *supra* note 7, at 74.

¹¹⁴ See Arts. 5(1) and 6 UCITSD; art. 6(1) AIFMD; art. 14 EuVeCaR (registration); art. 14 EuSEFR (registration); arts. 5, 6 ELTIFR; art. 5(1) MMFR draft; art. 5 MiFID II; art. 8 CRD IV.

¹¹⁵ See Arts. 6, 7 UCITSD; arts. 6-10 AIFMD; arts. 7-10, 12-14 EuVeCaR; arts. 7-10, 12-14 EuSEFR; art. 7 ELTIFR (referring to AIFMD); arts. 5, 6 MMFR draft (referring to UCITSD and AIFMD); art. 9 et seq. MiFID II; art. 10 et seq. CRD IV.

¹¹⁶ See Arts. 6, 7 UCITSD; arts. 6-10 AIFMD; arts. 7-10, 12-14 EuVeCaR; arts. 7-10, 12-14 EuSEFR; art. 7 ELTIFR (referring to AIFMD); arts. 5, 6 MMFR draft (referring to UCITSD and AIFMD).

¹¹⁷ See Paulo Câmara, *The AIFM’s Governance and Remuneration Committees*, at 293 et seq. in *THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS* (Dirk A. Zetsche ed., 2nd ed. 2015); EC, Commission Staff Working Document: Corporate Governance in Financial Institutions: Lessons to be Drawn from the Current Financial Crisis, Best Practices; accompanying document to the Green Paper Corporate Governance in Financial Institutions and Remuneration Policies, SEC (2010) 669 (June 2, 2010).

¹¹⁸ See Arts. 10-15 UCITSD, Arts. 12-19 AIFMD; arts. 7, 10-13 EuVeCaR, arts. 7, 10-13 EuSEFR; art. 7 ELTIFR (referring to AIFMD); arts. 5, 6 and 12, 22 MMFR draft.

and extensive reporting obligations to NCAs especially with regard to the use of securities financing techniques. Also covered is the NCA's power to impose leverage limits or other intervene against a product set-up.¹¹⁹

Modern European risk management rules are driven by developments in risk management methodology introduced via the banking sector.¹²⁰ Since cross-sectoral consistency is a stated policy goal, we deem the tripartite distinction between institutional risk management (risk organisation), operational risk management (risk procedures) and quantitative risk management (risk measurement) to be a common feature of European risk management law.¹²¹ Similarly, the substantive rules on risk management show remarkable similarities.¹²² These include the types of risks to be considered; upgrading operational risk to the same level as financial risk; measurement methodologies; risk measurement across sectors that rely on a commitment approach, VaR or company-specific models; and the imposition of risk limits.

b) Discussion

The platform provider is deemed the most efficient focal point of regulation.¹²³ Regulating the platform rather than products or distribution allows a certain level of proportionality in regulation whilst not sacrificing investor protection. Platform regulation does not protect investors in a paternalistic way by prohibiting them from taking on certain investment risks, but provides them with protection from risks such as fraud or negligence. Of particular importance are the rules on conflicts of interest which prevent platform providers from marketing businesses in which they hold significant stakes on a preferred basis with a view to flipping or dumping these stakes. All these details can be regulated at low cost for the product offering. It does not come at a surprise that outside of Europe several countries have focused on platform providers.¹²⁴ Within the EU, we see a

¹¹⁹ See Art. 24 AIFMD; art. 39 et seq. MiFIR (product intervention).

¹²⁰ See Dirk A. Zetsche & David Eckner, *Risk Management*, at 323 et seq. in *THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS* (Dirk A. Zetsche ed., 2nd ed. 2015).

¹²¹ *Id.* Zetsche & Eckner.

¹²² See Art. 51(1) UCITS; arts. 15, 16 AIFMD; art. 7 ELTIFR (referring to AIFMD) with additional rules in arts. 5(2) and 23(6) ELTIFR; arts. 21-25 MMFR draft (EuVeCaR and EuSEFR as low key regulation do not provide explicitly for risk management).

¹²³ Klöhn, Hornuf & Schilling, *supra* note 2, at 65.

¹²⁴ See ASIC, *supra* note 33, at 21 et seq. (detailing the approaches in New Zealand, Canada, and the US.) as well as s. 738C and Chapter 7 of the Australian Corporations Act 2001, as amended by the Australian Corporations Amendment (Crowd-sourced Funding) Act 2017 (No

platform-focused approach notably in the UK, but also in the Netherlands, Italy, France and Germany.¹²⁵

ESMA voices the concern that crowdfunding platforms try to circumvent the application of MiFID by making securities non-transferable. Circumvention of MiFID not only reduces the cross-border availability of crowdfunding platforms but also, more importantly, the level of investor protection. ESMA urges regulators to “reduce the incentive” for circumvention.¹²⁶ However, as long as the MiFID framework imposes significant costs that could de facto erase crowdfunding in smaller countries in particular, national regulators will refrain from imposing such legislation. They would face the risk of erecting excessively high barriers of entry to the crowdfunding market, rendering the market dysfunctional before it even started. Even if a passport for the whole of Europe looks more appealing, a new approach is of the essence.

IV. ‘MiFiD light’ platform regulation: policy considerations

In the preceding section, we established the need for regulation of platforms according to the ‘manager’ type of regulation of European financial law. At the same time, the MiFID II/MiFIR as well as the other fully regulated AIFMD, UCITS and the CRD/CRR framework with regulation-induced fixed costs starting at EUR500,000 p.a. are too costly for crowdfunding platforms as long as the overall transaction volume per platform is low and costs per product are high. While this may change with crowdfunding growing into an established way of financing, costs and the substance of regulation today will influence whether crowdfunding *can* be established this way – with Italy being the most prominent example of how overly strict

17/2017); IOSCO, Research Report on Financial Technologies (Fintech), *supra* note 34, at 68.

¹²⁵ See Policy Statement 14/4 of the FCA, *The FCA’s Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-Readily Realisable Securities by Other Media Feedback to CP13/13 and Final Rules* (March 2014). For an overview of implementation in Europe see ESMA, *Investment-Based Crowdfunding - Insights from Regulators in the EU*, at Ann1, ESMA 856 (May 13, 2015) (stating that 14 MiFID-regulated crowdfunding platforms are licensed in the UK, two in the Netherlands and each one in Italy and Germany). About platform-focused approach / regulatory event in France, see European Commission, *Crowdfunding: Mapping EU Markets and Events Study*, *supra* note 54, at 63 et seq. See also Thierry Bonneau, *La régulation du crowdfunding dans le monde*, RISF 2014/2 p 5.

¹²⁶ ESMA, *supra* note 3, at 28.

regulation that demands diligence on a per-client basis can slow developments.¹²⁷

While our proposal looks similar to the Italian MiFID-style approach, it is different with regard to the most important question which is *which* of the many MiFID rules do apply. Our proposal is inspired by an often overlooked exemption in the MiFID framework in Article 4 (1) No. 2 (c) CRR.¹²⁸

Rather than the full MiFID model that has limited crowdfunding activity in Italy, we suggest developing the ‘MiFID light’ exemption of Article 4 (1) No. 2 (c) CRR further to a pan-European crowdfunding license. We outline in the following section how crowdfunding platforms could be regulated with little modification of existing legislation, while at the same time effectively pursuing the objectives of European financial law (*supra*, II.2.-3.).

1. Order transmission and execution as core activity

Our proposal addresses the platform activity as such. The platform’s core activity is bringing together capital supply and demand. MiFID II refers to this activity as ‘reception and transmission of orders’ and ‘execution of orders on behalf of clients’ (with regard to financial instruments).¹²⁹ While other regulated activities have similar effects, including operating markets of various types,¹³⁰ we deem order transmission and execution to be an adequate point of focus for a light-touch, yet efficient regulatory framework.

MIFID II provides an authorisation and passport for a specific type of small investment firm: The authorisation requires an

¹²⁷ See for Italy Legislative Decree No. 179 of 19 Oct. 2012, subsequently converted into Law No. 221 of 17 Dec. 2012, was implemented by Consob Regulation No. 18592 of 26 June 2013 (drawing on MiFID on MiFID for equity based crowdfunding models); Nigro & Santoro, *supra* note 104. The MiFID-style licensing requirements imposed minimum costs on the platforms which they will transfer to issuers that are funded via the platform and make new entry in the market for crowdfunding platforms more expensive, see Gabison, *supra* note 59, at 22. Some commentators deem this law a nuisance rather than nurture of the crowdfunding development. See Edoardo d’Ippolito, Matteo Musitelli & Antonella Sciarrone Alibrandi, *supra* note 104 (referring to the MiFID suitability test as main hindrance for the Italian crowdfunding scheme); Aschenbeck-Florange et.al., *Regulation of Crowdfunding in Germany, the UK, Spain and Italy and the Impact of the European Single Market*, 24 et.seq (A publication of the European Crowdfunding Network in association with Osborne Clarke, 2013) available at http://www.osborneclarke.com/media/filer_public/51/b3/51b3007b-73aa-4b9a-a19d-380fc1d6ff35/regulation_of_crowdfunding_ecn_oc.pdf.

¹²⁸ Note that this approach differs from the exemptions stated in Art. 3 MiFID for domestic bespoke regimes, cited in European Commission, *Crowdfunding in the EU Capital Markets Union*, *supra* note 2, at 19.

¹²⁹ See Annex I A(1) and (2) of MiFID II.

¹³⁰ See Annex I A(8) and (9) of MiFID II.

initial capital requirement of EUR125,000. Member States may even reduce the level of required initial capital to EUR50,000 if the firm doesn't hold client money or securities.¹³¹ In order to make use of that 'MiFID light' status, the investment firm is prevented from dealing in financial instruments on its own account or underwriting issues of financial instruments on a firm-commitment basis. It is authorised to receive and transmit investors' orders for financial instruments and to execute investors' orders.¹³²

2. Licensing & Operating Conditions

a) Art. 4(1) No. 2 (c) CRR

From the licensing conditions (supra, III.3), besides the fact that there is a licensing requirement as such, capital requirements erect the most effective barrier to business. Our understanding of platform activity as order reception, transmission and execution allows for reliance on an exemption from the CRD IV/CRR framework. Article 4(1) No. 2 (c) CRR exempts certain intermediaries from the onerous CRD IV / CRR capital requirements. These include investment firms that do not function as depositaries, do not hold client assets and that focus on order reception and transmission, order execution, portfolio management and investment advice. These CRR-exempted investment firms are subject to minimum capital requirements of EUR50,000 or EUR125,000 respectively, calculated as initial capital plus a quarter of the annual overhead cost.¹³³

The MiFID licensing rules must be read in the context of crowdfunding. For instance, the knowledge and experience necessary for passing the fit-and-proper test relates to running an internet platform and investing in small- and medium-sized enterprises rather than the general distribution of financial products to the public. Further, crowdfunding platforms regulated under the MiFID light approach would need to keep adequate records, including the recording of telephone conversations or electronic communications relating to the reception, transmission and execution of client orders.¹³⁴ What constitutes adequate must be defined in light of MiFID's general mission to sustain proportionality. A platform with little traffic will be subject to different requirements than one platform with millions of daily users.

b) Operating conditions

MiFID's most costly provisions are framed as operating conditions in Ch. II MiFID II. Notwithstanding any exemptions

¹³¹ CRD IV, art. 29(3).

¹³² CRD IV, art. 29(1).

¹³³ See art. 95 et seq. CRR and art. 15 MiFID II.

¹³⁴ See art. 16 (7) MiFID II.

discussed *infra* (IV.4.), crowdfunding providers are subject to the MiFID rules addressing:

- Conflicts of interests¹³⁵;
- Duty to act honestly, fairly and with the best interests of the investor in mind¹³⁶;
- Marketing¹³⁷;
- Cost transparency¹³⁸;
- Kick-back rules¹³⁹;
- The intermediary's remuneration¹⁴⁰;
- Documentation and reporting¹⁴¹; and
- Best execution¹⁴².

Note that not all rules relating to investment advice and portfolio management¹⁴³ apply. Further, since Article 25 (4) MiFID II is limited to investment advice and portfolio management, the onerous 'know your client' requirements¹⁴⁴ do not apply.

c) In particular: MiFID Product Governance Rules

As part of the MiFID II product governance rules¹⁴⁵ the investment firm needs to understand the characteristics and

¹³⁵ MiFID II recital (9) and art. 6 (f) of COMMISSION DELEGATED REGULATED (EU) .../... of C 4417 final on Supplementing Directive 2014/65/EU of the European Parliament and of the Council with Regard to Regulatory Technical Standards on Information and Requirements for the Authorisation of Investment Firms (July 14, 2016); MiFID II recital (15) (45-48), (51-52) (57) (59) and arts. 27, 29, 33-36 of COMMISSION DELEGATED REGULATION (EU) .../... of C 2398 final on Supplementing Directive 2014/65/EU of the European Parliament and of the Council as Regards Organisational Requirements and Operating Conditions for Investment Firms and Defined Terms for the Purposes of that Directive (April 25, 2016).

¹³⁶ *Id.* MiFID II of COMMISSION DELEGATED REGULATION (EU) .../... of C 2398 final, recital.(15) (75-76) (91) (100) (116) (April 25, 2016).

¹³⁷ *Id.* recital (61-62) (65-66), arts. 36-37

¹³⁸ *Id.* recital (1) (74) (82) (114) arts.50, 89.

¹³⁹ *Id.* recital (76); see recital (76) and art. 24(9) of DIRECTIVE 2014/65/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on Markets in Financial Instruments and Amending Directive 2002/92/EC and Directive 2011/61/EU (May 15, 2014).

¹⁴⁰ *Id.* recital (40-41), art. 2(5), 27.

¹⁴¹ *Id.* recital (1) (28) (93) (96-98) (113-114), arts. 21 (a)(e), 22.2(c) and 3(b), 59-62, 76, 83-84.

¹⁴² *Id.* recital (90) (102-108), arts. 59.4(m), 64-66.

¹⁴³ *Id.* distribution strategy about the distributor, recital 44-46, at 29 et seq.

¹⁴⁴ *Id.* identification of the target market by the distributor: categories to be considered, recital 26-27, at 9.

¹⁴⁵ See Della Negra, *The Effects of the ESMA's Powers on Domestic Contract Law, in* REGULATING AND SUPERVISING EUROPEAN FINANCIAL MARKETS: MORE RISKS THAN ACHIEVEMENTS 160 et seq. (Mads Frederico Andenas and Gudula Deipenbrock eds., 2016). See recital (15-18)

relevant target market of each financial instrument.¹⁴⁶ These rules address conflicts of interest in the distribution chain of financial products created by commissions and other originator-oriented pay models.

In the context of crowdfunding platforms, these rules need re-reading since crowdfunding platforms rely on funding rather than distribution. If read with the objective of crowdfunding in mind, they would lead to a partial but not excessive regulatory burden. For instance, consider the rules imposed on product originators and product distributors. Platforms *offer* crowdfunding projects. In turn, they must have in place adequate arrangements to obtain sufficient information on the product from the originator. In fact, crowdfunding platforms tend to engage in due diligence of the funded firms prior to making them available on their platforms. If they do, they will have the information required by Article 16 MiFID II.¹⁴⁷

According to our crowdfunding understanding, the SME rather than the platform is *creating* the investment product (see the originator-related rules of Article 24 (2) MiFID II). In turn, rules relating to product origination¹⁴⁸ do not apply to the platform.

(20), Arts. 9, 10 of COMMISSION DELEGATED DIRECTIVE (EU) .../... of C 2031 on Supplementing Directive 2014/65/EU of the European Parliament and of the Council with Regard to Safeguarding of Financial Instruments and Funds Belonging to Clients, Product Governance Obligations and the Rules Applicable to the Provision or Reception of Fees, Commissions or Any Monetary or Non-Monetary Benefits, (April 7, 2016); ESMA, Consultation Paper Guidelines on Product Governance Requirements 2016/1436 (Oct.5, 2016); ESMA, Technical Advice to the Commission on MiFID II and MiFIR – Final Report, ESMA 2014/1569, ¶ 2.7. (Dec. 19 2014).

¹⁴⁶ Art. 16 s. 3 sub 6 MiFID II.

¹⁴⁷ Art. 16 (3) MiFID II, sub 5 (“An investment firm which manufactures financial instruments shall make available to any distributor all appropriate information on the financial instrument and the product approval process, including the identified target market of the financial instrument.”). On MiFID II’s target market requirement see recital (17-20), arts. 9 (1)(9)(11-14), 10 (1)(2)(3)(5)(7)(8) of COMMISSION DELEGATED DIRECTIVE (EU) .../... of 7 April 2016 on Supplementing Directive 2014/65/EU of the European Parliament and of the Council with Regard to Safeguarding of Financial Instruments and Funds Belonging to Clients, Product Governance Obligations and the Rules Applicable to the Provision or Reception of Fees, Commissions or Any Monetary or Non-Monetary Benefits; ESMA, Consultation Paper on Draft guidelines on MiFID II product governance requirements, ESMA *supra* note 143 at 5 et seq.; Martin Brennecke, *Der Zielmarkt eines Finanzinstruments nach der MiFID II*, WERTPAPIERMITTEILUNGEN 2015 1173.

¹⁴⁸ See Consultation Paper of ESMA/2016/1436, *supra* note 133, recital 39, at.12 and related to distribution of products manufactured by entities not subject to MiFID II product governance requirements, recital 52-54, at. 31

3. CF modifications?

If our proposal is implemented and the platform's core activity is deemed to be a MiFID activity, a licensing requirement will apply. In some countries, the minimum cost of doing business will be greater than it is today due to the fixed cost of regulation for regulated entities. While we generally accept this, in return for a much bigger pan-European market we seek to mitigate the negative impact of regulation-induced fixed costs by proposing some modifications that reduce costs for small-scale platform start-ups.

In particular, our concept requires three modifications of the MiFID framework.

a) Disregard of 'financial instrument' restriction – Neutrality as to Legal Form

First, it shall apply to all crowdfunding platforms regardless of whether the product is a financial instrument. This is to ensure that (1) the European passport functions smoothly across Europe regardless of which legal form is widely used for crowdfunding in the particular European country (counter path dependency), and (2) the legal form of investment can meet the respective SME's most suitable legal form rather than a regulatory demand. For instance, the crowdfunding license should extend to instruments such as convertible bonds, limited partnership units, individual debt obligations and the provision of direct debt. Further, the crowdfunding license shall apply to both crowdlending and equity crowdfunding platforms that function as agents without taking any funding obligations onto their own balance sheets.

b) List of applicable rules

Second, while the above interpretation of MiFID II derives from an understanding of the legal text, additional certainty is achieved with an exclusive list of MiFID II and MiFIR provisions that do not apply to crowdfunding platforms whose activity is limited to order reception, transmission and execution. Such a list could be added to MiFID II implementing legislation. For instance, it could be expressly stated that the platform merely *offers* a crowdfunding opportunity, without recommending or manufacturing it.

However, we do not propose a lighter touch with regard to cost transparency and investor protection. In fact, the opaque cost structures of platforms that charge both the funded firm and funders for their services is a cause for concern. Our anecdotal evidence in this regard shows a wide array of fee models and fee sizes, ranging from one percent to fifteen percent if fees for funder, funded firms and service charges are taken together.¹⁴⁹ It

¹⁴⁹ See Steib, *supra* note 112.

is crucial that the same transparency standards developed over the years for regulated intermediaries similarly apply for crowdfunding platforms, where most funders are vulnerable to hidden fees, and most funded firms have little choice but to accept the terms set by the platform.

c) From 'too small to care' to 'too big to fail'

Third, a balanced risk analysis follows the evolution of any FinTech business from (1) too-small-to-care, to (2) too-large-to-ignore and then to (3) too-big-to-fail (TBTF).¹⁵⁰ The MIFID-light framework focuses on investor protection at the too-large-to-ignore stage. This scenario requires two modifications to reflect the needs of the too-small-to-care and too-big-to-fail stages.

On the one hand, we propose a **relevance threshold** of EUR250,000, which refers to the total transaction volume processed by the platform.¹⁵¹ While redress through private law will be available for fraud below this threshold, no regulation should apply. This minimum threshold would enable platform start-ups to pilot and test new business models with little risk, and hopefully prove to investors that their innovations work. In balancing the need for investor protection with the need to further innovation, we believe that the overall risk level to investors from very small platforms is acceptable. Further, the EUR250,000 transaction threshold ensures that a certain vagueness on definitions, for instance delineating donation-based platforms from lending and investment platforms, does not impair the functioning of the regulatory system. Finally, supervising very small platforms is expensive for regulators and is in many cases superfluous. Experience tells us that most start-ups fail. The same insight applies to platform start-ups. Many platforms will vanish before surpassing the EUR250,000 transaction threshold. Hence, there is no need to spend scarce resources on their supervision.

On the other hand once regulators come to the conclusion that a platform is of **systemic importance**, for example if the platform substitutes for systemically significant financial institutions (TBTF) or the platform is linked to an institutional client base (TCTF), we recommend measures to control and limit systemic risk. These include (a) structural requirements for the platform (quarantine provisions, IT capabilities, capital adequacy, minimum capital requirements for maintenance and remedial

¹⁵⁰ DW Arner, J Barberis and RP Buckley, 'The Evolution of FinTech: A New Post-Crisis Paradigm?' (2016) 47 (4) *Georgetown Journal of International Law*, 1271.

¹⁵¹ This threshold is equal to 500 funding decisions if we assume that the average funding contribution amounts to 500 EUR. Data as to 2015 and 2016 suggest that the average contribution is a little less than that amount. [Cambridge Centre?*

purposes, and segregation of EU/EEA activities from non-EU/EEA activities) and (b) empowering regulators to shut down the activity (while preserving customer data), or to appoint a commissioner to run the quarantined EU/EEA platform business in the public interest.¹⁵²

4. Additional activities

Additional rules apply if platforms go further than simply order execution and transmission. Our base case scenario excludes platforms interested in channelling investors' money via the platform's own bank account to the SME or that function as depositories for investors' money, nor do we consider variants in which platforms provide advice to investors (albeit automatically) as to which investment they should choose. These activities are, for the most part, subject to the PSD II or a more extensive, or even full, MiFID II license. For instance, if a platform engages in providing investment advice with a search tool that relies on investors' risk sensitivity or other suitability criteria, the respective MiFID rules for investment advice will apply on top of the base case scenario rules laid out above.

V. Conclusion

In this paper, we have made three contributions to the discussion of how to regulate crowdfunding. First, we dismiss the idea that the risks of CF¹⁵³ are mitigated due to the relatively low size of contributions per investor. Regulation of a crowdfunding platform is necessary since the parties seeking capital are small start-ups with little choice as to funding and are less able to bear regulatory costs, while many funders are unsophisticated private investors in need of investor protection.¹⁵⁴ Further, both the established rationale of financial law (investor, financial system and stakeholder concerns) and the facilitation of the European single market warrant regulation. Second, we demonstrated that regulating the platform as the 'manager' of a crowdfunding scheme is the road the European Commission should take when implementing the CMU action plan. Third, we set out details of a MiFID II-oriented, light touch approach to crowdfunding regulation, based on the exemption provided by Article 4 (1) No. 2 (c) CRR. The MiFID-light framework is an adequate base case scenario to address the too-large-to-ignore stage of platform business where the total transaction amount exceeds EUR250,000 p.a. In addition, systemic risk-oriented regulation

¹⁵² We have addressed the arguement that crowdfunding platforms are too small to provide a risk to the financial system *supra*, at II.2.

¹⁵³ European Commission, Summary, *supra* note 80, at 6. A recent European Commission consultation on crowdfunding showed that one in four respondents considers the risks of fraud or misleading advertising in crowdfunding too high to even participate.

¹⁵⁴ Bradford, *supra* note 7, at 377.

for very large platforms should be embedded as a preventive measure.

Our three contributions would mitigate information asymmetry¹⁵⁵ and protect the market by building investor confidence. We would proceed not despite, but in recognition of, the economic potential of a well-functioning cross-border crowdfunding market in Europe. A light-touch regulation of crowdfunding provides the regulatory basis for a European crowdfunding passport, based on MiIFD, that mitigates against adverse effects from possible over-regulation after the financial crisis¹⁵⁶ and ensures some level of investor protection at the same time. This comes with the welcome side effects of (1) better information on the part of regulators and (2) the potential creation of a level playing field with other (regulated) forms of finance.

If our proposal is adopted, some crowdfunding platforms will not pass regulatory scrutiny or, given the fixed cost of regulation, unless their transaction volume surpasses the relevance threshold, will prove too small to remain in business. This is, however, a desired effect as regulation functions to single out less viable market participants, thereby ensuring that the public puts a higher level of trust in the remaining (licensed) entities.¹⁵⁷

Our proposal would ensure that (1) very small platforms can test and enter into a pilot stage with some clients, (2) reliable platforms can grow across borders and achieve economies of scale previously unavailable to them, while their conduct is regulated according to a simple yet flexible set of rules that already exists and ensures sufficient transparency, and (3) that systemic risk is monitored. This should provide a bright outlook for professionally managed platforms, investors and SMEs alike.

¹⁵⁵ Otherwise crowdfunding markets could render markets for lemons, see Ibrahim, *supra* note 7, at 591 et seq.; Tomboc, *supra* note 7, at 263 et seq.

¹⁵⁶ The “regulatory stimulus cycle”, where policymakers react and contribute to boom and bust cycles of financial markets is prominently examined. See Erik Gerding, *Law, Bubbles, and Financial Regulation* (2014).

¹⁵⁷ In fact, whether regulation will dry out innovation is a question of market maturity: The largest European crowdfunding market – the UK – draws on a MiFID-style platform regulation which is even more stringent than the one suggested herein.



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