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LEGAL CHALLENGES OF REAL ESTATE CROWDFUNDING

CANDIDATE: MIGUEL PAQUETE

SUPERVISOR: PROFESSOR ANA PERESTRELO DE OLIVEIRA

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À minha Mãe

*«Quem disse que morreu a madrugada?
Quem disse que esta noite foi perdida?
Quem foi que disse que eu podia ir,
Tão longe quanto nós podemos ser?»*

José Carlos Ary dos Santos (1973)

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ABBREVIATIONS

CMVM – Portuguese Stock Market Authority

EU – European Union

ICO - Initial Coins Offerings

JOBS Act – Jumpstart Our Business Startups Act

OECD – Organisation for Economic Co-operation and Development

REC – Real Estate Crowdfunding

REIT – Real Estate Investment Trusts

RJFC – Portuguese Crowdfunding Legal Framework

SEC – United States Securities and Exchange Commission

SPV – Special Purpose Vehicle

UK – United Kingdom

US – United States of America

U.S.C. – United States Code

VAT – Value Added Tax

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INTRODUCTION

The technical term “PropTech” can be broadly related to the use of new technologies (“Tech”) in the field of real estate industry (“Prop”). The new vague of digital transformations in other sectors of activity, such as the Financial sector, is now becoming also popular in the context of real estate, that has the potential to transform the way real estate transactions normally occur.

REC has recently emerged as a new form of investing in real estate, in the context of PropTech 3.0, allowing any type of investor to engage in this sort of project, without entailing excessive costs. The main legal question of this paper is to determine if the use of crowdfunding in this business sector would require a different legal approach in relation to the existing general legal framework for lending or investment crowdfunding, such as the European Commission Proposal for a Regulation on European Crowdfunding Service Providers or Law No. 102/2015, of 24 August, with respect to Portugal. If not, I propose a contribution to a possible legislative process by presenting the main risks and advising on the potential aspects that should be considered by the regulatory authorities.

In general terms, REC can be defined as an alternative financing channel for collecting funds from a crowd of investors, with the purpose of investing in real estate projects through online platforms. The great innovation in this type of crowdfunding is that the investor does not acquire the whole equity in the property as in direct real estate investments, but only a percentage of the equity in a property along with hundreds or even thousands of investors.¹ The investments are frequently backed by mortgages provided by the crowdfunded company as a suitable way of protecting the investors in case of default.

The growth of REC occurred after a period of crisis, which goes back to 2007 in the US, during which different risk management policies were implemented and the traditional financial institutions were forced to drastically reduce financing thresholds.² The significant effects of that period have been widespread on related areas with special relevance for the financial markets, which revealed the importance of the systemic risk.

¹ SCHWARTZ (2016), p. 11.

² BROWN, DAVIS (2008).

Direct property investments and REIT, the two standard investment forms, were no longer considered advantageous to investors due to their higher transaction and management costs. Investors were looking for alternatives when crowdfunding was adopted in the real estate field as a suitable option to ensure liquidity, just a few years after regular crowdfunding had become common through the Internet (hereinafter “regular or general crowdfunding”). As early as 2015, REC had grown to almost \$ 2.5 billion, having a huge impact, especially in the American market. This phenomenon is now taking its first steps in Europe, including in Portugal, and Asia.

Despite the reduced number of academic support elements in law, the core challenge in this paper is to approach this unexplored financing alternative from a legal perspective, having non-accredited investors as a target, given that this group may not be able to understand all the information used or the risks that these investments may entail in the future.

In view of these facts, in order to answer this legal question, the first step is to analyse, in Part I, the main elements of REC and the market in which it operates, within the context of PropTech. The market risks and the type of assets involved may determine a different legal approach. The first part also clarifies how REC platforms are normally structured.

Part II addresses the advantages and risks of REC in relation to traditional investors (banks, venture capitalists and business angels), which can be especially attractive to a certain group of investors. The scope is also to clarify which causes may justify the continuous growth of this method of financing so far.

Finally, in Part III, before the legal question is answered, we assess the American and Portuguese legal frameworks to understand whether some of the risks determined in Part II have been legally addressed. After only these three steps, it will be possible to find a proper answer to this legal question. Part III is followed by some concluding remarks, including a critical analysis of the future of this form of financing in Portugal.

1. REAL ESTATE CROWDFUNDING

1.1. PROPTech AND REC

Following the recent FinTech revolution in the context of the financial markets,³ the emergence of PropTech has become a main disrupting element in the context of the real estate industry. This concept can generally be defined as the use of new digital products within the real estate field, which is not a totally recent phenomenon.⁴

According to experts, Real Estate FinTech refers to the product that results from the connection of these two different areas (PropTech and FinTech) corresponding to “software-based platforms that optimize the buying and selling of real estate assets, (...) [including] classic properties or fund shares or debt and/or equity capital invested in real estate”⁵, such as REC platforms.

Although the real estate industry tends to be a “conservative sector”, which explains the slow use of digital products in this field,⁶ there is no doubt that the introduction of digital platforms for real estate purposes is a way of ensuring liquidity in this market, having a clearly positive impact on results. Nowadays, the community of young entrepreneurs is encouraged daily to create and implement new ideas in different business sectors, to which real estate players should not be indifferent.

The argument that some of the risks inherent to this sector⁷ are not completely solved by PropTech⁸ cannot prevent the use of new technologies in the real estate industry. Looking into the future, Real Estate FinTech, mainly focused on REC, has the potential to introduce innovation into this type of transaction, if properly followed by specific regulation and a moderate optimism by the crowd of investors. These reasons justify addressing this new method of real estate investment from a legal perspective, as well as all the risks raised.

³ The term Fintech can be broadly defined as “(...) the use of technology to deliver financial solutions (...) often seen as a uniquely recent marriage of financial services and information technology”. ARNER et. al. (2015), p. 3.

⁴ ANDREW BAUM recalls the first PropTech wave of 1980-2000 (PropTech 1.0) which “was all to do with data and computing power”, achieving PropTech 2.0 with the online residential market sector or even PropTech 3.0 through blockchain. BAUM (2017), pp. 10, 86.

⁵ FETH, GRÜNEBERG (2018), p. 1.

⁶ Ibid, p. 1.

⁷ Sections 1.2.1-1.2.2.

⁸ New digital products cannot solve, for instance, the physical deterioration of real estate assets over time. BAUM (2017), p. 85.

1.2. HISTORICAL APPROACH: THE ROOTS OF THE PRACTICE

Historically, it is difficult to determine when the crowdfunding practice began,⁹ but the very first initiatives in this area lead us, at least, to 2002, when the non-profit Blender Foundation launched a crowdfunding campaign as a way to financially support the Blender, a widely used three-dimensional animation software developed by a Dutch company called Not a Number.¹⁰ To deal with the financial distress caused by the reduction in sales associated with the dot.com crisis,¹¹ this campaign reached the amount of money needed (€ 100,000) in only seven weeks.¹²

Unlike regular crowdfunding, the first REC platform is more recent and easier to determine. The platform called Fundrise, founded in 2010 by BEN MILLER and DAN MILLER, introduced the first private market real estate investment platform in the world. This platform, whose main target was the American market, was only launched in 2011. The project is considered the cornerstone of a “whole new way to invest in real estate”¹³ that has been constructed since then. According to the information provided on the website, this project promises to rebuild the whole system of investing, making it easier for individuals to access the best investments. Fundrise is “reinventing the way people invest their money”.^{14/15}

Like regular crowdfunding, this type of crowdfunding has blossomed after a crisis period. It has been considered an important alternative to the traditional financing channels since the subprime crisis in 2008.¹⁶ From then on, investors have been witnessing an increase in similar platforms around the world. In 2014, BARRY RITHOLTZ identified more than one hundred REC platforms that were operating around the world.¹⁷ CrowdStreet,¹⁸

⁹ FERNANDO BELEZAS argues that this is close to the method used by the Portuguese social charity institutions (*Misericórdias*) since the XVI century. Such institutions used to collect money from the public to deal with their own expenses and to preserve their real estate over time. BELEZAS (2017) p. 24, not. 7, LUÍS GERALDES recalls that, in 1885, the “The New York” newspaper launched a campaign to collect funds to build the support base for the Statue of Liberty. Such project, known as the first big crowdfunding project, reached almost \$ 100,000.00 at that time. GERALDES, CARDOSO, SILVA (2017) p. 303, not. 3.

¹⁰ BELLEFLAMME, LAMBERT, SCHWIENBACHER (2013).

¹¹ MORIS, ALAM (2008).

¹² History section of the website www.blender.org accessed on 7 January 2018.

¹³ www.fundrise.com accessed on 7 January 2018.

¹⁴ Ibid, Section ‘Our Mission’.

¹⁵ In 2015, this platform gave the chance to small investors to invest in Lower Manhattan’s 3 World Trade Center, owning a stake for just \$ 5,000. Under the terms of the project, these investors were entitled to receive an annual return of 5 % on the five-year investment. NARS (2015).

¹⁶ GILLILAND (2017).

¹⁷ RITHOLTZ (2014). In the same year, SAMANTHA GOINS identified only 30 REC platforms. Nevertheless, she admitted that the actual number at that time could be much larger. GOINS (2014), p. 11.

¹⁸ www.crowdstreet.com accessed on 7 January 2018.

Groundfloor¹⁹ or RealCrowd²⁰ are just a few examples of REC platforms that continue online in 2017. Through some of these platforms, each investor can invest in different real estate projects with just \$ 10. Hence, the investor is entitled to receive either (i) a fixed interest rate plus the amount borrowed or (ii) any profits or rental income resulting from the project.

Recent unofficial statistics have concluded that REC grew from \$ 400 million in 2013 to \$ 1 billion in 2014.²¹ In 2015 these types of platforms generated over \$ 2.5 billion, registering a growth of 150%. Following this trajectory, a threshold of \$ 3.5 billion was expected in 2016, which would correspond to a growth of 40%.²² The first real estate platforms were based in the US, followed by the UK and Canada. In Europe, the German platform Companisto,²³ founded by DAVID RHOTERT and TAMO ZWINGE, was launched in 2012 and is currently one of the biggest platforms in the market. Both European and non-European investors are able to invest in real estate portfolios with just € 5.²⁴

Over the next few years, the emergence of these platforms that are especially dedicated to the Asian real estate market have the potential to change this scenario. Asia is generally considered a complex market, with different levels of development,²⁵ but recently the platform InvestaCrowd, founded in 2015, has been facing the challenge of providing access to real estate opportunities for Asian investors, namely in Hong Kong, Tokyo and Singapore.²⁶ Future investment levels there may explode and even surpass the American and European investment levels.

¹⁹ www.groundfloor.us accessed on 7 January 2018.

²⁰ www.realcrowd.com accessed on 8 January 2018.

²¹ In the US, REC grew from \$ 396.4 million in 2013 to \$ 1.014 billion in 2014, according to the data that have been disclosed through the Massolution 2015 Crowdfunding Report. COHEN (2016), p. 40.

²² These figures have not been confirmed by an official entity yet. This statistics group was drawn up by EquityMultiple Team, a New-York based commercial real estate investing start-up. EQUITYMULTIPLE TEAM (2017).

²³ www.companisto.com/de accessed on 8 January 2018.

²⁴ Through the platform Companisto, the project of a five-star superior luxury resort Weissenhaus reached € 7,500,000 of investments, involving 70,000 investors from 92 countries. The project is now considered a benchmark of REC history in Europe. TRAJKOVSKA (2017).

²⁵ Julian Kwan, the founder of the InvestCrowd platform, states that Asia has two types of markets: Japan, Korea, Singapore and, on the other hand, China, India, Vietnam or Thailand. Each group has its own dynamics and different levels of investor protection. ALOIS (2016).

²⁶ www.investacrowd.com accessed on 9 January 2018.

1.3. DEFINITION AND CHARACTERISATION

According to ETHAN MOLLICK (2014), the concept of crowdfunding²⁷ corresponds to a set of “(...) efforts by entrepreneurial individuals [or] groups - cultural, social and for-profit - to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries”.²⁸ Such definition is in accordance with the main elements that characterise the concept of crowdfunding: (i) an alternative financing approach, in the sense that the companies are not financially able to access credit through traditional sources (bank loans, business angels or venture capital funds); (ii) this credit is directly obtained from the crowd, a large group of investors that generally have similar interests and motivations;²⁹ and (iii) the use of Internet-based platforms is essential to connect the members of the crowd.³⁰

Real estate crowdfunding’s assumptions are similar to those of general crowdfunding, except with respect to the features of the real estate assets and real estate market, where the platform mainly operates. Here, the raising of funds is aimed to finance real estate projects that are available online through electronic platforms.³¹

Each REC project may be intended for the acquisition, lease, or total or partial rehabilitation of existing buildings, as well as the purchase of raw land.³² Furthermore, regarding the property type, these investment opportunities are emerging especially in properties for either (i) residential³³ or (ii) commercial³⁴ purposes. In just a few cases, the project can be designed to mix the two.³⁵

The players at stake are also the same as those in general crowdfunding: (i) the project initiator, which can be a company or an individual that proposes the idea and/or

²⁷ The term is frequently defined as a part of a general concept of crowdsourcing. This term was defined for the first time in 2006 by Jeff Howe and Mark Robinson in the American Wired Magazine being interpreted as “(...) an open call over the Internet, with the intention of animating individuals to make a [voluntary] contribution to the firm’s production process for free or for significantly less than that contribution is worth to the firm”. SCHWIENBACHER, LARRALDE (Forthcoming), p. 5.

²⁸ MOLLICK (2014), p. 2.

²⁹ HEMINWAY (2014), p. 38.

³⁰ MARTINS PEREIRA (2016), pp. 10-11, not. 36-38.

³¹ “REC consiste nella raccolta di fondi destinati a un progetto immobiliare attraverso un elevato numero di investitori (“folla”). MORRI, RAVETTA, p. 13.

³² MARCHAND (2015), pp. 25-26.

³³ Pursuant to the statistics dated 2014, “[the] residential [type] accounted for the highest proportion on investments with 57%”. GOINS (2014), p. 12.

³⁴ Commercial properties correspond to 26% of the offerings. Ibid.

³⁵ “The remaining 17% consisted of mixed used developments”. Ibid.

the project to be funded (“the entrepreneur”), (ii) the investors (individuals or companies) that are financially prepared to support the idea, and (iii) the platform “that brings the parties together to launch the idea”.³⁶

In light of these elements, REC can be defined as a set of efforts developed by entrepreneurs that collects funds from a crowd of investors (individuals or companies, which are accredited or not) connected through an electronic platform in order to finance different real estate projects with the aim of acquiring, leasing, or totally or partially restoring existing buildings or the purchase of raw land.³⁷ The impact of this specific type of crowdfunding should be autonomously examined due to the presence of two special elements: (i) the asset type, and (ii) the market where it operates.

1.3.1. REAL ESTATE ASSETS

“Real estate is one of the largest and best understood asset classes in existence”.³⁸ Real estate assets integrate a set of features that distinguish them from other assets, like bonds or stocks, frequently traded on the financial markets. Some of these features lead investors to opt for this class of assets instead of others, as follows:

- i) **Tangible.** Unlike stocks or bonds, real estate assets are only physical. In addition to all the property legal rights, real estate assets can be seen or touched. It is an asset that is easily traded even by less sophisticated investors. Due to its physical nature (in terms of dimensions or geographic location) the asset’s value can be determined more easily, when compared with intangible assets,³⁹ for accounting purposes. This value can even increase if improvements are made to the asset.
- ii) **Low correlation.** JAN DALHUSEIN (2016) recalls that “the essence of all the professional risk management is the selection and diversification of risk, limitation of transaction costs and tax efficiency.”⁴⁰ In this context, one of the ways to ensure

³⁶ BAKER (2015), p. 30.

³⁷ In a similar way, DENIS SCHWEIZER and TINGYU ZHOU argue that “REC is a form of financing in which real estate project developers make an open call on the internet (typically through specialized platforms) to sell a specified amount for equity- or bond-like shares in a company or project, with the aim of attracting a large group of (primarily accredited) investors”. SCHWEIZER, ZHOU (2016), p. 7.

³⁸ GOINS (2014), p. 1.

³⁹ Trademarks, copyrights or patents are considered intangible assets. “Intangible property has no physical substance. These assets derive their value from the rights inherent to their ownership. They are considered intangible because they cannot be seen or touched, yet they have the potential to possess value.” SPECIAL COMMITTEE ON INTANGIBLES (2012), p. 2.

⁴⁰ DALHUSEIN (2016), p. 319.

the mitigation of the risk is to build up a diversified portfolio.⁴¹ Real estate assets play an essential role in this matter due to their low correlation with other asset classes (stocks or bonds).⁴² This means that if real estate assets are included in a portfolio exclusively formed of stocks or shares, the investor will get diversification benefits. For this reason, real estate assets nowadays should not be considered anymore as an alternative but rather an essential component of a portfolio to ensure such diversification.⁴³

- iii) Stable yield levels. According to macroeconomic studies, real estate assets have the potential to generate a regular rental income, being sufficiently competitive with other fixed income alternatives.⁴⁴
- iv) Hedge against inflation. Economic scholars agree that the real estate asset class offers special protection against inflation, which is considered a “macroeconomic indicator which creates substantial distortions in financial statements, future earnings, and overall the performance of securities in the financial market”.⁴⁵ This asset class is able to protect the investor from these uncertainties, since some of the returns expected are typically indexed to inflation, e.g. rental income. In other words, “real estate can be considered a perfect hedge against inflation, under the strong assumption that future rent growth and discount rates move in line with expected and actual inflation rates”.⁴⁶
- v) Tax benefits. Real estate assets can be subject to different tax benefits. This means that if the investor complies with legal assumptions, there may be a reduction in, or in some cases an exemption from, taxes.⁴⁷
- vi) High transaction and management costs. All transactions involving real estate assets generally entail a high level of cost, including expenses on legal support (lawyers or notaries) that are necessary in more complex dealings in addition to taxes.

⁴¹ “Modern portfolio theory tells us that to decrease risk investment should spread across several uncorrelated assets. Global mainstream financial markets are becoming increasingly correlated and effective diversification is difficult to achieve”. GOINS (2014), p. 7.

⁴² SZELYES et al. (2014), p. 5.

⁴³ HUDGINS (2012), p. 14.

⁴⁴ GOINS (2014), p. 3, HUDGINS (2012), p. 14.

⁴⁵ PARAJULI, CHANG (2015), p. 1.

⁴⁶ According to the Gordon growth model. CASE, WACHTER (Forthcoming), p. 18.

⁴⁷ Portugal has several tax incentive examples for this asset class: the rehabilitation works made in buildings located in urban recovery areas may benefit from a VAT rate of 6% and other exemptions in terms of municipal property taxes.

Management costs are related to ongoing management, e.g. improvements in the building that may be required over time and taxes that are periodically due.

1.3.2. REAL ESTATE MARKET

The real estate market also represents a set of features that make it unique, when compared with other markets:⁴⁸

- i) Heterogeneous. The real estate market tends to be “highly heterogeneous”.⁴⁹ The physical characteristics or the location make each real estate asset unique. Hence, “since each property is heterogeneous and possesses unique risks, investors are not able to accurately quantify the risk of each investment and thus rely more on their gut feeling”.⁵⁰
- ii) Illiquid. Typically, the parties acting in this market spend some time choosing a counterparty to negotiate with and the best price that seems most advantageous to close the deal. As a result, these assets may not be automatically sold or exchanged for cash due to the heterogeneity of the assets mentioned above.⁵¹ According to XIN HE and ZHENGUO LIN (2016), this liquidity can be measured by the property’s time-on-market, for instance.⁵²
- iii) Volatile.⁵³ The real estate market is commonly described as a volatile market.⁵⁴ This means that it is expected that asset prices can increase or decrease over a short period of time, which may affect the expected returns. This complex indicator may be sensitive to internal factors felt within the country or to the effects of a worldwide crisis. A suitable example of this was “(...) many of the problems causing the financial crisis and global recession since 2008 have their origin in the

⁴⁸ HE et al. (2016), p. 1.

⁴⁹ LIN, LIU (2008), p. 36.

⁵⁰ NYSTRÖM, (2012), p. 2.

⁵¹ “The real estate market distinguishes itself from the financial market in its high degree of illiquidity. Unlike traders in the financial market who can readily buy or sell a security at its equilibrium price (...)” LIN, LIU (2008), p. 1.

⁵² The main factor that determines real estate liquidity has been extensively discussed in the literature. Most of the references are mentioned in LIN, LIU (2008), p. 12, including alternative ways to assess this liquidity.

⁵³ Volatility is an economic indicator that corresponds to a degree of variation of prices over a certain period, which can be mathematically calculated. If the volatility of the market is high, this means that the prices can quickly change over a short period of time.

⁵⁴ WHEATON (2015).

real estate markets, e.g. the US subprime crisis and the overinvestment in housing in many European countries”.⁵⁵

- iv) Asymmetric. Although this is not an exclusive feature of the real estate market,⁵⁶ information asymmetries are strongly present in this case, typically involving a seller, buyer and broker. Different scholars discuss which party is better informed or what is considered “better” information in this context.⁵⁷ The existence of asymmetric information is “(...) substantial and has key implications for [balanced] housing market outcomes”,⁵⁸ making such market even more heterogeneous.
- v) Restricted. In most of the cases, only accredited investors are financially able to bear the high level of costs or understand the complexity that real estate transactions normally involve. For these reasons, the real estate market is not seen as an investment option for less-sophisticated individuals or for those who expect an financial return immediately after the investment.

In a nutshell, the idiosyncratic dynamic of the real estate market is ensured by this non-exhaustive group of features. The real estate market should be distinguished from the financial market, even though they are connected.

1.4. PLATFORM MODELS

In terms of structure, the REC platform models also share similarities with regular crowdfunding platforms.⁵⁹ Most real estate projects promise high levels of financial return for the investors involved. For this reason, the platform models used are similar to those of debt and equity-based crowdfunding.

⁵⁵ ENGSTED, PEDERSEN (2013), p. 2.

⁵⁶ “Asymmetric information in the financial markets can adopt any of the following types: adverse selection, moral hazard, or monitoring costs.” BEBEZUK (2003), p. 7.

⁵⁷ According to DE WIT and VAN DER KLAUW (2013), the seller is better informed than the buyer, since the former “(...) has private information about certain attributes of his house and/or its own characteristics (e.g. risk preference, financial constraints, and degree of patience).” In the opposite direction, HORT (2000) and OIKARINEN (2012) argue that the buyers “(...) are likely to be better informed about the local market conditions than sellers, because ‘during the process of searching, buyers are more prone than sellers to shop around in precisely the same segment of the market in which they intend to trade.’” apud LIN, LIU (2008), pp. 3-5.

⁵⁸ KURLAT, STROEBEL (2015), p. 2430.

⁵⁹ Crowdfunding is frequently identified as an umbrella term encompassing different types of fundraising that consider the goal and the reward at stake: (i) “donation-based crowdfunding”, (ii) “reward-based crowdfunding”, (iii) “peer-to-peer lending”, (iv) “equity crowdfunding” and (v) “mixed crowdfunding”. GERALDES, CARDOSO, SILVA (2017), p. 304, not. 4.

One of the ways to engage in the investment is to use the traditional debt model. The investor lends a certain amount of money and receives a promissory note issued by the platform. The terms of the repayment may include only the payment of a fixed interest rate or the capital plus the interest. The maturity of the debt varies depending on whether it is a short or long-term debt.⁶⁰

Non-accredited investors should be aware of the different loan structures that can be used on these platforms. If the investor opts for a senior debt structure, this means that the loan on the platform is secured by placing a first ranking lien on the property, which “(...) gives investors significant protection”⁶¹ and the chances of being repaid in case of default are higher. On the other hand, the option of a so-called bridge loan⁶² brings about different consequences. This innovation in the market is considered a short-term debt, which means that it is due in less than one year, with the potential to generate higher interest rates. Nevertheless, a bridge loan is a risky option to invest “(...) as there is no guarantee that the proposed exit plan will be carried out to repay the loan”.⁶³

Equity crowdfunding is also an attractive way to enter into real estate investments.⁶⁴ These kinds of platforms are structured in a different way: the SPV, which is generally an LLC,⁶⁵ is used for each real estate project. This entity, managed by the platform, undertakes the ongoing management of the real estate assets, keeping the “profits, costs and administration as simple as possible”.⁶⁶ The crowd of investors purchase shares in this company and, in the capacity of shareholders of the SPV, are entitled to receive a percentage of the rental income or of the profits from the sale, if there are any. In other words, “the members of the LLC are the equity investors who hold an equity share in the property. They are not on title; the LLC is.”⁶⁷

⁶⁰ The debt’s maturity varies between 6 months and 25 years, according to the empirical studies of SAMANTHA GOINS. GOINS (2014), p. 10.

⁶¹ On the REC platform Instalend.com all the crowdfunding offerings on the platform are senior debt because they believe that “this creates the simplest and most efficient way for investors to understand the risks and returns associated with each deal”. FAQ Section <https://www.instalend.com> accessed on 17 March 2018.

⁶² “Bridge round is frequently realised when a company, which raised venture capital, appears in a situation of need for a further cash infusion to continue to grow”. MATEJKA (2016), p. 41.

⁶³ GOINS (2014), p. 10.

⁶⁴ Financial literature also discusses which crowdfunding model – equity or debt – can offer higher levels of return to the investors in the real estate market. SCHWEIZER, ZHOU (2016), pp. 31-32.

⁶⁵ The use of an LLC goes back to Germany in XIX century. The company is treated as a legal entity separate of its owners. All the owners of the firm enjoy limited liability, regardless of their participation in control. GEVURTZ, (2010).

⁶⁶ GOINS (2014), p. 10.

⁶⁷ BAKER (2015), p. 35.

According to DENIS SCHWEIZER and TINGYU ZHOU (2016), a slight evolution was registered in this context, in the sense that “in an earlier version of real estate crowdfunding, an LLC funded by accredited individuals would make loans to sponsors [crowdfunded companies] to renovate and sell residential properties. The loans usually matured in six to eighteen months and were backed by a personal guarantee from the sponsor [the crowdfunded company]. However, nowadays, many different types of investment options exist, including common equity, preferred equity, mezzanine debt, bridge loans, and so on.”⁶⁸ Having said this, considering the continuous use of this method of financing by the crowd, I believe that the diversity of equity contracts,⁶⁹ which have been emerging in regular crowdfunding, is going to be absorbed by real estate crowdfunding in the future.⁷⁰

SAMANTHA GOINS (2014) highlights the importance of the Lead Generation as another example of platform model. These kind of platforms, especially common in South East Asia, allow “the developers to list investment opportunities online (...), [putting] the investors in touch with the developers seeking finance”. However, these “platforms” do not collect the investors’ funds, nor do they offer any recourse if the investments made go wrong. For these reasons, since these “platforms” are hardly subject to legal duties of information or protection for the investor, lead generation models should not be considered a platform in a technical sense, in my view.⁷¹

⁶⁸ SCHWEIZER, ZHOU (2016), p. 7.

⁶⁹ The first contractual initiatives of this crowdfunding model include six different types of investments, especially in the US. This diversity may be justified through the fact that the SEC, 3 years after the JOBS Act, decided not to restrict the type of securities issued by the companies.

⁷⁰ About the diversity of contracts WROLDSEN (2016), pp. 25-28, GREEN, COYLE (2006), p. 171, CHANDLER (2016).

⁷¹ SAMANTHA GOINS argues that Lead Generation platforms “(...) purely allow developers to access a large pool of willing investors”. GOINS (2014), p. 10.

2. PROS AND CONS

In the absence of a clear position on REC by the European Securities and Markets Authority until now, the second part of this thesis is focused on both the potentials and risks of this particular form of financing from a regulatory perspective, of which the crowd of investors should be aware.

In practice, I understand that this regulatory authority should put forward clarification on risk management and governance with respect to REC, like other cases that also entail a high level of risk and speculation, which was the case with ICOs.⁷²

2.1. ADVANTAGES

Before the emergence of this financing alternative in the real estate sector, investments used to be made through the traditional players, namely banks, business angels⁷³ or venture capitalists.⁷⁴ However, investors seeking liquidity used to deal with some constraints on these investments forms, e.g. when the amount required by companies was too high for business angels or extremely low for venture capitalists, there were no opportunities to raise the capital. Considering these barriers, investors were looking for new ways to obtain capital, especially after the American sub-prime crisis period in 2007. Regular crowdfunding was identified as a successful way of rectifying this market failure of private equity.^{75/76} A few years after the employment of regular crowdfunding, this potential was adopted in the real estate sector and now, making a “comparison between traditional funding and crowdfunding in real estate across the globe shows evidence that the trend of crowdfunding in real estate has been increasing”.⁷⁷

⁷² In November 2017, the European Securities and Markets Authority took the initiative of alerting the investors regarding the high risks of ICO, given its rapid growth. This Statement qualifies these kind of investments as “extremely risky and highly speculative”. EUROPEAN SECURITIES AND MARKETS AUTHORITY (2017)

⁷³ “Angel investments are affluent individuals who provide capital for a business start-up, investing their own money. Angel financing, which has become one of the most relevant methods to finance new ventures”, providing capital at an early stage along with post-investment services. Unlike venture capital, angel investing can be considered long-term money. HENRIQUES (2012), p. 12.

⁷⁴ “Venture capital is not long-term money. The idea is to invest in the company’s balance sheet and infrastructure until it reaches a sufficient size and credibility so that it can be sold to a corporation or so that the institutional public-equity markets can step in and provide liquidity”. Depending on the portion of the equity, venture capitalists can receive high returns and decide the destination of the company. ZIDER (1998).

⁷⁵ PERESTRELO DE OLIVEIRA (2017), p. 240, PEREIRA DUARTE (2017), p. 251.

⁷⁶ Against, JOSÉ VICENTE LATORRE considers that the argument according to which crowdfunding is an alternative “(...) to mainstream financial systems, as, at least partially, untrue” since the investors do not have access “to all opportunities and ventures in the investment universe”, meaning that the economic field is far from perfect, LATORRE (2016), p. 17.

⁷⁷ MANOHAR et al. (2016), p. 10.

Before the project is launched, there is a due diligence period that is common to any investment, during which it is verified whether the company together with the project proposal are financially prepared to comply with the long-term conditions of repayment, in terms of liquidity.

One of the main differences between crowdfunding and traditional investors is the approval time for the projects. “A process that normally takes several months to initiate and finalize has now become a streamlined process [through crowdfunding]”.⁷⁸ There is a significant reduction in the due diligence time given that now the same process lasts weeks, days or even hours due to “(...) the accessibility, and efficiency of equity crowdfunding platforms”.⁷⁹ JEREMY COHEN (2016) reveals the importance of this feature stating that the “speed of execution in a real estate transaction is instrumental towards not only competing to win a deal, but also towards building a firm’s reputation of professionalism and efficiency. This competency can help [crowdfunding real estate platforms] to build upon [their] current momentum and continue to grow”.⁸⁰

The use of crowdfunding has also introduced a revolutionary method to invest in this sector with the dematerialisation of the real estate investments, i.e. a few years ago, a visit to the property used to be crucial to engage in this sort of projects and the only way of checking the physical condition of the building. Today, investors are invited to invest based only on the features advertised on REC platforms, “(...) without stepping away from his or her computer. Someone from New York, Kansas, or North Carolina can invest in a project in California, and vice-versa”.⁸¹ As a consequence of this online decision-making, there is a significant reduction in time consumption since the typical meetings with the investors are not needed to get the approval. “With real estate crowdfunding, you simply browse deals on a website, and invest or sell shares in properties with a couple of clicks”.^{82/83}

⁷⁸ BAKER (2015), p. 42.

⁷⁹ BAKER (2015), p. 42. Entrepreneurs used to wait between eight or twelve months to find angels interested in the projects plus the time of negotiation of the deal.

⁸⁰ COHEN (2016), p. 23.

⁸¹ BAKER (2015), p. 41.

⁸² SCHWARTZ (2016), p. 13.

⁸³ Unlike the crowd of investors, business angels “(...) routinely visit and engage with the entrepreneurs they fund, which reduces agency costs”. As a proof of their commitment, these investors invest “no more than a two-hour drive from their investments”. IBRAHIM (2015), p. 100.

As part of this dematerialisation process, REC is also prepared to combine most of the strengths of other forms of real estate investing,^{84/85} including lower management or transaction costs⁸⁶ given that all the investment steps are managed online. In some cases, crowdfunding platforms provide detailed features on proprieties at zero cost.⁸⁷

In terms of return, crowdfunding normally exceeds other forms of investment. Taking the old savings bank account as an example, current interest rates are extremely low, close to zero, according statistical studies by the Bank of Portugal.⁸⁸ In France, the expected returns on a savings account is around 0.75%, for instance.⁸⁹ In REC projects the returns are higher and almost reach 8.4% in the US and 6.3% in the UK.⁹⁰ Depending on the location and the features of the investment, a Portuguese REC project may currently promise returns of almost 3.70%.⁹¹

Investments in real estate through crowdfunding also have the potential to beat inflation. In other words, and taking the example above, a savings bank account establishes a long-term interest rate, which means that the returns will stay the same over time. In REC, the estimated return is calculated in a different way: the investor has the chance to beat inflation since the returns on this type of investment are rents or profits on sales that are adjusted in accordance with inflation. At this moment, there is an expectation that prices are going to rise over time.^{92/93}

⁸⁴ One of the classic forms to engage in some real estate project is through direct property investments, which usually provide higher levels of control. The management policies are sufficiently transparent because the investors are directly taking the control of their investments. Despite the large amount of operating costs and the inherent level of risk (that is hardly mitigated due to the absence of diversification benefits of the portfolio), this option has the potential to generate higher levels of return. GOINS (2014) p. 3.

⁸⁵ Indirect real estate forms of investing as corporate entities, investment funds and REIT. In this latter form, especially common in the UK, the trust is taking the control of the investment in the name and on behalf of the beneficial owner, which may compromise the transparency of the investment and the good levels of return.

⁸⁶ According to the information advertised by the crowdfunding platform Fundrise, there is a considerable difference between the management annual costs through this platform (1.0%) and the traditional investments (1.37%-6.45%) and it is concluded that “Fundrises saves you 0.37%-5.45% annually”. Price and Cost Structure Section <https://fundrise.com/pricing> accessed on 3 February 2018.

⁸⁷ SCHWEIZER, ZHOU (2016) p. 11.

⁸⁸ BANK OF PORTUGAL (2017), p. 39.

⁸⁹ SCHWARTZ (2016), p. 17.

⁹⁰ GOINS (2014), p. 8.

⁹¹ E.g. the real estate project that is currently available at Cidade Universitária in Lisbon, through the Spanish crowdfunding platform Housers www.housers.com/pt accessed on 3 February 2018.

⁹² “The problem is that it [will not] be able to beat inflation, so you will actually lose money in the long term by leaving it in a savings account!” SCHWARTZ (2016), p. 17.

⁹³ Section 1.2.1. iv).

REC and REIT are similar in terms of the management control of the investment portfolio since there is no need to manage the physical property, with the investors being hands-off the investment in both cases. Despite the similarities of control, there are considerable differences in terms of transparency: a REIT normally has thousands of properties under its own management, which means that the trustee “decides which property to buy and which property to sell”,^{94/95} whereas in REC it is the investor who decides which investments to make. The platform discloses all the features of the project on the website, including photos of the real estate asset, analyst reports or other relevant business strategic documents. Even after the investment, the investor has the chance to follow-up the results, since the platform “give[s] deal specific updates to investors, which are a luxury when compared to REIT analysis, whose reporting is often the result of many syntheses of statements.”⁹⁶

On the other hand, a significant reduction in the minimum investment levels is especially attractive for investors. Unlike traditional forms of investment, which used to require higher capital amounts to engage in this type of project, REC platforms allow investments starting with just € 50.⁹⁷ This reduction in the minimum investment amount has a double effect: it not only opens the door for the “average consumer to engage in [this type of] process”⁹⁸ but also offers the possibility of investing in more than one real estate project. Therefore, with the chance to invest in different real estate projects, the diversification of the investment portfolio⁹⁹ becomes a possibility, which means that if one real estate project fails, the resulting losses can be offset with gains from other projects.

To complement all these advantages, REC was subject to regulatory changes with respect to the type of investors. Initially, according to the original version of the JOBS Act (2012), general crowdfunding was restricted to accredited investors.¹⁰⁰ Currently, af-

⁹⁴ SCHWARTZ (2016), pp. 19-20.

⁹⁵ REIT represents “an amalgamation of many properties, which an individual investor cannot feasibly assess on a deep enough level”, COHEN (2016), p. 24.

⁹⁶ COHEN (2016), p. 25.

⁹⁷ The minimum investment amount varies according to the REC platform that is used. The Spanish REC platform Housers establishes as minimum investment € 50, whereas the German REC platform only € 5.

⁹⁸ BAKER (2015), p. 44.

⁹⁹ Section 1.2.1. ii) on the diversification of the investment portfolio.

¹⁰⁰ Namely (i) a natural person whose individual net worth, or joint net worth with that person’s spouse, exceeds \$ 1 million, excluding the primary residence or (ii) any natural person who had an individual income more than \$ 200,000 in each of the two most recent years or joint income with that person's spouse

ter Title III of the JOBS Act entered into force in 2016, non-accredited investors are allowed to invest in equity crowdfunding, without meeting the accredited investor requirements. REC platforms finally had the chance to tap this “huge investor base”,¹⁰¹ which has ensured the growth of this financing strategy to date.

2.2. RISKS

In abstract terms, risk can be defined as “the potential that events (routine, planned or unanticipated) may have an unexpected and noteworthy impact on results”.¹⁰² In more complex environments, where predictions and lack of knowledge are frequent, the risk expectedly increases. Despite the success of some investors, historic bubbles have resulted from expectations of future advances that should be used as main examples, as part of our “constructive collective process”.¹⁰³

From the history of financial markets,¹⁰⁴ we have inherited different concepts of risk – including risk asset ratio,¹⁰⁵ credit risk¹⁰⁶ or operation risk¹⁰⁷ – that should not be disregarded in the context of crowdfunding.¹⁰⁸ Investing in the real estate sector, as I have already demonstrated in Part I, entails a set of risks due to the features of the real estate market, where sometimes a diversified portfolio may not be sufficient to mitigate all the risks.¹⁰⁹ Also, the analysis of the institutional framework of the country where the real estate investment is made could be another strategy to the reduce the risk, according to some scholars.¹¹⁰

in excess of \$ 300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year, according to Title 17, § 230.501, (5)-(6) of the US Code of Federal Regulations. This Article includes more legal provisions regarding accredited investors.

¹⁰¹ BRIGGMAN, THERRIault (2016), p. 15.

¹⁰² LEMOS (2016), p. 4.

¹⁰³ SORNETTE (2009) apud LEMOS (2016), p. 4, not. 26.

¹⁰⁴ DIONNE (2013)

¹⁰⁵ This concept “is one of the key notions introduced in (...) Basel I and is now substantially used everywhere as a means of calculating a bank’s capital needs in respect of credit risk”. DALHUISEN (2016), p. 703.

¹⁰⁶ This means the “evaluation of the risk in the banking assets and in that connection especially of the creditworthiness of bank debtors and the likelihood of their default.” Ibid., pp. 701-702.

¹⁰⁷ This type of risk is related to the risk “connected with a failure of its organisation and systems [introduced by Basel II]”. Ibid., p. 699.

¹⁰⁸ According to empirical studies, personal networks, the quality of the underlying project and the geographic component of the investment are some of the factors that may help to mitigate the risks when general crowdfunding is used. MOLLICK (2013), p. 29.

¹⁰⁹ LEMOS (2016) pp. 6-7.

¹¹⁰ In 1995, TOM GEURTS and AUSTIN JAFFE approached the institutional framework of the countries as a variable of risk, namely the “(...) unfair administration of laws, the lack of law enforcement, corruption levels, nationalization and expropriation threats (...)” can have an important impact on the risk/return of the real estate investments. For this reason, the Authors argue that “institutional characteristics of countries should receive more attention”. GEURTS, JAFFE (1996), pp. 117-120.

In addition to the general risks, there are specific risks regarding REC that investors, in particular non-accredited investors, should be aware of.

2.2.1. FRAUD¹¹¹

Despite the potential growth of crowdfunding, some scholars have been concerned about the emergence of cases of fraud in this field.¹¹² The little evidence of these sorts of cases so far does not mean that the problem will not arise in the future.¹¹³

There is a risk of fraud, including when the collection of funds is not directed to the project's initially proposed goal or when the payment conditions for the REC project are not intentionally met, e.g. "a fraudulent entrepreneur could lure funders to invest in his project, and subsequently disappear with the funds, never to be heard from again. An entrepreneur may also exaggerate the projected returns on the project, and other promoters may similarly be led to overstate their prospects to attract investors".¹¹⁴

Real estate deals have always been characterised as local or regional investments. Nevertheless, as clarified above, REC has introduced a significant change on this point: there is an opportunity to engage in this type of funding without visiting the building, making such investment international and virtual. But apart from this potential, the investor should be aware of the problem of asymmetric supporting information. In this respect, there are different forms of asymmetric information in the real estate market but, in general terms, two "broad types can be distinguished: [i] those related to the characteristics of the property itself, and [ii] those related to the conditions of the market in which the property is traded".¹¹⁵

¹¹¹ The concept of fraud is hard to define, nevertheless "a good conception of fraud (...) must satisfy three general conditions: sufficient flexibility for the law to adapt to changes in behaviour by primary actors, sufficient clarity for the law to satisfy requirements of notice and guidance of discretion by legal actors, and sufficient content for the law to inform the public of the nature of the wrongdoing involved when an actor is held liable for fraud". About the concept of fraud BUELL (2011).

¹¹² ROBERTA KAMEL argues that the crowdfunding bills "should be renamed 'Fraud-Funding through Crowdfunding'". KAMEL (2012) apud BRADFORD (2017), p. 15.

¹¹³ "We find that the fraud rate in the crowdfunding market is still very low and that fraud is not a random phenomenon, which can be explained by empirical models". CUMMING et al. (2016) p. 33.

¹¹⁴ There is no registration of fraudulent REC cases so far, but we cannot say the same regarding general crowdfunding. In 2012, the Massachusetts Securities Division charged "(...) a man for collecting \$ 153,396 from twenty people who were led to believe that they were investing in a gaming site". TOMBOC (2013), pp. 266-269.

¹¹⁵ HE et al. (2016), p. 4. Seller-side, buyer-side or a brokerage relationship may also influence the asymmetric information levels. Scholars have tried to understand which party is better informed in the real estate sector. HE et al. (2016), pp. 3-5.

The democratisation process of REC, opening the door to non-accredited investors, will certainly aggravate the problems with respect to imperfect information, i.e. “the crowd is not as fit as the traditional lenders to evaluate the true risks and prospects of a new venture and thus may fall into the trap of false signals sent by entrepreneurs seeking funds or inability to assess the signals correctly”.¹¹⁶ Hence, fraudulent parties are aware of the fact that this group is characterised by having “previous little experience with securities offerings”, thereby being easier to defraud.

The lemons problem may also arise in the REC context¹¹⁷ as a consequence of these asymmetries. It is expected that most of the non-professional investors will not be able to distinguish profitable REC projects from unprofitable ones, i.e. “whether an entrepreneur or a project is good or bad constitutes information that is largely hidden from funders”.¹¹⁸ Considering that the whole REC process runs online, there are additional “inefficiencies”¹¹⁹ which increase the level of fraud – the possibility of easily changing name, the e-mail used (fake users) or the ease of disappearing before the regulatory entities take action, when the process goes wrong.

In one sentence, “(...) the entrepreneur holds all the cards. Investors have little information about what is to come and little control over what the entrepreneur does.”¹²⁰

2.2.2. DUE DILIGENCE¹²¹

Considering the complexity of international real estate deals, the due diligence period before the transaction becomes crucial for all the parties involved.¹²² Despite the several meanings of due diligence,¹²³ the main idea is to carry out a detailed analysis and

¹¹⁶ FIROOZI et al. (2017), p. 2.

¹¹⁷ “A “lemons market” is a market in which asymmetric information exists between sellers and buyers. Since the buyers are not fully informed as to the quality of the products, they discount the price of all products. High quality products will not sell for a price that reflects their quality and will, thus, exit the market. Only “lemons” are left in the market”. IBRAHIM (2015), p. 591.

¹¹⁸ TOMBOC (2013), p. 266.

¹¹⁹ Ibid.

¹²⁰ BRADFORD (2012) apud TOMBOC (2013), p. 267, not. 114.

¹²¹ The expression “comes from latin terms *diligentia* – care, carefulness, and *due* – proper, reasonable. [This term] began to be widely used in the United States in the 1930s when the United States Congress enacted the Securities Act of 1933 after the stock market crash in 1929.”. VIESTURS, AUZIŅŠ (2015), p. 92.

¹²² In REC cases, post contractual due diligence, when the buyer or the investor carries out due diligence after the transaction, is also relevant for monitoring purposes.

¹²³ VIESTURS, AUZIŅŠ (2015), p. 93.

assessment of all the real estate information, as well as related areas. Interpretation mistakes or omission of information may have a negative impact on the investor's returns. The verification process can be approached in two ways.

The first due diligence process is conducted by the REC platform, mainly focused not only on the structure and activity of the entrepreneur, i.e. "the performance of criminal, background and credit checks on both the company and its principals"¹²⁴ but also on the terms and conditions of the REC project. In the event of finding "red flags", the project may not be included in the investments portfolio of the REC platform.

Despite the importance of this diligence process, there are no uniform guidelines in this respect, at least in Europe. Each REC platform applies its own criteria and the "multiple layers of diligence"¹²⁵ are defined according to the management policies followed, meaning that the boundary between fraud and poor due diligence cases becomes tenuous and even more difficult to determine.¹²⁶ The transparency of the proceedings becomes a "grey zone" and the reputation of the REC platform can be irreversibly affected. If problems and doubts arise in this part of the proceedings, it is end of the platform.

After the project has been disclosed, the second due diligence process is undertaken by the investor. In real estate transactions, the parties frequently state that they are comfortable with the functioning of the market, with the type of asset at stake or even with the property value and its correspondence with the contract's price. Scholars argue that investors are frequently too optimistic about the future of the crowdfunded project.¹²⁷ Both factors increase the potential level of moral hazard ("too big to fail").¹²⁸

Having said that, "the question remains whether or not the buyer – a non-professional – has truly familiarised himself with the property that is being purchased" or, in the REC case, in which is being invested.¹²⁹ Although REC platforms always advise that investors should undertake their own due diligence procedures before the investment, the

¹²⁴ As advertised through the REC platform RealtyMogul.com, Section 'Due Diligence on Real Estate Sponsors' <https://www.realtymogul.com/resource-center/articles/due-diligence-on-real-estate-sponsors> accessed on 29 June 2018.

¹²⁵ EQUITYMULTIPLE Staff, 'Due Diligence Information', disclosed by EQUITYMULTIPLE Crowdfunding Platform, 3 August 2017 <https://www.equitymultiple.com/blog/investing-strategy/due-diligence/> accessed on 10 March 2018.

¹²⁶ Seedrs platform advises that "business failure does not mean equal poor due diligence. A large proportion of early-stage businesses are likely to fail (...) a reality that all our investors understand. No level of due diligence can prevent genuine business failure". GRANT (2017).

¹²⁷ MARTINS PEREIRA (2016), p. 24.

¹²⁸ SCHWARCZ (2017).

¹²⁹ VIESTURS, AUZIŅŠ (2015), p. 92.

average non-professional investor may not be able to comprehend all the information, “investors are not specialists and thus have access to less information about the industry, past performance of the entrepreneur, and many other pieces of value-relevant information”.¹³⁰

The only way to deal with this problem is to analyse all the information provided by the platform and go beyond that, which means studying the implications of all the potential risks that may arise, even if the real estate asset is commonly traded. The educational part is the key.¹³¹

In practice, most of the platforms deal with this problem by requesting that investors confirm the terms and conditions of the investment “by signature or – in the case of distance communication – by electronic confirmation legally equivalent to the signature. This provision is intended to ensure not only that investors have actual notice of the investment information sheet, but, above all, are aware of the potential risks associated with the investment, especially the risk of the total loss of the assigned capital”.¹³²

2.2.3. LACK OF LIQUIDITY

One of the major concerns of REC is the lack of liquidity due to the absence of a secondary market. This factor is particularly relevant because the real estate market is also illiquid *per se*, as already mentioned.¹³³

The liquidity problem is referred to as the “lack of an exit strategy for investors”,¹³⁴ which means there is no way to trade or resell the shares previously issued through REC. The investors, after investing the capital, “are usually locked into their investment and almost invariably cannot quickly sell such securities through a secondary market or exchange if their investment preferences change”.¹³⁵ The introduction of this

¹³⁰ SCHWIENBACHER, LARRALDE apud TOMBOC (2013), p. 268.

¹³¹ Despite the importance of this behaviour, GMELEEN TOMBOC argues that “if a potential investor has to spend much time and effort to study each project and form opinions on: (i) whether the entrepreneur is giving a complete and accurate description of the project; (ii) whether the product or service will be well-received by its target market; and (iii) whether his return on that project will be high enough to entice him to invest, it degrades user experience and discourages him from participating in future fundraising”. TOMBOC (2013), p. 269.

¹³² KLÖHN et al. (2016), p. 14.

¹³³ Section 1.2.2.

¹³⁴ AUSTIN (2018), p. 22.

¹³⁵ Ibid.

type of market could be a way to moderate the investors' optimism and an appropriate way to ensure the sustainability of REC market.

The previous step of creating a secondary market for equity crowdfunding has become controversial among scholars. RICHARD EPSTEIN (2015) argues that “the amounts invested are too small and the likelihood of major economic gains are too slight to justify the investments that would be required to create a secondary market”.¹³⁶ For the same reason, ANDREW SCHWARTZ (2015) states that “there will likely be only a very limited and illiquid secondary market for crowdfunded securities”.¹³⁷

Considering the possibility of introducing a secondary market within the REC context, regulatory measures would be immediately required. Cases of fraud are frequent,¹³⁸ namely “pump and dump” schemes,¹³⁹ which give this type of market an especially poor reputation. This would be the only way to ensure that investors are protected from these uncertainties.

I understand that the position assumed by the Authors mentioned above cannot be adopted in the REC field. It is expected that this form of financing will continue to grow over the next few years.¹⁴⁰ If the volume of investments increases, the investors will continue to be locked into their investments, even when they have lost interest in the project. The creation of a secondary market followed by a proper regulatory framework is the only way to ensure the protection of the investor and the sustainable development of the primary market.

2.2.4. ENFORCEMENT OF THE SECURITY

According to the practice, REC platforms always advertise to the crowd when the real estate projects are backed by a security, which is frequently a mortgage. This security

¹³⁶ EPSTEIN (2015), p. 50.

¹³⁷ SCHWARTZ (2015), p. 652.

¹³⁸ JANET AUSTIN provides the example of the Emerging Company Marketplace “the junior board of the American Stock Exchange, which opened in 1992 and closed in 1995, after only three years of operation”. AUSTIN (2018), p. 28.

¹³⁹ “The manipulator gradually acquires a large number of securities in a particular company. Positive false or misleading information is then disseminated about the company. This may be accompanied by a flurry of matched purchases and sales between associates to give the appearance of heightened interest in the securities, which in turn has a tendency to further artificially inflate the price. When the price of the securities has become inflated, the manipulator sells, that is “dumps,” the securities before the price falls back to a more realistic level”. Ibid. p. 23.

¹⁴⁰ Section 1.1.

is provided by the crowdfunded company, intended to reassure investors that the capital invested is guaranteed in case of default.

Many questions have been raised regarding how this security, which is granted in favour of different investors, can be enforced legally. Sceptic investors believe that the enforcement of this security is almost impossible to put in practice if we consider the large number of investors dispersed around the world. This topic does not intend to be an exhaustive study on enforcement of securities, but a brief note should be made on it, given that most of the scholars have not addressed this topic under the context of REC until now.

It should be mentioned briefly that, over the last few years, the number of REC platforms including real estate projects has increased, especially in Portugal. The future of this form of investing along with the favourable context of the real estate business in this country¹⁴¹ has promoted the multiplication of REC projects based in Portugal. On one hand, the activity of REC platforms that are securely established in Portugal are necessarily monitored by the Portuguese regulator and, on the other hand, the first wave of contracts backed by mortgages on properties located in Portugal may also be subject to Portuguese law. These reasons justify the interest in approaching the discussion on the enforcement of securities from a Portuguese legal perspective.

Having clarified this, one of the key questions at stake is to understand if the investors are legally able to enforce this security individually in the event of default, or whether this enforcement requires the intervention of all the investors (class action). Although the investors may establish the manner of enforcement in the contract (whether individually or collectively), Portuguese law must be analysed to assess whether there is an appropriate legal manner to pursue it.

I would suggest that a suitable starting point to answer this question is to analyse REC in comparison with syndicate loan agreements.¹⁴² I understand that both cases share several similarities in terms of composition: on one hand, there is always a plurality of creditors and, on the other, the security included in the contract is granted in favour of all

¹⁴¹ Section 4.

¹⁴² “A form of loan business in which two or more lenders jointly provide loans for one or more borrowers on the same loan terms and with different duties and sign the same loan agreement. Usually, one bank is appointed as the agency bank to manage the loan business on behalf of the syndicate members”. WOOD, (2008), p. 94 apud RODRIGUES (2017), p. 161, not.14.

the investors. The enforcement of the security is also a topic of debate in the context of this type of agreement.¹⁴³ Assuming that both contracts are similar in general terms, different legal positions can be put forward.

According to JOÃO PAULO MENDES RODRIGUES (2017), the enforcement of the security must be consensual among the investors. This Author argues that one creditor cannot act as it would be the sole creditor under the terms of the syndicated loan agreement. One of the arguments is that the creditor's rights are quantitatively different, in accordance with the proportion of the capital invested, but qualitatively equal, which corresponds to a communion of rights in this type of loan agreement. Supporting his position in the wording of Portuguese law, the Author argues that the co-ownership legal framework can be applied in the context of a communion of rights *in rem* of a security.¹⁴⁴

Nevertheless, this legal position brings about important procedural consequences of which the parties should be aware. In accordance with Portuguese procedural law, all the investors must be parties in the proceedings for enforcement purposes (class action), whenever the co-ownership legal framework is applied.¹⁴⁵ Otherwise, the judicial decision cannot definitively regulate the legal situation, which corresponds to a procedural illegitimacy with a consequent dismissal of the plaintiff of the instance.¹⁴⁶

In light of these arguments, I consider that this legal solution to enforce the security in the REC context, always requiring a meeting of wills or a sense of coordination between the investors, goes against the nature of crowdfunding itself, given that under the terms of this financing model, the investors do not know each other and it would be difficult to coordinate the enforcement of the security.¹⁴⁷

A different and more helpful standpoint capable of being adaptable to REC is argued by TERESA NOVO FARIA (2017), according to which a sole creditor is legally entitled to enforce the security. For this Author, this legal solution is only possible when the securities are individually granted in favour of different creditors on the same good: in this

¹⁴³ FARIA (2017), RODRIGUES (2017).

¹⁴⁴ This is legally possible since Article 1404 of the Portuguese Civil Code sets out that the co-ownership legal framework can be also adapted to the sharing of other rights.

¹⁴⁵ This a typical case of *litisconsócio necessário passivo*, which means that the co-holders should jointly be parties in the procedures.

¹⁴⁶ Articles 33, No. 1 and 278, No. 1, paragraph d) of the Portuguese Procedure Code.

¹⁴⁷ Section 1.2, Section 1.3.

case there is a multiplicity of rights *in rem* of a security, rather than a communion of rights.¹⁴⁸

In my view, REC is a suitable example of this multiplicity of rights, following the reasoning of TERESA NOVO FARIA (2017): a sole creditor is legally entitled to initiate the enforcement proceedings to benefit from its right *in rem*, as long as the security is individually granted and created in its own favour.

This legal position does not harm the remaining creditors. In fact, they would still be protected through the lodgement of claims mechanism. According to Portuguese procedure law, when the enforcement proceedings are initiated, the remaining creditors have the chance to join the process through the lodgement of claims,¹⁴⁹ assuming the legal position of claimants, allowing them to recover the capital invested. In this case, the claimant has a different legal status in relation to the person who initiates the enforcement process.¹⁵⁰

In a nutshell, I consider that REC may benefit from the academic debate that is currently ongoing in the context of syndicated loan agreements. In the absence of a clearer understanding, the enforcement of the security in the REC field may involve legal constraints that should be noted. Despite its recent relevance, the courts have not taken a position on this debate so far, which means that now is the appropriate time to encourage the academic community to put forward other solutions on this matter, before the legislator takes action.

In my opinion, the adopted legal solution should be in line with the features of REC, namely the plurality of investors dispersed around the world, allowing the creditors to exercise their own rights *in rem* of a security individually, under the terms of the Law. Otherwise, it will be impossible to coordinate the enforcement of the security among thousands of investors.

¹⁴⁸ FARIA (2017), p. 635, not. 130.

¹⁴⁹ Articles 789, No. 1, paragraph b) and 788, No. 1 of the Portuguese Code of Civil Procedure.

¹⁵⁰ A creditor who initiates the procedures benefits from a general enforcement in relation to all the assets of the debtor, whereas the claimant's enforcement is limited to its rights *in rem*. The initiator is also prioritised in relation to the claimants in terms of payments. FARIA (2017), p. 638.

3. REGULATORY APPROACH

From a European perspective, the European Commission has recently drawn up a proposal for a regulation on European Crowdfunding Service Providers for Business¹⁵¹ having different purposes, including to minimise the application of different legal rules across the jurisdictions on this matter or “to empower the investors with the necessary information on crowdfunding, including the information on the underlying risks”.¹⁵²

Although this proposal does not mention the possibility of applying crowdfunding in the real estate sector, this draft includes important legal rules that, in my opinion, must be adapted to the REC field regarding conflicts of interest,¹⁵³ the use of an SPV¹⁵⁴ or one important legal provision on “entry knowledge test and simulation of the ability to bear loss”,¹⁵⁵ which may have the potential to mitigate some of the risks identified in Part II.¹⁵⁶

Nevertheless, some opinions are not so optimistic on the Crowdfunding Proposal and critics have discussed the fragile nature of the draft, regarding the “inadequate investor and consumer protection as well as a lack of cross-border provisions”.¹⁵⁷ Without prejudice to future discussions or amendments, *prima facie* this proposal is ambitious and consistent, revealing the importance of crowdfunding in the EU context. However, this would have been a good opportunity for the European Commission to include a special reference on REC.

On a local level, Portugal, together with some other countries,¹⁵⁸ is now also taking the first step towards the regulation of investment crowdfunding. The Portuguese legal framework for crowdfunding corresponds to Law No. 102/2015, of 24 August, and the legal framework for sanctions that was recently passed by the Portuguese Parliament, Law No. 3/2018, of 9 February.¹⁵⁹ In this respect, the US was one of the first countries to regulate this method of financing when President Barack Obama passed the JOBS Act in

¹⁵¹ Proposal for a Regulation of The European Parliament and of The Council on European Crowdfunding Service Providers for Business, COM/2018/0113 final – 2018/048 (COD).

¹⁵² Ibid, p. 2.

¹⁵³ Ibid, Article 7, p. 22.

¹⁵⁴ Ibid, Article 4, No. 5, p. 21.

¹⁵⁵ Ibid, Article 15, p. 27.

¹⁵⁶ Section 2.2.

¹⁵⁷ BONINO (2018).

¹⁵⁸ Spain (Law 5/2015 of 27 April on *financiación participativa*), France (*Ordonnance n.º 2014-559 du 30 mai 2014 relative au financement participatif*) or Germany (*kleinanlegerschutzgesetz*, 10 July 2015). MARTINS PEREIRA (2016), pp. 265-282.

¹⁵⁹ Along with CMVM Regulation No. 1/2016, of 25 May, that defines the requirements of access, registration, refusal and suspension of this type of platform in Portugal.

2012, encouraging small entrepreneurs to develop new business models and facilitating the method as capital is obtained. A recent debate was ongoing in Germany to understand if REC should be included in the general framework for crowdfunding.¹⁶⁰

In view of the legal question initially presented, the scope of Part III is to assess if the current Portuguese legal framework for general crowdfunding can be applicable to the real estate sector, given that the former omits any reference to this possibility.

3.1. TO REGULATE OR NOT TO REGULATE?

Before assessing the possibility of applying the current legal framework for general crowdfunding to REC, there is a preceding question on whether this new form of crowdfunding should be regulated.

I believe that the application of crowdfunding in the real estate sector should be specially regulated and deserves the attention of both legislator and supervisory entities, putting forward some arguments in this regard. Firstly, it is irrefutable that REC is a very recent activity whose procedures are unknown for most investors.¹⁶¹ Considering also as a fact that most non-accredited investors are not prepared to deal with the risks involved,¹⁶² the general legal rules of each jurisdiction may not be sufficiently efficient to protect investors' expectations. Having special and uniform legislation particularly designed for this purpose, by introducing, for instance, special legal presumptions in fraud cases, would mean that investors do not need to demonstrate all the general assumptions before the Court in order to confirm the existence of a loss¹⁶³ and this could mitigate all the differences in terms of legislation across countries.

Another reason to justify the special regulation of REC pertains to the essential role of the regulator. The regulatory entities of each State have an important role on this matter, not only in regulating the activity of REC platforms and reducing asymmetric information, but also in verifying the veracity and legality of the information provided by the crowdfunded companies on the real estate projects.

¹⁶⁰ The German Government was considering ruling out REC from the law on crowdfunding "*Kleinanlegerschutzgesetz*" ("KASG"). Nevertheless, the German Crowdfunding Association was against this position: the scope of the law should be enlarged instead of limited, considering that the "success of REC confirms the need to create more living space and help solve the tense housing situation in Germany". To understand the arguments of both parties, TORRIS (2018).

¹⁶¹ Section 1.1.

¹⁶² Section 2.2.

¹⁶³ Section 3.3.

Another question is when should both legislator and supervisory authorities start regulating REC. In this respect, I follow the understanding of JAN DALHUISEN (2017), according to which regulatory approaches should take place “at the top, not at the bottom of the market”.¹⁶⁴

History shows that regulatory measures are mainly frequent during or after a period of crisis: the Housing and Economic Recovery Act of 2008¹⁶⁵ or the Securities Act of 1933¹⁶⁶ are just a few suitable examples of this regulatory tendency after a moment of crisis. This means that late implementation of legislation may compromise its efficiency, given that some of the effects of the crisis will not be avoided. The main idea of JAN DALHUISEN (2017) is to adopt preventive behaviour in regulatory terms, taking the right measures when the markets are experiencing a period of success and prosperity, and not when chaos and scepticism are already present. The same logic should be applied to REC.

Investors are now dealing with the “top of the market”, using JAN DALHUISEN’s terminology, since empirical studies confirm that a significant growth of REC is expected during the next few years and the number of fraud cases in the Portuguese scenario is almost inexistent. Hence, I understand that this is the appropriate time to reflect on the regulation of this special form of crowdfunding, in accordance with this reasoning.

Therefore, as I believe in opting for a regulatory approach, I will demonstrate that the application of the current Portuguese legal framework for general crowdfunding to the real estate field may be subject to different limitations derived from the nature of the real estate market transactions, compromising the efficiency of the regulation of this activity.

3.2. LIMITATIONS ON INVESTMENTS

An example of limitations on applying the current Portuguese legal framework for general crowdfunding to REC is related to the amounts raised that are particularly relevant in this business sector.

¹⁶⁴ DALHUISEN (2017), p. 12.

¹⁶⁵ This act was created after the subprime crisis of 2008 in the US, whose scope was primarily to introduce a set of measures to minimize the effects of the crisis.

¹⁶⁶ After the collapse of the stock market of 1929, “key components of the regulatory safeguards put in place during the Depression were the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), the legislation that had the greatest effect on the securities market”. KELLER, (1988), p. 329.

For each offer of debt or equity crowdfunding, the Portuguese framework sets out a ceiling of € 1,000,000 and the activity or product under these crowdfunding models cannot exceed this amount in a 12-month period. Said amount can be reached through a sole offer or as a result of all the offers launched in the EU.¹⁶⁷ However, this limit may be increased up to € 5,000,000 when the campaign is exclusively addressed to companies or individuals whose annual income is equal to or more than € 70,000.¹⁶⁸

Real estate transactions typically require considerable levels of investment capital. As a result of the increasing demand in some cities, e.g. Lisbon or London, housing prices are still rising.¹⁶⁹ Moreover, assessing the signs of the market, the “real estate financing market also continues to show good signs of recovery with the banks, equity investors and other sponsors increasingly becoming more available to finance real estate acquisitions and developments”,¹⁷⁰ which implies a possible decrease in housing prices cannot be expected.

On the other hand, since a large proportion of REC’s target investors are non-accredited, typically middle-class individuals, whose annual income is certainly less than € 70,000,¹⁷¹ there are reasons to believe that the number of REC cases with a ceiling of € 5,000,000 will be reduced.

Considering that the investment limits implemented are low for REC purposes, the only manner of applying the current legal framework to the real estate sector is to review this legal provision. A suitable solution could be to introduce different tiers of offerings, also implementing different assumptions for each of them, following the example of the American legislator.

The JOBS Act 2012 was recently amended through Regulation A+¹⁷², which introduced two tiers of offerings “each with slightly different requirements”:¹⁷³ “Tier 1” for offers that do not exceed \$ 20 million in a 12-month period and “Tier 2” for offers with a ceiling of \$ 50 million in a 12-month period. As expected, offerings under Tier 2 are

¹⁶⁷ Article 19, number 1 of CMVM Regulation No. 1/2016, of 25 May.

¹⁶⁸ Article 19, number 2 of said Regulation.

¹⁶⁹ Following the Portuguese case, currently, a T1 flat in the centre of Lisbon can now easily reach € 1,000,000, given that the increase in demand was not followed by the proper increase in supply.

¹⁷⁰ FERREIRINHA, COUTINHO (2017), p. 269.

¹⁷¹ The law does not mention whether this annual income is gross or net income: if it is gross income, this means that the monthly income of the individual would be around € 5,000.

¹⁷² These amendments were adopted on March 25, 2015, becoming effective on June 19, 2015.

¹⁷³ KNYAZEVA (2016), p. 3.

subject to additional requirements, being subject to an ongoing reporting regime undertaken by SEC. As proof of this potential in the REC context, the American REC platform Groundfloor, based in Atlanta, has recently received regulatory approval under the terms of this Regulation.¹⁷⁴

In view of the rapid growth of REC, one can conclude that the legal framework for general crowdfunding may present some barriers in terms of limits on investments. The solution could be to introduce different tiers of investments, in accordance with the current market prices regarding REC.

3.3. PROTECTION OF THE INVESTOR

Noting that this is an unexplored area from a regulatory perspective, I understand that investor protection should be assumed as one of the main priorities for both legislator and supervisory authorities.

The Portuguese legal framework includes some legal provisions in this regard, namely Article 16 of CMVM Regulation No. 1/2016, of 25 May, together with Article 17 of Law No. 102/2015, of 24 August, according to which a crowdfunded company is required to provide a mandatory document mentioning all the relevant information addressed to the investors, using appropriate and clear language, so that they can take their own investment decisions in a responsible manner. Article 16 sets out an exhaustive list of information (“essential information addressed to the crowdfunded investors”), standardising the elements that should be disclosed through this kind of prospectus.

Despite the importance of this positive effort by the Portuguese legislator in this regard, I believe that more legal options could be implemented to protect the investor.

As far as due diligence procedures are concerned,¹⁷⁵ it is time for the supervisory authorities to assume a position on this matter for two core reasons: on the one hand, these procedures are frequently considered a “grey zone” by investors and, on the other, the law does not refer to any solution for it. My proposal would be for the regulatory authorities to issue specific guidelines in this respect. Regardless of the management policies followed, each platform would be required to comply with the institutional step-plan before concluding on the level of risk applied to the real estate project. Each level of risk

¹⁷⁴ HOBEY (2018).

¹⁷⁵ Section 2.2.2.

would be characterised by different objective criteria, e.g. (i) the number of criminal proceedings against the crowdfunded company's principals, (ii) the size of the company's debt, (iii) the analysis of the company's balance sheet, and (iv) conflicts of interests, among others, according to which progressive levels of risk could be applied.

A similar position was adopted by OECD regarding the automatic exchange of financial information on tax matters.¹⁷⁶ Chapter 4 sets out all the due diligence procedures that should be adopted according to the type of account at stake.¹⁷⁷ Despite the case-by-case analysis of each due diligence procedure, this approach in the tax field demonstrates that the step-plan followed could be standardised, along with the criteria assessed by each platform. I maintain that a similar reasoning should be applied *mutatis mutandis* to the REC field as one of the ways to ensure the transparency of the platforms' internal proceedings.

Another problem is related to the imminent risk of fraud that may become frequent in the future, as previously defended in Part II.¹⁷⁸ The recent Portuguese sanction framework for crowdfunding would be an appropriate time to reinforce investor protection, but this was not the option of the legislator. In view of this fact, I understand that it would be pertinent to consider a similar solution to the one included in the American legal framework, according to which the investor only has to prove to the Court that the defendant “[made] an untrue statement of a material fact or [omitted] to state a material fact required to be stated or necessary in order to the make statements, in the light of the circumstances under which they were made, not misleading”.¹⁷⁹ Once this condition has been verified, the plaintiff does not need to prove that this illegal act caused loss and the entire purchase price is recovered, unless “the defendant shows that some portion of the damages recoverable did not result from the fraud”.¹⁸⁰ Additionally, according to section 4(a)(c) of the Securities Act, the liability procedures include not only the issuer of the securities but also the principal executive officer, principal financial officer, controller or principal accounting officer, directors, and partners of the issuer.

¹⁷⁶ OECD (2018).

¹⁷⁷ “This standardised approach ensures a consistent quality of information is reported and exchanged”. Ibid., p. 72.

¹⁷⁸ Section 2.2.1.

¹⁷⁹ BRADFORD (2017), p. 20 along with Securities Act of 1933 § 4A(c)(2)(A), 15 U.S.C. § 77d-1(c)(2), (3).

¹⁸⁰ Ibid. not. 122 and Securities Act of 1933 § 4A(C)(1)(B), 15 U.S.C. § 77d-1(c)(1)(B).

There is no reason to exclude this generous liability presumption for private plaintiffs from the Portuguese law on REC.

Finally, in terms of competency, and bearing in mind the manner in which REC works,¹⁸¹ one must ask which court is competent to decide any dispute arising from REC. Three possible answers are on the table: (i) the place of the building (*lex rei sitae*), (ii) the courts where the plaintiff is located or (iii) the jurisdiction where the crowdfunded company has its main place of business. None of these three options would be able to protect the investors, given the dispersion of elements typical of REC.

A proper solution to protect the investors' needs could be to use an arbitration system as a remedy in the event of litigation, as argued by STEVEN BRADFORD (2017), i.e. an online arbitration system conducted by expert arbitrators, who are familiar with REC.¹⁸² The goal would be to implement "all proceedings (...) through written, online submissions, with no hearing and no oral testimony".¹⁸³ Thereby, from the REC platform's perspective, it would also be easier to submit all the relevant information online if needed. The Scholar admits that the method is not perfect, but this mechanism would have, at least, the potential to reduce the costs and the amount of time consumed in the event of litigation, a position which I follow.

4. THE FUTURE OF REC IN PORTUGAL

There are arguments to believe that REC will become popular in Portugal during the next few years. The Portuguese real estate market has registered a high level of demand over the last few years, particularly after the period of crisis. Different policies to attract foreign investment were implemented, contributing to a boost in the Portuguese real estate sector: the "Golden visa" programme,¹⁸⁴ "non-habitual resident" tax framework¹⁸⁵ or the group of tax incentives for the rehabilitation of buildings in certain areas

¹⁸¹ Through REC it is easy to invest abroad, with a couple of clicks in just a few seconds, making this form of investing truly international, vide Section 2.1.

¹⁸² JAN DALHUSEIN always argues that transnational arbitrators should not be experts in the field. DALHUSEIN (2015).

¹⁸³ BRADFORD (2017), p. 30.

¹⁸⁴ According to Law No. 23/2007, of 4 July, subject to subsequent amendments, a residence permit is provided if the investor makes one of the following "investment activities": (i) the purchase of real estate with a value of at least € 500,000, (ii) the transfer of capital of at least € 1 million or (iii) in the employment sector, the creation of (at least) 10 jobs.

¹⁸⁵ This tax framework allows individuals, after becoming residents in Portugal, to benefit from reduced tax rates of 20% (if the income results from high added value activities, namely, engineers, doctors, dentists, auditors or tax consultants, among others) or exempt from tax for certain types of income derived from sources abroad if a double tax treaty is applied. See Portuguese Ministerial Order No. 12/2010, 7 January.

of the city¹⁸⁶ were some of the factors that have contributed to positive results in the Portuguese economy.

The implementation of these policies was also followed by an increase without precedent¹⁸⁷ in the number of tourists in Portugal. A favourable climate and the almost inexistent risk of terrorism are some of the reasons that justify this boost since 2011.

But problems in the real estate sector, especially in Lisbon and Porto,¹⁸⁸ remain unsolved. The supply level has not followed the same trajectory as demand. The growing number of tourists and investors has triggered an increase in prices: according to official data from the Portuguese Statistical Office the average selling price is around € 2,231 per square meter.¹⁸⁹ Lisbon is currently one of the most expensive cities in Europe. In contrast, the growth in salaries and purchasing power of the Portuguese residents has not been proportional to this rise in prices registered in both sale and rental markets. In this respect, the Bank of Portugal has recently issued its institutional concern on the current state of the real estate sector through its Stability Financial Report.¹⁹⁰

Before 2007, investors used to obtain capital through the banking sector as a way to ensure liquidity. In the case of real estate, the capital provided used to be higher than the value of the property, sometimes corresponding to 110% or 120% of that value. Today, the requirements to provide capital are stricter and the financing thresholds are not as high as before the subprime financial crisis of 2007.¹⁹¹ In a short period of 10 years, *Banco Privado Português* (BPP, 2008), *Banco Português de Negócios* (BPN, 2008), *Banco Espírito Santo* (BES, 2014) and *Banco Internacional do Funchal* (BANIF, 2015) are some cases of banks that have failed in Portugal, demonstrating the fragility of this sector in terms of liquidity. The constraints of the banking sector justify the fact that investors are seeking new forms of investing to ensure liquidity, especially in the real

¹⁸⁶ If certain legal conditions are met, the buildings that are subject to rehabilitation works are exempt from Municipal Property Taxes for a period of 5 years and may also benefit from a reduced VAT rate of 6%, instead of the normal VAT rate in Portugal of 23%.

¹⁸⁷ Statistical studies demonstrate that the number of foreign tourists visiting Portugal reached a new record of 12.7 million people in 2017. KHALIP (2018).

¹⁸⁸ According to the Portuguese statistical office, real estate prices in Porto registered an increase of 22% during the second quarter of 2017. CAVALEIRO (2017).

¹⁸⁹ CARREGUEIRO, CAVALEIRO (2017).

¹⁹⁰ BANK OF PORTUGAL (June 2018)

¹⁹¹ Bank of Portugal has recently passed a recommendation, introducing restrictions on home and consumer credits. BANK OF PORTUGAL (February 2018).

estate sector.¹⁹² The banking sector is no longer considered a potential way to obtain credit for investment.

In view of these circumstances, one could say that a “window of opportunities” to use REC has been created in Portugal as a mechanism to provide capital for small investors that cannot compete with big corporate groups and to allow non-accredited investors to access this market, dealing with the costs and prices that are typically higher in this business field.

Taking the path of the international REC platform Housers as an example, the first real estate offering in Portugal was only launched at the end of 2017. 4 REC offers have become available in this country so far: 3 projects in Lisbon and 1 in Porto.¹⁹³ If the goal of the project is achieved, together with the previously agreed payment conditions, there are reasons to predict that REC will become a common investing practice in the Portuguese real estate market, having the potential to attract even more REC platforms located in other countries that are also willing to invest in Portugal.

¹⁹² In the context of the State Budget of 2015, the possibility of introducing REIT into Portuguese law (*Sociedades de Investimento em Património Imobiliário*) was discussed, following the example of the UK, Australia, Germany, Canada, France, Italy and Belgium. Due to its management policies and the special tax framework applied, this investing vehicle is considered a suitable way to attract more investments into Portugal. This debate is not new, but a recent study of EY and the Portuguese Association of Real Estate Promoters and Investors has recommended, once again, the implementation of this investing vehicle in Portugal. EY, APPII (2018).

¹⁹³ In Lisbon, the buildings are located in Campo de Ourique, Cidade Universitária and Estádio Nacional. All the information is online <https://www.housers.com/pt/oportunidades/marketplace> accessed on 16 April 2018.

5. CONCLUDING REMARKS

- I. The emergence of REC is relatively recent. The effects of the subprime crisis going back to 2007 and the absence of real estate financing alternatives are some of the reasons that justify its rapid growth over the last few years: some statistical studies on this matter have revealed that REC grew from \$ 400 million in 2013 to \$ 1 billion in 2014, and in 2015 this type of platform generated over \$ 2.5 billion, registering a growth of 150%.
- II. Even though real estate is considered one of the largest and best understood asset classes, the employment of REC in this sector does not eliminate the special features involved: the real estate market is *per se* heterogeneous, illiquid, volatile, asymmetric and restrictive.
- III. Despite REC including a large number of advantages in terms of equity return, reduced levels of management and transaction costs, convenience and timings, there is a special group of risks that investors should be aware of, such as cases of fraudulent behaviour or poor due diligence processes.
- IV. In the context of REC, there is a liquidity problem, given that investors, after investing the capital, are frequently locked into their investments. This is particularly relevant in the REC context, if we consider that the real estate market is also illiquid *per se*. There are reasons to argue that the creation of a secondary market is one of the ways to ensure the sustainable development of the primary market.
- V. When the real estate project is backed by a security, mortgage enforcement proceedings is one of the key discussions about REC. Considering the way in which REC investments work, the proper legal solution would be to allow the investor to enforce its own right *in rem* of a security on an individual basis. This is the only way to harmonise the enforcement proceedings with the plurality of investors involved.
- VI. Considering REC's special group of features, the Portuguese legal framework for crowdfunding may reveal some constraints when applied to the real estate sector, particularly regarding limitations on investments: the established ceiling of € 1,000,000 may not be sufficient, if we consider the current unstoppable rise in prices.
- VII. On the other hand, it should be highlighted that REC's main target are non-accredited investors: unlike traditional lenders, this group of investors may not be

able to detect the risks involved in this type of investment activity. If the general law is applied to this special form of crowdfunding, investor protection should be reinforced, introducing standardised guidelines for REC platforms, legal presumptions in favour of the investor in the event of cases of fraud or even litigation alternatives through online arbitration systems.

- VIII.** In Portugal, it is irrefutable that there is a genuine “window of opportunities” in the real estate sector. During the last few years, different policies have been implemented to attract foreign investors and the results have surpassed all the expectations.
- IX.** In view of these facts, REC is one of the few options that allows middle class investors to engage in real estate projects. Due to the absence of fraud or litigation cases, there are reasons to believe that this is the golden period for REC and the right moment to approve specific regulation.

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