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Chapter 10: The Regulation of Crowdfunding in Europe[*]

10.1. The Capital Markets Union and the European Institutions' Work on Crowdfunding

On 30 September 2015 the European Commission published its Capital Markets Union (CMU) Action Plan.[1] The Plan aims to tackle investment shortages by increasing and diversifying the funding sources for European businesses – especially small and medium-sized enterprises (SMEs) – and long-term projects and to provide more options and better returns for savers and investors. Crowdfunding is a cornerstone of the CMU Action Plan. The Commission conducted a public consultation on crowdfunding, set up a website on which it informs market participants on its ongoing work[2] and established a European Crowdfunding Stakeholder Forum (ECSF), which at the time of writing, has held four meetings since its creation.[3]

The Commission's work on crowdfunding had started earlier. Building on its Green Paper on Long Term Financing of the European Economy,[4] the European Commission held public consultation on crowdfunding between October and December 2013 and subsequently published a programmatic communication paper to the other European institutions on 27 March 2014 titled "Unleashing the potential of Crowdfunding in the European Union."[5]

In May 2016 the European Commission published a Commission Staff Working Document, reporting on the Commission's work on crowdfunding since its publication of 2014.[6] The report states that "crowdfunding remains relatively small in the EU but is developing rapidly. It has the potential to be a key source of financing for SMEs over the long term."[7] The Commission asserts that "[g]iven the predominantly local nature of crowdfunding, there is no strong case for EU level policy intervention at this juncture. Crowdfunding is still relatively small and needs space to innovate and develop."[8] However, "[g]iven the dynamism of crowdfunding and the potential for future cross border expansion, it will be important to monitor the development of the sector and the effectiveness, and degree of convergence of, national regulatory frameworks."[9] The Commission therefore intents to "maintain regular dialogue (…) with the European Supervisory Authorities, Member States, and the crowdfunding sector to promote convergence, sharing of best practice and keep developments under review". The aim is to be able to act in a timely manner if further steps to support convergence of regulatory approaches in the member states is necessary, "both to promote the development of the sector and to ensure appropriate investor protection".[10]

The European Parliament has stated in 2015 that "the CMU should create an appropriate regulatory environment that enhances cross-border access to information on the companies looking for credit, quasi-equity and equity structures, in order to promote growth of non-bank financing models, including crowdfunding and peer-to-peer lending".[11] The European Parliament resolution of 19 January 2016 underlines the potential of innovative market-based funding and stresses the need to streamline regulatory regimes. At the same time, it notably asks the Commission to give "breathing space for the emergence of these new models and to explore and promote them, giving priority to their cross-border dimension and ensuring the reduction of market entry barriers."[12]

[*] Preliminary draft of a contribution to a book on the economics of crowdfunding edited by D. Cumming and L. Hornuf.

10.2. Aim and Scope of this Chapter

The aim of this chapter is to give an overview of the regulation of crowdfunding in Europe on the level of the member states as well as on the supranational EU level and to assess whether there is need for more supranational regulation. As such regulation should take into account to what extent platforms have an incentive to provide investors with optimal financing contracts and develop other market-based solutions for the various risks faced by investors, this chapter also tries to shed light on the contractual terms, under which crowdinvesting is taking place in Europe, and investor protection mechanisms crowdinvesting platforms have developed in the absence of regulatory requirements.

The focus of this paper is on crowdinvesting rather than crowdlending or reward based or donation based crowdfunding. While there is a vibrant crowdlending market in Europe, it does not seem to be frequented by start-ups, perhaps due to the fact that debt financing is unsuitable for firms without hard assets (Armour/Enriques 2017, p. 11). The European market for reward based or donation based crowdfunding seems to be rather insignificant, especially when compared to the US. A regulatory reason seems to be the Directive on Consumer Rights,[13] which grants consumers purchasing under a distance sales contract a right of withdrawal within 14 days of receipt of the goods without justification (Armour/Enriques 2017 at p. 30 et seq.). Finally, this report will be limited to "hard" law, i.e. will not cover the various soft law regimes that have been established, e.g. by the European Crowdfunding Network.[14]

10.3. EU Law

10.3.1. Overview

Currently there is no specific crowdfunding regulation at the EU level. There are however, several legal acts, which set the general regulatory framework for crowdinvesting, such as the prospectus requirement and conduct of business regulation for financial intermediaries. Note, however, that these acts apply only if the crowdinvesting model falls within the scope of application of these acts. As a general rule, this requires the distribution of transferable securities such as stocks or mini bonds. As the German market shows, crowdfunding can take place on the basis of investment contracts which do not fall into the scope of current European regulation (see below 10.4.3.1).

10.3.2. Prospectus Requirement

The standard tool of Securities Regulation to mitigate information asymmetries between investors and issuers prior to the investment decision is the issuer's duty to disclose all relevant information in a document known as the prospectus (on information asymmetries in crowdinvesting see Hornuf/Schwienbacher 2016 sub 4.5). Usually this obligation is enforced publicly (i.e. by the state) by requiring issuers to submit the prospectus or an equivalent document with the competent authority before offering or marketing the securities ("gun jumping laws"). Moreover, securities laws around the world have chosen to supplement this regime by the means of private law because no regulator has – and probably should not have – the manpower and the resources to verify all information contained in a prospectus before approving the offering within a reasonable period of time. The corner stone of this supplementary private law enforcement regime are the rules on prospectus liability, i.e. liability for material misstatements contained in a prospectus or for the complete failure to submit a prospectus with the competent authority before the offer.

The EU Prospectus Directive[15] and the accompanying Prospectus Regulation[16] regulate the public law side of the above mentioned regime and set out some rudimentary rules for the private law side. The Prospectus Directive is a legal act which is not directly applicable. It must be implemented by the member states, i.e. it obliges the member states to pass domestic law implementing the rules contained in the Directive. The Prospect Regulation is directly applicable in all member states and thus does not need to be implemented by the member states.

Under Art. 3(1) Prospectus Directive member states shall not allow any offer of securities to be made to the public within their territories without prior publication of a prospectus. Art. 13(1) Prospectus Directive states that no prospectus shall be published until it has been approved by the competent authority of the home member state. The prospectus shall contain all information which, according to the particular nature of the issuer and of the securities offered, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities, Art. 5(1) Prospectus Directive. The Prospectus Regulation sets minimum requirements with regard to what information must be included in a prospectus, the format of the prospectus, the modalities of disclosure and the methods of publication and dissemination of the prospectus. Once a prospectus has been approved by the competent authority of the home member state, it shall be valid for the public offer in any number of host member states, Art. 17(1) Prospectus Directive. This scheme of mutual recognition in the EU is commonly referred to as the "European Passport".

The Prospectus Directive contains several exemption clauses. Under Art. 3(2)(a), (b) Prospectus Directive, the prospectus requirement does not apply to offers addressed solely to qualified investors and to offers addressed to fewer than 100 natural or legal persons per member state, other than qualified investors. Also, there is no prospectus requirement for offers of securities with a total consideration of less than EUR 100.000 which limit shall be calculated over a period of 12 months, Art. 3(2)(e) Prospectus Directive. Finally, the Prospectus Directive allows member states to refrain from imposing a prospectus requirement as long as the total consideration of the offer is less than EUR 5 million, Art. 1(2)(h) Prospectus Directive.[17] Thus, member states *must* exempt offers from the prospectus requirement if the total consideration is less than EUR 100.000 and they *must* require a prospectus if the total consideration is EUR 5 million or more. Within that range between EUR 100.000 and EUR 4.99 million member states can choose: They may impose a prospectus requirement, and they may choose to allow such offers without a prospectus.

Finally, the Prospectus Directive applies only to offerings of transferable securities as defined by Art. 4(1)(44) MiFID. The paradigm of such securities are stocks (common or preferred) and bonds, Art. 2(1) lit. a Prospectus Directive. The concept of security under EU law is much narrower than for example in the United States.[18] Thus, there are several investment contracts not covered by the Prospectus Directive, especially subordinated profit participating loans (*partiarische Nachrangdarlehen*) which are issued on the German crowdinvesting market. Such offers must be accompanied by a prospectus only if member states' domestic securities laws require a prospectus to be published.

In conclusion, there is no single unified prospectus regime in Europe but a hotchpotch of different domestic regimes, partly harmonized by the EU Prospectus Directive. The main divide runs along the investment contracts that are being offered:

- If start-ups offer transferable securities as defined by MiFID, the harmonized EU prospectus regime applies, unless the total consideration is less than EUR 5 million <u>and</u> the member state, in which the offer is being made, has chosen to exempt the offer from the prospectus requirement. If the consideration is less than EUR 100.000, such exemption is mandatory.
- If start-ups offer investment contracts which do not qualify as transferable securities, the EU prospectus regime does not apply. Whether the start-up has to publish a prospectus is solely a question of (non-harmonized) domestic law.

10.3.3. Platform Regulation

10.3.3.1. Authorization, Organizational Requirements, and Conduct of Business Regulation

Overview

The major regulation of financial intermediaries is contained in the Markets in Financial Instruments Directive (MiFID) – a tight regulatory regime which has just been remolded in 2014 (therefore often referred to as MiFID II).[19] As a directive, MiFID is not directly applicable; its rules must be implemented by the member states. So, just like the Prospectus Directive, MiFID obliges the European member states to pass domestic law implementing the rules contained in the Directive.

Authorization and European Passport

MiFID establishes among others requirements in relation to the authorization and operating conditions of investment firms. Under Art. 5(1) MiFID each member state shall require that the provision of investment services be subject to prior authorization by the competent authority. If investment firms obtain authorization they may freely provide investment services within the territories of all EU member states, Art. 34(1) MIFID. Thus, authorization obtained under MiFID grants investment firms a "European Passport".

Organizational Requirements

Art. 16 MiFID establishes organizational requirements, e.g. with regard to the compliance structure of the investment firms or measures to be taken to prevent conflicts of interest. While Art. 16 MiFID contains the general organizational objectives and principles, the specific rules are contained in delegated or implementing regulations passed by the European Commission (so called Level-2-acts).[20] Artt. 24 to 30 MiFID contain the rules under which investment firms must conduct their business with regard to investor protection. As a general rule, Art. 24(1) MiFID obliges member states to make sure that, when providing investment services, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply with all principles set out in MiFID and the respective Level-2-acts. Specific aspects of this general duty to always act in good faith are the investment firm's information duties and know-your-customer-requirements.

Information Duties

Under Art. 24(4) MiFID appropriate information shall be provided in good time to clients or potential clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges. The information must be provided in a comprehensible form in such a manner that clients or potential clients are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to take investment decisions on an informed basis, Art. 24(5) MiFID. All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading. Market communications shall be clearly identifiable as such, Art. 24(3) MiFID.

Know-Your-Customer-Rules

The requirements of the know-your-customer-rules depend on the nature of the investment service:

- If an investment firm provides investment advice, it must obtain the necessary information regarding the client's or potential client's knowledge and experience, that person's financial situation including the investor's ability to bear losses, and his or her investment objectives so as to enable the investment firm to recommend to the client or potential client the investment services and financial instruments that are *suitable* for him or her (*suitability test*), Art. 25(2) MiFID.

- If an investment firm provides other investment services such as the reception and transmission of orders in relation to financial instruments, the investment firm must ask the client or potential client to provide information regarding that person's knowledge and experience relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is *appropriate* for the client (*appropriateness test*), Art. 25(3) MiFID.
- An investment firm is exempted from the appropriateness requirement, if it merely receives and transmits client orders with respect to non-complex financial instruments such as shares and bonds admitted to trading on a regulated market or on an equivalent third-country market or on a multilateral trading facility (MTF), Art. 25(4) MiFID. This exception, however, is not relevant for the European crowdinvesting market, because even if there is a secondary market financial instruments offered by start-ups to the crowd are neither listed on a regulated or equivalent market nor on an MTF.

MiFID's Scope of Application

All aforementioned rules apply only to investment firms within the meaning of Art. 4(1) MiFID, i.e. to firms providing *financial services* as defined by Section A of Annex I MiFID, relating to *financial instruments* as defined by Section C of Annex I MiFID. Therefore, the regulatory regime for crowdfunding platforms in Europe is just as divided as the prospectus regime:

- If crowdinvesting platforms broker investments in firms offering stocks, bonds, units in collective investment undertakings or other financial instruments listed in Section C of Annex I MiFID, they are governed by the national securities laws implementing MiFID.
- If crowdinvesting platforms broker other investment contracts not covered by MiFID, such as profit participating loans offered by German crowdinvesting platforms, MiFID and its implementing rules of national law do not apply. Crowdinvesting platforms are governed by domestic bespoke regimes for investment firms operating outside the scope of MiFID.
- If crowdinvesting platforms merely provide the investment service of receiving and transmitting orders in transferable securities (such as stocks and bonds) and units in collective investment undertakings and/or of providing investment advice in relation to such financial instruments and are not allowed to hold client funds or client securities, member states can opt to exempt them from MiFID's rules if the unregulated investment firm is allowed to transmit orders only to investment firms authorized under MiFID, credit institution authorized under the European Capital Requirements Directive (CRD) or certain other institutions (so called Art. 3 exemption). If those firms are exempted under Art. 3 MiFID they may be governed by domestic bespoke regimes for investment firms operating outside the scope of MiFID (if such bespoke regimes exist).

10.3.3.2. Capital Requirements

MiFID investment firms are subject to EU wide capital requirement regulation Under Art. 15 MiFID, member states shall ensure that the competent authorities do not grant authorization unless the investment firm has sufficient initial capital. These requirements are governed by the EU Capital Requirement Directive (CRD)[21] and the EU Capital Requirements Regulation (CRR)[22]. These requirements depend on the nature of the investment service.

- The default capital requirement is EUR 730,000, comprising only of certain so-called Equity Tier 1 items, Art. 28 CRD in connection with Art. 26(1)(a) to (e) CRR.
- If an investment firm merely receives and transmits orders for financial instruments and holds client money or securities, it shall have initial capital of EUR 125,000, Art. 29(1) CRD.
- If an investment firm merely receives and transmits orders for financial instruments and is not allowed to hold client money or securities, member states may reduce this amount to EUR 50,000, Art. 29(3) CRD.

10.3.3.3. Anti-Money Laundering Regulation

Crowdinvesting platforms that operate under MiFID are subject to anti-money laundering and terrorist financing rules under the Anti-Money Laundering Directive.[23] If they operate outside MiFID, platforms can be subject to the Anti-Money Laundering Directive if they provide certain payment services within the meaning of the Payment Services Directive[24].

10.3.3.4. Regulation under the Distance Marketing of Consumer Financial Services Directive

If the platform's activity qualifies as concluding a distance contract for financial services, its consumer clients have a right to obtain pre-contractual information as well as a right of withdrawal within 14 days without justification under the Distance Marketing of Consumer Financial Services Directive.[25]

10.3.3.5. Data Protection

If platforms or issuers process personal data they will be governed by EU data protection legislation, namely the European General Data Protection Regulation.[26]

10.4. Laws of the Member States

10.4.1. Overview

As we could see, there is no uniform legal framework for crowdinvesting in Europe. The main divide runs through the investment contracts that are being offered. If start-ups offer investments in transferable securities, these offerings are covered by the prospectus requirement of Art. 3 Prospectus Directive unless an exemption applies. Platforms brokering such investments are regulated by MiFID, unless exempted under Art. 3 MiFID. If start-ups offer investment contracts not covered by MiFID the offers are subject only to the domestic bespoke prospectus regimes. Investment firms brokering such investments are governed by domestic financial intermediary regulation.

Thus, it is not surprising that there is a great variety of crowdinvesting regulatory regimes in the European member states. It is impossible to cover all those regimes, given the space constraints of this chapter. Furthermore the European Commission has put together a comprehensive report on those regimes in its 2016 working document on crowdfunding.[27] Therefore, this chapter will be limited to the two member states which seem to have the most relevant crowdinvesting markets in Europe as regards the size of the domestic crowdinvesting market, i.e. to the United Kingdom and to Germany. As it turns out, these two states suit themselves almost perfectly for a report on European crowdinvesting regulation because they can be seen as two antagonistic approaches of regulating crowdinvesting.

10.4.2. United Kingdom

10.4.2.1. Prospectus Requirement

In the United Kingdom the legislator of the Financial Services and Markets Act (FSMA) has made use of the option provided by the Prospectus Directive to exempt all offerings of securities to the public from the prospectus requirement if the total consideration is less than EUR 5 million.[28] Therefore, start-ups can issue transferable securities such as stocks and bonds to the crowd without a prospectus as long as they collect less than EUR 5 million within 12 months. This generous exemption from the prospectus requirement reduces start-ups' and platforms' incentives for regulatory arbitrage by designing investment contracts which would fall outside the scope of the Prospectus Directive. Furthermore, crowdinvesting platforms do not seem to gain much from designing such contracts, because they would still be providing "financial promotions" covered by the FSMA 2000 [see below at 10.4.2.2]. This is why in the UK crowd investors usually obtain classical transferable securities, especially common and preferred stock. The exemption from the prospectus requirement applies regardless of whether securities are offered on a crowdinvesting platform or other financial intermediary or directly by the issuer. However, issuers may not market crowdinvesting securities directly to the public, they need to rely on an FCA authorized person such as a crowdinvesting platform.[29]

10.4.2.2. Platform Regulation

As start-ups offer transferable securities to the crowd, UK crowdinvesting platforms provide classical financial services – usually the receipt and transmission of orders – and therefore fall under the legislative provisions implementing MiFID, namely the authorization requirement[30] and the organizational and conduct of business requirements of FSMA 2000. Even if crowdinvesting platforms would market only non-transferable securities or other investment contracts which would not fall under MiFID, they would most likely be covered by the same rules as their activities would be considered as "financial promotions" (Armour/Enriques 2017 at p. 23 n. 58).

The Financial Conduct Authority (FCA), the UK financial markets regulator, issued a policy statement to specify what those requirements mean for crowdinvesting platforms in 2014.[31] It has published a review of its regulatory regime in 2015[32] and is at the time of writing in the aiming to publish a second review in early 2017[33].

As platform regulation in the UK follows MiFID, the law contains a general obligation to ensure that financial promotions offered on the platform are fair, clear and not misleading.[34] Platforms must ask their clients for information necessary to assess whether the securities are appropriate, i.e. whether the investors have the necessary knowledge and experience to understand the risks involved.[35] In practice, platforms require investors to answer a simple automated test about the characteristics of equity crowdfunding investments, for which guidance is provided (Armour/Enriques 2017, at p. 23).

Statements by the FCA, however, suggest that platforms play a crucial role in securing a sufficient level of investor protection under the UK regime. In its 2015 review the FCA stated that "[w]e are particularly looking to see that platforms are disclosing *all relevant information* to enable potential investors to make informed decisions on whether or not to invest".[36] Compare this with the mandate by Art. 5(1) Prospectus Directive under which a prospectus shall contain "all information which (…) is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer and of any guarantor, and of the rights attaching to such securities." It seems as if according to the FCA's interpretation, the platforms' disclosure duties under MiFID serve as a perfect functional equivalent of the missing prospectus requirement. Put differently, although start-ups are exempted from publishing a prospectus, the

FCA's interpretation of MiFID (or the implementing provisions of the FSMA 2000) ensures that in the end investors are furnished with the same information, i.e. all information necessary to assess the value of the offered securities – only not by issuers but by crowdinvesting platforms.

10.4.2.3. Investor Access

Investor access to crowdinvesting securities is restricted in the UK. Platforms may market non-readily realisable securities, i.e. securities for which no liquid secondary market exists, only to the certain types of investors (see also Ridley 2016 at p. 68 et seq.).[37] These are

- professional clients, or
- retail clients who confirm that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorized person ("advised investors"), or
- retail clients who are venture capital contacts or corporate finance contacts, or
- retail clients, who are certified or self-certify as sophisticated investors; or
- retail clients who are certified as high net worth investors, or
- retail clients who certify that they will not invest more than 10% of their net investible financial assets in unlisted equity and debt securities (i.e. they certify that they will only invest money that does not affect their primary residence, pensions and life cover) ("restricted investors").

Note that unlike in the US the UK regulation knows no single-issuer limits but only an aggregate limit, i.e. for all non-readily realizable securities as an asset class. Also there is only a relative (percentage-wise) investment restriction, i.e the absolute amount a single retail investor can invest depends on the amount of his or her overall investible financial assets. Finally, just like in the US, as a general rule platforms may rely on the information provided by the investor in a "Restricted Investor Statement".[38] Therefore, investors seem to be able to avoid investment limits by lying about the amount of their investible financial assets.

10.4.3. Germany

10.4.3.1. Prospectus Requirement

Unlike in the UK, the German legislator has chosen not to make use of the Prospectus Directive's option to exempt all offerings with a consideration of less than EUR 5 million from the prospectus requirement. The small offer exemption provided by German law is available only to securities offerings of less than EUR 100,000 within a 12-month-period.[39] The same rule applies to firms offering investment contracts which do not qualify as securities.[40]

The strict prospectus requirement gave German crowdfunding platforms a strong incentive for regulatory arbitrage by designing investment contracts not covered by German prospectus regulation. This is why in November 2012 crowdinvesting platforms in Germany began to broker subordinated profit-participating loans (*partiarische Nachrangdarlehen*) to the crowd. These are hybrid investment contracts which are loan-based but mimick features of equity. At the time of introduction to the crowdinvesting market these investment contracts were outside the scope of German prospectus regulation (Klöhn/Hornuf/Schilling 2016a at p. 58 et seq.). Therefore, by switching to profit participating loans, crowdfunding platforms greatly increased their potential to earn fees. Before, they could collect a maximum amount of (less than) EUR 100,000 per offer without triggering a prospectus requirement. After the introduction of profit participating loans, there was no limit as to the maximum amount to be collected.

For reasons unrelated to crowdinvesting, the German parliament introduced a prospectus requirement for offers of profit participating loans in 2015 (Klöhn/Hornuf/Schilling 2016a).[41] Because the legislator did not want to put an end to crowdinvesting, it also introduced a specific crowdinvesting exemption, under which firms could continue to offer profit participating loans to the crowd under the following conditions:[42]

- The investments must be offered exclusively on a crowdinvesting platform. Thus, the exception to the prospectus requirement does not extend to issuers executing direct offerings to the crowd.
- The crowdinvesting platform must be subject to regulatory oversight either under the laws implementing MiFID or under the (much more rudimentary) rules of the Trade Regulation Act (*Gewerbeordnung*). It especially must be obliged to monitor the subscription limit described below.
- The aggregate value of the offer must not exceed EUR 2.5 million. The law does not specify a time-period during which multiple offerings by the same issuer will be aggregated when calculating the 2.5-million-limit.

Even when the offering is exempted from the prospectus requirement, the issuer must prepare a so-called "investment information sheet" (*Vermögensinformationsblatt, VIB*) which must contain the most essential information about the investment. The issuer must submit the investment information sheet to the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin*) and make it available to every potential investor.[43] The investment information sheet must contain a highlighted warning notice on its first page which says: "The purchase of this investment is associated with significant risks and can result in a total loss of the money invested."[44] Every investor must confirm the understanding of the warning with a signature containing the place and date of signature and the investor's first and family name on the investment information sheet itself.[45]

10.4.3.2. Portal Regulation

As start-ups offer investment contracts not covered by MiFID, German crowdinvesting platforms do not fall into the regulatory scope of this directive. Hence, their activities are not governed by the German law implementing MiFID and they are not overseen by the federal securities regulator BaFin. Instead they fall under the regulatory reach of the Trade Regulation Act (*Gewerbeordnung*), an act not specific to securities issues which also contains some rudimentary organizational and conduct of business rules for financial intermediaries who are acting outside the reach of MiFID. For the same reason, no capital regulatory requirements apply to crowdinvesting platforms in Germany. Instead, they are required to obtain professional liability insurance under the Trade Regulation Act.[46]

10.4.3.3. Investor Access

The exemption from the prospectus requirement mandates that investors stay within certain subscription limits (on investment limits with reference to Germany and the United States, see Bradford 2015).[47] Unlike the UK, German law only limits the amount that an investor may invest in one issuer (single issuer limit), but not the amount that an investor may invest in the entire crowdinvesting market (aggregate limit). The exact amount of the subscription limit depends on the investor's freely available assets and monthly net:

- If the investor provides a statement that he or she has freely available assets of at least EUR 100,000, he or she can invest up to a maximum of EUR 10,000 in an issuer.
- If the investor does not have that amount of assets, the limit is twice the investor's monthly net income, but in any case not more than EUR 10,000.

- In all other cases (i.e. particularly if the investor does not provide the statement on assets and income), the investor is limited to a maximum investment of EUR 1,000.

Crowdinvesting platforms have a duty to monitor that investors stay within the subscription limits but can rely on the investor's information on freely available assets.[48]

10.4.4. Comparative Summary

As stated before, the UK and Germany offer two almost antagonistic crowdinvesting regulatory regimes:

- UK law offers the maximum exemption from the securities prospectus requirement allowed by the Prospectus Directive (the 5-million-limit) while the German legislator only offers the minimum exemption required by the Prospectus Directive (the 100,000-limit).
- In the UK crowdfunding platforms therefore broker transferable (non-readily realizable) securities, while in Germany they broker investment contracts not covered by the Prospectus Directive.
- In the UK crowdfunding platforms are subject to the standard MiFID regime implemented in the FSMA and the FCA's Conduct of Business Handbook, while in Germany they are subject only to some rudimentary provisions of the Trade Regulation Act.
- In the UK crowdfunding platforms are regulated by FCA, i.e. the national Financial Markets Authority, while in Germany they are overseen by the trade offices which have no specific expertise in the financial markets sector.

10.5. Crowdinvesting Contracts and (Other) Market-Based Safeguards

10.5.1. Overview

We have seen that there is no EU regulation which specifically addresses crowdinvesting and that the scope of application of EU securities laws governing securities offers to the public and financial intermediation is limited. Furthermore, we have seen that there is a tremendous variety in crowdinvesting regulation regimes in the member states, as exemplified by the two almost antagonistic regulatory landscapes of the UK and Germany. All this might call for the European legislator to step in and create a level playing field by passing detailed new rules. Such call, however, might turn out to be premature. It has been pointed out in the early law-and-economics scholarship on securities regulation that issuers might have an incentive to disclose all information relevant to investors without any legal obligation, simply because without such disclosure investors would "assume the worst" and put their money into other ventures (Stigler 1964; cf. Grossman 1981; Milgrom 1981). Also, even in the absence of any legal obligation crowdinvesting platforms might have incentive to provide investors with good investment opportunities by virtue of simple reputation mechanisms (see, e.g., Klein/Leffler 1981; Shapiro 1983). Thus, before calling for more detailed regulation, one should try to assess to what extent such reputational and market mechanisms seem to be at work.

10.5.2. The Crucial Role of Crowdinvesting Platforms

When making this assessment, crowdinvesting platforms seem to be of particular importance (on the role of portals see also Anand 2014, sub IV.). They are the only repeat players on the crowdinvesting market acting as intermediaries between start-ups and investors. However, they are much more than investment brokers. They fulfill three additional functions:

- They are *gatekeepers*, because they decide which start-ups can run crowdfunding campaigns on their platforms.

- They are *information intermediaries*, because they reach out to start-ups and tell them what information they must provide to investors. Also, they usually channel communications between investors and businesses in an investor-relations portal.
- Finally, they are *drafters of investment contracts*; they choose what types of investment contracts start-ups offer to the crowd, and they design the details of those contracts.

Crowdinvesting platforms' profits depend on the amount of funds that they manage to raise (Belleflamme/Omrani/Peitz 2015). Increasingly, platforms also participate in the future success of the companies, e.g. on the basis of carried interest provisions (on the importance of aligning the portal's with investors' interests, see Anand 2014, sub IV.). But the bulk of their profits does not depend on the ultimate success of the venture but on the success of the fundraising campaign. Accordingly, platforms compete to broker fundings. Moreover, the crowdinvesting market has characteristics that are typical of network economies (Klöhn/Hornuf/Schilling 2016b at p. 10; cf. also Viotto 2015 at p. 38). The more investments are brokered by a crowdinvesting platform, the more market participants will know the contracts offered by the platform, and ultimately the more attractive the portal will be for future campaigns and investments. Successful crowdinvesting platforms can accordingly expect to earn larger profits even if the market volume remains stable. For the same reason, it is increasingly difficult for new crowdinvesting platforms to enter the market.

What are the implications of competition between crowdinvesting platforms? There are three plausible scenarios (Klöhn/Hornuf/Schilling 2016b at p. 11):

- *Race to the top*: in the most optimistic scenario, platforms try to develop optimal financing agreements. Put simply, these are contracts that minimize the total costs of the financing. The level of investor protection in these contracts is neither maximal nor minimal, but optimal. These are the contractual rules to which companies and investors would agree if they were rational, fully informed, and could negotiate with each other without transaction costs. Of course, nobody knows exactly what these rules would be. Nevertheless, competition between platforms would ensure that they would constantly strive to discover them.
- *Race to the bottom*: under a more pessimistic view, platforms would create the laxest contracts possible in order to attract start-ups. The contracts would unilaterally favor the interests of the start-ups, so that they could exploit investors as much as possible. This scenario would be most likely to arise if the crowdinvesting market was characterized by a small number of companies and a large number of potential investors eager to engage in crowdinvesting.
- *No race at all or race to nowhere in particular*: in the final scenario, there is no competition between platforms to design contracts, or else such competition results in divergent aims and practices. In this scenario, contracts do not change at all or only due to exogenous factors (tax law, regulations, etc.). It is also conceivable that all platforms would simply follow the market leader, copying the design of contracts currently in use and thereby stifling the urge to innovate.

On a theoretical level, there are good reasons to take all three scenarios seriously (Klöhn/Hornuf/Schilling 2016b at p. 11 et seq.). A race to the top scenario is plausible because the crowdinvesting market represents a two-sided market (on two-sided market characteristics of crowdfunding platforms see Viotto, 2015 at p. 38 et seq.). Platforms can only remain in the market as long as they satisfy the demand of both, successful start-ups and a sufficient number of investors. The race to the bottom scenario might be supported by the nature of the companies that tend to be financed by crowdinvesting. In its seed stage, a start-up essentially consists of an idea. It may be more or less attractive to investors, but it has not really been tested in the marketplace. Moreover, it is almost always advisable for owners to reinvest all of their profits in order to grow their businesses.

The value of an investment in a start-up therefore generally only emerges after a protracted period. In the meantime, it is very difficult to distinguish between good and bad start-ups, i.e. those with potential for growth and managerial integrity, and those that merely exist to enrich themselves at the expense of the investor. The final scenario, in which there is a lack of competition and, thus, no race at all or a race to nowhere in particular, might be supported by the present competitive situation of crowdinvesting markets in most European countries, which is an duo- or oligopolistic structure.

One of the major future tasks of law-and-economics scholarship in the area of crowdinvesting is to gather empirical evidence which allows an answer to the question which of the aforementioned scenarios is most plausible. As of now there are only a few fact-based studies or hints as to what this answer might be. The first is a study on financial contracting on the German crowdinvesting market (see below 10.5.3). The second are accounts of other market-based investor protection mechanisms (not related to contract design) that have been developed by crowdfunding platforms, especially in the UK, in the absence of specific legal obligations (see below 10.5.4).

10.5.3. Crowdinvesting Contracts in Germany

From a financial contracting point of view the German crowdinvesting market is highly interesting. Remember that in Germany start-ups do not offer transferable securities to the crowd (such as stocks and bonds) but subordinated profit participating loans (see above 10.4.3.1). Originally, these contracts were virtually unregulated. Even after the introduction of a prospectus requirement for offering profit participating loans to the public in 2015 they remain largely unregulated because start-ups make use of the 2,5-million-exemption from that requirement, because platforms brokering such investment are operating outside the scope of MiFID and because these platforms are not overseen by the German financial regulator BaFin but by the local trade offices who have no specific expertise in the field of corporate finance.

The absence of regulation gave German crowdinvesting platforms the opportunity to develop and experiment with new contractual designs. In a recent study Klöhn/Hornuf/Schilling 2016b provide an overview of the contractual terms which are currently being used as well as the development of those terms. The most important results can be summarized as follows:

1. There is a tremendous dynamic in the market. From the beginning of crowdinvesting in 2012 until today investment contracts have undergone significant change on every platform that has since then been in the market.
2. In some respects contract development follows the classical pattern known from other markets with an oligopolistic structure, i.e. runner-up firms have changed their standard contracts and adopted clauses used by the market leader. Nevertheless platforms do not seem to just stick to these standards[49] but keep changing their contracts and experimenting with innovative ideas.
3. So, while there is evidence that crowdinvesting platforms are actually using contractual design to compete, it is less clear whether this is a race to the top or a race to the bottom. The relatively few insolvencies of start-ups funded by crowdinvesting as well as estimates on the firm survival, which show a higher survival rate of crowd-funded compared with German start-ups in general (Hornuf/Schmitt 2016), might support the race to the top thesis. On the other hand, compared to the earnings of venture capital funds absolute returns in crowdinvesting seem to be low (Hornuf/Schmitt 2016). In particular, to date, there have been only a few exit opportunities for crowd investors.

10.5.4. Other Market-Based Safeguards in Europe

Crowdinvesting platforms have experimented with several mechanisms beyond investment contract design to reduce the risk of misallocation of funds and of outright fraud (Armour/Enriques 2017). These mechanisms might be divided into three groups: (1) mechanisms to utilize the collective wisdom of crowd investors, (2) mechanism to use VC or angel investor backup and (3) pricing tools.[50]

Wisdom of the Crowd

One of the most obvious mechanisms to unleash the wisdom of the crowd, which is commonly used by platforms all over the world, is to initiate discussion about the risks and potential of the investment opportunity on an internet forum hosted by the platforms. However, in its 2015 review on UK crowdinvesting, the FCA reported that negative comments had been deleted from such forums on some sites.[51]

Another mechanism along the same line, often used in practice not only in the UK but all over Europe, is to let potential investors know not only the aggregate amount of funding pledged by prior investors, but also the individual distribution. This might send valuable information to the crowd because the more a single investor pledges, the more careful his or her due diligence will have been (Armour/Enriques 2017 at p. 43). Along this line, a study of German crowdinvesting platforms finds that, where such information is made available, large investments by a single investor are positively correlated with the number of subsequent investments later the same day (Hornuf/Schwienbacher 2015).

Finally, crowdinvesting platforms have experimented with restricting investor access to individuals which are expected to be particularly sophisticated or at least well-aware of the risks of crowdinvesting. In Germany, the crowdinvesting platform Innovestment started with a minimum investment per individual of EUR 1,000 but later abolished this requirement, possibly due to competitive pressure by other platforms using much lower investment limits (the two leading platforms Companisto and Seedmatch use investment limits of EUR 5 and EUR 250 respectively). In the US, AngelMD is an investment platform which allows only medical professionals to invest in medical start-ups (Armour/Enriques 2017 at p. 44).

Angel Investor or VC Backup

Crowdinvesting platforms' pay is usually tied to a large extent to fundraising success and only to a small extent to ultimate investment success. Therefore, their incentives to screen start-ups before offering them to the crowd might be suboptimal (Armour/Enriques 2017 at p. 45). Certainly, it is not easy for crowdinvesting platforms to signal to the crowd that their screening is reliable. As a possible remedy, platforms have designed models under which members of the crowd invest alongside VC funds or angel investors at the same contractual terms. For example, the UK platform SyndicateRoom, only lists companies that are already backed by professional business angels. It then offers its members the "same share class and same price per share" if they decide to invest alongside these professionals (Armour/Enriques 2017 at p. 45).[52]

Also, In the UK some platforms have tried to make use of contractual protection devices used by VC's to offer the crowd a more attractive investment. For example, as Armour/Enriques 2017 (at p. 46) point out, the platform Seedrs signs investment agreements in its capacity as crowdfunders' nominee. Those agreements grant investors pre-emption rights, tag-along rights, and veto rights regarding important issues, such as the winding-up of the company, changing the business of the company, issuing preference shares, transferring assets out of the company, making certain loans, or increasing director salaries beyond an agreed level. These rights are exercised by the platform on investors' behalf.[53]

Pricing Tools

Start-ups are extremely difficult to price. Given the far from perfect incentives of crowdinvesting platforms to ensure that start-ups are valued at appropriate levels (see above), crowd investors face an exceptionally high adverse selection risk when making their investment decisions. Moreover, most crowdinvesting platforms offer investments at a take-it-or-leave-it price. This exacerbates the danger of herding among crowd investors because on the platforms website investors can only observe decisions to make an investment as opposed to decisions to abstain from making an investment (Armour/Enriques 2017 at pp. 12 et seq.). Some platforms have experimented with alternative pricing models. For example, the German crowdinvesting platform Innovestment started with an ambitious auction mechanism designed by an econcomics Ph.D.-candidate writing about auction theory (see Hornuf/Neuenkirch 2016 for details on the auction mechanism and empirical evidence on the characteristics which influence pricing). In the UK, Crowdcube offers a "price review" mechanism which relies on the bargaining power of investors willing to buy a relatively large stake in the company (see Armour/Enriques 2017 at. p. 49 et seq. for details).

10.6. Outlook

So what should the EU do? Any section about the regulatory perspectives in Europe must start with the realization that a full-blown harmonization of the laws governing crowdinvesting is, at least for the next ten years, simply not feasible. As the German experience shows such harmonization would require extending the European term of „financial instruments" (as within the meaning of MiFID) or „transferable securities" (as within the meaning of the Prospectus Directive) to any investment contract regardless of its exact legal structure, i.e. to adopt a concept of "financial instruments" or "transferable securities" similar to the concept of "security" which is predominant in the United States. This would be a huge step. It would significantly extend the reach of European securities regulation to areas and markets which had been unregulated before. The potential side effects of such step are almost impossible to assess. Furthermore, there are several (at least on a national level) powerful interest groups whose constituents rely on finance provided by investments not governed by EU regulation (take the Federal Association of Cooperatives in Germany) and who would no doubt strongly oppose such regulation. Crowdinvesting is simply not important enough to convince any decision maker in Brussels or Luxemburg to take this step.

Given this – rather sobering – fact, one must realize that any attempt to regulate crowdinvesting on the EU-level will be limited to financial-instruments-based or securities-based crowdinvesting. Market participants will be able to avoid such regulation by designing investment contracts not covered by EU regulation, such as subordinated profit participating loans in Germany. The most important implication is that stricter regulatory requirements in the area covered by European law (securities and financial instruments) will increase issuers' and platforms' incentives to avoid such regulation by designing investment contracts not covered by EU law.

Taking into consideration that crowdinvesting platforms seem to be experimenting with contractual clauses and other market based solutions to protect investors (see above 10.5.3 and 10.5.4), the best option seems to be not to further regulate the market but to actually do the opposite and liberate the market in order to create a level playing field for securities-based- and non-securities-based crowdinvesting.

- The first step towards such level playing field must be a reform of the small offerings exemption in the Prospectus Directive. The proposal for a new Prospectus Regulation goes into the right direction and creates a mandatory exemption for offers of a consideration below EUR 500,000 (as of today this limit is EUR 100,000).[54] It prevents member states from imposing disclosure requirements which would constitute a disproportionate or unnecessary burden in relation to such offers and thus increase fragmentation of the internal market. This is the right approach, but the European legislator should go further and exempt any securities offer to the public with a consideration below EUR 1 million from the prospectus requirement.[55]

- The second step could be tailored exemptions from MiFID's organizational and conduct-of-business requirements to lower market entry barriers for crowdfunding platforms and to give crowdfunding platforms more breathing space to develop market-based investor protection tools. For example it is highly doubtful that the appropriateness test required by MiFID has any significant effect on investor protection in the UK. Instead, EU law could require that MiFID crowdinvesting platforms adopt investor protection measures specifically designed to the dangers of crowdinvesting (e.g. herding) if it seems probable that such mechanisms will not be adopted due to reputational and/or market pressure.

10.7. Literature

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[49] The two market leaders – measured by the amounts of funds raised – are the crowdinvesting platforms Companisto and Seedmatch.
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