



POSITION PAPER

Crowdfunding

I. Background

1. During the last few months crowdfunding has become a hot issue in the regulatory agenda in most developed countries, trying to close the gap between a fast growing activity and the lack of an appropriate regulatory framework.
2. Crowdfunding has grown fast in the last three or four years as a result of two key factors: technological innovation and the financial crisis. While the latter has led to severe constraints on lending by traditional credit providers to the real economy, technological advances facilitate much faster word of mouth spreading of information between those in need of financing and potential funders.
3. On the other hand, there are concerns arising from the fact that crowd funding is showing rapid growth in a regulatory limbo, raising worries about potential misuse, with adverse implications in terms of investor protection.
4. Several European countries have recently speeded up new legislation on crowdfunding, in the absence of a common European framework. The European Commission has recently issued a Communication on “Unleashing the potential of crowdfunding in the European Union”. While at the moment the EC does not intend to come up with legislative measures, the Communication proposes a number of actions aimed at promoting, raising awareness and building confidence in crowdfunding.
5. In such a rush to new ruling across Europe, SMSG suggests that ESMA should take a proactive approach toward proposing some common standards both in terms of investor protection, as well as in terms of transparency requirements to be imposed on the platforms that support crowdfunding.
6. Crowdfunding involves many different forms and business models. From ESMA’s and its investor protection perspective, the only relevant ones are those falling under pure financial crowdfunding, where contributors are promised to get some financial return from the money they contribute.
7. Inside this category, however, loan based still clearly dominates over securities based. While only the latter fall under ESMA’s field of responsibility, consumer protection issues are quite similar to those existing in loan based crowdfunding. For this reason the working group considers that ESMA approach should be coordinated with EBA.

II. Crowdfunding categories and activity

8. The main problem when tackling crowdfunding is the lack of a clear and universal definition, as it involves many different types, covering different business models, and falling under many different potential regulatory efforts.
9. Some recent definitions extracted from institutional studies or pronouncements are:
 - a. European Commission: “An open call to the public, typically through the internet, to finance a specific project”.
 - b. UK Financial Conduct Authority: “A way in which people can raise money through online portals (CF platforms) to finance or refinance their activities and enterprises”.
 - c. US SEC: “An evolving method of raising capital that has been used outside of the securities arena to raise funds through the Internet for a variety of projects”.
 - d. IOSCO: “An umbrella term describing the use of small amounts of money obtained from a large number of individuals or organizations, to fund a project, a business or personal loan, and other needs through an online web-based platform”.
10. Key elements are, therefore, three:
 - a. The small amount of money each participant provides (crowd),
 - b. The online nature of calls for participation,
 - c. The presence of a platform to facilitate contact between providers and users of funds
11. Under those three common elements, there are many different types of crowdfunding depending on the purpose of the fundraising as well as the instrument used to contribute the funds. The most widely used taxonomy distinguishes between non-financial and financial CF, the difference being what the providers of money get in return for providing the funds
 - a. Non-financial, sometimes also named community crowdfunding, includes all forms of monetary contributions where the provider of money is not expecting any financial return. Donations, sponsoring, or reward seeking (in the form of a product or service of lower value than the contribution) are among the most cited categories of non-financial CF.
 - b. Financial crowdfunding, includes all those contributions where the provider of money expects some financial return. Among these are included loan-based (also known as peer-to-peer lending), and securities-based, also named investment crowdfunding. Securities issued may be shares or bonds.
12. Given the open nature of crowdfunding, it is virtually impossible to know the level of activity, either in terms of calls for money, or money raised, or even the number of platforms that are facilitating the calls. Appraisal of the actual volume and growth of activity has to rely on estimates, either from the most advertised platforms, or from crowdfunding associations, or specialized consultants.

13. To make an estimation of activity and breakdown among different crowdfunding categories, we have crossed several secondary sources recently published:
 - a. Estimates of worldwide activity, as published by Massolution (2013), a consulting company specialized in the monitoring of platforms; and by IOSCO (2014). Both of them emphasize that their estimates for crowdfunding volumes are probably in the lower range, as these are based on observations from a limited sample of platforms.
 - b. Estimates of activity in the UK, as recently published by NESTA (2013) in a joint team effort together with the Universities of California-Berkeley and Cambridge, with a much higher accuracy, in terms of sample used and data cross check.
14. Worldwide crowdfunding activity during 2013 is estimated to be in a range between \$3 and \$6 billion (Europe representing between one quarter and one third of worldwide activity), while for the UK alone the figure is about \$1,5 billion. European activity can be estimated in a range between \$2 and \$2,5 billion.
15. According to the same sources, activity has been growing fast, at yearly rates above 50% since 2009, the first year that any crowdfunding activity was reported.
16. Regardless of the accuracy of overall estimated numbers, and the possible discrepancies among the different sources, all of them seem quite homogeneous in terms of breakdown across the different categories of crowdfunding: there seems to be a 50/50 breakdown between financial and non-financial categories.
17. Financial categories, however, present a clear bias towards loan-based crowdfunding (peer-to-peer), representing over 90% of overall financial. The rest, that is some 10% of financial or 5% of total crowdfunding activity, would be the so called investment crowdfunding, resting on securities issues, most of them in small equity issues, being virtually null the issuance of bonds.
18. From all these sources we can make an educated guess about the absolute, as well as relative, size of investment crowdfunding in Europe in the range between 50 and 100 million euros in 2013. This represents a marginal figure (less than 0,3 %) when compared to the overall IPO market in Europe (estimated at 26 billion euros in 2013, according to PriceWaterhouse), although growth rates are clearly higher in crowdfunding than IPO, or any other conventional forms of finance.
19. A somewhat similar conclusion is reached by IOSCO in its recent report, when they recognize that financial crowdfunding does not currently constitute a systemic concern. But, if allowed to grow without proper management, and given the interconnectedness with other industries (non-bank lending, shadow-banking, among others), there is a possibility of becoming a systemic issue.
20. A similar conclusion is reached by UK's Financial Conduct Authority, formerly responsible only for investment crowdfunding, and from April 1st also assuming responsibility over loan crowdfunding. According to FCA: "loan based is generally of lower risk than investment-based crowdfunding; however the market has the potential to develop new and innovative models in the future where the risks can be substantially higher."

III. Benefits and risks of crowdfunding

- Benefits:

21. There is no doubt that crowdfunding presents some benefits as a potential source of finance, especially for small firms and innovative projects, that are unable to access bank finance, venture capital or reach the stage of initial public offerings. Better access to finance for small businesses would in turn promote entrepreneurship and ultimately contribute to growth and job creation.
22. Crowdfunding offers additional advantages both for project promoters and for investors or project contributors. Besides access to new and convenient sources of finance, project owners can get feedback from the crowd, wider and faster relationships with customers and investors, possibility of market testing and validation, etc.
23. Benefits from crowdfunding are especially evident in Europe, where SME difficulties to access finance are probably more intense. Aware of the increasing potential of crowdfunding, especially as an alternative source of finance for SME's, the European Commission has taken several initiatives in the last year.
24. The "Green paper on long term finance of the European Economy", published in March 2013, explicitly incorporates in section 3.4 the need to develop or promote other non-traditional sources of financing like crowdfunding.
25. The EC launched in October 2013 a Consultation Document "Crowdfunding in the EU- Exploring the added value of potential EU action", addressed to anyone with an opinion on crowdfunding (contributors, fundraisers, platforms, national authorities, academics, associations, and all other interested parties) in order to get some light about true crowdfunding potential, as well as what could be done by the EC to support its further development. .
26. The Commission received over 900 responses to the consultation questionnaire, almost half of them actual or potential contributors to crowdfunding campaigns. The vast majority of respondents perceive crowdfunding to be highly beneficial for innovation, and a large majority consider it beneficial for SMEs and entrepreneurs too. A further advantage of crowdfunding for many respondents is that no traditional financial intermediaries are involved in the process, leading to decentralization of finance and less bureaucracy.

- Risks:

27. Against the alleged benefits, there are different types of risks associated with crowdfunding. The simplest one, common to all types – financial and nonfinancial- is the risk of fraud (money collected not used for the stated purposes), as internet-based communication facilitates the spreading of fraudulent representation and false statements.
28. For financial crowdfunding the main risk is that contributors do not receive what they were promised, either due to fraud, or simply to project failure. This risk is inherent to any type of investment, but

in crowdfunding it is exacerbated by information asymmetry between investors and issuers/promoters, as well as by the difficulties in exercising shareholders rights in a complex ownership model

29. Probably the most important risk, from the point of view of investor protection, is the liquidity risk, as there is no secondary market for investments done via crowdfunding platforms: once an investor's money is locked into a lending contract, or invested in share equity (or bonds) there is little scope to sell out except at a significant discount to the face value. Given the widespread access of these investment opportunities to retail investors, the implications for unwary investors are clear.
30. Another risk in crowdfunding investments is the so called platform risk. As long as any contact between issuers and investors is conducted through a platform, an additional source of risk is that of the platform being temporarily or permanently shut down, therefore not being able to fulfill its role as intermediary, contact with promoters, or collection of repayment.
31. Among respondents to the EC Consultation, a large majority consider that a scandal could undermine contributors' confidence in crowdfunding. The majority of stakeholders accept the financial risk (the risk of their investment being unprofitable or the risk of losing the invested capital as a result of project failure).
32. The great majority of regulatory and supervisory authorities answering the questionnaire perceive the risk of equity dilution and lack of liquidity as too high.

IV. Approaches to crowdfunding regulation: recent trends

33. As it was explained in section II above, crowdfunding activity has been growing fast in most developed countries, in the absence of a specific regulatory framework. The potential for growth acceleration of that activity, with an increasing role of social networks in an environment of difficulties for traditional finance sources, have forced many countries to react and design specific regulation trying to maintain an adequate equilibrium between investor protection and not killing activity growth.
34. Crowdfunding activity started earlier, and has been growing faster, in the United States, and therefore it is in that country where earlier advances have been made towards an appropriate regulatory framework.
35. The first piece of legislation dates back to April 2012, with the signature of the JOBS Act, whose Title II and Title III are devoted to Crowdfunding. JOBS Act imposed on the SEC the task of developing the regulatory standards for those two titles.
36. Title II was implemented on September 23, 2013. According to it, companies on equity crowdfunding platforms will be able to promote their investment offerings over the social networks as long as that promotion leads back to a platform that verifies Accredited Investors before giving access to the investment offering. It is a first step in allowing companies raising capital to market/advertise publicly on line, though potential investors are limited to accredited investors.
37. Finally, Title III ruling was proposed by SEC on October 23, 2013. Its main advance is the opening up to new categories of investors the possibility to participate in crowdfunding transactions subject to these meeting certain requirements at three levels:

- The amount to be raised by the issuer must not exceed \$1 million during a 12 month period
- Individual investments made by private individuals during a 12 month period are limited to either 5% or 10% of one's annual income depending on whether such income is below or above \$100.000 respectively.
- Transactions must be conducted through an intermediary that either is registered as a broker or is registered as a new type of entity called a "funding portal"

38. Title III Ruling by SEC was open for comments from experts, regulators, advocates or opponents during a 90 day period. Afterwards SEC will analyze those comments and produce a final ruling, so that Title III is expected to come into effect some time during spring 2014.

39. In Europe the majority of countries do not have any specific regulation on CF, but rather leave it to be dealt with under the existing relevant regulatory frameworks, depending on the nature of the operation –financial versus non-financial and of the supporting platform. This way, financial crowdfunding may fall under banking legislation (European Payment Services Directive, Consumer Credit Directive, or Mortgage Credit Directive), or securities legislation (Prospectus Directive, MiFID)

40. In the case of pure investment crowdfunding (securities issues), absence of specific regulation leaves it under the limits as stated in the Prospectus Directive: European wide requirement of a prospectus for issues larger than 5 million, and no obligation at all for issues under 100.000 euros. It is inside this range, probably the one where most crowdfunding issues are expected to fall, where no homogeneity at all exists, and where each country is trying to frame its own crowdfunding activity.

41. Some European countries have decided to take regulatory action on financial crowdfunding (among these Italy, the UK, France, or Spain) while others have sought to address concerns around crowdfunding through guidelines (Germany, Belgium, or Netherlands).

42. Italy was the first European country to produce a legislation specifically directed at crowdfunding through "Decreto Crescita" (Growth Decree) published in October 2012, and later developed by "Regolamento" in June 2013. Italy's regulation is highly restrictive as it applies only to startups, not established business, and is dedicated to development and commercialization of high tech products or services.

43. The management of supporting CF platforms is not limited to investment services companies or banks, but also to any other company approved by CONSOB, and issue sizes are subject to maximum limits of 500.000 euros within a time period of 12 months.

44. France is in the process of approving a specific ruling for crowdfunding, as it was advanced by the Ministry of Economics on a draft regulation presented on 14th February, 2014. A quality label will be granted by government for platforms, linked to transparency and customer protection aspects.

45. Those platforms, however, will not be imposed any capital requirements, though they will be required to perform duties on information and advice to investors regarding the risks involved in investments. For issues up to 1 million euros only a light prospectus will be required, and a maximum 1.000 euros per investor per project will be required, in order to ensure risk diversification.

46. Spain is in the process of approving a crowdfunding framework (under the name "Plataformas de Financiación Participativa") quite similar to the one advanced in France. Under the project of Law that

is being discussed, issuance is limited to 1 million euros per project; and investor participation is also capped at 3.000 euros per project, and 6.000 euros per platform for a one year period.

47. Platforms are imposed minimum capital requirements, and are responsible to supply to investors all the information they need to make informed decisions, as well as to certify in front of regulators (CNMV or Bank of Spain) that investors are aware of the risks they are assuming.
48. In the UK, the FCA issued on October 2013 a consultation paper on the regulatory approach to crowdfunding. After processing comments and responses received, FCA has recently issued a Policy Statement on 6th March 2014 “The FCA’s regulatory approach to crowdfunding over the internet”. The rules are related to security-based but also to loan-based crowdfunding, as long as FCA takes responsibility over this type of crowdfunding as from April 1st 2014, taking it from the Office of Fair Trading.
49. Regarding securities-based crowdfunding, FCA approach is somewhat different from the Italian, Spanish or French approaches, formerly described. Contrary to these, FCA assumes that the approach based on applying restrictions on an individual firm basis at the authorization stage is not a long term solution. Alternatively, FCA approach should mean that crowdfunding investment opportunities are available to more retail investors than currently, but with appropriate safeguards to check that investors are able to understand and bear the risks involved.
50. Under this disclosure based regime, firms running the platforms will be required to ensure that investors have the information they need to be able to make informed investment decisions and that all communications are fair, clear and not misleading. As long as these information requirements are guaranteed, there are no limits on issuance, or individual investment. For those investors not meeting the information/advice requirements, platforms will have to monitor that they invest no more than 10% of their available asset in any single project.
51. The technology neutral approach of FCA regulation on crowdfunding is made clear as long as rules will provide the same level of protection to investors whether they engage with firms on line or off line as a result of direct marketing or telephone selling.
52. A special consideration should be given to the case of Germany, as it has not produced any recent advance towards specific regulation of crowdfunding, and yet it is one of the European countries where equity crowdfunding has been more active, with some estimates around 15 million euros issued in 2013.
53. In the absence of any specific regulation, crowdfunding issues in Germany are bound by the prospectus legislation: only offerings less than 100.000 during a 12 month period euros are exempted from formal prospectus. The largest platforms, however, have used a loophole to surpass the 100.000 lines, and that is the so called “partiarisches Darlehen” a certain kind of shareholder loan, whose return incorporates profit participation schemes. This type of equity-like instrument received its approval from German financial and banking authorities to go through the 100.000 barrier.

V. The EU position towards crowdfunding

54. Building on the responses received to the consultation on crowdfunding, as well as on the consultation on long-term financing, the European Commission published on March 27 a Communication about “Unleashing the potential of Crowdfunding in the European Union”
55. While the Commission does not intend to come up with legislative measures at the moment, the above mentioned Communication proposes a number of actions aimed at promoting, raising awareness and building confidence in crowdfunding.
56. To get a better overview of how crowdfunding fits in the wider financial ecosystem, the Commission will carry out a study in 2014, and will set up the European Crowdfunding Stakeholder Forum as an expert group of high level representatives of associations of concerned stakeholders groups and national authorities.
57. The Commission will closely follow efforts by industry associations to develop standards (at national and European level) on transparency and best practices.
58. The EC will launch a study to examine the existing national self-regulatory bodies and their rules, and will explore the potential of establishing a European quality label.
59. The Commission will keep this emerging sector under close monitoring with the support of the Forum, and will regularly assess the state of EU and domestic regulatory frameworks applicable to crowdfunding, and consider whether further action is necessary. The Commission will also consider whether to calibrate requirements on the specific features of crowdfunding with financial returns.
60. Finally, as long as crowdfunding is a global activity, the Commission will closely follow international developments and will support efforts to promote regulatory convergence of approaches at international level.

VI. SMSG position

61. SMSG welcomes the opportunity to give ESMA an opinion and advice about crowdfunding, at a time of increasing awareness on the opportunities and risks around such a finance alternative, and in the middle of a recent move towards ruling it in several European countries.
62. An initial challenge is the lack of a clear and uniform definition of crowdfunding, as it covers many different business models, all of them having in common an open call, through internet, to raise funds with many different objectives.
63. In order to guarantee the technology neutral approach of regulation, however, the basic principles on crowdfunding should be the same whether the call is made on-line or off-line (like through phone or direct marketing channels).
64. Among the many different types of CF currently out there, we consider that only those which offer something in return should be allowed as general norm for actual fundraising. In fact, ESMA should be concerned with pure securities-based crowdfunding, which represents a much smaller size than loan-based.

65. However, given that both –loan based and securities based- raise similar concerns in terms of investors protection, we consider that ESMA approach towards crowdfunding should be coordinated with EBA in order to get a common position in terms of an appropriate equilibrium between impulse to crowdfunding and consumer protection.
66. This common approach with EBA is especially appropriate at a time when the European Commission is taking important steps to raise awareness on crowdfunding, and keep a close monitoring on crowdfunding activity and regulatory developments, as well as considering to establish a European quality label, or specific requirements on financial crowdfunding.
67. In this sense, the working group considers that ESMA –with EBA- should be proactive in giving advice to the EC regarding specific regulation on crowdfunding especially on the investor or consumer protection aspects.
68. At a time when several European countries are producing specific regulations on crowdfunding, the working group considers that ESMA's priority should be to try to get the maximum homogenization and clarification about crowdfunding across European countries.
69. It would be impossible and ineffective to make amendments to the current regulatory frameworks limiting crowdfunding (Prospectus, Transparency, MAD, etc.). But some kind of unified regulation should be targeted, without necessity to change member countries' regulation on IPO.
70. Some countries regulate crowdfunding by defining maximum issue levels inside the 100.000 to 5 million euro range that Prospectus Directive leaves for each country to decide; as well as limits on the amount each investor can invest, either in a single project or during a one year horizon. Other countries do not impose specific limits, but rather emphasize a disclosure approach to crowdfunding.
71. In both approaches, however, a key role is to be played by crowdfunding platforms, as the guarantors that investors get all the information about the projects and the risks involved, in order to make their decisions on an informed basis.
72. Given this pivotal role for crowdfunding platforms, the working group considers that ESMA should take the lead on setting out standards on transparency requirements and potentially, where eg shareholder services or market making activities are undertaken by the platform, capital requirements, to be imposed on platforms on a European wide setting.
73. Such a homogeneous approach towards platforms could also form the basis for a future European label to be granted to crowdfunding platforms meeting more exigent and harmonized requirements at a European level.
74. Some exemptions could be granted from the obligation to prepare a prospectus, independently of the limit specified in the home country, for those platforms fulfilling specific requirements in terms of: transparency towards investors; performing duties about investors awareness and/or financial sufficiency; guaranteeing platform continuity, etc.
75. Regarding quantitative limits to maximum individual investments in crowdfunding, the working group considers that it is not to ESMA to make these choices. Nevertheless, in the MIFID context investment products should be appropriate to the investor's profile. To the extent that more leniency would be offered in crowdfunding investments, this should be balanced by some type of limits on maximum investor amount, either in absolute or relative terms.

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