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Crowdfunding: Approaches to Regulation

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Abstract

Crowdfunding had been consistently lauded as one of the fintech's branches that would connect small investors and SMEs and fill the lacune of financial systems. The regulators in the EU and around the world have started to produce specific regulation relatively recently, e.g., the Regulation (EU) 2020/1503 on European crowdfunding service providers for business was issued only a year ago and still waits to be introduced into the Member states legislation.

This paper will analyse the actual goals of the Regulation and its relevance to crowdfunding's purpose. After the comparison to other regulators' policies, in the final part, we will discuss the state of crowdfunding, its perspectives and the merits of regulations.

Key words: crowdfunding, ECSP, EU legislators, fintech regulation

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Rationale of Crowdfunding

The rise of fintech had been generally following the two routes: 1) improving the efficacy and streamlining already existent financial operations; 2) including the unbanked and underbanked clientele into the system of financial services. Crowdfunding, which is the mechanism that allows project owners to request funding from a potentially large pool of investors, is usually placed into the second category.

As financial technologies had been changing the landscape of financial services dramatically the lofty expectations towards the future of crowdfunding became the staple of academic and financial literature.

“Crowdfunding promises to democratise financing processes and create a level playing field for competing ideas”¹.

“Crowdfunding, in particular peer-to-peer lending and equity funding, *effectively* channels funds from households to those parts of the economy that are not served by traditional financiers, providing funding for projects that may otherwise not be financed”².

Therefore, crowdfunding was supposed to fill the small gaps inaccessible for the large and over-regulated financial institutions. Consequently, it had become popular in the countries with oppressive capital controls (like China) and low profitability rates (the EU).

For a long time, crowdfunding had not been regulated at all or regulated through the application of the legislation created for a different type of financial products. But inevitably almost all regulators around the world had moved to create the specific regulation:

- by expressly prohibiting the problematic behaviour of the crowdfunding platforms and project owners;
- establishing requirements, in many cases copied from the other financial sphere.

¹ Cai, W., Polzin, F., & Stam, E. (2021). Crowdfunding and social capital: A systematic review using a dynamic perspective.

² CAMAC (2014) Crowd sourced equity funding report. May 2014.

While such approaches will limit the potential for abuse, is it helping crowdfunding's phenomena fulfil the aforementioned expectations of mutual democratic enrichment?

This paper will analyse and compare the approaches to regulation from that point of view.

The European Union Approach

Single Market orientation

In the podcast about the European Union of my home university department of World Politics and World Economics, one of the speakers mentioned that 'Europeans locked themselves up in ivory tower'. The other participants concurred. This image had been elaborated in two directions: 1) the new norms are created inside the European Union (and become even more standardized in recent times) and then perceived universal and suited for everyone – the prided 'Brussel's effect'; 2) the Europeans are not interested about anything beyond their borders, they do not even think about what they can offer to the world besides their 'values' and consumers' capacity.

While such opinions may be too polemical and controversial there is a possible ground for such declarations.

The initial underlying goal of the Single Market was to increase the economic codependency of the members in order to prevent the next catastrophe of world war. After this was accomplished, in the 1980s the idea was reborn with the purpose to improve the competitiveness of the region. The Member States were expected to diversify themselves inside the regional system of labour's division, maximizing their advantages with the additional benefit of economy of scale.

Such ambitious project with the most advanced integration in the world naturally created the resistance of the dissolving sovereignties. Similarly to the global world outside, there were losers and winners, and all member states had been watching each other cautiously to prevent excessive benefiting at other members' expense. On the other side, every Member State had to enjoy the benefits equally. Consequently, the means turned to an end. The unified market without borders became value on its own.

The Regulation (EU) 2020/1503 on European crowdfunding service providers for business can be used as an illustration to this thesis. In its text and the preceding scholarly literature the necessity of the uniform regulation of crowdfunding had been stressed continuously, mainly for the reason that the small countries with their small population cannot support the prospective projects, therefore it is necessary to pool the potential investors from more developed and populous ones.

“...crowdfunding services have remained hitherto largely national, to the detriment of a Union-wide crowdfunding market, thus depriving businesses of access to crowdfunding services, especially in cases where those businesses operate in smaller national markets”³.

This demonstrates total lack of understanding of crowdfunding which mostly capitalizes on the social capital and benefits from the local affiliations⁴. Psychologically the investors prefer to invest in already known entities or ventures and uncomfortable to be the first one.

And even besides that in Regulation (EU) 2020/1503 the only borders that exist are between the Member States. It totally excludes the possibility of funders and project owners from outside the Union. What is really surprising considering the possible competitive advantages of the EU for both foreign projects and the attractiveness of the regions for foreign investors.

There are also other characteristics of the proposed regulatory regime that cast doubts on its competition resilience.

Prioritization of Cross-Border Activities

The self-importance of cross-border crowdfunding services can be also deduced from the following articles of Regulation (EU) 2020/1503's preamble:

“(30) The growth and smooth functioning of cross-border crowdfunding services require a sufficient scale and public confidence in those services. It is therefore necessary to lay down uniform, proportionate and directly applicable requirements for the authorisation of crowdfunding service providers. Requirements for crowdfunding services should therefore facilitate cross-border provision of those services, reduce operational risks, and ensure a high degree of transparency and investor protection.

“(31) In order to ensure effective supervision of the crowdfunding service providers, only legal persons that have an effective and stable establishment in the Union, including the necessary resources, should be able to apply for authorisation as crowdfunding service providers under this Regulation”.

³ Regulation 2020/1503. Art. 13 of the Preamble.

⁴ G. Giudici, M. Guerini, C. Rossi-Lamastra. Reward-based crowdfunding of entrepreneurial projects: the effect of local altruism and localized social capital on proponents' success.

Therefore, the line of reasoning is following: 1) companies established in the Union are easier to regulate; 2) effective regulation will facilitate cross-border activities, reduce risks, and ensure investor protection; 3) a sufficient scale and public confidence will lead to the growth and smooth functioning of cross-border crowdfunding services.

The cross-borderness is presented as the final goal. The uniformness and exclusion of foreign companies are required to achieve it and not economic benefits.

Of course, crowdfunding is in the developing stage and still requires a sand-box treatment. The final chapter of Regulation (EU) 2020/1503 establishes a deadline for the Commission and regulating authorities to submit to the European Parliament the results of this preliminary phase with suggestions of tweaking.

Another reason may be the strategic choice in favour of manager (platform) regulation. Product regulation is hardly executable due to the varied non-standardized nature of crowdfunding. The full disclosure and publishing of prospects by project owners would be too heavy a burden for SMEs and start-ups and will not achieve the necessary goals due to the lack of background information. The 'know-your-client' approach is too cumbersome for crowdfunding service providers and would repel the potential funders by its over-inquisitiveness. "...cross-border notification *per product or per sales effort* over time is more expensive than one notification *per platform* where the platform has multiple products to fund and where funding periods for each product are limited to several weeks or months"⁵.

And since crowdfunding platforms can be regulated properly only if they are under the EU's control, the easiest choice would be to eliminate all entities established outside the EU.

Consumer Protection

The Regulation (EU) 2020/1503 is glaringly investor-centric. Though SMEs are even mentioned in the first article of Regulation (EU) 2020/1503's preamble, there are no mechanisms for their protection in the text: "Crowdfunding is increasingly an established form of alternative finance for start-ups and small and medium-sized enterprises (SMEs), typically relying on small investments". All the guarantees for the support of continued services are directed to investors.

⁵ Zetzsche, D., & Preiner, C. (2018). Cross-Border crowdfunding: Towards a Single crowdlending and Crowdinvesting market for Europe

“The provision of crowdfunding services generally involves three types of actors: the project owner that proposes the project to be funded, investors who fund the proposed project, and an intermediating organisation in the form of a crowdfunding service provider that brings together project owners and investors through an online platform”⁶.

But all the norms in Regulation (EU) 2020/1503 are devoted to the protection of the investors despite project owners being also vulnerable to the crowdfunding service providers’ abuse of their intermediary position. “(T)he platform functions as the SME’s sole investment bank. The platform provider may impose its own fee-driven interests upon the firm. For instance, it could press the SME to acquire another firm funded by the platform, or forego business opportunities taken up by other platform-funded firms, or make additional funding dependent on egregious fees.”

No limitations or restrictions of platforms’ fees from project owners were introduced. Certainly, the Union competition law is capable to compensate in this part but it will require significant time and case law to delineate rules and expectations and that contradicts the goals of Regulation (EU) 2020/1503.

Viability of Current Orientation towards Retail Investors

The lopsided protection of investors may be justified by the necessity to build up trust in the institution of crowdfunding. Now the situation looks grim.

The idea of crowdfunding is based on the two principles:

1. matching up investors and entrepreneurs too small to get serviced by standard financial institutions;
2. ‘wisdom of crowds’, the idea that multiple investors’ choices are more correct than individual ones.

The ‘wisdom of crowds’ concept can be judged similarly to the supposed ‘wisdom of markets’ that had been proved wrong for a long time and applicable only to abstract economic theories. *Information asymmetry and the lack of transparency* cited as the main barriers for SMEs to receive traditional financing from banks are not diminished but even exacerbated in the crowdfunding realm.

⁶ Regulation 2020/1503. Art. 2 of the Preamble.

55% of SMEs fail in their first five years of existence⁷. It is a level of risk that most professional investors (angel or venture) are accustomed to but for the unprepared public, it can be much higher than its risk aversion tolerance.

The most eagerly funded projects are start-ups because they incite more optimism in potential investors and promise the largest returns. But they are at the same time the most prone to fail.

The SMEs which are supposed to be the main beneficiaries of crowdfunding cannot excite the naive investors by asking to finance regular running of business. Also it is hard for them to provide easily accessible but still convincing financial prospects and business plans about likely returns. The candidates that would be motivated enough to take time from the actual business to prepare all documents will surely comprise many fraudulent elements.

Are measures on Regulation (EU) 2020/1503 capable to overcome these problems? Unlikely. They are mostly prudential and based on faithful reporting and warnings and organizational requirements to the platforms. Therefore, such measures will not mitigate these hazards.

No actual guarantees and protections are granted to clients of crowdfunding platforms. Most of the protection mechanisms such as:

- import of the division between sophisticated/non-sophisticated investors from MiFID Directive 2014/65/EU (professional/retail clients);
- risk warnings;
- contingency funds (that crowdfunding platforms are not obliged to establish);
- basic disclosure;
- reflection period;
- caps on the investment amount

are aimed at dissuading investors from participating in projects and lending. At one point it is said that *“the crowdfunding service provider shall clearly advise the prospective investor to refrain from making the investment”*⁸. Overall, the aim of the document is far from stimulating the investments and no institutional or legal mechanism is established to facilitate their return. Regulation (EU) 2020/1503 does not bind the platform owners with strong fiduciary duty, except

⁷ Commission Staff Working Document. Crowdfunding in the EU Capital Markets Union. Pg. 16.

⁸ Regulation 2020/1503. Art. 23(13).

“act honestly, fairly and professionally in accordance with the best interests of their clients”⁹. The responsibilities of a crowdfunding service provider end with disclosure and the only prohibited potential abuse is the use of a platform by the owners and affiliated persons.

Considering all this, can we really be confident that the current image of crowdfunding “from people to small business” will continue to exist unchanged?

The growing popularity of crowdfunding may be of the same origin as the entrance of private investors into financial markets due to the introduction of mobile applications that enable small retail non-professional investors to buy financial products on the go. For many of them, this is the first market cycle and they are not prepared for an inevitable downturn. The massive losses can spurn investors and forever smear the reputation of crowdfunding projects or loans with possible exceptions of reward- or donation-crowdfunding.

In fact, crowdfunding increasingly becomes the domain of institutional investors. Both crowdfunding lending and equity platforms are increasingly raising finance from banks, pension funds, mutual funds and asset management companies¹⁰.

In this case, the public retail investors will serve their role as trailblazers and step aside for the institutional investors that will choose projects for funding according to financial standards. The natural persons’ forays in lending and equity funding will be akin to speculative market trading. At this next level of crowdfunding’s evolution, the exclusive nature of regulation will block the development of industry and isolate the Union from the global market.

Still, the regulation can be needed even if it will lead to the virtual extinguishing of the crowdfunding institution. The general disappointment combined with financial scandals can lead to organized mob backlash akin to Robinhood/GameStop scandal. Tight regulation can ensure a smooth transition to the next step.

The Chinese Approach

China being a world leader in P2P platforms can present an interesting case for comparison.

Firstly, the Chinese funders are more practically oriented. The most popular platforms are reward-based and the legislation treats them as marketplaces for goods paid in advance.

⁹ Ibid. Art. 3(2).

¹⁰ Mason, C., Parhankangas, A., & Landström, H. (2020). *Why crowdfunding may not be the great democratising force in investment.*

Secondly, the project owners often utilize the specific Chinese cultural concept of “guanxi” - accumulated interpersonal exchangeable trust¹¹. Thirdly, as a majority of other fintech projects the most popular crowdlending and crowdfunding platforms are the spinoffs of supergiants Alibaba and Tencent¹².

The equity funding is more strictly regulated and not widely spread in China; therefore I will focus on crowdfunding or, more precisely in case of China, P2P-lending.

P2P-lending enjoyed its boom in China in the first half of the previous decade for the following reasons:

1. deposit rates controlled by the state;
2. severe underbankedness of many Western regions and rural areas;
3. lack of regulation;
4. raised income of population;
5. liquidity injections by the government;
6. limited options for investment.

The Chinese government eagerly lets the private sector compensate for its deficiencies and achieve economic and technical development. But inevitably when the private businesses decide they are too big to fail, their mistake is corrected.

Low levels of financial literacy and lack of control brought the sectors’ development almost to a halt. In the absence of regulation, the majority of Chinese P2P platforms deviated from the original information intermediary business model and adopted the ‘guarantee’ model in order to attract investors: the platforms became the final counterpart for both investors and project owners. Essentially, they became credit institutions with no regulation. Considering the normal rate of defaults in crowdfunding, such business models were far from stable and self-supported.

Multiple defaults of the platforms provoked the public outcry and subsequent long-awaited regulation. In 2016 Interim Measures on Online Lending were introduced with measures similar to Regulation (EU) 2020/1503:

¹¹ Zhao, L., & Vinig, T. (2019). Guanxi, trust and Reward-Based Crowdfunding success: A Chinese case.

¹² Yang, D., & Zhang, X. (2016). Review of the domestic crowdfunding industry development.

- Division of clients' and platforms' assets;
- Caps on investment;
- Disclosures of borrowers' information.

Moreover, the platforms are regulated on central and regional level and the idea of two-tier system of platforms - regional and national - are discussed. But most important is re-establishing all platforms as information intermediaries.

As a result, the number of p2p-lending platforms fell to 29 from over 6000 with \$115 billion in unpaid debt ¹³.

Considering the outcome of crowdfunding in China, similarities of regulation in the EU seem like a bad prospect for industry, though they may lie in the global trends.

The USA Approach

The US Securities and Exchange Commission established the following rules for crowdfunding¹⁴:

- Obligatory registration for crowdfunding intermediary;
- Division of investors into accredited and non-accredited categories;
- Division of project owners;
- Three-level of crowdfunding campaigns with different maximum amounts: Reg CF, Reg D, Reg A+;
- Limit on a maximum aggregate raised amount of \$5 million in a 12-month period depending on the type of investors;
- Disclosure of information in filings with the Commission and to investors and the intermediary.

The prominent point of regulation is increasing the requirements depending on the amount of raised funds and company's category. Considering that the US markets do not suffer from lack of

¹³ China's Peer-to-Peer Lending Purge Leaves \$115 Billion in Losses. (2020). Bloomberg. <https://www.bloomberg.com/news/articles/2020-08-14/china-s-peer-to-peer-lending-purge-leaves-115-billion-in-losses>
¹⁴ SEC - Regulation crowdfunding. (2017). <http://www.sec.gov/smallbusiness/exemptofferings/regcrowdfunding>

investment opportunities, the necessity to regulate is not pressing and SEC even had laxed its requirements recently.

Conclusion

As we can see from the listed approaches to crowdfunding regulation, no regulator tried to implement the specific instruments to support crowdfunding as a P2P-phenomenon.

“(T)rust is important in commercial relationships because it is crucial to the health of the financial system and the economy”¹⁵.

Regulation (EU) 2020/1503 focuses on drilling crowdfunding platforms on documents’ archiving and financial discipline but will it be able to contribute to the institution itself through improving its trust issues? Judging from its content - unlikely.

Despite the supposed equality and democratization, crowdfunding is not evenly dispersed across all the project owners and not even skewed towards the best one. Therefore, like in any other SMEs’ financing accumulation of the initial capital through personal connections is of imminent importance. The other option is utilization of social capital and soft power. This the EU still has in abundance - many investors from overseas would be interested to invest in European companies just for personal experience to participate in the European culture.

But the Regulation (EU) 2020/1503 effectively cuts off all the foreign investors while not introducing any guarantees (and even explicitly denying them) for retail investors that are supposed to be the core of crowdfunding.

But after looking at the other attempt of the regulations and general industry trends it is hard to blame the EU for inadequacy. Evidently crowdfunding had already passed its heyday in the middle of the last decade. The hopes and expectations for this institution do not reflect the reality. Though finance in fact democratizes itself constantly it is mostly done through technological advantage of computation, big data, processing, etc. The crowdfunding platforms are essentially social networks that just place information on offers with rare attempts to analyze it - Regulation (EU) 2020/1503 even expressly forbids the requirements of disclosure of sensitive business information¹⁶. It is impossible to imagine a successful audit of a company going for IPO without such disclosure.

¹⁵ Frankel, T. (2008). Trust, honesty and ethics in business. *Finance & Bien Commun*, 31-32(2). Pg. 87.

¹⁶ Regulation 2020/1503. Art. 16 of the Preamble.

Quite likely, the envisaged crowdfunding ideal will never realize. It was an unfortunate attempt to transfer inspirational reward-based and donation-based models into the cynical realm of investments. But unlike the capital markets that had been extremely democratized as well through the robo-advisors and other mobile applications, crowdfunding does not have ETFs, long-time growth-period, its risks are difficult to hedge, etc. It is hardly the appropriate instrument for mass retail investors.

Nevertheless, the process of regulation itself can be valuable for evening out normative field and speeding up the development process for the future dominance of the professional and institutional investors. Also, the regulation may mitigate shocks of inevitable fallouts and economic crises as was the case with China.

From this point of view, the standardized cross-border single market of crowdfunding is a necessary prerequisite for the secondary market of promissory notes, shares and other financial instruments that can indeed help with financing SMEs and improve access to financing.

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