Support for – and Proposed Improvements to – the European Commission Proposal for a Regulation on European Crowdfunding Service Providers (ECSP) for business

The European Crowdfunding Network (ECN) welcomes and strongly supports the initiative to implement a unified European wide regulatory framework for Crowdfunding Services Providers for Businesses. The proposed text would surely be welcome by many start-ups and SMEs, investors and platforms as a way to boost capital formation and investment opportunity across Europe. We find the proposal a relevant and detailed reflection of the problems the crowdfunding market is facing in Europe, as has been highlighted over the past five years by relevant research from independent organisations and ECN.

We find the proposal balanced and specific in its current form and have identified many aspects that we believe are well designed to ensure transparency, customer protection and platform operations. Some aspects of the current proposal could, however, adversely impact the development of alternative financing and therefore be contrary to the stated objectives. We therefore would like to offer a set of recommendations for modification or clarification that we believe would align the proposal with its stated goals even more.

Given that the ECN’s members comprise of both loan and investment (the latter representing both equity and debt) based platforms, we sought input from representatives of each type of platform. We also reached out to relevant platforms that are not members of our network and involved also those in developing our opinion.

We comment below on the key aspects, which we believe would benefit from modification and/or clarification.
Support for – and Proposed Improvements to – the European Commission Proposal for a Regulation on European Crowdfunding Service Providers (ECSP) for business

Key Proposals

Differences between investment and loans

The proposed regulation text takes a fundamental and structuring premise that “loan based crowdfunding ("loans") and investment based crowdfunding ("investment") are comparable business funding alternatives.”

Investment takes the form of equity or debt capital of start-ups with an expectation after a medium-long term (often 5-10 years duration) of a positive exit (potential capital gain, in the case of equity; or capital return and interest, in the case of debt), and risk of total or partial loss can be high. During the duration of the investment, the entire capital is invested and generally, no repayments are made.

Loans offerings are sometimes short-term bullet loans (3-12 months duration with capital repayable at the maturity of the loan) but in the majority of cases, they are amortising loans (equal repayment of capital and interest over the duration of the loan with maturity up to 5-7 years). In case of amortising loans, half of the initial investment has been paid back at mid-term duration, therefore reducing the risk exposure by 50%. In all cases, the interest rate of the loan is known at the time of investment.

Proposition: Ensure that the proposed regulation clearly recognises the differences between lending and investment-based crowdfunding and target project owners and proposes measures adapted to each.

€1 million threshold per 12 months

The limitation of the proposed regime to offerings of a maximum of €1 million per 12 months is highly problematic. The number of businesses currently using a loan or investment-based crowdfunding to raise in excess of €1 million per year is significant and growing quickly. Furthermore, the ability for platforms to facilitate these larger funding rounds is critical to the platforms’ achievement of critical mass and therefore their long-term sustainability. The threshold is also inconsistent with the very purpose of the proposed regulation.

We note that the opening sentence of the second preamble to the proposed regulation reads: “Obtaining finance is challenging for small and nascent firms, particularly when they move from a start-up into the expansion phase” (emphasis added). Given the Commission’s desire to contribute to the CMU’s objectives and promote funding not solely for seed-stage businesses but also for expansion-stage and mature ones.

Proposition: A threshold of €8 million (the maximum prospectus threshold a Member State can set under Article 3(2)(b) of Regulation 2017/1129(EU) should be agreed by all Member States and a subsequent exemption can be made within the Prospectus Regulation related to the ECSP. Already today the €8 million threshold has been adopted by some Member States for crowdfunding.

Payment Services

The regulation establishes in Article 9(2) and 9(3) that crowdfunding platforms who opt into this regime shall not hold clients’ funds or provide payment services unless authorised as a payment service provider as defined in Article 4(11) of Directive 2015/2366/EU.

The general approach taken by investment and loan-based crowdfunding platforms is to (1) collect funds from investors via bank transfer, debit card or similar payment mechanism, (2) have those funds held in a segregated account at a deposit-taking bank and (3) either distribute those funds to the project (if an investment is completed), send them back to the investor (if the investor requests) or else have the bank continue to hold them pending investment by the investor.

In each part of this process, both the payment services and the holding of client funds are being conducted by authorised payment/credit institutions.

Proposition: Clarify that payment flow facilitation of the type described above is not intended to be captured by the prohibitions in Article 9(2) and 9(3) and clearly recognise the possibility for platforms to be registered as a Payment Agents of Payment Service Providers (as defined in Article 4(11) and Article 19 of Directive 2015/2366/EU).

Marketing Rules

Article 19(2) of the proposed regulation establishes that marketing communications cannot “comprise marketing of individual planned or pending crowdfunding projects or offers.” The rationale for this measure, as set out in paragraph 37 of the Preamble, is to avoid platforms treating “any particular project more favourably by singling it out from other projects offered on the platform.” This is a sensible objective, but the proposed restriction is significantly broader than needed and will make it unduly difficult for many project owners to raise the capital or obtain the financing they are seeking. A more proportionate (and market-standard) approach would be to allow platforms’ marketing communications to reference a live or pending campaign in one of two situations:

- For example, sending out a newsletter listing each new campaign, or all campaigns that have reached certain funding milestones.
- For example, a project wants to purchase digital advertising, and the platform assists with the process because it can get a better rate for the project owner through bulk buying.

Both of the above situations represent very common ones in crowdfunding today, while neither of these situations create the risk of favouritism that Article 19(2) seeks to address.

Proposition: Modify Article 19(2) to allow for communication of individual campaigns so long as it is either (1) done on an objective basis or (2) merely a facilitation of a communication made by the project owner.

We understand that the Commission’s intention is for the restrictions set forth in Article 19 only to apply where the marketing communication is being provided to non-members of the platform. Platforms would therefore be free to communicate with their own members outside of the restrictions of Article 19. It would be helpful if this could be clarified in the text.

Proposition: Modify Article 3(1)(j) to establish that communications directed solely at platform members are not included in the definition.
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European Crowdfunding Network

The European Crowdfunding Network AISBL (ECN) is a professional network promoting adequate transparency, (self) regulation and governance while offering a combined voice in policy discussion and public opinion building. ECN was formally incorporated as an international not-for-profit organisation in Brussels, Belgium in 2013.

We execute initiatives aimed at innovating, representing, promoting and protecting the European crowdfunding industry as a key aspect of innovation within alternative finance and financial technology. We aim to increase the understanding of the key roles that crowdfunding can play in supporting entrepreneurship of all types and its role in funding the creation and protection jobs, the enrichment of European society, culture and economy, and the protection of our environment.

In that capacity we help developing professional standards, providing industry research, as well as, professional networking opportunities in order to facilitate interaction between our members and key industry participants. ECN maintains a dialogue with public institutions and stakeholders as well as the media at European, international and national levels.

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1. Common Propositions

Differences between investment and loans

The proposed regulation text takes a fundamental and structuring premise that "loan based crowdfunding ("loans") and investment based crowdfunding ("investment") are comparable business funding alternatives."

Investment takes the form of equity or debt capital of start-ups with an expectation after a medium-long term (often 5-10 years duration) of a positive exit (potential capital gain, in the case of equity; or capital return and interest, in the case of debt), and risk of total or partial loss can be high. During the duration of the investment, the entire capital is invested and generally, no repayments are made.

Loans offerings are sometimes short-term bullet loans (3-12 months duration with capital repayable at the maturity of the loan) but in the majority of cases, they are amortisable loans (equal repayment of capital and interest over the duration of the loan with maturity up to 5-7 years). In case of amortisable loans, half of the initial investment has been paid back at mid-term duration, therefore reducing the risk exposure by 50%. In all cases, the interest rate of the loan is known at the time of investment.

Also, very different types of enterprises are interested in the two instruments: whilst investment-based funding is primarily interesting for start-ups, typical borrowing companies are more mature (10-15 years of existence). The comparison of the characteristics, risk profiles and target segments of these two instruments clearly show profound differences which makes the option of regulating them in an equivalent manner, challenging. The proposed regulation further offers the possibility for platforms to either operate within the stated limits or to seek authorisation under Directive 2014/65/EU (MiFID II).

Whilst this could be an option considered by investment-based crowdfunding platforms (which deal in transferable securities), it is clearly not an option for loan-based crowdfunding platforms whose businesses do not fall under MiFID II scope. Also, considering how MiFID has been applied in a very inconsistent manner across Member States, opting for this option will mean losing a unified approach.

Proposition: Ensure that the proposed regulation clearly recognises the differences between lending and investment-based crowdfunding and target project owners and proposes measures adapted to each.

€1 million threshold per 12 months

The limitation of the proposed regime to offerings of a maximum of €1 million per 12 months is highly problematic. The number of businesses currently using a loan or investment-based crowdfunding to raise in excess of €1 million per year is significant and growing quickly. Furthermore, the ability for platforms to facilitate these larger funding rounds is critical to the platforms’ achievement of critical mass and therefore their long-term sustainability. Put simply, with a €1 million threshold, the platforms who opt into the regime are unlikely to reach the scale needed to survive for long, while those platforms who are focused on achieving critical mass will choose to stay out of this regime—and so largely eschew crossborder crowdfunding—to continue facilitating larger deals domestically.

Beyond these market and economic realities, the threshold is also inconsistent with the very purpose of the proposed regulation. We note that the opening sentence of the second preamble to the proposed regulation reads: "Obtaining finance is challenging for small and nascent firms, particularly when they move from a start-up into the expansion phase" (emphasis added).

Given the Commission’s desire to contribute to the CMU’s objectives and promote funding not solely for seed-stage businesses but also for expansion-stage and mature ones—who, in the majority of cases, require more than €1 million in funding per year—the €1 million cap would be highly counterproductive toward the expressed goals of the European Commission.

And with respect to loans in particular, as stated above a loan is different to a transferable security, which is recognised by the Member State regulators in not regulating lending activities under Directive 2014/65/EU (MiFID II). Furthermore, as the underwriting of a loan is based on an analysis of the company’s cash flow and therefore its capacity to reimburse the debt over time, there is a direct correlation between the size of the loan, that of the enterprise requesting it and its financial strength. Larger loans are therefore less risky than smaller ones granted to smaller and often more fragile SMEs. A retail investor is taking (within the same risk grade) less risk in investing in a €3 million loan than a €30,000 one.

Additionally, the capacity to finance large volume of loans is attracting institutional investors and state-owned organisations which are prepared to deploy their investment capacity if they are assured that investment will be deployed over a reasonable amount of time, through a mix of small and large loans.

Proposition: A threshold of €8 million (the maximum prospectus threshold a Member State can set under Article 3(2)(b) of Regulation 2017/1129/EU) should be agreed by all Member States and a subsequent exemption can be made within the Prospectus Regulation related to the ECSP. Already today the €8 million threshold has been adopted by some Member States for crowdfunding.

Payment Services

The regulation establishes in Article 9(2) and 9(3) that crowdfunding platforms who opt into this regime shall not hold clients’ funds or provide payment services unless authorised as a payment service provider as defined in Article 4(11) of Directive 2015/2366/EU. We believe this provision reasonable, but it might be helpful if there could be some clarification as to how this would apply to the activities commonly conducted by crowdfunding platforms today.

While every platform is slightly different, the general approach taken by investment and loan-based crowdfunding platforms is to (1) collect funds from investors via bank transfer, debit card or similar payment mechanism, (2) have those funds held in a segregated account at a deposit-taking bank and (3) either distribute those funds to the project (if an investment is completed), send them back to the investor (if the investor requests) or else have the bank continue to hold them pending investment by the investor. In each part of this
process, both the payment services and the holding of client funds are being conducted by authorised payment/credit institutions. However, there is the risk of interpreting the platform’s role in facilitating this flow of funds in a way that it is deemed to be either providing payment services, holding client funds or both. Our understanding is that this is not the intention behind the proposed regulation, and that the Commission anticipates platforms being able to participate in the funds flows as described above without becoming authorised as a payment service provider. It would, therefore, be helpful if the regulation could make relevant clarifications.

Furthermore, the proposed text does not clearly state that platforms can also be registered Payment Agents (in the sense of Article 4(11) and Article 19 of Directive 2015/2366/EU) of payment service providers as this status offers a recognised regulatory status and added layer of control in which to operate and be supervised. Proposition: Clarify that payment flow facilitation of the type described above is not intended to be captured by the prohibitions in Article 9(2) and 9(3) and clearly recognise the possibility for platforms to be registered as a Payment Agents of Payment Service Providers (as defined in Article 4(11) and Article 19 of Directive 2015/2366/EU).

Conflicts of Interest and Inducements

We fully support rules preventing conflicts of interest, but we have identified three potential improvements with respect to the measures set out in Article 7 of the proposed regulation.

First, the prohibition on platforms having a financial participation in a crowdfunding offer (Article 7(1)) does not seem problematic to the extent that it only prohibits the platform from investing its own money in the offering. However, some investment-based platforms charge a “carry” fee to investors based on the performance of their investments; it is charged only when, and if, an investment delivers in excess of the capital initially invested. This is an indirect participation in the investment, and it is essential to ensure that (1) as administrator of the investment post-completion, the platform’s interests are aligned with that of the investors and (2) investors do not need to pay any out-of-pocket fees for the administration services. Our understanding is that it is not the Commission’s intention to prohibit carry or similar fees tied to the performance of an investment, but it would be helpful if clarification could be provided that Article 7(1) does not apply to such fees.

Proposition: Clarify Article 7(1) to establish that carry or other performance-based fees charged by the platform do not constitute financial participation in a crowdfunding offer.

Second, the prohibition on managers, employees and major shareholders investing in crowdfunding offerings (Article 7(2)) seems unnecessary, as this can also create alignment of interest. The capacity for a platform to attract investors (both private and institutional) is largely based on the trust it creates over time. The main element at the foundation of that trust is transparency. Releasing all known information at the time of financing of the project, communicating in a timely manner with investors on any question they might have during and after the financing period, and in case of repayment defaults. Demonstrating that management puts their own money (“skin in the game”) “where their mouth is”, greatly reinforces the transparency and therefore the trust with investors, as all parties have an alignment of interest. So long as managers and employees are investing on exactly the same terms (pari passu) as other investors, and receive no preferential treatment in the investment, there simply is not a risk of a conflict, and doing so has allowed employees and managers to better understand and improve the investor experience.

Third, also with respect to Article 7(2), it is important to recognise that institutional investor shareholders of platforms are also often shareholders in thousands of SMEs, e.g. insurance companies, which would make the prohibition on investments by major shareholders exceedingly difficult to control.

Proposition: Reconsider the prohibition in Article 7(2) with a view to allowing investments irrespective of their origin, so long as they are made on the same terms (pari passu) and based on the same information.

In addition, we think it would be helpful to clarify the application on the rule on inducements (Article 4(3)), which prohibits the payment or receipt of fees for introducing investors to particular offers on a platform. We appreciate this alignment with existing regulations on inducements, for example under Directive 2014/65/EU, but we would suggest clarifying that such fees may be paid for the introduction of investors to a platform generally. As a nascent industry, crowdfunding platforms can benefit from referrals from other firms, which will increase awareness and visibility of the services provided. Such referral arrangements may require a commercial element and, provided any fees are paid fairly, and payment does not conflict with the interests of investors, we do not see such arrangements being problematic.

Proposition: Amend Article 4(3) should be amended to allow for fees for the introduction of investors/project owners to a platform being paid.

Marketing Rules

Article 19(2) of the proposed regulation establishes that marketing communications cannot “comprise marketing of individual planned or pending crowdfunding projects or offers.” The rationale for this measure, as set out in paragraph 37 of the Preamble, is to avoid platforms treating “any particular project more favourably by singling it out from other projects offered on the platform.” This is a sensible objective, but the proposed restriction is significantly broader than needed and will make it unduly difficult for many project owners to raise the capital or obtain the financing they are seeking. A more proportionate (and market-standard) approach would be to allow platforms’ marketing communications to reference a live or pending campaign in one of two situations:

- The communication on all campaigns, or on selected campaigns based purely on objective factors. For example, sending out a newsletter listing each new campaigns, or all campaigns that have reached certain funding milestones. This
allows platforms to highlight to investors campaigns that might be new or newly interesting to them, but it does not allow platforms to favour a particular campaign at their own discretion.

- The marketing communication is made by the project owner but facilitated or distributed by the platform. This would apply to cases where, for example, a project wants to purchase digital advertising, and the platform assists with the process because it can get a better rate for the project owner through bulk buying.

Both of the above situations represent very common ones in crowdfunding today, and they are important ways of communicating about campaigns. At the same time, neither of these situations create the risk of favouritism that Article 19(2) seeks to address.

Proposition: Modify Article 19(2) to allow for communication of individual campaigns so long as it is either (1) done on an objective basis or (2) merely a facilitation of a communication made by the project owner.

In addition to the above, we understand that the Commission’s intention is for the restrictions set forth in Article 19 only to apply where the marketing communication is being provided to non-members of the platform. Platforms would therefore be free to communicate with their own members outside of the restrictions of Article 19. It would be helpful if this could be clarified in the text.

Proposition: Modify Article 3(1)(j) to establish that communications directed solely at platform members are not included in the definition.

2. Loan specific propositions

Key Investment Information Sheet to be prepared by the Entrepreneur

A “Key Investment information sheet” ("KIIS") is indeed an important requirement to ensure transparency of information given to all potential investors. It should be sufficiently detailed and harmonised to enable the comparison of projects to promote sound investment decisions. In practice, platforms are supporting Borrowers in providing project specific information and we believe they will be able to ensure that the administrative burden on the Borrower remains limited.

As part of the information requested to be included in the “KIIS” in ANNEX I, Part A(C) is a hyperlink to the most recent financial statement of the project owner, if available. This proposal raises two issues:

- It is not compulsory in many Member States for SMEs to publish their accounts, so this document is therefore not considered as public data.
- Even where it is, the data may not easily be available to the public or many entrepreneurs prefer to pay a fine for non-publication rather than render public information they see as confidential. In these cases, entrepreneurs would, likely, strongly object to the publication of financial statements on a platform.

As an alternative, we suggest that key financial figures and ratios which have been used as the base for the platform to perform its analysis be permitted in lieu of full accounts, as is the market practice. This information should be uniform for all offers on a given platform, thereby facilitating the comparison of one offer with another for investors. Where financial statements are in the public domain and accessible to investors, they subsequently can be accessed by interested parties already.

Proposition: The “Key Investment Information Sheet” should be allowed to include key financial figures and ratios in lieu of a hyperlink to financial statements.

3. Investment specific propositions

SPVs and Discretion

It is very encouraging that the proposed regulation provides for certain exercises of discretion (Article 4(5)) and the use of SPVs (Article 4(6)). It is essential for investment-based crowdfunding to be able to exercise certain types of discretion on behalf of investors – and to use an SPV or similar structure to do so – for several reasons:

- This allows the platform to negotiate and enter into investment agreements and related documentation with the project owner for the benefit of investors. Such agreements ensure that investors receive the same types of investor protections as non-crowdfunding investors would. In the absence of the ability to exercise discretion or use an SPV, it would be very difficult for crowdfunding investors to join this documentation and so obtain those protections.
- This makes it significantly easier for the project owner to raise further capital and, ultimately, exit. When a company has a large number of direct investors (which would be the case for a crowdfunded company in the absence of an SPV), it can be very difficult, and at times impossible, to complete major corporate transactions like further financings or sale. Likewise, unless the platform is able to exercise discretion on behalf of the investors in order to sign documents and take certain other decisions in connection with a financing or sale, such transactions may not be able to proceed.
- This makes the administration of the investment significantly easier for both the investors and the project owner.

That said, there are several points in the proposed regulation that relate to this concept but that may require clarification.

First, the proposed definition of “crowdfunding services” in Article 3(1)(a)(ii) only addresses the MiFID activities of (1) receiving and transmitting orders (point 1, Section A, Annex I of Directive 2014/65/EU) and (2) placing financial instruments without a firm commitment basis (point 7, Section A, Annex I of Directive 2014/65/EU). Given the role of the platform (often via the SPV) in executing and administering investments, we think it would be helpful if this definition could be expanded at least to include the further primary activity of executing orders on behalf of clients (point 2, Section A, Annex I of Directive 2014/65/EU). It is also worth considering whether the definition should include the ancillary activity of safekeeping and administration of financial instruments.
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(point 1, Section B, Annex I of Directive 2014/65/EU). We are conscious that the Commission is keen to avoid regulatory arbitrage by other types of financial services firms, but there would be negligible risks of such arbitrage arising simply from the addition of these activities.

**Proposition:** Expand Article 3(1)(a)(ii) to include the activities of executing orders on behalf of clients and safekeeping and administration of financial instruments.

Second, in the discretion provision in Article 4(5), we think it would be helpful if it could be made explicit that the word “parameters” is intended to the ordinary activities of a platform or SPV in this context, i.e., conducting due diligence on the business (and choosing not to complete an investment if unsatisfied with the results), negotiating the legal terms of the investment documentation and taking various post-investment actions on behalf of investors. In addition, it should be clarified that such exercise of discretion would not amount to the SPV being deemed to be an AIFM under Directive 2011/61/EU.

**Proposition:** Clarify Article 4(5) to establish that discretion that may be exercised with respect to due diligence, investment documentation, post-investment activity and similar types of decisions.

**Secondary Trading**

It is encouraging that the proposed regulation provides for bulletin boards for secondary trading (Article 17), but we do have concerns about the requirement that any suggested reference price for a trade be non-binding (Article 17(2)). Small companies are often keen to ensure that their valuation does not swing wildly, and if a highly motivated seller chose to sell investments for significantly less than they were worth—or indeed a surge of buyers led the price to go significantly above what the company thinks it should be—that can cause significant problems for the company in future fundraising rounds.

There is, therefore, some value to be had in facilitating trades only at a fixed price, and while a fixed price should by no means be mandatory, prohibiting it does not seem sensible either. It is worth noting that our understanding is that the use of a fixed price would not render such a bulletin board a “multilateral system” for purposes of Directive 2014/65/EU (so long as each transaction is an individual one between buyer and seller, rather than a matched bargain system or similar arrangement).

**Proposition:** Amend Article 17(2) to remove the requirement that a reference price be non-binding.

4. **Conclusion**

We would again emphasise our strong support for this proposed regulation. We are convinced that it will create the opportunity to make Europe the best market in the world for crowdfunding, and the positive impact on businesses, investors and the economies of Member States and the EU as a whole will be substantial. We believe that the European Commission has provided with this a strong basis for an informed discussion by Member States and the European Parliament, which we hope will be able to turn this proposal into a positive impact for the European Capital Market Union.

However, we believe that the above recommendations are essential to making the regulation work as intended. We very much hope that they will be reflected in the forthcoming discussions within the European Council and the European Parliament. We believe that adapting the proposal as proposed above will make the difference between the success and failure of this initiative – and as such have a significant impact on access to finance for Small- and Medium-sized Enterprises in all EU Member States.