

Systematic and conceptual framework for crowdfunding regulation

FERNANDO ZUNZUNEGUI,

UNIVERSIDAD CARLOS III

ABSTRACT

Crowdfunding is a financial service that connects investors with business developers seeking financing through a platform. There are two forms: investment crowdfunding in the strict sense, whether equity or debt crowdfunding, and credit crowdfunding, which includes loans as the most usual model. In this paper we deal with the systematic and conceptual framework for crowdfunding regulation. We do so from a functional perspective. The form in which raising financing is implemented, whether through securities or loans, does not alter its function. Regulation of crowdfunding is guided by the same principles as the rest of financial services. Applying outmoded solutions for a market not based on current technology would be a mistake. The diversity of local frameworks is giving way to a degree of confluence from which certain considerations can be extracted. Reforms are guiding the legal framework towards the same type of solutions.

Keywords: *Crowdfunding, Fintech, MiFID, platform economy, ESMA*

TABLE OF CONTENTS: 1. Introduction. 2. Crowdfunding and the collaborative economy. 3. Nature. 4. Principles. 5. Regulation models. 6. Legislative policy proposals. 7. BIBLIOGRAPHY.

1. Introduction

The measures to facilitate company financing, in particular for start-ups, notably include crowdfunding¹. It is an alternative to traditional bank financing². It has advantages and disadvantages. A plurality of financing sources contributes to competition and encourages stability³. Control of market power and assessment of solvency in order to responsibly grant credit are requirements that must be applied to both lending institutions and crowdfunding providers. The return of bank financing after overcoming the worst moments of the financial crisis need not have negative connotations.

Crowdfunding is a financial service that connects investors with business developers seeking financing through a platform. There are two forms: investment crowdfunding in the strict sense, whether equity or debt crowdfunding, and credit crowdfunding, which includes loans as the most usual model⁴. Donation and reward crowdfunding platforms are outside the scope of our interest. They are not financial services.

In this chapter we deal with the systematic and conceptual framework for crowdfunding regulation. We do so from a functional perspective, beginning with reference to the Proposal for a Regulation on European Crowdfunding Service Providers (ECSP), approved by the European Parliament on 27 March 2019 (referred to below as "the Proposal for a Regulation")⁵. This Proposal for a Regulation sets out a path through the territory that is being explored⁶.

¹ Doctrine highlights the "funding gap" for "start-up firms", which has been exacerbated by restricted bank lending as a consequence of the financial crisis. See J. Armour and L. Enriques. "The promise and perils of crowdfunding: Between corporate finance and consumer contracts", *The Modern Law Review*, no. 81.1, 2018, pages 51 and 52.

² See, from another perspective, M. Cuenca. "Fintech y crédito responsable: Big data y *credit scoring*" [Fintech and responsible lending: big data and credit scoring] in Zunzunegui, F. (editor), *Regulación financiera y Fintech* [Financial regulation and Fintech], 2019 (in press), which states that the "dependence of the business and consumer sectors on the banking market has brought about terrible consequences". It is true that irresponsible lending gave rise to the financial crisis. As stated in the preamble of Directive 2014/17/EU of 4 February 2014 on credit agreements for consumers relating to residential immovable property: "The financial crisis has shown that irresponsible behaviour by market participants can undermine the foundations of the financial system".

³ This is a new path for channelling lending that does not replace and does not mirror bank lending (see D. Salvador Sáez. "El "crowdfunding" mediante préstamos con interés e inversión de capital" [Crowdfunding through interest-bearing loans and capital investment] in Marimón Durá, R. (editor), *Shadow Banking y financiación empresarial alternativa* [Shadow Banking and alternative business financing], 2017, pages 108 and 160).

⁴ As stated in the preamble of the Act 5/2015 of 27 April, on Promoting Business Financing "the intention here is only to regulate legal structures that give priority to the financial component of the activity or, to put it another way, in which the investor expects to receive monetary remuneration for its participation, thus leaving outside the scope of this regulation crowdfunding implemented through purchases or donations."

⁵ European Parliament legislative resolution of 27 March 2019 on the proposal for a regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP).

⁶ The Proposal for a Regulation implies a change in attitude by the European Commission which, after studying the phenomenon, recommended not taking action due to there being no reason to intervene at EU level (Communication "Unleashing the potential of Crowdfunding in the European Union" [COM(2014) 172 final] of 27 March 2014 and working document SWD(2016) 154 final). "An error in perception", according to Carmen Estevan de Quesada [*El Crowdfunding de inversión (Crowdinvesting)*, 2018, page 143], since the lack of a harmonised regulatory framework with a proliferation of local regulations creates legal uncertainty

2. Crowdfunding and the collaborative economy

Crowdfunding is part of the collaborative economy⁷. Internet use reduces the cost of communication and facilitates location-independent access to services. It shares the main characteristics of the collaborative economy⁸. It operates with market platforms in triangular relationships. It is part of the digital service platform economy⁹; these platforms have been described as society's new infrastructure¹⁰.

The financial nature of the activity gives them autonomy. Being a financial service justifies their exclusion from the general regulations for the collaborative economy¹¹. Regulation of them has a different scope and different objectives. Its purpose is the combined provision of different financial services in order to ensure the correct operation of the financial market and protect investors¹². However, there are shared elements regulated by the general regulations for the collaborative economy, which could apply to crowdfunding¹³.

and is a “powerful disincentive for platforms.” This author considered the Proposal for a Regulation (page 144) to be good news.

⁷ Matilde Cuena calls it a “manifestation of the collaborative economy in the financial sector” [in “Fintech y crédito responsable: Big data y *credit scoring*” [Fintech and responsible lending: big data and credit scoring] in Zunzunegui, F. (editor), *Regulación financiera y Fintech* [Financial regulation and Fintech], 2019 (in press)].

⁸ According to Teresa Rodríguez de las Heras, the structural and operational considerations of electronic platforms that operate in a closed digital environment “apply entirely to CP [crowdfunding platforms] as a starting point, since they are installed on the same architecture” [“La responsabilidad de las plataformas: Alcance, límites y estrategias” [Platforms' responsibility: scope, limits and strategies] in Moreno, E. and Cazorla, L. (Coordinators), *Crowdfunding: aspectos legales* [Crowdfunding: legal aspects] 2016].

⁹ See C. Busch, H. Schulte-Nölke, A. Wiewiórowska-Domagalska and F. Zoll. “The rise of the platform economy: a new challenge for EU Consumer Law?”, *Journal of European Consumer and Market Law*, 5(1), 2016, pages 3-10, who propose a European platforms directive that clarifies the role of platforms and defines the duties and responsibilities, which is necessary “to adjust EU contract law to the changing markets structure” (page 9).

¹⁰ N. Srnicek. *Platform capitalism*, 2017, page 92, with a tendency towards monopoly.

¹¹ In that sense, the Proposal for a Regulation on promoting fairness and transparency for business users of online intermediation services does not affect the application of pertinent rules concerning EU law applicable to financial services [see paragraph 32 of the preamble to the aforementioned Proposal, COM(2018) 238 final, 2018/0112 (COD), Brussels, 26 April 2018].

¹² Francisco Uría Fernández states that reasons for regulating crowdfunding are “a reasonable level of legal certainty” and a “sufficient level of protection” of clients (“El *crowdlending*” in Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [Crowdfunding platforms] 2018, page 99).

¹³ Teresa Rodríguez de las Heras sees the rapid expansion of crowdfunding as being explained by the convergence of an economic factor, a social factor and a technological factor but “it is the technological lever that has made it possible for these propositions to materialise” [“La responsabilidad de las plataformas: Alcance, límites y estrategias” [Platforms' responsibility: scope, limits and strategies] in Moreno, E. and Cazorla, L. (coordinators), *Crowdfunding: aspectos legales* [Crowdfunding: legal aspects] 2016]. See E. Macchiavello. *Feedback on the European Commission “Proposal for a Regulation on European Crowdfunding Service Providers (ECSP) for business”*, paragraph 8, 12 May 2018; highlighting certain aspects of crowdfunding regulation that could be enriched with the general regulations for online platforms, among which are mentioned: “disclose the functioning of the ranking/scoring mechanism used and of the algorithm deployed for matching the orders and the terms and conditions to which the borrower will adhere, but also reference to the use of user data”. Available at: https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-5288649/feedback/F11570_en?p_id=181605

3. Nature

Crowdfunding is a new financial service based on technology¹⁴. The platform is its main tool¹⁵. It is a new way of channelling savings into productive investment¹⁶. It arises from combined provision of primary market services and other financial services, such as reception and transmission of orders¹⁷. This combination gives rise to a new hybrid service that until now has lacked adequate regulation. They are not information society service providers¹⁸. They are information intermediaries, gatekeepers¹⁹. They scrutinise investment opportunities, select projects and design contracts. They are intermediaries that provide market services. For that reason, it is not very appropriate to classify crowdfunding as a mechanism for financial disintermediation²⁰. They are not mere contact points²¹. They can no longer be classified as "peer-to-peer platforms". Some of the business models were marketed in this way at the beginning. However, what is of interest from a financial perspective is a crowdfunding service that is richer and more sophisticated than a meeting point.

¹⁴Preamble of the Proposal for a Regulation on European Crowdfunding Service Providers (ECSP) for Business, 8 March 2018, page 1.

¹⁵ According to Vicente Cuñat, a platform "is more than a mere instrumental intermediary because it is incorporated in the very structure of the transaction as a beneficiary of the new forms of contracting" ["Primer Prólogo" [First Prologue] in Estevan de Quesada, C., *El Crowdfunding de inversión (Crowdinvesting)*, 2018, page 15].

¹⁶ It is closer to direct channelling through the stock market than indirect channelling with the banks acting as middlemen. Regarding these concepts, see the first chapter of the author's manual, *Derecho del mercado financiero* [Financial market law], third edition, 2005.

¹⁷ According to Kevin Thomas Davis and Jacob Murphy "platforms combine the functions of a market (exchange) operator and a provider of financial services" ("Peer to Peer lending: structures, risks and regulation", *JASSA: The Finsia Journal of Applied Finance*, 2016, pages 37 and 38).

¹⁸ However, depending on the business model, they may fall within the scope of Directive 2000/31/EC of the European Parliament and of the Council on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market. This is stated in the Communication "Unleashing the Potential of Collective Microfinance in the European Union" [COM(2014) 172 final] of 27 March 2014, page 7. Conversely, Sandra Camacho Clavijo considers that the crowdfunding service provider "is a provider of information society services" ("La naturaleza jurídica de la financiación participativa en las modalidades de crowdfunding" [The legal nature of participatory financing in the forms of crowdfunding] in Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [Crowdfunding platforms], 2018, page 37), "the material basis for specifying the applicable material law" (page 38).

¹⁹ "Trusted third parties" in the terminology used by Teresa Rodríguez de las Heras ["La responsabilidad de las plataformas: Alcance, límites y estrategias" [Platforms' responsibility: scope, limits and strategies] in Moreno, E. and Cazorla, L. (coordinators), *Crowdfunding: aspectos legales* [Crowdfunding: legal aspects] 2016] by taking on the roles of access control, project selection and supervision of compliance with internal regulations.

²⁰ In this sense, Teresa Rodríguez de las Heras maintains the "hypothesis of re-intermediation", according to which platforms operate as "trust generating intermediaries" ["La responsabilidad de las plataformas: Alcance, límites y estrategias" [Platforms' responsibility: scope, limits and strategies] in Moreno, E. and Cazorla, L. (Coordinators), *Crowdfunding: aspectos legales* [Crowdfunding: legal aspects] 2016].

²¹ Although there are regulations that present it as disintermediation of the banking business. In this sense, the preamble of the Act 5/2015 of 27 April, on Promoting Business Financing considers that crowdfunding platforms "constitute a novel mechanism for financial disintermediation".

Their development is linked to their good reputation²². They bring about inclusion and financial efficiency²³. In principle, crowdfunding is open to all projects that seek financing, but for reasons of efficiency and to build their own reputation, platforms select projects that have a greater likelihood of producing profits with a particular risk. Platforms are allowed to decide which projects will be included. Efficiency takes priority over inclusiveness. Platforms thus act as gatekeepers.

From a functional perspective, it is a financing mechanism through platforms that operate online. The form in which raising financing is implemented, whether through securities or loans, does not alter its function²⁴. We therefore consider the Proposal for a Regulation to be right in regulating crowdfunding in a unitary manner²⁵. It is a service within the framework of the stock market, which is naturally complemented by payment services. Within this framework, the regulation closest to its nature is MiFID²⁶. It is not a matter of putting new wine in old wineskins. It is simply a matter of being practical and using clear and comprehensible language in order to make progress with regulating crowdfunding.

For reasons of clarity and legal certainty, the MiFID definition should be used insofar as possible. The Proposal for a Regulation does this to a large extent.

The Proposal envisages a direct crowdfunding service and an intermediation service, whether placing of financial instruments without a firm commitment basis, advice or reception and transmission of orders for transferable securities, or loans issued by the promoters²⁷. In this definition, the terms "transferable securities",

²² See J. Armour and L. Enriques. "Individual Investors' Access to Crowdfunding: Two Regulatory Models", *The Economics of Crowdfunding*, 2018, according to whom "like reputational intermediaries generally, in the long run platforms stand to gain more from establishing a record of good-quality offerings on their portals" (page 263).

²³ See A. A. Schwartz. "The Gatekeepers of Crowdfunding", *Wash. & Lee L. Rev.*, no. 75, 2018, pages 885-955.

²⁴ Financing through loans is a better fit for established companies with proven solvency. Financing through shares is more appropriate for start-ups. However, from the functional perspective of the platform's services, this division is diluted and hybrid models arise, such as participation loans. See J. Armour and L. Enriques. "The promise and perils of crowdfunding: Between corporate finance and consumer contracts", *The Modern Law Review*, no. 81.1, 2018, pages 56 and 57.

²⁵ This was the option chosen by Act 5/2015 of 27 April, on Promoting Business Financing which we commented on in "Régimen jurídico de las plataformas de financiación participativa (crowdfunding)" [Legal framework for crowdfunding platforms], *RDMF Working Paper 3/2015*, June 2015, "the correct option since the economic role performed by lending platforms and securities platforms is the same and the needs for customer protection are similar" (page 9). Available at http://www.rdmf.es/wp-content/uploads/2015/07/zunzunegui-wp-3_2015-regimen-juridico-de-las-plataformas-de-financiacion-participativa.pdf. This unitary option is criticised by J. Pulgar Ezquerro. "Ley de fomento de la financiación empresarial y «crowdfunding»: aspectos críticos" [The Act to Promote Business Financing and crowdfunding: critical aspects] in Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [Crowdfunding platforms] 2018, pages 274-276, according to whom this unitary option under the control of the stock market authority "which seeks to transfer elements and rules for the stock market" is questionable "due to treating financing platforms as listed companies" (page 275). We do not share this view since the treatment is more similar to that of market infrastructures than listed companies and, furthermore, it is justified.

²⁶ By MiFID we refer to the system established by Directive 2004/39/EC (MiFID I), revised by Directive 2014/65/EU (MiFID II).

²⁷ Art. 4a Proposal for a Regulation.

"placing of financial instruments on a firm commitment basis" and "reception and transmission of orders" are from MiFID.

Information from crowdfunding providers, included in advertising, must be "impartial, clear and not misleading"²⁸, just as in MiFID²⁹. It would have been desirable to follow this technique when determining the conduct principles.

With this approach, it is the stock market authorities who should naturally receive new powers over crowdfunding³⁰. These are the authorities most focused on transparency and investor protection. The banking authorities focus more on protecting solvency. In the Proposal for a Regulation, it is ESMA³¹ that has powers to regulate and supervise crowdfunding.

MiFID distinguishes between activities and services. Based on this conceptualisation, the framework for crowdfunding is that the service and the person providing it is regulated. The person is regulated as a crowdfunding service provider.

"Crowdfunding service providers" (referred to below as the "providers") are not mere intermediaries. In triangular relationships, they provide market services to their clients, whether promoters or investors. It is an activity that goes beyond that of an intermediary. Providers perform professional assignments on a trustee basis that must be framed within the scope of a mandate. The evolution of platforms has left behind the direct (peer-to-peer) relationships with which they sought to cut out the banks as middlemen³², a grammatical utopia that was attractive for gaining clients. As the business matured, it moved from disruption to collaboration. Platforms are now integrated in the financial systems and are one of the most far-reaching parts of it.

In principle, platforms do not take their own position in the projects whose financing they manage. They are not a counterparty for their clients. Nor are they investors in relation to promoters, or promoters in relation to investors. There are exceptions to this rule. The Proposal for a Regulation allows a platform to take part in financing a project in a percentage not exceeding two per cent³³. We think

²⁸ Art. 14.1 Proposal for a Regulation of 27 March 2019. This modifies the Commission's proposal, which referred to information having to be "clear, comprehensible, complete and correct". Omitting that the information should be "not misleading" was criticised by Better Finance as inconsistent with MiFID and not acceptable from the perspective of protecting investors. See Better Finance, *Feedback on a Regulation on European Crowdfunding Service Providers for business*, 8 May 2018, page 3.

²⁹ Art. 24.3 MiFID II.

³⁰ Concerning the opportunity to put crowdfunding under the control of stock market authorities, see R. Palá Laguna. "Aspectos administrativos de la Ley 5/2015, de fomento de la financiación empresarial: autorización, supervisión e inspección por la CNMV de las plataformas de crowdfunding" [Administrative aspects of Act 5/2015 on Promoting Business Financing: authorisation, supervision and inspection of crowdfunding platforms by the Spanish Securities and Exchange Commission] in Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [Crowdfunding platforms] 2018, pages 173 and 174.

³¹ European Securities and Markets Authority.

³² A mediation or brokerage contract could be applicable to this.

³³ Art. 7a.2 Proposal for a Regulation.

that this is a sufficient share to align interests, without being a significant share that compromises the platform's independence.

A natural complement of crowdfunding is offering liquidity to investors that are clients of the platform. With this option —offering secondary trading services— providers compete with trading systems. The Proposal for a Regulation limits this development. It only allows providers to offer a "notice board" of reference prices for the buying and selling of loans or transferable securities financed by the platform³⁴. In addition, the provider must warn that it does not manage a trading system thereby protecting stock exchanges and other trading systems from the emergence of platforms.

We see this as regulation in stages. Firstly, competition is opened up and the crowdfunding service is regulated as a primary market activity with the possibility of combining different investment services. This leads to a second stage in which the mechanism has matured: regulation of secondary market services, offering investors liquidity³⁵. The crowdfunding system is currently incomplete, since without provision of liquidity, the crowdfunding market cannot develop³⁶. At the moment, investors who hold initial positions, who may be professional investors or linked to the promoters, show the way for retail investors³⁷. There is a herd effect not offset by price information in the secondary market.

It is true that automation of crowdfunding with algorithms that make it possible to diversify investments with a secondary market, may make crowdfunding an alternative to banking³⁸. But it is not shadow banking³⁹. The service they provide does not contribute to transforming terms. It does not create the systemic risk that banking activity has⁴⁰. Bankruptcy of a platform does not cause a bank run. In any case, winding up crowdfunding platforms in difficulties is aided by the link

³⁴ See art. 17 Proposal for a Regulation.

³⁵ Regarding divestment mechanisms, see E. Moreno Serrano. "Cuestiones jurídicas derivadas de la aplicación del «crowdfunding»" [Legal questions arising from the application of crowdfunding], Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [crowdfunding platforms], 2018, pages 260-266. They consider it to be "especialmente interesante" that there is a market in which units acquired through crowdfunding can be sold (page 262).

³⁶ There is no reason to assume that crowdfunding presupposes that there is no secondary trading market. For a contrary view see, A. Paredes Pérez. "Aproximaciones al crowdfunding" [Approaches to crowdfunding] in Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [Crowdfunding platforms], 2018, page 22.

³⁷ See J. Armour and L. Enriques. "Individual Investors' Access to Crowdinvesting: Two Regulatory Models", *The Economics of Crowdfunding*, 2018, page 262.

³⁸ See O. Havrylychuk. "Regulatory framework for the loan-based crowdfunding platforms", *OECD Economics Department Working Papers*, no. 1513, 2018, who considers that crowdfunding platforms may be more stable than bank intermediation (page 37).

³⁹ Although, originally, it may have been a form of bottom-up parallel banking. See, by the author, "Shadow Banking, Crowdfunding y seguridad jurídica" [Shadow banking, crowdfunding and legal certainty], *Papeles de Economía Española* [Spanish economic papers] no. 146, 2015, pages 145-159, which draws the conclusion that "international financial regulation bodies must push forward the principles of crowdfunding regulation in order to avoid regulatory arbitrage and have companies choose to provide services from places with the most lax regulations" (page 156).

⁴⁰ As Matilde Cuenca says, the platform "does not create assets or undertake risks in financing transactions" [in "Fintech y crédito responsable: Big data y *credit scoring*" [Fintech and responsible lending: big data and credit scoring] in Zunzunegui, F. (director), *Regulación financiera y Fintech* [Financial regulation and Fintech], 2019 (in press)].

between investors and promoters. With this aim in mind, the Proposal for a Regulation requires providers to keep records of the transactions and continuity measures to enable reimbursements in the event of a provider becoming insolvent⁴¹.

However, there may be cases of platforms that securitise their loans and that may become part of shadow banking⁴². In practice, banking uses the platforms' intermediation to provide credit without the risk control required by sectoral regulations. In these cases, platforms may be acting as shadow banks. If that is the case, the prudential rules for the banking sector should apply to them⁴³.

4. Principles

Regulation of crowdfunding is guided by the same principles as the rest of financial services. It must ensure the smooth operation of the market with efficiency, stability and integrity, ensuring adequate investor protection.

Fintech does not change these principles. The means does not affect the function⁴⁴. Technology gives rise to new services but the function remains, i.e. financing projects from the public's savings⁴⁵.

However, in Fintech regulation and crowdfunding in particular, efficiency and competitiveness have been given priority over investor protection or the system's stability and integrity. Hence the leading role of innovation hubs and sandboxes. This focus has been justified by novelty, the advantages for users of access to new technologies and the need for the authorities to learn within an initial environment in which Fintech is developing strongly but has not reached systemic importance. A wait-and-see focus has been imposed up until now⁴⁶. This is based

⁴¹ See paragraph 36 of the preamble and art. 10.2.g of the Regulation.

⁴² See O. Havrylychuk. "Regulatory framework for the loan-based crowdfunding platforms", *OECD Economics Department Working Papers*, no. 1513, 2018, who cites cases in the United States in which "platforms securitise their loans and sell ABS to leveraged and 'too-big-to-fail' institutional investors that are prone to runs and moral hazard problems. In these cases, lending-based crowdfunding platforms risk to become an element in the chain of the shadow banking" (pages 37 and 38).

⁴³ See M. Cuenca, "Fintech y crédito responsable: Big data y *credit scoring*" [Fintech and responsible lending: big data and credit scoring] in Zunzunegui, F. (director), *Regulación financiera y Fintech* [Financial regulation and Fintech], 2019 (in press), in which the author describes these actions as "legal abuse of law" and proposes applying the sectoral prudential rules to bank loans, as investors through platforms.

⁴⁴ According to Vicente Cuñat, "the legal interests to be protected do not differ from those we know of substantively except for everything related to the medium of communication" ["Primer Prólogo" [First Prologue] in Estevan de Quesada, C., *El Crowdfunding de inversión (Crowdinvesting)*, 2018, page 13].

⁴⁵ According to Vicente Cuñat, the form of communication "is the differential characteristic that also has structural effects" (*Ibidem*).

⁴⁶ In the European Union, a Communication of the European Commission of 2014 and a Working Document of 2016 "concluded that there was no strong case for EU level policy intervention at that juncture" (section 1 of the Explanatory Memorandum of Proposal for a Regulation on European Crowdfunding Service Providers (ECSP) for Business of 8 March 2018). From the perspective of competition law, F. Carmona, A. G. Q. Lombardo, R. Rivera, C. Pastor, J. V. García, D. R. Muñoz and L. C. Martín recommend this approach. *Competition issues in the Area of Financial Technology (FinTech)*, a study requested by the ECON Committee, EU Parliament, July 2018: "The state of the industry does not justify, on its own, a large-scale deployment or reform of competition tools" (page 105). There are authors who continue to take this approach. See J. Armour and L. Enriques. "The promise and perils of crowdfunding: Between corporate finance and consumer contracts", *The Modern Law Review*, no. 81.1, 2018, according to whom: "At this

on a negative view of financial regulation. As if it were a burden. From this viewpoint, it is a matter of giving the market an opportunity to develop, when regulation necessarily goes hand-in-hand with the take-off of a new financial activity⁴⁷. What Fintech, and crowdfunding in particular, needs is legal certainty. But with flexible regulation, adapted to the characteristics of the new activity, which is global and technological. In order to achieve these objectives, there must be close collaboration between the various authorities, including data protection and competition. In turn, the authorities must learn to use the new tools that data technology provides for better regulation and financial supervision (RegTech)⁴⁸.

Although the original approach based on promotion could be justified, the regulation of crowdfunding must be guided not only by the principle of efficiency to promote competitiveness, but also by the other principles of financial regulation. The development of crowdfunding constitutes a threat to the stability of the financial system, and it is not sustainable without adequate investor protection⁴⁹.

5. Regulation models

In order to regulate crowdfunding, it is necessary to take a functional approach and avoid inertia. Applying outmoded solutions for a market not based on current technology would be a mistake⁵⁰. Lack of coordination has encouraged local responses with diverging approaches⁵¹, some of which are outmoded. Continuous reforms have been necessary to update the system to the new needs. Following these reforms, there has been some convergence with shared principles.

early stage of the market's development, we consequently advocate permissive regulatory regime" (page 53), so "for the present, regulators are well advised to stand back and observe" (page 84).

⁴⁷ As Kern Alexander says, "the financial system can be characterised as a law-related system" (*Principles of Banking Regulation*, 2019, page 298), such that crowdfunding is integrated in the financial system, which is also a "law-related system".

⁴⁸ See: Arner, D. W., Barberis, J., and Buckley, R.P. "FinTech, RegTech, and the reconceptualization of financial regulation", *Nw. J. Int'l L. & Bus.*, no. 37, 2016, pages 371-414, with whom we agree that "regulating rapidly transforming financial systems requires increasing the use of and reliance on RegTech", defining RegTech as "technological solutions to regulatory processes" (page 373).

⁴⁹ See Zetzsche, D., and Preiner, C. "Cross-Border Crowdfunding: Towards a Single Crowdlending and Crowdinvesting Market for Europe", *European Business Organization Law Review*, 19(2), 2018, pages 217-251, who propose "regulating the platform as the 'manager' of a crowdfunding scheme" and that with this proposal there is "a desired effect as regulation functions to single out less viable market participants, thereby ensuring that the public puts a higher level of trust in the remaining (licensed) entities" (pages 246 and 247).

⁵⁰ J. Armour and L. Enriques. "The promise and perils of crowdfunding: Between corporate finance and consumer contracts", *The Modern Law Review*, no. 81.1, 2018, "that take the form of the application of the existing frameworks designed with other contexts on mind" (page 53).

⁵¹ In the opinion of Vicente Cuñat, "there are diverse instrumental solutions, motivated by the perspective from which each legislature has considered this phenomenon in which the new intermediaries aid the development of activity that could be regarded as included in shadow banking" ["Primer Prólogo" [First Prologue] in Estevan de Quesada, C., *El Crowdfunding de inversión (Crowdinvesting)*, 2018, page 16]. In the same way, Juan Ignacio Ruiz Peris considers that "disparities between different national rules create great complexity in the applicable regulatory framework with the resulting legal uncertainty for operators" ["Segundo Prólogo" [Second Prologue] in Estevan de Quesada, C., *El Crowdfunding de inversión (Crowdinvesting)*, 2018, page 21].

The nature of the service determines its regulation. We are dealing with a service that integrates market services with provision of other financial services. Unintegrated predigital regulation is no longer adequate. We are moving towards an omnibus regulatory model⁵².

Regulation of crowdfunding must take an objective approach, regulating the platforms, or a subjective approach, regulating those who provide the crowdfunding service through platforms. The Proposal for a Regulation quite rightly regulates the persons involved. Platforms are contracting systems operated by a market service provider.

For clarity's sake, there is a tendency to objectify the activity by the term "platform", which confuses the platform with the service provider⁵³. There is nothing new in this. The stock market, as a place, the trading floor, became confused with the activity. But in the same way that the stock market as a trading centre or place should not be confused with the stock market as a manager of a "multilateral trading system", the crowdfunding service provider should not be confused with the platform or internet portal through which its services are provided. This confusion has led, in some jurisdictions, to regulation of platforms or portals and references to the provider come in the form of references to "the Platform"⁵⁴. This is a disturbing approach. It makes it harder to assign responsibilities. The person responsible is always the provider of the service provided through the platform.

The MiFID system has chosen to subjectively regulate trading, clearing and settlement systems. The Proposal for a Regulation takes this subjective approach towards regulating crowdfunding. It regulates "crowdfunding service providers" and gives the provider a professional statute with a European passport. These providers are responsible for the platform through which they operate. They manage the platform as an online trading system open to the public.

The Proposal for a Regulation defines the "crowdfunding service" as provision of the crowdfunding service directly or with intermediation⁵⁵. It is a definition that, though complex, is useful in defining the activity. The term "crowdfunding" thus ceases to be an umbrella to refer to an alternative to banking financing through the internet and becomes a technical legal concept. The providers of the

⁵² K. T. Davis and J. Murphy. "Peer to Peer lending: structures, risks and regulation", *JASSA: The Finsia Journal of Applied Finance*, 2016, page 38.

⁵³ As Sandra Camacho Clavijo says, the platform "is a technological medium, not a person" ("La naturaleza jurídica de la financiación participativa en las modalidades de crowdfunding" [The legal nature of participatory financing in the forms of crowdfunding] in Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [Crowdfunding platforms], 2018, page 36).

⁵⁴ For example, United States law regulates "funding portals" [SEC Final Rule: Crowdfunding of 30 October 2015], and in Spanish law, Act 5/2015 devotes title V to the "legal framework for crowdfunding platforms".

⁵⁵ Art. 3.1.a) defines the "crowdfunding service" as "the provision of a crowdfunding platform which enables either of the following: i) direct crowdfunding service, comprising the facilitation of matching a specific investor with a specific project owner and of matching a specific project owner with a specific investor, ii) intermediated crowdfunding service, comprising the facilitation of matching an investor with a project owner and determining the pricing and packaging of offers in respect thereof, or the facilitation of matching a project owner with an investor and determining pricing of offers in respect thereof, or both".

mentioned service become providers of a new financial service, which goes beyond the technical aspect of offering electronic trading mechanisms.

Just like the rest of the financial services, the regulation of crowdfunding has the Law-Protocol structure. It is a common approach in financial regulation⁵⁶. It has its origins in the "Lamfalussy process", which distinguishes between four levels in financial regulation⁵⁷. The first sets out the principles, which are regulated in the second level. Then the third brings in the authorities' technical criteria in the form of a protocol that provides operators with a safe harbour. The Lamfalussy process ends with a fourth level involving effective application of the regulations including the protocol (enforcement).

To simplify: there is a regulatory block that covers the first two levels and a protocol in the third level. The protocol does not include industry-approved codes of conduct or other self-regulation initiatives (soft law)⁵⁸.

With regard to the regulatory block, there is debate as to the appropriateness of regulating through principles or rules. There is actually a tendency to combine principles with rules. This approach is followed in environments in constant change, such as crowdfunding, in which the rules can soon become obsolete. Crowdfunding should be regulated with principles. In fact, the jurisdiction that has allowed greatest growth in this type of service, the United Kingdom, is governed by principles. However, in order to achieve a degree of legal certainty, these principles must be rounded off with some rules, but also, and especially, a technical protocol. The Proposal for a Regulation includes the protocol in the form of "regulatory technical standards" alongside the numerous principles⁵⁹.

In short, the distinction between law and protocol is highly useful in regulating new matters in constant change. In our case, a regulation is proposed that determines the principles and essential bases for regulation. In turn, the protocol, in the form of "regulatory technical standards" will be adapted as the sector evolves.

6. Legislative policy proposals

The above considerations are the basis for making some proposals about legislative policy. The diversity of local frameworks is giving way to a degree of

⁵⁶ Referring to the Spanish model, this is a regulatory model "strongly inspired by the policies and protocols of financial market regulation and supervision" [T. Rodríguez de las Heras. "La responsabilidad de las plataformas: Alcance, límites y estrategias" [Platforms' responsibility: scope, limits and strategies] in Moreno, E. and Cazorla, L. (Coordinators), *Crowdfunding: aspectos legales* [Crowdfunding: legal aspects] 2016].

⁵⁷ See: Moloney, N. "The Lamfalussy legislative model: a new era for the EC securities and investment services regime", *International & Comparative Law Quarterly*, no. 52.2, 2003, pages, 509-520.

⁵⁸ For example, the first section of the European Crowdfunding Network's Code of Conduct states that it "merely sets out best practice principles and do not constitute Court-enforceable regulations". Available at: <https://eurocrowd.org/membership/code-of-conduct/>

⁵⁹ According to arts. 10 to 14 of Regulation (EU) 1095/2010, the European Commission is delegated powers to approve the standards produced by ESMA.

confluence from which certain considerations can be extracted. Reforms are guiding the legal framework towards the same type of solutions.

– Necessary regulation

We consider it necessary to regulate crowdfunding right away. It is a global service that is constantly growing. It has arisen as an alternative to bank financing and fills a gap in the financing of small companies and start-ups⁶⁰. Regulation adds costs but it is essential for the viability of this new financial service⁶¹. Regulation should be adapted to its nature, i.e. as a financial service⁶². The intention is not to create a substantive system of contractual relationships between clients and the platform or between clients themselves.

– Global coordination

Regulation requires global principles and coordination between different financial authorities.

The Financial Stability Board, as the body responsible for establishing international standards to promote financial stability, should approve "Crowdfunding regulation principles"⁶³. In this task, the European supervisory authorities (ESAs) should jointly act as the main gatekeepers. Moreover, financial authorities must coordinate with the competition and data protection authorities.

The Proposal for a Regulation approved by the European Parliament is a good starting point. Local regulations are obstacles to the development of platforms whose service offer knows no borders. If each platform does its own thing, that will create a new Wild West, leaving platforms' clients unprotected and creating a reputational risk that compromises the activity's future development⁶⁴. What

⁶⁰ It is a service with its own space with the same risk of adverse selection – i.e. that only projects that no-one wants to finance use it – as venture capital and business angels. See J. Armour and L. Enriques. "Individual Investors' Access to Crowdfunding: Two Regulatory Models", *The Economics of Crowdfunding*, 2018, pages 258-261.

⁶¹ As C. Steven Bradford says, "losses due to fraud and manipulation may drive investors away from crowd-funded securities offerings" ("The regulation of crowdfunding in the United States", *The Economics of Crowdfunding*, 2018, page 210).

⁶² In an initial approach in 2015, we considered that crowdfunding platforms "constitute a new type of investment service company, close to infrastructure managers", "managers of a system for contracting financial products through the internet", so the activity should be set within the legal framework of the stock market and provide the intermediary with a simplified statute that makes it possible to achieve greater legal certainty and enhance client protection ("Shadow Banking, Crowdfunding y seguridad jurídica" [Shadow banking, crowdfunding and legal certainty], *Papeles de Economía Española* [Spanish economic papers], no. 146, 2015, page 157).

⁶³ For inclusion in the Compendium of Standards (available at: https://www.fsb.org/work-of-the-fsb/about-the-compendium-of-standards/key_standards/) in the image and likeness of the Core Principles for Effective Banking Supervision of the Basel Committee and IOSCO's Objectives and Principles of Securities Regulation.

⁶⁴ Conversely, there are authors who propose deregulating the sector to allow all platforms to compete on an equal footing. Lars Klöhn recommends "liberate the market in order to create a level playing field for securities-based and non-securities-based crowdfunding" (in "The Regulation of Crowdfunding in Europe", *The Economics of Crowdfunding*, 2018, page 244). This suggestion goes against the tendency in countries such as Germany and China which, after an initial Wild West stage, have started to regulate the activity. Mass fraud may compromise the development of the activity, as is taking place with cryptocurrency ICOs.

crowdfunding needs is legal certainty, which requires definition of the activity, adequate regulation and control of it with a specific framework for resolving difficulties. In the event of a platform becoming insolvent and unable to meet its commitments, there must be a resolution plan to manage the transfer of positions to another platform in the sector with sufficient robustness to continue the business.

– Functional approach

Regulation of crowdfunding must be functional, in view of the economic role it plays in facilitating financing through the internet. It is also an activity that takes the form of providing various services which, when combined, create a new one. For this reason, it must be regulated with an autonomous system that takes as a reference the regulation of market and investment services. In the European Union, the conceptual reference point is the MiFID system. In accordance with this conceptual structure, the scope of the crowdfunding service must cover all kinds of products, whether financial or lending instruments, including investment contracts. For this purpose, the MiFID concept of a "financial instrument" should be expanded to include all "crowdfunding instruments"⁶⁵, so that any instrument used to provide the crowdfunding service is regulated, unless there is a specific framework. There should not be a closed list of contracts that can be used by platforms to provide the service⁶⁶. There should be freedom of design. Flexibility must be provided to allow the crowdfunding service provider to design the contracts that will be contracted through the platform. This aids financial engineering in the creation and contracting of crowdfunding instruments. In short, legal innovation should be permitted without compromising the system's stability and investor protection.

Limiting the object to MiFID instruments, for example, could lead to regulatory arbitrage and compromise investor protection⁶⁷. The Proposal for a Regulation thus falls short in limiting the object of crowdfunding to transferable securities and loans. It leaves out holdings in private limited companies, which are not transferable securities, but may be an important source of financing for small and medium-sized enterprises⁶⁸.

See D. A. Zetzsche, R. P. Buckley, D. W. Arner and L. Föhr. "The ICO Gold Rush: It's a scam, it's a bubble, it's a super challenge for regulators", *University of Luxembourg Law Working Paper*, no. 11, 2017, pages 17-83, which points out "the risk of a very hard landing" (page 39).

⁶⁵ The "securities" notion in US law should be followed. While this is vague, it is sufficiently broad to cover a large part of the products contracted on platforms, including interest-bearing loans. See C. S. Bradford. "The regulation of crowdfunding in the United States", *The Economics of Crowdfunding*, 2018, page 188.

⁶⁶ In Spain, the closed list in art. 50 of the Act 5/2015 of 27 April on promoting Business Financing ended up leaving out the instrument most used in practice for alternative financing: discounting of promissory notes.

⁶⁷ This happened in Germany, when platforms decided to market investment contracts not included within the scope of MiFID and, consequently, not subject to the supervision of the financial authority (BaFin), making it necessary to extend protection to those instruments. See L. Klöhn. "The Regulation of Crowdfunding in Europe", *The Economics of Crowdfunding*, 2018, pages 233-236.

⁶⁸ For this reason, the Spanish act quite rightly includes private limited company shares as instruments that can be contracted through platforms (art. 50.1.b Act 5/2015).

As far as clients are concerned, the crowdfunding service must be regulated for all kinds of project promoters on the one hand, and investors on the other. Consumers must be able to access lending through crowdfunding platforms, since when consumers receive financing from other consumers, they are not protected by the Consumer Credit Directive. So there is no justification for the Proposal for a Regulation excluding consumers from the scope of crowdfunding. This is one of the main gaps in the proposal. Financing of consumers through platforms not included in the consumer credit legislation should be included within the scope of the European regulation.

– **Reserved activity**

Provision of crowdfunding services should be reserved for institutions previously authorised by the financial authority. In order to habitually provide the service on a profit-seeking basis, it should be necessary to obtain authorisation following verification of the regulated conduct and solvency requirements.

– **Secondary trading services**

Crowdfunding providers should be allowed to offer secondary trading services. This complement provides the necessary liquidity for products contracted through the platforms⁶⁹. The prohibition on resale harms investors by reducing their liquidity⁷⁰. This additional service does not raise problems for market stability. Offering secondary market services does not transform the platform into shadow banking in the same way that this cannot be said of multilateral trading systems regulated by the MiFID system.

– **Product governance**

Providers must have product governance policies as the basis for selecting products and designing contracts to adapt the offer to clients' needs. These policies must be published on the platform so that clients can be aware of them and so they can be subject to the control of the financial authorities. Product governance is not at odds with contractual freedom. Each provider must be free to configure its business strategy and business model.

– **Client assessment**

Providers must have a system for assessing their clients. This system must include assessment of investors, as well as assessment of project risk (with

⁶⁹ The lack of a secondary market is an information deficiency that harms investors. See J. Armour and L. Enriques. "The promise and perils of crowdfunding: Between corporate finance and consumer contracts", *The Modern Law Review*, no. 81.1, 2018, according to whom: "In a secondary market, investors assess their own valuation of the security against that reflected in the market price, which adjusts depending on demand. With equity CF, the price neither changes in response to demand nor reflects informed investors' bids" (page 59).

⁷⁰ According to C. Steven Bradford, "they seem counterproductive, hurting investors rather than protecting them in any way. The resale restrictions make these small business investments even less liquid than they are, with one additional risk—the risk of illiquidity—added to what is already a very risky investment" ("The regulation of crowdfunding in the United States", *The Economics of Crowdfunding*, 2018, page 197).

scoring systems), including assessment of the solvency of borrowers who are natural persons⁷¹. This is a requirement that not only protects clients and the reputation of providers, but also protects the stability of the financial system.

– **Information for clients**

The Proposal for a Regulation is a control system based on transparency. Information is the basis of the crowdfunding service providers' business. Rules of conduct intensify for these kinds of providers. Providers must provide information about the nature and risks of the products they design and select and must disclose any conflicts of interest. The aim is not to overcome the information asymmetry that exists between providers and their clients but instead to safeguard their interests.

– **Client education**

Platforms must have education plans for their clients, in particular retail investors⁷². The educational materials must be available on the platform. The purpose of these materials is to make investors understand the risk warnings. The intention is not to turn them into professionals or to overcome information asymmetry.

– **Liability towards clients**

⁷¹In the United Kingdom, the FSA has proposed modifying the legal framework for crowdfunding to “focus particularly on credit risk assessment, risk management and fair valuation practices, especially for platforms with more complex business models”, introducing a fit and proper test when the client has not been advised [PS19/14: Loan-based (“peer-to-peer”) and investment-based crowdfunding platforms: Feedback to CP18/20 and final rules, June 2019, page 5].

⁷² See C. S. Bradford. “The regulation of crowdfunding in the United States”, *The Economics of Crowdfunding*, 2018, pages 195 and 196, who lists the minimum contents that educational materials should have.

The platform's liability towards its clients for losses caused in providing its services should be clearly defined⁷³. Clauses completely exempting them from liability with regard to user claims are, of course, abusive⁷⁴.

In any case, providers must have sufficient insurance cover for their professional liability⁷⁵.

– Guarantee fund

In order for the new activity to be sustainable, sufficient guarantees must be provided. The main direct guarantee against fraud is the creation of a fund, financed by the platforms' owners, in order to cover losses caused by cases of fraud or insolvency of crowdfunding service providers. The principle of sectoral solidarity is applied. This fund does not cover the market risk of the investment failing but does cover fraud or insolvency of the provider.

This could create a level playing field for competition and certainty between the provision of crowdfunding services and other financial services, such as investments or deposits, which already have guarantee funds.

The main risk to the development and continuity of the crowdfunding business is the possibility of the provider not meeting its commitments, either due to committing fraud by appropriating funds for investment through the platform or closing the business due to insolvency or any other difficulty. As trusted third parties, platforms attract investment and must cover such risks of service interruption. Alongside the guarantee fund, providers must have a resolution plan to manage the closure of business and transfer clients' "accounts" to another provider.

⁷³ According to C. Steven Bradford, "crowdfunding intermediaries should be liable if they have actual knowledge that statements posted by others on their platforms are false or if they are aware of red flags that should make them aware of the fraud" ("Shooting the messenger: the liability of crowdfunding intermediaries for the fraud of others", *U. Cin. L. Rev.*, no. 83, 2014, pages 408 and 409). In the opinion of S. Álvarez Royo-Villanova, the platform "is liable for hiding relevant data or lack of ordinary due diligence but not for erroneous information provided by the promoter that cannot be discovered through normal project analysis" ("El equity crowdfunding o inversión en masa -la crowdfunding por medio de emisión de valores y obligaciones-" [Equity crowdfunding or mass investment - crowdfunding through the issuance of securities and debentures] in Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [Crowdfunding platforms], 2018, pages 71 and 72). See F. Pañeda Usunariz. "La responsabilidad de la plataforma de crowdfunding" [The liability of the crowdfunding platform] in Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [Crowdfunding platforms], 2018, pages 123-141, who uses as a basis the concept of brokerage rather than consideration as a financial service, which hinders the allocation of responsibilities. The same opinion was expressed by J.L. García-Pita y Lastres. "Nuevas formas de financiación empresarial, «financiamiento crowdfunding» e hibridación entre «plataformas de crowdfunding» y «entidades de pago»" [New forms of business financing, financial crowdfunding and hybridisation between crowdfunding platforms and payment institutions] in Martínez-Echevarría, A. and Pañeda Usunariz, F. (editors), *Las plataformas de crowdfunding* [Crowdfunding platforms], 2018, pages 187-244, who also considers that the activity of these intermediaries "may not be part of the financial system" (page 194), which we do not agree with.

⁷⁴ According to Carmen Estevan de Quesada, the majority of crowdfunding platforms exclude "any liability in the event of promoters breaching their compensation obligation, stating that promoters alone are responsible for keeping their promises" [*El Crowdfunding de inversión (Crowdinvesting)*, 2018, page 45].

⁷⁵ See art. 10.2 paragraph m (new) Proposal for a Regulation of 27 March 2019.