BEUC
The European Consumer Organisation

The Consumer Voice in Europe

EUROPEAN COMMISSION'S LEGISLATIVE PROPOSAL ON CROWDFUNDING – MISSED OPPORTUNITY!

Proposal for a Regulation on European Crowdfunding Service Providers (ECSP) for Business

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Why it matters to consumers

Given the fall in returns on traditional saving products, consumers are increasingly attracted to alternative investment opportunities such as those offered by crowdfunding platforms. Growth in crowdfunding services offers potential benefits to consumers, but this growth also comes with an increased level of risk that consumers may bear when investing into the projects offered by crowdfunding platforms.

As a relatively new form of financing, crowdfunding platforms have also not yet faced the test of a recession. It is key that all crowdfunding platforms are adequately regulated at the EU level and that consumers understand the significant risks involved when investing in these platforms. Investor protection cannot be an afterthought. It should be a guiding principle.

Summary

On 8 March 2018, the European Commission proposed new EU-wide crowdfunding rules that could have served as a solid basis to protect consumers who invest through crowdfunding platforms.

While BEUC welcomes the Commission's move to regulate crowdfunding platforms at the EU level, we have strong concerns that the voluntary label proposed by the European Commission caters only for the interests of crowdfunding platforms, and not its users.

Creating a purely voluntary label for crowdfunding platforms will not set a minimum standard for investor protection across the European Union. On the contrary, operating a voluntary EU regime alongside national rules could provide a route for crowdfunding platforms to dodge stronger rules that are already currently in place in certain EU Member States. Several EU Member States already impose stricter investor protection requirements in their national law offering better consumer protection, compared to the rules put forth by the European Commission in its proposal.

To ensure that the proposal is fit for purpose, BEUC is calling for the European Commission's legislative proposal to be turned into **a binding instrument ensuring that all crowdfunding platforms are subject to minimum harmonised rules** in the European Union. BEUC is also calling for stronger investor protection standards to protect the interests of consumers when investing on these platforms:

- A requirement for crowdfunding platforms to disclose in a prominent manner **the overall default rate of the projects offered on their platform;**
- **The proposed knowledge test should be mandatory**, and projects should only be available to knowledgeable investors;
- **Maximum investment amounts should be mandatory** and based on an absolute threshold of €3,000;
- **Minimum due diligence requirements** for crowdfunding platforms when selecting projects;
- **Business continuity arrangements** to protect against crowdfunding platform insolvency;
- **Minimum capital requirements** for crowdfunding platforms.

1. Crowdfunding in Europe: A growing market, but not without risks

Lending or investing through crowdfunding platforms to innovative SMEs is gaining ground in the European Union. The activities of these platforms have significantly grown in the European Union in recent years. Across Europe, there are already more than 500 crowdfunding platforms, and approximately €4.1 billion was raised from investors through these platforms in 2015.[1] New crowdfunding services allow consumers direct access to a wider range of investment options, giving them the opportunity to easily invest in innovative start-ups. Given the fall in the nominal returns of traditional saving products, consumers are also increasingly attracted by a 'search for yield' to invest in alternative investment vehicles, including those offered by crowdfunding platforms. However, crowdfunding remains a relatively new form of financing, and investments through such platforms come with fundamental risks that cannot be ignored.

When investing on crowdfunding platforms, consumers are exposed to potentially significant capital risk, and they may not witness a return on their investment or may receive less money than what they originally invested. Investors are also frequently exposed to liquidity risk and may not be able to exit their investment early. At present, retail investors also do not have access to deposit or investor compensation guarantee schemes when investing through crowdfunding platforms. The International Organization of Securities Commissions (IOSCO), an association of the world's securities regulators, estimated in 2014 that the default risks associated with equity investments in crowdfunding to be around 50% and the default risks associated with peer-to-peer lending to be 30% in 2009.[2]

The majority of projects that seek financing through crowdfunding platforms are smaller companies with a significantly high failure rate. According to statistics from Eurostat, the one-year survival rate for enterprises created in 2014 was only about 80 per cent, while the five-year survival rate of enterprises first created in 2010 shows that typically less than half of them survive.[3] The risks associated with investing in start-ups is high, and individual retail investors may not always possess the necessary knowledge or capabilities to assess the associated investment risks. Even for professional investors, investing in start-ups can be a risky venture and usually involves a significant amount of due diligence. Since there is an information asymmetry between the lenders and the borrowers on a crowdfunding platform, there is also a risk that retail investors may base their investment decisions solely on the screening carried out by crowdfunding platforms, which is not an adequate basis for making investment decisions. There is therefore a significant potential that retail investors could be exposed to unsuitable investments.

Already, our members have identified several problems with crowdfunding platforms operating in their countries. Our French member, UFC-Que Choisir, recently found that major crowdfunding platforms operating in France do not live up to consumer expectations. According to their study, platforms frequently do not rigorously assess the risks of investment projects listed on their platforms, and overemphasise the potential returns that investors can accrue through their investments, while underplaying risks.

1 'Crowdfunding in the EU Capital Markets Union', *European Commission, 3 May 2016,* https://ec.europa.eu/transparency/regdoc/rep/10102/2016/EN/10102-2016-154-EN-F1-1.PDF, p. 9, (accessed 23 June 2018).

2 'Crowd-funding: An Infant Industry Growing Fast', IOSCO, 2014, http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf, p.5, (accessed 26 June 2018).

3 'Business demography statistics', *Eurostat,* November 2017, http://ec.europa.eu/eurostat/statistics-explained/index.php?title=Business_demography_statistics, (accessed 23 June 2018).

Consumers are frequently attracted to invest in crowdfunding platforms with interest rate promises of up to 7 per cent. However, an analysis carried out by UFC-Que Choisir shows that the final returns for investors, after taking into account defaults[4] and the deduction of taxes, are likely to be closer to between 0.33 and 1.66 per cent.[5] Our Austrian member AK Wien has also exposed the weak disclosure practices of crowdfunding platforms, with information related to the risks of investing often down-played, while potential returns were frequently exaggerated.[6]

Given the significant financial risks assumed by investors when lending or investing through such platforms, BEUC believes that strong safeguards are necessary for retail investors. We regret that the Commission's proposal does not provide the adequate answers to our concerns.

2. European Commission's legislative proposal – What are our concerns?

On 8 March 2018, the European Commission launched a legislative proposal to regulate crowdfunding platforms in the European Union. While BEUC welcomes the Commission's move to regulate crowdfunding platforms at the EU level, we have strong concerns that the voluntary label proposed by the Commission caters only for the interests of crowdfunding platforms, and not its users.

Currently, crowdfunding platforms in Europe are not covered by clear consumer rights rules set at the EU level. National rules are either non-existent or differ from one country to another, preventing platforms from easily offering their services across borders. Under the terms of the Commission's proposal, crowdfunding platforms will be able to choose to, either provide services under applicable national legislation on crowdfunding, or alternatively to seek authorisation to provide crowdfunding services under a label as a 'European Crowdfunding Service Provider' (ECSP) for business. The ECSP label would be granted by the European Securities and Markets Authority (ESMA) and would allow platforms to comply with a single set of rules defined at EU level, instead of having to comply with divergent national regulatory regimes on crowdfunding.

Creating a purely voluntary label for crowdfunding platforms will unfortunately **not set a minimum standard for investor protection across the European Union.** In fact, **operating an optional EU regime alongside national rules could lead to regulatory arbitrage**, providing a route for crowdfunding platforms to **dodge stronger national rules that are already currently in place in certain EU Member States.** In cases where national laws are stricter than the proposed rules by the European Commission under the regulation, there would be an incentive for national crowdfunding platforms to be authorised under the crowdfunding regulation as an ECSP, instead of complying with national rules. Additionally, crowdfunding platforms who operate in Member States where there currently is no regulation of such platforms may not be incentivised to apply for the voluntary EU label, leaving consumers unprotected in these countries.

[4] Crowdfunding platforms in France are required to disclose their default rates. According to figures from UFC-Que Choisir, the default rates for loans financed for longer than one year through crowdfunding platforms was 11.21% in December 2016.

[5] 'Financement Participatif – Alerte sur les risques et abus', *UFC-Que Choisir*, 23 February 2017, https://www.quechoisir.org/action-ufc-que-choisir-financement-participatif-alerte-sur-les-risques-et-abus-n24530/ , (accessed 23 June 2018).

[6] 'Crowdfunding: An analysis of 18 platforms in Germany, Switzerland, United Kingdom and Austria see from the perspective of consumer', *AK Wien*, April 2014, http://akeuropa.eu/_includes/mods/akeu/docs/main_report_en_337.pdf (accessed 30 August 2018).

To ensure effective consumer protection for all EU citizens investing on these platforms, **a minimum harmonised set of EU rules must be established for all crowdfunding platforms in the European Union, instead of an *à la carte* opt-in framework** that could allow platforms to potentially dodge stricter national rules. The European Commission's proposal should be turned into a binding instrument, setting harmonised minimum protections for investors on crowdfunding platforms across all EU Member States. An EU framework based on harmonised consumer protection standards will ensure a level playing field across EU Member States for crowdfunding platforms, while equally improving the scalability of user-friendly crowdfunding platforms across Europe.

All platform operators should adhere to a binding set of minimum harmonised rules determined at the EU level.

The European Commission's legislative proposal currently only applies to lending or equity-investing through crowdfunding platforms to businesses, while lending to consumers through crowdfunding platforms is excluded from the scope of this proposal. Reward- and donation-based crowdfunding also fall outside the scope of the current directive. In recent years, the consumer credit market has changed significantly, with the proliferation of crowdfunding platforms offering loans to consumers online. Current EU legislation, such as the Consumer Credit Directive, was designed for more traditional forms of lending and may not adequately cover the new risks associated with new forms of online lending.

The European Commission has set out in its Consumer Financial Services Action Plan 2017[7] that it will address concerns associated with lending to consumers through crowdfunding platforms during the forthcoming evaluation of the Consumer Credit Directive. Easier access to online credit for consumers could pose risks in terms of irresponsible lending resulting in over-indebtedness. BEUC believes that lending to consumers through crowdfunding platforms deserves regulatory attention and should be adequately addressed under the review of the Consumer Credit Directive.

Consumer lending through crowdfunding platforms merits regulatory attention and should be dealt with under the forthcoming review of the Consumer Credit Directive.

3. What further reforms are needed?

In addition to calling for binding harmonisation, BEUC also has a number of proposals to enhance safeguards for consumers when investing on crowdfunding platforms. Indeed, BEUC is concerned that in several respects, the European Commission's proposal could inadequately protect consumers compared to measures which have already been implemented under national legislation in EU Member States.

BEUC therefore calls for additional changes to the Commission's proposal to protect the interest of consumers when investing on EU crowdfunding platform:

- **Crowdfunding platforms should disclose in a prominent manner the overall default rates of projects offered on their platform**

BEUC welcomes the Commission's proposal for the mandatory provision of a Key Investor Information Sheet (KIIS) with a clear warning of the risks associated with investing in crowdfunding platforms, including the potential for partial or full capital loss. The KIIS will also provide prospective investors with key information about the crowdfunding projects

[7] 'Consumer Financial Services Action Plan 2017: Better Products, More Choice', *European Commission*, 2017, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017DC0139, (accessed 30 August 2018).

and the project owners, including information about investors' rights and the fees associated with an investment.

In addition to the KIIS, crowdfunding platforms should be required to disclose the default rates of the crowdfunding projects offered on their platforms on a regular basis. This information should be published on a prominent place on the crowdfunding platform's website.

Disclosing the default rate of associated projects listed on the website, in a prominent manner, would give retail investors an additional tool to assess whether it is in their interest to invest or not. The UK's Financial Conduct Authority[8] (FCA) found that crowdfunding platforms tend to downplay risks, often omitting or 'cherry-picking' information, giving potentially unrealistic optimistic impressions of prospective investment listed on their website. A requirement to disclose the overall default rate could reduce such 'cherry-picking' and give investors a more accurate view of the risks associated with their investments.

Requiring platforms to disclose the default rates of projects listed in their website should also encourage them to pursue a better selection of projects, that are likely to provide a return for investors. In France, as of 30 June 2015, crowdfunding platforms are required to publish an annual report with detailed information about their activities, including the loan default rate.[9]

- **Proposed knowledge test should be mandatory, and projects should only be available to knowledgeable investors**

We welcome the Commission's proposed knowledge test, designed to assess the investor's knowledge and understandings of the risks when investing in crowdfunding platforms. However, the knowledge test should be made mandatory, and investors should be barred from investing in a crowdfunding offer if a platform assesses that the investment would be inappropriate for the retail investor. Under the current proposal, if an investor is assessed as having insufficient knowledge, then a crowdfunding platform will only be required to provide a risk warning, and this risk warning cannot prevent the prospective investor from investing on the platform. The platforms must have a restricted access website that would only be disclosed in the case of a successful test.

- **Maximum investment amounts should be mandatory and based on an absolute threshold**

Under the Commission's proposal, crowdfunding platforms will be required to offer prospective investors the possibility to simulate their ability to bear losses, calculated as 10 per cent of their net worth. However, the test is purely symbolic as it is not mandatory, and investors cannot be prevented from investing in a crowdfunding project irrespective of the results of this simulation.

As investments on crowdfunding platforms can be prone to significant risk and capital losses, a **maximum investment limit of €3,000 per project should apply** in order to reduce the exposure of retail investors to potentially risky investments and to prevent them from concentrating all of their investments into a single venture. Diversification plays

[8] 'A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media', *Financial Conduct Authority,* February 2015, https://www.fca.org.uk/publication/thematic-reviews/crowdfunding-review.pdf, p.8, (accessed 24 June 2018).

[9] For more information, please consult the following document (pages 11-12). 'Marketing of crowdfunding offers, calculating of default rates and run-off management of platforms', *Autorite des Marches Financiers,* 2018, http://www.amf-france.org/technique/multimedia?docId=workspace://SpacesStore/1945d9b8-2452-42d1-916e-cc7e98851931_en_1.0_rendition, (accessed 23 June 2018).

a key role in lowering the risks for retail investors and could also limit the potential losses that investors could be exposed to. Several EU Member States already impose limits on the amount that retail investors can invest into a single project. For instance, in Spain and in Portugal, retail investors can only invest €3,000 per project and a maximum of €10,000 per year.[10] In Belgium, a maximum investment limit of €5,000 applies per crowdfunding offer.[11]

- **Minimum due diligence requirements for crowdfunding platforms**

To enhance investor protection, BEUC believes that crowdfunding platforms should be required to perform a minimum level of due diligence on potential crowdfunding offers to be listed on their platforms. This should include a thorough list of steps to be undertaken by platforms in order to ensure a significant amount of assessment of the project before it is advertised on the crowdfunding platform. These minimum due diligence requirements could include requiring platforms to carry out background checks on project owners, including creditworthiness checks, bankruptcy checks, money laundering checks on the directors, and checks on the good standing of the company (including, for instance, a criminal background check). The minimum due diligence requirements could also include a requirement for the business plans of crowdfunding projects to be reviewed by an appropriate third party.

- **Business continuity arrangements for crowdfunding platforms**

There is a risk that crowdfunding service providers may go bankrupt. In the event of insolvency of the crowdfunding service provider, arrangements must be guaranteed to ensure that retail investors can continue to receive loan repayments or to benefit from their investments. As retail investors are not able to assess the insolvency risk of a platform, protection is needed to guard against the risk of the bankruptcy of the platform. Crowdfunding platforms should be required **to draw up and publish online their business continuity plans.**

- **Minimum capital requirements for crowdfunding platforms**

The Commission's proposal currently foresees no capital requirements for crowdfunding platforms who apply for the ECSP label. In order for the crowdfunding sector to grow in a sustainable manner, crowdfunding platforms should be required to hold appropriate levels of regulatory capital. A number of EU Member States already apply capital requirements for crowdfunding platforms under their national regimes. For instance, in Spain, €60,000 minimum share capital is required for crowdfunding platforms, or a professional liability insurance (or a combination of both). In the United Kingdom, the CRD IV minimum capital requirement apply, and the minimum requirement is to have own funds of €50,000. In Portugal, €50,000 minimum capital requirements apply, or a liability insurance up to such an amount.[12] In order to limit regulatory arbitrage, crowdfunding platforms under the ECSP regime should be required **to comply with minimum capital requirements of €50,000**.

[10] 'Impact Assessment accompanying the Proposal for a Regulation on European Crowdfunding Service Providers for Business', *European Commission*, 8 March 2018, https://ec.europa.eu/info/law/better-regulation/initiative/181605/attachment/090166e5b9160b43_en, (accessed 23 June 2018), p. 82.

[11] 'New crowdfunding supervision and tax advantages in Belgium', *Osborne Clarke,* 6 January 2017, http://www.osborneclarke.com/insights/new-crowdfunding-supervision-and-tax-advantages-in-belgium/, (accessed 23 June 2018).

[12] 'Impact Assessment accompanying the Proposal for a Regulation on European Crowdfunding Service Providers for Business', *European Commission*, 8 March 2018, https://ec.europa.eu/info/law/better-regulation/initiative/181605/attachment/090166e5b9160b43_en, (accessed 23 June 2018), p. 78.

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