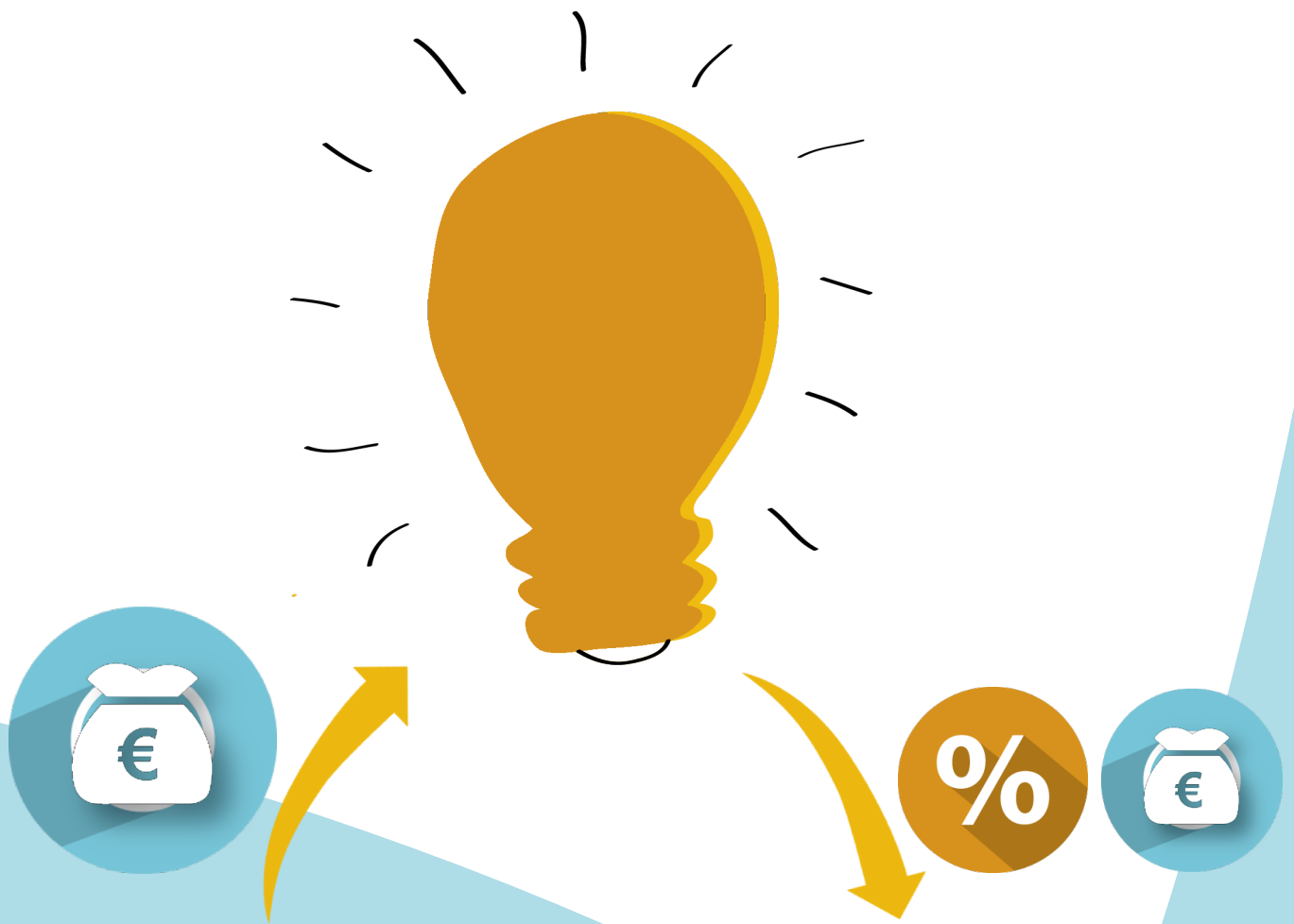


THE DESIGN OF FINANCIAL RETURN-BASED CROWDFUNDING AT EUROPEAN LEVEL

A research based on the information asymmetry risk, existing regulations and Capital Markets Union plans



Successful design of financial return-based crowdfunding at EU level

A research focussed on the risk of information asymmetries, Securities Directives and CMU plans

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Author

Rhodé Betting

Study Programme	Master of Science in European Studies
Specialisation	Regulation
Faculty	Behavioural Management and Social Sciences

Graduation Committee

Dr. S. Donnelly

Faculty	Behavioural Management and Social Sciences
Department	Public Administration

UNIVERSITY OF
TWENTE.

Dr. M.L. Ehrenhard

Faculty	Behavioural Management and Social Sciences
Department	Business Administration, IE Nikos Research Group

UNIVERSITY OF
TWENTE.

Thijs Munsterman

Department	Topicus Finance
Function	Governance/Information Analyst



Marteniek Bierman

Department	Topicus Finance
Function	Manager Governance



Preface

Dear reader,

This research has been conducted in the scope of a master thesis which symbolises the end of an era as student. Due to the paths chosen during my student life, I ended up with the interesting combination of financial return-based crowdfunding and related policy as subjects for my research. The combination of both fields intrigues me, therefore I will continue research in the combination of these fields for my second master thesis (for the master Business Administration).

Luckily I could conduct this research during an internship at the innovative company Topicus Finance. Next to this thesis, a document with practical short and long-term recommendations for Topicus, as derived from the research, is the result of the internship. I definitely enjoyed the six month period at Topicus Finance. I appreciate their help, but also their offer to decide on my thesis structure freely. I would like to thank all the Topicus colleagues for providing me a challenging internship.

For the field work of this research I have conducted 18 in-depth, face-to-face interviews with experts in the field of financial return-based crowdfunding. I really appreciate all the detailed information the respondents shared with me; I have learned so much in a short time. To guarantee their anonymity, I cannot name them to thank them. Nevertheless, when reading this they all know I mean them. Therefore, thank you very much for your collaboration. Without your help I could never finish this thesis and conduct such an extensive and interesting analysis.

Finally, to bring this research to a good end, there have been a few people who need a special word of thanks. I would like to thank Thijs Munsterman and Marteniek Bierman – as external supervisors from Topicus – for reading my extensive texts and their subsequent useful feedback. Next to that, I appreciate their constructive thinking along. I would also like to thank Dr. Donnelly and Dr. Ehrenhard – as supervisors from the University of Twente – for taking the time to read the thesis parts and their constructive and useful feedback. It was pleasant to cooperate with all four supervisors, so thanks for your support!

Hopefully reading this report gives you new insights and information to think about and discuss with peers. Additionally, I hope this research will encourage researchers and regulators to take a position in the fragmented financial return-based crowdfunding field by taking their responsibility of necessary work that needs to be done.

If there are any questions or remarks please feel free to contact me.

Kind regards,

Rhodé Betting

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List of abbreviations

AFM	Dutch Financial Markets Authority	FRCF	Financial return-based crowdfunding
AIF	Alternative Investment Fund	FSAP	Financial Services Action Plan
AIFMD	Alternative Investment Fund Managers Directive	FSPG	Financial Services Policy Group
AMLD	Anti-Money Laundering Directive	ICSD	Investor-Compensation Schemes Directive
AUM	Asset Under Management	MAR/MAD	Market Abuse Regulation/Directive
CCD	Consumer Credit Directive	MCD	Mortgage Credit Directive
CMU	Capital Markets Union	MiFID	Markets in Financial Instruments Directive
CRD	Capital Requirements Directive	MS(s)	Member State(s)
CRR	Capital Requirements Regulation	Fundraiser	Entrepreneur/individual requesting a loan
CSD	Central Securities Depository	Money-lender	Individuals from the crowd
DNB	The Dutch Central Bank	MTF	Multilateral trading facility
EBA	European Banking Authority	NCA(s)	National Competent Authorities
EC	European Commission	PD	Prospectus Directive
ECB	European Central Bank	PSD	Payment Services Directive
EEC	European Economic Community	SME(s)	Small and Medium Enterprise(s)
EMD	Electronic Money Directive	SPV	Special Purpose Vehicle
EMU	European Monetary Union	UCIT	Undertakings for Collective Investment in
ESMA	European Securities and Markets Authority		Transferable Securities Directives
EU	European Union	UK	United Kingdom
EuSEF	European Social Entrepreneurship Funds Regulation	USA	United States of America
EuVECA	European Venture Capital Funds Regulation		
FED	Federal Reserve		

1. Introduction

1.1 Thesis motives

The recent financial crisis showed poor bank finance in the European Union (EU). Existing Securities and Credit Directives have shown to be insufficient when a financial downturn occurs. The European Commission (EC) reacted with plans for a Capital Markets Union (CMU), which aims to create deeper and more integrated capital markets in the 28 Member States (MSs) of the EU. In the broader context, the CMU is part of the Investment Plan of the EC providing more 'Jobs and Growth'.

The CMU aims to remove barriers that exist between investors' money and investment opportunities and at the same time overcome obstacles which prevent businesses from reaching investors.¹ Thus, in order to integrate European capital markets and to increase the creation of jobs and growth, the EC is researching how to diversify financing resources, to reduce fragmentation in national financial markets, and to improve access to finance for businesses.² This is necessary as traditional investors – as a consequence of the crisis – have moved their investment activity upstream and focus more frequently on later-stage investments³, leaving new businesses in desperate need of finance from such investors, but at the same time facing difficulties in securing this one most important resource to succeed.⁴ But not only businesses face hard times, also individuals who are looking to buy a house experience the challenge of obtaining a mortgage. At this point financial return-based crowdfunding (FRCF) comes into the picture, as the loan-crowdfunding model provides an alternative finance option to bank loans for individuals and the equity-crowdfunding model for small and medium enterprises (SMEs).⁵ The EC has recognised the power of FRCF and has therefore included it as alternative finance option in the further development of the CMU plans.

Even though FRCF delivers many advantages for different stakeholders⁶, it also carries risks⁷ because financial returns are involved as both the fundraiser and money-lender are committed to their responsibilities and have a stake in the crowdfunding process and the inherent financial aspects. One of the biggest risks is information asymmetry between the fundraiser (i.e. entrepreneur requesting a loan or equity or individual requesting a loan) and money-lender (i.e. an individual from the crowd (for legibility reasons money-lender and investor are used interchangeably)), resulting in possibly dramatic consequences, especially concerning cross-border transactions.⁸ It is important that both parties in FRCF are well, and equally, informed due to the intended and expected returns, but often the money-lenders are not informed well, as they are the 'crowd' consisting of a wide range of kinds of people, often without the necessary knowledge and experience. Besides, the fundraiser will always have more knowledge of its own projects and may take fraudulent actions posing a risk on the money-lenders, as the latter are not expected to know the detailed information about the project in which they invested in. Concluding, information asymmetry in particular poses a risk on actors involved in FRCF and should therefore be taken into account when FRCF is designed at EU level.

With the CMU plans to integrate financial markets and the information asymmetry risk for crowdfunding actors in mind, a key challenge arises: A balance should be found between on one hand a more integrated CMU, which involves more finance options, more harmonisation and rules, more actors, and more systems – that all together increase the complexity – and on the other hand the addition of FRCF

¹ European Commission (2015a), p. 2.

² Ec.europa.eu; banking and finance: http://ec.europa.eu/finance/capital-markets-union/index_en.htm

³ Block and Sandner (2009).

⁴ Manchanda and Muralidharan (2014), p. 369; Golic (2014), p. 39.

⁵ See Ahlers et al (2015); Vismara (2015), p. 1.

⁶ See for example De Buysere et al. (2012), p. 22.

⁷ See for example Argawal et al. (2011, 2013); Stemler (2013); Wilson and Testoni (2014).

⁸ See infographic: http://ec.europa.eu/finance/capital-markets-union/docs/financial-markets-for-investors_en.pdf

as a solid alternative finance option to the CMU plans, which is new and unknown – making it even more complex. The search to how to design that balance is the basis of this study.

1.2 Thesis objectives and relevance

In line with the motives outlined above, the research question of this study is: **“How should financial return-based crowdfunding be designed at EU level, with the ‘information asymmetry’ risk in mind and thereby focusing on the existing Securities and Credit Directives and the new Capital Markets Union plans?”**. The following sub-questions have been developed in order to guide the research towards answering the main research question:

1.	To what extent are the existing Securities and Credit Directives sufficient to include FRCF?	Literature review
2.	What is the impact of FRCF as part of the CMU plans?	Literature review
3.	How do the limited rights and influences of money-lenders increase the information asymmetry between the fundraiser and money-lenders?	Theoretical framework/interviews
4.	How can the information asymmetry between the money-lender and fundraiser be decreased?	Theoretical framework/interviews

This research adds in several ways to the nascent scientific knowledge and practical experience in the field. Firstly, policy-makers and the industry are facing the challenge of how FRCF should be regulated⁹, whether current regulations are sufficient, if they should place restrictions on growth of FRCF, or even whether there is enough regulation already.¹⁰ The results of this study give an insight in how this should be done to make FRCF as successful as possible – with regard to information asymmetry – and therefore putting policy-makers and the industry into the right direction of realising that design. Secondly, the EC is currently consulting the private and public community to gain knowledge how FRCF can be best implemented regarding the CMU plans.¹¹ The results of this thesis add to the EC’s knowledge by providing an overview of the most successful way of designing it at EU level, in the context of the existing Directives and CMU plans. This is based on an in-depth literature review and case-study analysis of interviews with experts in the field and therefore adds as background information to EC in their process of receiving relevant information. Thirdly, the EC is gathering information on industry approaches to information disclosure and MS approaches to regulation in particular.¹² The preliminary results suggest that the diverse national approaches in these areas may encourage crowdfunding activity locally, but may not be necessarily compatible with each other in a cross-border context.¹³ However, as crowdfunding increases the creation of jobs and growth¹⁴, it is preferable that it acts cross-border. This study gives insight in the amount of harmonisation which is preferred by the experts when FRCF is designed for cross-border purposes. Fourthly, crowdfunding as part of financial regulation has received very little attention in the scientific world as it is relatively new. Also, financial regulation is often perceived, or deliberately presented, as ‘technical’ and therefore receiving limited scrutiny, whereas politics in fact is omnipresent in the process.¹⁵ Therefore, this study adds to the nascent literature field in general, as well as decreasing the ‘technical’ picture of the subject and making it more ‘political’ by focussing on the information asymmetry risk between the actors in line with the Modern Corporation and Agency Theory. Hence, the thesis combines two scientific disciplines, FRCF and policy, adding to the cross-pollination of scientific fields. Fifthly, FRCF, as part of financial regulation, is constantly becoming more relevant, as accountability and transparency of financial services governance have become a matter of great public interest due to its huge impact.¹⁶ As the crisis

⁹ See Schacht (2014).

¹⁰ European Commission (2014c), p. 23.

¹¹ European Commission (2015c).

¹² European Commission (2015a), p.15-16.

¹³ European Commission (2015a), p. 16.

¹⁴ European Commission (2015a).

¹⁵ Quaglia (2010), p. 3.

¹⁶ European Commission (2015a), p. 13.

has demonstrated, the governance of financial services has far-reaching economic and political repercussions, making politics of financial services regulations a very topical subject of broad public interest.¹⁷ Therefore, a potential successful design for FRCF, as conclusion of this thesis, adds to a deeper understanding of how crowdfunding may impact European economic growth in general. Besides, knowing the frames of a potential successful design decreases the risk of negative consequences due to harming regulation. Hopefully, the conclusions of this study will inform and open the public discussion on the importance of the subject under study. Finally, this study aims to increase the in-depth information of regulators and practitioners in the field regarding the design of FRCF, so that eventually the best resources and most efficient measures can be developed, as legislation may not always be the appropriate policy response to the challenges described in section 1.1. In many cases the onus will be on the market to deliver solutions.¹⁸

1.3 Thesis structure

The structure of this thesis is as follows. Chapter 2 provides a literature review, starting with the basics of crowdfunding (section 2.1), FRCF in the context of Securities Directives and Credit Directives (section 2.2), FRCF in the context of the CMU plans (section 2.3), and decreasing FRCF risks regarding information asymmetry in particular (section 2.4). Subsequently, chapter 3 provides the theoretical framework by relating the information asymmetry risk (and its future outlook) to Modern Corporation and Agency Theory. Chapter 4 describes the methodology of the research, whereafter chapter 5 provides an analysis of the results and chapter 6 clarifies the conclusions found. Finally, chapter 7 elaborates on the scientific and practical limitations and recommendations of the study.

To summarise, section 1.1 of this chapter clarified the financial crisis to be the cause of the CMU plans' development, of which crowdfunding is part. However, it is not clear yet how crowdfunding will be 'designed' at EU level. Therefore, section 1.2 described the goal of the research and the subsequent research question: "How should financial return-based crowdfunding be designed at EU level with the 'information asymmetry' risk in mind and thereby focussing on the existing Securities Directives and the new Capital Markets Union Plans?". The section also explained the scientific and practical relevance of this study. Finally, section 1.3 provided an overview of the thesis structure. The next chapter provides an extensive literature review.

¹⁷ Quaglia (2010), p. 3.

¹⁸ European Commission (2015a), p. 5.

2. Literature review

As reviewing the literature is one of the most important and indispensable tasks in carrying out a research project¹⁹, this chapter provides such a literature review in order to collect the existing information for this research. Policy documents, regulations, and directives of European institutions – among others retrieved from databases such as EUR-Lex²⁰ – are used as a starting point for the review. Additionally, relevant literature is searched for by using the search-words ‘loan-based/equity-based crowdfunding’, ‘EU Securities Directives’, ‘EU Credit Directives’, ‘Capital Markets Union plans’, and ‘crowdfunding risks’. These search words, and in some cases a few extensions on them, were used in the databases of HeinOnline, Scopus, Jstor, and GoogleScholar. Furthermore, the snowball-sampling technique is used to find additional literature. This process has been repeated until information saturation was reached.

When all relevant literature was collected, the articles were weighted by means of the Journal reputation and the amount of article citations – to make sure the source is reliable. Articles that are cited more often are likely to be more reliable as they provide two sides – pros and cons – of the story. Besides, articles from Journals with a good reputation are assumed to have better data and therefore to be more reliable.²¹

2.1 The basics of crowdfunding

The first body of literature reviewed deals with crowdfunding, its advantages, disadvantages and its relation to regulation.

Crowdfunding is an emerging type of funding²² that has grown significantly since 2009²³. It is based on Web 2.0²⁴ and seen as a combination²⁵ of microfinancing²⁶ and crowdsourcing²⁷. Since it is a relatively nascent research field, the literature has not provided a common definition yet, but some more general definitions such as ‘the process of raising money from a large number of contributors who typically contribute small amounts through the use of the internet or social media’²⁸, or ‘an open call, essentially through the internet, for the provision of financial resources either in form of donation or in exchange for some form or reward and/or voting rights in order to support initiatives for specific purposes’.²⁹ As the definitions show, it is pitching an (business) idea to the general public and asking for donations to help bring your idea into reality.³⁰ Concluding, crowdfunding describes a variety of different models for offering and selling financial instruments over the internet.³¹

Those different models are the four crowdfunding forms that have emerged over the past years: donation, reward (including pre-purchase), lending and equity (see Figure 1).³² In addition to these widely acknowledged four forms of FRCF, some authors give an overview of potential crowdfunding modalities, which are derivatives or a combination of some of the four crowdfunding types.³³ This shows the modular character of crowdfunding. Because, if it is possible to create a synthetic product that mimics all the features

¹⁹ Bryman and Bell (2015).

²⁰ The EUR-Lex database provides access to European Union law documents.

²¹ Weingart (2012).

²² Schwienbacher and Larralde (2010); Manchanda and Muralidharan (2014), p. 369; Golic (2014), p. 39.

²³ See Richards (2012).

²⁴ Web 2.0 is the term for the internet that is characterized by user-generated content usability and interoperability. It provides individuals a platform to collaborate and combine resources and knowledge for a specific purpose. See Brabham (2008); Kleemann et al. (2008); Schwienbacher and Larralde (2010).

²⁵ See Mitra (2012); Siegel (2013), p. 778.

²⁶ Microfinancing is the lending of small amounts of money to an individual or enterprise in need. See Rutherford (2000); Siegel (2013), p. 785.

²⁷ Crowdsourcing is the process of taking on an overwhelming task by farming out small, manageable tasks to the ‘crowd’, as more persons always know more than one person and more persons get always done more than one person. See Kleemann et al. (2008); Bradford (2012a), p. 27.

²⁸ Belleflamme et al. (2014).

²⁹ Schwienbacher and Larralde (2010).

³⁰ Manchanda and Muralidharan (2014), p. 371.

³¹ Heminway (2013), p. 335.

³² Bradford (2012a), p. 14-26.

³³ Golic (2014), p. 45; De Buyser et al. (2012), p. 10-11; Gajda and Walton (2013), p. 7-11.

of a peer-to-peer loan and had the same risk and yield trade-off, there would be a lot of demand to buy that paper.³⁴

However, the ambulatory movement is dangerous, as ‘everyone is chasing ‘it’, but they don’t know what ‘it’ is, and that is kind of scary’.³⁵ Besides, the rapid growth raises questions about potential risks, including whether firms involved might lower their standards to stay competitive; after all, derivatives tied to the debt were blamed for spreading the risks around the globe, and then amplifying investors’ losses when the housing market crashed.³⁶ Nevertheless, derivatives could help satisfy investors’ demand for peer-to-peer assets, while also helping others hedge risks on loans they have already bought.³⁶ Moreover, the instruments could also bring more investors swooping into the market simply to take speculative wagers.³⁶ Even though many investors show scepticism, others argue that ‘derivatives give investors the ability to protect against losses on the loans of the company arranges making it just smart risk-management.’³⁷ Despite the different opinions, it is clear that crowdfunding has large potential and is likely to grow cross-border as sector.

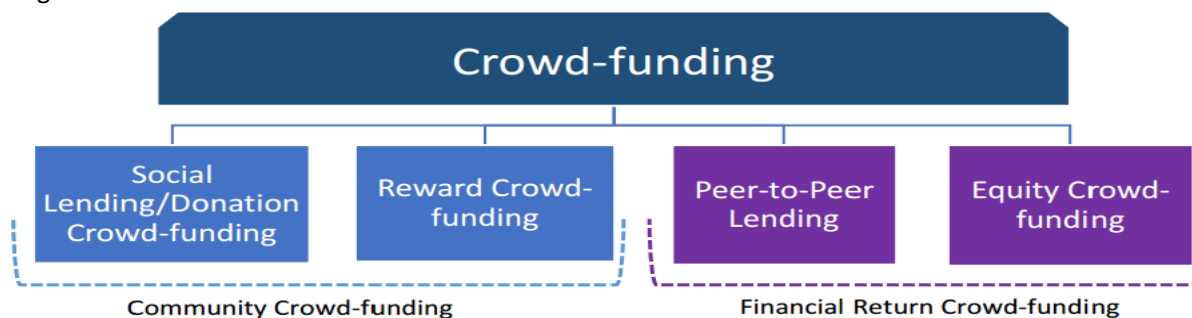


Figure 1: Crowdfunding forms; source: Kirby and Worner (2014, p. 8)

To this research, only loan-based and equity-based crowdfunding (now called loan-crowdfunding and equity-crowdfunding) are relevant. Both forms of FRCF are affiliated to the financial markets and therefore to the financial supervisory and regulatory framework.³⁸ In loan-crowdfunding – also called peer-to-peer lending as it mostly directly connects borrowers and lenders without a financial institution as intermediary³⁹ – contributors give funds with the expectation that they will be repaid.⁴⁰ This model takes two forms: in one form contributors are repaid only the principal amount – the amount they loaned to the recipient, while in the other form contributors receive the principal amount plus interest.⁴¹ In the case of equity-crowdfunding, contributions are made to entrepreneurs and in turn a share in the profits of the business is expected.⁴² Subsequently, FRCF has three main business models: the client segregated account model (bank originates the loan), the notary model (platform originates the loan), and the equity crowdfunding model.⁴³ The third model, equity crowdfunding, is different from peer-to-peer lending as it allocates stock equity to investors, with the financial return coming in the form of dividends and/or capital growth.⁴³

FRCF advantages & disadvantages

FRCF has grown fast due to its simplicity and advantages for different actors (see Table 1). In general, FRCF can help economic recovery by financing SMEs, which are a key engine of economic growth, with better access to capital for their development and expansion with, finally, economic recovery and job

³⁴ Dickinson, B. Of Canaan Partners in Alois (May 3, 2015).

³⁵ Rotman, F. Of QED Investors in Alloway and Scully (May 1, 2015).

³⁶ Alloway and Scully (May 1, 2015).

³⁷ Laplanche, R. Of LendingClub in Alloway and Scully (May 1, 2015).

³⁸ Hakvoort (2015), p. 1.

³⁹ See for example AFM (2014), p. 8; Xu et al. (2015), p. 71.

⁴⁰ Bradford (2012a), p. 16; Friesz (2015), p. 138.

⁴¹ Friesz (2015), p. 138.

⁴² Hemer (2011), p. 14; Friesz (2015), p. 138.

⁴³ Kirby and Worner (2014), p. 4.

creation as result.⁴⁴ More specifically and firstly, regarding the fundraiser, FRCF is regarded not just as a source of raising capital but also a mode of validation of the creator's business idea as it gives a projection of target markets.⁴⁵ It tests the popularity of a project and therefore act as a marketing tool by increasing brand awareness among the public.⁴⁵ Hence, it leads to crowd attention that indirectly results in customers co-constructing the product and thereby co-creating unique value for them,⁴⁶ leading to higher customer acceptance.⁴⁷ Secondly, regarding the money-lender, FRCF provides access to investment opportunities, early access to new products, better community participation, more support for new products/ideas, and the formalisation of already existing informal contracts. Thirdly, regarding the crowdfunding platforms, FRCF provides the possibility to take a percentage of the amount received by the money-lender as a commission to accommodate the fundraiser to show its idea to the crowd (thus being a facilitator). Besides, platforms can maximise the number and size of successful projects to gain an even bigger commission.

Actor	Advantages/incentives	Disadvantages/disincentives
Fundraiser	<ul style="list-style-type: none"> - CF Provides the ability to raise capital, often without giving up large parcels of equity interest. Besides, it is an affordable and attainable alternative for venture and seed capital; Reasons for lower cost of capital: <ul style="list-style-type: none"> - CF provides a low cost alternative to channelling savings to the real economy, usually at rates lower than those attainable through traditional funding avenues. - Better matches between projects and supporters, access to global funders; - Bundling the sale of equity with early access to products, limited-edition products and name recognition; - Provide information about the projects; - Crowdfunding increases supply in the area of early-stage capital. - CF Spreads risk as the crowd often consists of individuals with funding requests filled in smaller incremental amounts. Background of more information: <ul style="list-style-type: none"> - Early access to products; - Early market research, which reduces the variance of post-launch demand; - Facilitate the early development of an ecosystem around the product; - Engage potential users in the ideation and design of a product. 	<ul style="list-style-type: none"> - Limited capacity for raising money due to national regulations; - Disclosure risk: disclosing information may have negative repercussions on patentability and on bargaining with potential suppliers. Another potential risk: besides the product or the service, strategy, key employees, customers and costs must also be disclosed; - Unlike with business angels and venture capitalists, there is no industry knowledge, relationship and status; - Due to the large number of investors, investor management may be more costly (comments, attention, interaction); in addition, creators must deal with differing visions and strong personalities; - It is difficult to raise follow-up financing.
Money-lender	<ul style="list-style-type: none"> - Access to investment opportunities; - Early access to new products; - Community participation: social activity, consumption value, recognition from the creator; - Support for a product, service or idea; - Formalisation of contracts: crowdfunding formalises what would otherwise be informal finance. 	<ul style="list-style-type: none"> - Creator incompetence; - Fraud: the lack of repeated financing interaction increases the potential for fraud. They may become a target for professional criminals; - Project risk, information asymmetry.
Platforms	<ul style="list-style-type: none"> - Revenue model: the transaction fee for successful projects is 4-5% of the total funding amount; - Objective: to maximise the number and size of successful projects; - Requirements: to attract a large community of funders and creators and to develop a market design to attract high-quality projects, reduce fraud and facilitate efficient matching between ideas and capital. 	<ul style="list-style-type: none"> - Reputation risk.

Table 1: FRCF advantages and disadvantages, own editing based on Kuti and Madarász (2014) and Kirby and Worner (2014, p. 4-5).

Next to the many advantages, there are also disadvantages that may bear risks to the actors involved (see Table 1). Firstly, regarding the fundraiser, often a limited capacity for raising money in crowdfunding is available due to national regulations.⁴⁵ For example, in the US this is \$1 million as described by the JOBS

⁴⁴ Kirby and Worner (2014), p. 5.

⁴⁵ Manchanda and Muralidharan (2014), p. 371.

⁴⁶ Prahalad and Ramaswamy (2012).

⁴⁷ Schwiendbacher and Larralde (2010).

Act.⁴⁸ Besides, there is a fear of confidentiality loss, because the idea is shared with others and there is a risk that it will be stolen and be implemented before the pioneer does.⁴⁹ Secondly, regarding the money-lender, creator incompetence exists, information asymmetry leading to project risks, and possibly also fraud. Finally, regarding the crowdfunding platforms, FRCF has reputation risks as disadvantage.

FRCF risks and regulation

Accompanied by the advantages and disadvantages of FRCF, there are also risks that derive from the process in which three actors are involved. The crowdfunding process consists of the *matching* and *continuous service provision stages*⁵⁰, in which all actors - *crowdfunding platforms, money-lenders, and fundraisers* – might fail in accomplishing their obligations. Section 2.4 elaborates in further detail on these risks regarding the different actors. However, in line with the risks, equity-crowdfunding is least popular due to a lack of certainty and its interplay with securities laws (among others to decrease risks) that likely have implications.⁵¹ But also loan-crowdfunding has its risks. To both, the amount of information that money-lenders and fundraisers have (and the difference between it) is very relevant in this context, as individual funders (the crowd) often do not have formal training and might not be equipped to assess the financial risks involved⁵², while the fundraisers know all details of their own project. Therefore, the balance between investor protection and capital formation plays a key role when regulation FRCF.⁵³

As result, legal issues regarding monetary regulations are one of the most significant challenges for organisations when FRCF is conducted.⁵⁴ Namely, FRCF may be considered as a general solicitation of public saving, and these activities of private companies may be limited under the regulation on equity issuance on both the type of crowdfunding as a viable financing source and the capacity of firms to collect funding from the crowd.⁵⁴ To clarify, some countries have regulation on the amount of stakeholders that some businesses are allowed to have; in the USA national regulations typically limit the extent to which companies can advertise security offerings to the public, limiting it often to qualified investors and people with whom the entrepreneur already has clear links.⁵⁵ In this case, a money-lender is treated as an investing member of the crowd rather than a shareholder. The growing global context in which FRCF occurs may make activities cross-border even more complex, due to different national regulations, higher amounts of money that are at stake and a larger and differed crowd with different levels of background knowledge.

In order to make crowdfunding cross-border less complex, to decrease the risks of FRCR and to protect the actors involved, politicians in Brussels see the necessity to design crowdfunding at EU level. When working on such policies, the regulators take into account several key issues (see Table 2).⁵⁶

Key issues concerning money-lenders	Key issues concerning platforms
<ol style="list-style-type: none"> 1. The significant potential for loss of some or all of their capital; 2. The significant risk of dilution of equity holdings through further rounds of capital raising; 3. The very limited possibility of liquidating an investment; 4. More limited information may be available about the project than for a listed firm investment. 	<ol style="list-style-type: none"> 1. The potential for investors to over-estimate the amount of due diligence undertaken by platforms in relation to the viability of the project; 2. The potential for conflicts of interests to harm the interests of investors, in particular where the platform is remunerated by issuers, and/or projects; 3. The high operational risks and probability of failure of the platform itself and risk of discontinuity in the services offered that it entails; the implications of this could be significant where the platform holds client money or assets or is involved in another way with the post-sale administration of the investment; 4. The potential for platforms and/or investors to exploit privileged access to the project's intellectual property.

Table 2: Key issues concerning money-lenders and platforms, source: ESMA (2014), p. 11-12

⁴⁸ See US Government Printing Office (2012).

⁴⁹ Manchanda and Muralidharan (2014), p. 371.

⁵⁰ AFM (2014), p. 8-9.

⁵¹ Bradford (2012a), p. 24; Siegel (2013), p. 788; Fink (2012), p. 12-14; Friesz (2015), p. 133/138; Heminway and Hoffman (2010), p. 885-886.

⁵² De Buyssere et al. (2012), p. 16.

⁵³ See Friesz (2015), p. 133.

⁵⁴ Zhang (2012), p. 15.

⁵⁵ Kappel (2009).

⁵⁶ ESMA (2014a), p. 11-12.

On top of the issues mentioned above, the EBA argues that the convergence of practices across the EU for the supervision of FRCF is desirable in order to avoid regulatory arbitrage, create a level-playing field, ensure that market participants can have confidence in this market innovation, and contribute to the Single European Market.⁵⁷ Furthermore, according to the International Organisation of Securities Commissions, the FRCF market is nearly doubling in size each year.⁵⁸ This expansion – coupled with potential cross-border complexities – carries the possibility that crowdfunding will pose a growing set of investor protection risks in the future.⁵⁹ Without proper safeguards, FRCF could become a breeding ground for fraud and claim victims of the most vulnerable segments – those saving and investing for retirement.⁵⁹ Therefore, the basis for policies is clear: in order for crowdfunding to become a viable and lasting means of funding for emerging companies and individuals, fraud has to be limited, and money-lenders must be protected.⁶⁰ Finally, the report of the World Bank which describes that FRCF in the developing world will grow even more and could raise ninety to ninety-six billion dollars a year by 2025⁶¹, is an incentive to act immediately. A conclusion to the points discussed above is that, if harnessed properly, FRCF is likely to pick up some of the slack from conventional banks post-recession and to become a powerful tool to spur growth and eliminate inequality.⁶²

2.2 FRCF in the context of the EU Securities Directives and Credit Directives

The second body of literature reviewed deals with the development and functioning of existing Securities Directives regarding equity-crowdfunding (section 2.2.1) and Credit Directives regarding loan-crowdfunding (section 2.2.2), and the application of these Directives to FRCF (section 2.2.1.1 and 2.2.2.1).

2.2.1 Back to the start: the development of EU Securities Directives

Since 1964, European legislation on securities had been enacted to achieve integrated European Economic Community financial markets by the end of 1992.⁶³ Totally integrated financial services markets, thus a Single Market, was desirable as it was expected to increase investor protection⁶⁴ and the GDP with 1.5%.⁶⁵ However, by 1993, financial services as part of the Single Market was still incomplete, due to differences in national regulations and related sensitivity of these fields because of their impact on the economy and savings.⁶³

In perspective of the introduction of the euro, a Financial Services Policy Group (FSPG), which would identify and prioritise a set of actions to speed-up the integration process, was established in 1998.⁶³ The barriers to the integration process, as identified by the Giovannini Group⁶⁶, should be removed by mainly the private sector, providing for inter-operability between national systems and delivering considerable benefits within a significantly shorter timeframe than required for full system mergers.⁶⁷ The public sector should also partly be involved because taxation and legal certainty barriers should be removed by them, as it reflects more fundamental differences in the concepts of underlying national laws and would appear more difficult to remove.⁶⁸ Hence, it would be a joint responsibility for both parties.

Based on the recommendations of the FSPG, the EC drafted the Financial Services Action Plan (FSAP) in 1999, which had to be implemented by 2005.⁶⁹ The aim of the FSAP was to eliminate the fragmentation in the EU clearing and settlement infrastructure by implementing harmonising measures in core securities

⁵⁷ EBA (2015), p. 2.

⁵⁸ See Schacht (2014), p. 46; Kirby and Worner (2014), p. 6.

⁵⁹ Schacht (2014), p. 46.

⁶⁰ Cornell and Luzars (2014), p. 1.

⁶¹ See World Bank (2013), p. 43-44; Friesz (2015), p. 137.

⁶² Zhang (2013), p. 31.

⁶³ De Visscher et al. (2007), p. 4.

⁶⁴ Hazen (2014), p. 1735.

⁶⁵ Dardac and Georgescu (2008), p. 64; See Cecchini Report (1998).

⁶⁶ The Giovannini Group was formed in 1996 to advise the EC on issues relating to EU financial integration and the efficiency of euro-denominated financial markets.

⁶⁷ The Giovannini Group report (2001), p. ii.

⁶⁸ See The Giovannini Group report (2001).

⁶⁹ De Visscher (2007), p. 4; European Commission (1999), p. 19-31; Enriques and Gatti (2008), p. 43.

matters.⁷⁰ This was necessary because the fragmentation led to the need of access to many different national systems discouraging cross-border financial transactions due to high costs and complexity.⁷¹ Besides, it turned out to be inconsistent with the objective of creating a truly integrated EU financial system.⁷² Moreover, the fragmented financial markets failed in attracting investments from overseas.⁷³ To solve these problems, the EC had been working on 42 legislative measures (in scope of the FSAP) with the aim of creating an efficiently and safe Single Market in the financial services.⁷⁴

The large amount of 42 legislative measures, mainly developed and reformed between 2003 and 2004, were designed to strengthen the European financial industry, by encouraging both free access and competition, and the creation of more efficient markets.⁷⁴ The aim of these Directives was to bring uniformity to EU securities law and was considered to be an effective way to lower transaction costs, particularly when the value of a single set of rules is much greater than the content of the rules themselves.⁷⁵

Furthermore, the final stage of the European Monetary Union (EMU)⁷⁶ in 1999, the introduction of the FSAP in 1999, and the physical introduction of the euro in 2002 gave new momentum to financial market integration, facilitated by the integration of the Lamfalussy Architecture.⁷⁷ The implementation of Lamfalussy, as advised by the Committee of the 'Wise Men'⁷⁸, increased the efficiency of the regulatory and supervisory framework within the financial markets, by removing obstacles in the way of their integration into the Single Market.⁷⁹ Though, setting up an EU Single Market also implied a thorough monitoring of the financial stability through a constant review of the regulatory and supervisory framework.⁸⁰

At the time of development of those Directives, the EU existed of two competing coalitions (hence, 'interests'⁸¹): the 'Northern' market-making coalition ('Anglo-Saxon': including UK, the Netherlands and the Nordic countries) and the 'Southern' market-shaping coalition ('Roman': including France, Italy, Spain, Belgium and other Mediterranean countries).⁸¹ These competing coalitions impacted the development of infrastructures (e.g. financial market regulations, the exchange of assets, etc.) that aim to provide the legal bedrock for the integration process through uniform rules, lower costs, and a higher level of investor protection.⁸² However, such infrastructures are related to a *regulated market*⁸³ (as securities regulations deal with securities trading listed on a regulated market), while the FSAP Directives do not apply to *exchange-regulated markets*⁸⁴, making the latter mainly left to national laws and the FSAP Directives optional.⁸⁵ This means high costs of compliance with laws for other market players for issuers admitted to trading in exchange-regulated markets. To clarify: if an issuer restructuring its debt through a tender offer for its bonds (assuming the bonds are held by investors throughout Europe), he/she would theoretically

⁷⁰ Enriques and Gatti (2008), p. 43.

⁷¹ The Giovannini Group (2001), p. ii; 2003, foreword).

⁷² The Giovannini Group (2001), p. ii.

⁷³ The Giovannini Group (2003), foreword.

⁷⁴ The Giovannini Group report (2001), foreword.

⁷⁵ Enriques and Gatti (2008), p. 74.

⁷⁶ As part of the Maastricht Treaty signed in 1992. See European Commission (2012b) for more information.

⁷⁷ See Mügge (2006); Posner (2007); Quaglia (2007); Quaglia (2010), p. 3; Quaglia (2011), p. 3.

⁷⁸ Dardac and Georgescu (2008), p. 64.

⁷⁹ Dardac and Georgescu (2008), p. 63-64.

⁸⁰ Dardac and Georgescu (2008), p. 63.

⁸¹ Quaglia (2010), p. 8.

⁸² Enriques and Gatti (2008), p. 43.

⁸³ A regulated market is a listed market for the exchange of financial activities over which a government body exerts a level of control. Such a market offers flexibility both to issuers and holders of debt finance and focuses on the broadest range of institutional and retail investors. See <http://www.londonstockexchange.com/specialist-issuers/debts-bonds/our-markets-for-debt/our-markets-for-debt.htm>

⁸⁴ An exchange-regulated market is a more flexible alternative to the requirements regarding denomination and financial information compared to a regulated market. It is aimed at issuers targeting professional investors and admits listed securities providing substantial flexibility and a favourable tax regime. See: <http://www.londonstockexchange.com/specialist-issuers/debts-bonds/our-markets-for-debt/our-markets-for-debt.htm>

⁸⁵ Enriques and Gatti (2008), p. 75.

have to comply with different local tender offer regulations, rather than making an offer in a jurisdiction using a passport mechanism, thus making it more costly and complex.⁸⁶

From a broader context, the harmonisation provisions introduced by the FSAP were likely to be a ‘cooperative strategy’: an agreed-upon solution that several national legislatures decide to adopt to solve the problems stemming from multiple regimes applying to cross-border transactions.⁸⁷ The reason to do so was the increased importance of securities transactions cross-border within the EU that were in line with the emergence of a more integrated and securitised financial system since the launch of the EMU.⁸⁸ But the FSAP’s goal to create uniformity regarding securities laws was still not fully attained and therefore also the financial Single Market was not complete. Several reasons for failure were the lack of a uniform system of civil liability and enforcement for violation of the FSAP rules, a lack of uniformity in the Takeover Bids Directive (as it only provides a framework that leaves MSs a very wide degree of freedom on how to implement it), and there are interpretational issues that may jeopardise the uniformity efforts of the Directives.⁸⁹ Consequently, transaction costs stemming from the diversity of legal regimes and from their simultaneous application to some cross-border transactions have been reduced, but where at the time far from negligible.⁹⁰ The failure is not surprising, as effective uniformity can only be achieved through substantive law harmonisation measures that are comprehensive, maximal, and leave no room for discretion at the MS level.⁹⁰ Therefore, uniformity is realistically unattainable in absolute terms unless enforcement is centralised and securities regulation comes under the exclusive domain of EC institutions.⁹¹

Nevertheless, although the uniformity goal had not been fully achieved after the FSAP implementation, the progress made since 1999 should not be underestimated.⁹² The Directives set common focal points for the MSs through which the project of integrated financial European markets was well under way before the first signs of the crisis erupted.⁹³ It cannot be denied that cross-border securities trading, and subsequent activities, are complex, let alone the legal aspects to keep control over it. With equity-crowdfunding having basically the same foundations as Securities, it creates new unique challenges for securities regulators.⁹⁴

2.2.1.1 Application of existing Securities Directives to FRCF

In order to converge legal interpretation and practice in the EU – for the FRCF market to grow to a stable and alternative financing option – the European Securities and Markets Authority (ESMA) considered the application of existing European Directives and Regulations to equity-crowdfunding. The ESMA reported its considerations by means of *Advice* and *Opinion* publications to the European Institutions and National Competent Authorities (NCAs), respectively.

The Advice to the EU Institutions highlights gaps and issues in the current applicable regime where action may be considered to ensure there is a regime protecting investors while also enabling crowdfunding platforms.⁹⁵ These gaps and issues include the impact of the Prospectus Directive (PD) thresholds, capital requirements and the use of the Market Financial Instruments Directive (MiFID) optional exemption, and the potential development of a specific EU crowdfunding regime (in particular for those platforms that currently operate outside the scope of the MiFID).⁹⁵ With regard to those Directives, several regulatory burdens are perceived by the platforms (see Appendix I for an overview of the applicability of each particular Directive). The MiFID, PD and Directive on Investor-Compensation Schemes (ICSD) apply only where the securities are transferable; therefore it should be recalled that securities need only to be capable

⁸⁶ Enriques and Gatti (2008), p. 76.

⁸⁷ Enriques and Gatti (2008), p. 47; See Baum, H. (2000). Globalizing Capital Markets and Possible Regulatory Responses, in *Legal Aspects of Globalization, Conflict of Laws, Internet, Capital Markets and Insolvency in a Global Economy*, 77, 99-110 (Basedow, J., and Kono, T., eds., 2000).

⁸⁸ The Giovannini Group report (2001), p. 1.

⁸⁹ Enriques and Gatti (2008), p. 76-78.

⁹⁰ Enriques and Gatti (2008), p. 44.

⁹¹ Hertig and Lee (2003); Enriques and Gatti (2008), p. 81.

⁹² Enriques and Gatti (2008), p. 47.

⁹³ Quaglia (2010), p. 1.

⁹⁴ See Friesz (2015), p. 134.

⁹⁵ European Crowdfunding Network (2014).

of being traded on the capital markets for being ‘transferable’ (making the existence of a secondary market not a determining factor).⁹⁶ Moreover, in cases where the applicability of MiFID is properly understood, the impact of regulatory requirements is much less significant than some platforms appear to believe, and that efforts should be made to correct this misperception.⁹⁶ Because of this misperception, ESMA is worried that platforms have strong incentives to devise business models which fall outside MiFID scope by constructing models that would technically be loan-crowdfunding platforms or to use securities that are not transferable, so as to avoid regulatory requirements.⁹⁶ ESMA concerns that where such incentives exist and lead to crowdfunding based on securities which are not transferable, protection for investors and fundraisers is reduced.⁹⁶ The very nature of the securities may in fact increase the risks for investors, by making it harder to liquidate an investment.⁹⁶ This could also in the longer-term hamper the development of crowdfunding, if the form of the securities impedes the development of a secondary market and limits the possibility for platforms to operate cross-border.⁹⁶ ESMA therefore advises the EU institutions to consider whether there is a case for action at EU level to reduce the incentive to structure business models so as to fall outside MiFID.⁹⁶ Thus, where crowdfunding platforms are operating within the MiFID scope the current EU-regime provides a reasonable degree of risk mitigation, but not where such platforms are operating outside MiFID.⁹⁶ The impact of this gap in terms of investor protection could be mitigated by measures at national level; however, such action at national level could not provide a passport and would not address the lack of scalability.⁹⁶

The Opinion to the NCAs provides clarity on how crowdfunding business models fit within the existing EU regulatory framework and therefore provides guidance to who may be considering how to regulate platforms operating outside the scope of the harmonised EU rules on the key risks inherent to crowdfunding and the key components of a regulatory regime to address them.⁹⁵ The analysis of how the main business models across existing EU rules, e.g. the MiFID, the PD, the Directive for Alternative Investment Fund Managers (AIFMD), and other financial and banking regulations, is aimed to help create an understanding of the possibilities within the existing framework on national level.⁹⁵ However, NCAs’ experience in applying the AIFMD is limited while even more structures may emerge in future which could be considered to be Alternative Investment Funds (AIFs), or if managers of existing structures will cross the size threshold for authorisation under AIFMD.⁹⁷ Therefore it would be useful to consider whether the AIFMD was intended to capture vehicles investing in single instruments, with no discretion on the part of the vehicle to change the instrument invested in, and where the extent of the vehicle’s discretion is the timing and manner of exit from the investment.⁹⁷ But, any consideration of this issue would need to consider contexts other than crowdfunding to ensure that unintended loopholes were not created in the applicability of AIFMD.⁹⁷ Concluding, the implementation of an EU crowdfunding framework will be delicate work and in need of close and ongoing involvement of the crowdfunding sector.⁹⁵ The precise approach chosen for FRCF will have impact on which legislation is applicable, and in which way.⁹⁸

2.2.2 Back to the start: the development of EU Credit Directives

In line with the Securities Directives, Credit Directives were developed to regulate credit in the EU, which is applicable to loan-crowdfunding in the context of this thesis. These regulations have been developed to regulate the market of financial credits in the EU. The Single Market Review⁹⁹ and the White Paper on the Integration of EU Mortgage Credit Markets¹⁰⁰ aim to smooth the flow of credit data across the EU, as well as the need for data protection. Several directives came forth of these documents, such as the

⁹⁶ ESMA (2014a), p. 28.

⁹⁷ ESMA (2014a), p. 29.

⁹⁸ ESMA (2014a), p. 13.

⁹⁹ European Commission (2007c).

¹⁰⁰ European Commission (2007b).

Consumer Credit Directive¹⁰¹ (aims among others to offer a high degree of consumer protection¹⁰²) and the Mortgage Credit Directive¹⁰³ (aims to create an EU-wide mortgage credit market with a high level of consumer protection¹⁰⁴).

Together the EU Credit Directives aim to protect customers by providing enough information and increase transparency through harmonisation. To prevent consumers not seeing the risks and getting high debts, policies and information provision about credit is necessary as consumers often do not know the impacts of different loans. Besides, transparency is also important for financial institutions providing the loans, as customers seeking to take out a loan with another institution – be it in the domestic market or cross-border – may face higher prices or be denied access to credit because of the lender's inability to access complete information of the customer.¹⁰⁵ In a cross-border context, this may impede the ability of new credit providers to compete for customers, as well as it reduces the choice and mobility of customers.

To summarise, both the consumer and credit institutions benefit from policies. Because loan-crowdfunding is also a form of credit and involves risks it therefore may be useful to regulate it at EU level as well. How this, according to the literature and policy documents, should be done is explained in the subsection 2.2.2.1 below.

2.2.2.1 Application of existing Credit Directives to FRCF

The EBA considered the Capital Requirements Directive (CRD)¹⁰⁶/Capital Requirements Regulation (CRR)¹⁰⁷, Mortgage Credit Directive (MCD)¹⁰⁸, Payments Services Directive (PSD)¹⁰⁹, Electronic Money Directive (EMD)¹¹⁰, and their applicability to loan-crowdfunding (see Appendix II for a detailed application of each particular Directive/Regulation).¹¹¹ Also the Consumer Credit Directive (CCD) is assessed, although this Directive does not fall within EBA's scope.¹¹² The results show – in combination with the early stage of FRCF market development – that convergence of national legislation into EU legislation should be done according to existing EU law; therefore EU regulators should provide clarity on the applicability of available law to loan-crowdfunding.¹¹³ Loan-crowdfunding services are provided using a large number of business models¹¹⁴, which is why different pieces of EU financial regulation could potentially apply.¹¹⁵ Application of existing regulations would lead to crowdfunding participants having confidence in this new market segment.

The CRR/CRD is argued to be least relevant to crowdfunding platforms, because platforms are generally not qualified as credit institutions or banks.¹¹⁵ The PSD is argued to be most relevant as it covers the

¹⁰¹ European Commission (2008a).

¹⁰² European Parliament and the Council (2014c).

¹⁰³ European Commission (2014d).

¹⁰⁴ Ec.europa.eu, Banking and Finance, Mortgage credit: http://ec.europa.eu/finance/finances-retail/credit/mortgage/index_en.htm

¹⁰⁵ Ec.europa.eu, Banking and Finance, Credit histories: http://ec.europa.eu/finance/finances-retail/credit/history/index_en.htm

¹⁰⁶ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338–436).

¹⁰⁷ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1–337).

¹⁰⁸ Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (OJ L 60, 28.2.2014, p. 34–85).

¹⁰⁹ Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC (OJ L 319, 5.12.2007, p. 1–36).

¹¹⁰ Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC (OJ L 267, 10.10.2009, p. 7–17).

¹¹¹ Hakvoort (2015), p. 1; EBA (2015).

¹¹² EBA (2015), p. 24.

¹¹³ EBA (2015), p. 2.

¹¹⁴ See Kirby and Worner (2014), p. 4

¹¹⁵ Hakvoort (2015), p. 1.

payments-related aspects of crowdfunding activities.¹¹⁶ The PSD (II)'s application needs further consideration because it intermediates in the transfer of funds between investors and beneficiaries.¹¹⁷ However, a uniform interpretation of the PSD is necessary, as the EBA points out discrepancies of MSs' interpretations.¹¹⁷ Because loan-crowdfunding is not a regulated banking activity (yet)¹¹⁷, crowdfunding platforms should also closely observe the work underway from MSs, apart from only monitoring initiatives at EU level.¹¹⁷ But even though the PSD is made applicable to loan-crowdfunding, still lending-related aspects are uncovered by EU law, leaving several risks unlikely to be addressed.¹¹⁸ These risks include a lack of or insufficient requirements on any due diligence processes and assessment of borrowers' creditworthiness conducted by a platform, and a lack of or insufficient safeguards against platform default.¹¹⁸ For these risks, the EBA suggests potential ways to address them, including requirements regarding due diligence procedures on projects advertised on a crowdfunding platform, and requirements regarding internal procedures and to address platform defaults.¹¹⁸ Furthermore, the EBA is in favour of imposing on crowdfunding platforms certain obligations with respect to informing investors about the borrowers and about the risks connected with the investment.¹¹⁹ Finally, the activity of such platforms should be subject at the very least to notification of the relevant financial regulator.¹¹⁷

2.3 FRCF in the context of the Capital Markets Union plans

The third body of literature reviewed deals with the FRCF in the context of the CMU. Particularly, section 2.3.1 clarifies the CMU plans, whereas section 2.3.2 elaborates on FRCF as part of these plans.

2.3.1 The Capital Markets Union plans

The financial market integration level prior to the crisis was driven by debt-based wholesale banking flows which were prone to sudden reversals in the face of shocks.¹²⁰ Therefore, the integration across the EU has fallen after the crisis, since banks and investors were increasingly retreating to home markets.¹²¹ This made building a Single Market for capital a more urgent task than ever.¹²¹ As a result, the EU has taken measures to making financial institutions and markets more stable, competitive and resilient¹²², leading to the CMU plans as part of the Investment Plan.¹²³ Thus, the CMU plans can be seen as a reaction to market-failure, due to poor bank finance in history.

Five principles		Six goals
1.	It should maximise the benefits of capital markets for the economy, jobs and growth;	Maximising the benefits of capital markets so they can support economic growth and job creation;
2.	It should create a Single Market for capital for all 28 MSs by removing barriers to cross-border investment within the EU and fostering stronger connections with global capital markets;	Creating a Single Market for capital by removing barriers to cross-border investments;
3.	It should be built on firm foundations of financial stability, with a single rulebook for financial services which is effectively and consistently enforced;	Helping the EU to attract investments from all over the world and become more competitive.
4.	It should ensure an effective level of consumer and investor protection;	Helping SMEs raise finance more easily;
5.	It should help to attract investment from all over the world and increase competitiveness.	Improving access to financing for all businesses around Europe;
6.	-	Diversifying the funding of the economy and reduce the cost of raising capital;

Table 3: Five key principles and six goals of the CMU

¹¹⁶ EBA (2015), p. 2; Wojdylo and Czarnecki (2015), p. 2; Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC.

¹¹⁷ Wojdylo and Czarnecki (2015), p. 2.

¹¹⁸ EBA (2015), p. 2.

¹¹⁹ Wojdylo and Czarnecki (2015), p. 1-2.

¹²⁰ European Commission (2015a), p. 8.

¹²¹ See interview with Commissioner Hill, 27 February 2015: http://ec.europa.eu/information_society/newsroom/cf/fisma/item-detail.cfm?item_id=20190&newsletter_id=166&lang=en

¹²² European Commission (2012a), p. 3.

¹²³ European Commission (2014b), p. 14.

The CMU plans, as proposed in the EC's Green Paper¹²⁴ and consisting of five principles¹²⁵ and six goals¹²⁶ (see Table 3), are a new frontier of Europe's Single Market by turning the vision of free capital flow, as one of the fundamental principles on which the EU was built, more than fifty years on from the Rome Treaty into reality.¹²⁷ The plans consist of greater diversification in the funding of the economy and reducing the cost of raising capital by integrating capital markets to enhance the shock-absorption capacity of the EU. Besides, enhancing the flow of capital – through efficient market infrastructure and intermediaries – would increase investment without increasing levels of indebtedness.¹²⁸ Moreover, stronger capital markets would complement banks as a source of financing, and would unlock more investment for all companies and for infrastructure projects, attract more investment into the EU from the rest of the world, and make the financial system more stable by opening up a wider range of funding sources.¹²⁹ Therefore, the principles are based on the identification and removing of barriers that stand between investor's money and investment opportunities, and overcoming the obstacles which prevent businesses from reaching investors.¹²⁹ The EC aims to put in place the building blocks for a fully functioning CMU by 2019.¹²⁷

1.	Improving access to financing for all businesses across Europe (in particular SMEs) and investment projects such as infrastructure;
2.	Increasing and diversifying the sources of funding from investors in the EU and all over the world;
3.	Making markets work more effectively and efficiently, by linking investors to those who need funding at lower cost, both within MSs and cross-border.

Table 4: Actions to be taken and defined by the first consultation period

Through consultation, the first three actions in the scope of the CMU are defined (see Table 4 for an overview and Appendix III for the details). The consultation period indicated the nature of the problems and possible measures as solutions, which is useful as legislation may not always be the appropriate policy response to challenges, and the onus in many cases will be on the market to deliver solutions.¹³⁰ Sometimes, non-legislative steps and the effective enforcement of competition and Single Market laws might offer the best way forward.¹³⁰ Moreover, the EC supports market-driven solutions when they are likely to be effective and regulatory changes only where they are necessary (proportionality principle). At the same time, when opening up national markets for financial services, the CMU should also add in developing financial markets at national level.¹³¹ However, policy responses may require appropriately tailored action at national level – based on country specific recommendations of the EC – given the diverse levels of development of capital markets across the EU.¹³¹

The first action (Table 4) focuses on alternative financing sources, and is divided into smaller focus points, which are addressing information problems, increasing standardisation, and the development alternative means of financing. The second action focuses on the attraction of institutional, retail and international investors, and is divided into smaller focus points, which are institutional investment, retail investment, and international investment. Finally, the third action focuses on the relevant laws, enforcement and supervision of the laws, and technology. These latter aspects are divided into smaller focus points, which are the Single Rulebook, supervisory convergence, data and reporting, market infrastructure, securities law, company law, corporate governance, insolvency issues, taxation issues, and technology. As regards the character of FRCF, it touches many of the mentioned focus points, resulting in FRCF being part of the CMU plans.

¹²⁴ See European Commission (2015a).

¹²⁵ European Commission (2015a), p. 5.

¹²⁶ European Commission (2014b), p. 14.

¹²⁷ European Commission (2015a), p. 3.

¹²⁸ European Commission (2015a), p. 4; See Gabor and Vestergaard (2015), p. 2.

¹²⁹ European Commission (2015a), p. 2.

¹³⁰ European Commission (2015a), p. 5.

¹³¹ European Commission (2015a), p. 6.

2.3.2 FRCF as part of the Capital Markets Union plans

The follow-up of the above described three actions have resulted in five concrete areas (see Appendix IV) where the need for progress is high and that can bring potential early benefits.¹³² Altogether, actions should be taken on the demand side, as well as the supply side. On the demand side, improving access to finance, including to risk capital, notably for SMEs, is an important priority.¹³³ Success over time will depend on overcoming information problems, the fragmentation of key market segments and lowering the costs of access to capital markets.¹³⁴ On the supply side, the development of capital markets in the EU will depend on the flow of funds into capital market instruments.¹³⁴ Moreover, boosting the flow of institutional and retail investment into capital markets would promote the diversification of funding sources.¹³⁴ Also, enhancing the confidence of retail investors in capital markets and financial intermediaries could increase the flow of household savings into capital market instruments which are now largely held in home equity and bank deposits.¹³⁴ Finally, increasing the global competitiveness and attractiveness of European capital markets in this way could also boost the flow of investment.¹³⁴ Therefore, more integrated capital markets will depend on overcoming the barriers that are fragmenting markets and holding back the developments of specific market segments.¹³⁴

Hence, free European flow of capital and easier access to finance should be accomplished through integrated capital markets added with relationship-based lending. While capital markets can complement the role of bank lending for the business parties, their diversity and scant credit information is often better suited to relationship-based lending.¹³⁵ Thus, banks ask for more detailed information before credit is granted, while alternative financing methods provide an easier and cheaper way to obtain financing. Therefore, alternative funding sources such as crowdfunding can play an important role for small and rapidly growing start-ups in innovative industries¹³⁵, SMEs and even individuals. In case of businesses, equity issues and debt underwritings are characterised by substantial fixed costs of due diligence and regulatory requirements that smaller firms often do not have.¹³⁵ Due diligence is still necessary in crowdfunding, however, often there is less disclosure making intensive due diligence impossible. The lack of information poses an information asymmetry on the money-lender and fundraiser. Besides, as the majority of the crowd does not pay (enough) attention to such pre-investment research (if it is conducted in the first place), the information asymmetry becomes even greater. If the crowdfunding market grows (cross-border), the information asymmetry between the money-lender and fundraiser may pose a risk on the credibility of both parties.

However, through the increased alternative funding options based on relationship-based lending (e.g. crowdfunding), financial interests (in business enterprises) may look less like investment instruments commonly known as stock or debentures, and more like loans, gambling bets, rights to consumable products or services or charitable or other non-profit donations.¹³⁶ Hence, it is not a surprise that relationship-based lending has grown significantly due to its nature of a 'socially mediated phenomenon which relies in great part of the intrinsic trust people place in shared connections on social networks, community affinities, and the ratings of others on trusted, mainstream websites'.¹³⁷ Therefore, trust between the actors is a key role and creates a challenge for platforms to drive capital from the crowd to those that need it in a safe way.¹³⁸ To create such safe money transfers, potential money-lenders need disclosure documents to help them understand the risks, the lack of guarantees, liquidity limitations and other potential pitfalls.¹³⁸ In addition, all relevant parties should provide robust, easily understood investor

¹³² European Commission (2015a), p. 10.

¹³³ European Commission (2015a), p. 8.

¹³⁴ European Commission (2015a), p. 9.

¹³⁵ European Commission (2015a), p. 13.

¹³⁶ Heminway (2013), p. 335.

¹³⁷ The World Bank (2013); CrowdfundInsider (20 October 2013).

¹³⁸ The World Bank (2013); Luzar (2013).

educational tools, as transparency and education is everything.¹³⁹ Hence, FRCF risks, particularly information asymmetry, should be decreased, leaving the money-lenders without barriers that may restrain them from investing.

Despite the CMU's positive intention, concerns arise about the content of the CMU plans. Five challenges of the EC's market infrastructure plans are identified: Regulation of Securities Financing Transactions (SFTs) receiving minimal attention (especially compared to high-quality securitisation), inconsistency of CMU plans with the EC's work on shadow banking (work on shadow banking stresses the urgency of regulating SFTs due to their crucial role in leverage, pro-cyclicality and interconnectedness, while the CMU plans downplays the systemic issues related to SFT markets), EC's thinking about SFTs seems reduced to a notion of promoting 'free flow of collateral' (with as risk to repeat mistakes of the pre-crisis period when MSs and EU institutions delegated regulatory responsibility to SFT market participants), and the just described CMU weaknesses as part of a larger regulatory trend (by which proposals to regulate SFT markets have been watered down recently).¹⁴⁰ In addition, it is argued that the CMU plans will harm investors in the long-term unless there is more emphasis on investor protection, because failing to address consumer protection is not viable in the long-term as the CMU will not succeed if profit becomes the main driver of behaviour as it was in the run-up to the financial crisis.¹⁴¹ In this context, domestic regulators should be able to protect consumers such as by restricting marketing or cubing new product offers to specific consumers.¹⁴¹ The problem is clear: over-stimulating demand without mechanisms that ensure clear understanding of the product, its risks and its opportunities, invites the prospect of bringing investors to the market, many uninformed, and simply creating avoidable consumer detriment.¹⁴¹ Concluding, the CMU seeks to encourage new ways of funding companies, such as crowdfunding, but broader consumer protection in this emerging sector was not being addressed.¹⁴¹ However, the concrete input as regards crowdfunding may be focused on consumer protection after these critics. Finally, the CMU report on crowdfunding that will be published early 2016 will show whether such scepticism is fair.

2.4 FRCF risks

The fourth body of literature deals with the exact risks FRCF bears. The literature differs on the risks in a more general and specific way; this section provides an overview of these risks. First, the general risks and possible wrong-doing of actors is described (section 2.4.1), where after the particular information asymmetry risk is elaborated (section 2.4.2). Finally, section 2.4.3 describes how this information asymmetry risk can be mitigated.

2.4.1 General FRCF risks and subsequent possible wrong-doing

FRCF is risky – particularly when it concerns small businesses in start-up phase – as it involves a potentially dangerous combination of investment risk and relatively unsophisticated investors.¹⁴² The potential for fraud and self-dealing are high, especially when the money-lender has no pre-existing relationship with the fundraiser.¹⁴³ It is likely that loan-crowdfunding is less risky because it is based on loans instead of investments, nevertheless, there are still risks involved.

Agrawal et al. describe FRCF risks regarding four stages in the crowdfunding process, which are risks that involve the lack of adequate pre-investment screening and due diligence, weaker investment contracts, and poor post-investment support and monitoring (see Table 5).¹⁴⁴ They argue the lack of careful due diligence, unrealistic investor expectations, the opportunity cost of low expert advice, inexperienced

¹³⁹ Luzar (2013).

¹⁴⁰ Gabor and Vestergaard (2015), p. 2.

¹⁴¹ EurActiv (March 10, 2015).

¹⁴² Bradford (2012b), p. 2.

¹⁴³ See Bradford (2012a), (2012b), p. 2-3, and Ellenof (2013), p. 20.

¹⁴⁴ Agrawal et al. (2013).

creators, and absence of strict governance, reporting, accounting and other requirements to protect investors as problematic.¹⁴⁵

Phase	Risk
1. Selection & valuation	- No due diligence research by investors due to small amount invested/lent or lack of expertise; - Biased or overoptimistic investment/lending decisions (or a free-riding problem);
2. Investment	- Standardised platform contracts, while tailored contracts are necessary; - Lack of risks diversification (imitation risk problems); - Lack of follow-up investment rounds (shares get diluted);
3. Post-investment support & monitoring	- Lack of (or less) content-linked valuable support by the crowd (because of lower returns due to small investments); - Information asymmetry between investor/lender and demander (often due to geographic distance); - Lack of repeated interactions reduces reputation to act in line with crowd's interests (potential fraud);
4. Exit	- Lack of monitoring and illiquid assets (often 5-10 years before return); - IPO or M&A as exit is not likely, but pre-thought strategy applied.

Table 5: FRCF risks, source: Argawal et al. (2013)

Kirby and Worner categorise the FRCF risks by risk of default, risk of platform closure/failure, risk of fraud, risk of illiquidity, risk of cyber-attack, and lack of transparency/disclosure of risks (see Table 6).¹⁴⁶ Furthermore, the authors also explain that FRCF could pose systemic risk on the long-term depending on the size, liquidity, cross-border nature of crowdfunding, and the interconnectedness through securitisation practices and bank involvement. Firstly, the crowdfunding market is currently small but it is doubling in size each year.¹⁴⁷ This means that even though the current market size is too small to cause systemic risk, it has the potential to grow to a sizeable market in a short amount of time.¹⁴⁷ Secondly, liquidity lacks due to relatively few platforms providing a secondary market on which to sell loan portfolios (loan-crowdfunding) and no secondary market for shares in start-ups exists, due to the inability to accurately judge the value of equity shares (equity-crowdfunding).¹⁴⁷ This is unattractive for money-lenders who want to liquidate positions. Thirdly, cross-border crowdfunding activities are new and therefore need further in-depth work to understand the legal implications; the newness is inherently a reason why cross-border complexities could become a source of systemic risk in future.¹⁴⁷ Fourthly, the securitisation of peer-to-peer unsecured loans opens the market to new investment, but also opens the rest of the financial market to exposure to packaged loans which are predominantly unsecured in nature.¹⁴⁷ Since the market segment is extremely small, it is not currently a source of systemic risk but could nevertheless become in future.¹⁴⁷

Risk category	Explanation
1. Risk of default	In equity-crowdfunding the risk of default/investment failure is estimated to be around 50%. In peer-to-peer lending there has been a concerted effort by the industry to reduce default rates, which reached a high of 30% in 2009. While there has been some success in reducing default rate, the actual rate of default in many cases is unknown as many of the platforms have only opened in the last three years and the loans originated by them have only recently started to mature.
2. Risk of platform closure/failure	Despite the short life of crowdfunding, there has already been a case of peer-to-peer lending platform closing leaving no data on contracts behind and resulting in 100% investment loss. Investors bear a higher risk than in many other types of investments.
3. Risk of fraud	This is compounded in both peer-to-peer lending and equity-crowdfunding by the anonymity created by the online aspect of these industries. This is the case for both the lender/investor and borrower/issuer parties, whereby the opportunity to defraud is an ever present reality.
4. Risk of illiquidity	Investors cannot sell their participations as there does not exist a secondary market. This lack of liquidity in FRCF could be a risk for investors if they are not aware of this.
5. Risk of cyber-attack	The online nature of FRCF makes it vulnerable to the risk of cyber-attacks.
6. Lack of transparency/disclosure of risks	Risks tend not to be disclosed until a lender/investor becomes a member of the platform.

Table 6: FRCF risks, source: Kirby and Worner (2014)

Possible wrong-doing

In line with the existing risks, Cornell and Luzar elaborate on two ways of possible wrong-doing of the crowdfunding actors, as potential fraud will increase when crowdfunding becomes usual. First, a

¹⁴⁵ Argawal et al. (2013), p. 1, 6, 9.

¹⁴⁶ Kirby and Worner (2014), p. 5.

¹⁴⁷ Kirby and Worner (2014), p. 6.

crowdfunding campaign solicits and accepts money from money-lenders using deliberately misleading pretences about the nature of the project or the expected outcomes.¹⁴⁸ Second, money-lenders commit to funding a project, business or cause with a deliberate intention to cancel or reverse the transaction – or to extract returns not offered to other backers or fails to complete transactions.¹⁴⁸ However, the authors have found no real cases of FRCF fraud¹⁴⁸, but this may be the case because FRCF was less popular before 2014 and has grown fast since then.

Threat category	Explanation
1. Pre-empted fraud	A suspicious crowdfunding campaign is shut down by the platform before any money changed hands. In these cases, the escrow-protected nature of fund exchange proved an important safeguard for those backing a campaign.
2. Stillborn fraud	Occurs when a campaign that is submitted for launch is summarily rejected by the platform. While campaigns are rejected for a variety of reasons ranging from technical errors to merely being incomplete, there are certainly many that get rejected because they carry a risk of fraud; they are filtered out before they are ever launched. Crowdfunding platforms have a good incentive to avoid projects that might end up with contentious or disputed results. Because, in today's online culture, breaches of trust and reputation can be as damaging to a crowdfunding website as any bureaucratic investigation. Nevertheless, some dubious campaigns do slip through these first-tier fraud detectors.
3. Attempt fraud	Could take place due to a campaign using IP that they did not own, or similar misrepresentations. While these deliberate attempts often are 'pre-empted' or 'stillborn', several campaigns have been launched that have used copyrighted IP or have disputable claims. Such cases show that there indeed are 'bad actors' out there, who, if given a chance, will try to use a platform to attract money from unsuspecting backers. They are good examples of how the transparency and public nature of modern platforms, by design, thwart these attempts at fraud. The effect of 'the wisdom of the crowd' does an effective job of 'outing' these attempts before money changes hands.
4. Perceived fraud	Accusations of fraud often come when the 'perks and rewards' are significantly delayed, as backers may have to wait for a very long time to receive their promised reward. Even in some cases the project fails and the backer may never get the product.
5. Backer fraud	A contributor may deliberately pledge money to crowdfunding campaigns with the intent to withhold the funds or to file a claim to get the money refunded.
6. Backer-creator fraud	Project creators contribute to their own campaigns either directly or through surrogates. This is a grey-area since the intention may merely be to demonstrate some funding momentum or to 'put the project over the top', but the crowd will sometimes respond negatively to this practice if they can even detect it. An example is money laundering.
7. Broker/portal fraud	As like the social media revolution, crowdfunding has spawned hundreds and thousands of niche platforms – and thus increases the chance of fraud and other malfeasance. The greater the number of portals, the greater the risk that portal operators themselves may engage in fraud, or enable fraud.

Table 7: Threats of fraud, source: Cornell and Luzar (2014), p. 2-3

Next, Bradford described the possible wrong-doing of intermediaries in particular, as they face a significant risk of liability for fraudulent statements posted on their platforms.¹⁴⁹ Currently, legislations on liability issues do not exist, however, if platforms discover that presented information is fraudulent and do not remove it, it basically is complicit to fraud.¹⁵⁰ Because if platforms spent the slight costs to remove the fraudulent offerings or the fraudulent post harm to money-lenders would have been prevented.¹⁵⁰ In cases when platforms do not know about fraud, or does question whether a post is fraudulent, the intermediary can choose to avoid the costs of investigation by removing the questionable offering.¹⁵⁰ Nevertheless, if platforms are aware of facts which point to fraud and proceed without any further investigation, they have voluntarily chosen to bear the risk of liability. According to Bradford, crowdfunding intermediaries should not be able to knowingly facilitate fraud, but they must be protected from excessive liability if the crowdfunding exemption is going to be practicable.¹⁵¹ Therefore, platforms must take steps to prevent fraud by for example providing publicly accessible communication channels that allow investors to 'communicate with one another and with representatives of the issuer about offerings made available on

¹⁴⁸ Cornell and Luzar (2014), p. 2.

¹⁴⁹ Bradford (2015), p. 408.

¹⁵⁰ Bradford (2015), p. 379.

¹⁵¹ Bradford (2015), p. 373.

the platform'.¹⁵² A clarifying example of what happens when such wrong-doing excesses is Trustbuddy in Sweden. As a follow-up on potential wrong-doing, Cornell and Luzar provide an overview of fraud threats, which are categorised in pre-empted fraud, stillborn fraud, attempt fraud, perceived fraud, backer fraud, backer-creator fraud, and broker/portal fraud (see Table 7).¹⁵³

Despite the extensively described risks in the literature, the opinions about their real impact differ, as the literature provides scattering information about successful fraud cases. While several articles offer critiques and warnings about fraud, none cite any successful fraud cases, according to Cornell and Luzar.¹⁵⁴ But at the same time Luzar criticises the report of the World Bank, which argues that data from the major existing platforms show that no successful fraud has perpetrated through pledge-based platforms, while attempts at fraud have been made but were thwarted by the transparency inherent in crowdfunding: would-be money-lenders asked questions and challenged the fraudulent postings, revealing the frauds and resulting in their removal from funding platforms within 24 hours.¹⁵⁵ Luzar questions the definition of 'fraud' in this context, as 'the type of fraud where people take the cash and flee to the Bahamas is rare, but that does not mean fraud is rare in a more general sense'.¹⁵⁶ Even though only four fraud cases are documented of the 43,193 Kickstarter projects, the question remains how many go undocumented, as Luzar argues.¹⁵⁶ To summarise, the literature clearly describes the many risks involved in FRCF. Information asymmetry is argued as an important factor by all authors.¹⁵⁷ Therefore, the next section elaborates on this particular risk in detail.

2.4.2 Decreasing FRCF's information asymmetry risk

The information asymmetry issue is repeatedly pronounced in FRCF¹⁵⁸, often pointing at the lack of due diligence, with biased or overoptimistic decisions, the lack of risk diversification (imitation risk problems), and lack of content-linked valuable support by the crowd as results.

Firstly, the money-lender may have less adequate professional knowledge or experience of the industry or project to which it will give the money. This leaves the money-lender with an information backlog to the fundraiser. Secondly, for the fundraiser it is difficult to disclose a sufficient amount of information if its money-lenders do lack professionalism and the capacity to interpret the information provided. Thirdly, the fundraiser is responsible for presenting its idea to the crowd with the necessary amount of information provided. No one, unlike traditional fundraising forms, guarantees the security of original ideas, the provided information, etc. Hence, the fundraiser has definitely power over the crowd as it is the only one who can truly access sensible and limited information about the project for which the money is raised. Thus, the fundraiser balances on the playing field of providing enough information for its crowd, but not too much detailed and sensitive information that might result in the crowd not supporting the idea.

The literature on information cascades among investors in entrepreneurial settings differentiates between informed and uninformed investors by distinguishing two categories, institutional vs. retail investors.¹⁵⁹ Equity-crowdfunding is characterised by 1) high risk and uncertain projects that seek finance; 2) typically amateur investors with limited skills and opportunities to perform due diligence and high monitoring costs; 3) no certification mechanisms such as affiliation with prestigious underwriters or venture capitalists; 4) the functioning of the crowdfunding markets relies on the wisdom of the crowd and; 5) the (nick) name of the individual investors is publicly available, making it feasible for investors to interpret the

¹⁵² Bradford (2015), p. 374.

¹⁵³ Cornell and Luzar (2014), p. 2-3.

¹⁵⁴ Cornell and Luzar (2014), p. 3.

¹⁵⁵ The World Bank (2013), p. 44.

¹⁵⁶ Luzar (2013).

¹⁵⁷ James (2013).

¹⁵⁸ Schwienbacher and Larralde (2010).

¹⁵⁹ Vismara (2015), p. 29.

signal provided by their behaviour.¹⁶⁰ This lively updated information facilitates the rapidity and their size of informational cascades.¹⁶⁰

The results may be several forms of moral hazard, which decrease by several investment rounds (enabling the money-lenders to make decisions based on achieved milestones and new information¹⁶¹) in traditional financing ways. However, in crowdfunding, the total target is obtained before execution of the project starts, making it unable for money-lenders to access and evaluate project achievements at a later stage. Additionally, 'wisdom of the crowd' and 'bad lemon' problems (will be explained in chapter 3) may arrive as well. Nevertheless, preventing moral hazard and bad lemon problems, as well as lowering the level of asymmetric information would help reduce all of possible consequences of the above mentioned risks.¹⁶²

In order to decrease the described risks and problems, the World Bank argues the importance of ecosystem trust between entrepreneurs, funders and customers.¹⁶³ Also, facilitating conversations between industry participants and thinking socially are argued by Luzar to increase such trust.¹⁶⁴ Moreover, Friesz argues that the incorporation of a stronger investor education mechanism into the regulations can achieve the appropriate balance between investor protection and capital formation.¹⁶⁵ Education is useful, because disclosures are only useful if money-lenders know how to use them; therefore, stronger education mechanisms are needed because investors are left to make investment decisions completely on their own in crowdfunding.¹⁶⁶ This is concerning because many investors are unaware of the need to diversify investment and the risks associated with equity investing.¹⁶⁷ A good example is the fact that only about 4% of Americans having the skills to compare credit offers; how will they ever effectively select among crowdfunding offers in that case?¹⁶⁸

Next, the World Bank provides several techniques to mitigate FRCF risks, which are no risk mitigator, FRCF regulation, government oversight, regulated crowdfunding portals, background checks, mandated disclosures, social network, investor caps and education, and mandated reporting; from high impact to mitigate risks to low impact to mitigate risks, respectively. The development of a process that comprises a number of techniques may be possible to significantly reduce risks to investors and entrepreneurs.¹⁶⁹ Therefore, such techniques may be considered in totality rather than individual recommendations as a means to detect 'bad actors'.¹⁶⁹ A schematic overview of the World Banks' protective mechanisms is provided in Table 8. Nevertheless, the issue of fraud protection, on information asymmetry in particular, has transformed the process of legalising equity-crowdfunding (and loan-crowdfunding) crowdfunding into a gruelling, complex and contentious process – as regulators, industry stakeholders and special interests wrangled over new rules to protect money-lenders from fraud.¹⁷⁰

Summarised, this chapter provided a literature review beginning with the basics of crowdfunding and its complexity to steer or control the practice cross-border due to its nature and newness. Secondly, the existing Securities Directives and Credit Directives are reviewed and their possible applicability to FRCF is assessed. Thirdly, the new CMU plans are described as well as the way FRCF fits in these plans due to its relationship-based lending. Finally, the general risks of FRCF are described, the possible wrong-doing of actors as a consequence of these risks, the information asymmetry risk in particular, and the actions that can be taken to mitigate this information asymmetry risk. The next chapter elaborates on the information

¹⁶⁰ Vismara (2015), p. 30.

¹⁶¹ Bergemann and Hege (1998).

¹⁶² Akerlof (1970); Stiernblad and Skoglund (2013), p. 15.

¹⁶³ Luzar (2013); The World Bank (2013).

¹⁶⁴ Luzar (2013).

¹⁶⁵ Friesz (2015), p. 133.

¹⁶⁶ Siegel (2012), p. 796; Friesz (2015), p. 146.

¹⁶⁷ Black and Gross (2005), p. 37; Friesz (2015), p. 147.

¹⁶⁸ Barnard (2009), p. 227; Friesz (2015), p. 147.

¹⁶⁹ The World Bank (2013), p. 47.

¹⁷⁰ Cornell and Luzar (2014), p. 1.

asymmetry risk by clarifying how Modern Corporation and Agency Theories can explain the impact of the information asymmetry risk for and how this risk should be tackled.

Actor/type	Risk	Rationale	Mitigation tactic
1. Business	Fraud	The securities markets have examples of fraud	<ul style="list-style-type: none"> - Background checks for issuers; - Mandatory auditing, financial disclosures and business reviews; - Requiring all-or-nothing financing (prevents fraudsters from raising money and then disappearing when donors ask difficult questions); - Restricting or monitoring social media communication about offerings; - Requiring all crowdfund raising to take place on portals that are registered with a national regulatory body that oversees securities; - Providing investor education to learn how fraud has been perpetrated in the past so that investors can identify it in future; - Mandatory holding periods to prevent pump-and-dump schemes.
2. Business	Failure	Crowdfund investments offer no guarantee of return	<ul style="list-style-type: none"> - Educating investors about portfolio diversification as a means to prevent total loss of investment(s).
3. Business	Anti-money laundering	Using businesses as a cover for illegal money transfers	<ul style="list-style-type: none"> - Placing caps on amounts that may be raised in specific time periods; - A 'cooling off period' between reaching the funding target and funds transfer to allow for further diligence by investors and regulators.
4. Business	Sector risk	Crowdfunding has had the most traction in consumer products and extensions of popular brands or games	<ul style="list-style-type: none"> - Build on small successes in areas like science and energy; - Raise small amounts of capital to show market interest and customer validation; - Consider leveraging the crowd for only a small part of the overall capital raise to identify risk and de-risk the bigger investment.
5. Business	Subsequent funding failure	Bringing on crowdfund investors creates a more complicated investor table that may deter subsequent investors	<ul style="list-style-type: none"> - Consider the use of a Special Purpose Vehicle (SPV) to group all crowdfund investors into one voting group to ease communication and voice; - Offer to buy out crowdfund investors at subsequent rounds of financing at the current price.
6. Investor	Investor liquidity & losses	Crowdfunded stocks are not liquid, businesses do fail and investors can lose their investments.	<ul style="list-style-type: none"> - Investment limits for non-accredited investors; - Allowing for crowd vetting and crowd diligence to discuss the merits/risks of the offering in a public manner; - Promote the creation of secondary markets after a 12-month holding period where shares may be traded based on supply and demand.
7. Entrepreneur	Lack of issuer experience	Entrepreneurs do not always have all the experience needed to build, run, and raise capital for a business	<ul style="list-style-type: none"> - Create education programs about how to build a business; - Create education programs about how to raise money from the crowd and follow through with a plan once funded; - Requiring the participation of either a securities broker/dealer, an attorney or accountant.
8. Regulatory	Regulatory & compliance risk	Regulatory bodies may resist or reject the argument that crowdfunding is an appropriate and effective method of financing early-stage companies	<ul style="list-style-type: none"> - Work with local governments prior to offering crowdfund investing; - Engage with local regulatory and policy constituents to build crowdfunding frameworks.
9. Industry	Market rejection	Investor community might not have an appetite for this new emerging asset class	<ul style="list-style-type: none"> - Leverage the media to share success stories of businesses that have been successful with crowdfunding investing and jobs that have been created; - Share early financial engagement stories of investors who have backed crowdfunded companies and why; - Offer crowdfund investments in tandem with more traditional investments to act as an honest broker.

Table 8: Protective mechanisms against potential fraud, source: The World Bank (2013), p. 48-49

3. Theoretical framework

This section explains the disagreement between the existing models (and definitions) in the sector, but clarifies the necessity of agreement in order to stimulate market growth and to develop relevant policies. Subsequently, the separation of ownership and control in FRCF is described, after which the rights of the shareholders have been reduced. In this context, information asymmetry plays an important role and therefore should be decreased in order to increase shareholders' involvement and commitment. Finally, the importance of decreasing the information asymmetry through extensive information provision and consistency in the sector to provide clarity for all participants will be explained. To conclude, a transparency balance and a level-playing field will be needed to boost the growth of the crowdfunding market. The regulation process to do so exists of risk awareness/understanding in the short-term and the development of a flexible European legal framework that takes into account the modularity of FRCF in the long-term.

3.1 The meaning of crowdfunding

The literature review showed that researchers' opinions about the existing FRCF forms and models differ, due to the fast growth of crowdfunding, including the continuous development of new modular forms and models with different focuses. Hence, FRCF has entered our lives and the financial sector not very long ago – in its current shape – enabling researchers and practitioners to reveal the possibilities of this alternative financing form. FRCF has recently become an interesting funding option for businesses and individual fundraisers, and an investment possibility with a considerable fun-factor for money-lenders. Nevertheless, FRCF may be a temporary hype, or a paradigm shift in the economy or financial revolution. It is too early to make such a conclusion, nevertheless, it is clear that FRCF fits within the 21st century mantra in which sustainability and a sharing-economy are trending. In line with this, FRCF fulfils a third function, namely marketing, in which the 'know your customer' and 'the customer is the brand' principles are increasingly important. Considering the FRCF developments so far, it has resulted in different forms (loan/equity-crowdfunding, peer-to-peer, etc.), models (at micro level, co-investments, etc.), and focuses (national, sector specific, etc.).

However, to make such a nascent FRCF market a successful part of the financial sector, consensus should be reached on its existence and its content in the first place. If agreement on different forms and models is reached, the market will be able to grow significantly as policy-makers and practitioners know where they have to focus on. Until agreement is reached and FRCF's different forms and models are acknowledged, the market has limited space to grow. Therefore, proposition 1 has been developed:

P1: *Good crowdfunding policy can only be developed when consensus is reached on existing crowdfunding forms and related definitions and the interpretations of such definitions among policy-makers and practitioners.*

Acknowledgement of FRCF's diversity and consensus on the definitions will create clarity and focus, so policy-makers, practitioners, and researchers will be able to develop a consistent and sustainable FRCF sector. Thus, the scientific community and practitioners will benefit from a defined viewpoint as a reference for future work. Additionally, if agreement on the definitions is reached, attention can be paid to solve the information asymmetry risk which exists between money-lenders and fundraisers, in order to make the FRCF environment safer. To do so, the 'power' of money-lenders as regards their influence and the received information needs to be clarified. Therefore, the next section explains the increased amount of money-lenders and their subsequent limited rights regarding their relationship with the fundraisers, by means of Modern Corporation theory.

3.2 Money-lenders' ownership, control and power (rights) – Modern Corporation Theory

The past century has shown three trends that fundamentally changed the character of the economy, which are concentration of economic power, dispersion of stock ownership, and separation of ownership and control.¹⁷¹ The latter two impact the crowdfunding sector since the crowd is large and the power over ownership has been transferred from money-lender to fundraiser. It has to be noticed that bondholders are included with the stockholders as part owners in this context.¹⁷² Therefore, the next subsections explain the reduced power of money-lenders, due to the increased amount of owners and the separation between ownership and control and the subsequent control over that ownership, respectively.

3.2.1 Dispersion of stock ownership – The unlimited crowd as shareholder

The amount of owners (money-lenders) in FRCF has multiplied, resulting in the wealth of innumerable individuals being concentrated into huge aggregates whereby control over this wealth has been surrendered to a unified direction – the fundraiser (e.g. the management of the company invested in).¹⁷³ Due to the investor increase, no individual holds a controlling financial interest in a crowdfunded project.¹⁷⁴ Hence, wealth is constantly drawn together into aggregations of increasing size, while at the same time control is thrown into the hands of fewer men.¹⁷⁵ Therefore, no single individual holds an important proportion of the total ownership, while the largest stockholding represents a small proportion of the total ownership and the number of total owners continuously increases. The outcome of this separation of ownership and control is ownership of wealth without appreciable control, and control of wealth without appreciable ownership.¹⁷⁶ Now, control is a function on its own and can be defined as a wide variety of kinds and conditions of control situations that derive wholly or partly from ownership, as those who have the actual power to select the management really have the power.¹⁷⁷ In line with this, a difference can be made between legal (through e.g. contracts) and factual (through e.g. real executive power) control. Thus, the situation is drawn that a crowdfunded project has no dominant owners and control over such a project is maintained merely apart from ownership.¹⁷⁸ 'Joint control' is the result, as neither the owner has control over his ownership, nor does the owner has influence over the total crowdfunded project, because management has the control. Therefore, control is not a clearly defined phenomenon to an individual, but an element in the organisation which is broken up and appears in various forms; it may be held to a greater or lesser extent by a wide variety of individuals.¹⁷⁸ Hence, the power of the individual shareholder has significantly reduced in FRCF.

In addition, the internet, as communication medium in FRCF, has simplified reaching the (foreign) money-lender. While the internet could possibly function as a communication channel to create commitment among money-lenders, it is merely used to include a crowd as large as possible, and thus to increase the amount of money-lenders. But without proper communication to the crowd, this may lead to a distance between the fundraiser and its financiers – the crowd. This distance increases even further because platforms and fundraisers are experimenting with creative solutions, as there is a lack of sufficient regulation in the sector while at the same time money-lenders do not understand the platforms' way of working. One of the consequences of such innovative solutions is that crowdfunding is increasingly part of a bigger funding project, through which the amount of shareholders increases even further, with as result even more limited rights of the shareholders. Consequently, the distance between the fundraiser and the

¹⁷¹ See Berle and Means (2009), p. xlii.

¹⁷² Berle and Means (2009), p. 113.

¹⁷³ Berle and Means (2009), p. 4-5.

¹⁷⁴ See Berle and Means (2009), p. 13.

¹⁷⁵ Berle and Means (2009), p. 18.

¹⁷⁶ Berle and Means (2009), p. 66.

¹⁷⁷ See Berle and Means (2009), p. 67.

¹⁷⁸ Berle and Means (2009), p. 111.

crowd increases as the fundraiser has to spread his attention to other funding institutions (be it a bank loan, Business Angel, etc.) as well. Therefore, proposition 2 has been developed:

P2: *The increase of money-lending participants in crowdfunding and the internet as new communication medium and channel reduce the rights of money-lenders while at the same time the distance between those money-lenders and fundraisers increases.*

The increase of shareholders may become problematic in the long-term. A society in which businesses are carried under the ultimate control of a handful of individuals – and thus where the economic power is in the hands of the few persons who control that company – is a tremendous force which can harm or benefit a multitude of individuals, affect whole districts, shifts the currents of trade, bring ruin to one community and prosperity to another.¹⁷⁹ Especially now the crisis is disappearing, the crowdfunding sector cannot sustain any scandals if it wants to become a successful financing option.

3.2.2 Shareholder rights – The crowd as committed participants

Shareholders have traded their legal position of private ownership in the role of recipients of capital returns many years ago.¹⁸⁰ Therefore, shareholders are often uninterested in the day-to-day affairs of the company nowadays. Additionally, those interested in the day-to-day affairs – the management (e.g. the fundraiser) – have the ability to manage the resources to their own advantage without effective shareholder scrutiny. Therefore, the concentration of economic power has built up in the hands of the management, while the separation of ownership and control has released management from the requirement to serve the stockholders.¹⁸¹ Subsequently, the condition evolves where interests of owner and manager may, and often do, diverge¹⁸², and by which the owners have almost no instruments to steer the management. Thus, the function of having power over the crowdfunded project has become separated from the function of having interests in that project.¹⁸³ The money-lender is left with a set of legal and factual *interests* in the company, while the fundraiser has control are in the position of the legal and factual *powers* over those interests. The problem arises that that there is no justification that those in control of the company will also choose to operate it in the interests of the owners. Whether they will do so depends on the degree to which the self-interest of those in control may run parallel to the interests of ownership and, insofar as they differ, on the checks of the use of power which may be established by political, economic, or social conditions.¹⁸⁴

The above drawn situation brings six aspects relevant to FRCF. Firstly, the position of ownership has changed from active to passive agent, in which ownership of actual properties is replaced by pieces of paper representing a set of rights and expectations with respect to the company.¹⁸⁵ But control over, or responsibility of, the company in which he has an interest is very little. Basically, the owner has become practically powerless through his own efforts to affect the underlying property.¹⁸⁵ Secondly, the spiritual values that formerly went with ownership have been separated from it as there is no physical property anymore that is capable of being shaped by its owner to bring the owner direct satisfaction apart from the income the owner yields directly.¹⁸⁵ Hence, there is little incentive for the owner to be committed and to take responsibility at the moment. Thirdly, the value of an individual's wealth has come to depend on forces entirely outside himself and his own efforts¹⁸⁶, as management has taken the power and control over ownership of the shareholder. Fourthly, wealth is less and less in a form which can be employed directly by its owner as it is incapable of direct use to create a subjective value – other than the market value – to the owner.¹⁸⁶ Sixthly, the 'owner' of industrial wealth is left with a mere symbol of ownership while the power,

¹⁷⁹ Berle and Means (2009), p. 46.

¹⁸⁰ Berle and Means (2009), p. ix.

¹⁸¹ Berle and Means (2009), p. xlvii.

¹⁸² Berle and Means (2009), p. 7.

¹⁸³ Berle and Means (2009), p. 112.

¹⁸⁴ Berle and Means (2009), p. 113-114.

¹⁸⁵ Berle and Means (2009), p. 64.

¹⁸⁶ Berle and Means (2009), p. 65.

the responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control.¹⁸⁶

In line with the above drawn problems, the desire for personal profits is the prime force motivating control according to Berle and Means, resulting in differing interests of control to those of ownership. Therefore, the managers can serve their own pockets better by profiting at the expense of the company, than by making profits for it because that is a practically clear gain to the persons in control when realising that the interests of a profit-seeking control runs directly counter the interests of the owners.¹⁸⁷ Finally, the opposing groups – ownership on the one side and control on the other – will move further away from each other resulting in a management capable of perpetuating its own position.¹⁸⁸ Consequently, the balance between the need of the FRCF project on the one hand and the desires and opportunities of the money-lender on the other is key.¹⁸⁹ But for the tens or even thousands of owners in crowdfunded projects, individual initiative no longer exists as their group activity on a scale is so large that the individual has dropped into relative insignificance.¹⁸⁸ Shareholders were supposed to be capitalists that are reasonably able to protect themselves. But the fact is that they do not toil or spin to earn reward; they have become – intentionally or unintentionally – beneficiaries by position only.¹⁹⁰ As solution, money-lenders' power over their ownership may be increased by protective rules (legal control) and increased involvement and commitment (factual control) in the invested projects. Therefore, proposition 3 has been developed:

P3: *Money-lenders rights and influence should be increased by protective rules and tight involvement in, and commitment to, the crowdfunding project invested in, in order to accelerate the additional marketing function of crowdfunding, with crowdfunding market growth and success as ultimate goal.*

If money-lenders' rights are too unsatisfactory, they will have no incentive to provide money to certain projects or to keep involved in the long-term, therefore FRCF will only become interesting as a sustainable alternative financing option if money-lenders become more involved. The close involvement of money-lenders increases the possibility to monitor their investments or loans and subsequent returns. Additionally, when involvement increases, the internet can accelerate the share of projects among a large crowd and make even more money-lenders committed through social pressure at online social networks. This may even result in money-lenders acting as ambassadors for the projects, by trying to get other investors involved as well. The ambassadors-function increases the power of money-lenders, as they have more influence over their own returns. To clarify; if a bank manager – from whom a baker has obtained a loan – buys bread at that bakery, the bakery's assets are not influenced other than in the form of more sales. But if a FRCF money-lender buys bread at the bakery in which he has invested, the bakery's sales grow, but in the end also the money-lenders' own interest. And due to the absence of a secondary market, money-lenders cannot easily exit or make the investment liquid, resulting in a vicious circle in which the money-lender will try to increase the sales of the bakery by acting as an ambassador for the sake of his own interest. Obviously, money-lenders will have an opportunity to exit in such a case when a secondary market has been developed. However, this latter aspect is out of the scope of this study as this is not the case at the moment.

Concluding, the involvement and commitment of money-lenders seems to be necessary for FRCF to be a sustainable, innovative, and disruptive financing option. The ambassadorship fits within the current lifestyle in which the sharing-economy, sustainability and the Y-generation which constantly wants to be innovative and disruptive, is key. But even though money-lenders regain part of their power through involvement and commitment, the problem of different interests between the money-lender and fundraiser remains. This actually becomes a problem when the money-lender will be incapable to truly control the management.¹⁹¹ As a solution, traditional ways of funding (e.g. venture capitalists) use

¹⁸⁷ Berle and Means (2009), p. 114-115.

¹⁸⁸ Berle and Means (2009), p. 116.

¹⁸⁹ Berle and Means (2009), p. 62.

¹⁹⁰ Berle and Means (2009), p. xxxv.

¹⁹¹ Stiernblad and Skoglund (2013), p. 16.

sophisticated contracting, pre-investment screening and post-investment monitoring to mitigate goal conflicts between money-lenders and fundraisers.¹⁹² Nevertheless, such instruments are not generally accepted or applied in most crowdfunding situations nowadays. The result is a typical principal-agent problem (in which the principal has delegated a task to an agent, but is not able to control the delegation) which often arises due to goal conflict and information asymmetry between the money-lender and fundraiser. The reasons for this are the large distance between both actors, the anonymous relationship due to the internet as medium, the separated functions of ownership and control (factual control), and the limited rights due to a lack of control instruments (legal control). If these aspects are not tried to be reduced it may result in moral hazard (in cases where the fundraiser knows more about its intentions than the money-lender, while the latter is paying the consequences of the risks taken by the former) and adverse selection. Therefore, the next section explains the importance of clear and structured information provision to the money-lender in order to reduce the information asymmetry risk between both actors, by means of Agency Theory.

3.3 Structuring the information provision - Agency Theory

This section explains the relationship between the money-lenders (principals) and fundraisers (agents) regarding the information asymmetry between both actors. Information asymmetry – the claim that agents possess more information than their principals¹⁹³ – allows agents to be unresponsive to principals¹⁹⁴, and since the previous section clarified the limited power of money-lenders, unresponsive principals are not desirable. Even when both actors have similar goals, conflict may arise over the use of resources to fulfil the desires. Thus, money-lenders experience difficulty in motivating fundraisers to act on their behalf, as both parties have different interests and asymmetric information.

3.3.1 Transparency and a level-playing field

Information asymmetry increases the distance between the money-lender and fundraiser and decreases the power of the former, as described in the previous section. Therefore, the rights and influences of money-lenders should be increased in order to get the money-lenders more involved and committed to the crowdfunded project. However, the lack of a clear definition developed by the scientific community or by law has caused an inconvenient and chaotic crowdfunding scene without clear or structured regulation in the sector. Not only consumers are confused, but also the platforms and fundraisers are principally out of control when acting in the crowdfunding market. The obscurity obviously does not benefit growth of the sector as money-lenders may be withhold to invest as there are few protection measures, less certainty and consistency – next to the fact that investments in general are not safe.

Besides, the lack of clarity and rules regarding crowdfunding may also lead to platforms and fundraisers act in a, for the money-lenders, unsafe or dangerous way – as the former actors are not bound to rules. The result may be moral hazard in which the fundraiser – with an information advantage – has an incentive to behave inappropriately from the perspective of the money-lender. There are several forms of moral hazard regarding crowdfunding. Firstly, there is the risk of unscrupulous fundraisers taking advantage of the disperse crowd by making decisions about how much risk is taken while the money-lenders bear the costs when things go badly.¹⁹⁵ Secondly, fundraisers can value equity inaccurately in equity-crowdfunding. Because equity value is often the only information provided to the crowd, money-lenders are less able to price the company and thus have to rely on the price offered by the fundraiser.¹⁹⁶ Thirdly, there is a

¹⁹² Kaplan and Strömberg (2001); Stiernblad and Skoglund (2013), p. 16.

¹⁹³ Waterman and Meier (1998), p. 183.

¹⁹⁴ Waterman and Meier (1998), p. 177.

¹⁹⁵ Krugman (2009), p. 63; Stiernblad and Skoglund (2013), p. 14.

¹⁹⁶ Stiernblad and Skoglund (2013), p. 14.

difference between risk tolerances as the fundraiser is less governed and monitored than in a typical financing relationship, they may take more risk than the crowd is willing to pay for.¹⁹⁶ In crowdfunding, the crowd has less incentive to actively govern and monitor the fundraiser¹⁹⁶, due to the relatively small donations and the social influence on the wisdom of the crowd aspect. Moreover, the crowd may share a common interest in monitoring and governing the fundraiser, but may lack the incentives to do so because no individual investor is prepared to bear the costs of monitoring and governance.¹⁹⁷

Thus, clarification of the FRCF market will boost the growth of the many possibilities the concept brings for all participants. The information asymmetry will only decrease when consistency in the information provision and the approaches taken by platforms and fundraisers become more similar. Next to that, structured information provision will decrease the social influence effect of the Wisdom of the Crowd theory, of which the latter refers to the aggregated individual intelligence of a crowd, making them wiser and more efficient than individuals.¹⁹⁸ A crowd can guide other money-lenders in which projects are the best risks, as money-lenders are savvy enough to know *when* to follow the herd.¹⁹⁹ Therefore, money-lenders' powerful investment tool are the observations of others' lending decisions²⁰⁰, which leads to good investment outcomes.²⁰¹ However, if 'the crowd' takes others members' (investment) decisions into consideration and are impressed that they are more knowledgeable, 'the crowd' may be exposed to the 'social influence effect', also referred to as herd behaviour.²⁰² This has a negative impact on the wisdom of the crowd, as individuals influence each other's decisions when things are purchased or invested for example.²⁰³ This effect narrows the diversity of opinions and thereby reduces the wisdom of the crowd as a whole.²⁰⁴ Communication channels through which the crowd can virtually come together to disseminate and share information may be useful in this context, in order to develop clear, consistent and structured information provision. However, such channels can also be used by the fundraiser in its own favour by developing its investors and funnelling them into a single forum.²⁰⁵ Yet these very enhancements also carry the risk that they will facilitate fraud by providing a ready-made audience for anyone seeking to disseminate inaccurate information about an issuer.²⁰⁵ In order to prevent the above described problems, information provision should be transparent, structured, and consistent among all FRCF actors. Therefore, proposition 4 has been developed:

P4: *Money-lenders' rights and influences should be increased by decreasing the information asymmetry between the money-lender and the fundraiser through the development of a good transparency balance (including clear information provision) and a level-playing field among all participants.*

A good balance between transparency and the development of a level-playing field will decrease the social influence effect and moral hazard problems that may arise due to information asymmetry as money-lenders will be able to inform themselves and make considered investment decisions. Furthermore, adverse selection of projects will be decreased when the information provision increases and information asymmetry decreases. Without proper information provision, money-lenders may be exposed to an adverse selection of projects on platforms.¹⁹⁷ This may result in a 'bad lemons' problem on the long-term as high information asymmetry may push high quality projects out of the market to the extent that only low quality projects are left.²⁰⁶ But, if the fundraiser is unable to effectively signal the quality or need of their project and the money-lenders are therefore unable to discern between high and low quality projects,

¹⁹⁷ Stiernblad and Skoglund (2013), p. 15.

¹⁹⁸ Surowiecki (2005), p. 4-5; Brabham (2008); Howe (2008)

¹⁹⁹ Zhang (2013), p. 30-31.

²⁰⁰ Zhang (2013), p. 31; Brown (2014), p. 2.

²⁰¹ Zhang (2013), p. 31.

²⁰² Salganik and Watts (2008); Stiernblad and Skoglund (2013), p. 18.

²⁰³ Salganik and Watts (2008), p. 338.

²⁰⁴ Lorenz et al. (2011); Stiernblad and Skoglund (2013), p. 18.

²⁰⁵ Brown (2014), p. 3.

²⁰⁶ Akerlof (1970); Stiernblad and Skoglund (2013), p. 15

fundraisers with high quality projects will abandon the market because the crowd is unwilling to give the fundraisers a fair price for the project.¹⁹⁷ Moreover, if the money-lender lacks sufficient information to differentiate between high and low quality projects, they may pick the wrong ones (e.g. low quality projects) to support, decreasing the rate of crowdfunding success of high quality projects. A solution is to screen all projects incoming in platforms, but platforms often work as a market place only and therefore projects are not screened. However, if such problems are not addressed, the market of high quality projects on a crowdfunding platform will be depleted²⁰⁷ and no cross-border or secondary market will be able to develop.

3.3.2 Private and public cooperation

As shown in the previous section, the reduction of information asymmetry between the money-lender and fundraiser can thus be achieved by increasing transparency and a level-playing field, so that both crowdfunding participants have clarity about how they should operate to create a sustainable crowdfunding sector. Since the platforms and fundraisers are in control of the information provision, the private sector itself should be responsible for the creation of transparency as well as a level-playing field for all participants. However, the past years have shown that they will not be able to do that themselves, because the function of platforms, their way of working, the fundraisers and their projects presented, and the money-lenders are so diverse, that they will probably not be able to solve it themselves and to create a well-functioning level-playing field. Therefore, the public sector (e.g. regulators) should steer and facilitate this process of the private sector, so that close cooperation within the sector develops.

Through close cooperation between the private and public sectors, policy-makers and practitioners can develop a regulation structure that fits the current needs of the market and takes into account the actors involved and their diversity of crowdfunding models. But since there is also a great diversity regarding the crowdfunding market across Europe, it is best that the regulatory framework will be developed at European level. This will leave the policy-makers at European level the possibility to structure the market by steering it through simple rules, so that the nascent crowdfunding market will be able to grow in each Member State to enable the development of cross-border trade. Therefore, the following proposition is developed:

P5: *A level-playing field and transparency can best be developed through the efforts of the crowdfunding market itself (private sector), but the opportunity to do so should be facilitated by the government (public sector). Therefore, the EU should take the lead by steering the crowdfunding market into a certain direction without developing too extensive legislation discouraging market growth.*

3.3.3 Short-term and long-term vision of the crowdfunding market

The private and public sectors together will be able to develop a structure of loose rules to create a clear overview of the crowdfunding market for all actors involved in the short-term. These rules should not be too detailed or rigid, as that may decrease market growth as it is still in a nascent state. To do so, there are two sides of the information provision aspect that needs to be highlighted. First, from a platform and fundraiser perspective: the rules developed at European level should decrease the information asymmetry between all European actors involved, by steering the MSs into a single direction in which they can develop their own legislation in line with the national financial cultures. In this stage, policy-makers should make clear to all actors that FRCF – especially equity-crowdfunding – is just not safe as investments are always risky. However, it can be tried to continuously make it as safe as possible, but it will be valuable if participants really would understand the fact that investing is just not safe. Therefore, and second, from a money-lender perspective: work needs to be done at the financial illiteracy and education aspects too. This focus should be put on risk awareness and understanding towards consumers, among others, by means of the guidelines. The approach of decreasing the information asymmetry from two sides will increase the

²⁰⁷ Stiernblad and Skoglund (2013), p. 15; Akerlof (1970).

development of a level-playing field, as the different actors involved will become more equally informed or at least will have a more equal experience in the sector.

When the measures for the nascent market have been implemented, policy-makers should start focussing on the creation of a single European legal framework when the market is mature²⁰⁸, so that a basis for a single approach towards FRCF in all MSs will be created. If the FRCF market has grown into a stable environment only, the European FRCF can be made as safe as possible for money-lenders. Nevertheless, FRCF earns the possibility to grow into a trustworthy market, as it brings many benefits according to previous research. However, a balance should be found between risk awareness and understanding and the creation of a legal European crowdfunding framework to use its full potential. Therefore, proposition 6 has been developed:

P6: *The EU should support growth of the crowdfunding sector by facilitating MSs with a framework of simple rules in which the focus is laid on a balance between creating risk awareness and understanding among consumers in the short-term and building a European-wide legal structure in the long-term.*

3.3.4 Flexibility and modularity

If the FRCF market is mature and European policy-makers try to develop a legal framework, the diversity of forms and models, as well as their different working methods, should be taken into account. It is likely that the amount of creative, innovative, and disruptive models will increase in future. Besides, the then existing rules should be recognised when developing a more extensive legal framework, so that rules do not contradict and are not redundant. Therefore, flexibility should be warranted when policies will be developed. Moreover, the legal framework needs to be agile and lean, so that the modularity of FRCF is taken into account any point in time. Thus, policy-makers should focus on the existing and expected alternative financing forms of crowdfunding, as well as the possibility that existing forms will change in the future. Concluding, a balance should be found between a single legal framework and the flexibility to take the modularity into account by working in an agile way. Therefore, proposition 7 has been developed:

P7: *The EU should take care of adopting flexible policies – focused on risk awareness and understanding among consumers in the short-term – so that policy-makers will be able to develop a policy and legal structure for FRCF in a lean way on the long-term, through monitoring the market growth and the growing modularisation of FRCF forms/models closely to consequently adapt existing policies and adopt new policies when necessary.*

If FRCF's modularity and flexibility are taken into account, the FRCF will be able to grow, in order to become a successful alternative financing option for SMEs and other individuals which want to obtain funding in a cheaper and easier way compared to traditional financing options.

To summarise, the reduced power of money-lenders through the increase of shareholders and the separation of ownership and control is clarified. Subsequently, to increase market growth, protective rules should be increased and money-lenders' involvement should be stimulated to reduce information asymmetry in which internet plays a key role. To increase structure in the sector, transparency should be increased and a level-playing field should be created, with a secondary and cross-border market as result. The private sector should be responsible for information provision (to increase transparency and develop a level-playing field), in cooperation with the public sector, which should steer and facilitate this development with simple rules in the beginning. In this context, the public sector should focus on risk awareness and understanding in the short-term (nascent market) and a more extensive legal framework in the long-term (mature market). Taking into account the modularity of different crowdfunding models and forms is important, as well as preserving the flexibility to develop policies and laws in an agile and lean way when the market matures.

²⁰⁸ In between a 500-800 billion crowdfunding market according to the regulatory or supervisory authority respondents.

4. Methodology

4.1 Research design and techniques

This research is a qualitative case-study study – which is the most popular method for ‘how’ questions²⁰⁹ – to explore the crowdfunding field under study.²¹⁰ A case-study is useful when a contemporary phenomenon is studied within a real-life context, and therefore applicable as the case in this research is the (Dutch) FRCF sector.

Firstly, a literature review has been conducted, of which the findings were used for the development of propositions based on the Modern Corporation and Agency Theories. The use of literature and policy documentation as research technique has many advantages, such as its stability (can be reviewed repeatedly), unobtrusiveness (not created as a result of the case-study), specificity (can contain the exact names, references, and details), and broadness (can cover a long span of time, many events and settings).²¹¹ The units of analysis of this review are FRCF participants, the FRCF sector as a whole, and policy-making at EU level, resulting in an embedded case-study design, as more embedded units of analysis are analysed within the single case.²¹²

Secondly, individual interviews are conducted through which information is retrieved about the functioning of the current FRCF market according to Dutch participants (and a few other European participants) and the desirable design of FRCF at EU level. The use of investigative interviews as technique is useful in the topical study conducted in this thesis²¹³, as it targets directly on the case-study topics and is insightful as it provides explanations as well as personal views.²¹¹ In line with this, semi-structured open-ended interviews are used in particular, because they provide the opportunity to gain in-depth knowledge about the subject and relationship, and leaves the possibility to ask additional questions if necessary.²¹⁴ Thus, the units of observation are individual actors of FRCF (see respondent list in Appendix V).²¹⁵ Concluding, the interviews are transcribed with TranscriberPro and coded with Atlas TI 7.0. The output of Atlas TI 7.0 is used for the analysis.

4.2 Data collection

Interviews are one of the most used techniques to collect data in case studies²¹⁶, but are hard to conduct and interpret well. Because, for semi-structured open-ended interviews it is important – as interviewer – to ask good questions, be a good listener, stay adaptive, have a firm grasp of the issues being studied, and avoid biases to conduct research ethically.²¹⁷ To be well prepared the author gained sufficient knowledge to conduct interviews before the interviews started, by means of experience obtained in previous interviews for a Bachelor thesis and reading the ‘Qualitative Interviewing’²¹⁸ and ‘Case-Study Research’²¹⁹ books.

While structured interviews provide the opportunity to standardise questions and the recording of answers to minimise differences between the respondents²²⁰, non-structured interviews provide the opportunity to gain in-depth knowledge about the subject matter; in this thesis a middle-way is found: semi-structured interview to have both advantages. In addition, the interview patterns ‘Main Branches of

²⁰⁹ Yin (2014), p. 32.

²¹⁰ Babbie (2010), p. 309; Shadish et al. (2002), p. 500-501.

²¹¹ Yin (2014), p. 106.

²¹² Yin (2014), p. 50.

²¹³ Rubin and Rubin (2012), p. 32.

²¹⁴ See R. Betting (2015), Methodological Essay about Methodological challenges regarding Open-ended Interviews (3 July 2015).

²¹⁵ Yin (2014), p. 92.

²¹⁶ Yin (2014), p. 110.

²¹⁷ Yin (2014), p. 73.

²¹⁸ Rubin and Rubin (2012).

²¹⁹ Yin (2014).

²²⁰ Bryman and Bell (2003).

a Tree' and 'River and Channel' are used to structure the interviews, as sufficient knowledge was already acquired by the literature review to develop several main questions regarding sub-topics of the larger research question²²¹, while at the same time some respondents knew more about particular aspects, resulting in only talking about those subjects.²²¹ In combination these patterns appear to be very useful to ask questions of similar depth and length (thus balanced), while it is possible to create depth at one or few particular issues, as most respondents differ in their areas of expertise (heterogeneous respondent group).²²¹

To assure the quality and diversity of the information retrieved from the respondents, respondents that have first-hand experience in the subject and which have different backgrounds and represent different standpoints²²² were invited for an interview in October and the beginning of November 2015. The respondents were divided in groups: platforms, fundraisers, investors (also money-lenders included), relevant FRCF organisations, and regulatory or supervisory authorities (see Appendix V). Hence, most relevant actors in the Dutch FRCF field (+ a few other European actors) are included as respondents and were contacted by email to make appointments for face-to-face interviews. Some people referred me to their colleagues in cases where those colleagues had more relevant experience in the field. In addition, in each interview is searched for existing gaps or missing information to demonstrate thoroughness and in order to create a complete picture.²²² Furthermore, all interviews are recorded and transcribed, after which they are coded in order to ensure accuracy.²²² Finally, the respondents were asked to go over the transcript to comment on what was missed or misinterpreted in the transcription, or whether they wanted to add something afterwards.²²² In total 18 interviews (60-minutes duration each) have been held until saturation was reached. Saturation is reached between 12-20 interviews when the sample is heterogeneous and when trying to achieve maximum variation.²²³ The 18 respondents have been divided into four respondent groups: platforms (loan and equity platforms), fundraisers, investors, relevant FRCF organisations (crowdfunding lawyers, risk compliance and crowdfunding consultancies, crowdfunding IT developers, etc.), and regulatory or supervisory authorities (relevant ministry, financial markets supervisory authority, central bank, etc.). Additionally, an informal talk has been held with a policy advisor of another Dutch ministry, but this conversation has to be kept confidential and is therefore not included in the data analysis of this research; it only functions as background information for the interpretation of the gathered data. Besides, one of the 18 interviews has been conducted via email due to the travel distance.

In line with the face-to-face interviews, it is assumed that the respondents have given honest answers and true insights as they requested to stay anonymously and made a lot of changes in the transcript – or asked to use particular phrases only as background information – when the transcriptions were sent to them to control the interpretations. Moreover, unfortunately, one respondent even withdraw because the information given was too sensitive for publication, increasing the likeliness of their honest answers.

4.3 Data analysis

Analysing case study evidence is especially difficult because the techniques still have not been well defined.²²⁴ Nevertheless, relying on theoretical propositions derived from the literature and theories used is always a good strategy to conduct a case study.²²⁴ In addition to the propositions derived from the theories, Atlas TI 7.0 has been used to analyse the data. In order to make full use of the software in a correct way, video tutorials²²⁵ were studied in order to get familiar with the software. In addition, an Atlas TI 7.0 software expert has been contacted by email in order to provide answers to some questions. The interview transcriptions of all respondents have been coded inductively resulting in 166 codes and 22 code families

²²¹ Rubin and Rubin (2012), p. 124.

²²² Rubin and Rubin (2012), p. 60.

²²³ Guest et al. (2006), p. 61.

²²⁴ Yin (2014), p. 132.

²²⁵ Video tutorials from: <http://atlasti.com/video-tutorials/>

(see Appendix VI). The quotations linked to the codes, and the codes linked to other codes, were brought into relationship with each other (in Atlas TI 7.0), in cases such relations applied. These relations were finally analysed after which a network of codes was developed. The analysis is conducted by means of this extensive code network. During the analysis, a consideration is made between the codes and quotations of which the content is 'experienced' by the respondent or whether the respondent 'thinks so' or 'has heard so'. The experienced content of the codes and quotations had priority above the others, as the respondent has experienced it himself, making that data more reliable than when respondents have heard things or may think something. Moreover, in order to analyse the retrieved data in a meaningful way and for legibility reasons, the analysis is structured by respondent groups in which the 18 respondents are classified.

4.4 Method limitations/validity problems

Despite the fact that the research methods used in this thesis suited best to the study, there are several limitations to the methods that may bring problems to the validity and the reliability of the research.

Firstly, the use of literature and documentation as research technique contains weaknesses, such as irretrievability (documents can be difficult to find), biased selectivity (if collection is incomplete), reporting bias (reflects unknown bias of any given document's author), and access (may be deliberately withheld).²²⁶ However, through extensive literature search in different sources and databases – with as result 174 references – these limitations are significantly reduced. In other words, almost all available literature and documents are included as there is not that much published yet due to the nascent stage in which the crowdfunding market currently is.

Secondly, face-to-face interviews as research technique has limitations such as bias to poorly articulated questions, response bias, inaccuracies due to poor recall, and reflexivity (interviewee gives what interviewee wants to hear).²²⁶ This is not desirable, but inherent to interviews. These limitations are reduced by sending a preliminary document with guiding questions to the respondents so that they were informed about the content of the interview – it was tried to manage respondents' expectations. Besides, the open-ended questions left room for additional information that the respondents wanted to talk about. Finally, starting with a general question during the interview and leaving the respondent talk until he/she is silent and then asking follow-up questions gives the respondent the feeling that they are not pushed into a certain direction and that they can answer freely in a way that they are comfortable with. Hence, through applying the tools of the 'Qualitative Interviewing' book²²⁷ it is tried to reduce the limitations and possible problems that are inherent to interviewing.

Summarised, this methodology section explained the research design and techniques of this case study. Semi-structured, in-depth, face-to-face interviews have been held with 18 experts from the FRCF sector, which are transcribed and coded inductively, in order to draw the analysis. The analysis is based on the code network derived from the interviews coded in Atlas TI 7.0. The literature provides several limitations to the method and techniques used, but such limitations were reduced as much as possible through the use of correcting measures.

²²⁶ Yin (2014), p. 106.

²²⁷ Rubin and Rubin (2012).

5. Analysis & discussion

5.1 Defining the current FRCF market

5.1.1 *Hyping an old principle in a new jacket*

All four respondent groups (platforms, fundraisers, investors, relevant FRCF organisations, and regulatory or supervisory authorities) argue FRCF to be an old principle, as many years ago the financial sector started with the ‘Banco’ where the supplier and demander negotiated about the value of money at a courtyard. Thus, FRCF exists already for centuries²²⁸, and many projects have been crowdfunded before the internet came up.²²⁹ However, it is given a fancy new name nowadays, because the internet plays a key role – instead of the courtyard.²³⁰ The internet is the foundation through which people are connected via networks, also called Investing 2.0.²³¹ Additionally, the internet offers the possibility to shorten the chain by cutting the middle man, resulting in a lower cost base.²³² This trend fits within the current lifestyle, as 95% of the crowd executes their financial transactions online.²³¹ FRCF has become more noticed and easier accessible through the internet, also for the less experienced crowd.²³³

The respondents distinguish three kinds of money-lenders. First, the less experienced crowdfunders (which are triggered by the marketing of projects via slick videos consisting of subjective information) often assume FRCF to be an awesome experience, without thinking about the risks and consequences of the possibility to lose money.²²⁹ Second, the medium experienced crowdfunders often see it as a hobby and can incorporate the risks.²³⁴ Third, the experienced crowdfunders (often professional investors) see it as a gambling game with the hope for high returns and often have the financial knowledge and capacity to take those risks.²³⁵ It is that the first group is most vulnerable.

Because money-lending and investing is an old occupation – and the two latter groups are familiar with it – the hype around FRCF often happens among the less experienced money-lenders.²³⁵ Through easy access and a fun outlook, FRCF attracts those money-lenders to push the buttons themselves.²³⁶ Initially, easy access and a fun outlook was the power of FRCF, but the problem arose when the less experienced money-lenders expect the relation with the fundraiser to be well defined, and that the execution mechanism of platforms is stable and works.²³⁷ Well, wake up, the investors’ and regulatory and supervisory authorities’ respondent groups argue this is definitely not the case. However, the platform respondent group responds to this that the regulators and supervisors seem to have lost the overall picture of the FRCF market, after new FRCF business having entered the market in a quick tempo. The platform respondents argue over their competitor-platforms that they are sometimes disillusive as they try to let their own businesses look safe and reliable, without applying to the poor regulations that are in place for starting a platform.²³¹ Moreover, projects are often presented in good daylight (with colourful videos) hiding their subjective project information content.²³⁸ Furthermore, projects are often fully funded after an hour, because money-lenders assume the project and/or platform to be reliable and safe when many other investors are involved and the information looks ‘nice’.²³¹ This indicates that the provided project information often does not have informing the money-lenders as goal, but attracting them to invest in the projects.²³⁹ Therefore, the hype around FRCF seems to be maintained by the platforms and fundraisers

²²⁸ Respondent 3 (platform), respondent 18 (regulatory or supervisory authority), respondent 4 (platform).

²²⁹ Respondent 3 (platform).

²³⁰ Respondent 3 (platform), respondent 14 (relevant FRCF organisation).

²³¹ Respondent 2 (platform).

²³² Respondent 14 (relevant FRCF organisation), respondent 5 (investor).

²³³ Respondent 17 (regulatory or supervisory authority).

²³⁴ Respondent 3 (platform), respondent 16 (regulatory or supervisory authority).

²³⁵ Respondent 12 (relevant FRCF organisation).

²³⁶ Respondent 17 (regulatory or supervisory authority), respondent 2 (platform).

²³⁷ Respondent 17 (regulatory or supervisory authority), respondent 5 (investor).

²³⁸ Respondent 4 (platform), respondent 11 (relevant FRCF organisation).

²³⁹ Respondent 4 (platform).

themselves, by providing subjective and attractive information in different ways to make projects look better than they actually may be.

Finally, all four respondent groups agree that even though FRCF is an old principle, the same risks are involved as in traditional financing ways. However, the internet as medium, decentralisation as trend, and the sharing-economy as lifestyle are likely to impose additional obscurity in the sector because it is relatively new and unknown. Subsequently, all respondents request for transformation of the FRCF sector into a stable and reliable market, which stimulates growth, prevents unfair practices, and too many defaults. Thus, it is time to transform the hype into a new paradigm, in which risks are considered seriously and are made aware among the crowd – in a uniform and clear way. If this step is taken, FRCF – as a new paradigm – can be regulated and supervised to increase its success.

5.1.2 FRCF definitions

All four respondent groups request for clear definitions of the FRCF concepts, to create clarity and market structure. Therefore, the interview data is merged to propose three definitions, which create a basis for further development as regards the FRCF forms (Figure 2 provides a schematic overview).²⁴⁰ The first definition is for *loan-crowdfunding*, which occurs more often than equity-crowdfunding (because companies rely more on loans than equity²²⁹), is perceived easier than equity-crowdfunding, and is characterised by a strong social trust between the fundraiser and money-lender.²⁴¹ Loan-crowdfunding can be distinguished in consumer credit (also called peer-to-peer lending) and business credit (also called crowd-lending), and is about providing a loan to an individual or company, and getting that loan (often plus interest over it) returned in the end.²⁴² Regarding consumer credit, the platform is often intermediary, but it happens to be the case that the platform is a credit provider in practice.²⁴³ In most countries different licences are needed for both activities, as consumer credit is based on European regulation.²⁴³ Regarding business credit, there is no relevant European regulation, only if the platform is recognised as credit institution (e.g. bank), but there is no such case in the Netherlands yet.²⁴³ Therefore, the rules that such platforms have to apply are different in each particular case. To structure this knowledge for the scientific community, the following definition of loan-crowdfunding is proposed:

“Loan-crowdfunding is the relation between a fundraiser and money-lender in which the money-lender provides a small loan (as part of the total loan from the crowd) to the fundraiser (which can be an individual or a company) with the expectation that the money-lender will get his loan and an interest over that loan returned.”

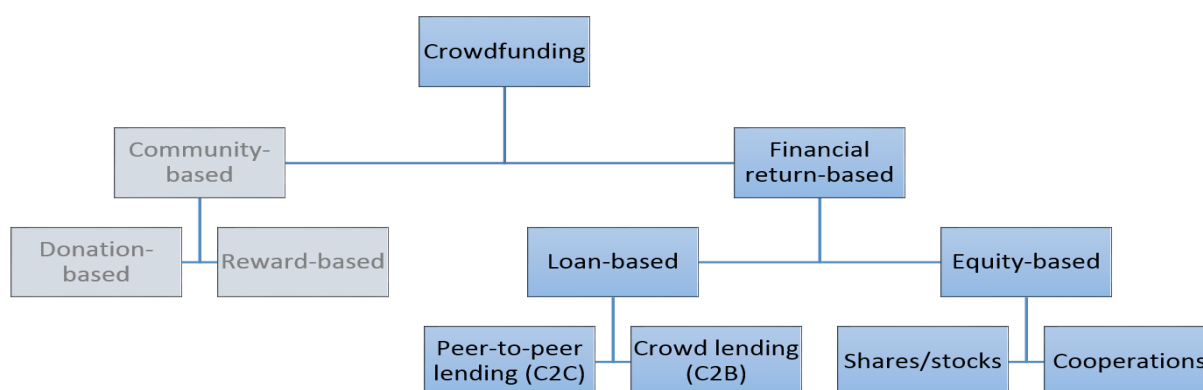


Figure 2: FRCF models and forms

²⁴⁰ Respondent 5 (investor), respondent 6 (investor).

²⁴¹ Respondent 3 (platform), respondent 13 (relevant FRCF organisation), respondent 9 (relevant FRCF organisation).

²⁴² Respondent 3 (platform), respondent 5 (investor).

²⁴³ Respondent 10 (relevant FRCF organisation).

Second, *equity-crowdfunding* is participation in a company, including a financial return over a resalable financial product.²⁴⁴ Thus, this investment form with securities is often seen as a gamble (especially when the fundraiser is an unstable start-up), in which investors hope for returns.²⁴⁵ Equity-crowdfunding takes often the form of shares in a company or sometimes with cooperations (if the platform does not have a licence to act as an investment company).²⁴⁶ From a regulatory point of view, among others the European market abuse regime is applied.²⁴⁷ Furthermore, the respondents argue that a secondary market is desirable, enabling money-lenders to resell their shares by providing an additional exit option. However, a secondary market is not available in the Netherlands at the moment, due to the fact that organisations change their actions in such a circumstance what is often contrary to the licence they have.²⁴⁷ Though, it would function as a safeguard for investors, through which those will be attracted to invest more, benefitting the platforms through more sales. To structure this knowledge for the scientific community, the following definition of equity-crowdfunding is proposed:

“Equity-crowdfunding is the relation between a fundraiser and investor in which the investor provides a small amount of money (as part of the total investment from the crowd) to the fundraiser (which is often a company) with the expectation that the investor will participate in the company, get a financial return and is able to sell the share.”

The problem with defining FRCF as an umbrella term is that loan and equity-crowdfunding consist of different models, related to the responsibilities that platforms (want to) take. Some platforms operate as intermediary (execution only in which the platform functions as a market place to bring supply and demand together) while others operate as a financial provider (and provide financing), according to the platform respondents.²⁴⁸ As intermediary, the platform only connects supply and demand, and does not take care of the risk assessment or monitoring. But as a financial provider, the platform should take care of all those fact, according to Dutch law. Because the latter category has more responsibility, it is obvious that such platforms need stricter licences and supervision than intermediaries.²⁴⁹ To structure this knowledge for the scientific community, the following definition of FRCF – as umbrella term – is proposed:

“FRCF consists of two broad forms (loan-crowdfunding and equity-crowdfunding that can be divided in intermediary and financial provider models) of which the latter has more responsibilities than the former due to the added risk assessment and monitoring tasks and which can be complemented by different modules.”

5.1.3 Modularity

FRCF is seen as very modular, and see it becoming even more modular in future. As indicated by all respondent groups, there are three levels of modularity that can be distilled, which are *the form and model of the activity*, *the added modules to the form used*, and *the geographic level of the activity*. Firstly, FRCF consist of two broad *forms*: Loan and equity-crowdfunding. As mentioned above, the *models* differ, such as consumer credit or business credit, shares, or cooperations. Moreover, a platform can act as an intermediary, or financial provider.²⁵⁰ These forms and models can be used over different sectors (respondents operate in the mortgage, sustainable energy and combined sectors²⁵¹), what might change the models constantly, as well as target groups or fundraisers (existing company or start-up for example).

Secondly, platforms can add new *modules* to the existing platform (see Figure 3).²⁵² Giro accounts, bond, funds, NPEX exchange can be adhered to the existing operation of platforms, and in future maybe

²⁴⁴ Respondent 10 (relevant FRCF organisation), respondent 3 (platform)

²⁴⁵ Respondent 5 (investor).

²⁴⁶ Respondent 12 (relevant FRCF organisation).

²⁴⁷ Respondent 10 (relevant FRCF organisation).

²⁴⁸ Respondents 10, 14, 17 (relevant FRCF organisation), respondent 6 (investor).

²⁴⁹ Respondent 4 (platform).

²⁵⁰ Respondent 3 (platform).

²⁵¹ Respondents 1, 2, 3 and 4 (platforms).

²⁵² Respondent 17 (regulatory or supervisory authority).

even the block chain will become part of it.²⁵³ Next to that, co-investment models appear more often in which different funding options are combined and in which sometimes even the government participate.²⁵⁴ A new approach derived from the co-investment idea and traditional funding is for example a Business Angel Syndicate, in which a particular party or investor with a lot of experience conducts due diligence for other investors.²⁵⁵ But also shadow-banking happens more often, in which loans are basically securitised so that it behaves more like a share because there is a security that presents the loan which can be handed over from person to person.²⁵⁶

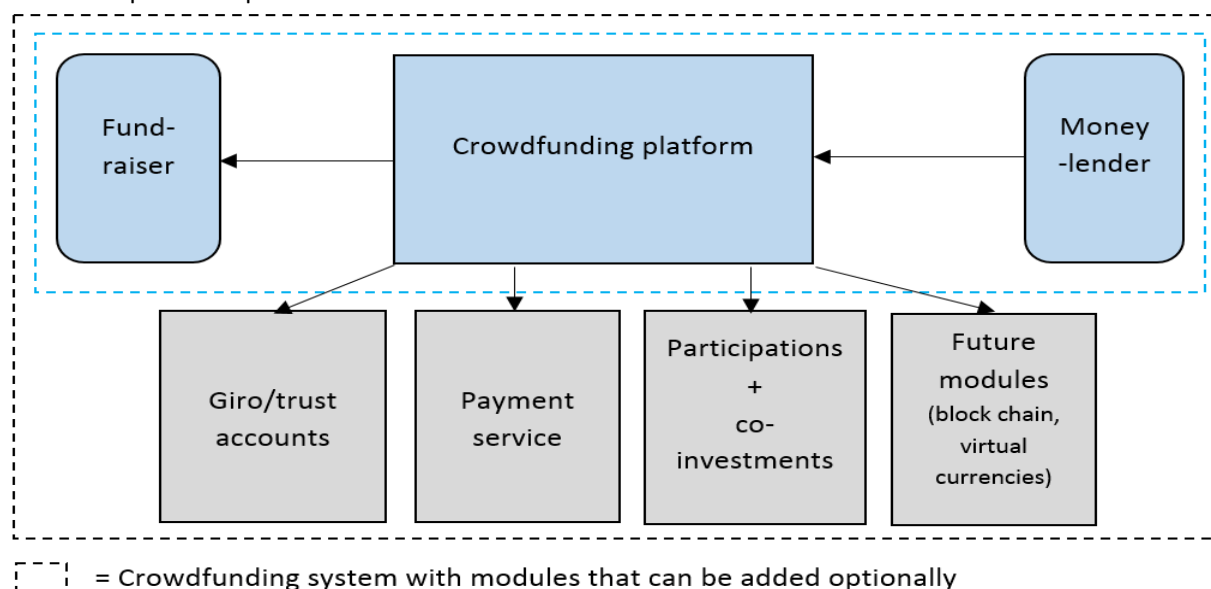


Figure 3: FRCF modularity model, source: respondent 17 (regulatory or supervisory authority)

Thirdly, platforms can operate at different *geographical levels*, such as local, national, continental or global. Most platforms operate nationally, as the local level is too limited and cross-border trade is still difficult due to different national regulatory regimes.²⁵⁷ Most platforms aspire to operate internationally, but that is often expensive due to a lack of uniformity among national rules.²⁵⁸ To do so, platforms have to apply for a licence at the national authority which can be passported for other European countries. However, there is only partial mutual recognition – the licence has to be accepted – but the MS may impose additional rules. Thus, platforms still have to check whether they are compliant to national regulations if they want to operate in other MSs. Additionally, the fact that some countries have already mature markets, while others figuratively just noticed the existing of crowdfunding makes cross-border trade and being compliant to rules even more complex.²⁵⁹

The three levels of modularity are cheered by the investors', fundraisers', and platforms' respondent groups, but the regulatory and supervisory authorities', and relevant FRCF organisations' respondent groups take a more anxious viewpoint. The private sector aims for market growth (which is often perceived to be achieved by innovation and entrepreneurship), while the public sector take a more global view and see the dangers of FRCF's modular character, where no proper policies are present at the moment. However, those different views of the public and private sectors is not striking, as taking a broader perspective is the task of the public sector, while the private sector is primarily focused on their own

²⁵³ Respondent 3 (platform), respondent 17 (regulatory or supervisory authority).

²⁵⁴ Respondent 16 (regulatory or supervisory authority).

²⁵⁵ Respondent 11 (relevant FRCF organisation).

²⁵⁶ Respondent 13 (relevant FRCF organisation).

²⁵⁷ Respondent 8 (relevant FRCF organisation).

²⁵⁸ Respondent 1 (platform), respondent 12 (relevant FRCF organisation).

²⁵⁹ Respondent 12 (relevant FRCF organisation), respondent 9 (relevant FRCF organisation).

businesses or sector particularly. Nevertheless, the substantial question here is whether the crowd can distinguish and understands these different approaches, and the subsequent risks of choosing one out of the different approaches.²⁶⁰

Since the FRCF sector has experimented several years, the relevant FRCF organisations' respondent group (which views FRCF market growth from a distance) makes the general observation that platforms increasingly become the front-end by operating as intermediary, while money generators become the back-end by executing the control of the funding.²⁶¹ Despite that this development results in monotone propositions, it is not a problem if FRCF' modular character and the differences between the models and forms (and consequent risks) are clarified to the crowd.²⁶² The different models and forms drift apart with a fast pace, increasing obscurity for the crowd and new market entrants (e.g. platforms), as no clear rules or guidance is facilitated for participating in crowdfunding or establishing a platform, respectively.²⁶³ Therefore, all respondents agree that the differences between the forms and models should be made clear to the crowd.

Another observation is that the modularity is accelerated by the fact that platforms try to work around the regulatory structure which is shaped by the regulators.²⁶⁴ However, this is inherent a problem of policy-making and combined with the creative and innovative financial sector, platforms are clever enough to constantly develop new forms so that the heavy rules will not apply to them.²⁶⁵ According to the investors', fundraisers', platforms', and relevant FRCF organisations' respondent groups, the regulators lag behind the fast pace of innovativeness of the private sector. Combined with the services provided online, regulators seem anxious to react, because they are not familiar with this type of practice and definitely not with the fast pace the private sector adapts to this online way of working.²⁶⁵ Such a quickly developing modular market increases the challenge to regulate²⁶⁵ but it is important that regulators take into account the changing world – particularly the internet business – and react to the regulatory legacy in an innovative way, just as the private sector does.²⁶⁵ Therefore, all respondents, except the regulatory or supervisory authorities, argue the necessity of changing the financial policies elementary and executing them well. Unfortunately, the regulatory or supervisory authorities' respondent group denies that it can work harder and more pro-active in order to create clarity and structure in the FRCF market, as they argue to be as pro-active as they are able to. However, even though the investors', fundraisers', and platforms' respondent groups may have less knowledge of developing and executing policies, they are the actors that work in the FRCF sector itself and therefore experience the difficulties and are likely to want the market succeed for the sake of their own futures. In addition, the legal experts from the relevant FRCF organisation respondent group agree the need of a pro-active attitude of regulators. Therefore, the regulatory and supervisory authorities' respondent group can learn from the private sector by not only taking into account their request concerning the content of the FRCF sectors' policy, but also concerning the way and pace of policy development.

5.2 Money-lenders' rights and influence

5.2.1 *Reduced rights through a large crowd and the internet*

The amount of money-lenders with a certain level of experience is inherent to the ticket sizes in FRCF, according to the platforms', fundraisers', relevant FRCF organisations', and regulatory or supervisory authorities' respondent groups. Professional investors still fulfil a relatively small part of the crowd,

²⁶⁰ Respondent 18 (regulatory or supervisory authority).

²⁶¹ Respondent 12 (relevant FRCF organisation).

²⁶² Respondent 12 (relevant FRCF organisation), respondent 6 (investor), respondent 11 (relevant FRCF organisation).

²⁶³ Respondent 9 (relevant FRCF organisation).

²⁶⁴ Respondent 11 (relevant FRCF organisation).

²⁶⁵ Respondent 1 (platform).

investing larger tickets.²⁶⁶ The less experienced money-lenders fulfil the greater part of the crowd²⁶⁷, but invest smaller tickets (100-500 euros) as they often have no much ‘spare’ money to lend or invest but want to participate because of the close relationships with the fundraiser.²⁶⁸ The result is a large crowd, of which each participant has invested a small amount of money, which is confirmed by the investor respondents. Therefore, the total ownership in FRCF has grown significantly, compared to traditional funding methods. And the amount of lenders or investors increases even further in cases of co-investments, in which funding can be raised through a partial bank loan, business angel and FRCF for example. Consequently, the fundraiser has to not only pay attention to its crowdfunders, but also to other investors that have invested via more traditional financing ways.

Mostly, when money-lenders have provided money to a fundraiser, they also want to have influence in the project. However, if a fundraiser offers 5% of its shares for 40.000 for example, the influence of each individual money-lender on the project is so small that it is negligible, according to the fundraiser respondent. This problem becomes bigger if it is not only about 5% of the shares, but about 90% or 100%, as then the total amount of ownership becomes even larger. Moreover, money-lenders often have no power to block any actions by the management judicially²⁶⁹, as no single individual has enough influence.²⁷⁰ In other words: the control is in hands of the total crowd, but due to the large amount fulfilling a small part of the total funding, individual money-lenders do not have significant control over their investments. Hence, as all respondents agree, the rights of money-lenders are very limited. The lack of a secondary market reduces their rights even further, as they are bound to their shares without a possibility to sell it.²⁷¹ But as institutional investors claim resalable shares, such a market will probably develop soon.²⁷² Nevertheless, relevant FRCF organisations (who support actors in the field and therefore see the differences among projects and platforms) criticise the limited rights of money-lenders, as they are the ones who take the (great) risks.²⁷³ But again, according to the investors’ respondent group, the most significant problem is that most money-lenders are not aware of their limited rights²⁷⁴, and if they do, they often do not recognise the full consequences of their limited rights, which bears concerns to their ability to make rational investment decisions.

Additionally, the internet as medium is shown to be successful by attracting an even larger crowd, resulting in even less rights per individual who has invested in a project. Moreover, the influence of social media makes FRCF looks nicer and easier accessible than ever before, attracting the crowd which is sensible for such ‘advertisement’.²⁷⁵ But, the use of the internet (and people’s anonymous behaviour on it²⁷⁶) and the movement of attracting a continuously larger crowd increases the literally and figuratively distance between the fundraiser and money-lender, leaving the money-lender with less responsibility for the success of a supported project. And this is basically contrary to what a fundraiser should want.²⁷⁷ Therefore, a solution is to make money-lenders part of the success of the project, by involving them in the marketing or using them as advisor.²⁷⁷ However, this will only be useful if fundraisers communicate better with their money-lenders, as having a large amount of investors will only be appreciated and sustainable if money-lenders have a certain influence over their ‘own’ money.

²⁶⁶ Respondent 12 (relevant FRCF organisation), respondent 5 (investor).

²⁶⁷ Respondent 7 (fundraiser).

²⁶⁸ Respondent 10 (relevant FRCF organisation), respondents 1, 2, 3 (platforms), respondent 8 (relevant FRCF organisation).

²⁶⁹ Respondent 7 (fundraiser).

²⁷⁰ Respondent 3 (platform), respondent 18 (regulator or supervisory authority).

²⁷¹ Respondent 10 (relevant FRCF organisation), respondent 17 (regulatory or supervisory authority).

²⁷² Respondent 10 (relevant FRCF organisation).

²⁷³ Respondent 11 (relevant FRCF organisation), respondent 8 (relevant FRCF organisation).

²⁷⁴ Respondent 5 (investor).

²⁷⁵ Respondent 2 (platform).

²⁷⁶ Respondent 13 (relevant FRCF organisation).

²⁷⁷ Respondent 3 (platform).

5.2.2 Increasing money-lenders' rights through protection and involvement

The literature review described the advantage of FRCF being used as marketing accelerator. This works as follows: money-lenders provide money to the fundraiser and therefore get involved in, and committed to, the project, because it is the money-lenders' money making him concerned about the success of the project – whether it is for the financial return involved or personal feelings. Subsequently, the money-lender can function as marketer for the project and to other money-lenders who may participate in the project as well.²⁷⁸ Hence, money-lenders can act as ambassadors²⁷⁹, and they are also willing to do so as they are often concerned about the project.²⁸⁰ Tight involvement of money-lenders by fundraisers is also useful for platforms, as the crowd may consider the platform as more reliable and make repeated investments at that platform.²⁸¹ Furthermore, being ambassadors is also valuable for the returns of money-lenders themselves, as they can actively involve and recruit other money-lenders so that the project grows, resulting in higher returns for each money-lender.²⁷⁷ However, even though all respondent groups see the potential of the ambassadorship-principle (if it is executed well), their opinions differ on the absolute impact of such a vicious circle. The relevant FRCF organisations' and regulatory or supervisory authorities' respondent groups argue that it may change a few percentages on the return, but it will not be significant. However, the respondents directly involved in crowdfunding (fundraisers', investors', and platforms' respondent groups) are more enthusiastic about it, but argue that it costs time to build such a trustworthy relationship with the money-lenders, as it will not happen automatically on the basis of a simple contract.²⁸²

Next to the positive results for the fundraisers and platforms, the close involvement of money-lenders may result in more power for the money-lenders, as they are able to attract additional funding through persuading other money-lenders to get involved. In such cases, money-lenders can act as advisors for the fundraisers or can take positions in boards.²⁸³ This is quite normal for shareholders in traditional financing ways, but not very common in FRCF.²⁸⁴ Or, if things go wrong according to the money-lender, the money-lender can block actions of the fundraiser – and if the fundraiser does not accept that the marketing of the money-lender may result in negative marketing.²⁷⁷ In this context, the investor gets a steering role which should be normal when a money-lender has invested a significant amount.²⁷⁷ For the investors' respondent group this is desirable, however, it is obvious that fundraiser respondent is less keen about it as fundraisers want money-lenders to have as little influence as possible, while providing funding in return; unfortunately this does not work, they should provide influence in return for funding. Because, if money-lenders rights are reduced through an increase of owners, while at the same time their rights over their investments are reduced, money-lenders have no incentives left to participate in FRCF anymore.

Though, the relevant FRCF organisations', and regulatory or supervisory authorities' respondent groups argue that money-lender involvement only is not enough to make FRCF a sustainable alternative financing option. Because money-lenders and fundraisers have different interests – what is problematic since ownership and control have been separated – money-lenders should be provided with rights by additional protection rules. Such protective rules enable money-lenders to regain part of their power over their invested money, by for example obliging the use of trust accounts²⁸⁵, proxies²⁸⁶, guarantee schemes, escrow services²⁸¹, or standardised contracts. Next to that, solutions from traditional funding ways, such as sophisticated contracting, pre-investment screening and post-investment monitoring can be used to mitigate goal conflicts and the information asymmetry between money-lenders and fundraisers. Also the

²⁷⁸ Respondent 6 (investor), respondent 9 (relevant FRCF organisation).

²⁷⁹ Respondent 16 (regulatory or supervisory authority), respondent 8 (relevant FRCF organisation).

²⁸⁰ Respondent 17 (regulatory or supervisory authority), respondent 16 (regulatory or supervisory authority).

²⁸¹ Respondent 4 (platform).

²⁸² Respondent 9 (relevant FRCF organisation), respondent 7 (fundraiser).

²⁸³ Respondent 3 (platform), respondent 5 (investor).

²⁸⁴ Respondent 5 (investor).

²⁸⁵ Respondent 4 (platform), respondent 10 (relevant FRCF organisation).

²⁸⁶ Respondent 14 (relevant FRCF organisation).

platforms' respondent group sees the necessity of such protective rules, but mainly for the sake of its own business. But the most remarking aspect to this extent is that the fundraisers' and investors' respondent groups do not directly see the essence of more protective rules, probably because investors do not even see their risks and consequences most of the time or because the investor respondents are just familiar and experienced with crowdfunding, while the fundraiser only wants to receive funding without all the hassle with money-lenders. This latter argument bears immediately concerns about the trustworthy relationship of the money-lender and fundraiser, as it indicates that the fundraiser will not act in advantage of the money-lender, and subsequently developing the conclusion that money-lenders should be taken care of, preferably through protective rules and involvement.

Balance of money-lender involvement

Several issues – which derive from the increased investor amount and the separation of ownership and control – can be discussed as regards the question of the level of involvement of money-lenders, as a balance should be found in empowering the crowd.²⁸⁷ First, it can be discussed whether an investor who invested 10 euros earns the same (amount of) rights and influences as an investor who invested 1000 euros in a certain project.²⁸⁸ Second, the smallest investor often has the largest mouth in practice, and therefore forces to have more influence than a larger investor.²⁸⁸ Third, in the case of equity-crowdfunding, investors are shareholders – even though that may be hidden through cooperations – accompanied by a responsibility including taking place in a crowdfunded company's board of commissioners, as such a function cannot be left to the platform.²⁸⁹ Thus, a shareholder is legally responsible, but does not have the power or influence to block any actions of the company in the case of crowdfunding, which is scary.²⁸⁹ Formally, a shareholder has nothing to say but legally may get into trouble if something happens with 'his' crowdfunded company.²⁸⁹ The investors' respondent group acknowledges these dangers, but is unable to specify the particular dangers and potential consequences, unfortunately. Fourth, some platforms operate contrary to consumer law at the moment, by imposing aspects to the money-lenders which are definitely not possible according to law and therefore jeopardise the money-lenders.²⁹⁰ If the regulatory and supervisory organisations do not control such unfair and illegal practices – which is the problem at the moment, according to the relevant FRCF organisations' respondent group – it may be useful to increase the crowd's rights by better protective rules and by close involvement, in order to prevent unfair practices and defaults.

In order to create the right influence balance for money-lenders, their needs need to be taken into account, together with the needs of the crowdfunding project. As partial solution, money-lenders can empower themselves by bundling their individual powers and increase their influence as a total owner group.²⁹¹ The respondents propose several solutions to do so, which are an independent identity (in which the money-lenders can group themselves²⁸⁹), a business angel syndicate (in which a group of investors can be linked to an experienced business angel which can conduct quality due diligence and monitoring²⁹²), the facilitation of fora (at which money-lenders can discuss available propositions or share information²⁹³), the facilitation of open Q&As (to provide money-lenders the possibility to ask questions to other investors²⁹⁴), the possibility to offer co-investments via personal accounts (in which investors search for other reliable and potential partners to invest with²⁹³), and the expedience test (in which money-lenders are tested for their reasonable understanding of financial products and investments.²⁹⁰ This instrument will enter into

²⁸⁷ Crowdsourcingweek (2015).

²⁸⁸ Respondent 12 (relevant FRCF organisation).

²⁸⁹ Respondent 6 (investor).

²⁹⁰ Respondent 11 (relevant FRCF organisation).

²⁹¹ Respondent 18 (regulatory or supervisory authority).

²⁹² Respondent 9 (relevant FRCF organisation).

²⁹³ Respondent 8 (relevant FRCF organisation).

²⁹⁴ Respondent 8 (relevant FRCF organisation), respondent 1 (platform).

force in the Netherlands in 2016), or a monitoring tool (for money-lenders to monitor their investments by providing insights in, and control over, their individual investments and progress²⁹⁵). This latter instrument takes an educational action by reducing the possibility of money-lenders using a scattergun approach when making investments, as this does not help their understanding or having overview over their financial actions.²⁹⁵ All these partial solutions may, in the case of being well combined, provide a total solution to empower and protect money-lenders.

In addition, the fundraiser's respondent group argues that fundraisers often do not have the time to keep money-lenders involved and committed²⁹⁶ – as they are busy and just forget it. However, money-lenders are very useful to fundraisers, whether it is for the funding or the advice.²⁹⁷ Because this argument derives from the fundraiser's respondent group, it is important to further empower money-lenders by additional legal protective rules and instruments which give them more power, as the fundraisers and/or platforms are likely to be incapable enough to involve money-lenders to the extent needed by facilitating the above described solutions. However, at least the existing rules should be assessed whether they are sufficient for FRCF and whether they are executed well enough, as it is argued by the relevant FRCF organisations' and platforms' respondent groups to not be the case at the moment.²⁹⁸ However, it has to be noted here that the platforms' and some experts of the relevant FRCF organisation's respondent groups are no legal experts, and may therefore make unreliable statements as regards the quality of the execution of existing laws.

5.3 Reducing the information asymmetry between money-lender and fundraiser

5.3.1 Transparency and a level-playing field

The limited rights of money-lenders increase the information asymmetry between the money-lenders and fundraisers (which indicates that the former has more information than the latter, allowing fundraisers to be unresponsive to money-lenders²⁹⁹), as money-lenders will not be capable to influence fundraisers as regards their decisions. To decrease the subsequent moral hazard and social influence effect of the wisdom of the crowd, transparency should be increased and a level-playing field should be developed according to the respondents, in order to reduce the information asymmetry.

Transparency

The increase of transparency is equal to better information provision, which is argued to be a condition for the well-functioning FRCF market by the platforms', fundraisers', relevant FRCF organisations', and regulatory and supervisory authorities' respondent groups.³⁰⁰ As regards the information provision to the crowd, the education of general financial risks which the business involves, and the particular project risks which are presented on the platforms are most important for the FRCF market according to the platforms', fundraisers', relevant FRCF organisations', and regulatory and supervisory authorities' respondent groups.³⁰⁰ In line with that, the relevant FRCF organisations' respondents argue that all information which may be necessary for the crowd to conduct due diligence and make considered investment decisions should be provided.³⁰¹ Hence, the general tendency and mentality regarding information provision should be that any information that could potentially be useful material for the money-lenders – regardless whether shares are resalable or not – should be provided and made transparent.³⁰² Currently, such information is often subjective and shown in attracting videos, but such information provision should be objective and

²⁹⁵ Respondent 6 (investor).

²⁹⁶ Respondent 11 (relevant FRCF organisation), respondent 7 (fundraiser).

²⁹⁷ Respondent 7 (fundraiser).

²⁹⁸ Respondent 10 (relevant FRCF organisation), respondent 1, 2, 4 (platforms).

²⁹⁹ Waterman and Meier (1998), p. 177.

³⁰⁰ Respondent 16 (regulatory or supervisory authority), respondent 3 (platform).

³⁰¹ Respondent 13 (relevant FRCF organisation).

³⁰² Respondent 10 (relevant FRCF organisation).

informing instead.³⁰³ An information provision obligation for platforms exists (in the Netherlands as part of civil law) to control this, but the platforms and their users themselves argue those rules to be too limited at the moment.

In more detail, also information about the screening (of money-lenders and fundraisers), monitoring (of projects), and the costs of crowdfunding needs to be made transparent (independent of which actor conducts the task), as is mostly done in traditional financing ways. As the platform respondents argue, some platforms screen fundraisers before their projects are accepted on the platform and the money-lenders before their investments are accepted, while others do not conduct such screening. Moreover, some platforms monitor project progress after they are 100% funded, but some platforms do not conduct monitoring or offer the possibility to monitor projects.³⁰⁴ However, all respondents agree that the crowd should be informed about both aspects: whether the platform conducts or offers screening and/or monitoring and in which way these tasks are fulfilled. The information regarding screening is important in order to know a risk assessment in advance, while monitoring offers the possibility to follow the process of the project or to influence the fundraiser in that process.³⁰⁵ Additionally, cost transparency should be made transparent, as it costs time to screen fundraisers and money-lenders and obliged licences are expensive; then the crowd knows the real costs of crowdfunding.³⁰⁶ Moreover, it is useful for the crowd to know the default ratio of platforms to see which platforms are reliable or not.³⁰⁷ The respondents provide several solutions for information provision, such as standard contracts³⁰⁸ between the fundraisers and the money-lender, memoranda, the platforms' website, or other instruments.

All respondents agree that the increase of transparency through clear, structured, and objective information provision about platforms' tasks, the information asymmetry will be reduced, enabling the crowd to make better considered investment decisions, which subsequently will reduce their investment risks.³⁰⁹ Also, transparency is argued to lead to the crowd's ability to compare different projects among different platforms, for which tools such as crowdfunding comparability websites are useful.³¹⁰ However, a remark is that transparency is only desirable to a certain extent, as the FRCF actors participate to earn returns (capitalistic mentality), but history has shown that capitalism does not require full transparency.³⁰⁴ In other words, actors would like to have (others') information to find interesting propositions, without other actors knowing their information.³⁰⁴ This is similar for investors, fundraisers and platforms, as they all aim profits, indicating the importance to constantly search for the right information balance between all actors, in which the desires for transparency of the regulatory and supervisory authorities and not-too-much transparency of the fundraisers and investors are considered.³¹¹ In this context, the respondents agree that platforms and fundraisers together should be held responsible for the information provision towards the crowd, as they possess the information.³¹² The fundraiser is mentioned to be responsible for the delivery of necessary information, while the platform – as online medium – is responsible for the facilitation and transmission of the information provision so that it reaches the crowd.³¹³ This shared responsibility is obvious according to the platforms' and relevant FRCF organisations' respondents, as the fundraisers and money-lenders are clients of the platform – indicating that they would take care of and feel responsible for their clients³¹⁴ – and that clients may expect at least some service by means of information

³⁰³ Respondent 9 (relevant FRCF organisation).

³⁰⁴ Respondent 5 (investor).

³⁰⁵ Respondent 3 (platform).

³⁰⁶ Respondent 11 (relevant FRCF organisation), respondent 12 (relevant FRCF organisation).

³⁰⁷ Respondent 10 (relevant FRCF organisation), respondent 14 (relevant FRCF organisation).

³⁰⁸ Respondent 9 (relevant FRCF organisation).

³⁰⁹ Respondent 17 (regulatory or supervisory authority).

³¹⁰ Respondent 4 (platform).

³¹¹ Respondent 16 (regulatory or supervisory authority).

³¹² Respondent 14 (relevant FRCF organisation).

³¹³ Respondent 14 (relevant FRCF organisation), respondent 16 (regulatory or supervisory authority).

³¹⁴ Respondent 11 (relevant FRCF organisation), respondent 1 (platform).

provision and monitoring as they pay for it.³¹⁵ Hereby, the responsible parties (platforms) acknowledge that they care about their clients (crowd), indicating that they are willing to increase transparency if that benefits their businesses and thus the FRCF sector. And because the fundraisers' respondent group is probably willing to invest in this aspect, regulators should take a pro-active role in facilitating it.

Level-playing field

Next to increased transparency, the presence of a level-playing field (in which all actors play by the same rules) is necessary for a well-functioning FRCF market according to all respondents. Basically, three smaller level-playing fields are desirable for the platforms, fundraisers, and money-lenders respectively, which together form one single FRCF level-playing field. At the moment, the respondents argue that no level-playing field is present in the Netherlands, nor in Europe.³¹⁶ As regards the *level-playing field for the platforms*, uniformity regarding two kinds of information provision is needed that should be made really clear to the crowd.³¹⁷ On one hand the platform needs to explain the working method of its own system and the subsequent risks. Therefore, the platforms' character (intermediary or credit provider function)³¹⁵, the handling of its financial flows (via a third party or differently)³¹⁸, the funding goal of projects (is it used as working capital or differently)³¹⁹, the related parties behind the platform (are there any institutional investors that have conflicted interests with the platform, as the crowd only sees the tip of the ice berg)³²⁰, the risk assessment of projects (are projects assessed before they are put online?), and the monitoring option of the projects (does the platform monitor the projects or does it offer a tool to the investor to do so?)³¹⁵ should be clarified to the crowd. On the other hand, the platform needs to explain the general financial risks that are part of FRCF, such as structural risks that exist apart from the platform itself or the presented projects. In this context, the platform is obliged by Dutch law to warn each money-lender for the possible risks and therefore takes a sort of educational role (wild west sign). Therefore, the respondents argue that platforms are responsible for explaining the importance of risk-spreading and that – in any platform that they may go – investments are just not safe, nor riskier than in stock markets.³²¹

Moreover, platforms do not present their propositions in a uniform and structured way, while it is desirable to develop a standard and uniform method to present such propositions, so that the crowd can compare them.³²² In such a case, the risk assessment of projects should also be conducted in a uniform way, otherwise propositions will still not be comparable.³²³ Therefore, respondents agree that a public rating instrument which explains at which basis a rating needs to be done is useful as it increases the equality and similarity among platforms.³²⁴ As a positive consequence, the possibility for fundraisers to choose another platform when a project is rejected at a first platform reduces, as there will not be any 'easy' platforms anymore because all platforms do their risk assessment via a similar method.³²⁰ Therefore, a natural filter is created to prevent adverse selection or the 'bad lemons' problem, as only reliable projects will be presented. On top of that, platforms can be linked together if information provision of projects and the general risks are presented in a uniform way, enabling money-lenders to make also comparisons among the available platforms.³²⁵ However, to do so the platforms need to receive uniform information from the fundraisers, therefore a level-playing field for fundraisers is necessary as well.

³¹⁵ Respondent 11 (relevant FRCF organisation).

³¹⁶ Respondent 12 (relevant FRCF organisation).

³¹⁷ Respondent 17 (regulatory or supervisory authority).

³¹⁸ Respondent 9 (relevant FRCF organisation).

³¹⁹ Respondent 3 (platform).

³²⁰ Respondent 13 (relevant FRCF organisation).

³²¹ Respondents 13, 8, 11, 14 (relevant FRCF organisation), respondent 2 (platform).

³²² Respondent 8 (relevant FRCF organisation).

³²³ Respondent 3 (platform), respondent 11 (relevant FRCF organisation).

³²⁴ Respondent 2 (platform).

³²⁵ Respondent 1 (platform), respondent 13 (relevant FRCF organisation), respondent 4 (platform).

As regards the *level-playing field for fundraisers*, a sort of standardised document (such as a key investment document) or a similar summary of the Prospectus is desirable so that fundraisers need to deliver similar sorts of information enabling the crowd to compare different projects in a structured manner.³²⁶ Even though some platforms and the fundraiser argue that this is up to the fundraiser, they all acknowledge the necessity of information provision harmonisation in this context.

As regards the *level-playing field for the crowd*, the information provision in a uniform and structured way – by the fundraiser and platform – results in all money-lenders having the same information to conduct due diligence and to make considered investment decisions. In line with this, all money-lenders should have clear in what projects and why they have invested, because, if the fundraisers and platforms have taken all possible efforts to inform the money-lender, the money-lender himself is responsible for its own deeds in the end: *caveat emptor* (the buyer is warned).³²⁷ An expedience test may be a good help, but the money-lender himself is responsible for providing honest answers and therefore anyone who wants to ‘play’ with money is responsible for well informing himself.³²⁷ Thus, the crowd does not need very strong direct protection (also because they apparently are not that rational when making investment decisions³²⁸) according to the fundraiser and platforms, but some protective rules may be useful because fundraisers do not want to get liability problems³²⁹ with their money-lenders making sufficient information provision necessary.³³⁰ Therefore, a rule may be imposed that creates the possibility for money-lenders to invest in a blocked period during which no any institutional money can be invested in a certain proposition.³³¹ Such a ‘freeze-period’ will enable only one channel through which money-lenders can invest on the same financing conditions. Moreover, it would weaken any attempt for arbitrage from bigger players who would like to make money on the back of others and making offline side-deals.³³¹ Consequently, argued by an expert with European crowdfunding experience, if all money-lenders are able to lose and win in the same way, FRCF will be much more compelling and a stronger alternative financing option, as well as an investment product.

Concluding, too many different national rules apply at the moment, making cross-border trade expensive, due to the partial mutual recognition of licences. If transparency will increase, and a level-playing field will be developed, the development of a secondary market and cross-border trade will be boosted, due to all actors playing by the same rules and through clarification of the legislation. Moreover, the respondents argue that the social influence effect of the wisdom of the crowd theory will decrease, as each money-lender has the necessary information and subsequent tools – the level-playing field – to make considered investment decisions by themselves, without relying too much on the crowd. Furthermore, if the platform risks, project risks and structural risks of FRCF are clarified by the platforms, the crowd will be able to understand the importance of conducting good diligence, the quality of projects, and risk-spreading, resulting in a decrease of adverse selection. Additionally, moral hazard problems will decrease because fundraisers and money-lenders are on a more equal position regarding the information provision and the rights, respectively, due to the supporting instruments provided by the level-playing fields.

5.3.2 Private and public cooperation

Private sector drive

The execution of increasing transparency and the development of a level-playing field are tasks for the private and public sector together, according to all respondents. Because the platforms and fundraisers are considered to be responsible for, and in control of, the information provision and facilitation towards the crowd, the private sector has to take the lead in increasing the transparency and developing the level-

³²⁶ Respondent 10 (relevant FRCF organisation).

³²⁷ Respondent 14 (relevant FRCF organisation).

³²⁸ Respondent 18 (regulatory or supervisory authority), AFM (2015).

³²⁹ Research on liability issues regarding FRCF is on-going, conducted by the Crowdfunding Hub and FG Lawyers. See crowdfundinsider (2015).

³³⁰ Respondent 11 (relevant FRCF organisation).

³³¹ Respondent 13 (relevant FRCF organisation).

playing field. It is likely that they take their role quite seriously as apparently new parties that act as a sort of ‘lead investor’ are developing with the aim to provide information to the crowd, conduct due diligence for them, and monitor the investments afterwards.³³² Some respondents argue this movement in the form of traditional business angels that act as property managers, while others consider the traditional banks to improve and upgrade their business into sustainable business models for the future through providing advice to crowdfunding participants.³³³ In addition, if such a lead investor also spreads risks, it looks more like a fund.³³⁴ But due to a scattered FRCF field, with many different crowdfunding models and forms as well as executions of it, the private sector will not be capable enough to develop a level-playing field fully by themselves. They acknowledge the present risks in the FRCF sector with the current regulation. Besides, each individual actor in the sector argues that a level-playing field and transparency are desirable, but no single party has enough power to impose such standards on other parties. Next to that, each platform wants the sector to become successful, but prefers its own individual growth first. Though, ideally, the FRCF market would function based on norms and values in which each actor takes its responsibility to make the market successful and to protect the crowd at the same time (self-regulation); however that is not realistic.³³⁵ In other words; the private sector argues to be unable to handle it alone anymore.

Public sector coordination

To support, the public sector argues to have a task to steer and facilitate this process that the private sector has started. Even though the regulator is never responsible and the market is always responsible for its own deeds, the regulator needs to support the private sector to indicate actions in cases the responsible parties do not take their responsibility.³³⁶ Basically, this is how policy and legislation works³³⁷, and it is a contemporary occurrence in the FRCF market. Therefore, according to the fundraisers’, platforms’, investors’, and relevant FRCF organisations’ respondent groups, regulators have to take their responsibility to facilitate market growth, as it is appalling to see that some public sector parties pass the bucket that easily – while the market is screaming for help – due to unknown practices in the sector and new technological innovations that may scare regulators off who therefore shift away their responsibility. Even though an awaiting position from the regulator is sometimes better than a pro-active position, as the past years have shown, the warranty of the growth, stability and continuity of the market should have become a point of the regulator’s attention right now.³³⁸

Additionally, such close cooperation is always necessary as once regulation has been developed, there will always be private parties that try to work around the legal or regulatory structures so that the rules will not apply to them.³³⁹ By involving the private sector when developing regulation, a basis and support for the regulation will be created, reducing the chance that the private parties will try to work around the regulatory structure.³³⁹ Moreover, the combination of the public sector’s knowledge of developing regulation and the private sector’s knowledge of the FRCF market will decrease the chance of over-regulation as both parties will balance each other to define a minimum amount of rules.³³⁴ Over-regulation is never desirable, but especially not regarding FRCF, otherwise there would be nothing ‘alternative’ to it anymore.³³⁴

Cooperation approaches

The cooperation between the public and private sectors can be designed top-down or bottom-up, according to the regulatory or supervisory authorities’ respondent group. As regards the top-down

³³² Respondent 14 (relevant FRCF organisation).

³³³ Respondent 7 (fundraiser), respondents 12, 14 (relevant FRCF organisation), respondent 5 (investor).

³³⁴ Respondent 3 (platform).

³³⁵ Respondent 12 (relevant FRCF organisation), respondent 16 (regulatory or supervisory authority).

³³⁶ Respondent 18 (regulatory or supervisory authority), respondent 5 (investor).

³³⁷ Respondent 18 (regulatory and supervisory authority).

³³⁸ Respondent 12 (relevant FRCF organisation), respondent 1 (platform).

³³⁹ Respondent 4 (platform).

approach, co-regulation can be used in which the regulators and the trade organisation – as representative of the private sector – co-design the regulation.³⁴⁰ In the Netherlands this has happened concerning the development of the Code of Conduct and the expedience test for money-lenders, in which the trade organisation described their wishes and the Dutch regulators acted in a strict way to make the Code of Conduct useful.³⁴¹ Thus, the Ministry of Economic Affairs, the Ministry of Finance and the Financial Markets Authority (AFM) cooperated with the private sector; it is a co-production in which the Ministry of Finance and the AFM focus on the legislation and the consequences of that legislation, while the Ministry of Economic Affairs focuses on stimulating the FRCF market and the private sector provides input.³⁴² In addition, the Dutch Central Bank (DNB) focuses on continuity and stability of the financial markets, but not yet of the FRCF market as it is still too small.³⁴³ As regards the bottom-up approach, co-investments can be used in which the governments can participate in the form of providing guarantees concerning FRCF.³⁴⁴ For example, governments can guarantee the crowdfunded part in co-investments, so that governments do not have direct cash out but the investment is made more solid for money-lenders as the government guarantees the investments of the crowd.³⁴⁴ Thus, if the crowd recognises the provided government guarantee they may have an incentive to invest, making the guarantee only symbolic as probably the project will raise the 100% funding as there is a guarantee for the crowd.³⁴⁴ Hence, governments that act as crowdfunding guarantee do not have direct cash outflows, but do boost the economy.³⁴⁴ Currently, the Dutch Ministry of Economic Affairs is experimenting with this approach.³⁴⁵

Cooperation at European level

European regulators can cooperate with national regulators and the private sector directly, offering them a unique position in increasing transparency and the creation of a European level-playing field. Because the internet does not recognise boundaries (and therefore neither the platforms, nor its users are bound by national boundaries and regulations), development of regulation at a European level is necessary.³⁴⁶ According to the platforms', fundraisers', and investors' respondents, a European regulatory framework would make cross-border trade easier, because it will result in mutual recognition of national licences – if existing licences stay in their current form. If not, European regulatory framework would make cross-border trade even easier through the same licences for the whole EU. Also, more and more financial regulations are getting developed from a European level and the whole Eurozone pays with the Euro, so harmonising FRCF regulation at that level is not a strange thought.³⁴⁶ Next to that, the first platform take-overs have already taken place, increasing the importance of developing European regulation.³⁴⁶ However, it is a utopia to think that regulators will regulate it in just a second when using their unique position to design regulation directly from a European level.³⁴⁷ According to all respondents, developing FRCF regulation from a European level is a complex and time-consuming process.³⁴⁴

Nevertheless, the CMU plans show that Brussels takes FRCF seriously by looking for best practices regarding FRCF regulation in its MSs. In the UK for example, institutional investors reacted immediately by entering the market when a level-playing field was created through the ambitious vision of the government and their strict supervision of the flexible rules, through which the market matured quickly.³⁴⁸ Such light touch regulation makes the market professional and boosts market growth. It may be useful for other MSs to learn from the UK in this context, as the British government is familiar with their financial sector and has waited a while, after deciding that the market needed to be regulated and steered into a single and clear

³⁴⁰ Respondent 9 (relevant FRCF organisation).

³⁴¹ Respondent 9 (relevant FRCF organisation), respondent 11 (relevant FRCF organisation).

³⁴² Respondent 16 (regulatory or supervisory authority).

³⁴³ Respondent 17 (regulatory or supervisory authority).

³⁴⁴ Respondent 2 (platform).

³⁴⁵ Respondent 16 (regulatory or supervisory authority), respondent 1 (platform).

³⁴⁶ Respondent 12 (relevant FRCF organisation).

³⁴⁷ Respondent 9 (relevant FRCF organisation), respondent 6 (investor).

³⁴⁸ Respondent 3 (platform), respondent 5 (investor).

direction.³⁴⁹ However, the private sector respondents argue that regulators should be careful with copying best practices across Europe, due to cultural differences and national image concerns. Nevertheless, regulators need to be tough to decide for light touch regulation half-way the crisis, discussing that their pro-active regulatory position and clear vision might have been the key to the success of their FRCF market.³⁴⁹ Maybe other national regulators should step aside from the idea that everything needs to be regulated 100% and drawn up in many details before implementation; that is just not realistic and investments are never 100% safe.³⁴⁹ Another point of attention for European regulators is the USA, which takes a total different approach than the EU towards FRCF. Under normal conditions, the EU takes a top-down approach, as Brussels develops regulation for the MSs. But in the USA, the SEC develops regulation for the States, but each State can make an exemption on top of that.³⁵⁰ But since this is not the European approach, pan-European coordination becomes increasingly important.³⁵⁰

But, according to three platforms, the real problem with European regulation in the financial services sector is that it develops slack-backed regulation with no clear visions, waits what happens, and then finally takes a look at what the result is.³⁵⁰ No wonder that developing free flow of capital has been a task of the last 50 years. In addition, European regulators forget that the private sector – with their technological innovations – moves way faster than all regulators together.³⁵⁰ And regarding the Dutch case, it seems that the Dutch regulators do not really realise how quick the market acts and reacts to certain events.³⁵¹ European regulators are for example also looking at credit unions, but those unions are not the future; respondents argue that those are already the past.³⁴⁹ Therefore, regulators should take their responsibility by acting more pro-actively and developing a strategic vision.³⁵¹ It is in their interest that the FRCF market, as well as its stability and continuity, grows.³⁵¹

Next to the European regulators' mentality, the problem with regulating FRCF is that this form of alternative financing aims to offer fundraisers easier access to funding as probably the traditional ways do not offer that easy access, argued by a relevant FRCF organisation.³⁵² But the existing rules are not developed for specific entities, but for kinds of investors as asset class. But why should an 'alternative' investor get less protection than a traditional investor; only because the alternative investor invests in smaller amounts or in a smaller context as the market is still not mature?³⁵² Therefore, regulation needs to be designed that protects particular asset classes, and not just FRCF money-lenders.³⁵⁰ The subsequent question which derives from alternative financing will then also be solved, as when the FRCF market matures and the 'alternative' has become less alternative, the relevant rules can still be there, as it was designed for asset classes and not for FRCF money-lenders. This is also acknowledged by the regulatory and supervisory authorities and is therefore useful to take into account.

European approach towards existing regulation

According to the relevant FRCF organisations' respondent group, existing regulation needs to be assessed first, before developing new regulations. As the literature review showed (and Appendix I and II), several regulations seem to be able to include FRCF on certain aspects.³⁵² For example MiFID II includes FRCF now, and the Prospectus rules will be made less strict.³⁵³ Therefore, additional FRCF regulation only needs to be developed when it is really necessary and existing regulations cannot be used to include FRCF.³⁵² Though, the Dutch regulatory and supervisory authorities keep an eye on the European regulators in this context, as several aspects need to be tackled at that level.³⁵⁴ On the one hand, maximum harmonisation would be useful according to the respondents, because in such a case every MS will act in a

³⁴⁹ Respondent 5 (investor).

³⁵⁰ Respondent 1 (platform).

³⁵¹ Respondent 2 (platform).

³⁵² Respondent 11 (relevant FRCF organisation).

³⁵³ European Commission (2015b) and respondent 16 (relevant FRCF organisation).

³⁵⁴ Respondent 16 (regulatory or supervisory authority).

uniform way regarding crowdfunding. However, such a one-size-fits-all approach would mean a strong consensus solution – especially considering the fragmented rules and market stage across the MSs – which is never the most efficient approach.³⁵⁵ Next to that, maximum harmonisation may lead to too strict rules considering the current national FRCF markets by which the markets may be prevented from growing which is not desirable. Furthermore, maximum harmonisation is often not used in cases of financial services in the EU. On the other hand, minimum harmonisation is not ideal, as there will still be different rules to which the platforms have to obey to.³⁵⁵ And if the EU really aims fully free flow of capital, such a silo approach has to disappear.³⁵⁰ Therefore, a balance needs to be found between the approach in the short-term when the market is still at a nascent stage, and the approach in the long-term when the market has matured.

Concluding, the respondents agree that the EC should act more pro-actively and take their responsibility by guiding the private sector in this nascent market stage.³⁵⁶ To do so, the national governments of the MSs should align centrally to facilitate the pipes for FRCF – security, safety, mobility, and collectivity – after which the private sector will develop the rest on top of that, this all coordinated by the EU through the development of Guidelines.³⁵⁷ At such an initial stage, the MSs are free to experiment with new forms of FRCF and interpret the Guidelines through their own cultural approaches, so that the market has room for development. Several years later, when the market has become mature, European regulators can start developing a more central European regulatory framework in a lean and flexible way, so that new innovative models and forms of FRCF can be included in the rules. Through the development of such Guidelines – and a European regulatory framework – the European FRCF market will be clarified to all relevant actors, boosting their participations and thus market growth.³⁵⁸

5.3.3 Short-term and long-term vision for the FRCF market

To clarify the short-term and long-term periods, the Dutch timeline is taken as example (see Figure 4). Currently, the Dutch FRCF market is at a nascent stage, but if the current growth line is maintained the market will mature in the next three years (around 500 million).³⁵⁹ This is the moment when the AFM starts developing regulation. This period, between now and a 500 million FRCF market is seen as the short-term. From 500 million and more it is seen as a mature market and long-term, which is also the period in which the DNB probably starts monitoring the stability and continuity of the FRCF market (around 6.4 billion).³⁵⁹ Such a division of short-term and long-term periods with accompanying market sizes can also be made at European level, relatively.

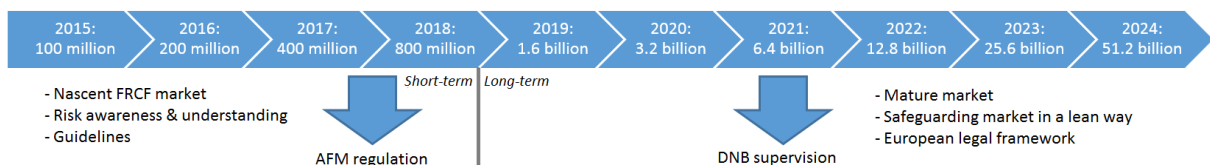


Figure 4: Time line Dutch FRCF market

When discussing the tasks to be conducted in the short-term and long-term, the European approach towards developing a regulatory framework needs to take care into account two key challenges of the FRCF market: the development of *risk awareness and understanding of the financial risks that exist by means of Guidelines*, and the *safeguarding of the market by means of a lean developed European legal framework*.³⁶⁰

³⁵⁵ Respondent 3 (platform).

³⁵⁶ Respondent 2 (platform).

³⁵⁷ Respondent 1 (platform), respondent 11 (relevant FRCF organisation), respondent 10 (relevant FRCF organisation).

³⁵⁸ Respondent 11 (relevant FRCF organisation).

³⁵⁹ Respondent 17 (regulatory or supervisory authority).

³⁶⁰ Respondent 4 (platform).

Short-term regulatory strategy

At a nascent market stage, the MSs need room for experimentation and growth, as too much rules would restrain the FRCF market from growing.³⁶¹ For example, Italy has developed too strict crowdfunding rules from the beginning, which resulted in straight market failure.³⁶² If such shortcomings take place at European level it may lead to the end of the FRCF market as alternative financing option. Therefore, the European FRCF market needs to grow and become mature first, after which later stronger rules can be developed. But if such a ‘free-ride’ period takes too long, the MSs will have developed their own national detailed regulation, making it harder to ever reach harmonisation in the EU, so a search towards the balance between both is key.³⁶³

In the short-term, European regulators need to create a level-playing field and increase transparency by means of Guidelines for structured and uniform information provision.³⁶⁴ In this context, a balance between sufficient information provision (for the money-lender to make considered investment decisions) and risk awareness and understanding (for the money-lender to understand investment decisions, e.g. financial literacy education³⁶²) needs to be found, as these are two different aspects. Namely, information provision provides the opportunity to make considered decisions, but only if the crowd is able – depending on the intelligence, knowledge, experience, and willingness – to do so.³⁶⁴ To clarify, a Prospectus contains interesting information about a project, but does not say anything about the quality of the investment.³⁶⁵ This depends on the interpretation capability, as the money-lender should be capable enough to interpret the provided information in a correct way and should subsequently make a rational decision.

National financial situations need to be taken into account when developing Guidelines from Brussels, otherwise the development of harmonised FRCF regulation will result in never ending conflict situations between the MSs.³⁶⁶ Therefore, national cultures and financial regimes need to be respected by introducing Guidelines that grandfather the MSs by pushing them into a central direction – without too many harmonising rules – in the beginning.³⁶⁶ At this stage, also existing regulation needs to be assessed to find out whether they can be adapted to include FRCF and how they should be executed well.³⁶⁷ As a consequence, the developed Guidelines should involve the provision of clear, structured and uniform information provision, and risk awareness and understanding, so that a European level-playing field will be ensured and transparency will be increased. Because no one likes to fill in lengthy information documents or to pay large amounts of money to facilitate information provision, simple rules (light approach) towards the platforms will be helpful and will maintain the ‘alternative’ aspect of this alternative financing form.³⁶⁸ The Guidelines as a framework of loose rules, which the MSs can implement in their national systems, lead to indirect protection of the crowd and market growth, without imposing too strict rules.³⁶⁹ The result will be platforms operating in a similar way across the EU, enabling the crowd to compare different propositions at different platforms in different MSs.

The Dutch government proposed a draft amendment act Financial Markets 2016 (‘Wijzigingsbesluit Financiële Markten 2016’), which aims to develop a level-playing field between loan-crowdfunding platforms (concerning business credit) and equity-crowdfunding, to align rules regarding these both methods because they differ significantly at the moment.³⁷⁰ Even though it is still work in progress, the amendments offer the private sector to react in certain direction in which the regulator wants them to steer, and is therefore doing quite well in facilitating the increase of transparency and the development of

³⁶¹ Respondents 10 (relevant FRCF organisation), respondents 15, 17, 18 (regulatory or supervisory authority).

³⁶² Respondent 9 (relevant FRCF organisation).

³⁶³ Respondent 11 (relevant FRCF organisation).

³⁶⁴ Respondent 16 (regulatory or supervisory authority).

³⁶⁵ Respondent 12 (relevant FRCF organisation).

³⁶⁶ Respondent 5 (investor).

³⁶⁷ Respondent 4 (platform), respondent 2 (platform).

³⁶⁸ Respondent 13 (relevant FRCF organisation), respondent 10 (relevant FRCF organisation).

³⁶⁹ Respondent 14 (relevant FRCF organisation).

³⁷⁰ Respondent 10 (relevant FRCF organisation).

a level-playing field.³⁷¹ This shows that the Dutch regulators have a strong desire to grow regulation accordingly to the market as the end result of the market is not visible yet.³⁷⁰ This desire of balancing monitoring and regulation development is also acknowledged by the EBA and ESMA – the European equivalents of the AFM and DNB.³⁷⁰ Thus, regulators see the necessity of a flexible market without bureaucratisation of the market.³⁷² However, the Dutch and European mentality may become too awaiting if the market will grow faster than its current growth line, but this is still insecure.

Long-term regulatory strategy

When the market matures this analysis becomes a little tougher, as it cannot be foreseen how (in terms of modularity, amount of cross-border trade and market value in comparison with traditional financing ways) the market will look like at that moment yet. Therefore, the relevant FRCF organisations' respondents argue that regulators have to assess whether it is useful to create more binding legislation (e.g. the development of Directives or Regulations) in the long-term, depending on the size and form of the FRCF market.³⁶⁹ However, it is likely that a stricter legal framework is desirable in order to increase the market clarification and harmonisation across the EU.³⁷³ Hence, European regulators should take this opportunity to create structure and clarity in the European FRCF market, so that cross-border trade can be made the standard.³⁶⁹ Because, any rules that build more structural trust in the system are better for each market participant than rules that impose disclosure burdens.³⁷⁴ However, the problem with developing a legal structure that builds trust in the system is that market participants will always try to work around the legal structures, so that the rules will not apply to them; or the other way around.³⁷³ For example, if rules for Dutch investment companies are way stricter than rules for crowdfunding platforms that fulfil the same tasks, the investment companies will show their best efforts to fit within the crowdfunding framework instead of the investment company regulatory framework.³⁷³ Therefore, rules applied to FRCF should be similar to rules of other, traditional financing forms, in the long-term when the market matures.³⁷⁵ If a level-playing field is present, this will function, as traditional investors will have public information, but no option for negotiation about the transparency of additional information, which is important according to the regulatory or supervisory authorities' respondent group.³⁷⁵

The relevant FRCF organisations' respondent group also argues that the development of a European legal framework will be hard work anyway, as a monster of regulation has been created, which became so ineffective and difficult to understand throughout the years. Directives have become so complicated to implement in one way across all MSs, establishing patchworks of rules which are unsatisfactory.³⁷³ Even though the CMU plans indicate that European regulators will try to adapt existing regulations, respondents argue that a new directive, particularly for FRCF, would be ideal, as that would be at least clarifying for actors involved.³⁷⁶ One way or another, a harmonised and uniform legal framework is desired at European level, but will take many years to develop.³⁷⁶ The first step to such a framework is the inclusion of FRCF in the CMU plans.

Capital Markets Union

The CMU report, which will be published early 2016, describes the national policy responses regarding actions taken so far to identify national best practices.³⁷⁷ Despite of the best practices that may be used across the EU, the respondents express the wish for harmonised interpretations of regulations among all MSs what takes time, as there is no consensus about the way of harmonising it yet.³⁷⁸ However, European

³⁷¹ Respondent 2 (platform).

³⁷² Respondent 10 (relevant FRCF organisation), respondent 18 (regulatory or supervisory authority).

³⁷³ Respondent 17 (regulatory or supervisory authority).

³⁷⁴ Respondent 13 (relevant FRCF organisation).

³⁷⁵ Respondent 16 (regulatory or supervisory authority).

³⁷⁶ Respondent 10 (relevant FRCF organisation).

³⁷⁷ Respondent 15 (regulatory or supervisory authority).

³⁷⁸ Respondent 10 (relevant FRCF organisation), respondent 16 (relevant FRCF organisation).

regulators argue FRCF being a development from the private sector and therefore will follow that market development with a bottom-up regulator approach.³⁷⁹ In line with this, the EC has taken initiatives to contribute the support of crowdfunding emergence activities, including an Expert Group (that explores the potential of establishing a 'quality label' to build trust with users and provide expertise to the EC in promoting transparency, best practices and certification), raising awareness (with regard to promoting information, training and raising standards in this context), and mapping the national regulatory developments (to ensure functioning of the internal market and to assess whether regulatory intervention is necessary at EU level).³⁸⁰ But also self-regulation at national level and an extension to European level has been discussed by the European Crowdfunding Stakeholder Forum.³⁷⁹ Consequently of the actions already taken, a careful balance between the objectives of investor protection and continued expansion of crowdfunding to enable the development of this new funding channel across the EU are focus points at the moment.³⁷⁹ Hence, the FRCF market will be monitored after which a next report will be published.³⁷⁹

The majority of the respondents is sceptic about the usefulness of the CMU plans regarding the FRCF market. The acknowledgement and inclusion of FRCF in the plans will definitely add to the general recognition of the concept and the markets' professionalism³⁸¹, but FRCF is warned to be careful about what the CMU triggers because of its globalisation goal.³⁸² To clarify, the CMU will not bring that many in terms of regulation, but it will change the mind-set of European regulators and citizens.³⁸² In addition, respondents argue that the CMU plans are not well defined considering existing regulations, but only consider national best practices.³⁸³ The reason for considering the different national approaches so far and the cautious way of formulation is probably because some powerful MSs are quite sceptic towards FRCF.³⁸⁴ European regulators should be careful with that, as such alternative financing options may not be the biggest deal today, but they offer SMEs a lot and may offer other parties more in future.³⁸⁴ For example, European regulators could take a look at other financing possibilities that currently are facilitated via the EIB or the EIF and which are bank-based; these may become more crowdfunding-based in future.³⁸⁴

Maybe the described arguments are more fears than critics, as it is thought that the CMU will lead to friction as traditional financing ways feel increasingly stricter rules since the crisis, while alternative financing get away with less strict rules; for whose advantage?³⁸¹ Traditional financial institutions watch the development of FRCF with aversion, as they argue platforms to not compete fairly with banks.³⁸² But since the market does not care about that (the more competition the better), the only solution seems to be the increase of competition between those traditional financial institutions and the innovative financial sector; thus the creation of a level-playing field for the traditional and alternative sectors combined.³⁸² Consequently, regulators should adapt their regulatory development speed to the market development speed, otherwise too many unfair practices will occur due to fierce competition. Such a level-playing field will also set an interest rate level for the traditional and new financial sectors together, contrary to the current situation in which the European Central Bank (ECB) and Federal Reserve (FED) set an interest rate for the traditional sector and the FRCF markets set their own interest rates. In the latter situation, the platforms can play freely by creating interests that are different from those set by the ECB and FED.³⁸² The conclusion is crowdfunding having a better price discovery, e.g. the ability to find the real price of money or the interest rate. And the reason why crowdfunding can achieve this is because it lets the market forces decide.³⁸²

³⁷⁹ Respondent 15 (regulatory or supervisory authority).

³⁸⁰ Respondent 15 (regulatory or supervisory authority), European Commission 2014c.

³⁸¹ Respondent 11 (relevant FRCF organisation).

³⁸² Respondent 13 (relevant FRCF organisation).

³⁸³ Respondent 11 (relevant FRCF organisation), respondent 5 (investor), respondent 12 (relevant FRCF organisation), respondent 4 (platform).

³⁸⁴ Respondent 16 (regulatory or supervisory authority).

5.3.4 Flexibility and modularity

Despite the current obscurity in the FRCF market, the outlook is that FRCF is likely to stay and will even grow.³⁸⁵ Moreover, FRCF doubles each year and is likely to exceed the size of venture capital.³⁸¹ Additionally, research has shown that the interest on equity-crowdfunding in the UK (and some other parts of Europe) is much higher than anyone expected.³⁸⁶ So all cynical stories about FRCF do not seem reasonable as so far – apart from the Trustbuddy case³⁸⁷ – the FRCF sector is quite successful. Nevertheless, the coming years will show whether FRCF is as promising as many people think, because in probably 3-7 years the first reimbursements need to be done and the question is if that will happen.³⁸¹ Of course, a scandal like the Trustbuddy case can also happen in other countries, and one large negative case will definitely destroy the market growth at this point in time.³⁸⁸ On the other hand, it is not unthinkable that many platforms will collapse in the coming years, as just too many platforms pop-up at the same time while there is no demand for so many platforms at the moment.³⁸⁹ Nevertheless, the trend that people tend to do everything online and need to do more effort to be seen online indicates FRCF having a better future than traditional funding ways.³⁹⁰ Therefore, regulators should take care of FRCF's modular character by developing flexible policies to support future market growth. In line with that, a balance should be found between steering the market (which is called for by all FRCF participants at the moment) and too strict rules to safeguard the money-lender.³⁹¹ Consumer protection is key on one hand, while keeping administrative costs as low as possible on the other hand; all with the modular character taken into account.³⁹¹

Last years, the private sector has shown to be very innovative and dynamic.³⁹² Due to the growing importance of the internet, technological innovations and the subsequent online networks which connect the crowd (their interests and their money), the financial sector has become more dynamic and democratic than ever before. It seems that average crowd is taking over control over the financial sector, as they own parts of the business, try to increase their influence and experiment with new possibilities. This disruptive behaviour against the traditional sector leads to a changing financial sector which develops constantly new forms of FRCF and other alternative financing options. It is likely that FRCF becomes very modular with the standard platforms as basis to which different modules can be added so that it finally almost looks like a traditional bank.³⁹³ Also, platforms are developing block chains of financing products currently.³⁹² In line with this, such platforms are also starting to collaborate with traditional banks in order to let grow the amount of co-investments.³⁹³ Moreover, the use of FRCF will broaden to other sectors. For example, the Netherlands lags behind on the idea of crowdfunding real estate while it is already happening a lot in the USA.³⁸⁶ Furthermore, with European regulation FRCF will grow across the EU, however, it will probably also lead to global trade because the internet has no barriers. For example, national licences to operate as a platform that can be passported across the EU needs to be flexible, as new modules may be added in future and which also need to be added to the licence in that case.³⁹¹

Consequently, the European FRCF market needs to be regulated in a flexible and lean way, to secure the success of the innovative market growth.³⁹³ Flexible regulation is necessary for modular FRCF as it constantly will increase transparency and develop the level-playing field between the new FRCF actors and the traditional sector, so that it will finally harmonise and even integrate.³⁸⁶ Besides, flexible regulation will be able to deal with the growing market, new sectors to which it will broaden, and national differences.³⁹¹ Finally, lean policy development will decrease the possibility of over-regulation and too strict rules at the

³⁸⁵ Respondent 2 (platform).

³⁸⁶ Respondent 5 (investor).

³⁸⁷ See ECN (2015).

³⁸⁸ Respondent 12 (relevant FRCF organisation).

³⁸⁹ Respondent 4 (platform).

³⁹⁰ Respondent 13 (relevant FRCF organisation).

³⁹¹ Respondent 10 (relevant FRCF organisation).

³⁹² Respondent 1 (platform).

³⁹³ Respondent 17 (regulatory or supervisory authority).

nascent market stage. Too many rules would be too expensive for the newly established parties, and let's be honest; it would not fit within the character of an alternative financing form as it is known nowadays.³⁸⁶ However, developing flexible and lean regulation would have been easier if no existing linking regulations were in place yet.³⁹³ Through the presence of existing European regulations, regulators constantly stretch those existing regulations, even though respondents argue that new regulation would make a flexible and agile regulatory approach easier.³⁹⁴

Nevertheless, it is not likely that a new regulatory piece, particularly for FRCF, will be published in the next years, as the EC is focusing on new rules which will fit within the existing financial services regulatory framework.³⁹⁵ However, if regulators really want to keep pace with the speed of the innovative private sector, flexible policies which fit within the existing framework should be key; otherwise national regulations will have to be adjusted significantly, which takes too much time if the regulation asks for flexibility.³⁹⁶ Therefore, policy-makers should take into account the online worlds' rapid growth, resulting in policy change from an 'offline' to an 'online' character.³⁹⁷ Hence, it should be accepted that the internet has changed the location of the financial business: the courtyard or street corners as location to negotiate about the value of money have been replaced by online market places, in the form of platforms.³⁹⁸ It is time to let the general inclination of people being scared for new techniques disappear, and to start develop policies which fit future growth.³⁹⁹ If so, consumer protection is guaranteed and market growth is secured, resulting in the stay of good projects and platforms, while the unprofitable ones will leave the market.⁴⁰⁰ Thus, adverse selection will automatically decrease when regulation and market growth are synchronised. The fit of the policies and market is important, as the interest rate is low at the moment, but may increase in a few years. If there is still no level-playing field at that moment, the crowd will leave the market because it will become too dangerous, leaving the alternative financing market as an illusion.³⁹⁶

Summarised, the first section of the analysis clarified the lack of consensus on the definitions of FRCF and its two main forms which are basically old concepts in a new jacket with a modular character. After that, it is explained that the increase of the amount of money-lenders and the increased distance through the internet as medium has limited their rights. In addition, the separation of ownership and control decreases their power even further. Therefore, money-lenders should get involved more in projects for fundraisers to use them as marketing tool because that increases the money-lenders' influence. But in order to further increase the rights of money-lenders, the information asymmetry risk between money-lenders and fundraisers needs to be decreased. The primary way to do so is increasing the transparency and creating a level-playing field for all participants. In line with this, information provision is key, in the form of risk awareness and understanding in the short-term. In the long-term, the focus should be put on the development of a more coherent European legal framework, which should developed in a lean way and consists of flexible policies to be able to deal with new modules that will exist in future. This regulatory development process should be done in close cooperation between the private sector and public sector. In this context, the input has to come from the private sector while it is facilitated, coordinated and steered by the public sector. Table 9 provides a schematic overview of the analysis of respondents' opinions.

³⁹⁴ Respondent 6 (investor).

³⁹⁵ Respondent 8 (relevant FRCF organisation).

³⁹⁶ Respondent 2 (platform).

³⁹⁷ Respondent 1 (platform).

³⁹⁸ Respondent 13 (relevant FRCF organisation).

³⁹⁹ Respondent 14 (relevant FRCF organisation).

⁴⁰⁰ Respondent 3 (platform).

Sector	Private			Public	
Respondent group	Platforms	Fundraisers	Investors	Relevant FRCF organisations	Regulatory/Supervisory authorities
P1	- Old concept, new form (Investing 2.0, fits within 21 st century mantra); - Lack of regulation and clarity due to quick development of FRCF; - FRCF definition proposed as umbrella-term;			- Not experienced, medium experienced, professional money-lender groups; - Subjective information provision to ‘sell’ many propositions;	
Respondents ‘ agreement P1	- Consensus definition needed; - Subsequent policy development possible; - FRCF definition as umbrella-term;			- Equity-crowdfunding definition (involves ownership + interest return); - Loan-crowdfunding definition (involves loan + interest return); - Modularity: existing forms/models, adding new models, geographic level.	
P2	- Limited money-lenders’ rights due to lack of protective measures, secondary market and influence;		- Money-lenders do not know their limited rights or consequences;	- Lack of money-lenders’ power due to responsibility lack of platforms and fundraisers;	
Respondents ‘ agreement P2	- The internet as medium for platforms enables the reach of a large and dispersed crowd; - Increased ‘owner’ amount through large not-experienced crowd investing smaller tickets/few professionals investing larger tickets; - Lack of using large investor pool for advice or marketing.				
P3	- Using money-lenders as ambassadors to create vicious marketing circle; - Increase involvement to commit money-lender for long-term;				- Protective measures (standardised contracting, pre-screening, post-monitoring) in addition to involvement to increase money-lenders’ powers;
Respondents ‘ agreement P3	- Build trustworthy relationship between money-lender/fundraiser to increase success and sustainability for both actors and platform; - Take care of money-lenders through providing them influence and protective rules combined.				
P4	- Discussion if each investor earns same influence while not invested same amount; - Fundraisers do want to involve money-lenders but do not have the time or money to think how to do so;				- Shareholder is legally responsible, but does not have power to control (separation ownership/control);
Respondents ‘ agreement P4	- Find right involvement balance: weight needs of project and needs of money-lenders carefully; - Empower money-lenders individually and in group form by means of connections between them, provide screening/monitoring tools, co-investments, expedience test, etc. - Increase transparency/objective information provision about platforms, projects, subsequent risks and general financial FRCF risks; - Create a level-playing field for platforms, money-lenders, and fundraisers to create equality, clarity and reduce the information asymmetry risk.				
P5	- Platforms/fundraisers are responsible for information provision/facilitation towards crowd; - Private sector has to take joint responsibility to stimulate/accelerate FRCF market growth; - EU regulators have to use powerful position (cooperate with national regulators and private sector directly) by developing from European level but is time-consuming and complex; - Likely that EC focuses on best practices to spread across MSs; - EU regulators should accept/deal with FRCF market never being 100% safe, focus on protection of consumers; - Re-active regulatory approach of regulators in NL and EU, but should be pro-active;				- Regulators responsible for facilitating/steering the possibility of information provision by platforms and fundraisers and market growth; - Bottom-up (co-investments)/top-down (co-regulation) regulatory approaches from public sector; - Regulatory approach is as pro-active as possible, but basically still re-active.
Respondents ‘ agreement P5	- Joint responsibility of both public and private sector by strengthening each other’s efforts of market growth stimulation and facilitation; - Too pro-active approach results in too strict rules which decrease market growth, while too re-active approach results in market failure, therefore the rights balance needs to be found/adjusted constantly according to FRCF market growth.				
P6	- No strong regulation for nascent market, but loose rules to steer actors and create structure; - Harmonise across EU FRCF regulation in long-term, when market is mature to increase cross-border trade and the development of a secondary market.				- Awaiting approach in nascent market stage to enable market growth (but too awaiting according to private sector). - Wait for a European response and maybe adjust existing regulation.
Respondents ‘ agreement P6	- Loose organised FRCF market in short-term to enable experimentation and growth, stricter organised market in long-term to protect market and consumers for failures or unfair practices; - Short-term: risk awareness/understanding by means of steering Guidelines for MSs (will respect national differences in financial regimes); - Long-term: safeguarding market in a lean/agile way by means of a European legal framework with stricter rules (will increase harmonisation); - CMU will bring a mentality change and professionalism as regards the FRCF market, but content-wise the effect is debated.				
P7	- FRCF will stay and become more modular; - Private sector requests a visionary approach of regulators.			- All actors have to work together to organise modular FRCF; - Regulator alone is never responsible, it is private sectors’ invention.	
Respondents ‘ agreement P7	- Private sector is very innovative, dynamic, changes with a fast pace and new modules will be developed to add to existing FRCF forms/models; - Regulators (public sector) should adapt to this fast pace, be more pro-active and steer the FRCF market into the right direction by flexible policies that can be adapted when the market changes and new modular forms will be developed;				

Table 9: Schematic overview of analysis and respondents' opinions

6. Conclusions

This thesis clarified how FRCF should be designed at EU level with the information asymmetry risk, existing securities and credit directives, and CMU plans as foundation. By means of an extensive literature review of the – practically and scientifically – fragmented FRCF market, the conclusion is drawn that the market is at a nascent stage, in which MSs are experimenting with innovative and disruptive crowdfunding forms and models, and that there is neither consensus about a general definition of FRCF, nor about loan-crowdfunding or equity-crowdfunding in particular. As a first step into the direction of defragmenting the scientific and practical FRCF field, this thesis developed definitions for FRCF, loan-crowdfunding and equity-crowdfunding, for which others are invited to develop them. Next to that, the literature review provided a description of existing regulations and their ability to be adapted to include FRCF. Furthermore, the meaning and basis of the CMU plans is explained, as well as its possible implications for the future of FRCF.

In order to start clarifying the FRCF field, a case study has been conducted, by means of in-depth face-to-face interviews with 18 experts in the (mostly) Dutch FRCF field. The analysis of the interview data revealed that money-lenders' rights are very limited as regards crowdfunding. The rights are decreased through an increase of the total amount of owners in crowdfunding, as well as through the internet that functions as a medium and subsequently increases the distance. These developments decreased the ability of money-lenders to control fundraisers, which reduces their rights. Additionally, the separation of ownership and control decreased their rights even further, by putting the power in the hands of the managing few (fundraiser), while ownership is in hands of the many (crowd). This separation increases the information asymmetry.

To increase the money-lenders' rights in order to make crowdfunding a more sustainable financing option, the information asymmetry between both actors has to decrease. The primary solution to do so, according to the respondents, is to increase transparency and develop a level-playing field among all actors involved. Clear, structured and uniform information provision is key in this context. The information provision has to focus on risk awareness and understanding by the crowd in the short-term, as too many strict rules at a nascent market stage will kill the young sector. The most obvious instruments are European Guidelines, through which the MSs will be steered into a certain direction, while still providing room to implement the Guidelines in the national cultures and financial regimes. In addition, a coherent European legal framework has to be developed to safeguard the resilience of the market in the long-term, when the market is more mature and can handle stricter rules. Such a European legal framework has to adapt existing regulations first, as over-regulation is a definitely no go. Now the market starts growing, regulators should assess the existing legal framework and market growth constantly, in order to decide whether existing regulations have to be adapted or whether new rules should be created.

Remarkably, the interviews showed that all respondents more or less agreed on the lack of transparency and a level-playing field and the subsequent need for it, while those aspects and the subsequent discussed process to get there, are desirable according to all respondents. Thus, all respondents desire to conquer the same challenges, but the way towards it differs. Because, the relevant FRCF organisations' and regulatory or supervisory authorities' respondent groups viewed the FRCF market and subsequent necessary steering and regulation from a broader view (the total picture) than the platforms', fundraisers', and investors' respondent groups. The former respondent groups took all considerations with references to the global financial markets, while the latter respondents groups only seem to care about their own businesses, the Dutch FRCF market, and – if it can make them more profits in future – also the European FRCF market. These views explain the equal desires of respondents but their different views on the necessary approaches to realise those desires. However, this is not remarkable, as the private parties want to have prosperous businesses, while the public parties have to facilitate and supervise that in a more abstract context. Nevertheless, this difference may create some friction between the different respondent groups and their public or private backgrounds, but in the end all respondents agree on the necessity of

transparency, a level-playing field, the regulatory weight differences in the short-term and long-term, and the flexibility and modularity aspects; through one way or another.

The regulatory development in the short-term and long-term should be driven by the private sector input, while facilitated and steered by the public sector. First, existing regulations need to be adapted to FRCF where possible. Next, the Guidelines and the European legal framework should be developed from a European level, as this offers the possibility to create a European-wide level-playing field and the real creation of free flow of capital across the EU – more than 50 years after the Rome Treaty, in which the latter was initiated. In addition, all newly developed rules should be created in a lean and flexible way, so that future models, forms or modules of FRCF can fit within the designed regulations. This latter aspect is very important, since FRCF is a growing market with a lot of potential and benefits for many actors; therefore, its success should be supported and maintained by close monitoring and intervention when necessary. If so, the FRCF market will grow cross-border and become a successful and sustainable alternative financing option, which competes with traditional financing ways in a fair and just manner. Finally, in the scope of the CMU, the crowdfunding document, which will be published in the beginning of 2016, will describe in more detail the EU's approach to boost the FRCF market and develop a Single Capital Market as chosen by the EC.

7. Limitations and recommendations

This chapter explains the scientific and practical limitations of this study. Besides, since case study research is about questions and not necessarily about answers⁴⁰¹, several practical and scientific recommendations for new business opportunities and follow-up research, respectively, are provided.

7.1 Scientific limitations

A traditional classification of financial services comprises of banking (including financial conglomerates), securities markets, and insurance.⁴⁰² Post-trading activities (including payment services and the clearing and settlement of securities) can be broadly seen as part of banking and securities markets, respectively.⁴⁰² However, these latter post-trading activities are often neglected by scholars in their literature because it is rather ‘technical’ and less ‘political’ due to the fact that regulatory activity had been minimal in the field. Because post-trading activities have become an important policy area in their own right after the establishment of the EMU and the Single Market in financial services⁴⁰², this might be a minor limitation to the literature review of this thesis and thus it might provide a limited view on the history of securities directives.

Next to that, there has been a trade-off between the scope of the research and its depth. Therefore, both equity- and loan-crowdfunding forms are taken into account, as they both constitute FRCF. However, the equity-crowdfunding part exceeds the loan-crowdfunding part as it seems to be more potential than loan-crowdfunding on longer-term and in a broader sense. Though, this assumption does not suggest that loan-crowdfunding is less important. On the opposite, loan-crowdfunding plays an increasing role in the financial services, especially for individuals. However, still, the profit opportunities, and therefore the growth opportunities, of equity-crowdfunding remain – according to the respondents – greater than those of loan-crowdfunding equity.

Moreover, this study is based on a Dutch case study and generalises the information to a European level. Until, and even after if changes may occur, crowdfunding is regulated at EU level, FRCF at national level may deal with different regulations and rules. Hence, the research does not deal with the implementation of soft measures in the MSs, which may have influence on the new EU regulation in the field if the process delays. However, this would be an interesting follow-up research. Following the same logic, the international level, such as the USA regulations, is mentioned only whenever this is directly relevant to explain developments in the EU.⁴⁰³ Therefore, further cross-cultural research is useful.

In addition, the literature and theory argues that the probability of shirking increases if the preferences of principals and agents diverge, if there are high levels of uncertainty, or if the agent has a distinct information advantage.⁴⁰⁴ However, it might be assumed that when preferences of both actors diverge too much, they both won’t cooperate at all. Therefore, the Agency theory may be too limited for the usage of this research in the context of the increasingly expanding FRCF sector that touches more actors and relationships than only the fundraiser-money-lender relationship.

Furthermore, the research conducted in this thesis considered a single-case study, possibly creating scepticism and criticism as it produces a weaker effect than multiple-case studies.⁴⁰⁵ It is tried to make extremely strong arguments to justify the case researched⁴⁰⁵, even though some respondents disagreed with each other. Therefore, multiple-case studies on a meso-level may be useful, by for example including the private and public sectors input separately, as well as loan-crowdfunding and equity-crowdfunding studies separately. But also multiple-case studies at macro level will add to the scientific literature by

⁴⁰¹ Yin (2014), p. 74.

⁴⁰² Quaglia (2010), p. 5.

⁴⁰³ Quaglia (2010), p. 6.

⁴⁰⁴ Waterman and Meier (1998), p. 176.

⁴⁰⁵ Yin (2014), p. 64.

researching the FRCF markets at different countries. As regards the latter proposal, the EC is working on such a research at this moment.

Finally, the research conducted in the context of this thesis has resulted in an even broader study than expected before. However, due to the fragmented field and scattered opinions about the FRCF sector, the actors and the definitions inherent to these aspects, such a broad approach was not to be prevented. While this study created the basis for the development of a level-playing field for researchers, future research may be more useful for regulators if it is more specific. In line with this, in-depth face-to-face interviews can be held, but on a much more specific part of the FRCF market to increase the depth of the research. Luckily, that will be possible as this study has set the basis to do so.

Unfortunately, the time and paper space were too limited to describe national differences as regards the current regulatory approaches concerning FRCF. Such detailed national differences would have made the study probably more useful as it indirectly would indicate the approaches of different MSs and function as best practices for other MSs. Nevertheless, other researchers are already researching this in detail, as well as the EC itself.

Even though it would have been very interesting and useful to study equity-crowdfunding and the relevant securities directives only, this direction was not chosen for due to the interests of the company for which this study was conducted. In addition, many researchers are working on this currently, making it less useful if this study would have included the same aspects. In addition, the literature showed vagueness and obscurity about FRCF definitions and concepts, making it more useful to focus on clarity and definitions to create a foundation for further research first.

7.2 Practical limitations

Despite of the fact that crowdfunding is relatively new, there is a lot of information about it, as it is part of the innovative and disruptive FinTech environment which receives a lot of attention. However, because the field is so young, the information is often no peer-reviewed literature but blogs or newspaper articles. The result is that information used from such sources is up to date and important, as such sources reach a large audience, indicating that the information they provide is the 'news' of the day for their readers. But, the information provided is often not validated or reviewed to a certain extent by other practitioners in the field. Hence, it is the influence of the journalists or bloggers that decide what information they publish. But that is just the consequence of conducting research in a nascent field, even though it is tried to filter such 'grey' literature.

Even though the crowdfunding field is not yet that large in the Netherlands, new parties pop-up every day. Therefore, initially all large and important parties – at the time – were contacted to make interview appointments. However, at the end of the research period – six months later – many new parties have evolved that continuously start to play a more important role. Unfortunately, due to a lack of time, it was not possible to include those parties at a later stage.

Even though it was thought that it would be hard to schedule all 18 face-to-face interviews with the respondents, they were remarkably easy to schedule because all respondents are very encouraging that research on this aspect from the FRCF market is conducted and they all are very curious and interested in the results of this study as it benefits the growth of their sector by informing researchers, regulators and practitioners in the field.

7.2 Scientific recommendations

To begin with, this study showed that FRCF is fragmented and consists of many different models, forms and modules. Therefore, follow-up research on all particular modules, which are added to existing forms and models at the moment, will help understanding the level of fragmentation. Additionally, follow-up research on potential future models will help preparing to adapt to the changes later. In this context,

debated modules such as the block chain technology, the use of Big Data and Business Intelligence, and Machine Learning should be focused on. What do such innovative technologies bring as regards flexible regulation if they will be used in practice?

Besides, the analysis showed the differences between less, medium and experienced money-lenders and the subsequent importance level of information asymmetry and relevant information provision. It is useful to conduct follow-up research in more detail on the three investor groups and possible differences regarding their information needs and protection, specifically. In line with this, it will be interesting to see the impact of an increased amount of professional investors with larger investment tickets (which will occur when a secondary market develops for example), compared to the current large amount of less experienced investors investing smaller tickets. Because, it is assumable that if less investors invest with larger tickets, the rights of money-lenders will automatically increase due to the lower amount of owners. Therefore, it is interesting to research whether this relationship is bilateral or just unilateral. If it occurs to be a bilateral relationship, it is likely that the rights of money-lenders will increase with the same trend as the amount of professional money-lenders with larger tickets increases. If this happens to be the case to a large extent, the passing of ownership from the hands of the 'investing many' to the 'managing few' changes considerably from the current situation.

Moreover, the analysis clearly showed that all respondents require more transparency and a level-playing field through uniform information provision and empowerment of the money-lenders. Several respondents proposed (partial) solutions for these challenges, by emphasising the importance of certain instruments which can be implemented/used by platforms, fundraisers or regulators. A few examples of these solutions are, an expedience test to 'screen' money-lenders before investments, the use of very brief Prospectuses, standardised contract content, an independent organisation to assess platforms prior to undertaking, platform to link investors in order to bundle their powers, the usefulness of the same conditions a level-playing field delivers, the effect of monitoring opportunities for investors on their knowledge, returns, and project commitment, the use of an obligatory risk-spreading control by platforms, and uniform risk assessment format for projects by platforms). Follow-up research on the usefulness/effect of such individual measures is useful, as well as research on the usefulness/effect of certain measures combined, as they may deliver a synergetic result (or the opposite). Thus, it is important to understand the effect of all measures before they will be implemented.

Furthermore, in the case of money-lender empowerment, follow-up research on the absolute effect of the ambassador function possibly exercised by money-lenders is important. Such a study will clarify the effect of ambassadorship on the marketing and sales of the fundraiser, but also the commitment of the money-lender, which may result in increased investor rights and thus protection. Besides, maybe the study will provide insight in other ways for keeping money-lenders involved and committed, reducing the importance of implementing other protective measures. Thus, further research on these aspects is necessary in order to find out which measures deliver the best results for a long-term regulatory strategy.

Also, the analysis showed hard results about the cooperation performance of the public (regulators and supervisors) and private sectors (FRCF actors). The FRCF actors argued that regulators and supervisors operate in isolation, while the regulators and supervisors themselves think they operate very pro-active and in close cooperation with the private sector. Therefore, it is useful to research the best way to continue policy developments concerning FRCF, for the sake of the markets' success. Maybe the approach of co-regulation should be increased between not only the ministries, central bank, and the financial supervisory authority, but also in closer cooperation (than the current situation) with the private sector, even though it is time-consuming and complex. In the end it may deliver better results in terms of acceptance through support of the FRCF actors. However, in such a case, the cooperation between the Dutch central bank and the financial supervisor should also increase. The question is how this can be reached, as the power division between both parties is vague in the case of FRCF.

Finally, when the EC will publish its crowdfunding document in the beginning of 2016, it is interesting to research the impact in terms of a European mentality change towards FRCF. This document will likely influence the European and national approaches significantly, and may even increase friction between the traditional and alternative financial sectors. Therefore, the progress in terms of regulatory development and market growth are important to analyse, as these will determine the adjustments of existing regulation or the development of new legislative texts. On top of that, the in this thesis proposed definitions may be confirmed when they are in line with the EC's document, and may subsequently be tested or agreed on. However, if the definitions will not fall in line with the EC's document, they may be rejected by the scientific community and practitioners, after which follow-up research will provide the opportunity to develop new definitions for the concepts. Therefore, close supervision of the EC's progress and direction, and the reaction of the FRCF actors on that direction will be significant for the success of the European FRCF market in the next years.

7.3 Practical recommendations

First, it is recommended that all actors of the private sector take their responsibility by driving market growth and pushing the regulators to start working on flexible regulation for FRCF. Consequently, regulators have to take their responsibility by steering the market growth through clear and structured Guidelines that create a safer market, as well as risk awareness and understanding. The FRCF market has great growth potential but still needs to be recognised and accepted by regulators and it is the private sector's task to show them.

Second, in the coming few years the relevant FRCF parties have to experiment and develop new functions, forms and models within the market so the potential of FRCF is shown. In line with this, new opportunities arise that probably are very interesting business cases. A few examples to this extent are new modules to add to the existing platforms (bitcoin technology, virtual currencies, etc.), network creation for investors (to enable investor-connections through platforms or social media to empower them), new/changing advisory roles for banks or other third parties (consultancies, financial advisors, etc.), and the creation of a level-playing field for the alternative financing sector and traditional financing sector combined (prevent friction between both sectors despite of the changing regulations). The role change of traditional financial advisors due to the development of FRCF provides an interesting follow-up research for the author of this study. Finally, as these future developments are key for the success of the FRCF market, according to the respondents, European regulators should facilitate the possibility to let the private sector experiment with such business cases in the short-term.

8. References

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9. Appendices

9.1 Appendix I – Adaptations to existing Securities Directives and Regulations to include FRCF

9.1.1 – Prospectus Directive [2003/71/EC as amended]

The Prospectus Directive (PD) requires publication of a prospectus before the offer of securities to the public or the admission to trading of such securities on a regulated market, unless certain exclusions or exemptions apply.⁴⁰⁶ The Prospectus should specify who is responsible for the information of the Prospectus and cannot be published until it has been approved by the NCA.⁴⁰⁶ Therefore, in theory, the PD would be applicable to securities offered to secure investment in projects funded through crowdfunding platforms; however, there are some practical issues:⁴⁰⁶

***a)** The PD applies only where instruments are transferable securities, as defined in MiFID [Arts 1(1), 2(1)(a)]. If the instrument used were not a transferable security but nevertheless was a MiFID financial instrument, MiFID disclosure requirements would apply. However, where the instrument is not a MiFID financial instrument, any disclosure requirements would depend on national law as MiFID would not be applicable. It should be noted that provided the instruments are transferable securities, the PD would apply to the issue, provided that the size of the offer and/or investor base triggers the application of the PD, even if it were deemed that the MiFID did not apply to platforms for other reasons.*

***b)** The size of the offer may not trigger the application of the PD, because*

i. Offers with a total ‘annual’ consideration below €5m are outside the scope of the Directive [Art 1(2)(h)];

ii. Offers with a total ‘annual’ consideration below €100k are excluded from the obligation to publish a prospectus [Art 3(2)(e)]; however, MSs have discretion to apply national requirements to offers between €100k and €m and practices in this regard vary;

***c)** Offers are also exempt from the obligation to publish a Prospectus if the offer is addressed only to ‘qualified investors’, which are essentially professional clients under MiFID [Art 3(2)(a), Art 2(1)(e)].*

***d)** Offers are also exempt from the obligation to publish a prospectus if the offer is addressed to fewer than 150 natural or legal persons per MS other than ‘qualified investors’ [Art 3(2)(b)].”*

Moreover, even where there is no obligation to publish a Prospectus under the PD, where MiFID applies there would still be disclosure requirements under MiFID in relation to financial instruments.⁴⁰⁷ These obligations would apply to the platform as the authorised investment firm, rather than directly to the issuer of the securities.⁴⁰⁷

9.1.2 – Markets in Financial Instruments Directive [2004/39/EC] (MiFID)

Where applicable, MiFID would impose duties on the crowdfunding platform in its capacity as investment intermediary (a firm does need to be carrying on MiFID services/activities in relation to MiFID financial instruments, and not exempt in this case).⁴⁰⁷ The benefit of being in scope of MiFID is that a platform has a passport to carry on the services/activities for which it is authorised throughout the EU without any additional authorisation being required, in accordance with a single set of rules.⁴⁰⁸ Furthermore, the capital requirements, organisational requirements and conduct of business would apply as for other investment firms depending in some cases on the services provided.⁴⁰⁸

The MiFID applies in relation to the list of ‘financial instruments’ set out at Section C of Annex 1 to the Directive; regarding crowdfunding these are most likely transferable securities (e.g. equities or ‘mini-bonds’), though others such as units in collective investment undertakings would be possible.⁴⁰⁸ With regard to Art 19(6) in relation with crowdfunding, it can be argued whether the appropriateness test could

⁴⁰⁶ ESMA (2014a), p. 13.

⁴⁰⁷ ESMA (2014a), p. 14.

⁴⁰⁸ ESMA (2014a), p. 15.

be dis-applied, because ‘shared admitted to trading on a regulated market’ would not be relevant in most cases, as the shares in question are generally not admitted to trading on a regulated market.⁴⁰⁸ Moreover, bonds or other securitised debt (excluding those containing derivative), could be relevant in the context of crowdfunding and therefore a platform would not need to carry out an appropriateness assessment where the other conditions of Art 19(6) are met.⁴⁰⁸ Next to these two aspects on the list of ‘non-complex financial instruments’, there are other instruments that shall be considered non-complex if there are frequent opportunities to dispose of/realise the instrument at publicly available market prices and adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood so as to enable the average retail client to make an informed judgement about whether to transact.⁴⁰⁸ However, ESMA considers such instruments not complex as there often is no secondary market and limited other opportunities to dispose of or realise the investment.⁴⁰⁹

Where a platform is carrying out MiFID services/activities in relation to MiFID financial instruments and does not meet conditions to be exempt, it would need to be authorised as an investment firm and comply with the relevant MiFID requirements.⁴¹⁰ The question which services/activities a platform carries out needs to be assessed case-by-case as business models can vary and the definitions were not designed with these business models in mind.⁴¹⁰ However, often this activity is the reception and transmission of orders (in the absence of regulatory constraints), in which the platform receives orders from investors and transmits them to the issuer or another third party intermediary.⁴¹⁰ Furthermore, there is the question whether platforms might act outside the MiFID scope. To operate outside the Directive scope, the basis on which the platform offers the service does not involve the reception and transmission of orders but only the collection and transmission of expressions of interest, there would have to be a real, substantive distinction between the expression of interest and something which could be considered as an order.⁴¹¹ In addition, in determining which service/activity the platform was carrying out, the platform’s business model, marketing to projects and investors of the services it offers and structure of its revenue generation would have to be consistent with this characterisation of the service it provided.⁴¹² This includes also the discussion whether the platform carried out execution of orders on behalf of clients.⁴¹² Another problem that arises is whether platforms provide ‘advice’ when technically there has been no personalised recommendation, even though the client may think the platform did.⁴¹² This is particularly worrisome because investors may rely on the platform’s ‘due diligence’. Besides, any platform that undertakes to find a specified level of investment, it is subject to the full €730k MiFID/CRR capital requirements.⁴¹³ Moreover, there is also the difference between ‘open offer’ of securities on the one hand and ‘placing on the other regarding the activities of platforms. Because, MiFID may apply to investment services/activities related to the issuance of securities in primary markets, MiFID does not regulate the public offer of securities in the primary market as such (this is done by the Prospectus Directive).⁴¹³ Finally, there is the question whether crowdfunding platforms are operating MTFs, as they currently only operate in primary markets with typically one seller per financial instrument, though there may be multiple buyers.⁴¹⁴ ESMA argues crowdfunding platforms not operating MTFs, however, if a secondary market for these instruments is developed and this brings together multiple buying and selling interests it would be an operating MTF.⁴¹⁴

Art 3 of the MiFID provides an option to exempt firms if they do not hold of client money or securities, provide only the investment services of reception and transmission of orders and/or investment advice, transmit orders only to authorised firms, and are regulated at national level.⁴¹⁴ Such firms do not benefit from a passport, but are also not subject to MiFID capital or other requirements.⁴¹⁴

⁴⁰⁹ ESMA (2014a), p. 15-16.

⁴¹⁰ ESMA (2014a), p. 16.

⁴¹¹ ESMA (2014a), p. 16-17.

⁴¹² ESMA (2014a), p. 17.

⁴¹³ ESMA (2014a), p. 18.

⁴¹⁴ ESMA (2014a), p. 19.

The operation of a platform within the MiFID would be as follows. Where a platform is carrying out business within the MiFID scope and there is no applicable exemption, the platform could either be directly authorised as an investment firm, be operated by an investment firm or credit institution that has an existing MiFID authorisation, or act as the tied agent of an investment firm or credit institution.⁴¹⁵

9.1.3 – Directive on Investor-Compensation Schemes [97/9/EC]

The Directive provides access to compensation up to a specified amount for investors where the investment firm is no longer financially able to meet its obligations and requires all authorised investment firms to belong to such a scheme (applies only to MiFID firms related to MiFID instruments).⁴¹⁵ Where firms are exempted from MiFID under the optional exemption 2004/39/EC Art 3 the ICSD does not apply, although MSs may require such firms to be members of an investor compensation scheme.⁴¹⁵

9.1.4 – Market Abuse Directive [2003/6/EC]

Most instruments currently offered through crowdfunding platforms are outside the scope of this Directive as it prohibits insider dealing and market manipulation in relation to financial instruments which have been admitted to trading on at least one regulated market or for which a request for such admission has been made.⁴¹⁵ However, in cases that the Directive applies, the insider dealing prohibition applies to owners and managers of the issuer and to those who have access to the inside information through their professional activity (which could include the platform where separate from the issuer).⁴¹⁵ There are some obligations on issuers and managers of firms in this context.

9.1.5 – Alternative Investment Fund Managers Directive [2011/61/EU]

The AIFMD could be applicable to a platform where it manages a non-UCITS collective investment undertaking which raises capital from a number of investors with a view to investing it in accordance with a 'defined investment policy' (then the investment vehicle could be an AIF).⁴¹⁶ In addition, the ESMA has issued guidelines (including a set of factors) on the definition of an AIF.⁴¹⁷ Besides, AIFM contains various exclusions from scope which regard the definitions of 'holding companies' (Art 2(3)(a)) and securitisation special purpose entities (Art 2(3)(g)).⁴¹⁸ Furthermore, holding companies established by platforms to date typically would not fall within the scope of Art 2(3)(a) exemption and could be considered as AIFs.⁴¹⁹ However, some SPVs could be qualified as securitisation special purpose entities under the exemption and would therefore not be considered as AIFs.⁴¹⁹ Moreover, AIFMs which manage AIFs with total Asset Under Management (UAM) are exempted (Art 3(2)) and subject to at least registration by and information provision to the home MS NCA.⁴¹⁹ Such AIFMs can opt into the rest of the Directive, but unless they do so do not benefit from a passport.⁴¹⁹

There are some other requirements applicable when a platform is within the AIFMD scope. The Directive prevents AIFMs from carrying out activities other than investment management, administration and marketing of an AIF and certain related activities.⁴¹⁹ There is no provision for authorised AIFMs to carry out MiFID services/activities where the AIF is internally managed.⁴¹⁹ This is different when the authorised AIFM is a legal person external to the AIF itself, then it would be subject to the initial capital, organisational and conduct of business requirements under MiFID.⁴¹⁹ Nevertheless, if AIFMD were applicable, requirements would include the appointment of a manager for the AIF, which would need to be authorised, and hence subject to organisational and capital requirements.⁴²⁰ Finally, the marketing of AIFs is in principle restricted to professional investors, but MSs may choose to allow it for retail investors too.⁴¹⁹

⁴¹⁵ ESMA (2014a), p. 20.

⁴¹⁶ ESMA (2014a), p. 21.

⁴¹⁷ See ESMA (2014a), p. 21-22 for more information on the definition of AIFs.

⁴¹⁸ See ESMA (2014a), p. 22.

⁴¹⁹ ESMA (2014a), p. 23.

⁴²⁰ See ESMA (2014a), p. 23.

Furthermore, the question as to whether a crowdfunding platform which offered investors indirect investment through an AIF could operate only with an AIFM authorisation depends on the assessment of which MiFID services/activities it would need to provide and how that relates to what is permitted under AIFMD.⁴²¹ Authorised AIFMs are permitted to carry out a range of activities⁴²², and if the platform where the AIFM and were deemed to be providing only the MiFID services/activities of reception and transmission of orders and/or investment advice (as defined in MiFID) it would seem to be possible where the manager is external to the AIF itself, because MSs may permit these activities under Art 6(4) of AIFMD.⁴²³ Moreover, if it were determined that platforms intrinsically offer execution of orders this possibility would not be open to them, because these services/activities cannot be undertaken by virtue of authorisation as an AIFM as such and are not listed in Art 6(4).⁴²³

Besides, if the platform is the AIFM and is external to the AIF, it would mean initial capital requirements on the platform of €125,000 and ongoing capital requirements depending on the level of overheads and total assets under management in the AIFs.⁴²³ If such a platform only carried out the MiFID service of reception or transmission of orders, with or without provision of investment advice, it would seem feasible that it could operate a crowdfunding business model on the establishment of a separate AIF for each project invested in.⁴²³ However, it is not clear whether a platform would choose the authorised AIFM form as the initial capital requirement is significantly higher than under the MiFID.⁴²³ Therefore, it seems more likely to be relevant for a platform that structured a single vehicle with multiple sub-funds, each investing in a single project, or potentially 'clusters' of investment opportunities in a single fund.⁴²³ Finally, where the AIFM manages AIFs with AUM under the threshold specified in Art 3(2), the AIFM would be able to carry out additional MiFID services and to be authorised under MiFID (if not exempted), unless the MSs imposed additional restrictions which prevented this.⁴²³ However, such registration would not give rise to a passport for the marketing of the AIF unless the AIFM opted into the whole Directive, which would in turn imply that it loses the right to be authorised under MiFID.⁴²³

9.1.6 – European Venture Capital Funds Regulation [EU No 345/2013]

The Regulation lays down conditions which managers have to meet if they want to use the designation 'EuVECA' in marketing material relating to qualifying funds, which are established in a MS and which intend to invest at least 70% of assets in small firms that do not issue listed securities and meet certain other conditions.⁴²³ Once registered as having met the conditions described in the Regulation, AIFMs can market qualifying funds throughout the EU, using the designation EuVECA.⁴²³ Some of the rules are: managers of such funds must act honestly, fairly and with due skill, care and diligence; take steps to prevent malpractices that could harm the interests of investors or entities invested in; promote the best interests of the funds, their investors and market integrity; apply a high level of diligence in the selection and ongoing monitoring of investments in qualifying portfolio undertakings; adequately know/understand the entities they invest in; ensure no investor obtains preferential treatment unless that is disclosed in the funds' rules/instrument of incorporation.⁴²⁴ There are some other rules as well, but there is no requirement to appoint a depository.⁴²⁴

Moreover, managers are required to own sufficient resources to manage the funds, but no amount of own resources or methodology for calculating them is mandated.⁴²⁴ Therefore, it would seem attractive for a platform using an AIF as a vehicle for indirect investment in projects to seek to do so within the parameters of an EuVECA because the capital requirements are likely to be much lower than for an AIFM authorised under AIFMD and potentially lower than those applicable if a different structure were used requiring

⁴²¹ ESMA (2014a), p. 24-25.

⁴²² Those activities are mentioned in the Annex of the Directive.

⁴²³ ESMA (2014a), p. 25.

⁴²⁴ ESMA (2014a), p. 26.

authorisation under MiFID, and the qualification would bring with it a passport which is not available to registered AIFs.⁴²⁴

9.1.7 – European Social Entrepreneurship Funds Regulation [EU No 346/2013]

The Regulation follows the approach of the Venture Capital Regulation in relation to managers of funds investing in social enterprises, which where the requirements are met may be marketed as ‘EuSEFs’ and benefit from a passport.⁴²⁴ The same restrictions on the clients to whom the funds may be marketed apply as in the Venture Capital Funds Regulation (art 6).⁴²⁴

9.1.8 – Distance Marketing of Financial Services Directive [2002/65/EC]

The Directive applies where there is a contract between a supplier and a consumer (see the Directive for the specific definitions) which is concluded without the two parties being physically in the same place; therefore it would be likely to apply in principle to the investment contract and to any separate contract with the platform, because the investor’s counterparty would be a supplier.⁴²⁴ The Directive requires information disclosures about the supplier and financial service, whether there is a right of withdrawal and any applicable out-of-court redress/complaints/compensation mechanisms.⁴²⁴ Furthermore, it provides for a 14 day right of withdrawal (longer for life insurance and pensions) but states that this right shall not apply to financial services ‘whose price depends on fluctuations in the financial market outside the supplier’s control, which may occur during the withdrawal period’.⁴²⁴ This exclusion explicitly covers transferable securities and units in collective investment undertakings (Art 6(1)(2)); in cases where the securities are not transferable, consideration would need to be given as to whether the price of the particular security was capable of fluctuating within the withdrawal period before determining whether the right of withdrawal should be dis-applied.⁴²⁵

9.1.9 – Third Anti-Money Laundering Directive [2005/60/EC]

This Directive prohibits money laundering and terrorist financing and applies to firms including credit institutions and financial institutions (the latter including MiFID investment firms, collective investment undertakings, and firms providing certain services offered by credit institutions without being one).⁴²⁵ The MSs are required to extend it to other categories of institution if necessary, but has to notify the EC when they use this power.⁴²⁵

MSs may impose stricter requirements, but the Directive requires firms to carry out due diligence on customers and to have in place appropriate record-keeping and other internal procedures, as well as that those firms have an obligation to report any suspicious activity, to co-operate with any investigations by relevant public authorities, and not to disclose the report or any investigation.⁴²⁵

Not many platforms would be automatically captured by this Directive, as most of them are currently operating outside the scope of the MiFID; however, the definition of ‘financial institution’ also includes those carrying out money transmission, participation in securities issues and the provision of services related to such issues, and safekeeping and administration of securities.⁴²⁵ Therefore, depending on the business model, this could capture some platforms.⁴²⁵

⁴²⁵ ESMA (2014a), p. 27.

9.2 Appendix II - Adaptations to existing Credit Directives and Regulations to include FRCF

9.2.1 – Capital Requirements Directive [2013/36/EU] & Capital Requirements Regulation [575/2013]

The CRR defines credit institutions as an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account (Article 4(1)), p. 1).⁴²⁶ However, the typical platforms providing loan-crowdfunding do not hold deposits or repayable funds and therefore do not fall under the scope of the CRD/CRR.

9.2.2 – Mortgage Credit Directive [2014/17/EU]

So far, few platforms provide solutions for real estate investment at the moment. Where platforms are considered to provide mortgage credit in the course of their trade, business or profession, it could be acting as a creditor (as defined in the MCD) to whom the obligations of the Directive apply.⁴²⁷ Where the platforms' function is simply to provide a meeting point, it could potentially be subject to the Directive requirements on credit intermediaries unless its actions are limited to 'merely introducing' the consumer and the creditor.⁴²⁷

9.2.3 – Payments Services Directive [2007/64/EC]

The PSD is subject to crowdfunding because FRCF consists of a money-handling aspect. Depending on the business models of the platforms, different aspects of the PSD are relevant. Therefore, also the recently adopted PSD II meets FRCF. However, to what extent depends on the business model of the platforms.⁴²⁸

9.2.4 – Electronic Money Directive [2009/110/EC]

Only if a platform receives and keeps funds (until the required funding level for a specific project's financing is reached), after which the funds would be paid out via an electronic wallet service, it could be subject to the EMD. However, it can also be argued that it does not meet FRCF as the funds received by lenders are to be used only with borrowers inside the platform for financing purposes.⁴²⁹ But in cases where electronic money institutions are entitled to engage in the provision of payment services it appears to be relevant in defining money-handling aspects of crowdfunding and can therefore be considered to be relevant.⁴²⁹

9.2.5 – Consumer Credit Directive [2008/48/EC]

The CCD will only be relevant as the platform acts as a lender or borrower, but that is often not the case. Should a platform itself provide credit to borrowers, or should it lend funds to consumers for them, in turn, to lend on to borrowers, the CCD's provisions concerning creditors would apply to the platform.⁴³⁰

9.3 Appendix III – Details of three direct actions of CMU plans (Table 4)

Regarding the **first action** – improving access to financing for all businesses across Europe and investment projects such as infrastructure – *alternative funding sources* play an important role, as small firms typically depend on external finance to grow while bank finance is often hard to access.⁴³¹ More efficient and effective markets can help to reduce the costs of accessing corporate bonds and other capital markets and would benefit all businesses.⁴³² In this context, the EU requires a significant amount of new infrastructure investment to maintain its competitiveness.⁴³² To increase alternative funding sources *information problems* should be addressed first. Proper feedback from banks when they decline a loan and International Financial Reporting Standards (IFRS) play a key role in this context.⁴³² But, imposing these

⁴²⁶ EBA (2015), p. 25.

⁴²⁷ EBA (2015), p. 26.

⁴²⁸ EBA (2015), p. 26-30.

⁴²⁹ EBA (2015), p. 30.

⁴³⁰ EBA (2015), p. 31.

⁴³¹ European Commission (2015a), p. 13.

⁴³² European Commission (2015a), p. 14.

rules on smaller firms would increase costs, therefore the development of a simplified, common and high quality accounting standard tailored to smaller firms could be a step forward in terms of transparency and compatibility.⁴³² This could result in attracting more foreign investors, more private investment and support for regulators to adopt a more tailored prudential regime for infrastructure investments.⁴³²

Second, *standardisation* can kick-start markets. A common set of market rules, transparency on product features and consistent supervision and enforcement may help, as a certain degree of standardisation may attract investors and increase market depth and liquidity.⁴³³ Additionally, a more integrated European covered bond market, greater standardisation of corporate debt issuances, and emerging investment category will benefit cost-effective funding of banks, a liquid secondary market, and further access to finance, respectively.⁴³³

Third, *alternative means of financing* need to be developed. Although the online nature of mechanisms such as peer-to-peer lending and crowdfunding would suggest great potential to contribute to the financing of the economy across national borders, there is limited evidence of cross-border or pan-European activity.⁴³³ Recently it became clear that the diverse national approaches of MSs may encourage crowdfunding activity locally, but may not be necessarily compatible with each other in a cross-border context.⁴³⁴

Regarding the **second action** – Increasing and diversifying the sources of funding from investors in the EU and all over the world – the *attraction of institutional, retail and international investors* play an important role, as this depends the flow of savings into capital market instruments and ultimately the size of capital markets. In the context of attracting investors, *institutional investment* in general needs a boost first. The European asset management industry and pension and insurance sectors play a pivotal role in channelling money into the economy.⁴³⁵ Therefore, further action is needed to identify lower-risk infrastructure debt and/or equity investments and to remove national barriers in this respect.⁴³⁶ Besides, private equity and venture capital should be up-scaled, as risk-capital investment at development stages of new businesses often lack scale.⁴³⁶ In an effort to promote the provision of risk capital in the form of equity participation or loans under certain conditions to start-ups and social business, the EU put in place in 2013 the EuVECA⁴³⁷ and EuSEF⁴³⁸ Regulations, of which the scopes should be widened. Furthermore, public funding is important and the lack of exit opportunities for investors needs to be tackled to create better environments for business angels, venture capital, and public offering.⁴³⁹ Finally, banks are likely to remain key actors in capital markets, while issuers, investors and intermediaries will continue to play major roles in credit intermediation and information provision.⁴³⁹ At the same time, new technologies and business models are emerging, such as peer-to-peer lending or other types of non-bank direct lending, which seek to offer funding to SMEs and start-ups.⁴³⁹ Barriers to entry to providing and growing these services alongside bank lending need to be reduced.⁴³⁹

Second, *retail investment* needs a boost by restoring investors' trust, which is a key responsibility for the financial sector, as retail investors will only be attracted to invest in capital markets if they trust them, as well as the intermediaries operating in them.⁴⁴⁰ Also, financial literacy (to enable consumers to choose products effectively) and supervision and regulation (to build investor confidence) should increase.⁴⁴¹ Regarding the latter aspect, ESMA and the EIOPA have been given increased powers on investor protection through MiFID II and other regulations.⁴⁴² Moreover, cross-border competition in retail financial services

⁴³³ European Commission (2015a), p. 15.

⁴³⁴ European Commission (2015a), p. 16.

⁴³⁵ European Commission (2015a), p. 16-17.

⁴³⁶ European Commission (2015a), p. 17.

⁴³⁷ Regulation (EU) No 345/2013 on European Venture Capital Funds

⁴³⁸ Regulation (EU) No 346/2013 on European Social Entrepreneurship Funds

⁴³⁹ European Commission (2015a), p. 18.

⁴⁴⁰ European Commission (2015a), p. 19.

⁴⁴¹ European Commission (2015a), p. 19-20.

⁴⁴² European Commission (2015a), p. 20

could bring greater choice, lower prices and better services, but fraud, hacking and money laundering should be prevented.⁴⁴²

Third, international investment plays a role, as European capital markets must be open and globally competitive, well-regulated and integrated to attract foreign investment, which means maintaining high EU standards to ensure market integrity, financial stability and investor protection.⁴⁴² Given the global nature of capital markets, it is important that the CMU is developed taking into account the wider global context, by which international trade and investment policy⁴⁴³ helps as it enables an appropriate level for investors in Europe and a level playing field across the EU.⁴⁴⁴ Concluding, the EC is searching for measures that could be taken to increase the attractiveness of EU markets to international investors.⁴⁴⁵

Regarding the **third action** – making markets work more effectively and efficiently, by linking investors to those who need funding at lower cost, both within MSs and cross-border – the *laws, enforcement, supervision* and *technology* play a key role. In this context, the development of the *Single Rulebook* has been a major step towards a more harmonised regulatory framework for capital markets first, but its success depends on the effective implementation and consistent enforcement of the rules.⁴⁴⁵ In addition, *supervisory convergence* is important as the success of reforms depend on the implementation and consistent enforcement of the rules.⁴⁴⁶ European Supervisory Authorities (ESAs) play a key role here, therefore they should be considered as the different national supervisory regimes may result in differing investor protection levels, barriers to cross-border operations and discouraging companies seeking financing in other MSs.⁴⁴⁶ Furthermore, the development of common *data and reporting* across the EU could help to support closer capital market integration.⁴⁴⁶

Second, *market infrastructure* and *securities laws* – the ‘piping’ which channels investments and the laws under which it is treated – play a role as they are key determinants of the efficiency and ease by which investments can be made.⁴⁴⁷ Additionally, collateral is a vital part of the financial system and therefore needs to be regulated appropriately.⁴⁴⁷ Besides, investors have difficulties assessing the risk of capital investments in different MSs, while opposing views hold that harmonisation at EU level and a single definition of securities would not be necessary.⁴⁴⁷ Next to that, greater legal certainty in cases of cross-border transfer of claims and the order of priority of such transfers needs to be achieved.⁴⁴⁸ Finally, banks are important capital market intermediaries by providing liquidity through market making.⁴⁴⁸ To increase this after the crisis, it is researched how to achieve better priced and robust liquidity conditions, notably whether measures could be taken to support liquidity in vulnerable segments and whether there are barriers to entry for new market participants who can play a role in matching buyers to sellers.⁴⁴⁸

Third, *company law, corporate governance, insolvency* and *taxation* play a role. The revision of the Shareholders Rights Directive and the protection of minority shareholders rights improve the attractiveness of companies to foreign investors and long-term capital.⁴⁴⁸ Besides, further reforms to company law are necessary in order to reduce obstacles to cross-border mobility and restructurings for businesses.⁴⁴⁸ Moreover, reducing national differences in the area of conflict-of-laws rules for cross-border insolvency proceedings could contribute to the emergence of pan-European equity and debt markets, by reducing uncertainty for investors needing to assess the risks in several MSs.⁴⁴⁹ In addition, differences in tax regimes across MSs can impede the development of the Single Market and should therefore be addressed. This is inherent to work on simplifying withholding tax relief procedures related to post-trading, differences in tax

⁴⁴³ COM (2010) 343

⁴⁴⁴ European Commission (2015a), p. 20-21.

⁴⁴⁵ European Commission (2015a), p. 21.

⁴⁴⁶ European Commission (2015a), p. 22.

⁴⁴⁷ European Commission (2015a), p. 23.

⁴⁴⁸ European Commission (2015a), p. 24.

⁴⁴⁹ European Commission (2015a), p. 25.

treatment of different types of financing, and tax incentives for R&D expenditure at young innovative companies.⁴⁴⁹

Fourth, *technology* is an important driver of capital markets integration through the development of electronic trading platforms, high frequency trading and 'FinTech'⁴⁵⁰ companies.⁴⁴⁹ Unfortunately, European and national company law has not kept pace with technological development by insufficiently integrating the benefits of digitalisation as exchange of information between companies is often still paper-based.⁴⁵¹ The use of modern technologies in these areas could help reduce costs and burdens, but also ensure more efficient communication, particularly in a cross-border context.⁴⁵¹

9.4 Appendix IV – Five areas of CMU plans that can bring early benefits

This appendix clarifies the five concrete areas, as follow-up of the three defined actions, where the need for progress is high and that can bring potential early benefits.⁴⁵² The first area is *lowering the barriers to accessing capital markets* (1). Key part here is the prospectus⁴⁵³, which is a gateway into capital markets for firms seeking funding or seeking to issue debt or equity.⁴⁵² Therefore, the EC is reviewing the current prospectus regime through a public consultation by looking at when a prospectus is required, streamlining the approval process, and simplifying the information included in prospectuses.⁴⁵²

The second area is *widening of the investor base for SMEs* (2). By improving credit information an efficient and sustainable capital market for SMEs can be built, by for example developing a minimum set of comparable information for credit reporting and assessment.⁴⁵² Also, standardised credit quality information and credit scoring are aspects with broad support from MSs so that access to finance by SMEs can be increased.⁴⁵²

The third area is *building sustainable securitisation* (3). Securitisation⁴⁵⁴ can provide a powerful mechanism for transferring risk and increase bank's capacity to lend.⁴⁵² Therefore, transparency and standardised instruments are necessary, which are provided by the Solvency II and Liquidity Coverage Ratio delegated acts.⁴⁵⁵ For investors, an EU-wide initiative should need to ensure high standards, legal certainty and comparability across securitisation instruments so that transparency, consistency and availability of key information, particularly in the area of SME loans, and promote the growth of secondary markets to facilitate both issuance and investments.⁴⁵⁶

The fourth area is *boosting long-term investment* (4). The Investment Plan is a solution⁴⁵⁷, including the establishment of the new European Fund for Strategic Investments (EFSI), and a Communication on long-term financing of the European economy setting out a range of measures to boost investment.⁴⁵⁶ Besides, the recently finalised Long-term Investment Funds (ELTIFs) regulatory framework allows investors to put money into companies and infrastructure projects for the long-term (mainly useful for insurance companies or pension funds).⁴⁵⁶

The fifth area is *development of European private placement markets*⁴⁵⁸ (5). If barriers to the development of pan-European private placement markets, such as differences in national insolvency laws,

⁴⁵⁰ FinTech is the combination of innovative financial services and the availability of capital through the use of new digital technologies, such as crowdfunding. See European Commission (2015a), p. 25.

⁴⁵¹ European Commission (2015a), p. 26.

⁴⁵² European Commission (2015a), p. 10.

⁴⁵³ The prospectus is a detailed document setting out company information, and the terms and risks of an investment. See European Commission (2015a), p. 10.

⁴⁵⁴ Securitisation is the process by which assets such as mortgages are pooled together for investors to invest in. See European Commission (2015a), p. 10.

⁴⁵⁵ European Commission (2015a), p. 10-11.

⁴⁵⁶ European Commission (2015a), p. 11.

⁴⁵⁷ See European Commission (2014b).

⁴⁵⁸ Private placements are ways through which companies can make offerings of securities to an individual or a small group of investors not on public markets. See European Commission (2015a), p. 11.

lack of standardised processed, documentation, and information on the credit worthiness of issuers, are decreased those placements can provide a cost effective way to raise finance.⁴⁵⁶

9.5 Appendix V – List of heterogeneous respondent group

Respondent group	Respondent number	Sector
Crowdfunding platforms (e.g. equity-crowdfunding and loan-crowdfunding platforms in different sectors such as sustainability and mortgages, etc.)	Respondent 1	Private sector
	Respondent 2	
	Respondent 3	
	Respondent 4	
Money-lenders (e.g. investors and money providers)	Respondent 5	Private sector
	Respondent 6	
Fundraisers (e.g. equity project owner)	Respondent 7	Private sector
Relevant FRCF organisations (e.g. lawyers, crowdfunding consultancy, risk compliance consultancy, crowdfunding management, and crowdfunding IT providers, etc.)	Respondent 8	Private sector
	Respondent 9	
	Respondent 10	
	Respondent 11	
	Respondent 12	
	Respondent 13	
	Respondent 14	
Regulatory or supervisory authorities (e.g. relevant ministry, financial markets' supervisor, Dutch central bank, etc.).	Respondent 15	Public sector
	Respondent 16	
	Respondent 17	
	Respondent 18	

9.6 Appendix VI – Code list and code network derived from Atlas TI 7.0

Code-Filter: All 166 codes

Adverse selection- Fundraisers leave market	Money-lender- Sufficient information provision to make considered decision	Regulation- Prevent market downfall because of too strict rules in nascent phase
Adverse selection- General problem that exists	Money-lender- Type of person/investors	Regulation- Prevent market downfall because of unfair practices
Adverse selection- Information provision grows	Money-lender- Understanding project importance	Regulation- Preventing individual gains
Adverse selection- Money-lenders leave market	Money-lender- Unite with others online to strengthen power	Regulation- Risk awareness + safety creation
Adverse selection- UK strong regulation to prevent adverse selection	Monitoring- Avoiding pyramid game	Regulation- Self-regulation
Best practices- UK is a good example except financial cultural differences	Monitoring- Content	Regulation- structural trust instead of disclosure increase
CF form- Cross-border focus	Monitoring- Content: annual statistics	Regulation- To protect consumers not for specific asset class or funding type
CF form- Different crowdfunding forms and business models	Monitoring- Content: payment traffic	Regulation- Trying to work around regulation structure
CF form- Equity-crowdfunding	Monitoring- Linking investors via monitoring tool	Regulation- UK has strong regulatory vision from beginning
CF form- Loan-crowdfunding	Monitoring- Loosely monitoring by AFM	Regulation- US example
CF form- Loan-crowdfunding business credit	Monitoring- Preventing bad lemons	Risks- CF is risky, unexpected and not safe
CF form- Loan-crowdfunding consumer credit	Monitoring- Structure	Risks- Currency exchange risks
Defaults- Clear communication about possibilities	New role- Trade organisation	Risks- Effect of risk awareness
Defaults- Prevention of project defaults	New role- Consultancy/advisor to support fundraisers, platforms or third parties	Risks- Importance of risk-spreading
Definition- Anonymity	New role- ECN's role/function	Tool- CF prospectus/obligatory information provision
Definition- CF is a hype	New role- Supporting platforms by applying for licence	Tool- Check money-lender after investment for verification
Definition- CF is a new paradigm/revolution	New role lead investor- Conducting due diligence for money-lenders	Tool- Contract content
Definition- Decentralisation/remove middle man	New role lead investor- Conducting monitoring for money-lenders	Tool- Dashboard with rules for platforms to apply (Ruler)
Definition- Existing business with internet as new communication channel	Platform- Clarify risks	Tool- E-residency card
Definition- fundamental fault in economy	Platform- IT experience	Tool- Expedience test for money-lenders (passendheidstoets)
Definition- Easily accessible funding possibility	Platform- Lack of experience	Tool- Financial literacy education
Fundraiser- Balance of involving investors	Platform- Licences to start platform	Tool- Independent platform assessment organisation
Fundraiser- Network importance	Platform- Responsibility	Tool- Investor's compensation scheme if platform is bankrupt
Fundraiser- Quickly fully funded projects	Platform- role as facilitator/market place only	Tool- Level-playing field
Fundraiser- Responsibility	Platform- Support of experienced people	Tool- Linking investors to cooperate/exchange info
Fundraiser- Rights and influence	Platform- Time & amount of projects presented	Tool- Money-lender screening before investment
Fundraiser- Support by conducting crowdfunding	Platform- Type of people set up platform	Tool- Money-lenders' investing with same conditions
Geography- Project location	Recommendation	
Information asymmetry- Acknowledgement of existence	Regulation- Acknowledgement by CMU	
	Regulation- AFM Standard Products rapport	
	Regulation- Alternative financing looser regulation than existing financing	
	Regulation- Anxiety/insecure how to regulate	

<p>Information asymmetry- Conflicted interests/double agenda</p> <p>Information asymmetry- Language barriers</p> <p>Information asymmetry- Money-lenders' reluctance to inform themselves</p> <p>Information asymmetry- Platform-fundraiser</p> <p>Information asymmetry- Principal/Agent problem</p> <p>Information provision- Amount of information provided</p> <p>Information provision- Bank's due diligence overvalued</p> <p>Information provision- Importance</p> <p>Information provision- Minimum demand of information provision necessary</p> <p>Information provision- Quality</p> <p>Information provision- Structure</p> <p>Information provision- Subjective project information</p> <p>Market growth- Depending on private sector drive not regulation</p> <p>Market growth- Developing crowdfunding market</p> <p>Market growth- Experimenting of MSS</p> <p>Market growth- Nascent crowdfunding market</p> <p>Market growth- UK has mature CF market</p> <p>Modularity- Co-investment models</p> <p>Modularity- Creation of innovative financial products</p> <p>Modularity- Government guarantee</p> <p>Modularity- Taking into account existing national legislation</p> <p>Money-lender- Being project ambassadors</p> <p>Money-lender- Experience</p> <p>Money-lender- Lack of conducting due diligence</p> <p>Money-lender- Responsibility</p> <p>Money-lender- Rights and influence</p> <p>Money-lender- Spread among presented projects</p>	<p>Regulation- Awaiting position of regulator</p> <p>Regulation- Balance/gap between being platform or advisor</p> <p>Regulation- Complex at EU level</p> <p>Regulation- Cooperation private and public sector</p> <p>Regulation- Cooperation supervisory authorities</p> <p>Regulation- Correct market failure</p> <p>Regulation- Creating/guaranteeing continuity/clarity/standardisation</p> <p>Regulation- Cultural differences among MSS</p> <p>Regulation- Difference of regulation between platforms depending on licence</p> <p>Regulation- Equity-crowdfunding stronger than loan-crowdfunding</p> <p>Regulation- EU top-down/national regulation</p> <p>Regulation- Existing laws and regulations</p> <p>Regulation- Gap working way different national policy-makers</p> <p>Regulation- Gap working way policy-makers and businesses</p> <p>Regulation- Guidelines</p> <p>Regulation- Lean/flexible policy developing method</p> <p>Regulation- Legacy regulatory framework</p> <p>Regulation- Loan-crowdfunding stronger than equity-crowdfunding</p> <p>Regulation- Maximum harmonisation</p> <p>Regulation- Maximum harmonisation (Regulation) regulate now instead of changing law later to EU level</p> <p>Regulation- Minimum harmonisation (Directive)</p> <p>Regulation- No self-regulation</p> <p>Regulation- Over-regulation</p> <p>Regulation- Pose consequences if rules not applied</p> <p>Regulation- Prevent market downfall because many defaults</p>	<p>Tool- Monitoring financial status of fundraisers</p> <p>Tool- Monitoring investments for money-lender afterwards</p> <p>Tool- Monitoring projects for investors initially</p> <p>Tool- No maximum investment amount at platforms</p> <p>Tool- Passported</p> <p>Tool- Prospectus obligation</p> <p>Tool- Risk-spreading control by platforms</p> <p>Tool- Risk assessment of projects by platforms/law</p> <p>Tool- Risk awareness through checklist, guide or sign</p> <p>Tool- Secondary market importance</p> <p>Tool- Standardisation to increase money-lenders' rights</p> <p>Tool- Toetredingsvereisten/screening voor platforms</p> <p>Tool- Wisdom of the crowd reliance funest for market</p> <p>Transparency- Balance</p> <p>Transparency- Costs of crowdfunding</p> <p>Transparency- Importance</p> <p>Transparency- Lack of transparency among projects</p> <p>Transparency- Look further than tip of the iceberg</p> <p>Transparency- Platforms' comparing possibility/importance</p> <p>Transparency- Projects' comparing possibility/importance</p> <p>Trust account- Responsibility</p> <p>Usage- CF as gambling game</p> <p>Usage- CF as easy accessible funding option</p> <p>Usage- CF as marketing</p> <p>Usage- CF as second option funding after banks</p> <p>Usage- Job creation</p>
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