

# Bridging Entrepreneurial Finance in the EU: The New Crowd Funding Regulation

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**Abstract:** Bridging finance to small and medium enterprises (SMEs) is a must in the sustainable economic development of any country. Access to finance is an essential determinant for business start-ups, development and growth for SMEs. In these years, crowd funding digital platforms have flourished fast as an innovative form of financing for SMEs. Their characteristics allow them to perform SME credit risk assessment better and quicker than traditional financial intermediaries. Compared to banks, for instance, crowd funding digital platforms benefit from minimal capital requirements and a flexible organizational structure that, thanks to the new digital technology, can collect and process information and big data much more quickly. To foster the growth of the crowd funding industry in the EU and ensure investor protection, the legislator introduced the European Crowd funding Service Provider Regulation (ECSPR). The new regulation aims to create a standardized regulatory framework by harmonizing the crowd funding services in the common market and facilitating cross-border operations, enhancing investor protection, promoting transparency and ensuring compliance with the regulatory requirements to increase investor confidence. This article discusses the ECSPR's objectives, requirements and critical provisions. Furthermore, it evaluates the ECSPR's results against the EU legislator's initial intents of fostering the growth of the crowd funding industry and enhancing investors' trust and confidence with protection measures. A balance between these two would be optimal.

**Keywords:** Financial innovation, European Crowdfunding Service Provider Regulation (ECSPR), authorization, ESMA's supervision, passporting rights, Key Investor Information Sheet (KIIS), regulatory arbitrage.

## 1. INTRODUCTION

The development of small and medium enterprises (SMEs) is one of the critical elements in the sustainable economic development of any country. SMEs play a vital role in raising productivity growth in the economy by spurring innovation, encouraging the production process and stimulating stronger competition. Even not innovative SMEs have a role in an economy since they provide value-added services and drive the growth of the economy through the creation of new jobs. Access to finance is a crucial determinant for business start-ups, development and growth for SMEs [1]. These firms have very different needs and face different challenges concerning financing compared to large businesses, which have access to equity capital markets. It is, therefore, imperative to eliminate any barrier between potential entrepreneurs and sources of funds in order to stimulate new business start-ups and to ensure started businesses reach their growth potential. A lack of finance can not only constrain cash flows and hamper businesses' survival prospects but also discourage new players from starting new businesses. To this extent, ensuring SMEs have access to the finance they need to invest and grow is an essential priority for world governments [2].

However, traditional funding sources, such as banks, often fail to meet the diverse and dynamic

needs of these businesses and authorizing loans always require collaterals that a start-up or SME may not have. In recent years, an alternative financing option has emerged to bridge the gap between SMEs and the necessary capital, which is crowd funding. Crowd funding is an innovative form of financing for companies, [3] which differs from traditional supply channels (e.g. venture capital and private equity funds and financial institutions) in at least two ways. First, it uses open online platforms to raise finance, and second, it broadens the range of potential investors, potentially extending the investments to non-professional investors like in the stock markets. The online platforms function as intermediaries between promoters and investors, allowing approved companies to present their business projects and investors willing to accept risks and returns of a particular project to participate in the investment. [4] The online platform works as a marketplace where offer and demand meet. The idea of collective intelligence drives the concept [5]. Crowd funding pursues the goal of democratizing financing processes by creating a level playing field for competing ideas and by making the investments of these ideas accessible to everyone, even not sophisticated investors. At the same time, it contributes to a diversified financial system that is less dependent on bank finance, limiting systemic and concentration risks [6].

This tool has been experiencing significant popularity in several European countries and worldwide

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in recent years due to its ability to connect SMEs with a wide range of potential investors. While crowd funding has several significant benefits for SMEs, it also faces potential challenges. For instance, it was said that there is a need for investors' protection and accountability in the crowd funding industry [7]. In addition, the crowd funding market in EU member states would arguably benefit from harmonizing the current fragmented regulatory landscape [8].

In 2020, the EU Legislator introduced the European Crowd funding Service Provider Regulation ("ECSPR"), [9] which became applicable on 10 November 2021 as a response to the needs of investors' protection, transparency and accountability in the crowd funding industry. The ECSPR deals with both loan-based and investment-based crowd funding in its scope (including equity-based crowd funding), as these forms can be structured as comparable financing alternatives. The ECSPR does not apply to the following categories:

- a. crowd funding services provided to project owners who are consumers (as defined by Directive 2008/48/EC);
- b. other "related services" to crowd funding services provided by national laws;
- c. crowd funding offers exceeding an amount of 5 million Euros, which must be calculated over 12 months as the sum of:
  - i. the total consideration for offers of securities and instruments admitted for crowd funding purposes and the amounts raised through lending on a crowd funding platform by a specific project owner; and
  - ii. the total consideration for public offers of securities by the project owner as an offer or under the exemption provided for in Regulation (EU) 2017/1129 [10].

This background sets the stage for further exploration of the recently introduced regulation (ECSPR) and its impact on bridging entrepreneurial finance in the EU. The article will first discuss the features and structure of crowd funding, enumerating the benefits and challenges that this new financing channel poses. Then, it will examine the ECSPR objectives, requirements and critical provisions. Finally, it will assess the ECSPR's results against the main

initial objectives of fostering the growth of the crowd funding industry and enhancing investors' confidence and, therefore, investors' protection. The difficult task of the EU legislator is striking the right balance between promoting innovation through SMEs (with crowd funding online platforms) and protecting investors' interests.

## **2. FEATURES, BENEFITS AND RISKS OF CROWD FUNDING**

Crowd funding is a manifestation of marketplace investing, and it includes either lending transactions, whereby the investors/lenders expect to receive the principal and interest at the end of the lending period, or equity transactions, where a privately held company offers securities to the general public through the medium of an online platform. The distinction is consequently made between loan-based crowd funding, commonly referred to as peer-to-peer (P2P) lending, and equity crowd fund or, more generally, investment-based crowd funding, which could also refer to bonds and other debt securities [11].

Marketplace investing also includes other transactions which do not necessarily involve the crowd. Its crucial identifier is the digital platform where financial transactions occur between the recipient of funds and investors. The latter accesses the platform for executing either primary market transactions – such as the granting of a loan or the subscription of a bond – or secondary market transactions (such as the sale of loan participation or investment securities). The platform is similar to exchange, and marketplace investing presents similarities with exchange investing [12]. However, crowd funding platforms are a manifestation of direct finance and, therefore, of disintermediation relative to traditional intermediaries [13]. Nonetheless, platforms play an essential role in reducing information asymmetries between recipients and lenders/investors. The latter either rely on the platform's checks of recipients and other information conveyed through the platform, including rating or scoring of recipients, or on automatic diversification of investments by the platform [14].

Both types of crowd funding provide similar benefits to investors. Crowd-lenders and crowd-investors may receive higher returns, diversification opportunities, investing in an alternative market, often resilient to changes in mainstream markets, and possibly emotional satisfaction from helping people and

participating in a project in which they believe. From this perspective, it was said that the financial system might benefit from increased competition among different operators, investment diversification and innovation [15].

Alternatively, there are several significant advantages for SMEs through project creators. One of the primary advantages is that it provides increased access to capital. Unlike traditional financing options, crowd funding allows businesses to expand their pool of potential investors, including individuals, institutions, and other businesses. Broadening the funding base increases the chances of securing the necessary capital [16]. Nowadays, platforms like Kick-starter and Indiegogo have helped numerous European SMEs raise significant amounts of money to launch innovative products or expand their operations. Crowd funding also offers SMEs the opportunity to diversify their funding sources. Relying solely on banks or venture capitalists can be risky, as these sources may have limited availability or stringent requirements. By utilizing crowd funding, SMEs can spread the risk across a more significant number of investors, reducing their dependence on a single funding source. This diversification not only enhances financial stability but also provides SMEs with more flexibility in managing their capital structure [17].

Another significant benefit of crowd funding is the market validation and customer engagement it offers to SMEs. When businesses present their ideas or products on crowd funding platforms, they receive feedback and support directly from potential customers. This interaction helps SMEs refine their offerings, identify market demand, and build a loyal customer base. Moreover, successful crowd funding campaigns can generate significant publicity and brand awareness, further boosting the growth prospects of SMEs.

The two forms of crowd funding also share some risks. The most significant are observed from the investor's perspective and are linked to its 'direct' character: crowd-investors, because of their inexperience in start-up and seed companies and the absence of professional intermediaries performing due diligence, pricing and information functions, might suffer from the effects of market failures (asymmetric information and moral hazard). Lock-in periods may be more extended than average loan maturity, and the investees, generally start-ups and seed companies, are riskier than other companies and typically attract

venture capitalists who factor in a high percentage of defaults (FCA, 2013). They may not realize the risks involved in relying on incomplete or misleading information and lose their money because of fraud or investee or platform defaults. Conflicts of interest between the platform and investors, although potentially minimized by reputation concerns and incentives to reinforce the network effects of the platform, might arise, especially in the case of remuneration schemes based on the volume/number of transactions. Although investors investing small sums in each project mitigate risks through diversification, this creates disincentives to gather information, monitor and seek legal enforcement (coordination problem). As a result, crowd-investors tend to attach particular importance to information made available by the platform in making their investment decisions, while loan-based crowd funding platforms have introduced automated investment tools to serve customers better [18].

### **3. THE ECSPR OBJECTIVES, KEY PROVISIONS AND REQUIREMENTS**

In order to address the existing risks and create a standardized regulatory framework to foster the growth of the crowd funding industry in the EU, the legislator introduced the ECSPR. The ECSPR aims to harmonize the crowd funding services in the common market, enhance investor protection, promote transparency and ensure compliance with the regulatory requirements to increase investor confidence. The ECSPR achieves its goals by introducing an authorization and registration process, a supervision and enforcement mechanism, several investor protection measures and disclosure requirements, and facilitations for cross-border operations and passporting rights [19].

#### **3.1. Authorization and Registration Process**

The ECSPR introduces a standardized framework for the authorization and registration of crowd funding platforms operating within the European Union (EU). This process is a crucial aspect of the regulation as it ensures that only qualified and reliable platforms can offer crowd funding services to investors and entrepreneurs [20]. Under the ECSPR, crowd funding platforms are required to obtain authorization from their national competent authority (financial authority) before they can operate within the EU. The competent authority is responsible for assessing the platform's compliance with the regulatory requirements and ensuring it meets the necessary standards. The authorization process involves a thorough review of the

platform's business model, ownership and governance structure. The platform must also demonstrate its adequate financial resources to cover its operational costs and potential liabilities. Additionally, the application should outline the platform's risk management procedures, including measures to prevent money laundering, fraud, and conflicts of interest [21].

The competent authority evaluates the platform's ability to provide a secure and transparent environment for crowd funding activities. This assessment may involve on-site inspections, interviews with key personnel, and a review of the platform's internal policies and procedures. The competent authority may also seek additional information or clarification from the platform during the assessment process. If the competent authority is satisfied with the platform's compliance, it grants authorization, allowing it to operate as a crowd funding service provider within the EU. Finally, the competent authority may impose specific requirements or conditions on the platform, such as periodic reporting, audits, or additional risk management measures [22].

Legal entities already authorized under Directive 2009/110/EU or Directives CRD IV (Directive 2013/36/EU), MiFID II (Directive 2014/65/EU), PSD 2 (Directive (EU) 2015/2366) before the entry into force of Regulation (EU) 2020/1503 in question, wishing to provide crowd funding services, are subject to a simplified authorization procedure, which among other things allows them not to submit documents or elements of evidence that they have already been previously provided when applying for authorization under those Directives or national law, provided that such information or documents remain up-to-date and accessible to the competent authority.

In addition to authorization, crowd funding platforms must register with a central online register maintained by the European Securities and Markets Authority (ESMA) [23]. The registration process involves providing basic information about the platform, such as its name, address, and contact details. The purpose of the registration is to create a centralized database of crowd funding platforms operating within the EU, allowing investors and entrepreneurs to access information about authorized platforms.

The authorization and registration process promotes transparency and accountability in the crowd funding industry. By maintaining a central register of authorized

platforms, the ECSPR enables investors and entrepreneurs to access reliable information about the platforms they are considering. This transparency enhances investor confidence and facilitates informed decision-making. In addition, it ensures that crowd funding platforms meet the necessary standards of transparency, risk management, and investor protection. Finally, by establishing a standardized framework, the ECSPR ensures that all platforms operate under the same rules and regulations, promoting fair competition, encouraging innovation, and attracting more participants to the crowd funding ecosystem.

### **3.2. Supervision and Enforcement**

The ECSPR also introduces a robust framework for the supervision and enforcement of crowd funding activities within the EU through system of national competent authorities responsible for the supervision of crowd funding platforms within each member state of the EU [24]. These competent authorities are tasked with monitoring the activities of crowd funding platforms, assessing their compliance with the regulatory requirements, and enforcing the provisions of the ECSPR. To effectively supervise crowd funding platforms, the competent authorities have the power to conduct on-site inspections, request information and documentation, and interview key personnel [25]. These supervisory activities enable the competent authorities to assess the platform's compliance with the regulatory requirements, identify any potential risks or issues, and take appropriate enforcement actions if necessary [26].

The ECSPR also introduces a system of sanctions and penalties for non-compliance with the regulatory requirements. The competent authorities can impose administrative sanctions, such as fines or public warnings, on crowd funding platforms that fail to meet the necessary standards. These sanctions serve as a deterrent and encourage platforms to adhere to the regulatory requirements, ensuring investor protection and maintaining the integrity of the crowd funding industry. The competent authorities which granted authorization also have the power to withdraw the authorization in certain listed situations [27].

In addition to the national competent authorities, the European Securities and Markets Authority (ESMA) plays a significant role in the supervision and enforcement of the ECSPR. ESMA acts as a central coordinating authority, facilitating cooperation and

information exchange between the national competent authorities. ESMA also maintains a central online register of authorized crowd funding platforms, providing investors and entrepreneurs with access to reliable information about the platforms operating within the EU [28]. ESMA has the power to intervene in cases where there are concerns about the functioning of the crowd funding market or the effectiveness of the supervision by the national competent authorities. ESMA can issue guidelines and recommendations to ensure consistent application of the ECSPR across the EU. Furthermore, ESMA can also take direct enforcement actions against crowd funding platforms that operate on a cross-border basis within the EU.

Firstly, by conducting supervisory activities and imposing sanctions, the competent authorities deter fraudulent or misleading activities and foster a secure and transparent crowd funding environment. Secondly, the supervision and enforcement mechanisms promote consistency and harmonization across the EU. The ECSPR establishes a standardized framework for crowd funding platforms, ensuring that they operate under the same set of rules and regulations. Fair competition encourages responsible behaviour and facilitates cross-border crowd funding activities within the EU, contributing to the overall growth and development of the crowd funding industry.

### **3.3. Cross-border Operations and Pass Porting Rights**

To facilitate cross-border operations and pass porting rights for crowd funding platforms within the EU, the ECSPR allows authorized crowd funding platforms to operate and offer their services to investors and entrepreneurs across multiple member states subject to certain conditions and requirements [29].

This provision enables platforms to access a larger pool of investors and entrepreneurs, fostering innovation and economic growth. Pass porting rights are a crucial feature of the ECSPR that facilitates cross-border operations for crowd funding platforms. Pass porting allows an authorized crowd funding platform to provide services in other member states without additional authorization or registration. Once its home country's competent authority authorizes a platform, it can exercise its pass porting rights to offer services to other member states. The pass porting rights under the ECSPR are based on mutual recognition, which means that member states must

recognize the authorization of the home country's competent authority and allow the platform to operate within their jurisdiction. However, member states can impose certain conditions or requirements on the platform, such as additional reporting obligations or language requirements, to ensure compliance with their national laws and investor protection measures.

The pass porting rights provided by the ECSPR offer several benefits for crowd funding platforms. Firstly, they simplify expanding into new markets within the EU. Instead of navigating through complex and time-consuming authorization processes in each member state, platforms can rely on their home country's authorization and exercise their pass porting rights to operate in multiple member states. Secondly, pass porting rights promote consistency and harmonization across the EU. By allowing platforms to operate under the same rules and regulations in different member states, the ECSPR creates a level playing field for crowd funding platforms, hopefully increasing fundraising activities.

However, it is essential to note that pass porting rights are not unlimited. Member states can impose restrictions or limitations on the cross-border activities of crowd funding platforms if there are concerns about investor protection or the stability of the financial system. These restrictions must be proportionate and justified, and the competent authorities of the home country and the host member state(s) must cooperate to address any concerns or issues.

### **3.4. Investor Protection Measures and Disclosure Requirements**

The ECSPR introduces a comprehensive set of investor protection measures and disclosure requirements to ensure the safety and transparency of crowd funding activities within the EU. These measures aim to enhance investor confidence, promote informed decision-making, and mitigate the risks associated with crowd funding investments. In particular, the investor protection measures vary depending on whether the investor would qualify as a "sophisticated" or "non-sophisticated" investor, according to the criteria and procedure outlined in Annex II of the ECSPR [30].

One of the primary investor protection measures introduced by the ECSPR is the requirement for crowd funding platforms to provide clear and comprehensive information to investors. The regulation mandates that platforms disclose relevant information about the

projects listed, including financial statements, business plans, and risk factors. This disclosure ensures that investors have access to accurate and reliable information, enabling them to assess the viability of the projects and make informed investment decisions. Regarding single offers, ECSPR imposes crowd funding service providers to provide clients with a six-page document without footnotes called “Key Investor Information Sheet” (KIIS), [31] based on the KID-PRIPs model and prepared by the project owner [32]. Crowd funding service providers need to verify the completeness, clarity and correctness of the document [33]. The KIIS must contain certain fundamental information about the specific project owner, instrument and conditions of the offer, particularly regarding risks, main terms, price and fees. The ECSPR also mandates that crowd funding platforms provide a standardized risk warning to investors in the KIIS [34]. This risk warning should clearly outline the potential risks associated with crowd funding investments, including the possibility of losing the entire investment; the lack of deposit or investment guarantee schemes and of a proper appropriateness test about the specific risks (if this is the case) and the opportunity not to invest more than 10% of their net worth (if they are non-sophisticated investors). By providing this risk warning, the regulation ensures that investors know the inherent risks of crowd funding and can make informed decisions based on their risk appetite. If the investors belong to the non-sophisticated investor category, the ECSPR introduces special protections. In particular, before accessing the offers, non-sophisticated investors must perform an ‘entry-knowledge test’. The test aims to verify whether and which crowd funding services are appropriate for them, considering their past investments in transferable securities, admitted instruments and loans and their understanding of risks and professional experience with crowd funding investments [35]. Non-sophisticated investors must also use platforms’ systems to simulate their ability to bear loss, calculated as 10% of their net worth [36]. Additional measures for non-sophisticated investors added are an explicit warning in case of investment above €1,000 or 5% of the client’s net worth, which must be agreed to by the investor, and a four-day withdrawal right [37].

Furthermore, the ECSPR requires crowd funding platforms to implement appropriate risk management measures. Platforms must have robust procedures to identify, assess, and mitigate potential risks, including

measures to prevent money laundering and fraud [38]. They are also subject to organizational requirements like adequate measures to ensure effective and prudent management, [39] including the segregation of duties, business continuity and the prevention of conflicts of interest [40]. In fact, crowd funding platforms cannot participate financially in the projects offered to the investors, even if the platforms’ and clients’ interests would be aligned. They can accept their managers, employees and controlling shareholders only as investors (not as project owners) and conditional on disclosure and equal terms.

In addition to the investor protection measures, the ECSPR introduces other disclosure requirements for crowd funding platforms. The regulation mandates that platforms provide clear and transparent information about their operations (i.e. default rate) [4], fees, and charges [41]. This includes disclosing any fees or charges that may be deducted from the funds raised through the platform to ensure that investors have a clear understanding of the costs associated with crowd funding investments and can make informed decisions.

Moreover, the ECSPR requires crowd funding platforms to establish a complaint-handling procedure. Platforms are expected to have a mechanism in place to address investor complaints and resolve disputes in a fair and timely manner [43]. This ensures investors have recourse in case of any issues or concerns and promotes trust and confidence in the crowd funding industry.

Finally, the ECSPR introduces a provision of asset safekeeping and payment services [44]. Accordingly, crowd funding platforms must inform their clients of the nature, terms and conditions of those services and which law applies to them. If crowd funding service providers carry out payment transactions related to transferable securities and admitted instruments for crowd funding purposes, they shall deposit the funds with a central bank or a financial institution authorised per Directive 2013/36/EU [45]. An entity providing custody services must hold an authorisation by Directive 2013/36/EU or 2014/65/EU [46]. Similarly, a crowd funding service provider providing payment services must do it following Directive (EU) 2015/2366 [47].

### **3.5. Capital Requirements for Crowd Funding Platforms**

The ECSPR, in its final approval, has also embraced the Council’s suggestion to introduce

prudential safeguards for operational risk, mainly consisting of Common Equity Tier 1 (CET1) requirements, [48] in alternative to or combination with professional insurance [49]. The CET1 must be calculated equal to an amount at least the higher of EUR 25.000 or one-quarter of the fixed expenses of the preceding year, [50] reviewed annually, which are to include the cost of servicing loans for three months where the crowd funding service provider also facilitates the granting of loans [51].

Financial institutions wishing to provide their clients with crowd funding services are exempted from the prudential safeguard since they are already subject to capital adequacy requirements under the Basel Accords [52]. Although the Regulation is not explicit in this regard, they might need to comply only with the conduct of business and investor protection requirements specific to crowd funding platforms. The regime will be detailed and completed by several technical standards issued by the ESMA or EBA.

#### **4. IMPACT OF ECSPPR ON BRIDGING ENTREPRENEURIAL FINANCE IN THE EU**

The ECSPPR introduces a comprehensive framework for regulating crowd funding activities within the EU. While the regulation aims to promote investor protection, foster innovation, and facilitate cross-border operations, it is not without its challenges and criticisms. One of the main challenges of the ECSPPR is the potential burden it may impose on crowd funding platforms, mainly smaller and emerging platforms. The regulation introduces a set of requirements and obligations that platforms must comply with, including authorization, disclosure, and risk management measures. These requirements may require significant resources and expertise, making it difficult for smaller platforms to enter or compete in the market. The regulatory burden may stifle innovation and limit the diversity of crowd funding platforms available to investors and entrepreneurs. However, the regulation does not distinguish between small and medium or large issuers and to what extent should be bound by disclosure duties in investment-based crowd funding [53].

Another challenge of the ECSPPR is the potential for regulatory arbitrage. Regulatory arbitrage refers to platforms seeking authorization in member states with less stringent regulatory requirements or lower costs. The result could lead to a concentration of platforms in certain member states, creating an uneven playing field

and potentially undermining investor protection measures. It could be argued that the ECSPPR should have stricter harmonization requirements to prevent regulatory arbitrage and ensure a level playing field for all crowd funding platforms operating within the EU [54].

Furthermore, the ECSPPR has been criticized for its limited scope. The regulation primarily focuses on lending-based and investment-based crowd funding, where investors receive financial returns or equity in exchange for their investments. However, other forms of crowd funding, such as donation-based or reward-based crowd funding, are not explicitly covered by the ECSPPR [55]. Critics argue that this narrow scope may leave certain crowd funding activities outside the regulatory framework, potentially exposing investors to risks and limiting the effectiveness of investor protection measures [56]. For instance, the ECSPPR expressly states that does not apply for crowd funding services provided to project owners who are consumers as per Art 3(a) of the Consumer Credit Directive (CCD) No 2008/48/EC [57] although consumer crowd-lending has been one of the prevalent segments of the European crowd funding market. This exclusion has been partially justified because the CCD already covers consumer crowd-loans and will be covered by the Directive on Consumer credits, which has already been approved by the Council of the European Union and awaits the first reading at the European Parliament [58]. Another essential exclusion concerns all sorts of tokens. The initial coin offerings (ICOs), defined as the offers of 'utility tokens', are outside the scope of the ECSPPR. However, the security tokens classified as financial instruments / transferrable securities cannot be excluded from its scope when offered through crowd funding platforms [59].

Another criticism of the ECSPPR is the potential for regulatory fragmentation. While the regulation aims to harmonize crowd funding regulations across the EU, member states still have some flexibility in implementing certain provisions. For instance, the MiFID II term 'transferable securities' has been interpreted differently in the various Member States, leading to fragmentation in the classification of private limited liability companies' shares and silent partnerships, commonly used in crowd funding. The ECSPPR at Art. 2(1) introduced the category of 'admitted instruments for crowd funding purposes', namely shares of limited liability companies not considered transferable securities under national law but not subject to restrictions on transferability

according to Art. 2(1)(n). However, the power to assess whether the shares of a private company fulfil the definition of admitted instruments and what are the obstacles to transferability lies in the hands of the national competent authorities, leading to variations in interpretation and enforcement, creating a fragmented regulatory landscape. For instance, share transfers in private limited companies in many Member States are subject to notarial authentication and, therefore, being not transferable securities, they are not considered 'admitted instruments' for crowd funding purposes (like in Germany, Austria, Luxembourg and Malta). In contrast, in other countries like Italy, Netherlands, Spain, Ireland and Romania, the same shares have been indicated by the national competent authorities to ESMA as admitted instruments for crowd funding purposes [60]. Furthermore, in some countries, the regulatory framework allows *private placements* of corporate bonds by unlisted companies, which are subject to less stringent reporting and credit rating requirements [61]. Also, standardized loans available on a bulletin board are accepted as transferable securities in certain countries (i.e. The Netherlands) but not in others [62]. However, a lack of information on issuers and standardized documentation, illiquid secondary markets, and differences in insolvency laws across industry players and jurisdictions currently limit the development of these markets. Critics argue that this fragmentation may hinder cross-border operations and create additional compliance burdens for crowd funding platforms operating in multiple member states [64].

Lastly, the ECSPR has been criticized for its limited focus on investor education and awareness. While the regulation introduces disclosure requirements and risk warnings, critics argue that more emphasis should be placed on educating investors about the risks and rewards of crowd funding investments, helping (especially non-sophisticated) investors make more informed decisions and mitigate the potential for losses. Additionally, critics argue that the regulation should encourage platforms to provide educational resources and tools to investors, promoting financial literacy and responsible investing [64].

## 5. CONCLUSION

Crowd funding digital platforms have flourished fast as an innovative form of financing for SMEs. Their growing popularity and capacity to attract more investors have impacted traditional financial intermediaries, such as banks and venture capital

firms, which may face increased competition. Crowd funding digital platforms benefit from several advantages: being submitted to minimal capital requirements, having a flexible organizational structure and exploiting digital technology to collect information and big data about the project proponents raising funds that allow them to carry on the assessment of credit risk of borrowers better and faster than banks.

The EU legislator introduced the ECSPR to provide a comprehensive framework for regulating crowd funding activities within the EU to enhance investors' confidence, promoting a level playing field for crowd funding platforms and contributing to the overall growth and development of the crowd funding industry:

1. The ECSPR requires crowd funding service providers to be licensed by the national competent authorities and registered with a central online register maintained by the ESMA.
2. The ECSPR submits all the authorized crowd funding service providers to the supervision and enforcement mechanism coordinated by the ESMA.
3. The ECSPR contains investor protection measures, disclosure requirements, capital requirements and facilitations for cross-border operations.

However, the ECSPR has its challenges and criticisms. The first is the potential burden on crowd funding platforms. The crowd funding service providers generally do not undertake the risks of a financial institution. They instead act like brokers between borrowers and investors without facing the capital constraints that affect banking activities. Digital platforms are 'transparent' intermediaries between borrowers and investors. At the same time, banks are 'opaque' intermediaries that extend credits to clients on their books while receiving deposits from savers as liabilities. Since digital platforms do not create a systemic risk for stability as banks do, it seems acceptable that they should not comply with similar strict capital requirements. In addition, excessive disclosure requirements for transparency, which is already one of the main drivers to attract their clients, might be too heavy a burden for the crowd funding service providers that could instead limit their compliance to the satisfaction of the minimum requirements.

The second concern is the risk of regulatory arbitrage due to the differences in the legal regimes



effective for crowd funding that push the operators to seek authorizations in member states with loose regulatory requirements to reduce costs. The result would be a concentration of platforms in a few member states and an uneven playing field.

The third problem regards regulatory fragmentation. The ECSPR aims at achieving a high level of harmonization in the regulation of crowd funding but, at the same time, recognizes the competence of the national rules and the national competent authorities of every member state. Certain matters, like, for instance, the civil liability of the operators or the admitted transferable securities and financial instruments for crowd funding, due to the discretion left to the member states, may remain un-harmonized.

The fourth and fifth issues are the limited scope, which may leave certain crowd funding activities outside the regulatory framework and the need for investor education, which will have to be taken into consideration by the ESMA.

Soon, the Commission will have to assess the overall impact of the ECSPR on the crowd funding industry as requested by Art. 45(2), letters (a, b, f, g, h, j, t-w), which imposes a re-calibration of the requirements to create a level playing field within the EU market. At this aim, the national competent authorities have opened a communication channel to inform, on an annual basis, ESMA (many already did) about the securities and the types of private limited liability companies that fall within the ECSPR's scope. ESMA compares such information from the national competent authorities with the one collected on its own. It evaluates the KIIS of all the issuers in the different countries to compare the treatment of similar admitted instruments and their transferability across the various national laws. Finally, ESMA must transmit such comparison to the Commission, which has to draft and present a Report under Art 45(2) to the European Parliament and the Council. The Report shall assess the functioning of the market for crowd funding service providers in the Union; whether the scope of services and all requirements imposed by the ECSPR remain appropriate to pursue the objectives of the regulation; the functionality of the admitted instruments for crowd funding in the cross-border transactions; and the possibility to introduce new specific measures or corrections in the regulation to promote sustainable and innovative crowd funding projects and the use of Union funds. Addressing these concerns, as mentioned above, and striking a balance between fostering

innovation and investor protection will be crucial for the effective implementation and success of the regulation.

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- [9] The EU Crowdfunding Service Provider Regulation n. 2020/1503 of 7 October 2020, amending EU Regulation 2017/1129 and EU Directive 2019/1937, accompanied by the Directive (EU) 2020/1504, amending Directive 2014/65/EU on markets in financial instruments and published on 20 October 2020.
- [10] The limit of 5 million euros was chosen given that it represents the threshold used by the majority of Member

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- [13] Digital platforms are the new instruments for financial disintermediation (or new forms of intermediation), for they offer their services directly to existing and potential clients on the web. See Fenwick, M, McCahery, JA, & Vermeulen, EPM, 'Fintech and the financing of SMEs and entrepreneurs: From crowd funding to marketplace lending', in Douglas Cumming, Lars Hornuf (eds), *The Economics of Crowd funding Startups, Portals and Investor Behavior* (2018 Palgrave Macmillan), pp. 103-129.
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- [17] EU Commission, 'Impact Assessment Accompanying the Document Proposal for a Regulation [...] on European Crowdfunding Service Providers (ECSP) for Business-Staff Working Document' (8 March 2018) SWD(2018) 56 final, 13 ff.
- [18] Cheng C *et al.* "The Impact of Automated Investment on Peer-to-Peer Lending: Investment Behavior and Platform Efficiency." *JGIM* vol.29(6), 2021, pp.1-22; K Judge, The Future of Direct Finance: The Diverging Paths of Peer-to-Peer Lending and Kickstarter, 50 *Wake Forest L. Rev.* 603 (2015).
- [19] Macchiavello E (ed) *Regulation on European Crowd funding Service Providers for Business: A commentary*, (Edward Elgar Publishing 2022); P Ortolani, M Louise (eds) *The EU Crowd funding Regulation* (2021 OUP); D Brüntje, O Gajda, *Crowd funding in Europe State of the Art in Theory and Practice* (2016 Springer).
- [20] Art. 12(1) of the ECSPR.
- [21] Art. 12(2) of the ECSPR.
- [22] Art. 12(3) of the ECSPR.
- [23] Art. 14 of the ECSPR.
- [24] Art. 15(1) of the ECSPR.
- [25] Art. 15(2) of the ECSPR.
- [26] On the relationship between ESMA and NCAs see, Pala G, M Lamandini and R D'Ambrosio ESMA and NCAs: cooperation in supervision (Art 32) in Macchiavello 'Regulation' (n 19) pp. 409-418.
- [27] See Art. 17 of the ECSPR.
- [28] Art. 14 of the ECSPR.
- [29] Art. 18 of the ECSPR.
- [30] A sophisticated investor is either: a legal person owning at least EUR 100.000 or has a turnover of at least EUR 2.000.000 or a total balance sheet of at least EUR 1.000.000; or a natural person meeting at least two of these three criteria: personal gross income of at least EUR 60.000; has covered an executive position for at least 12 months in a legal person and has knowledge of large financial markets' transactions; is used to carry out at least ten significant transactions per quarter, over the previous four quarters.
- [31] See Art. 23 and Appendix I of the ECSPR.
- [32] Regulation No 1286/2014 on packaged retail and insurance-based investment products.
- [33] The original EC Commission proposal did not require correctness. The term correctness constitutes an additional liability for the service providers, which are considered not mere intermediaries but also gatekeepers for investor protection. See Macchiavello E, 'Disintermediation in fund-raising', (n 11) 303 f.
- [34] Art. 19(2); Art. 21(4); Art. 23(6) comma (c) of the ECSPR.
- [35] See from Art. 21(1) to Art. 21(4) of the ECSPR.
- [36] Art. 21(5) of the ECSPR.
- [37] See Art. 21(7) and Art. 22 of the ECSPR.
- [38] Art. 5 of the ECSPR.
- [39] Art. 4 of the ECSPR.
- [40] Art. 8 of the ECSPR.
- [41] Art. 20 of the ECSPR.
- [42] Articles 6 and 24 of the ECSPR.
- [43] Art. 7 of the ECSPR.
- [44] Art. 10(1) of the ECSPR.
- [45] Art. 10(2) of the ECSPR.
- [46] Art. 10(3) of the ECSPR.
- [47] Art. 10(4) of the ECSPR.
- [48] Art. 11(1) and (2) of the ECSPR.
- [49] Art. 11(6) and (7) of the ECSPR.
- [50] Where a crowd funding service provider has been in operation for less than 12 months, it may use forward-looking business estimates in calculating the fixed overheads. See Art. 11(5) of the ECSPR.
- [51] Art. 11(8) and (9) of the ECSPR. See De Smet J and V Colaert, 'Between investor protection and access to crowdfunding: the entry knowledge test and the simulation of the ability to bear loss (Art 21 and Annex II)' in Macchiavello 'Regulation' (n 19), pp. 280-299.
- [52] Art. 11(3) and (4) of the ECSPR.
- [53] Ferrarini G, 'Regulating FinTech: Crowd funding and Beyond', in G Barba Navaretti, G Calzolari and AF Pozzolo (eds) *FinTech and Banks: Friends or Foes? European Economy Banks, Regulation, and the Real Sector 2017.2*, pp. 121-142.
- [54] Majumdar AB, 'Regulatory Arbitrage in Cross Border Crowd funding', in Douglas Cummings and Sofia Johan (eds) *The Oxford Handbook of IPOs* (OUP: New York 2018), Ch. 29.
- [55] However, the EC Commission stated that the notion of 'business activity' includes public entities and not-for-profit entities, which can be project owners under the ECSPR 'as long as they raise funds for an activity that generates some economic benefit' even just for the 'ultimate beneficiaries (whether monetary or nonmonetary)', not only for its owners or members. See ESMA, 'Questions and Answers on the European Crowd funding Services Providers for Business Regulation', (20 May 2022) 12, para 3.1.

- [56] Hooghiemstra SN, 'The European Crowdfunding Regulation – Towards Harmonization of (Equity- and Lending-Based) Crowd funding in Europe?', (accessed 13 October 2023), <https://ssrn.com/abstract=3679142>
- [57] Art. 1(2)(a) of the ECSPR.
- [58] See EU Commission, 'Proposal for a Directive of the European Parliament and of the Council on consumer credits' COM (2021) 347 final. However, the Directive does not introduce a comprehensive and harmonized framework for consumer crowd-lending services and operators, which will probably remain fragmented. See E Macchiavello, 'The Challenges Awaiting the European Crowd funding Services Providers Regulation: Ready for Launch?' NJCL 2022/2, pp. 96-97.
- [59] In this logic, the MiFID II and the Prospectus Regulation have been changed to include among the transferable securities also those 'issued by means of distributed ledger technology', see Art. 18 of the Regulation (EU) 2022/858 of the European Parliament and of the Council of 30 May 2022 on a pilot regime for market infrastructures based on distributed ledger technology, and amending Regulations (EU) No 600/2014 and (EU) No 909/2014 and Directive 2014/65/EU ("The EU Pilot Regime") OJ L 151, p. 1–33. See also the recently introduced Regulation (EU) 2023/1114 on markets in crypto-assets, and amending Regulations (EU) No 1093/2010 and (EU) No 1095/2010 and Directives 2013/36/EU and (EU) 2019/1937 ("MiCA"), OJ L 150, p. 40–205, which lays down uniform requirements for the offer to the public and admission to trading on a trading platform of crypto-assets. For a comment, see F. Annunziata and T. de Arruda, 'Crowdfunding and DLTs: the imperative need for more clarity', in Macchiavello 'Regulation' (n 19), pp. 565-577; Hacker P, Thomale C (2018) Crypto-securities regulation: ICOs, token sales and crypto currencies under EU financial law. ECFR 15:645–696.
- [60] See ESMA, 'European Crowd funding Service Providers for Business Regulation (2020/1503) - Miscellaneous reporting to ESMA' (10 November 2021) ESMA35-42- 1305, 3, <[www.esma.europa.eu/sites/default/files/library/esma35-42-1305\\_crowdfunding\\_tables.pdf](http://www.esma.europa.eu/sites/default/files/library/esma35-42-1305_crowdfunding_tables.pdf)>.
- [61] For instance, these are differently categorized and treated in Italy and Portugal.
- [62] See Gargantini M, Secondary markets for crowdfunding: bulletin boards (Art 25) in Macchiavello 'Regulation' (n 19), pp. 350-366; Hakvoort A, 'Secondary Trading of Crowd funding Investments', in Ortolani and Lousse (n 19) 281.
- [63] Macchiavello E, The Challenges Awaiting the ECSPR (n 58), pp. 100 ff.
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Received on 20-10-2023

Accepted on 17-11-2023

Published on 12-12-2023

<https://doi.org/10.6000/2817-2302.2023.02.16>

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