iLINC Legal & Technology Briefs

A Crowdfunding Taxonomy For Start-Ups

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Crowdfunding has become an attractive means for start-ups to acquire the necessary funds for their projects. Whereas start-ups may fail to receive funding from traditional sources, such as banks, private equity houses and angel investors, the crowd can invest directly into projects or undertakings they truly believe in. Indeed, traditional sources may be reluctant to provide funds to high-risk undertakings. Moreover, the supply of venture capital remains limited in Europe. Furthermore, more and more start-ups have become active in the operation of crowdfunding platforms themselves. Whether a start-up operates a crowdfunding platform or aims to collect funds through such a network, both activities may be subject to regulation. Much depends upon the type of crowdfunding. This brief aims to provide digital start-ups with a taxonomy of crowdfunding types. The regulatory environment highly depends upon the type of crowdfunding a start-up is engaged in. For instance, some crowdfunding models may require a start-up to draft a prospectus.

Crowdfunding refers to open calls to the wider public to raise funds for specific projects.[1] This method of funding is particularly community based and is often promoted through the internet and social media channels. Considering that the recent economic crisis had a severe impact for web entrepreneurs to access finance, crowdfunding is now seen as a valuable alternative to traditional sources of early stage capital. Moreover, due to close engagement with the public, crowdfunding can be used as a marketing tool as it allows the start-up to test and promote its idea.[2]

Regulatory fragmentation remains a key hurdle for crowdfunding projects within Europe. National laws allow for local crowdfunding industries to grow, yet fragmentation reduces the potential market size and leaves little room for scale.[3] Because the European financial directives are interpreted differently across member states, the emergence of a healthy European crowd fund industry is currently unlikely.[3] A pan-European position is missing as there is too little cross-border engagement between the national financial services regulators. Additionally, EU MS legislation often differentiates among crowdfunding models (equity, lending and donations or rewards). Consequently, legal uncertainty may prevent start-ups from obtaining the necessary funds.

1. Crowdfunding Regulation in Europe

There is currently no pan-European legal framework governing crowdfunding activities. This means that the rules that apply to crowdfunding differ from Member State to Member State.

A general distinction should be made between two types of start-up activities related to crowdfunding.

Start-up Crowdfunding Platforms

Start-ups wishing to set up their own crowdfunding platforms can be subject to various regulatory regimes, such as:

- Regulation concerning distance selling
- Regulation concerning financial and online intermediation
- Banking regulation (peer-to-peer lending)
- Financial investment regulation
- Payment services regulation
- Consumer Protection and Consumer Credit Regulation
- …

Start-up Funding via the Crowd

Start-ups who wish to collect funds via crowdfunding can be subject to regulation as well. In particular, collecting funds via the crowd can be subject to the prospectus directive, which requires from entities to publish a prospectus before funds can be collected. This legislation can indirectly influence the amount of money one can collect through crowdfunding platforms.

Both activities can be subject to regulatory measures. Whether or not these activities will be regulated, and to what degree, will depend on the type of crowdfunding involved.

1.1. A Crowdfunding Taxonomy

Crowdfunding can take many forms. Depending on the type of crowdfunding, different legislation may apply. Although not exhaustive, the following taxonomy of crowdfunding may guide start-ups in their navigation through EU and national legislation. This taxonomy is both relevant for start-ups that wish to set up their own crowdfunding platform and start-ups looking to obtain funds via crowdfunding.

1. Crowd Sponsoring

Donations-based: Contributors give money to a project without being promised anything in return.[4] Typically used for small campaigns, it is the most frequently used model of crowdfunding.[5]

Rewards-based: These campaigns offer contributors products or services, typically of a lower value, in exchange for their contribution.

Pre-sales: The campaigner collects funds in order to develop a future product and contributors are promised the future product once its development has finished. The contributors take the position of an on-line shopper at a time when the product is not yet developed.[6]

2. Equity or Crowd Investing

The campaigner wishes to attract investments from a group of people, instead of being funded by a business angel or private investors.

Profit or Revenue sharing: These crowdfunding projects offer the contributors a share in future profits of the business or royalties of the artist to which they contributed. Contributors will have to know on what basis the profit share will be calculated. Reliable mechanisms have to be put in place in order for the contributor to monitor the realised profits.[6]

Securities-based: The investments made by the crowd are turned into securities, i.e. shares or bonds. It is estimated that campaigners using this form of crowdfunding collect on average €50.000 in the EU. Start-ups must keep in mind that issuing shares or bonds brings along certain voting rights for the investors. Nevertheless, it can be a viable alternative to bank, venture capitalist, and angel financing.[6]

3. Crowd Lending

Crowd lending is the financial crowdfunding model where the campaigner, e.g. the digital start-up, takes the position of a borrower and the contributors act as lenders.[6] Campaigners promise to pay back the contributors on specified terms, e.g. interest rate. Crowd lending allows the start-up to keep all decision and ownerships rights. As banks are not as keen to provide funds after the crisis, crowd lending could be a valuable alternative.

Peer-to-Peer lending: Peer-to-peer lending shares similarities with crowd lending, but differs in that the lenders and borrowers usually do not know each other. For start-ups the motivation generally is a higher financial return. Interest rates are based on risk, which in turn is based upon financial data and securities. This model is favoured for those borrowers looking to find loans at a lower interest rate than the ones they can receive from a bank: default rates on average are very low.[4] This form of lending is on the rise in Europe.[4]

1.3. Regulatory Differences

In order to give a clear view on how crowdfunding regulation may differ among Member States, we provide a comparative analysis between the 4 Member States that are known for their start-up communities. The overview provided is general and only serves as an indication of the overall regulatory regime in the Member States chosen. For a more detailed analysis of the EU legal regimes we refer to the European Crowdfunding Network's Review of Crowdfunding Regulation.

United Kingdom – London

Start-up Crowdfunding Platforms

Equity or crowd investment models often require an authorisation from the UK Financial Conduct Authority. Although exemptions could be invoked, enhanced policing is likely to reduce the ability to rely on these exemptions. The lending model will also require an authorisation. Donations and rewards based models are not subject to financial regulation.

Start-up Funding via the Crowd

There is a prospectus requirement for undertakings offerings transferable securities, such as shares. The prospectus is required once a threshold of 5 million € within 12 months is reached.

France – Paris

Start-up Crowdfunding Platforms

Lending activities conducted habitually for profit are considered credit operations (crowd lending). These require a French banking passport. Only those loans which are granted without interest of other returns do not fall under the regime.

Start-up Funding via the Crowd

In general, start-ups that issue securities or other financial products (crowd investment) have a prospectus requirement if the threshold of 100.000? € within 12 months is reached.

Germany – Berlin

Start-up Crowdfunding Platforms

Crowdfunding platforms that facilitate the offer of securities, investment products or shares in collective investment undertakings are likely to be considered an operator of a platform providing financial services, for which authorisation will be required. In general, one could argue that under the German legal system, donation and rewards-based crowd funding models should not be considered investment products.

Start-up Funding via the Crowd

Start-ups that issue securities or other investment products (crowd investment) have a prospectus requirement if the threshold of 100.000 € within 12 months is reached.

Netherlands – Amsterdam

Start-up Crowdfunding Platforms

Crowdfunding platforms could fall under the Dutch Financial Services Act due to its intermediary role concerning consumer credit, repayable funds and financial instruments.

Start-up Funding via the Crowd

There is a prospectus requirement for start-ups issuing securities. The threshold is rather high in comparison to other Member States: a prospectus is required when a threshold of 2.500.000 € within 12 months is reached.

1.2. The Prospectus Requirement

Start-ups that wish to gather investments via crowdfunding may have to publish a prospectus before being able to do so. Prospectuses are legal documents that are used by undertakings to attract investment. Undertakings can be obliged to draft a prospectus when they issue a public offering. A public offering is a communication to the public in any form and by any means, presenting sufficient information on the terms of the offers and the securities to be offered in order to enable an investor to decide to purchase or subscribe to these securities, such as shares or bonds.[2, 3] The prospectus is thus of particular importance for start-ups who wish to acquire funding via crowd investing or equity investing.

The prospectus serves a two-fold purpose.

- The prospectus should contain all the information necessary for investors to make an informed decision, e.g. reasons for the offer, risk factors, information on the company, …[1]

- The prospectus has to be approved by the responsible supervisory authority. The responsible authority depends upon the law applicable to the public offering[4]. For instance, if a start-up wishes to target the Belgian public, the Belgian supervisory authority will be responsible. Once approved, the prospectus shall be published.

Depending on a Member State's definition of a public offering, crowdfunding could be categorised as such. Start-ups should be aware of this requirement. First, crowdfunding will in some instances only be valid when a prospectus has been approved and published. Second, the creation of a prospectus can be costly and administratively burdensome. Therefore, alternative crowd funding methods could be considered.

2. Future of Crowdfunding Regulation

The European legislator is currently exploring how crowdfunding in Europe could be promoted. At the moment though, the European Commission does not plan on regulating crowdfunding as such.[1] A communication was released to develop a common understanding at the EU level and to prepare the ground for future actions.[7] One of the main goals is to raise awareness, provide information and training modules for project owners, especially for crowd lending and crowd investing.

References

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2. Startup Europe Crowdfunding Network, Final Report (Brussels, 19 April 2014)

http://www.crowdfundingnetwork.eu/files/2014/05/20140519_Final-Report_Startup_Europe_Crowdfunding_Network.pdf

3. Tax & Legal Group of the European Crowdfunding Network, *Review of Crowdfunding Regulation, 'Interpretations of existing regulation concerning crowdfunding in Europe, North America and Israel*

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6. Commission, 'Crowdfunding in the EU – Exploring the added value of potential EU action' (Consultation, 3 October 2013)

7. http://europa.eu/rapid/press-release_MEMO-14-240_en.htm

8. Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading.

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2003:345:0064:0089:EN:PDF

9. Directive 93/22/EEC of 10 May 1993 on investment services in the securities field.

10. A list of competent authorities can be found on the website of the ESMA:

http://www.esma.europa.eu/page/Competent-authorities-responsible-authorisation-and-supervision-central-counterparties-CPPs

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