



# Crowdfunding, an emerging market in Europe?

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### What is crowdfunding?

Crowdfunding is a means of fundraising from the crowd, generally by using the internet.

Crowdfunding is becoming an increasingly popular way to connect entrepreneurs in need of financing, with investors—mostly retail investors—in search of various forms of returns ranging from pure profit to impact investing and even non-financial returns.

Historically, entrepreneurs used to face funding challenges when financing their start-ups as banks were not supportive of their innovative ideas. Often, their funding capacity was limited to personal savings complemented by whatever could be collected from direct family members and close relationships.

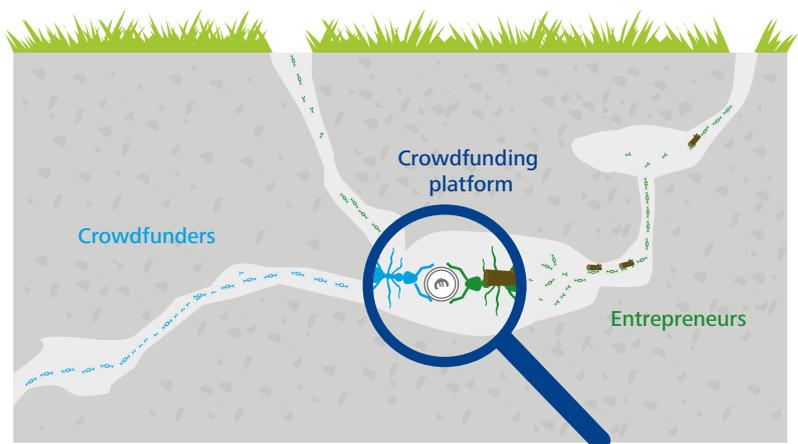
The development of the internet across our society has enhanced and accelerated communication and connections between people and communities sharing similar ideas. Entrepreneurs quickly understood its benefits and started advertising their innovative ideas through the net. Communicating about a project through the internet and financing the project through alternative funding channels and mass markets became a reality.

However, the size and broadness of the web quickly became a challenge for entrepreneurs desperately searching for financing means: how to successfully reach investors interested in their niche projects? Thus, the first crowdfunding platform appeared on the net.

Crowdfunding platforms connect crowdfunders (investors) and entrepreneurs through dedicated websites such as Kickstarter, SmartAngels, MyMicroInvest, Crowdcube, ... and they are booming across the globe.

Why are they so successful? Probably because they offer, at a very low entry cost, an easy alternative to traditional financing and investing. Investors can choose projects they like, projects they feel emotionally connected to and decide to sponsor them.

Crowdfunding is furthermore strongly connected to social and impact investing.



### How to categorize crowdfunding activities?

The first category of crowdfunding activities is donation, by far the oldest and most widespread one. Crowdfunders finance a specific project with no financial return or capital reimbursement expectations. Their aim is to contribute to a specific or sustainable project in the society. These are often run by NGOs or social organizations. Occasionally, a non-financial return is granted to the generous crowdfunders as a token of appreciation. This form of crowdfunding is lightly regulated.

The second category is called the lending model. Crowdfunders lend money through a platform and thereby finance entrepreneurs' projects. The loans may or may not carry interest and are theoretically reimbursed at maturity. This lending model is the most common crowdfunding model involving financial return. It is not formally regulated but falls naturally under the European Banking Authority regulations and policies.

The third and last category is called the equity model. Crowdfunders invest their money in the equity of a project through a crowdfunding platform. If the project performs well, they might get dividends and make a profit on the sale of their shares of the company at a later stage. It is not formally regulated and triggers higher risks for the crowdfunders. The European Securities and Markets Authority (ESMA) has recently published an Advice and an Opinion on investment-based crowdfunding (the equity model).

### What is the European crowdfunding market like?

According to the European Crowdfunding Network (ECN) Review of Crowdfunding Regulation dated October 2013: *"The rise of crowdfunding over the past decade is a result of the ongoing digitalization of processes and communication in our society, with easy access to high-speed internet and digital devices."*

Crowdfunding has recently been moved to the forefront in the discussion on access to finance. This is a result of the economic crisis and the associated market failures of the incumbent financial services industry, which provides financing to Small- and Medium-sized Enterprises (SMEs).

Europeans save their money rather than assume risk by investing it in small enterprises, and they admire established institutions rather than the entrepreneurs who built them. According to statistics, some 30 percent of SMEs face liquidity problems and only 30 percent of SMEs have access to bank credit at any given time. Plus, the availability of bank loans for SMEs has declined over recent years, while collateral requirements have increased. Still, SMEs are the main contributors to job creation and represent around 67 percent of all jobs in Europe.

This drastic lack of funding for SMEs has a visible impact on Europe's economy. It is the main reason why we are witnessing a political discussion on the topic and why crowdfunding is expanding.

ECN is the lobbying group of crowdfunders and believes in the opportunities that crowdfunding can offer to the European economy.

We witnessed this belief at the ECN annual general meeting in Paris in November 2014. This event gathered hundreds of crowdfunders and platform representatives from all over Europe, each with a strong motivation to promote and push this emerging industry a step ahead. This time, market regulators, financial lawyers, venture capital firms and angel investors also attended the conference.

Is crowdfunding a booming alternative to the existing finance market? The reply to this question is probably positive, if one looks at the crowdfunding initiatives that are emerging across Europe. In France, for example, there are more than a hundred crowdfunding platforms collecting almost €100 million every year, mainly through lending. The United Kingdom market is also very advanced with almost 100 platforms collecting annually about €1 billion, mainly through lending and donation.

Moreover, these amounts seem to double every year.



### Regulation or no regulation?

That's the dilemma.

There is a lot of criticism around the incompatibility of the existing European financial industry regulations and that of crowdfunding, which are almost non-existent at a European level so far. To mitigate this, countries such as France have implemented their own regulation to support the industry through a "*décret sur le financement participatif*" facilitating equity and lending crowdfunding. The UK is also utilizing a mix of existing regulation on collective investment schemes for equity crowdfunding and some new tailor-made regulation for the lending category. Similar initiatives have taken place in Italy and other European countries. These will not facilitate the harmonization of the regulation across Europe, even if crowdfunders request facilities for European cross-border crowdfunding activities.

On one hand, size is critical to survive—so is scalability—and these will be enhanced with a European regulation. On the other hand, crowdfunding is today a business of proximity. Most initiatives are local, supported by local platforms for local entrepreneurs and local investors in their local languages.

### What is the feedback from ESMA on crowdfunding?

ESMA formally gave its feedback on investment-based crowdfunding (equity crowdfunding) in two publications in December 2014, an Opinion and an Advice.

ESMA believes that crowdfunding has to be taken seriously. It is considered to be a new type of business that tends to be organised into several continuously evolving business models. The European financial services rules were not designed with crowdfunding in mind, and it is difficult to map crowdfunding platform activities with European rules as activities vary. It is a fact that European Member States address crowdfunding either by fitting it as much as possible within existing rules or by adapting it on an ad hoc local basis.

There are many risks arising from investment-based crowdfunding such as the size of most projects, as they are financing small companies with a potential high failure rate. The securities issued by these small companies are generally unlisted and present significant risk for capital loss. They are either not liquid or are barely liquid.

Furthermore, the information available to investors prior to making an investment in a crowdfunding project is often limited and probably not sufficient for a sound and clear investment decision.

At a platform level, risks range from a conflict of interests between the crowdfunding project and the investors, to a platform failure if it administers client assets.

ESMA, however, considers that crowdfunding has strong potential for financing the real economy, and that it can widen the investment opportunities available to non-institutional investors.

Among others, the following European regulations may apply to crowdfunding: the Markets in Financial Instruments Directive (MiFID), the Alternative Investment Fund Managers Directive (AIFMD), the European Social Entrepreneurship Funds (EUSEF), the European Venture Capital Funds (EuVECA). But none of these regulations address the specificity of the crowdfunding industry.

### What about Luxembourg?

Interest in crowdfunding in Luxembourg is limited by two main factors: the size of the local market and the regulated Luxembourg finance and fund industries.

The size of the market is a key driver for the financial survival of a crowdfunding platform. Local initiatives that have emerged so far have struggled due to the small size of Luxembourg.

The Luxembourg finance and fund industries are very much mature, organized, and regulated, and they benefit under certain conditions from passporting facilities, which is what crowdfunding would be seeking in an ideal world. Their regulatory and operational costs are, however, not accessible and not affordable for the small investment projects driven by the crowdfunding market so far.

Luxembourg, however, presents a strong opportunity for crowdfunding platforms given its valuable experience as the European hub for investment management. Luxembourg could also become a hub for crowdfunding if a European regulation—incorporating passporting facilities—would arise.

#### Conclusion

Crowdfunding is a booming industry that expanded together with internet usage. It presents various models/categories such as donation and the lending and the equity models. ECN, the lobbying group of the crowdfunders and crowdfunding platforms, is organized and is pushing this industry forward but recognizes a lack of harmonization among European regulations for the moment. ESMA is of a similar opinion and formally expressed itself on the matter in 2014.

Luxembourg is looking for more European regulation for this industry and would probably position itself as a potential hub for platforms, leveraging its current financial and fund competencies.

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