Briefing

January 2017

Crowdfunding in Europe

Introduction and state of play

SUMMARY

Crowdfunding is a relatively 'young' form of financing – especially for SMEs and start-ups, but also for not-for-profit projects – that is developing fast in Europe. While researchers point out its benefits, among them the fact that project owners have greater control, and financial risk is spread among a larger number of people, they also note its drawbacks. The latter include a high cost of capital, occasional displays of a 'herd mentality', capable of depriving potentially worthier projects of adequate funding, and risks for investors from incompetence or fraud on the part of the project owners, and unclear regulations.

The European Commission (through a communication and two reports) and the European Parliament (through three resolutions) have taken an active interest in this form of financing. As a result, the Commission recently conducted a study on the state of the European crowdfunding market. It found that, while crowdfunding is developing fast, it is still concentrated in a few countries (the United Kingdom, France, Germany, Italy and the Netherlands), which have introduced tailored domestic regimes, and that it remains, for the time being, a national phenomenon with limited cross-border activity. The study therefore concluded that for the moment there is no strong case for EU-level policy intervention. Nonetheless, given the encouraging trends and the potential of crowdfunding to become a key source of financing for SMEs over the long term, the Commission noted that it will maintain regular dialogue with European supervisory authorities, Member States and the crowdfunding sector to monitor and review its development.

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PE 595.882

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Introduction

A company can be financed internally or externally. Internal financing is done through an entrepreneur's own contribution, or through reinvesting the company's retained earnings. External financing can take various forms, such as loans from banks, investments from business angels or venture capitalists, or funds raised through crowdfunding campaigns.

According to the European Central Bank's latest survey on the access of enterprises within the euro area to finance, external financing (mainly short-term and long-term bank-related products) remains the main source of financing for SMEs, which use it mainly for fixed investments and inventory. Even though bank financing in 2015-2016 became more available across firm sizes and countries, and the willingness of banks to provide credit to SMEs continued to increase, many SMEs in the start-up phase or seeking further expansion still find it challenging to secure investment finance.[1] Crowdfunding represents a viable option for ensuring them access to such finance.

What is crowdfunding?

Definition and main categories

Crowdfunding can be defined as an open call for 'the collecting of resources (funds, money, tangible goods, time) from the population at large through an Internet platform. In return for their contributions, the crowd can receive a number of tangibles or intangibles, which depend on the type of crowdfunding'. It generally takes place on crowdfunding platforms, that is, internet-based platforms that link fundraisers to funders.

Crowdfunding campaigns can raise funds for not-for-profit and for-profit projects or organisations. Consulting agency Massolution has developed one of the most commonly used classifications so far (also used by the Commission in its work),[2] which distinguishes between four categories of campaigns:

- **donation-based**, in which people do not receive any reward for their contributions (although, depending on the project and the jurisdiction, they can be entitled to tax deductions);
- **reward-based**, where people receive goods or services in exchange for their contributions;[3]
- **lending-based**,[4] in which contributors receive interest payments in exchange for financing a project with an associated rate of return and maturity date;
- **equity-based**, where people receive shares in the venture, in exchange for their contributions.

The International Organization of Securities Commissions (IOSCO) refers to the first two categories as 'crowd sponsoring' and the latter two as 'crowd investing'.

While the basic idea of crowdfunding is not new,[5] its modern version is a relatively young form of financing, since much of its development happened between 2006 and 2009. What contributed to its current momentum are *technological innovations*, which helped design new website architecture promoting user participation (such as 'Web 2.0' technologies[6]); the *financial crisis*, which resulted in constrained bank lending and pushed borrowers into seeking new means of funding; and *falling interest rates*, which pushed investors towards alternative forms of finance in their 'search for yield'.

A simple crowdfunding scheme

A paper by Kristof De Buysere *et al.* provides a useful simplified depiction of how a crowdfunding scheme works.

Proposition and investment phase

To start with, project owners send an application to an online platform (Ulule is one such platform in the EU) to present their idea or cause on its website. Some platforms pre-select ideas based on their own criteria, while others automatically publish every idea that gets submitted. Platforms that perform pre-selection may check, among other things, the background of the project owner or the feasibility of the crowdfunding plan.

After an idea is accepted by an online platform, the project owner is asked to create a funding goal, a period of time over which that goal has to be achieved, as well as an online 'pitch' (most of the time, a short video), presenting the idea to potential backers. Backers then fund the campaign directly through the online crowdfunding platform.

During the campaign, project owners are encouraged (but not obliged) to provide regular updates to their backers, via the project's platform, about the funds raised or the state of production of a good.

If the funding goal is reached within the allocated time frame, the project owner receives the money. If it is not reached, most platforms reimburse backers the money they gave (see below a description of the 'all-or-nothing' principle).

Post-investment phase follow-up

After the end of the campaign, some backers may choose to remain involved in the decision-making and overall strategy of the business. Some may even receive voting rights in the business (in the case of equity investment). In many cases, they continue to communicate with the project owners through the online platform.

Platform role and cost

Unlike traditional financial intermediaries, crowdfunding platforms do not borrow, pool, or lend money on their own account. Instead, they focus on matching project owners and backers, providing information about the projects and advice (for instance, on how to reduce investment risks). Platforms offer specific funding mechanisms, such as pledge levels (reward tiers offered to backers during the campaign), minimum pledge amounts and the all-or-nothing/keep-it-all-principle. According to Michael M Gierczak *et al*., 'the all-or-nothing-principle means that project initiators are only paid out the collected amount if they reach their pre-defined funding goal. This is based on the assumption that project owners are only able to accomplish their project and to deliver the promised returns if they have the complete resources required for doing so. However, some crowdfunding platforms are based on a keep-it-all-principle in which project initiators receive any sum collected. This funding principle is particularly used for charitable projects or projects which use crowdfunding as a subordinate source of funding'.

As a rule, platforms do not charge participation or membership fees. Instead, their revenues come from commissions (Ulule charges 8 % including VAT), if the project succeeds. Some other platforms charge no commission and instead rely on voluntary contributions and/or advertising revenues (for instance, HelloAsso).[7]

Benefits and drawbacks of crowdfunding for project owners

Benefits of crowdfunding

Garry A Gabison notes that in crowdfunding, project owners have more control over their project than when seeking financial support from banks or venture capitalists, both with regard to the project itself (for instance, the maturity period) and to the rewards given (for instance, the share schemes in equity crowdfunding). Not having to submit to the demands of banks or venture capitalists gives project owners more leverage to obtain financing at a lower cost. Yet again, because of its nature,[8] crowdfunding, in a way similar to insurance, spreads the financial risk involved among a large population of investors. Finally, it allows project owners to market-test their products or services during their campaigns, to reap non-financial benefits through backer feedback, and to obtain further funding from banks (using their campaigns as market studies), while at the same time moving up the funding escalator of corporate finance.

Drawbacks of crowdfunding

Gabison notes that the public nature of crowdfunding may deter potential project owners who are reluctant to disclose too much information for fear that it may damage their project. Furthermore, project owners might fail to get adequate funding due to people adopting a 'herd mentality', whereby most funds go to a few well-advertised projects. In the case of equity crowdfunding, since many project owners lack expertise in banking, they might fail to set an appropriate price for the shares in their venture. Also, while campaigners may be skilled in the products or services they propose, they may lack the skills for running a crowdfunding campaign and thus fail to get the funds they seek.

Gierczak *et al.* note that crowdfunding imposes a high cost of capital on companies, as platforms collect around 10 % of the capital raised on average and frequently charge additional fees for providing due diligence for projects, or insurance for project backers. Furthermore, project owners need to take into account interest on potential returns or other types of rewards. Finally, they need to consider other factors, such as the cost and time necessary for the (video) 'pitch', the updates and the day-to-day management of the campaign (feedback), and the post-investment efforts with regard to investors.

Risks for investors

Crowdfunding has its own risks. Gierczak *et al.* point out that it carries uncertainty, due to the fact that project backers' investment decisions are usually not based on financial data and may be influenced by emotions. 'In this regard, start-ups going bankrupt or delayed delivery of pre-sold products are among the most prevalent problems'.

Gabison notes that some of the common risks investors may face are (i) fraud (although so far rare in practice); because of the relative anonymity of the internet and the small amounts they invest, investors may be deterred from seeking compensation; (ii) incompetence or miscalibration on behalf of the project owner, which might result in the project's failure; (iii) in the specific case of equity crowdfunding, the lack of an efficient secondary market where equity-based investors can re-sell their shares; and (iv) unclear regulations and tax laws, which may influence the demand for funds or how crowdfunding itself evolves.

State of the market in Europe

A European Commission report, 'Crowdfunding: Mapping EU markets and events study', published in September 2015, studied the trends in the EU crowdfunding market during 2013 and 2014, for a variety of funding models including loans, equity and rewards. It further examined how, within the specified time frame, new national crowdfunding legislation ('events') adopted in France, Italy, and the UK influenced the industry.

The report identified 510 platforms operating in the EU within the period under observation, with an increase of 23.2 % in 2014 compared to 2013. The **UK** had the largest number of platforms (143, or 28 % of the EU total), which also accounted for over 90 % of the €2.0 billion raised by the participating platforms in total. The UK was followed by **France**, boasting 77 platforms and the greatest number of new platforms launched, **Germany** (65 platforms), the **Netherlands** (58 platforms) and **Italy** (42 platforms).

EU platforms employed a variety of funding mechanisms. In 2014, the three most common types of return offered by platforms were in the form of **rewards** (30.4 %), **equity** (22.9 %) and **loans** (21.0 %). A few platforms dominated the market, with five platforms representing over 80 % of the projects that had ended successfully (within the scope of the study) in terms of monetary value. All of these dominant platforms (except one) were lending ones and all were based in the UK. By Member State, the number of platforms by funding type was broadly similar across the largest EU markets, with a few exceptions. The majority of platforms offered a **single funding type**. The **average amount** raised across all funding types remained broadly constant at **€10 000** to **€12 000** during the period studied.

According to the report, crowdfunding projects were ongoing in every EU Member State over the period, with eligible project-level data evidencing a total of €2.3 billion raised successfully for 206 908 projects, where the project was either located in the EU or was supported by a platform located in the EU. While coverage varied significantly between Member States, the five largest markets by total amounts raised were France, Germany, the Netherlands, Spain and the UK.

Cross-border projects (that is, those for which the location of the project differed from the location of the platform), represented 8.5 % of the amount raised in 2013 and 7.3 % in 2014. In 2014, they amounted to €117 million. By funding type, the **highest value of cross-border EU projects** on participating EU platforms was attributed to loans, followed by equity, rewards and donations.

An analysis by funding type revealed the following trends:

- with regard to equity projects, the UK was the largest market in terms of participating platforms. The second and third-largest markets were France (€13.8 million) and Germany (€11.1 million). Most of the amounts raised were below €500 000, with the average amount raised per EU equity project by the participating platforms rising from €215 000 in 2013 to €260 000 in 2014. Only a small part of the equity activity of participating platforms was identified as being intra-EU and cross-border in nature;
- as far as loan projects are concerned, the UK had the largest amount raised (€1.1 billion) and the largest number of projects launched on the participating platforms. It was followed by Estonia (€10.8 million), Germany (€10.3 million) and France (€10.0 million). The average amount raised per EU loan project by the participating platforms was €10 800 in 2013 and €10 600 in 2014. Again, only a small part of intra-EU activity was identified as being cross-border in nature;
- finally, multi-funding type[9] platform projects were rare (eight out of 193 participating platforms in 2014, versus five in 2013). They helped raise €52.3 million for projects in 2014, more than double for this type of activity compared with 2013.

An analysis of crowdfunding trends in France, Italy and the UK before and after the occurrence of national 'regulatory events' in these Member States[10] revealed significant differences in how they had chosen to regulate crowdfunding, based on the level of development of their markets and the ongoing consultation within the industry at the time of regulation, and the nature of their pre-existing regulatory frameworks. The Commission report, however, noted that all three Member States had either undertaken or proposed further policy initiatives following the regulatory events, indicating that these events contributed to a broader policy momentum with regard to crowdfunding.

Existing EU-level legislative framework

The 2014 Commission communication 'Unleashing the potential of Crowdfunding in the European Union' notes that Member States have addressed concerns around crowdfunding in two ways: through guidelines (as in the case of Germany, the Netherlands and Belgium), or through regulatory action (Italy, UK, France and Spain). In addition to national legislation, crowdfunding can also be subject to EU legislation, depending on the business model used. The communication cites Directive 2000/31/EC on certain legal aspects of information society services, in particular electronic commerce, in the internal market (platforms charging money for successfully financed projects may engage in e-commerce); Directive 2006/114/EC concerning misleading and comparative advertising, which provides minimum harmonisation for misleading marketing practices in a business-to-business context; Directive 2005/29/EC concerning unfair business-to-consumer commercial practices in the internal market, which protects consumers against misleading and aggressive crowdfunding practices; and Council Directive 93/13/EEC on unfair terms in consumer contracts, in case the standard terms and conditions used by crowdfunding operators contain unfair clauses. In addition, crowdfunding activities may also be subject to EU state aid and competition rules.

Specifically for lending- and equity-based crowdfunding, the communication notes that further EU rules that may apply include provisions from Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading, Directive 2007/64/EC on payment services in the internal market, Directive 2004/39/EC on markets in financial instruments, Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, Directive 2011/61/EU on alternative investment fund managers, Directive 2008/48/EC on credit agreements for consumers, Directive 2002/65/EC concerning the distance marketing of consumer financial services, Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, Regulation (EU) No 345/2013 on European venture capital funds and Regulation (EU) No 346/2013 on European social entrepreneurship funds.

Position of the European Parliament

The Parliament has expressed its opinion about crowdfunding in three resolutions.

In its resolution of 9 July 2015 on building a capital markets union, Parliament noted that 'CMU should create an appropriate regulatory environment that enhances cross-border access to information on the companies looking for credit, quasi-equity and equity structures, in order to promote growth of non-bank financing models, including crowdfunding and peer-to-peer lending', underlining that 'investor protection rules should apply to all financing models to the same extent, irrespective of whether they are part of bank or non-bank financing models'.

Furthermore, in its resolution of 19 January 2016 on stocktaking and challenges of EU financial services regulation, Parliament underlined the potential 'of innovative market-based funding, in particular the opportunities of financial technologies, including crowdfunding and peer-to-peer loans and ... the need to streamline the respective regulatory requirements'. It therefore asked the Commission to allow for the emergence of these new models and to explore and promote them, 'giving priority to their cross-border dimension and ensuring the reduction of market entry barriers'.

Finally, in its resolution of 26 May 2016 on the single market strategy, Parliament noted 'the difficulties faced by business, and in particular SMEs and start-ups, in securing funding', and called on the Commission 'to make sure that crowdfunding can be done seamlessly across borders'.

State of the debate

On 3 May 2016, the Commission published a working document, 'Crowdfunding in the EU Capital Markets Union', which states that crowdfunding has the potential to be a key source of financing for SMEs over the long term. It notes, however, that, while the share of crowdfunding in the total funding of European business is growing fast, it remains a national phenomenon, with cross-border funding still limited. Given this fact, the Commission states that for now, 'there is no strong case for EU level policy intervention'.

Nonetheless, given the trends, the Commission stresses the importance of monitoring the development of the sector and the effectiveness (as well as the degree of convergence) of national regulatory frameworks. To this end, the Commission notes that it will 'maintain regular dialogue, through twice yearly meetings, with the European Supervisory Authorities, Member States, and the crowdfunding sector to promote convergence, sharing of best practice and keep developments under review'.

Main references

Eleanor Kirby and Shane Worner 'Crowd-funding: An Infant Industry Growing Fast', OICV-IOSCO Staff Working Paper, 2014.

Garry A Gabison 'Understanding crowdfunding and its regulations', European Commission Joint Research Centre (JRC), Science and Policy report, 2015.

Karen E Wilson and Marco Testoni 'Improving the role of equity crowdfunding in Europe's capital markets', Bruegel, 2014.

Kristof De Buysere, Oliver Gajda, Ronald Kleverlaan and Dan Marom 'A framework for European crowdfunding', 2012.

European Commission communication 'Unleashing the potential of Crowdfunding in the European Union', 2014; 'Crowdfunding: Mapping EU markets and events study', 2015; 'Crowdfunding in the EU Capital Markets Union', 2016.

Paul Belleflamme, Nessrine Omrani and Martin Peitz 'The Economics of Crowdfunding Platforms', 2015.

Michael M Gierczak, Ulrich Bretschneider, Philipp Haas, Ivo Blohm, and Jan Marco Leimeister 'Crowdfunding: Outlining the New Era of Fundraising'.

Endnotes

1 For more information, see Marcin Szczepanski's 'Barriers to SME growth in Europe', EPRS briefing, 2016.

2 There exist other taxonomies, such as the one established by Philipp Haas, Ivo Blohm and Jan Marco Leimeister, in their paper 'An Empirical Taxonomy of Crowdfunding Intermediaries' which differentiates between hedonistic (innovative and creative projects), altruistic (charitable projects) and for-profit crowdfunding.

[3] In this way, reward-based crowdfunding is comparable to preselling.

[4] IOSCO uses the more widely known term 'peer-to-peer lending', defining it as the 'use of an online platform that matches lenders/investors with borrowers/issuers in order to provide unsecured loans'.

[5] Michael M Gierczak *et al.* give the 'frequently cited example of ... the pedestal of the Statue of Liberty' where 80 % of the US$102 000 collected for the pedestal by the newspaper *World* – through a campaign consisting of financial contributions in exchange for the backers' names being printed in the newspaper – was donated by New Yorkers in the form of individual contributions of less than US$1.

[6] Michael M Gierczak *et al.* note that crowdsourcing describes 'the outsourcing of various tasks to an undefined group of people using information technologies'. They consider crowdfunding to be one of the main forms of crowdsourcing.

[7] For a broader discussion on the economics of crowdfunding platforms, see Paul Belleflamme et al. 'The Economics of Crowdfunding Platforms', 2015.

[8] In crowdfunding, the contribution (and thus the investment risk assumed by investors) consists of many small amounts; in contrast, in venture capital the project receives large amounts from just a few investors.

[9] Those supporting projects of a funding type that differs from the primary funding type offered by the platform.

[10] These events were (i) the regulation of equity crowdfunding by the Commissione Nazionale per le Società e la Borsa in Italy, (ii) the regulation of crowdfunding by the Financial Conduct Authority (FCA) and (iii) the regulation of crowdfunding and the introduction of two specific regulatory statuses that require registration with the French agency for the common register of insurance, banking and finance intermediaries (ORIAS).

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