



Vaasan yliopisto  
UNIVERSITY OF VAASA

**OSUVA** Open  
Science

This is a self-archived – parallel published version of this article in the publication archive of the University of Vaasa. It might differ from the original.

## Investor protection strategies in crowdfunding regulation: The 4-I's model

**Author(s):** Salo-Lahti, Marika; Annola, Vesa

**Title:** Investor protection strategies in crowdfunding regulation: The 4-I's model

**Year:** 2022

**Version:** Accepted manuscript

**Copyright** ©2022 Routledge. This is an Accepted Manuscript of a book chapter published by Routledge in *Responsible Finance and Digitalization: Implications and Developments* on 30 September 2022, available online: <https://doi.org/10.4324/9781003144427>

### **Please cite the original version:**

Salo-Lahti, M. & Annola, V. (2022). Investor protection strategies in crowdfunding regulation: The 4-I's model. In: Kalmi, P., Auvinen, T. & Järvenpää, M. (eds.) *Responsible Finance and Digitalization: Implications and Developments*, 171-185. Routledge International Studies in Money and Banking. London: Routledge.  
<https://doi.org/10.4324/9781003144427-14>

## **Investor Protection Strategies in Crowdfunding Regulation**

### **The 4-I's Model**

*Marika Salo-Lahti and Vesa Annola*

### **Abstract**

Crowdfunding is an alternative form of financing, which is typically operated by online platforms. The regulation on crowdfunding has been very heterogeneous with different national legislations. Despite the differences, one central goal of the financial market regulation is typically to protect investors. This chapter focuses on investor protection strategies in crowdfunding regulation. In order to tackle and systematize the strategies, we build and present a “4-I’s model”. The model consists of Investor, Investment, Intermediary, and Information parts. In our analysis of the model, we concentrate mainly on the new European Union (EU) regulation on crowdfunding, which can effectively boost the growth of the crowdfunding sector in the EU.

Keywords:

Crowdfunding regulation, systematization, regulation strategies, investor protection

### **11.1 Ways to protect investors in crowdfunding regulation and the 4-I's model**

Crowdfunding is an increasingly popular alternative form of financing typically used by startup companies and growing businesses. In *lending-based* crowdfunding, companies collect money from the crowd and it will be paid back with interest, resembling traditional bank lending. *Equity-based* crowdfunding, instead, means buying equity, usually shares. The idea is mostly similar to trading in the stock markets ([European Commission, 2015b](#)).<sup>1</sup>

Crowdfunding is operated via online platforms and the crowd includes wide variety of people who can be called investors. Crowdfunding entails significant risks from which investors need protection. Although there are many linkages to the banking and stock markets, the distinctive nature of crowdfunding leads to the need to construct its own investor protection regime. There are many possible solutions in building the regime. They can be called investor protection strategies.

In regulating crowdfunding the balance should be found between adequate investor protection and the costs of complying with the regulation. [Hornuf and Schwienbacher \(2017\)](#) state that maximizing investor protection can even hurt small firms as they can be too small to obtain finance from professional investors either. As traditional securities regulation mainly focuses on larger companies and offerings, the needs of the crowdfunding sector are best met with tailored regulation.

On the other hand, lighter regulation can be seen as a threat to investor protection and even enabling fraud. The possibility to invest small amounts to unlisted companies can attract unsophisticated investors to take risks they have difficulties to bear ([Hazen, 2012](#)). Fraud could severely diminish interest in crowdfunding. Accordingly, high level of investor confidence can lead to the growth of the sector ([European Commission, 2018](#)).

In this chapter, we will examine the investor protection strategies utilized in crowdfunding regulation. We concentrate mainly on the new EU legislation but we will also consider other regulatory opportunities adopted in different jurisdictions. We will discuss the potential advantages and disadvantages of the different regulative solutions. We aim at systematization of the investor protection strategies in the crowdfunding regulation and consider its position among other financial market regulation.

We systematize the investor protection in crowdfunding regulation with our 4-I's model consisting of Investor, Investment, Intermediary, and Information. By *investor* in our model, we refer to the protection elements which are based on the characteristics of investors. In the financial market regulation – as well as crowdfunding regulation – this is mainly executed with investor classification. Investors can also be protected via regulating the *investment* itself. Crowdfunding regulation typically contains different types of limits concerning invested amounts. The *intermediary* refers to the platforms as an intermediary of the crowdfunding. The investors are protected by regulating the organization, authorization, operation, and supervision of the crowdfunding service providers (CSPs). Finally, connected to the *information* part, disclosure duties are built to protect investors.

Crowdfunding regulation strategies are typically tied to certain key factors through which investor protection is implemented. The purpose of the 4-I's model is to support identifying and coherently reviewing these key regulatory issues. The focus is not on specific points. The four components of the 4-I's model constitute a tool for picking up relevant investor protection factors to evaluate, analyze, and systematize regulation of crowdfunding. The model will allow not only a broader but also a more detailed comparison of different crowdfunding regulatory strategies.

Crowdfunding is a new regulative target in financial markets. However, as a phenomenon, it is not entirely novel. Financial market regulation faces many similar problems regardless of the instrument or the platform. We believe that this 4-I's model also contributes to enabling comparisons between regulatory strategies in different parts of the financial markets.

## 11.2 Towards single market and EU-wide crowdfunding

The European Union (EU) has recently updated its action plan for Capital Markets Union (CMU).<sup>2</sup> The aim of the CMU is to create “truly single market for capital across the EU”. In addition to that it benefits citizens, investors, and companies, efficient single market can also speed up EU's recovery from the economic crisis caused by the COVID-19 pandemic. Market-based funding is important for companies for all sizes but it is especially so for SMEs. Under the era of COVID-19 it will be even more important as bank lending may not be sufficiently available. Traditional bank funding can be even unattainable for many new innovative companies as they often lack the tangible collateral required for bank funding. ([European Commission, 2020](#)).

European crowdfunding sector is concentrated in a few Member States. Crowdfunding regulation has been scattered and in many countries *non-existent*. In spite of the harmonization of financial market regulation in the EU, there has not earlier been any EU-level regulation on crowdfunding ([European Commission, 2018](#)). Individual EU countries have made their own national solutions on whether or not and how to regulate crowdfunding. For example, Italy, Germany, Austria, and Finland have chosen to take regulatory steps. National regulations have adopted different ways to protect investors ([Cicchello, 2019](#)). Several national laws raise the barrier for cross-country operations. To add to the confusion, it has been uncertain if EU financial market regulation applies. Depending on the business model adopted by the platform, the MiFID II (Markets in Financial Instruments Directive) (EU) 2014/65 and other relevant EU regulation may or may not have applied ([European Commission, 2014](#)).

As part of its FinTech Action Plan, the European Commission adopted its proposal on EU crowdfunding regulation on March 2018. The aim of the regulation is to establish uniform rules on crowdfunding across the EU. On October 2020, The European Parliament approved the new regulation and accompanying directive ([European Parliament, 2020](#)). The regulation (EU) 2020/1503 has been applied from 10 November 2021. Technical standards will specify the implementation of the regulation ([ESMA, 2021](#)). Due to its current nature and its significance in the EU crowdfunding sector, the new EU regulation is emphasized in our analysis of the 4-I's model.

### 11.3 Investor – Investor classification as a protective tool

Investors form the first part of our 4-I's model. In creating efficient protection, the personal skills and qualities of investors are a key instrument of regulation. Classifying investors into groups by their experience and knowledge is one possible way to protect investors in financial regulation. This type of regime considers the different protection needs of investors. If the more vulnerable retail investors are under stricter protective measures, products and services could be offered to sophisticated investors with lighter rules and hence with lower costs.

Investor classification can be implemented in many ways. For instance, in the MiFID II clients are classified into three categories with different levels of investor protection. *Retail clients* have the strongest protection, while *professional clients* and especially *counterparties* can be served with less strict rules.

The original Commission proposal on the new EU crowdfunding regulation did not sort out investors into classes. However, classification of investors is now included in the new regulation. Sophisticated and non-sophisticated investors are distinguished and connected with different levels of investor protection. In spite of the differences between the regulations, the classification is based on the distinction between retail clients and professional clients of the MiFID II.

Many countries have ended up to the investor classification, as well, although the exact terms often differ. For instance, in the UK,<sup>3</sup> the strength of the investor protection varies depending on the client category. Direct crowdfunding promotions are restricted unless retail clients can be classified as sophisticated investors, high net worth investors, investors receiving investment advice from authorized person, or restricted investors who will not invest more than 10% of their net assets.<sup>4</sup> In addition to the differences in the properties of investors, this categorization recognizes to some extent the differences in investing manners.

The most significant role of the investor classification is to be the tool with which investor protection means can be targeted efficiently to the investors that are the most in the need of protection. Hence, the investor classification resonates behind the other "I's" in our model. When it comes to the Information, classifying investors considers the different information needs of the sophisticated and non-sophisticated investors. The latter can benefit from clearer and more comprehensible risk warnings and disclosures ([EBRD, 2018](#)). The role of the classification is essential also concerning the investment limits discussed in the Investment part. In addition, non-sophisticated investors can be protected by other specific means, such as by the reflection period stated in the EU regulation. Non-sophisticated investors have the four days period during which they can withdraw from the investment without penalty or giving a specific reason.

#### 11.3.1 Assessing the knowledge and appropriateness

Investor classification is significantly utilized in a central principle of financial markets: know your customer. Know your customer (KYC) is an internationally applied standard in financial services. It has two main purposes: to prevent money laundering, and to serve customers taking into account

their personal circumstances and knowledge. The KYC is especially important in regulating the investment advice and the suitability assessment related to it. In the MiFID II guidelines, the European Securities and Markets Authority (ESMA) has instructed how to carry out the KYC requirement. It is important, for instance, to have adequate policies that enable to collect and assess all the necessary information on clients. Questionnaires can be used to complete this task but special attention should be paid to the understandability of the questions (ESMA, 2018). In the US, the FINRA has formulated its KYC rule as requiring companies to use reasonable diligence to know the essential facts concerning every customer (FINRA, 2011).

Cognitive biases can cause problems in executing the KYC as people tend to have difficulties to objectively estimate their knowledge levels. Investors typically overestimate their abilities and suffer also from overoptimism. If investors are merely put to confirm that they have understood the given information it may not reflect the real knowledge levels. This should be taken into account also in the crowdfunding platforms, which can be interpreted to have a sort of KYC rule, although not as strict as in the MiFID II. Klöhn et al. suggest investor tests as a solution. These tests could be implemented digitally and they would illustrate the risks of crowdfunding and the gaps in the investor's knowledge. Investor education tests could be developed in cooperation with supervisory authorities, scholars, and practitioners (Klöhn, Hornuf, & Schilling, 2016, pp. 14–16).

The new EU crowdfunding regulation introduces entry knowledge test for prospective non-sophisticated investors before giving them full access to investments. Simultaneously, CSPs must assess the appropriateness of the services. To complete this task, the CSPs must gather information about the prospective non-sophisticated investor's experience, investment objectives, financial situation, and investor's basic understanding of risk. The assessment must be renewed every two years. If the required information is not given or if the investor has insufficient knowledge, skills, or experience, the CSPs must inform the prospective non-sophisticated investor about the possible inappropriateness and issue a risk warning. Correspondingly, the investor must expressly acknowledge that he has received and understood the warning.

Prospective non-sophisticated investors must also be required to simulate their ability to bear loss, calculated as 10% of their net worth. The wording of the final version is more demanding than the original Commission proposal where investors had to be *offered the possibility* to simulate their ability to bear losses. However, the Commission version did not separate non-sophisticated investors from sophisticated investors. Irrespective of the results of the knowledge test or the risk simulation, prospective investors are not prevented from investing. The European Banking Federation (EBF) has criticized this solution and states that limits would strengthen investor protection (EBF, 2018, pp. 3–4; European Consumer Organisation, 2018, p. 6).

Overall, the entry knowledge test and assessing information is a rather light procedure when it is compared, for instance, to the suitability assessment of the investment advice in the MiFID II. Although information on the client's characteristics and situation is gathered in both cases, only in investment advising personally customized recommendations are given and the advisor is liable on their suitability. In the reasoning (21) of the new EU crowdfunding regulation, it is expressly stated that the platforms can use filtering tools which can sort out offers based on criteria relating to objective product features. These types of tools do not constitute investment advice as long as they do not include a recommendation. Instead, the procedure in the crowdfunding regulation resembles the assessment of appropriateness in the MiFID II. In both cases, the client information is collected and a warning will be provided if needed.

## **11.4 Investment – Limits protecting investors**

### *11.4.1 Different ways to limit investments*

One way to strengthen investor protection is to limit the amount invested per investor. For instance, the German Small Investor Protection Act uses this type of regime. Similarly, in the US, the JOBS Act limits the amount of money that can be invested in crowdfunding platforms depending on the annual income of the investor. Limiting the amount invested is a general approach in many other domestic regulations, as well.

However, the way in which the limit is set varies. It can be some fixed amount of money or vary depending on the personal income, wealth, or financial assets. The limitation can concern each offering or take into account the total investments in the whole sector in a given timeframe, such as 12 months. Usually these limits depend on the categorization of investors – whether they are, for instance, retail or sophisticated investors (European Commission, [2018](#)).

The limitation is not self-evident. The Commission proposal of the new EU regulation did not use this type of regime. In its feedback on the new EU regulation, the EBF found it surprising that the maximum investment of each investor was not subject to any limitation. The EBF stated that the limit could ensure investor protection and promote responsible lending (EBF, [2018](#)). [Chervyakov and Rocholl \(2019\)](#) found that the proposal had a “lax and rather unclear stance on investor protection”. One reason for this statement was the lack of investment limit. The limit is now stated in the final version of the regulation. According to its reasoning (46), non-sophisticated investors should not be overexposed to crowdfunding projects.

Each time a non-sophisticated investor is investing an amount that exceeds the higher of either €1,000 or 5% of the investor’s net worth, the investor must be given a risk warning while the investor must give an explicit consent and prove that the investment and its risks are understood. So, investments above the limit are not *forbidden*.<sup>5</sup> The mandatory key investment information sheet (KIIS), discussed later in this chapter, must contain a standard notice that “we advise you not to invest more than 10% of your net worth in crowdfunding projects”. The plural form of “projects” can be interpreted as referring to the crowdfunding market in general.

In the UK, the Financial Conduct Authority (FCA) has recently updated its rules for lending-based crowdfunding. According to the feedback on the rules, some respondents deemed the investment cap of 10% of investible assets for restricted retail investors as arbitrary. This cap would be applied to, for instance, retail investors who are new to the asset class. Some respondents considered that this approach can prevent the access to P2P loans for certain investors, which will constrain the development of the sector. They also thought that this can give even misleading impression of the risk and impact negatively on competition. However, the proposal got also support from certain groups of respondents, such as consumer representatives. The FCA did not agree with the critique of the arbitrariness of the limit. Instead, it stated that the limit is a means to balance between protecting investors from bigger losses and giving them the freedom to invest ([FCA, 2019](#)).

The effectiveness of these types of limits in investor protection has faced some other critique, as well. [Hazen \(2012, p. 1765\)](#) states that limiting offerings to small amounts per investor will not deter “scammers from taking advantage of investors”. He sees that collecting small amounts from many investors can create investor protection threats in the same way as collecting significant amounts from few investors. However, if the amount invested in a single offer is limited, investors are not so deeply impacted by the potential failure of the specific project and they are forced to diversify investments ([Gabison, 2015](#)).

Investment limits have also been seen as a form of hard paternalism as they limit the freedom of investors by protecting investors *from themselves*. [Klöhn et al. \(2016\)](#) state that this type of regime is foreign to capital market regulation. Strongly paternalistic rules need adequate justification. Despite the critique, [Klöhn et al. \(2016\)](#) note that the features of the crowdfunding market could serve the justification. These features include the low quality of information disclosed, high risks, investors’

tendency to underestimate risks, and the danger of market bubbles. However, the limits should be applied only to investors that are more vulnerable, not to all investors.

### *11.4.2 Protecting the crowd by limiting the size of the crowdfunding offer*

In its impact assessment, the European Commission stated that limiting the size of the crowdfunding offer minimizes the risk of regulatory circumvention. However, it can curtail crowdfunding offers in specific capital-intensive sectors. The data derived from public consultations and market surveys (European Commission, 2018) indicated that most of the crowdfunding offers remain under the limit of €1,000,000, which was proposed to be the threshold for crowdfunding offers in the EU crowdfunding regulation.<sup>6</sup> On the other hand, the US Securities and Exchange Commission (SEC) has notified in its report on crowdfunding regulation that many issuers did not choose crowdfunding at all because of the low offering limit. Low limits may even lead to lowering of the average quality of issuers if many high-quality and high-growth issuers with substantial financing needs refrain from crowdfunding (SEC, 2019).

The prospectus regulation (EU) 2017/1129 must be taken into account in determining the appropriate threshold for crowdfunding offers. Problems may be caused from the flexibility of the prospectus threshold across the EU. Member States have been left the freedom to choose the national threshold to the obligation to publish a prospectus between €1,000,000 and €8,000,000. The regulation considers the costs of producing the prospectus which would be disproportionate in small offerings. Although the proposed crowdfunding regulation threshold of €1,000,000 corresponded to the minimum threshold of the European prospectus regulation, most EU countries use the prospectus threshold of €5,000,000. The difference would create inconsistencies in investor protection (Härkönen, 2018). The EBF stated that the proposed limit of €1,000,000 was very low and restricted the nature and scale of the investment projects in a way that does not advance investor protection. According to the EBF (2018), projects under €1,000,000 could bring even more uncertain outcomes. In the final version of the new EU regulation, the threshold is indeed set at €5,000,000.

## **11.5 Intermediary – Platforms as intermediaries**

The crowdfunding and its regulation are based on the role of platforms. The platforms can be seen as intermediaries between investors and companies that seek funding. The legal persons operating platforms are called CSPs in the new EU regulation. The CSPs are “gatekeepers” who must select the projects offered in a professional, fair, and transparent way.

The EU regulation includes the minimum due diligence requirements concerning the selection of projects, such as checking the criminal record of the project owner.<sup>7</sup> CSPs are also ruled to act with the best interests of their clients. To safeguard the objectivity and to avoid conflicts of interest, they cannot accept any monetary or non-monetary benefits for routing investor’s money to a particular offer. In addition, they cannot participate in the crowdfunding offers in the platform. The operating of the major shareholders, managers, employees, and their closely linked persons are also restricted. The authorization of the CSPs gives the competent authorities information on their operations, the quality of the management and internal organization, and procedures. The competent authorities that granted authorization also supervise the CSPs.

The CSPs are objective and do not take a risk at their own. Therefore, they do not create stability risks, and similar capital requirements as in the banking sector are not needed (Ferrarini, 2017). Instead, platforms decentralize risks and spread them to the crowd. The market changes affecting on, among others, interest rates do not influence directly on the platforms as they charge transaction fees that are rather fixed. The operational costs of the platforms are also much lower (Lenz, 2016). On the other hand, deposit guarantee schemes or investor compensation schemes protecting investors in

traditional banking and financial markets do not safeguard crowdfunding investors. Instead, crowdfunding investors are protected by other means, such as by regulating the operation of CSPs, their permitted activities, safekeeping of assets, authorization, and supervision.

However, this regulation has differed across jurisdictions. For instance, there are differences in the capital requirements. In Finland, the Crowdfunding Act 734/2016 required equity capital of €50,000 or an appropriate equivalent in order to register as crowdfunding intermediary. This requirement was grounded in the ESMA's opinion on investment-based crowdfunding (ESMA, 2014; HE 46/2016). Instead of one absolute number, the capital requirements could also reflect the nature and activities of the platform. Some minimum capital would anyhow ensure that operational and compliance costs are met in financial distress or platform failure caused by, for instance, IT failure or cyber-attack (EBRD, 2018). After the critique faced by the original proposal containing no capital requirements (e.g., European Consumer Organisation, 2018), the new EU regulation now regulates on prudential safeguards of either €25,000 or one quarter of the fixed overheads of the preceding year.

Investing in small companies can awake concerns of the liquidity of investments. The EU regulation enables investors to communicate their buying and selling interests to each other concerning offers originally made on that platform. It should be noted that this bulletin board does not mean that platforms could act as a trading system. In addition to be the enabler of the communication, one role of the platform is to be the information channel for investors. Although the fund-seekers must form the mandatory investor information, the provider of the information is the platform.

In general, the regulatory technique of the new EU regulation has undergone significant changes from the Commission's proposal. The Commission suggested that potential national regulation would be in force side by side with the EU regulation, and could be applied if services are not provided across borders. This approach would have differed from the majority of other financial market regulations (Härkönen, 2018).<sup>8</sup> The parallel nature of the regulation was criticized, for instance, by the European Consumer Organisation. As there are stricter investor protection rules in some Member States, it was feared that with the EU regime, platforms could avoid them (European Consumer Organisation, 2018). In the new regulation, the exemption of the national service providers was removed and transitional period was provided to comply with the EU regulation.

## **11.6 Information – From quantity to quality**

### *11.6.1 The problem of information asymmetry and how to overcome it*

Regulating informational asymmetries has traditionally been a key when protecting investors or a weaker party in general in financial markets. In particular, the amount of information has been highlighted. However, the focus of the regulation is becoming more diverse. This applies also to crowdfunding. The focus is shifting from quantity of information to quality and suitability.

Disclosure duties are important tools in preventing fraud, correcting information asymmetries and protecting investors. However, the actual impact of information depends, among other things, on the investors' abilities to comprehend and process the information. Instead of one homogeneous "crowd", the investors in crowdfunding are likely to be rather heterogeneous, which effects on their information processing (Heminway, 2014).

In the new EU regulation, attention has been paid on *how* investor information should be formulated in order for it to be understood and used. According to the regulation, all information given to the clients must be fair, clear, and not misleading. Because of the features of the online settings, this information must be provided on a clearly identified and easily accessible section in the platform and in a non-discriminatory manner. One problem emerges from the fact that people tend to be especially



lazy readers in online settings (e.g., [Lannerö, 2013](#)). Investor decision-making in the platforms can also be impaired by the “herding phenomenon” – investors choosing what other investors have already chosen. Typically, the first piece of information potential investors see is how much funds the company has already received and how much is still lacking from the target.<sup>9</sup> This social information can have excessive impact on the investor decision-making over more objective information ([Ciuchta, Letwin, Stevenson, & McMahon, 2016](#)).

When it comes to the interpretation of the information, the role of the financial literacy has been noted by the EU. According to the new CMU action plan, sound financial literacy is required in order to make good financial decisions. However, there is still room for improvement in the financial literacy levels. Although different types of disclosure obligations aim at safeguarding the investor information, problems may arise as the documents produced under these rules tend to be long, complex, difficult to understand, and sometimes even misleading and inconsistent. They might also lead to information overload ([European Commission, 2020](#)). The EU crowdfunding regulation introduces KIIS, which shall provide the potential investors with the necessary information and warnings concerning the crowdfunding offer in question. The KIIS must be clear, correct, and complete and consist of maximum six sides of A4-sized paper if printed. A standardized template of KIIS helps investors to compare the features of offers across platforms.<sup>10</sup>

When comparing crowdfunding regulations, differences can be seen on how standardized the information given to investors must be and is it approved by the supervisor. Although certain informational documents can be required, there may or may not be official templates to follow ([Sadzius & Sadzius, 2017](#)). In the EU-level regulation, there are predecessors of the KIIS. For instance, simplified documents for undertakings for the collective investment in securities (UCITS) funds were replaced by the key investor information documents (KIIDs) in 2012. The CESR, now known as ESMA, formed a standardized template for KIIDs which contained only two pages and illustrations that fostered the understanding of text ([CESR, 2010](#)). A few years later, key information documents (KIDs) were introduced for packaged retail and insurance-based investment products (PRIIPs). ([Salo, Haapio, & Passera, 2016](#)). According to the reasoning (17) of the PRIIPs regulation (EU) 2014/1286, standardized format allows retail investors to compare different products. The EU crowdfunding regulation states that when KIIS is provided, the obligations of the PRIIPs regulation are satisfied.

Standardized format and user-friendly design of information sheets gets justification also from consumer studies conducted by the EU. In the Commission’s study on the possible format of the KIDs, the exact structure of the document and the fact that it included visuals were appreciated by the consumers. However, the preferred ways in which information is presented varied in some cases between the EU countries, which may cause slight challenges in finding the best standardized way to present information.<sup>11</sup>

In addition to different types of simplified investor documents, it is appropriate to consider the relationship between prospectuses and KIIS.<sup>12</sup> Compared to the compact nature of KIIS, prospectuses tend to be rather long documents and costly to produce. In addition, before getting published they must be approved by competent authorities which is not the case for the KIIS. In the reasoning (67) of the crowdfunding regulation it is explicitly stated that the KIIS is tailored to the specific features of crowdfunding and the information needs of investors, and that the crowdfunding offers under the regulation should be exempted from the prospectus obligation. One important difference between KIIS and prospectus is also the responsible parties. Whereas the issuers are responsible for prospectuses, in crowdfunding, the CSPs are responsible for the provision of KIISes and their appropriateness. KIISes are still drawn up by project owners that seek funding.

It should also be noted that in the loan-based crowdfunding, the information needs can differ from equity-based crowdfunding. Accordingly, the EBF commented the EU legislation proposal by noting

that clear distinction should be made between these two types of crowdfunding as the information needs, among other things, can significantly differ (EBF, 2018). For instance, in the UK, there are different types of rules for equity- and lending-based crowdfunding. According to the FCA (2018), one reason for this distinction is that investment-based crowdfunding models tend to be quite simple, as lending-based platforms have adopted more complex models and can provide more structured financial service. In the new EU regulation, it is stated that both types of crowdfunding can be included in the same regulation since they can be structured as comparable funding alternatives. However, the difference between them must be taken into account, for example, when formulating the KIIS. The final version of the regulation also includes the default rate disclosure which is a specific tool for loan-based crowdfunding. In general, comparing the disclosure duties of loan-based crowdfunding to the traditional bank lending, the requirements resemble each other. However, it is notable that in crowdfunding the disclosures are made public to all crowd-lenders (European Commission, 2015b).

## 11.7 Conclusions

In this chapter, we have examined the investor protection strategies in the crowdfunding regulation. We have built our own 4-I's model to systematize the main strategies dividing them to Investor, Investment, Intermediary, and Information. The role of the platforms is crucial as they act as intermediaries between the investors and fund-seeking companies. The platforms are the channels for investor protection. Their role is to transmit information as well as limit investments, and issue warnings when needed.

In our analysis, we have mainly concentrated on the new EU crowdfunding regulation due to its very current nature as well as its significance in the EU. The regulation on crowdfunding among the Member States has been highly scattered: some countries have ended up with national regulation, while others have refrained from formulating any regulation. This has restricted cross-border offers and consequently the crowdfunding market is highly concentrated in a few Member States. The common regulation is a welcomed advancement.

One interesting feature in the EU regulation was its evolution from the original proposal's rather light investor protection procedure to the final version, which contains many typical protection elements of the crowdfunding regulation. When the investor protection strategies of the crowdfunding regulation in general were examined, it could be noted that while many similarities exist in different jurisdictions as well as partly in other financial market regulation, the exact means of regulation differ. One example is the investment limits for individual investors. In addition to the EU regulation, the limits are common in national regulations but their content varies wildly. These types of limits are unusual in the financial market regulation. All in all, the crowdfunding regulation is tailored in a way that exemplifies the unique nature of this growing financing method.

When the position of the crowdfunding regulation among the financial market regulation was considered, it was noted that some similarities exist. For instance, the role of the information reminds of that in the securities markets. Although, the disclosure duties are not as tight as in the Prospectus Regulation. In addition to transferring equity, the crowdfunding platforms act partly in the lending role the banks have traditionally had. One significant difference is that the strict capital requirements typical to banking sector do not apply to CSPs. Instead, investors are protected via other means, such as by regulating the operations and organization of the service providers. In crowdfunding, loans are not granted from the CSP's own account and deposits cannot be taken. In addition, financial products offered in the crowdfunding platforms differ from the traditional investment and savings products.<sup>13</sup> The regulatory regime of crowdfunding can be seen as some sort of a hybrid – it lies between banks and markets.

## Notes

## References

CESR (2010). *CESR's template for the Key Investor Information document*, CESR/10-1321.

Chervyakov, D., & Rocholl, J. (2019). *How to make crowdfunding work in Europe*. Bruegel Policy Contribution, No. 2019/6, Bruegel, Brussels.

Cicchello, A. F. (2019). Harmonizing the crowdfunding regulation in Europe: Need, challenges, and risks. *Journal of Small Business & Entrepreneurship*, 32(6), 585–606.

Ciuchta, M. P., Letwin, C., Stevenson, R. M., & McMahon, S. R. (2016). Regulatory focus and information cues in a crowdfunding context. *Applied Psychology: An International Review*, 65(3), 490–514.

EBF (2018). *EBF Position Paper on the proposal of a Regulation on Crowdfunding*. Brussels, 12 July 2018.

EBRD (2018). *Regulating investment- and lending-based crowdfunding: Best practices*. European Bank for Reconstruction and Development.

ESMA (2021). *Draft technical standards under the ECSP Regulation. Consultation Paper*.

ESMA (2018). *Guidelines on certain aspects of the MiFID II suitability requirements*.

ESMA (2014). *Opinion. Investment-based crowdfunding*.

European Commission (2020). *A Capital Markets Union for people and businesses – new action plan*. COM(2020) 590 final. Brussels, 24 September 2020.

European Commission (2018). *Impact assessment report – SWD(2018)56*. Brussels, 8 March 2018.

European Commission (2015a). *Consumer testing study of the possible new format and content for retail disclosures of packaged retail and insurance-based investment products*. Final Report.

European Commission (2015b). *Crowdfunding Explained*. doi:10.2873/313319.

European Commission (2014). *Unleashing the potential of Crowdfunding in the European Union*. COM(2014) 172 final. Brussels, 27 March 2014.

European Consumer Organisation (2018). *European Commission's legislative proposal on crowdfunding – missed opportunity!*

European Parliament (2020). *New rules to facilitate EU crowdfunding*. <https://www.europarl.europa.eu/news/en/headlines/economy/20201001STO88312/new-rules-to-facilitate-eu-crowdfunding>. 7 October 2020.

FCA (2019). *Loan-based (“peer-to-peer”) and investment-based crowdfunding platforms: Feedback to CP18/20 and final rules*. Policy Statement PS19/14, June 2019.

FCA (2018). *Loan-based (“peer-to-peer”) and investment-based crowdfunding platforms: Feedback on our post-implementation review and proposed changes to the regulatory framework*. Consultation Paper CP18/20, July 2018.

Ferrarini, G. (2017). Regulating FinTech: Crowdfunding and beyond. *European Economy*, 2, 121–142.

FINRA (2011). *Know Your Customer and Suitability*. Regulatory Notice 11-02.

Gabison, G. A. (2015). *Understanding crowdfunding and its regulations*. European Commission. JRC science and policy report.

Hazen, T. L. (2012). Crowdfunding of fraudfunding? Social networks and the securities laws – Why the specially tailored exemption must be conditioned on meaningful disclosure. *North Carolina Law Review*, 90, 1735–1770.

HE 46/2016 vp. *Hallituksen esitys eduskunnalle joukkorahoituslaiksi sekä eräiksi siihen liittyviksi laeiksi*.

Heminway, J. M. (2014). Investor and market protection in the crowdfunding era: Disclosing to and for the “crowd”. *Vermont Law Review*, 38, 827–848.

Hornuf, L., & Schwienbacher, A. (2017). Should securities regulation promote equity crowdfunding? *Small Business Economics*, 49(3), 579–593.

Härkönen, E. (2018). Regulating equity crowdfunding service providers – An innovation-oriented approach to alternative financing. *Nordic Journal of Commercial Law*, 2018/1, 202–230.

Klöhn, L., Hornuf, L., & Schilling, T. (2016). The regulation of crowdfunding in the German Small Investor Protection Act: Content, consequences, critique, suggestions. *European Company Law* 13(2): 56–66. Also available at SSRN: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2595773](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2595773).

Lannerö, P. (2013). *Fighting the Biggest Lie on the Internet*. Common terms beta proposal, Metamatrix Stockholm, 30 April 2013, [www.commonterms.net/commonterms\\_beta\\_proposal.pdf](http://www.commonterms.net/commonterms_beta_proposal.pdf).

Lenz, R. (2016). Peer-to-peer lending: Opportunities and risks. *European Journal of Risk Regulation*, 7(4), 688–700.

Oehler, A., Höfer, A., & Wendt, S. (2014). Do key investor information documents enhance retail investors’ understanding of financial products? Empirical evidence. *Journal of Financial Regulation and Compliance*, 22(2), 115–127.

Sadzius, L., & Sadzius, T. (2017). Existing legal issues for crowdfunding regulation in European Union Member States. *International Journal of Business, Humanities and Technology*, 7(3), 52–62.

Salo, M., Haapio, H., & Passera, S. (2016). Putting financial regulation to work: Using simplification and visualization for consumer-friendly information. *JusletterIT*, 25 February 2016.

SEC (2019). *Regulation Crowdfunding*. Report to the Commission.

---

<sup>1</sup> Reward-based and donation-based crowdfunding will not be handled in this chapter, as they do not contain investor protection needs. Accordingly, the crowdfunding regulation typically excludes these crowdfunding types.

<sup>2</sup> The first Capital Markets Union action plan was adopted in 2015.

<sup>3</sup> In spite of the Brexit, the UK is a good example when it comes to the crowdfunding regulation as it is the major market of the sector in Europe. See, e.g., [European Commission 2018](#), p. 30.

<sup>4</sup> [FCA \(2018\)](#), p. 54); [FCA \(2019\)](#), Annex C 4.7.7, p. 6. According to the FCA, prospective investors can classify themselves. In the feedback on the new rules, some respondents found the self-classification as “intrusive” and “off-putting” in an online context.

<sup>5</sup> The European Consumer Organisation proposed a mandatory limit of EUR 3,000 per project, which would limit potential losses as well as force to diversify. [European Consumer Organisation \(2018\)](#), pp. 6–7).

<sup>6</sup> See [European Commission \(2018/0048 \[COD\]](#), Article 2).

<sup>7</sup> The European Consumer Organisation criticized the original proposal for not having any due diligence checks. [European Consumer Organisation \(2018\)](#), p. 7).

<sup>8</sup> However, it should be noted that national exemptions in specific issues are permitted in the other EU-level financial market regulation, such as in the MiFID II.

<sup>9</sup> Typically, the fundraising company will set the target amount of money to be collected, and if this target will not be reached, the collected money will be returned.

<sup>10</sup> [European Commission \(2018\)](#), p. 55). See [ESMA \(2021\)](#), pp. 134–144), which introduces the draft template.

<sup>11</sup> [European Commission \(2015a\)](#), p. 193). However, key investor information documents have faced also critique. See, e.g., [Oehler, Höfer, and Wendt \(2014\)](#), pp. 116–117). The authors state that KIDs do not adequately help consumers to understand features of the financial products.

<sup>12</sup> When securities are traded on the regulated market, a prospectus must be published unless the offered amount falls below the exemption threshold discussed earlier.

<sup>13</sup> Regulation (EU) 2020/1503, reasoning (11), (43).