Tobias H. Tröger

Remarks on the German Regulation of Crowdfunding

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House of Finance | Goethe University
Theodor-W.-Adorno-Platz 3 | 60323 Frankfurt am Main

Tel. +49 69 798 34006 | Fax +49 69 798 33910
info@safe-frankfurt.de | www.safe-frankfurt.de

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Remarks on the German Regulation of Crowdfunding

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Tobias H. Tröger
Professor of Private Law, Trade and Business Law, Jurisprudence
Goethe-University, Frankfurt am Main, Department of Law
Theodor-W.-Adorno Platz 3
60629 Frankfurt am Main
Germany
Phone +49 69 798 34236
Fax +49 69 798 34536
troeger@jur.uni-frankfurt.de

Abstract: Crowdfunding is a buzzword that signifies a sub-set in the new forms of finance facilitated by advances in information technology usually categorized as fintech. Concerns for financial stability, investor and consumer protection, or the prevention of money laundering or funding of terrorism hinge incrementally on including the new techniques to initiate financing relationships adequately in the regulatory framework.

This paper analyzes the German regulation of crowdinvesting and finds that it does not fully live up to the regulatory challenges posed by this novel form of digitized matching of supply and demand on capital markets. It should better reflect the key importance of crowdinvesting platforms, which may become critical providers of market infrastructure in the not too distant future. Moreover, platforms can play an important role in investor protection that cannot be performed by traditional disclosure regimes geared towards more seasoned issuers. Against this background, the creation of an exemption from the traditional prospectus regime seems to be a plausible policy choice. However, it needs to be complemented by an adequate regulatory stimulation of platforms' role as gatekeepers.

JEL classification: G23, G28, G38, K22, K23.

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Remarks on the German Regulation of Crowdfunding

- Tobias H. Tröger* -

1 Introduction

Crowdfunding is a buzzword that signifies a sub-set in the new forms of finance facilitated by advances in information technology, usually categorized as fintech.[1] In contrast to financial innovation that pertains to (new or redesigned) financial products and is somewhat ambiguous in its social value,[2] crowdfunding capitalizes on previously unavailable digital techniques to match supply and demand on money and capital markets. These developments potentially disrupt traditional forms of intermediation by

* Professor of Private Law, Trade and Business Law, Jurisprudence, Goethe University Frankfurt am Main, Program Director Research Center Sustainable Architecture for Finance in Europe (SAFE). Associated Professor Institute of Monetary and Financial Stability (IMFS).

[1] On FinTech in particular Dirk A. Zetzsche et al., *From FinTech to TechFin: The Regulatory Challenges of Data-Driven Finance* (European Banking Inst. (EBI) Working Paper No. 6, 2017), https://ssrn.com/abstract=2959925.

[2] For proposals that seek to hedge financial stability against regulatory arbitrage without sacrificing the efficiency enhancing potential of financial innovation see, Eric Posner & E. Glen Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to 21st Century Financial Markets*, 107 NW. U. L. REV. 1307 (2013) (arguing for pre-screening of financial innovations through a Federal Drug Authority like agency); Tobias H. Tröger, *How Special Are They? Targeting Systemic Risk by Regulating Shadow Banks*, *in* RESHAPING MARKETS. ECONOMIC GOVERNANCE AND LIBERAL UTOPIA 185-207 (Bertram Lomfeld, Alessandro Somma & Peer Zumbansen (eds.), 2016) (showing how a normative approach to law enforcement allowed existing prudential regulation to capture regulatory arbitrage). For an overview of the regulatory challenges non-bank banks pose with regard to systemic risk, Eddy Wymeersch, *Shadow Banking and Systemic Risk* (EBI Working Paper No. 1, 2017), https://ssrn.com/abstract=2912161.

shifting the boundaries of the (financial) firm.[3] Put differently, crowdfunding does not lead to unprecedented forms of financing relations. Instead, it enables that traditional contractual or corporate law relationships between previously unacquainted providers and consumers of capital are initiated and concluded on novel, IT-driven platforms. From this vantage, the potential of crowdfunding to garner economically significant volumes of financing relationships seems indeed considerable.[4]

Once these projected developments gain traction, policy objectives traditionally pursued in financial regulation also become relevant for agents involved in crowdfunding.[5] Concerns for financial stability, investor and consumer protection, or the prevention of money laundering or funding of terrorism hinge incrementally on including the new techniques to initiate financing relationships adequately in the regulatory framework. More specifically, the legislation through which policy makers seek to implement the relevant objectives, ceteris paribus, have to be attentive to the specifics of crowdfunding.

Taken together with the aforesaid, the pertinent legislation has to pay particular attention to the role of the platforms and their operators because they are at the heart of the technological innovation, which – at the same time – may both attenuate traditional justifications for government intervention and create new jeopardies for established policy goals. On the other hand, the laws that govern the relevant financing relationships once they are concluded face far less challenges insofar as they are not materially affected by the way relationships are initiated and concluded. Put differently, the contract or corporate law framework that underpins financing relationship is old fashioned, but the way it is invoked is novel.

This paper illustrates German banking and securities laws' reaction to the challenges just sketched by looking at the example of crowdinvesting, *i.e.* the financing of companies by granting an

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[3] The extent to which allocation of resources occurs in a hierarchy (firm) depends on the transaction costs incurred in equivalent market transactions, for the fundamental insight Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); for a review of the literature carrying forward the theory of the firm see EIRIK G. FURUBOTN & RUDOLF RICHTER, INSTITUTIONS AND ECONOMIC THEORY 366-86 (2d ed., 2005). With regard to financial intermediation this means that market based solutions should become more prominent once the comparative advantages of intermediation within a big entity shrink, which is particularly the case if search costs are lowered as a function of technological improvements.

[4] The early literature points to crowdinvesting's potential to allow firms to receive financing from an additional source that complements bank and venture capital funding, Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 101, 113 (2011); MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 931 (2011); C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 103-4; for a delineation of crowdinvesting's potential in Europe see Dirk A. Zetzsche & Christina Preiner, *Cross-Border Crowdfunding – Towards a Single Crowdfunding Market for Europe* 6-8 (EBI Working Paper No. 8, 2017), https://ssrn.com/abstract=2991610; for Germany for instance Alexander Meschkowski & Frederike K. Wilhelmi, *Investorenschutz im Crowdinvesting*, 68 BETRIEBS-BERATER (BB) 1411 (2013); specifically on the idea of a relative decrease in the costs of capital as a result of lower search and agency costs in crowdinvesting relationships, Lars Klöhn & Lars Hornuf, *Crowdinvesting in Deutschland*, 24 ZEITSCHRIFT FÜR BANKRECHT UND BANKWIRTSCHAFT (ZBB) 237, 256-8 (2012) (arguing that the 'wisdom of crowds' is imperfect and partly irrelevant with regard to relevant agency relationships); but see also *infra* 2.1.

[5] For an overview see Zetzsche & Preiner, *supra* note 4 at 9-16. The European Securities and Markets Authority (ESMA) has also identified what it considers key components for an adequate regulatory reaction to the new phenomenon and outlined several specific responses that draw-on and develop the existing EU regulatory framework, ESMA, OPINION: INVESTMENT BASED CROWDFUNDING 10-12 and 12-27.

interest in the firm's future cash-flows.[6] After a brief delineation of the economic relevance of crowdinvesting and the legal forms it typically takes, this paper posits that the key regulatory challenge crowdfunding raises pertains to investor protection (*infra* 2). From this vantage, it looks at two exemplary aspects of financial regulation. At the heart of the first analytical section is the authorization (licensing) requirement that may kick-in before an agent is allowed to provide banking or financial services (*infra* 3). Typically, such a requirement is seen as a safeguard for financial stability, *i.e.* the constant and reliable supply of liquidity to the real economy, but also as a mechanism of investor protection.[7] In the second part of the substantive analysis, this paper addresses the prospectus requirement, which can be understood as a regulatory intervention to achieve allocative efficiency on primary markets (*infra* 4). It is usually understood as a means to overcome information asymmetries that impede efficient investment decisions in initial offerings.[8] The analysis describes how German banking and securities regulation deals with the technologically innovative technique of matching supply and demand for capital through a digital platform and evaluates whether the current treatment is sound from a public policy perspective and finally concludes (*infra* 5).

2 Economic relevance, legal forms, and regulatory challenges of crowdinvesting in Germany

Empirical research has not only looked at the economic relevance of crowdinvesting in Germany (*infra* 2.1), but also produced a rich set of insights on the legal design of crowdinvestment products (*infra* 2.2). This information allows to assess which objectives of financial regulation crowdinvesting affects (*infra* 2.3).

2.1 Market data

In an interdisciplinary research project, Germany's preeminent scholars in the field produced descriptive statistics on the domestic crowdinvestment market.[9] The most relevant take away from the data is not that the initial upward trend in the funds raised (a total of almost 53 million Euro since the first crowdinvestment initiative in August 2011) has abated recently,[10] but that fundraising is largely concentrated at two platforms (Seedmatch and Companisto). These key players also are highly successful in placing the issues of start-ups (the success rate was 100% and 95% respectively), whereas other platforms also have a significant fraction of failed offers that do not reach the funding-threshold. With all due reservations concerning methodologically unhedged inferences, the data seems to indicate that

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[6] For similar definitions see Lars Klöhn, Lars Hornuf & Tobias Schilling, *The Regulation of Crowdfunding in the German Small Investor Protection Act*, 13 EUR. COMP. L. 56 note 4 (2016); Klöhn & Hornuf, *supra* note 4 at 239.

[7] See for instance Reinfried Fischer & Christian Müller, *§ 32 KWG para. 5*, *in* KWG, CRR-VO (Karl-Heinz Boos, Reinfried Fischer & Hermann Schulte-Mattler eds., 4th ed. 2016).

[8] For the seminal contribution see Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); for a review of the literature see Luca Enriques & Sergio Gilotta, *Disclosure and Financial Market Regulation*, *in* THE OXFORD HANDBOOK OF FINANCIAL REGULATION (Niamh Moloney et al. eds., 2015) On the German view of the rationale see Anna Heidelbach, *Einleitung*, *in*: KAPITALMARKTRECHTS-KOMMENTAR (Eberhard Schwark & Daniel Zimmer eds., 4th ed. 2010).

[9] Lars Klöhn, Lars Hornuf & Tobias Schilling, *Crowdinvesting-Verträge*, 28 ZBB 142, 143-5 (2016); for additional empirical evidence see also Sascha Herr & Ulrich Bantaleon, *Crowdinvesting als alternative Unternehmensfinanzierung – Gundlagen und Marktdaten in Deutschland*, 53 DEUTSCHES STEUERRECHT (DStR) 532, 535 (2015); for granular data on the early phase, Klöhn & Hornuf, *supra* note 4 at 239-46.

[10] See also Christopher Danwerth, *Crowdinvesting – Ist das Kleinanlegerschutzgesez das junge Ende einer innovativen Finanzierungsform*, 28 ZBB 20, 22 (2016) (observing above average growth of crowdinvesting only in real estate, ecological project and movie financing).

platforms perform gate-keeper functions[11] and are in a position to build reputational capital not only in this respect but also as information intermediaries.

2.2 Legal structure of investment products

The main contribution of recent empirical research is that it illuminates the legal structure of typical crowdinvestment products offered through the platforms.[12] These insights are of critical importance, because they determine, how and to what extent crowdinvesting indeed affects the policy objectives of financial regulation. The legal structure of the investment products sold on crowdinvesting platforms defines both the cash-flow and governance rights vested with investors which in turn are crucial at least for investor protection, but also impact on financial stability concerns.

Issuers typically structure the financing relationship as unsecuritized term-debt[13] with fixed interest rates[14] and various extents of profit participation.[15] Moreover, in most cases investors also participate in an increase of the going-concern value of the issuer.[16] Loss participation is limited to the funds invested in gone concern scenarios.[17] Contractual arrangements in the indenture subordinate the redemption claim to all other claims against the issuer.[18] In sum, the contractual relations that underlie typical German crowdinvestments seek to mimic equity-like risk and return-structures. This becomes even more apparent, if the protection against claim dilution in the case of follow-up funding is considered,[19] which prevents new investors from externalizing risk to old ones and benefiting disproportionately from future cash-flows.

However, the governance rights granted to investors on crowdinvesting platforms are a far cry from those vested with shareholders. In essence, investors do not have any influence on the decision-making process at the issuer concerning questions of management and business strategy.[20] However, contracts provide for periodic disclosure of key financial and other relevant data that in some cases

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[11] For anecdotal evidence on very high rejection rates of up to 99%, see also Lars Hornuf & Armin Schwienbacher, *The Emergence of Crowdinvesting in Europe: With an In-Depth Analysis of the German Market* 25 note 12 (LMU Discussion Paper 2014-43, 2015), https://epub.ub.uni-muenchen.de/21388/1/Hornuf%20Schwienbacher%20-%20The%20Emergence%20of%20Crowdinvesting%20in%20Europe.pdf.

[12] The following section reiterates the main findings in Klöhn, Hornuf and Schilling, *supra* note 9 at 148-178.

[13] *Id*. at 149 and 152-4 (showing that contracts usually are loan agreements that can be terminated after 5-7 years after a minimum notice period has elapsed, whereas automatic termination after a fixed contract term represents an exception).

[14] *Id.* at 155-6 (finding annual interest rates varying from 1% to 8%, due either upon redemption or periodically (annually, quarter-annually)).

[15] *Id.* at 158-60 (identifying an unlimited pro-rata profit participation in four fifth of the cases and a capped participation in others).

[16] *Id.* at 161-5 (describing that investors either receive a payment based on an appraisal of the issuer at the time the investment is terminated or a fraction of the proceeds that accrue to equityholders if they sell their shares)

[17] *Id.* at 160 (also showing that liability was sometimes not limited in the past).

[18] *Id.* at 177-8. The reason for the subordination comes from prudential banking regulation which would submit borrowers to an authorization requirement, if the loans were not subject to a specific subordination clause, see Dörte Pölzig, *Nachrangdarlehen als Kapitalanlage*, 68 WERTPAPIER-MITTEILUNGEN (WM) 917, 919 (2014).

[19] *Id.* at 166-8 (indicating that contracts provide for a proportional adjustment of the participation ratio under which losses can only occur if the issuer is undervalued in the new round of financing).

[20] *Id.* at 168.

initiators also have to explain at web-based annual investor meetings.[21] Control rights beyond the entitlement to candid disclosure are almost non-existent.[22]

2.3 Regulatory challenges

In sum, the legal structure of a typical German crowdinvestment product exhibits an equity-like risk structure, but does not protect residual claimants through extensive governance rights, because it is structured as debt contract. If the special treatment of shareholders in corporate law can be justified on the grounds that they are the only stakeholders in a firm whose claims are otherwise unprotected,[23] a shareholder-like risk exposure without corporate law safeguards raises concerns and calls for alternative mechanisms to protect legitimate investor interests. Otherwise, the prototypical moral hazard problems inherent in any agency relationship loom large[24] and are particularly pronounced where founders and other controlling insiders (agents) of an issuer have no verifiable track-record that could guide investor (principal) decision making. To be sure, the negative cost of capital-effect that follows from insufficient investor protection against controller rent-seeking *ex post* should ultimately provide incentives for issuers and their controllers to improve the situation. The risk premium charged by rational investors diminishes, all else equal, the available funding for the projects.

However, even if investors understood the general risk that follows from the distinct features of the investment product they buy, the classical rational for regulatory intervention in securities markets prevailed: funding an unseasoned business without a robust track-record is fraught with informational asymmetries between investors and founders (insiders) that typically leads to adverse selection problems.[25] These are all the more serious, because the likelihood of failure of the funded venture and thus a default on investors' claims is generally high in crowdinvesting.[26]

On the other hand, equity like investments are not particularly sensitive with regard to financial stability or anti-money laundering objectives. Exposures of ultimate risk-bearers are straightforward and prudential regulation deals with them extensively if they lie with institutions that are critical for the liquidity supply of the economy. Similarly, the clearly defined cash-flow rights of equity-type investments are rather inapt for money laundering purposes.

3 Authorization requirements for platforms

In line with the majority view in the doctrinal literature, German supervisory practice largely exempts crowdinvesting platforms from the obligation to seek an authorization from competent authorities (*infra* 3.1). This generously enabling approach is not without doubt from a public policy perspective, if

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[21] *Id.* At 168-73 (describing that disclosure obligations provide *inter alia* for quarterly reporting, disclosure of annual accounts, overview of profit- and revenue participation).

[22] *Id.* at 173-76.

[23] For this rationale see for instance Theodor Baums & Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, 53 AM. J. COMP. L. 31, 34-5 (2005).

[24] For the basic model see Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); for an up-to-date specification John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategy*, *in* THE ANATOMY OF CORPORATE LAW 29, 29-31 (Reinier Kraakman et al., 3d ed., 2017).

[25] Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1077 (2003) (describing the key problems in venture capital investing); DOUGLAS J. CUMMING & SOFIA A. JOHAN, VENTURE CAPITAL AND PRIVATE EQUITY CONTRACTING AN INTERNATIONAL PERSPECTIVE 48-52 (2009) (showing that the features of equity claims make for lemon markets in both equity and debt financing of start-up firms because unprofitable ventures are more likely to issue equity while riskier ones have a proclivity to seek debt financing).

[26] See for instance Bradford, *supra* note 4 at 105.

the potential role of platforms as providers of critical market infrastructure and the investor protection objective of financial regulation are taken into account (*infra* 3.2).

3.1 Licensing requirements under German banking and securities regulation

Whether crowdinvesting platforms[27] require an authorization under the Banking Act hinges on the qualification of their activity as either financial or investment service.[28]

Regardless of the specific activities that are included in the statutory definitions, any financial and investment service has to pertain to "financial instruments" as defined in banking and securities regulation.[29] Prior to June 1, 2012 silent partnership interests ("stille Beteiligungen") and unsecuritized participation rights ("Genussrechte") were not included in this definition, essentially liberating crowdinvesting platforms from any authorization requirement and the prudential supervision attached to it. Since June 1, 2012, the definition of financial instruments also encompasses "financial assets" within the meaning of the Capital Investment Act,[30] and since July 10, 2015 these in turn also comprise subordinated profit participating loans. [31] Hence, the regulatory framework now captures in principle also the typical OTC investment products offered through platforms like for instance silent partnership interests, participation rights or subordinated profit sharing loans.

Therefore, the query has become whether the activity of crowdinvesting platforms with regard to financial instruments constitutes one of the enumerated business activities that are qualified as banking or investment service. The consensus view is that platforms do not engage in underwriting business ("Emissionsgeschäft"),[32] because they do not assume the risk of a successful placement of the financial instruments issued.[33] Similarly, the typical platform activities do not constitute placement business ("Platzierungsgeschäft"),[34] because this would require that the platform acts as agent of the issuer and—according to the interpretation of the Federal Financial Supervisory Authority [Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin] — discloses this agency relationship.[35] Instead, platforms

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[27] For an overview on the question if issuers need an authorization because they engage in "deposit business" ("Einlagengeschäft") within the meaning of Banking Act [Kreditwesengesetz, KWG], Sep. 9, 1998, BGBL. I at 2446, § 1 para. 2 No. 1, https://www.gesetze-im-internet.de/kredwg/ see for instance Michael Nietsch & Nicolas Eberle, *Bankaufsichts- und prospektrechtliche Fragen typischer Crowdfunding-Modelle*, 67 DER BETRIEB (DB) 1788, 1790 (2014)

[28] KWG § 32 with the relevant definitions being codified in KWG, § 1 para. 1a sentence 2 and Securities Trading Act [Wertpapierhandelsgesetz, WpHG], Sep. 9, 1998, BGBL. I at 2708, § 2 para. 3, https://www.gesetze-im-internet.de/wphg/.

[29] WpHG § 2 para. 2b; KWG § 1 para. 11

[30] Capital Investment Act [Vermögensanlagengesetz, VermAnlG], Dec. 6, 2011, BGBL. I at 2481, § 1 para. 2, https://www.gesetze-im-internet.de/vermanlg/.

[31] Prior to the 2015 reforms a debate existed about whether the definition of financial assets also included profit participating loans (see for instance Wolfgang Weitnauer & Josef Parzinger, *Das Crowdinvesting als neue Form der Unternehmensfinanzierung*, 4 GESELLSCHAFTS- UND WIRTSCHAFTSRECHT (GWR) 153, 155 (2013) (advocating an inclusive definition on normative grounds); Nietsch & Eberle, *supra* note 27 at 1790 and 1793 (2014) (opposing such a wide definition).

[32] As defined in KWG, § 1 para. 1 sentence 2 no. 10; WpHG, § 2 para. 3 sentence 1 no. 5.

[33] On the general precondition of a firm underwriting to fall under the statutory regime see Frank A. Schäfer, *§ 1 KWG para. 112*, *in* KWG, CRR-VO (Karl-Heinz Boos, Reinfried Fischer & Hermann Schulte-Mattler eds., 4th ed. 2016); Christoph Kumpan, *§ 2 WpHG para. 72*, *in* KAPITALMARKTRECHTSKOMMENTAR (Eberhard Schwark & Daniel Zimmer eds., 4th ed. 2010).

[34] As defined in KWG § 1 para. 1a sentence 2 no. 1c; WpHG, § 2 para. 3 sentence 1 no. 6.

[35] BAFIN, MERKBLATT – HINWEISE ZUM TATBESTAND DES PLATZIERUNGSGESCHÄFTS (2009), https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Merkblatt/mb_091211_tatbestand_platzierungsgeschaeft.html (requiring a disclosed open agency relationship).

typically only deliver offers to buy or sell as messengers.[36] However, despite some quibble about the precise meaning of the law,[37] platforms may indeed engage in investment brokerage ("Anlagevermittlung"),[38] because they intermediate the acquisition and sale of financial instruments.[39] According to the majority view, it does not matter whether the transactions occur on the primary or secondary market.[40] Hence, the execution of initial offerings through crowdinvesting platforms may fall under the definition of investment brokerage and thus constitute banking or investment services that in principle require the platforms' authorization. Be that as it may, brokerage activities that pertain to financial assets are exempt from authorization requirements if brokers acquire property rights neither in the assets nor in the invested funds of the customers.[41] This precondition tallies perfectly with the typical business model of crowdinvesting platforms. As a consequence, only a special form of trade supervision ("qualifizierte Gewerbeaufsicht") applies.[42]

Finally, authorization requirements could attach to platform activities because they may amount to the operation of a multilateral trading facility (MTF).[43] It is not convincing when some commentators simply rule-out this possibility by pointing to the regulatory rationale of the underlying European legislative initiatives that sought to capture MTFs as contemporary competitors of exchanges, which – according to this view – requires that platforms also host secondary market trading.[44] The relevant policy goal of the pertinent regulation is to counter the efficiency losses that are associated with a fragmentation of trade at many venues and in this regard price discovery on primary markets is just as important as that on secondary markets.[45] In fact, the German supervisor has repeatedly published the interpretation that crowdinvesting platforms can fall under the definition of MTF.[46] However, it is unclear under which preconditions BaFin will actually find the specific requirement of a "large number" of market participants trading at an MTF met in crowdinvestment initiatives.[47]

3.2 Evaluation

From a policy maker's perspective the query is whether an exemption from any licensing requirement for the crowdinvesting platforms, which is not only advocated by the majority view in the doctrinal literature but also present in the supervisory practice, is normatively justified.

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[36] Klöhn & Hornuf, *supra* note 4 at 249-50.

[37] For a detailed description of the relevant provisions' content see Jean David Jansen & Theresa Pfeifle, *Rechtliche Probleme des Crowdfunding*, 33 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 1842, 1850-1 (2012); Klöhn & Hornuf, *supra* note 4 at 250-1.

[38] As defined in KWG § 1 para. 1a sentence 2 no. 1; WpHG, § 2 para. 3 sentence 1 no. 4.

[39] See for instance Michael Nietsch & Nicolas Eberle, *Crowdinvesting – Welche Auswirkungen hat das geplante Kleinanlegerschutzgesetz?*, 67 DB 2575, 2576 (2014).

[40] BAFIN, MERKBLATT – HINWEISE ZUM TATBESTAND DER ANLAGEVERMITTLUNG (2011); Heinz-Dieter Assmann, *§ 2 WpHG para. 81*, *in* WPHG (Heinz-Dieter Assmann & Uwe H. Schneider eds., 6th ed, 2012).

[41] As defined in KWG § 1 para. 6 no. 8 Buchst. e); WpHG, § 2a para. 1 no. 7 Buchst. e).

[42] Trade Regulation [Gewerbeordnung, GewO], Feb. 22, 1999, BGBL. I at 202, § 34 para. 1 sentence 1, https://www.gesetze-im-internet.de/gewo/index.html#BJNR002450869BJNE025705118.

[43] As defined in KWG § 1 para. 1a no. 1b; WpHG, § 2 para. 3 no. 8. See also Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, 4 para. 1 no. 15, 2004 O.J. (L 145) 1 [hereinafter MiFiD].

[44] Klöhn & Hornuf, *supra* note 4 at 251.

[45] See MiFiD, recital 5.

[46] BAFIN, *supra* note 40; BAFIN, CROWDINVESTING, https://www.bafin.de/EN/Aufsicht/FinTech/Crowdfunding/Crowdinvesting/crowdinvesting_node_en.html.

[47] For a general overview see Assmann, *supra* note 40 at *para. 110*.

The answer seems straightforward from a financial stability perspective. The business model of platforms does not exhibit the typical fragility that signifies banks' lending business: Crowdinvesting platforms do not engage in private sector money creation, which is characterized by maturity and liquidity transformation (short-term funding of long-term investments) and thus susceptible to panic-driven runs.[48] However, the more momentum crowd-funding gets in corporate finance, the more relevant platforms become as providers of market infrastructure. As a result, financial stability concerns might militate in favor of licensing requirements akin to those traditionally stipulated for exchanges (regulated markets) where they serve as an enforcement mechanism for organizational obligations.[49]

The last aspect is also tied to the investor protection rationale for an authorization requirement. Providers of financial services are subject to certain conduct rules,[50] which are supposed to safeguard the preconditions for efficient investment decisions on public capital markets that operate smoothly and continuously.[51] Once again, the operational effectiveness of crowdinvesting platforms becomes ever more important the more financing relationships are initiated and concluded through them. Ultimately, this observation may call for specifically tailored conduct rules.[52] Such a regime could be part of the European Capital Markets Union project.[53] In any case, it should activate the role of platforms as gatekeepers and potential information intermediaries who scrutinize and signal the quality of issuers. To be sure, such a regime of enhanced investor protection will increase the operating costs of crowdinvesting platforms and consequently make this form of financing more expensive for issuers as well. Yet, from the policy maker's perspective, it is important that these private costs can be overcompensated by welfare gains from better investment decisions that lead to a more efficient allocation of capital.

4 (Issuers') primary market disclosure obligations

A recent statutory amendment to the German prospectus law provides for limited issuer choice with regard to the applicable primary market disclosure regime (*infra* 4.1). The evaluation of this regime is far from easy if the externalities – positive and negative – of mandatory comprehensive disclosure are taken into account (*infra* 4.2).

4.1 Prospectus requirements under German securities regulation

Potentially, an important channel through which information asymmetries between issuers and investors can be countered in crowdinvesting, can follow from a prospectus requirement. Obviously, the platforms as intermediaries cannot have an original duty to draw-up a registration document them-

[48] For a formal model see Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. PUB. ECON. 401 (1983).

[49] See MiFiD, art. 36 para. 1, 2004 O.J. (L 145) 1; Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, art. 44 para. 1, 2014 O.J. (L 173) 349 [hereinafter MiFiD II]. For a similar argument see Zetzsche & Preiner, *supra* note 4 at 36-7.

[50] See WpHG, §§ 31 et seq. Today, the regulation is shaped by European legislation (currently MiFiD, arts. 18-24; the transposition of the recast directive will not bring substantial changes, see MiFiD II, arts. 24-30), but has a long history that predates supranational initiatives, see Eberhard Schwark, *§ 31 WpHG para. 3-4*, *in*: KAPITALMARKTRECHTS-KOMMENTAR (Eberhard Schwark & Daniel Zimmer eds., 4th ed. 2010).

[51] MiFiD, recital 44; MiFiD II, recital 164; for the German view see Ingo Koller, *§ 31 WpHG para. 3*, *in* WPHG (Heinz-Dieter Assmann & Uwe H. Schneider eds., 6th ed, 2012).

[52] For the view that platforms are the adequate focal point for investor protection see also Klöhn, Hornuf & Schilling, *supra* note 6 at 65; Zetzsche & Preiner, *supra* note 4 at 29.

[53] Specifically on a regulatory regime that stipulates cross-border crowdinvestment activities and thus integrates the European crowdinvesting market Zetzsche & Preiner, *supra* note 4 at 16-7.

selves, but can serve as powerful gatekeepers, if the general prohibition to distribute financial instruments without prospectus[54] also applies for investments initiated and concluded through crowdinvesting platforms.

Until July 10, 2015 a full blown prospectus requirement under VermAnlG, § 6 for offerings with a nominal value of more than EUR 100.000 existed, yet certain financing relationships, like in particular profit-sharing loans with subordination clauses ("partiarische Nachrangdarlehen") were generally not captured by the regime.[55] The reform package of the Small Investor Protection Act[56] closed the unintended loopholes, but established an exemption for financial assets offered through crowdinvesting platforms ("Schwarmfinanzierung").[57] The main preconditions[58] are that the aggregate value of the offering does not exceed EUR 2.500.000, that subscription limits that depend on net worth and income of investors and range from EUR 1.000 – 10.000 are respected,[59] and that compliance with these preconditions is monitored by the platform. The primary source of information becomes the mandatory investment information sheet ("Vermögensanlagen-Informationsblatt"), which has to be prepared by issuers and provided to potential investors who have to confirm that they (read and) understood a specific warning that points to the risk of a total loss of the invested funds.[60]

Therefore, issuers on crowdinvesting platforms have limited choice regarding the regime for primary market disclosure.[61] They can either opt for a full-fledged prospectus and offer their product publicly without restrictions or accept limitations and make use of the exemption offered to crowdinvesting.

4.2 Evaluation

Given that the regulatory framework represents a narrow application of Roberta Romano's visionary and exhaustively discussed concept, it is easy to level a general critique against it. Burdening issuers

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[54] VermAnlG, § 18 para. 1 no. 2 and no. 3 empower the supervisor (BaFin) to prohibit public offerings of investments from going forward if they violate the prospectus requirements.

[55] See Meschkowski & Wilhelmi, *supra* note 4 at 1415; Klöhn & Hornuf, *supra* note 4 at 259; Nietsch & Eberle, *supra* note 31 at 2579.

[56] Small Investor Protection Act [Kleinanlegerschutzgesetz, KASG], July 3, 2015, BGBL. I at 1114, art. 2 no. 4.

[57] VermAnlG, § 2a.

[58] For a more granular description of the relevant statutory requirements, Klöhn, Hornuf & Schilling, *supra* note 6 at 59-60; for in-depths analyses see Danwerth, *supra* note 10 at 25-36; Matthias Casper, *Das Kleinanlegerschutzgesetz – zwischen berechtigtem und übertriebenem Paternalismus*, 27 ZBB 265, 275-80; Nietsch & Eberle, *supra* note 27 at 1789.

[59] For a policy discussion of investment limits see Klöhn & Hornuf, *supra* note 4 at 262-4. For a critique of the current limits see Lars Klöhn & Lars Hornuf, *Die Regelung des Crowdfunding im RegE des Kleinanlegerschutzgesetzes – Inhalt, Auswirkungen, Kritik, Änderungsvorschläge*, 68 DB 47, 52-53 (2015).

[60] VermAnlG, §§ 13, 15. For details see Klöhn, Hornuf & Schilling, *supra* note 6 at 60. For a delineation of the restrictions on advertisements see Gerd Waschbusch, *Die Masse macht's – Crowdfunding al Finanzierungsmöglichkeit für Existenzgründer*, 67 DER STEUERBERATER (STB) 206, 208 (2016).

[61] On the concept see Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2362, 2418 (1998) (proposing that issuers be permitted to opt into both US States' and foreign nations disclosure regimes); Alan R Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 86-91 (restricting issuer choice to the selection of a primary market disclosure regime); for a critique see Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment*, 85 VA. L. REV. 1335, 1345-56 (1999) (holding that the divergence between managers' private benefits and social benefits derived from disclosure rules will induce suboptimal outcomes under a regime of issuer choice).

with the higher than individually optimal costs of disclosure creates a positive externality,[62] because it reduces information asymmetries across primary and secondary markets beyond the individual issuer.[63] Investors can use the information disclosed to price similarly situated securities more accurately. As a result, the corporate governance benefits of more accurate share prices (better indicator for managerial performance, takeover signals etc.) accrue beyond the individual offering as well. However, there is a potential social loss associated with individually sub-optimal costs for IPOs, too. Simply put, the price to pay for the positive externality of more accurate prices across markets is that positive net present value projects might receive less or no funding, which in turn means that aggregate supply might be lower and the overall economy suffers a loss.

--- Insert figure 1 and figure 2 here ---

The interrelation becomes clear if the marginal costs are plotted for the individually optimal (MC*) and the regulatorily imposed, higher (MC1 and MC2) level of disclosure obligations against the marginal return curve (MR). Figure 1 illustrates that there is an immediate loss in funding available for the proposed project – represented by the shaded area – if costs associated with the disclosure regime are higher than privately optimal for the individual issuer, because issuers will offer less securities to the market. Figure 2 shows that if the regulatory framework drives marginal costs beyond the level of marginal returns, rational issuers will offer no share and thus will not receive any funding from public capital markets.

To be sure, it is still conceivable that the positive externalities from higher than individually optimal levels of disclosure offset the associated loss in total output. The magnitude of the overall welfare losses hinges on the availability of alternative sources of funding, which seem to be scarce in the specific case given the relative underdevelopment of the German seed and venture capital markets.[64] On the other hand, the size of positive externalities is critically determined by how much information beyond the individual issue of securities can be extrapolated from the offering and how many firms are actually similarly situated. In this regard, the very early stage, tiny ventures that can capitalize on the prospectus exemption promulgated in the Small Investor Protection Act seem highly idiosyncratic, which in turn makes any additional information to be disclosed in a full-fledged prospectus look rather firm specific and of insignificant value to public securities markets as a whole.[65] Although any robust conclusion as to the optimality of either regime required empirical testing, it is at least a plausible policy choice to allow those issuers who do not have access to other sources of capital to choose levels of costs (disclosure) better aligned with their preferences. After all, enhanced scrutiny of issuers

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[62] This is why the calculation based on issuer's private costs in Zetzsche & Preiner, *supra* note 4 at 23 is not fully convincing.

[63] For this argument see Merrit B. Fox, *Regulating the Offering of Truly New Securities: First Principles*, 66 DUKE L. J. 673, 699-702 (2016).

[64] For an overview see for instance GERMAN PRIVATE EQUITY AND VENTURE CAPITAL ASSOCIATION, THE GERMAN PRIVATE EQUITY AND VENTURE CAPITAL MARKET IN 2015, http://www.bvkap.de/sites/default/files/page/2015_bvk_market_statistics.pdf; WOLFGANG WEITNAUER, HANDBUCH VENTURE CAPITAL PARA. 73-80 (5th ed. 2016).

[65] Zetzsche & Preiner, *supra* note 4 at 23 purport that the current prospectus regime would not even generate relevant firm specific information, because it does not capture forward looking projections. This very strong posit seems doubtful already in light of level-1 regulation, Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, art. 7(2)(e), 2003 O.J. (L 345) 64.

by gatekeepers (*supra* 3.2) might work better than an information model, which always hinges on the willingness and capacity of investors to adequately process disclosed data.[66]

5 Conclusion

The German regulation of crowdinvesting does not fully live up to the regulatory challenges posed by this novel form of digitized matching of supply and demand on capital markets. It should better reflect the key importance of crowdinvesting platforms, which may become critical providers of market infrastructure in the not too distant future. Moreover, platforms can play an important role in investor protection that cannot be performed by traditional disclosure regimes geared towards more seasoned issuers. Against this background, the creation of an exemption from the traditional prospectus regime seems to be a plausible policy choice. However, it needs to be complemented by an adequate regulatory stimulation of platforms' role as gatekeepers.

[66] See also Zetzsche & Preiner, *supra* note 4 at 25 (arguing that investors are frequently not mainly driven by financial considerations). Yet, also a supportive stance vis-à-vis the venture depends on receiving accurate information in pertinent respect.

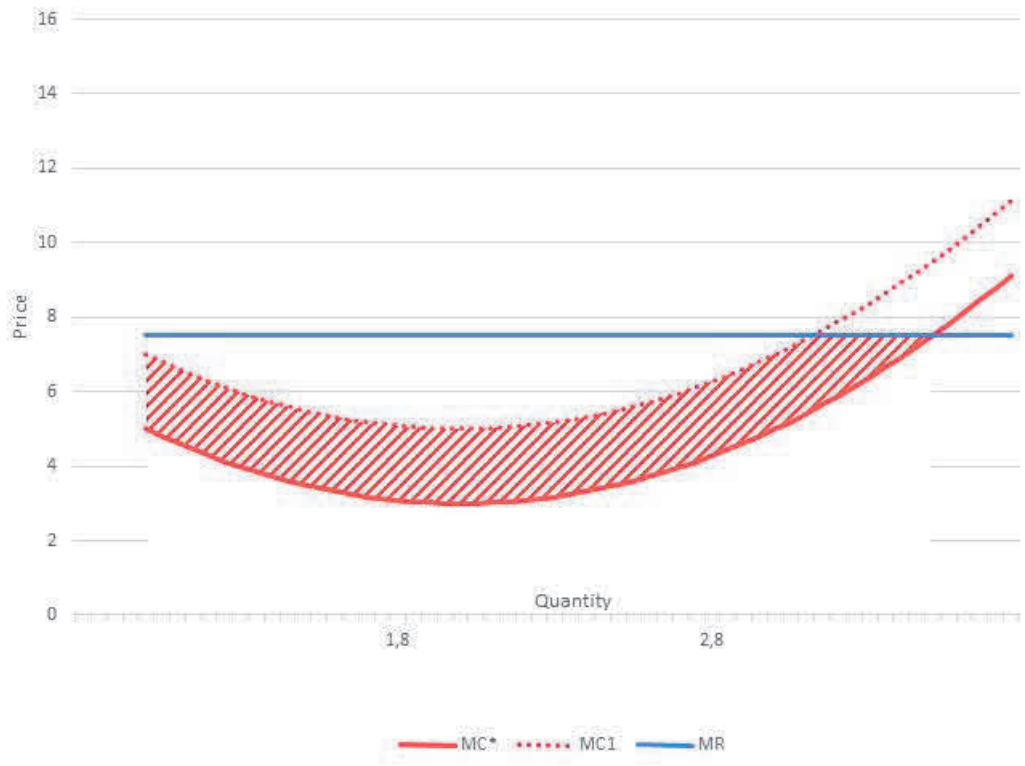

figure 1 - marginal cost and return in IPOs (less funding due to higher than individually optimal disclosure)

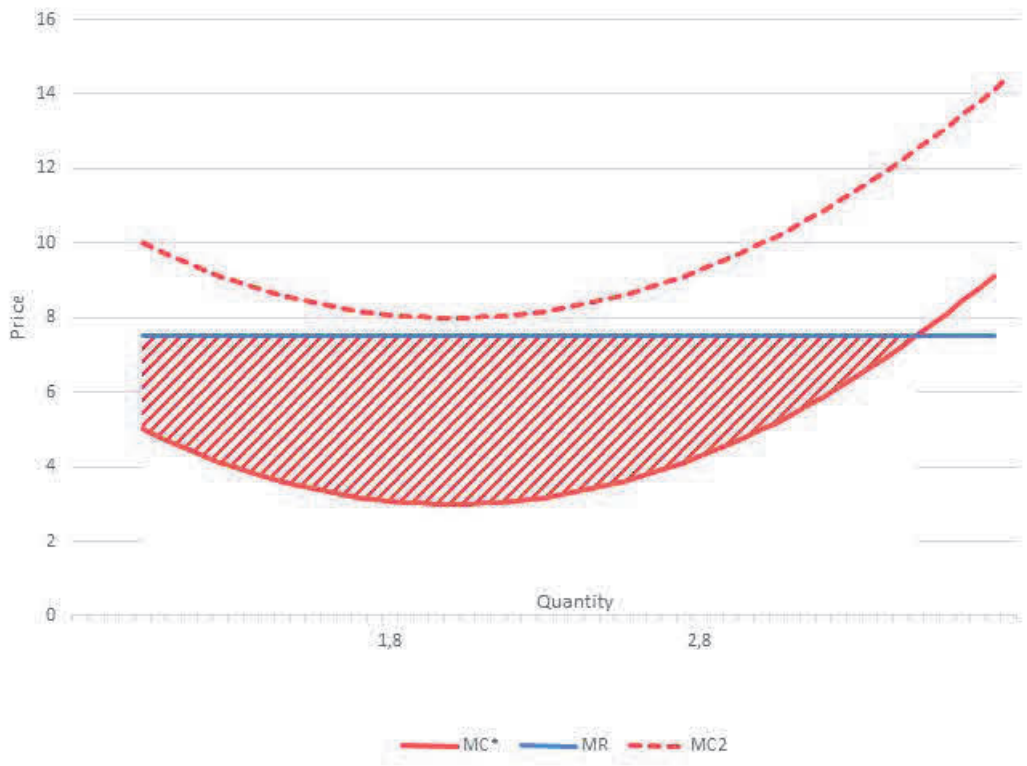

figure 2 - marginal cost and return in IPOs (no funding due to higher than individually optimal disclosure)

Address
European Banking Institute
c/o
Prof. Dr. Tobias Tröger
House of Finance
Box: 22
Theodor-W.-Adorno-Platz 3 (Westend Campus)
60629 Frankfurt am Main
Germany

EBI European Banking Institute

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