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FinTech and Alternative Finance: The Regulation of Marketplace Investing

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PRESENTATION OVERVIEW

A. Definitions: **FinTech**, **alternative finance**, marketplace investing

B. Marketplace investing

1) Different types and focus on **FR-crowdfunding**
2) Similarities and differences between LB and IB-crowdfunding (risks and benefits)

C. **Policy issues and trends in FR-crowdfunding regulation** in Europe and implications for CMU

D. **Proposal** based on a **functional approach**: analysis of single requirements based on economic functions, risks and characteristics of FR-crowdfunding

A. Definitions and relevant concepts
1. FinTech & alternative finance

- **FinTech= start-ups and new market entrants applying technology to finance, innovating the products and services currently provided by the traditional financial services industry**
  - Collection and use of big data in credit scoring, blockchain in transactions, etc.
  - Speed, convenience, response to user's needs
- **Alternative finance = areas of finance that offer alternatives to traditional banking and capital markets (especially for SMEs)**
  - Growth after the crisis: **distrust towards traditional providers and credit crunch**; '**democratic**' finance
  - **also non-FinTech**: credit funds, alternative growth markets; microcredit

Focus on alternative providers which are also FinTech

A. DEFINITIONS AND RELEVANT CONCEPTS
2. Effects

- → **DISRUPTION, especially in consumer banking, fund transfer and payments**
  - Incumbents forced to adapt/innovate, cooperate or retreat
  - **Regulatory arbitrage and competition issues** (loopholes, no banking or capital markets law, no capital requirements)

A. DEFINITIONS AND RELEVANT CONCEPTS
3. Marketplace investing

= digital platforms where financial transactions occur between recipients of funds and investors (direct, disintermediated, bilateral)

1) LENDING-BASED CROWDFUNDING (LB: P2P and P2B)

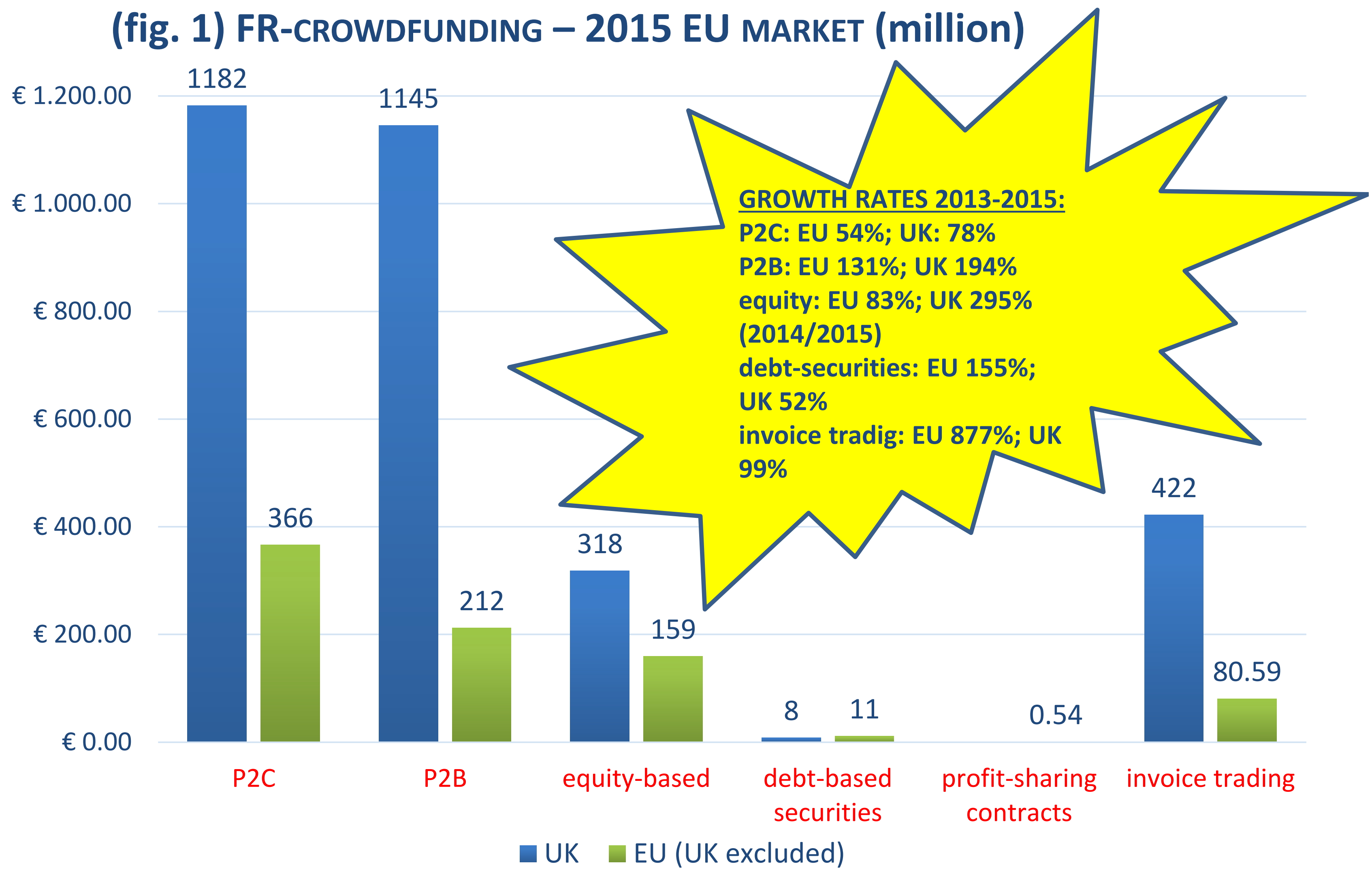
2) INVESTMENT-BASED CROWDFUNDING (IB)

Financial-return crowdfunding

3) Invoice trading

4) Club deals in equity securities (mainly professional investors)

B. Focus on Marketplace investing
1. FR-crowdfunding: market size



(Figures from Macchiavello, 'Financial-return crowdfunding', forthcoming; data extracted from Zhang et al., 'Sustaining Momentum', (2016) and Zhang et al., 'Pushing Boundaries', (2016))

B. Focus on Marketplace investing

2. LB *vs* IB crowdfunding: SIMILARITIES/1

Loans *vs* shares, bonds, right to share of profits (investment contracts) but:

- **investment component** (eg expectation of profits from the efforts of others)
- **Disintermediation**
- **clear role of platform in reducing asymmetric information** (*see* collection of information, checks, rating/category, etc. and reliance on information provided), **agency and collective action problems** (contract documentation, relationship management, etc.)
- **Similar products *de facto:***
    - **auto-bid models, hybrid products and guarantee funds (*see* collective schemes) in LB**
    - **hybrid instruments and illiquid instruments of start-ups in IB**

B. Focus on Marketplace investing
3. LB *vs* IB crowdfunding: SIMILARITIES/2

Benefits

For investors:

- ✓ Higher returns
- ✓ Diversification across types of investments and resilience
- ✓ Non-financial returns: «direct» finance, sense of involvement, expanded network

For receivers:

- ✓ > access to finance
- ✓ < transaction costs
- ✓ Market test/marketing tool

For the system:

- ✓ Increased competition in financing
- ✓ Innovation stimulator

Risks

For investors:

- ➢ Capital loss and coordination problem
- ➢ Illiquidity and concentration
- ➢ Lack of clarity, misleading advertisements, asymmetric information

For receivers:

- ➢ Disclosure of corporate information/unprotected innovative processes
- ➢ Agency costs, collective action problem
- ➢ borrowers discrimination and abuses (LB)

For the system:

- ➢ Fraud, money-laundering, financing terrorism, cyber-crimes
- ➢ Very low systemic risk (but now > interconnectedness)

B. Focus on Marketplace investing

4. LB *vs* IB crowdfunding: DIFFERENCES

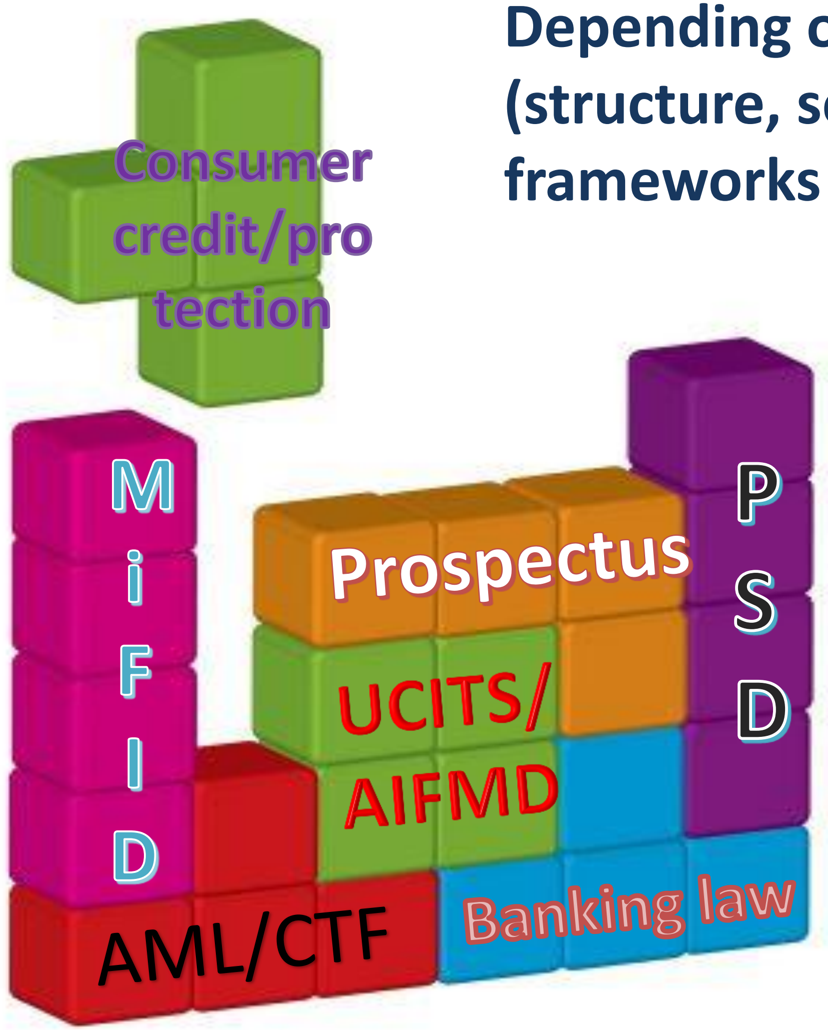
With relevance from a regulatory point of view (EB riskier):

- **Limited universe** of investible companies and so **less diversification** in **EB** crowdfunding *vs* LB
- **riskier** investees (start-up/seed companies) in **EB** (typical VC: more reliance on platform information/evaluations and higher level of defaults)
- Longer **lock-in periods and no secondary markets in EB** (compared with loan maturities and markets/buy-back options in LB)
- Different level of protection/**risk-mitigation instruments**
  - LB: guarantee funds, lending groups, social networks and supporters, rational herding, big data
  - IB: syndicate deals/co-investing with business angels, rational herding
- In IB more **limitations** to typical equity holders' **rights and platforms' role in firms' governance** (but *see* loan collection and restructuring in LB)
- **However, in LB increasing institutional participation** (banks and investment firms; 25%) *vs* no in IB (but venture capital funds, HNWI)

C. Policy issues

1. Difficult balance of different objectives

C. Policy issues
2. Applicable law, preferred framework and consequences



Depending on platforms' models (structure, services), national frameworks and traditions:

3. Regulatory trends in EU and implications – LB crowdfunding/1 -

Fragmentation in Member States (MSs) approaches:

A. TRADITIONAL APPROACH: application of existing laws

- **Banking framework** (eg Italy, Belgium; in the past France)
  - Too strict/restrictive (*vs* innovation, access to finance)
  - focus on **prudential** requirements, stability and systemic risk (banks bear the risk of lending deposits)
    - *vs* types of activities (no direct loans, no intermediating risk and maturities transformation, no liquidity creation), size of the crowdfunding sector
- **Payment services** (eg Italy; EBA)
  - Less restrictive (but no passport for low-volume PIs)
  - Focus on continuity of payments, money **segregation** and **security**
    - **no transparency, due diligence or borrower protection**!
- **Prospectus and securities regulation/investment services** (eg US)
  - Restrictive (unless MiFID exemption)
  - Focus on **transparency** but **not tailored** to crowdfunding (over-load?) and now also prudential and organisational requirements recipients un-protected (on the contrary, relevant burdens)

B. *AD HOC* REGULATION (eg UK, F, ES, PT *vs* only partial in DE, AT, NTL)

- Ability to respond to **specific risks** (insurance, warnings, borrower protection, limits, segregation)
- but anyway **different balances and fragmentation** among MSs

4. Regulatory trends in EU and implications – national laws on LB crowdfunding/2 -

Common characters:

- **new operator** under supervision of financial authority with **simple authorization** (eg 'fit and proper' executives, business continuity *vs* no minimum capital (insurance)
- **light regulation disclosure-based** (to investors/lenders and authority but also to borrowers)
- **Limits** to size of loan request, platform offering, investible sums (except UK), to activities (no handling money or investment services)
- **No investor test (self-assessment), only disclosure of due diligence**; additional conduct rules; redress mechanisms

Differences:

- In UK minimum initial capital; others require **adequate resources and organization** (S, P)
- **In UK also capital adequacy** (in Spain certain capital when volumes above certain thresholds)
- **Investor test** in NTL when > €500 (but only warning); **due diligence** in selection of borrowers in France, NTL; different level of additional duties
- **Withdrawal rights** (UK, NTL) ; different levels of **conflict of interest and AML/CTF** requirements

5. Regulatory trends in EU and implications – IB crowdfunding/1 -

Again fragmentation in MS approaches consequent to:

A. TRADITIONAL APPROACH

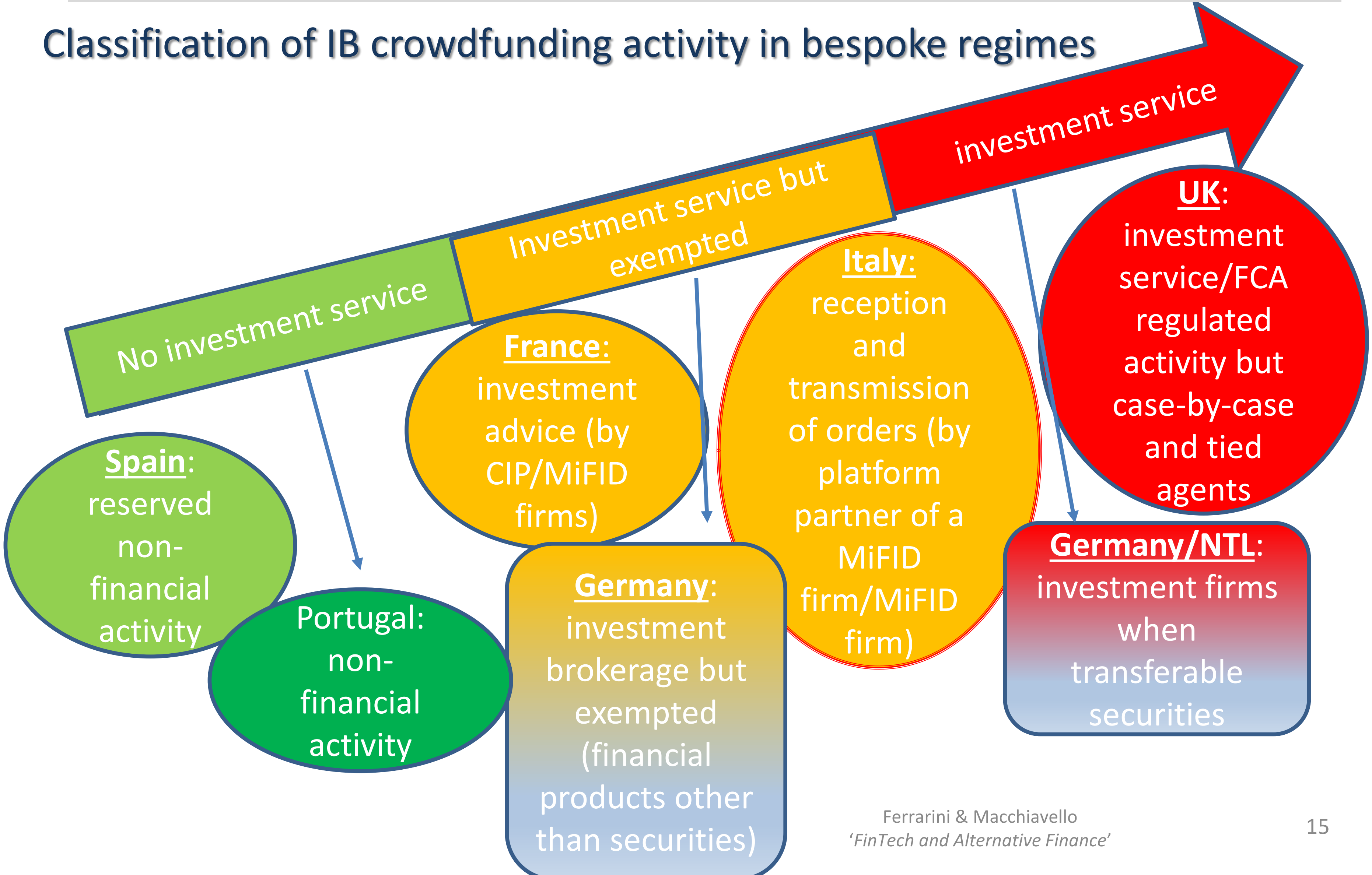
- Different models by platforms and interpretations of **investment products/financial instruments** (MiFID or not?)
  - *See* in Germany 'profit-participation loans' no financial products until 2015 *vs* in Italy;
  - In Germany participation in 'silent-partnerships' = financial instruments (other than transferable securities) while in Austria no financial instruments;
  - participation in private limited companies = financial instruments in Hungary but not in Italy
- Different interpretations of **investment services (very different regimes)**
  - Reception and transmission of orders (UK, Italy, Netherlands), investment advice (France), underwriting/placing (France), MTF/OTF (Belgium, Luxembourg)?

B. ***AD HOC* REGULATIONS** (special regimes IT, F, ES, PT *vs* single special provisions/products UK, AT, DE, NTL)

- taking advantage of MiFID exemptions: better **tailoring** (special warnings, limits in types of services/products and amount involved)
- but ***vs* common market**

6. Regulatory trends in EU and implications – IB crowdfunding/2 -

Classification of IB crowdfunding activity in bespoke regimes



7. Regulatory trends in EU and implications – national laws on IB crowdfunding/3 -

Common characters:

- **Exclusion of MiFID/Prospectus and new operator** under supervision of financial authority with **simple authorization** (eg 'fit and proper' executives, business continuity, minimum capital or insurance
- **light regulation based on disclosure** (to investors/lenders and authority but also to borrowers) and general conduct rules (diligence, fairness)
- **Limits** to investible sums and activities (no handling money or investment services)
- investor test **(UK, NTL, IT, F); only disclosure of due diligence**
- Withdrawal rights; redress mechanisms

Differences:

- In UK minimum initial capital; others require **adequate resources and organization** (S, P)
- **In UK also prudential requirements** (in Spain certain capital when volumes above certain thresholds)
- **due diligence** in selection of investees in Spain/France; **in Italy, co-investing (5% professional investors)**
- different levels of **conflict of interest and AML/CTF** requirements

8. Consequences

- **Low level of cross-border crowdfunding despite platforms' interest in expanding**
  - Both in terms of funding and recipients
  - In some markets, **many small national platforms**: no economies of scale, diversification, network effects
- **Unequal treatment** of EU **investors/users and evidence of incomplete harmonisation** within financial sector
- **Frictions with EU passports** (MiFID, PI, Treaty freedoms)
  - special requirements or limits as product intervention or Art. 24(12) MiFID II measures?
  - Spain reserve of activity *vs* MiFID/IP/Treaty freedoms (not passing the 'general good test')?
- *vs* MiFID II, Capital Markets Union, Banking Union, etc.

C. Proposals
1. General aspects

- Design **regulation enabling FR-crowdfunding but safeguarding** from highlighted risks (in particular, retail investors)
- ***Ad hoc* regulation with FUNCTIONAL APPROACH** to better tailor measures/requirements (no rigid separation among sectors and traditional legal categories)
- Reference in:
  - **EU law** but more **flexible/proportionate,** with **less attention to prudential requirements but adequate disclosure and organisational requirements** (adequate resources/insurance, back-up plans, segregation, warnings, investment limits)
  - **national *ad hoc* regimes**
- **Similar requirements in national regimes** to facilitate cross-border activity and use of **Treaty freedoms**, **towards EU harmonisation** Directive for alternative finance

C. Proposals
2. scope and authorisation

- Focus on **platforms' duties** but freedom in designing their business models
- Lighter regulation but **more stringent for more complex/risky services**
- **Not differences based on type of products** (eg financial instruments, investment products/contracts, loans) → **both LB and IB**
- **Simple authorisation** based on 'fit and proper' test of executives and shareholders, continuity arrangements, adequate organisation and resources (minimum capital/insurance)
- Periodic **reporting** about activities to Financial Authority

C. PROPOSALS
3. prudential and organisational requirements

- **Capital requirements** depending on type of activities/risk (advice, portfolio management *vs* simple intermediation)
- **Proportional organizational requirements**
- **Client money protection**: segregation/guarantee funds when dealing with clients' money

C. Proposals
4. Conduct rules

- **Adapted/proportional MiFID conduct rules depending on type of services** (advice/management *vs* brokering) and **investors** (retail *vs* professional)
  - Duty of care and loyalty, diligence in recipients' selection/checks
  - Fair, clear and not-misleading information
  - Conflict of interest
  - Investor test (understanding of risks/appropriateness, suitability depending on type of service)
- **Wide disclosure** obligations about platform, investment and specific risks, with **special warnings** (*see* Italy, France, Spain, Portugal, UK); **also to borrowers**
- **Investment limits**
- withdrawal rights

THANK YOU!