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Fair and Appropriate Pricing by Crowdfunding Platforms

Melvin Tjon Akon¹

I. Introduction

Lending-based crowdfunding, i.e., raising debt finance from the public through a dedicated internet platform (**crowdfunding**²), offers startups a source of financing to pursue their activities next to other sources of debt financing, such as venture capital, bank financing and direct lending by private equity firms. Whereas the (prospective) lender in those transactions is a sophisticated actor with the resources and incentives to price the loan or debt securities itself, in the case of crowdfunding the lenders may not be as sophisticated, especially if they are consumers (retail lenders). In addition, the companies raising funds through crowdfunding are often riskier debtors than the average company, due to *adverse selection*³. Therefore, these lenders may want to delegate due diligence in respect of the debtor/project and pricing to crowdfunding platforms.⁴ A crowdfunding platform can offer the pricing of the debt as a service to the (prospective) lenders or investors who provide the capital through the platform. Pricing by the platform thus brings potential benefits in terms of efficiencies, but also may expose the investors to several risks. One source of risk is mispricing by the platform, e.g. pricing the (interest payable on the) debt too low such that the lenders are not adequately compensated for the provision of the funds⁵, a risk that is not merely theoretical⁶. This note focuses on the regulation of this particular risk. In Luxembourg, crowdfunding is regulated by the European Crowdfunding Service Providers Regulation (**ECSPR**)⁷. The ECSPR is implemented by means of the law of 25 February 2022, which modifies the law of 16 July 2019 on the operationalisation of European regulations in the area of financial services (**L2019**) by introducing a new chapter therein (chapter 4c). The ECSPR contains a provision which regulates pricing by platforms, addressing the mispricing risk. More specifically, Article 4.4.d ECSPR states that where a crowdfunding service provider (**CSP**) determines the price of a crowdfunding offer, it shall ensure that the price is “fair and appropriate”. The European Banking Authority (**EBA**) is empowered to develop draft regulatory technical standards (**RTS**) to specify the factors that a CSP has to take into account when ensuring that the price of a loan it facilitates complies with the standard⁸. On 29 April 2022, the EBA published the draft RTS⁹, which are to be adopted by the European Commission in the form of a delegated regulation.¹⁰ The purpose of this note is to understand how these rules will work in practice (assuming the RTS will be adopted per the draft).

II. Level 1 (ECSPR): The “fair and appropriate” norm

What is the price of a crowdfunding offer? In order to answer this question, it is necessary to first define the offer. A *crowdfunding offer* is any communication by a crowdfunding service provider, in any form and by any means, presenting sufficient information on the terms of the offer and the crowdfunding project

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being offered, so as to enable an investor to invest in the crowdfunding project.¹¹ The wording is very similar to the definition of “offer of securities to the public” in the Prospectus Regulation¹². A *crowdfunding project* is the business activity or activities for which a project owner seeks funding through the crowdfunding offer.¹³ The project owner is any natural or legal person who seeks funding through a crowdfunding platform.¹⁴ The *crowdfunding service* provider is the legal person providing crowdfunding services, and a crowdfunding service is the matching of business funding interests of investors and project owners through the use of a crowdfunding platform¹⁵. The service may comprise the following activities: (1) facilitation of granting of loans, and (2) the placing of securities issued by project owners or a special purpose vehicle, and the reception and transmission of client orders in relation to those securities.¹⁶ The pricing of crowdfunding projects, as regulated by the ECSPR, relates to the facilitation of loans. Recital 11 ECSPR clearly states that the ‘pricing or assessing the credit risk of crowdfunding projects or project owners’ is included in such facilitation. The beneficiaries of these pricing services are clients of the CSP, which refers to any prospective or actual investor to whom a CSP (intends to) provide(s) its services.¹⁷ Investors, in turn, are natural or legal persons who ultimately grant a loan to the project owner.¹⁸ Those investors can be sophisticated, i.e., institutions considered professionals under MiFID II (e.g., banks, large undertakings) or those legal and natural persons who meet the criteria under Annex I ECSPR (on their request).¹⁹ The other investors are considered non-sophisticated and may include natural persons that are “consumers” under EU consumer law.²⁰ As discussed, the standard that the CSP must meet when determining the pricing of an offer is laid down in Article 4.4.d ECSPR, under the heading of “organisational and operational requirements”. According to the standard, the CSP must ensure that the price is “fair and appropriate”. While Recital 11 focuses on loans, the provisions of Article 4.4 ECSPR clarify that the rule applies to other forms of debt too and stipulate requirements applicable to the intermediate steps of the pricing process. Specifically, the CSP must undertake a reasonable assessment of the credit risk of the project or the owner, including the risk of non-payment required under “a loan, bond or other form of securitised debt”.²¹ In addition, it must base the assessment on sufficient information, conduct a valuation of the loan and have a risk-management in place that is designed to achieve compliance with these obligations.²² The pricing methodology is not only subject to this “fair and appropriate” standard (which seeks to ensure or effective and prudent management); key elements of the methodology must also be disclosed.²³ By requiring disclosure of its methodology, the rule contributes to the protection of investors as it reduces the information asymmetry between the investors and the platform.²⁴ Thus, in the section entitled “investor protection”, the ECSPR mandates the disclosure of the methodology and delegates rulemaking under Article 4.4.d ECSPR to the EBA to provide the elements of such disclosure.²⁵

III Level 2 (RTS): Particularisation of the norm

The notions of “fair” and “appropriate” are open terms, which are commonly used when the legislative strategy is to provide regulators with a flexible norm that allows for norm enforcement that is sensitive to the facts and circumstances of the action²⁶. The norm generally preserves the discretion of the addressee (*casu quo* the CSP) to some extent, but may cause confusion as to which facts and norms are most relevant. For example, in the present case the relative importance of investor protection and competitive dynamics in the decision matrix is not clear. The ECSPR focuses on investor protection and recognises that the

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facilitation of debt financing by a CSP “is to be distinguished from the activity of a credit institution”²⁷. Building on this premise, the EBA states that the pricing structure “is likely to be different from the one commonly used by banks, as the latter need to take into account the cost of capital (both regulatory and economic capital) as well as the cost of financing to raise funds to lend (through customer deposits or through various money or capital markets).”²⁸ It does not refer to the other financiers mentioned above (section I). The EBA concludes that while CSPs neither hold capital nor need to raise funds to finance the loans, a “fair and appropriate” pricing strategy requires that the price reflects the risk profile of the loan and that CSPs consider the “prevailing market conditions” at the point of loan origination and during the lifetime of the loan.²⁹ The RTS implement the rule in Article 4.4.d ECSPR through two separate provisions. Article 6 RTS is of general application and provides that when CSPs suggest the price of crowdfunding offers, they shall have in place an adequate pricing framework. Article 11 RTS provides the specifications pursuant Article 19.7.c ECSPR by stipulating that in order to ensure that the price of a loan is fair and appropriate, CSPs shall take into account the following factors: (a) the risk profile of the project owner or the crowdfunding project, (b) the net present value of the loan, (c) the prevailing market conditions at the point of loan origination and during the lifetime of the loan, and (d) the CSP’s business strategy. Two observations merit discussion. First, the language of Article 11 RTS (rightfully) indicates that the CSP has some pricing discretion. The stipulated factors must be “taken into account”, but how they must be accounted for or used as reference points is not further specified. There is no reference to industry practices or specific formulas in this respect. Recital 11 RTS clarifies that the price “should reflect the risk profile of the loan” and that the CSP “has considered how pricing compares to loans with similar conditions”³⁰, but the CSP does not need to “reflect” all the considerations in the price.³¹ Second, the notion of “prevailing market conditions” lacks clarity. It is not clear how the relevant market should be defined. Which products and actors constitute this market? While the EBA expressly juxtaposes CSPs and banks, this comparison may not always be useful in practice. For example, crowdfunding loans and bank loans are not per se substitutes, they may in fact be complements³² and thus not part of the same product market.³³ And what about other debt financiers, such as private equity or venture capital firms – are “loans with similar conditions” provided by these entities included in the notion of market? Further specification of the relevant market may thus be useful. That specification could take the form of a notion of relevance or specific product/market features, for which there is a precedent in the regulation of financial instruments trading.³⁴ There is also a precedent for such specification in the regulation of lending, laid down in the EBA Guidelines on loan origination and monitoring applicable to banks³⁵. These guidelines provide that banks should consider, and reflect in their pricing, costs related to “competition and prevailing market conditions, in particular lending segments and for particular loan products”³⁶. Similar specifications could be useful here too.

IV. Luxembourg-level implications

What are some implications of the rules for Luxembourg-based CSPs? First, the ‘fair and appropriate’ standard may generate uneasiness in some CSPs as they are uncertain how the supervisor will interpret and enforce the standard. The competent authority charged with enforcement of the rules is the CSSF.³⁷ In case a Luxembourg-based CSP does not comply with the rules, the CSSF has a number of powers, among which the power to impose fines. If a platform does not have a pricing method in conformity with Article 4.4.d ECSPR or does not disclose it in compliance with the RTS, the CSSF can impose administrative fines of EUR 500,000 or up to 5 per cent of the total annual turnover of the legal entity running the

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platform according to the last available financial statements approved by the management body.³⁸ Given the upper thresholds of the fines, CSPs may welcome guidance from the CSSF to reduce this uncertainty. Second, where the investors are consumers the CSP must consider how to structure its compliance with the disclosure rule in the ECSPR in a manner congruent with the rules of EU consumer law (as transposed in national law) in the case of marketing and other communications.³⁹ For example, when targeting investors who are consumers in the sense of the *Code de la consommation* (LCC), the CSP should observe the rules on unfair commercial practices⁴⁰. Among other obligations, the CSP should thus ensure that the disclosures on the pricing methodology provide the information required by the ECSPR, without at the same time materially distorting or being likely to materially distort the economic behaviour of the investors.⁴¹ Meeting that obligation involves a careful balancing act. In summary, CSPs that price crowdfunding offers must really take the time to design and manage their processes, as well as their communications with investors.

- 1 Attorney, Ph.D. candidate and regulatory strategist. This note is written on personal title.
- 2 Olena Havrylchyk, 'Regulatory framework for the loan-based crowdfunding platforms', ECO/WKP (2018)61 OECD Economics Department Working Papers, no. 1513, 10; European Commission, 'Identifying market and regulatory obstacles to cross-border development of crowdfunding in the EU', Final report, December 2017, 4.
- 3 Havrylchyk (n 1).
- 4 Ibid
- 5 Clifford Chance and European Bank for Reconstruction and Development, 'Regulating investment-based and lending-based crowdfunding: best practices', October 2018, par. 7.2.
- 6 Studies suggest that such mispricing exists. See e.g. Seth Freedman and Ginger Zhe Jin, 'The information value of online social networks: Lessons from peer-to-peer lending', *International Journal of Industrial Organization*, 2017, vol. 51, issue C, 185-222; Julapa Jagtiani and Catharine Lemieux, 'Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information', FRB of Philadelphia Working Paper No. 17-17, retrieved via SSRN; Adhami, Saman and Gianfrate, Gianfranco and Johan, Sofia A., 'Risks and Returns in Crowdlending' (3 March 2019), retrieved via SSRN.
- 7 Regulation (EU) 2020/1503 on European crowdfunding service providers for business.
- 8 Article 19.7.c ECSPR.
- 9 EBA, "Final Report on Regulatory Technical Standards on credit scoring and loan pricing disclosure, credit risk assessment and risk management requirements for Crowdfunding Service Providers", EBA /RTS/2022/05, 29 April 2022.
- 10 EBA Final Report, p 10.
- 11 Article 2.1.f ECSPR.
- 12 [Article 2.d Regulation \(EU\) 2017/1129](#).
- 13 Article 2.1.1 ECSPR.
- 14 Article 2.1.h ECSPR. Project owners are professionals, since the ECSPR does not apply to crowdfunding offers in which the project owners are consumers, see Article 1.2.a ECSPR.
- 15 Article 2.1.e ECSPR. The platform is a publicly accessible internet-based information system operated or managed by the CSP, see Article 2.1.d ECSPR.
- 16 Article 2.1.a ECSPR.

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- 17 Articles 2.1.g ECSPR.
- 18 Article 2.1.b and 2.1.i ECSPR.
- 19 Article 2.j ECSPR.
- 20 Article 2.1.k ECSPR.
- 21 Article 4.4.a ECSPR.
- 22 Article 4.4.b, Article 4.4.e and Article 4.4.f ECSPR.
- 23 Recital 4 eSCPR.
- 24 EBA Final Report, par 11.
- 25 Article 19(7)(c).
- 26 By way of example, see recital 71 of Commission Delegated Regulation (EU) [2017/565](#) : “In order to ensure that the scope of the advice allows for a fair and appropriate comparison between different financial instruments, investment advisers [] should comply with certain conditions if they present themselves as independent advisers”.
- 27 Recital 11.
- 28 EBA Final Report, par 14.
- 29 Ibid.
- 30 Recital 4 RTS.
- 31 See by contrast, EBA, “Final Report – Guidelines on loan origination and monitoring”, EBA/GL/2020/06, 29 May 2020, par. 202.
- 32 Anton Miglo, “Crowdfunding and bank financing: substitutes or complements?”, *Small Business Economics* (2022) 59:1115–1142.
- 33 For a parallel in competition law, European Commission, “Commission notice on the definition of relevant market for the purposes of Community competition law” (97/C 372/03).
- 34 For example, under Commission Delegated Regulation (EU) [2017/587](#), “prices published by a systematic internaliser shall be deemed to reflect prevailing market conditions where they are close in price, at the time of publication, to quotes of equivalent sizes for the same financial instrument on the most relevant market in terms of liquidity [...]”.
- 35 EBA/GL/2020/06, 29 May 2020, “Final Report – Guidelines on loan origination and monitoring”, par 202.
- 36 Ibid. See also <https://www.cssf.lu/en/crowdfunding-service-providers/>.
- 37 [Article 20-15](#) L2019.
- 38 [Article 20-17.1.1](#) and [20-17.2.5](#) L2019.
- 39 ESMA, “Questions and Answers On the [European crowdfunding service providers for business Regulation](#)”, answer 5.8.
- 40 [Article L. 121-1](#) LCC et seq.
- 41 [Article L. 122-1.2](#) LCC.

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