

ECN – 4th Crowdfunding Convention

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Good morning Ladies and Gentlemen,

Let me first of all thank the ‘European Crowdfunding Network’ for organising this conference and inviting me to speak. I think that at this juncture in the evolution of the industry, it is an excellent opportunity for me to speak with you as we turn our minds to considering the development of the Capital Markets Union (CMU).

Today I will take the opportunity to talk to you about ESMA’s role and the new Strategic Orientation on our future that we recently published. I will also explain how our work on financial innovation fits into this and reflect on our work on crowdfunding in particular before returning to the question of the CMU.

I know that for some of you the European Securities and Markets Authority (ESMA) is very familiar but for others it may be less so.

ESMA: its role and strategic direction

ESMA was established in 2011 as part of a series of measures taken to reinforce financial supervision across the EU. ESMA forms part of the overall European System of Financial Supervision (ESFS), which includes our sister authorities EIOPA, responsible for insurance, and EBA, responsible for banking. The System is a network that brings together European and national regulators and supervisory authorities from across the EU.

Given that our mandate covers securities markets, ESMA has focused on investment-based crowdfunding and my remarks today therefore relate to this specific part of the market. We have worked closely with EBA, which has considered loan-based crowdfunding.

So, what is ESMA's remit? Like any supervisor we worry about risks to financial markets, and our objectives are to promote investor protection, orderly markets and financial stability.

But there are also some distinctive elements to our role which are particularly relevant to our work on crowdfunding.

The first is that part of our remit is to improve the functioning of the European Union's internal market, in particular by ensuring a high, effective and consistent level of regulation and supervision. I will say more later on about how we do that, but it means that we have an interest in ensuring that there is a level playing field and in ensuring that there are no unnecessary barriers to pan-European and cross-border activity.

The second is that, like our sister authorities responsible for insurance and banking, we have a specific remit to monitor financial innovation. When we look at financial innovation we have a dual perspective. The first is that we try to understand what benefits it could bring and whether there are barriers to the emergence of those benefits that we can help to address. Of course, we also want to make sure we understand the risks, and how to address them in an effective but proportionate way.

This balanced approach to financial innovation reflects that we believe that financial innovation is essential for successful and viable financial markets. We need to recognise that very well-established phenomena in financial markets, like the stock market and investment fund, were at one point in time newly designed financial innovations. These financial innovations have provided tremendous opportunities for funding investments and economic growth. Of course, we should also recognise that financial innovations can go wrong and can entail high risks for investors or even the financial markets as a whole. Examples that come to my mind are securitisations and OTC derivatives, which played an important role in the financial crisis. As a result of these types of innovations, ESMA has an explicit mandate in its founding regulation to work on financial innovation.

So, how do we identify innovations? We carry out our own market monitoring and dialogue with stakeholders, and we benefit from the monitoring carried out by the national regulators in the EU. We have developed a methodology for filtering and prioritising these issues and deciding which ones we need to examine further. As you may know, we have recently started looking into the various applications of distributed

ledger technology. A few years ago, the hot new topic was crowdfunding.

What do we do when we identify an important innovation? That of course depends a little on the issue. But there are some common threads to the approach we take. The first is that we try to understand the commercial applications and business models that are emerging. We understand that innovative approaches may not fit neatly into the boxes that legislators had in mind when the rules were made so we try first to consider the function of the innovation, and later see how it maps into the regulatory framework. Then we try to see what the potential obstacles and gaps in that regulatory framework are, bearing in mind both the benefits and the risks, and whether we can reduce them.

At this point I will say a little more about the core activities of ESMA and how we are shifting our focus in line with the Strategic Orientation for 2016-2020 we recently published. Since we were established nearly five years ago, most of our work has focused on completing the single EU rulebook for financial markets. By the time we reach our fifth birthday in 2016, much of that work will be completed and we can increase our focus on one of our other core areas, promoting convergence in the supervision of financial markets.

Why is this supervisory convergence important? I think we all understand that having rules is not enough to ensure that we protect investors, have orderly financial markets and financial stability in practice. We all know that when supervisors take different approaches to these rules, and where supervisory outcomes diverge, that can create challenges for the effective functioning of the internal market, and for

firms' ability to operate efficiently across national borders. This is one reason why in ESMA's response to the Commission's consultation on CMU we underlined the importance of improving supervisory convergence, and you will see an emphasis on action in this area in the Commission's Action Plan.

I understand that running a business is not straightforward. But actually, supervising financial markets is not so easy either, and dealing with innovative businesses can pose some particular challenges for supervisors, particularly as your ideas and business models can evolve more quickly than the legislation. We therefore aim to assist supervisors in making choices regarding interpretation and application of rules, and the form and intensity of supervision of innovations. I will say more about how we try to do that in relation to crowdfunding later.

Investment-based crowdfunding meets several of the criteria we propose to use when identifying areas to focus our financial innovation monitoring and supervisory convergence work. We see an opportunity to inform the regulation and supervision of investment-based crowdfunding as where there are new economic circumstances, businesses, services, products or regulation it implies that NCAs do not yet have a tried and tested solution. National regulators also see the emergence of investment-based crowdfunding as very relevant to their markets. Given the potential benefits for businesses seeking finance and the risks for investors if things go wrong, it is also clear that this is an area where our work can have real impact.

One of the challenges of this kind of work for ESMA is that it is sometimes hard to show you a visible product from the work we do.

While some of our outputs are public, and I will refer to those specific to crowdfunding later, much of this work must necessarily remain confidential. But actually, some of our most tangible results can come from rather painstaking work behind the scenes to help the different national authorities reach similar conclusions in similar circumstances.

Crowdfunding: what we have found

So now that I have outlined the context I'll turn to the work that ESMA has done on investment-based crowdfunding.

Investment-based crowdfunding first became a topic of interest for ESMA in 2012 as a new phenomenon that was developing fast, albeit from a tiny base. We realised that it had the potential to provide a much needed new and complementary source of funding for smaller businesses, although it was also likely to present risks which needed to be managed.

We were aware that Member States, and specifically national regulators, had been working on how to treat crowdfunding. This was due in part to its novelty, the variety of emerging business models and the fact that existing EU regulations were not designed with this industry in mind. Some member states and national regulators had been seeking to clarify how crowdfunding fit into existing rules, others had been dealing with applicants on a case-by-case basis while several had begun to introduce specific requirements.

Against this backdrop we adopted a step-by-step approach in close cooperation with the EBA (on loan-based crowdfunding) with the objective to enable crowdfunding to reach its potential as a source of finance while ensuring that risks to users of crowdfunding platforms are

identified and addressed in a proportionate and convergent way across the EU. Drawing on member states and regulators' experiences with their home market we first assessed the state of the market, typical business models and their potential evolution, typical risks for project owners, investors and the platforms themselves and the likely components of an appropriate regulatory regime. We then prepared a detailed analysis of how the business models mapped across the existing EU legislation. Finally, we identified issues for consideration by policymakers at EU level. This work led to the publication of our Opinion to NCAs and Advice to the EU Parliament, Council and Commission in December 2014. Later, in July 2015, we published Q&As specifically regarding pertinent risks in relation to money laundering and terrorist financing in relation to investment-based crowdfunding.

The Opinion provides clarity on the rules likely to apply to investment-based crowdfunding. It mitigates the risk of divergent interpretations of existing legislation within the EU. We think that an important message from the Opinion is that the regulatory burden under legislation such as MiFID need not be as great as some in the industry seemed to think at the time.

The Advice to the EU institutions highlights our concerns that strong incentives currently exist for crowdfunding platforms to structure their business to fall outside the scope of regulation and note that one important driver for this seems to be the current rules on prospectuses. We advised the institutions to consider possible policy options to reduce the incentives.

Since then, the policy debate and our own work has moved forward. The Commission has published its CMU Action Plan and committed to publishing a report on the development of crowdfunding in 2016, which we await with interest. Meanwhile, the Commission is preparing its proposal for revision of the Prospectus Directive. ESMA responded to the earlier Commission consultation on both points.

Since publishing the Opinion, Advice and Q&A we have continued to monitor the evolution of the market. Back when we published the Opinion and Advice we identified a likely interest and potential benefit in the emergence of secondary markets for crowdfunded securities. Some markets were already operating, and we understood that others were approaching national competent authorities about possible authorisation. We saw similar developments in relation to loan-based crowdfunding. We have continued to keep abreast of the developments and have seen a range of different models, from relatively simple 'bulletin boards' for investors wishing to exit investments made on a particular platform to platforms which appear to combine primary and secondary markets with relatively little distinction between them. We have also seen some platforms form links with existing multilateral trading facilities (MTFs) and some new MTFs target crowdfunded securities. In our Opinion and Advice we identified the emergence of functioning secondary markets as likely to be important to secure the sustainability of investment-based crowdfunding so our aim in this area is to try to stay on the front foot in understanding the models used and any supervisory challenges arising from them.

We are also working behind the scenes with those national regulators who are regulating crowdfunding platforms, and with some who may be

required to do so in the near future. We have launched a supervisory forum to bring together the staff responsible for day-to-day licensing and supervision. Creating this network has greatly facilitated discussions between regulators and meant that we could help individual staff members receive information and answers from their counterparts. The forum has been of benefit in trying to achieve consistent outcomes for platforms where possible under various applicable legal regimes. It also proved useful in disseminating learning so as to enable supervisors to deal more readily with less familiar business models. We are now preparing to integrate and share lessons learned with the next wave of forum members as the number of countries that have regulated platforms is growing.

Unfortunately some features of the market that gave us concern when we prepared the Opinion and Advice have continued since then. Part of the market seems to be operating quite successfully within the scope of regulation. However, we remain concerned that a number of platforms appear to be making significant efforts to stay outside of regulation. This is not because we are trying to create business for our colleagues at national level. One reason for our concern is that we do think that there are important risks to investors in investment-based crowdfunding, as there are in other financial services businesses. The discipline of being regulated can help firms to manage these risks more effectively than they would otherwise. Each of us can probably think of a financial scandal that has taken place in our own country over the last ten years, and each time such a scandal takes place investor confidence is damaged. That is in no-one's interest as we try to stimulate an invigorated CMU with increased retail investor participation. It is also

counterproductive if the technique used to stay outside regulation is to use investment instruments that are not easily transferable; these risks limiting the possibilities for secondary markets that could make investment-based crowdfunding attractive to a wider range of investors.

Being authorised under EU rules also provides a passport enabling platforms to operate all across Europe without needing any further authorisation. This is a way to shortcut administrative hurdles that would otherwise arise and get access to an EU-wide investor base. We have clearly seen platforms with an appetite to operate cross-border and we know that a number have been doing so for some time. Furthermore, our analysis of the business models of most platforms suggested that access to this larger market was likely to be necessary for all but the largest platforms in the largest member states, given the need for a continuing throughput of projects seeking finance and critical mass in the investor base. We are therefore concerned that platforms' avoidance of regulation not only presents risks to investor protection but makes it harder for platforms to grow their business.

We are also concerned that a growing number of Member States are implementing national regimes to regulate crowdfunding, which do not provide for such a passport. While these regimes may address some of the risks specific to crowdfunding, they pose challenges for a level playing field and regulatory and supervisory convergence. They could also make it harder for platforms to achieve the scale that they need.

Looking forward to the Capital Markets Union

So, how do these observations affect our reflections on the next steps in the context of developing the CMU?

Through the CMU initiative we want to harness the full range of alternative sources to bank funding and facilitate the development of a larger and a more interconnected capital market across the EU. We recognise that there is a risk of over-regulating emerging channels, or regulating them inappropriately. However, we are concerned that a fragmented regulatory landscape could prevent crowdfunding from reaching its full potential.

Furthermore, only when investors feel sufficiently protected will they be willing to enter the capital markets and participate. As trust in the financial sector is still generally low, a lot of work remains to be done here. We are not convinced that structuring business models so as to stay outside the scope of regulation is sending the right message to potential investors and we encourage those platforms operating outside the EU regime to look again at whether the burdens are as great as they imagine.

Clearly, within the regulated sphere the increased focus on supervisory convergence ESMA has committed to in its strategic orientation is all the more important. The single rulebook I mentioned earlier will only deliver an internal market in practice when supervised consistently.

Having now returned to the subject I began with, it is time to conclude. I hope that today I have provided you with an insight into the way that ESMA has tried to support the further development of investment-based crowdfunding, and perhaps demonstrated that there can be a significant degree of alignment between our objectives and yours. We look forward to continuing a constructive relationship with you: let us work together in making this industry deservedly trusted by European investors.



Thank you for your attention and I hope the rest of your day is interesting and informative.

I will now happily take a few short questions.

Check against delivery