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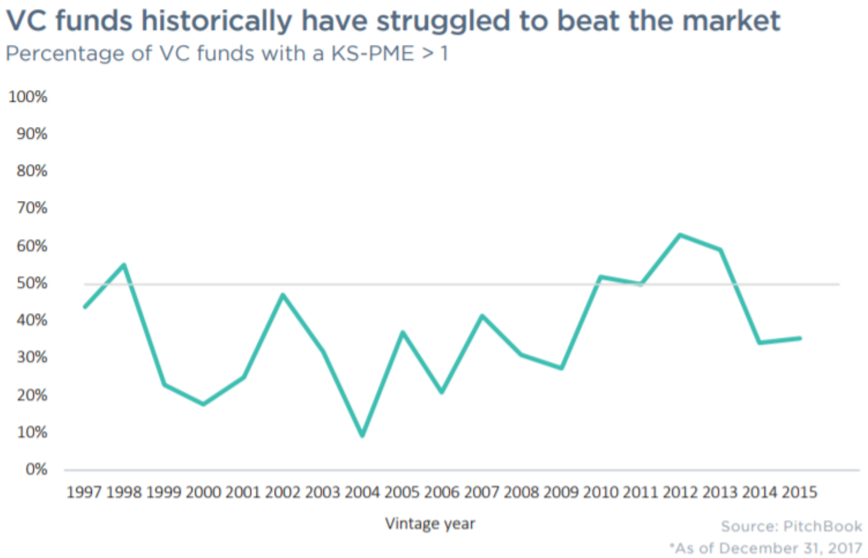
Feedback from the NCC on the EU crowfunding proposal

One of the stated aims of the proposed crowd funding regulation is to *"avoid creating regulatory arbitrage opportunities for financial intermediaries regulated under other Union legislation."* Limiting cross border regulatory arbitrage is arguably a laudable goal. However, the proposal to create an EU wide passport for equity crowd funding companies will most likely open up the door for another kind of regulatory loophole.

The MiFID II regulation has improved investor protection for buyers of liquid and highly regulated financial instruments. This concern for retail investors is unfortunately less prevalent in the proposed pan European regulation for crowd funding. It is therefore of great concern that the EU throw caution to the wind and actively champion retail investments into one of the least liquid and most risky asset classes. In addition the investor protection in the proposed regulation is significantly inferior to MiFID II. We should thus not be surprised if dubious investment professionals find their current regulatory environment too restricted and choose to migrate into equity crowd funding instead.

Most start-ups fail and the eventual winners are hard to pick. Even seasoned Venture Capital professionals generally fail to beat the performance of their public market equivalents (PME). If industry experts with rigorous screening procedures fail to identify the future winners, what chance does the average retail investor have?



https://files.pitchbook.com/website/files/pdf/PitchBook_2018_Global_PE_VC_Fund_Performance_Report_as_of_4Q_2017.pdf

It is likely that retail investors end up being offered investment opportunities that have already been rejected by the VC professionals. By enabling lightly regulated crowd funding companies to tap retail investors the EU may well be preparing the stage for a future wave of mis-selling scandals. It is a paradox that an investment advisor under MiIF II would probably not be permitted to recommend an investment in a non-liquid VC fund, when the EU actively encourages a less diversified investment under the crowd funding umbrella.

In a paper titled *The Siren Call of Equity Crowd Funding*[1], the author observes that the crowd funding is likely to attract the businesses that are least likely to succeed. He describes the performance of US angel investors who generate the bulk of their positive returns from about ten percent of their investments.

Without these winners angel investing would be a losing proposition on average. However, these winners are also the companies that are the least likely to seek crowd funding. In addition angels are far more sophisticated investors than the regular crowd investors. The author observes that investments are most likely to prosper when the angels:

(a) possess a great deal of experience in the same industry as the investment target

[1] Paper by Michael B. Dorff, 13. September 2013: *The Siren Call of Equity Crowd Funding*

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(b) spend a fair amount of time investigating prospects before investing
(c) spread their risk across several start-ups
(d) actively advise the entrepreneurs.

"Crowdfunders will generally not be able to pursue these strategies. With worse investments to choose from and without the experience or ability to help the businesses succeed, crowdfunders are highly unlikely to see the companies they choose thrive."[2]

We understand that easier access to capital can be beneficial to start-ups and small business ventures as well as crowd funding intermediaries. However, this is not acceptable, if this comes in the form of wealth transfers from unsophisticated investors.

The EU proposals observes that access to finance remains difficult for start-ups and SMEs due to structural information asymmetries. This makes these companies prone to over reliance on short term and expensive unsecured bank lending. However, an alternative explanation may be that this reflects the true cost of capital for the level of risk in these companies. Perhaps the reason why start-ups struggle to obtain financing simply is the high failure rate and the difficulty in identifying the few astounding successes that will make up for lossmaking majority.

The proposal of a Pan European passport effectively exposes retail investors to an underperforming asset class with significantly less investor protection than they have in other types of asset classes.

Article 15 contains provisions for evaluating the investors' competency and ability to absorb losses. However, regardless of the outcome of these evaluations the crowd funding companies are under no obligations to prevent retail investors from investing in equity crowdfunding projects. Compared to MiFID II this is utterly inadequate provisions which will have little or no effect on the actual investment decisions. It will be a mere paper exercise to provide a veneer of investor protection.

Article 16 proposes a general quote that all prospects needs to include which states: *"The appropriateness of your education and knowledge have not been assessed before you were granted access to this investment. By making this investment, you assume full risk of taking this investment, including the risk of partial or entire loss of the money invested."* We should be under no illusion that this quote will deter anyone from making the investment.

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The inherent risks to consumer protection in this lax pan European proposal is too high to allow it to be mandatory in all jurisdictions. Individual countries need to be allowed to tailormake their own crowd funding legislation in order to prevent future mis-selling scandals.

Statistics supporting more stringent equity crowd funding rules

In order to illustrate the level of risk in equity start-up investments we have dug into an assortment of statistical sources.

Firstly we compare the risk of heavy losses between liquid equity funds and start-ups in Norway. We observe that a global equity fund have a two percent likelihood of losing more than 35 percent of the value in a one year period. A national, and thus less diversified fund, have a two percent probability of losing 50 percent of its value. In comparison the risk of losing 100 percent of a single investment in a start-up is 30 percent in Norway.

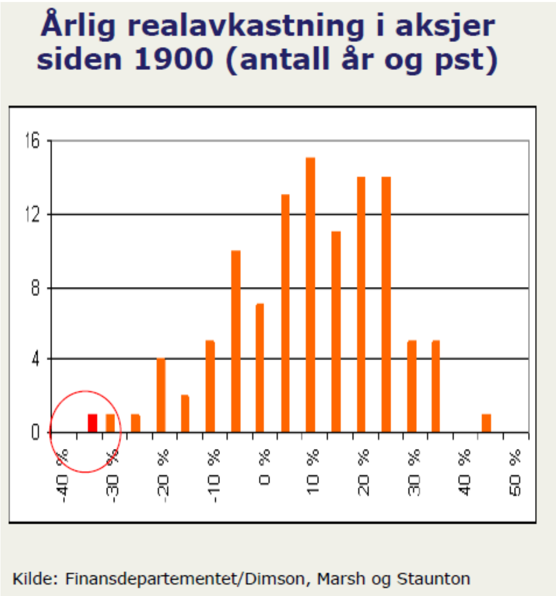
Worst case scenarios

	Probability	Loss
Equity fund, global	2 %	-35 %
Equity fund, national	2 %	-50 %
Start ups (limited companies)	30 %	-100 %

Source: The Norwegian Consumer Council, based on statistics from Morningstar Direct and Statistics Norway.

1. According to data that goes back to 1990, the global stock market has fallen annually about 35 per cent or more only two times (figures below). In other words, there is about two percent probability of losing more than 35 per cent of the money in a global equity fund. Under MiFID regulation these type of funds are considered high risk with a score of 6 or 7 on a scale where 7 is the maximum on the KIID documents. By comparison the risk of investing in unproven start-ups is on a different planet compared to equity funds with listed assets.
2.

In this context the risk of crowd funding equity investments even if investors are advised to spread their risk over several investments and limit the total exposure to 10 percent of investable assets. The crowd funding companies are under no obligation to block investors from investing too much or too narrow. If they did they would not have the means to ensure investors do not take on excess risk. Before launching the regulation and handing out passports the EU needs to gather statistical evidence on expected returns in this asset class and make sure that this is communicated to the consumer investors that the crowd funding industry targets.



Source: The Ministry of Finance, Norway, Marsh and Staunton.

The table below shows the survival rate for Norwegian start-ups. About 50 per cent of the companies fail after five years. During the first year about 30 percent fail.

Newly established enterprises by survival, legal form and year of establishing

	Numbler of newly established enterprises	Survival 1 year	Survival 1 year	Survived 2 years	Survival 2 years	Survival 3 years	Survival 3 years	Survival 4 years	Survival 4 years	Survival 5 years
		Survived	Asleep	Survived	Asleep	Survived	Asleep	Survived	Asleep	Survived
All organisational structures										
2011	46 910	48.0	4.1	43.4	1.0	36.3	0.9	31.4	0.6	27.3
2012	51 169	50.5	4.4	46.3	1.1	39.2	0.9	33.9		
2013	51 641	48.2	5.4	45.4	1.0	37.6				
2014	54 893	48.3	4.4	43.1						
2015	58 321	46.2								
General partnership (ANS)										
2011	254	53.9	3.5	46.5	0.4	37.8	1.2	32.3	0.8	27.6
2012	155	54.8	1.9	47.7	1.3	36.1	1.3	34.8		
2013	123	52.8	2.4	45.5	0.0	33.3				
2014	130	50.0	6.2	46.9						
2015	127	48.8								
Private limited company (AS)										
2011	12 912	69.8	5.0	67.7	1.1	59.8	1.3	53.7	1.1	49.1
2012	20 165	71.3	4.6	67.6	1.2	59.1	1.3	53.2		
2013	19 484	68.4	5.8	65.7	1.5	57.8				
2014	20 980	67.0	5.4	63.9						
2015	22 100	66.6								
Public limited company (ASA)										
2011	1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2012	1	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
2013	1	0.0	0.0	0.0	0.0	0.0				
2014	3	66.7	33.3	100.0						
2015	3	33.3								

Survival does not equal positive returns

50 percent of the start-ups may survive the first five years, but survival alone does not equal positive return on capital. In order to deliver positive returns a start-up needs healthy growth. The table below shows the proportion of companies experiencing 20 per cent growth in the following years.
In Norway high growth enterprises are defined as companies with an average sustained annual growth of 20 percent or more over a period of 3 years.

Medium growth companies grow between 10 and 19 percent annually. Growth is measured in both turnover and employment. To be included in the sample an enterprise must have had 10 or more employees at the beginning of the growth period.

About 10 percent of the companies in Norway experience medium growth. Only 5 percent fall into the high growth category. While it may be assumed surviving start-ups grow from a low base and on average deliver higher growth than more established businesses, they also need a higher rate just to break even. To achieve sustained growth the survivors usually need additional rounds of financing that dilute the original crowd funding investors. It is thus to be expected that even the majority of the early investors likely to earn a positive rate of return on their investment.

Best regards,

The Norwegian Consumer Council

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Head of section, finance

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