Supporter / Investor

Risk category: GENERAL

#8 - Limited knowledge on alternative finance

Definition

Alternative finance is an economic dynamic characterized by specific procedures, particular actors, different timing and budget structure. The crowdfunding world is extremely diverse and the process sometimes more complicated that it seems, as it requires high degree of self-assessment and selection of investment opportunities. Choosing for the project to support might be tricky - timing, warranties and investment conditions, procedures...

Lack of experience might lead to invest money on unrealistic projects, resulting in financial losses or in unsatisfaction. In the same way, lack of economic literacy can result in risky financial behaviors - i.e. excessive and unconscionable investments, which overcome the real financial capacity.

Focus on: Digital inequality and illiteracy

As per definition, crowdfunding is a financial operation happening via an **internet-based platform**. As a matter of fact, thus, supporters who are digitally illiterate or with limited access to the internet, can be deprived of the opportunity to participate, unless assisted by intermediate agents. This potential participant category might encompass a significant segment of middle-age and older citizens, especially in countries or territories where digital literacy has not well developed yet. Interestingly, these areas would be the ones in **greater need** for successful crowdfunding projects.
As a result, this citizen segment is cut-off from the benefits of crowdfunding both in economic and social-development terms. They are also the most-likely ones to fall victim of **malpractice and fraud** (either through incompetence or deceptive intention) by self-proclaimed intermediates that volunteer to mediate between them and the crowdfunding platform.

Mitigation strategy

Get preliminary training on alternative finance tools and procedures – attend local workshops and basic preparation, relying on experienced coaches and training centers – as well as on private financial accountants or bank analysts, to set the investment capacity.
In case of doubt about the product or initiative to support, always collect all the information on the project owner available on the internet and on the platform.

In general terms, make personal, grounded and well considered decisions when choosing on which project to place a certain amount of money. Do not rely on what "the mass" or friends preferred, as it is not always a certainty for success and satisfaction. Instead of be supportive of the “herd mentality”, check the support of other credible **local organizations or public authorities.** The engagement of an institutional actor might give the adequate level of accountability of a certain project and ensure the campaign accomplishment.

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Supporter / Investor

Risk category: GENERAL

#9 - Illiquidity, late returns & increase in default

Definition

In case of equity crowdfunding, future returns are expected from investments. However, it may take long to materialize if at all, in case of difficulty to scale the business. The chance that a company or individual will be unable to make the required payments on their debt obligation might happen to lenders and investors in virtually all forms of credit extensions. Market rules imply that higher levels of risk lead to higher required returns, and in turn, to higher interest rate. It is important to consider that, in the event of a default, investors may lose out on periodic interest payments and their investment in the bond.
Also due to value fluctuation, alternatively, assets may be subject to capital erosion over time.

The future of an investment, on the other hand, might also be represented by an **exit option** – which happens when a bigger and larger company, a venture capital or a "business angel" absorbs or buys the start-up out. The likelihood to accept this event is not to be declared, nor can it be forecasted at the moment of the investment. This change on the horizon can surely require for adjustments and further tuning of the individual financial prospect and forecast.

Mitigation strategy

Diversifying the investments is a good practice to prevent losing large amounts or the risk of capital erosion.
Before investing it would be necessary to do an appropriate financial measurement to estimate the riskiness of the debt operation, also assessing the ability of a company to meet financial obligations.
Default risk can be detected using standard measurement tools, including FICO scores for consumer credit, and credit ratings for corporate and government debt issues - provided by nationally recognized statistical rating organizations (NRSROs).
In case of lending, it might be considered to charge rates of return that correspond the debtor's level of default risk ot to opt for fixed-income securities, i.e. an investment providing a level stream of interest income over a period of time.
In relation to the exit option, the investors should require transparency and openness on when and how they will be able to withdraw their initial investment, along with any associated gains and overhead or the "tag-along" practice.

Focus on: The absence of a secondary market

For investors it would be relevant to have an early-stage equity secondary market as to be allowed to realize returns by selling shares in other companies or to reinvest in other firms, to either increase their share or buy into a round they may have otherwise missed out on.
Given that at the present time there are no secondary markets in place or only very few platforms have this option, it is necessary to consider having enough liquidity, as equity investments are blocked for 7-15 years and as no secondary markets are open to trade or sell shares/bonds.
Very experienced investors might consider adopting BDLT solutions. In fact, ledger technology (DLT) and blockchain offer the adequate infrastructure for secondary markets, enabling SMEs to exchange equity CF shares with security token to create liquidity. In other words, they eliminate the financial intermediary by providing an interface to connecting SMEs and investors.

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Risk category: GENERAL

#10 - Uneven or unclear regulatory system

Definition

Supporting a project on a foreign platform might be an interesting option to broaden the individual portfolio of investments, as it opens up to larger markets. Nonetheless, the lack of an international or EU-wide common crowdfunding regulation makes it unclear which law is to apply: the one of the SME's seat? Or does it depend on the platform? Or, even, on the supporter's location?

Same confusion might arise in relation to taxes. The latter, in fact, most of time depends on the national regulation, thus the fiscal impact or absorption of the investment may vary and not be clear in case of cross-border activity. Lack of coordination between legislations in different countries and a scarce guidance on applicable fiscal regulation could result in market fragmentation and law-breach, even unintentionally.

Sometimes, furthermore, different countries impose different investment limitations to the individuals, thus legal issues might arise in relation to the platform's fundraising terms and conditions.

Mitigation strategy

Before transferring or investing money on any project, it is key to check and verify its legal and fiscal terms, as well as the ones concerning the platform. Make sure the platform displays:

- legal framework
- the authority of reference
- division of responsibilities
- contractual details / obligations

Such information are an indicator of reliability, as they prevent future fiscal or legal issues. Require the platform to transparently express the specific country regulation applied, so that to avoid future fiscal issues or legal malpractices.

Focus on: the European Crowdfunding Service Providers (ECSP)

In order to better coordinate and make the diverse national legislation uniform, a new legislation has been proposed and is being adopted by the European highest institutions. It is the European Crowdfunding Service Providers (ECSP) for Business Regulation - COM(2018)0113 – C8 0103/2018 – 2018/0048(COD), which has the potential to make **pan-European crowdfunding** a reality.
Such regulation will harmonize the legal framework for the sector, offering a well-defined and structured legal skeleton for the activities of crowdfunding for business (lending and equity) all over Europe. The main innovations will be :

- A **single set of rules** will apply to crowdfunding services in the EU, up to € 5 000 000
- Strict rules to **protect investors** from financial losses
- **Member states responsible** for authorizing and supervising crowdfunding providers

At the present, the regulation's details are still to be finetuned and technical work on the text is under way within the three institutions. The law Is expected to come into effect in 2021. This accomplishment will largely ease the crowdfunding process for all the involved actors, thus largely benefit European startups and SMEs and to European investors.

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