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# HOW DOES THE LAW PROTECT THE CROWD? ABOUT CROWD INVESTOR PROTECTION MECHANISMS INTRODUCED BY THE EU REGULATION 2020/1503

**Jakub Brejdak** *

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ABSTRACT

*Crowdfunding services provide an unconstrained pool of investors who all receive investment proposals at the same time, and they mainly entail the raising of capital from individual people, including those who are not high-net-worth individuals. Crowdfunding allows a company to raise capital without conducting a formal public offering procedure. Equity crowdfunding, as a relatively new form of raising capital for business ventures, raises many doubts in the field of corporate governance. The fundamental advantage of crowdfunding from an entrepreneur's perspective is that the founder of the company does not have to cede as many rights to crowd investors as he or she would if the investor were a venture capital or private equity fund. As a result, a crowd investor is a passive investor by definition. To unify rules among Member States and create mechanisms of protection for this completely new type of investor, the Regulation (EU) 2020/1503 was enacted.*

*This paper aims to analyze the main investor protection mechanisms included in Regulation 2020/1503 and compare them with MIFID II provisions, which constitute the main protection mechanisms for traditional retail investors. This analysis enables an answer to whether crowd investors are offered a higher level of protection than traditional retail investors. The author of this paper claims that protection mechanisms introduced by Regulation 2020/1503 regarding non-sophisticated investors are an example of increasing paternalism in the financial markets. However, the characteristic of the equity crowdfunding market justifies a higher-level paternalism and intervention in order to protect non-sophisticated investors.*

**KEYWORDS:** *crowdfunding, crowd investors, investor's protection*

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* Jakub Brejdak, Ph.D. candidate – University of Warsaw/Visiting researcher – University College London; brejdak.jakub@gmail.com.

## 1. INTRODUCTION

Crowdfunding is becoming a more and more common form of raising capital for business ventures in Europe. Collecting capital from a mass group of anonymous investors (often not professional) creates new opportunities for companies at the early stage of development that has struggled with gaining the interest of business angels and venture capital funds.[1] Crowdfunding services provide an unconstrained pool of investors who all receive investment proposals at the same time, and they mainly entail the raising of capital from individual people, including those who are not high-net-worth individuals.

The literature often highlights that crowdfunding is a cheaper and more accessible source of capital for companies than traditional ones.[2] Nevertheless, as the majority of crowd investors are unprofessional, they face a larger degree of risk than institutional investors. Inexperienced individuals who are distributing capital in crowdfunding are making decisions based not on the same factors as institutional investors.[3] Their investment decisions are often based not on the expected capital return but, for instance, on the need to show support and endorsement to the mission or value a particular project represents.[4] Moreover, as research shows, crowd investors are often consumers of products and services provided by the company in which they invest.[5] Given the above, crowd investors elude the standard types of investors, creating an entirely new group of financial market participants.

This paper aims to analyze the main investor protection mechanisms included in Regulation 2020/1503 and compare them with MIFID II provisions, which constitute the main protection mechanisms for traditional retail investors. This analysis enables an answer to whether crowd investors are offered a higher level of protection than traditional retail investors. The author of the paper claim that protection mechanisms introduced by Regulation 2020/1503 regarding non-sophisticated investors are an example of increasing paternalism in the

1 Mochkabadi, K.: Volkmann, C.: *Equity Crowdfunding: a Systematic Review of the Literature*, Small Business Economics, 54(1), 2020, p. 77.

2 Klonowski, D. *Strategic Entrepreneurial Finance from Value Creation to Realization*. London, 2015.

3 Zhang, W.: et al.: *The Antecedents and Consequences of Crowdfunding Investors' Citizenship Behaviors: An Empirical Study of Motivations and Stickiness.*, Online Information Review, 43(4), 2019, p. 586.

4 Di Pietro F.: *Crowdfunding for Entrepreneurs: Developing Strategic Advantage through Entrepreneurial Finance*, London, 2020, p. 12.

5 Kuppuswamy, V.: Bayus, B.: *Does My Contribution to Your Crowdfunding Project Matter?*, Journal of business venturing, 32(1), 2017, p.72–89.

financial markets. However, the characteristic of the equity crowdfunding market justifies a higher-level paternalism and intervention in order to protect non-sophisticated investors.

## 2. INVESTOR PROTECTION

In the 1980s of the last century, there was a belief among legal doctrine related to the law & economics approach that most financial market laws are superfluous since sophisticated entrepreneurs and sophisticated investors enter financial contracts.[6] Investors typically perceive a risk of expropriation and penalize companies that did not contractually obligate themselves to treat investors fairly and provide information about themselves.[7] Entrepreneurs were incentivized to commit themselves through agreements with investors to minimize expropriation since they incurred these expenses when they issued shares.[8] However, numerous corporate governance misconducts on financial markets in recent decades and the financial crisis in 2008 showed that assumptions about deals made between rational issuers and rational investors were wrong.[9] Investors' limitations in comparing investments and evaluating long-term performance, all serve to increase information asymmetries.[10] Retail investors also have little power to oversee intermediaries and negotiate for safeguards.[11] Between retail investors and financial intermediaries can occur agency conflict.[12] Primarily, those issues are visible in the context of non-sophisticated investors who are unable to protect their rights through contracts. This type of investor is becoming more and more present in the financial markets, among others, in relation to the development of crowdfunding.

Currently, the prevailing view of legal researchers is that protecting investors promotes the growth of financial markets.[13] The protection can be focused

[6] Easterbrook, F.: Fischel, D.: *The Economic Structure of Corporate Law*, Cambridge MA, 1991.

[7] Ibidem.

[8] Bradley, C.: *Disorderly Conduct: Day Traders and the Ideology of 'Fair and Orderly Markets*.', The Journal of Corporation Law, 26(1), 2000, p. 65.

[9] Busch, D., *MiFID II and MiFIR: stricter rules for the EU financial markets*, Law and Financial Markets Review, 11(2), 2017, p. 127.

[10] Garten, H.: *The Consumerization of Financial Regulation.*, Washington University Law Quarterly, 77(2), 1999, p. 287–290.

[11] Ibidem.

[12] Howells, G.: *The Potential and Limits of Consumer Empowerment by Information.*, Journal of Law and Society, 32(3), 2005, p. 349–370.

[13] La Porta, R.: et. al.: *Investor Protection and Corporate Governance*, Journal of Financial Economics, 58(1), 2000, p. 3–27; Giannetti, M.: Koskinen, Y.: *Investor Protection, Equity*

on eliminating information asymmetries and preserving at the same time individual autonomy and favoring minimal intervention.[14] An example of this approach is the disclosure regime that requires the publication of relevant information in order to enable investors to evaluate their options and choose the best investments based on reported prospective risks and rewards.[15] The main advantage of this approach is that it promotes investor autonomy. The underlying presumption is that individuals will make wise judgments if provided with accurate information.[16] Nevertheless, in recent years increasing popularity is reaching a more paternalistic approach to investor protection which is more related to intervention for the person's "own good" and less oriented on reducing information asymmetries.[17] Paternalism is to assist those whose "judgment is so impaired due to immaturity, ignorance, incompetence, or the like that they do not know or appreciate that they are about to harm their interests".[18] Behavioral finance research shows that investment decisions are impaired by many systematic biases and cognitive errors.[19] The most common cognitive errors include overconfidence and over-optimism.[20] Investors may have too positive expectations for the market's future and their performance. Although they are aware that there is a chance for negative results, they think that only other individuals face these risks and not them specifically. On the crowdfunding market significant is also herding behavior described often as "wisdom of the crowd".[21] When crowd investors see other investors acting in a certain way, they may respond instinctively and do the same. Market breakdowns and speculative bubbles may be exacerbated by strong herding effects.[22]

*Returns, and Financial Globalization*, Journal of Financial and Quantitative Analysis, 45(1), 2010, p. 135-168.

14 Moloney, N.: *How to Protect Investors : Lessons from the EC and the UK*, Cambridge 2010, p. 46.

15 Ripken, S.: *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, Baylor Law Review, 58, 2006, p. 149-156.

16 Ibidem.

17 Ogus, A.: Regulatory Paternalism: When Is It Justified, in: Hopt K. et. al. (ed.): *Corporate Governance in Context* Oxford, 2005, p. 303.

18 Garren, D.: *Paternalism, part II*. Philosophical Books, 48(1), 2007, p.55.

19 Pompian, M.: *Behavioral Finance and Wealth Management How to Build Investment Strategies That Account for Investor Biases,* Hoboken, 2012.

20 Ripken, S.: The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation, Corporate Law: Securities Law, 2006, p. 149-156.

21 Hossain, M.: et al.: *Wisdom of the Crowd and Stock Price Crash Risk: Evidence from Social Media*. Review of Quantitative Finance and Accounting, 58(2), 2022, p. 709–742.

22 Juurikkala, O.: *The Behavioral Paradox: Why Investor Irrationality Calls for Lighter and Simpler Financial Regulation*, Fordham Journal of Corporate & Finance Law, 33, 2012, p. 40.

Paternalism is not only an act of kindness and benevolence of society toward vulnerable individuals, but it also protects whole markets and societies as aggregated errors and wrong decisions can have much wider consequences.[23] It is claimed that a paternalistic approach is justified when the benefits to investors from using an appropriate legal tool to reduce harmful externalities must be weighed against the expense of that intervention.[24]

Given the above, the EU Regulation 2020/1503 has an important goal to achieve with investor protection mechanisms. As crowdfunding enables numerous non-sophisticated investors to enter the financial markets for the first time, the regulation has to provide a suitable level of protection, balancing between investors' lack of financial knowledge and a risk appetite that is inherently associated with financial markets.

In the EU, the main framework for investor protection was introduced by MiFID II, which was implemented in the aftermath of the financial crisis in 2008.[25] MiFID II aimed to increase the protection of retail investors, enlarge it for more financial products and improve transparency in the market.[26] As a matter of principle, the scope of MiFID II encompasses the whole financial market. Nevertheless, the early years of crowdfunding practice in Europe proved that the equity crowdfunding practice escapes traditional financial market conventions and non-sophisticated crowd investors do not always behave the same way as retail investors do.[27] Moreover, several Member States introduced specific regulations on crowdfunding.[28] As a result, crowdfunding platforms were subject to a variety of national regimes, which broke up MiFID's harmonization and made it difficult to create a pan-European market for crowdfunding services.[29] That is why Regulation 2020/1503 set out specific rules for protecting investors in the crowdfunding market. Many rules implemented by Regulation 2020/1503 are directly related to MiFID II, but some of them indicate significant differences.

[23] Ripken, S.: *Paternalism and Securities Regulation*, Stanford Journal of Law, Business & Finance, 21(1), 2015, p. 55-56.

[24] Moloney, N.: *How to Protect Investors : Lessons from the EC and the UK*, Cambridge 2010, p. 301.

[25] Della Negra, F. *MiFID II and Private Law: Enforcing EU Conduct of Business Rules*. London, 2019.

[26] Busch, D., Ferrarini G., *Regulation of the EU Financial Markets : MiFID II and MiFIR.*, Oxford, 2017.

[27] Ibidem.

[28] Cicchiello, A., *Harmonizing the Crowdfunding Regulation in Europe: Need, Challenges, and Risks*. Journal of Small Business and Entrepreneurship, 32(6), 2020, p. 588.

[29] Ibidem, p. 84.

## 3. EQUITY CROWDFUNDING – MARKET MECHANICS

Regulation 2020/1503 in art. 3 oblige crowdfunding platforms to act honestly, fairly, and professionally and operate "as neutral intermediaries between clients". Those three fundamental standards protect transactional certainty and ensure investors are on the market. Further general standards are included in art. 19 which states that all information published by crowdfunding platforms should be fair, clear, and not misleading. The standards mentioned above are based on the idea that financial markets are transparent, which presupposes that market participants should have access to the data they need to make informed decisions. Crowdfunding service providers play a crucial role in shaping the effectiveness of the crowdfunding market as infrastructure providers for the functioning of this market. Contrary to investment firms regulated by MIFID II that operate on markets centered around main stock exchanges, crowdfunding platforms are creating and facilitating their market venues for transactions. Each crowdfunding service provider has its digital venue to service transactions and there is no one center market.

Regulation 2020/1503 highlights the neutrality of crowdfunding service providers but accommodating both sides of the market; buy-side (crowd investors) and sell-side (project owners) may create conflicts of interest. Regulation 2020/1503 forbids the participation of crowdfunding service providers in the offers. In addition, crowdfunding service providers should implement internal policies to ensure effective and prudent management, including the segregation of duties, business continuity, and the prevention of conflicts of interest, in a manner that promotes the integrity of the market and the interests of its clients. In art. 5 of Regulation 2020/1503 it is stated that a crowdfunding service provider shall undertake at least a minimum level of due diligence in respect of project owners that propose their projects to be funded through the crowdfunding platform of the crowdfunding service provider. But in fact, the legal requirement of due diligence is narrowed only to the project owner's check of a criminal background and non-cooperative jurisdiction establishment.

In his remarkable *efficient markets hypothesis*, Eugene Fama claimed that share prices reflect the accessibility of information on a particular market.[30] The market characterized as low efficient share valuation is based on the share price in the past. The semi-efficient market price of shares reflects all publicly available data like financial and annual reports. Strong efficient markets are those where price reflects all data that is not publicly available or confidential. In Fama's framework, used primarily to describe public markets, the equity

[30] Fama, E., *Efficient Capital Markets: A Review of Theory and Empirical Work.*, The Journal of Finance, 25 (2), 1970, p. 383–417.

crowdfunding market of private companies at the early stage of financing should be considered highly inefficient. The share price offered to crowd investors is determined based on valuations carried out at the request of the companies. Then this price is offered to investors, most of whom do not have the instruments and knowledge to verify it. That is why crowdfunding service providers play a crucial role in gatekeeping the information provided to investors.[31] Regulation 2020/1503 with annexes sets rules for publishing key investment information sheets. The sheet is an information document similar to the prospectus required for the IPO. However, contrary to the prospectuses that need to be approved by financial supervision authorities, the key investor information sheet does not require approval by the authority. Therefore, the crowdfunding service provider should verify those documents' completeness, correctness, and clarity. The crowdfunding platform also has the right and obligation to halt or withdraw the offer containing any error. As a result, crowdfunding services providers are highly responsible for the efficiency of the market they are creating. Nevertheless, it has to be also highlighted that the vast majority of crowdfunding service providers are charging fees from both sides of the market, which creates a strong incentive to boost the volume of transactions on their platforms. This incentive does not need to be aligned with the role of the gatekeeper function of crowdfunding service providers described above as quality can give way to the quantity of offered projects. In the situation where a crowdfunding service provider starts to be less selective in terms of offered projects on the platform, it becomes riskier for investors. It is a conflict of interest that has not been addressed by the regulation so far.

Concerning key investment information sheets it should be also mentioned that often the question arises as to whether the abundance of information actually enables investors to make well-informed judgments.[32] Even though the Regulatory Technical Standards set out the model of a key investment information sheet to increase comparability and clarity of data presented in the document, it still remains hardly likely that an individual without a financial background will be able to analyze it correctly.[33] Without the ability to be understood by

[31] Lee, J.: Investor Protection on Crowdfunding Platforms, in: Ortolani P., Louisse M. (ed.): *The EU Crowdfunding Regulation*, Oxford 2021, p. 376.

[32] Moloney, N.: *How to Protect Investors: Lessons from the EC and the UK*, Cambridge, 2010, p. 288; Enriques L.: Gilotta S.: Disclosure & Financial Markets Regulation, in: Moloney, N. et. al., *The Oxford Handbook of Financial Regulation*, Oxford, 2015, p. 511-536.

[33] Draft technical standards under the European crowdfunding service providers for business Regulation, 2021.

investors, regulated disclosures are likely a misuse of regulatory effort.[34] That is why the paternalistic approach which focuses on creating incentives for stimulating non-sophisticated investors' decisions for their "own good" rather than just providing an abundance of information to investors might be more effective.

## 4. CATEGORIZATION OF INVESTORS

Financial markets law traditionally creates levels of protection for different types of investors.[35] Various types of investors differentiate themselves in terms of the size of capital under management, experience, knowledge about financial markets, and risk appetite. Based on investor categorization, financial regulations offer a suitable level of protection.

Crowd investors, similarly to traditional investors, are not a homogenous group. The divergence in experience and held assets between investors in crowdfunding can be significant. That is why Regulation 2020/1503 introduces the main distinction of crowd investors into two types: sophisticated and non-sophisticated. This regulatory solution aims to match the degree of protection of the investor in a manner adequate to his or her knowledge and experience in financial markets. This distinction is patterned after the distinction for professional and retail investors from MiFID II, but it is adapted to the characteristics of the crowdfunding market. As a result, those two distinctions coincide in many elements but are not identical.

The analysis of the sophisticated investor already shows significant alignment with the MIFID II as part of the definition refers directly to this act and the list of professional clients treated as sophisticated investors under Regulation 2020/1503. Some researchers call professional clients from Annex II sophisticated investors *per se*.[36] In addition to sophisticated investors *per se,* some *opt-out* sophisticated investors have the approval of the crowdfunding service provider to be treated as sophisticated investors. Annex II to Regulation 2020/15 sets out different criteria for the approval of natural persons and legal entities. The legal entity to be approved and treated by the crowdfunding service pro-

34 Moloney, N.: *How to Protect Investors : Lessons from the EC and the UK*, Cambridge, 2010, p. 362.

35 Domina, M.: *Rethinking the Classification of Investors in Collective Portfolio Management: Towards a Recognition of Semi-Professional Investors.*, Journal of Business Law, 6, 2021, p. 499-518.

36 Lee, J.: Investor Protection on Crowdfunding Platforms, in: Ortolani P.: Louisse M. (ed.): *The EU Crowdfunding Regulation*, Oxford 2021, p. 376.

vider as a sophisticated investor needs to meet at least one of the following identification criteria:1) own funds of at least EUR 100 000; 2) net turnover of at least EUR 2 000 000; 3) balance sheet of at least EUR 1 000 000. Each criterion relates to a different indicator in the accounting ledgers so that, with the currently very diverse financial structures of legal entities, the most extensive possible range of entities can be covered by those criteria. These criteria indicate that the size of the entity, and not the type of activity, determines the classification of a legal entity as a sophisticated investor.

Natural persons to be treated as sophisticated investors need to meet at least two of the following identification criteria:1) personal gross income of at least EUR 60 000 per fiscal year or a financial instrument portfolio, defined as including cash deposits and financial assets, that exceeds EUR 100 000; 2) having at least one year of work experience in the financial sector, in a professional position which requires knowledge of the transactions or services envisaged, or having held an executive position for at least 12 months in a legal person that qualifies as a sophisticated investor according to the aforementioned criteria; 3) having carried out transactions of a significant size on the capital markets at an average frequency of 10 per quarter, over the previous four quarters. The criteria for natural persons, as opposed to those established for legal persons, include not only financial resources but are also related to the activity and experience gained directly on the financial market. Certain doubts can be expressed if particular criteria are arranged properly. The threshold of gross income on the level that doubles the average salary in the EU seems to be too low, even considering the requirement of fulfilling the second criterion.[37] Especially in the Member States where salaries are relatively higher, the number of investors classified as sophisticated can be considerable. Low-placed criteria in the categorization of investors can have a significant impact on the general protection mechanisms in crowdfunding. A minimal level of protection for sophisticated investors is envisaged to facilitate only the most financially knowledgeable market participants but it's not suitable for the majority of crowd investors.

When an investor is recognized as sophisticated, the recognition is valid for two years. The crowdfunding service provider must be informed of any change that would affect a sophisticated investor's status, and the crowdfunding service provider must notify the investor that they will no longer be classified as sophisticated if the requirements are no longer met. As the vast majority of criteria based on investors' financial situation are variable, the categorization of investors is also changing.

[37] [https://www.reinisfischer.com/average-monthly-salary-european-union-2022], accessed on 14/11/2022.

According to art. 2 of Regulation 2020/1503, all entities that have not been classified as sophisticated should be treated as non-sophisticated investors. Crowdfunding service providers are obliged to guarantee a higher level of protection to all entities classified as non-sophisticated investors. To this end, crowdfunding service providers are required to conduct an investor knowledge test about the risks associated with crowdfunding. Moreover, crowdfunding platforms can accept only investments from non-sophisticated investors who have confirmed that they are familiar with the warnings related to the risk associated with a given investment. In addition to the specific disclosure obligations imposed on crowdfunding platforms towards non-sophisticated investors, Regulation 2020/1503 obliges crowdfunding service providers to set the maximum amount of capital that non-sophisticated investors can invest in a single project. This solution is to protect investors against the lack of diversification, which seems particularly important when investing in business ventures at an early stage of development.

Recital 42 Regulation 2020/1503 states that the differentiation between professional clients and retail investors provided by MIFID II should serve as a foundation for the differentiation between sophisticated and non-sophisticated investors. However, it is necessary to consider all characteristics of the crowdfunding market in the differentiation process between sophisticated and non-sophisticated investors. This recital suggests that categories of retail clients and non-sophisticated investors are similar but not synonymous. Firstly, MIFID II introduced the same criteria of categorization for natural persons and legal entities, while Regulation 2020/1503 set out various criteria for natural persons and legal entities. As a result, an investor (especially a natural person who needs to meet only one of three criteria) may be acknowledged as a sophisticated investor according to Regulation 2020/1503, but it will not be considered a professional client under MiFID II.[38]

Secondly, crowdfunding service providers are obliged to evaluate the status of sophisticated investors every two years, while investment firms do not have to evaluate the status of professional clients regularly. It suggests that legislators expect variability in the status of crowdfunding investors, who largely are individuals, not institutions. Professional clients under MiFID II have mainly institutional character. It is reasonable to expect that institutional investors are more resilient to any volatility in the market than individuals (even experienced high-net-worth individuals). Professional clients are in the vast majority of cases licensed or authorized by market bodies, so there is no need to obligate investment firms to evaluate their status regularly. Noteworthy is the fact that a

[38] Lee, J.: Investor Protection on Crowdfunding Platforms, in: Ortolani P.: Louisse M. (ed.): *The EU Crowdfunding Regulation*, Oxford, 2021, p. 377.

professional client is able to ask an investment firm to be treated with a higher level of protection applicable to retail investors. On the contrary, sophisticated crowd investors do not have the right to choose between protection levels.

The categorization of investors should be seen as a tool to lay foundations for more paternalistic mechanisms. Regulators create criteria based on income and net worth levels to safeguard investors and apply the proper level of protection in order to prevent investors from losing sizable portions of their wealth or suffering financial losses that could prove disastrous. The goal is to protect crowd investors, as well as the entire market, from making wrong decisions that can disproportionately affect investors' welfare and market stability. The idea to create different levels of protection suitable to the individual experience and net worth has been deployed in capital markets regulation for many years and does not arouse any doubts. More disputable is the fact that Regulation 2020/1503 first set up a relatively low threshold for categorization as a sophisticated investor (wider than professional clients under MiFID II) and then addresses the vast majority of protection mechanisms only to non-sophisticated investors. However, research shows that investors which are categorized as sophisticated by the legal rules, in fact often do not have the required expertise to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment.[39] This group of investors is also vulnerable to cognitive biases. Some scholars highlight the financial crisis in 2008 was fueled mainly by professional investors' errors and wrong decisions and not retail investors who just suffered because of the decisions of financial institutions.[40] The fact that Regulation 2020/1503 by soothing criteria for investor recognition is sophisticated and leaves many individuals with a lower level of protection is causing a risk of possible market breakdowns.

## 5. ENTRY KNOWLEDGE TEST AND SIMULATION OF THE ABILITY TO BEAR A LOSS

The main aim of testing investors' knowledge is prevention from the uninformed ineffective behavior that is common in the equity crowdfunding market.[41] In the crowdfunding markets, statistically, there are many more nonpro-

[39] Smith, F.: *Madoff Ponzi Scheme Exposes 'the Myth of the Sophisticated Investor.'*, University of Baltimore Law Review, 40(2), 2010, p. 219-223.

[40] Davidoff Solomon, S.: Hill, C.:, *Limits of Disclosure,* Seattle University Law Review, 36, 2013, p. 602.

[41] Armour, J.: *Principles of Financial Regulation*, Oxford, 2016, p. 226.

fessional investors than in any other segment of the financial markets.[42] Many investment decisions on crowdfunding platforms are based on the willingness of an investor to show support for the values or purpose of a particular venture. Traditional indicators of successful investment, ROI or annual dividends, are not the main driver for crowd investors. This whole spectrum of various motivations behind investment decision in crowdfunding cause crowdfunding service providers to be fully responsible for a diligent *know-your-customer* (KYC) process. The KYC process is not only valuable for protecting against fraud or money laundering. But in fact, it also gives a basic notion of an investor's financial situation, knowledge, experience, and or motivations. It must be highlighted that crowd investors do not need specific financial knowledge to invest but should be aware of the possible economic consequences of their decisions. According to Regulation 2020/1503, all non-sophisticated investors should be evaluated by the test before fully accessing any offer on the crowdfunding platform. In practice, investors are tested at the moment of registering on a crowdfunding platform. The test contains two parts: 1) the first one evaluates investors' prior activity on the financial markets; 2) the second one checks investors' awareness of fundamental financial markets rules and possible risks. Suppose a test shows that a particular investment opportunity is unsuitable for the investor's profile. In that case, the crowdfunding service provider is obliged to inform the investor about this and communicate the risk of losing capital. An investor who receives communication like this must confirm that they understand it and are aware of potential risks. The Regulatory Technical Standards harmonize the text and way of displaying test results and warnings for the investors to ensure that those investors are informed clearly and in a uniform manner about the risks they would incur if they decided to invest in crowdfunding services. The attempt to harmonize the entry knowledge test is important from the market stability perspective. An investor who is investing in similar projects on different platforms should receive similar results from the test. Otherwise, instead of a universal investor protection mechanism, an entry knowledge test would become a subjective tool in the hands of crowdfunding service providers without real benefits for investors.

In addition to the entry knowledge test, Regulation 2020/1503 obliges crowdfunding service providers to simulate non-sophisticated investors' ability to bear the loss, calculated as 10 % of their net worth. The simulation is based on their total income, owned assets, and financial commitments. Suppose an investor decides to invest more than 1000 euros or 5% of his or her net worth. In that case, a crowdfunding service provider must put forward a risk warn-

[42] Di Pietro, F.: *Crowdfunding for Entrepreneurs Developing Strategic Advantage through Entrepreneurial Finance*, London, 2020, p.43.

ing and receive confirmation from the investor of getting acquainted with that notification. Those mechanisms illustrate the nature of crowdfunding, which is about collecting relatively small amounts of capital from a wide range of investors. According to Regulation 2020/1503, an investment of 1000 euros should be considered significant enough to provide extra risk warnings for the investor.

It is essential to highlight that regardless of the result of a test knowledge and simulation results, crowdfunding service providers cannot prevent potential investors from taking advantage of an investment opportunity on the platform. The knowledge test has mainly an awareness-rising and educational value. However, those functions of tests and simulation should not be underestimated. By addressing, or at least emphasizing, the biases that investors experience, better investor education may reduce the expanded danger of investing errors and provide the most long-term prospects for more rational decision-making.[43] It is also claimed that investor education supports greater market participation.[44]

Similarly, to Regulation 2020/1503 also, MIFID II establishes an entry knowledge test for investors. Nevertheless, the tests introduced by MIFID II are more complex. Investment firms must conduct two types of tests: the appropriateness test and the suitability test. The distinction between the two different assessments is based on the various roles that investment firms are able to perform. Investor services including reception and transmission of orders in financial instruments; and the execution of orders in financial instruments on behalf of clients require conducting an appropriateness assessment of retail clients. The appropriateness test applies to retail clients regarding enabling the investment firm to obtain information about the client's knowledge and experience of the relevant financial instrument or the relevant service so that it can assess whether the financial instrument or service is appropriate for the client.[45] In case that investment firm is offering investment advice or portfolio management the suitability test must be applicable. The suitability test enlarges the assessment of knowledge and experience setting the main focus on investors' financial situation, objectives, and risk tolerance.[46]

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[43] Cunningham, L.: *Behavioral Finance and Investor Governance*. Washington and Lee Law Review, 59(3), 2002, p. 788-792.

[44] Choi, SJ.: Pritchard, A.: *Behavioral Economics and the SEC*. Stanford Law Review, 56(1), 2003, p. 72.

[45] Busch, D.: *MiFID II. Stricter Conduct of Business Rules for Investment Firms*., Capital Markets Law Journal, 12(3), 2017, p. 361.

[46] Ibidem, pp. 366.

As the crowdfunding platform does not provide financial advice neither portfolio management, so it is not obliged to conduct this particular assessment. The role of a crowdfunding service provider can be described as passive. Their main task is to provide the necessary infrastructure and create safe market conditions for both sophisticated and non-sophisticated investors. Therefore, the knowledge test carried out by crowdfunding platforms, both in its structure and its goals, is more similar to the appropriateness test than the suitability test. Nevertheless, Regulation 2020/1503 provides a possibility for crowdfunding service providers to obtain investment firm status. In that case, a crowdfunding platform could be able to offer a wider pool of services that may require suitability assessment.

## 6. COOLING-OFF PERIOD

Cooling-off periods are typical mechanisms for consumer protection law.[47] This legal institution is widely used in e-commerce but also some jurisdictions applies among others to timesharing, insurance services, and loans.[48] Although it has been applied to particular financial products over the years, the cooling-off period is not a typical investor protection mechanism, and it does not occur in MIFID II. That is why the pre-contractual reflection period is included in the art. 22 of Regulation 2020/1503 should be considered a novelty in the European investor protection standards.

Cooling-off periods in the past were not used widely in investment transactions because legislators feared potential usage for speculation on the stock market.[49] There is a risk that some financial consumers could benefit from the ability to withdraw after a few days from the investment in case the share price went down. However, in equity crowdfunding investments share price fluctuations are much more minor (if those fluctuations occur at all) in comparison with public stock markets. The company sets out the share price on the crowdfunding platform based on the company's valuations. As equity crowdfunding investments are characterized as highly illiquid and the secondary markets equity crowdfunding is much less developed than in the traditional

[47] Atwell, C.: *Cooling Off Periods in Franchise Contracts: From Consumer Protection Mechanisms to Paternalistic Remedies for Behavioral Biases*, Business and Politics, 17(4), 2015, p. 699.

[48] Rekaiti, P.: Van den Bergh, R.: *Cooling-Off Periods in the Consumer Laws of the EC Member States. A Comparative Law and Economics Approach*. Journal of Consumer Policy, 23, 2000, p. 374.

[49] Izdebski, P.*: Konsumenckie prawo odstąpienia od umów o świadczenie usług maklerskich*, Monitor Prawniczy, 3, 2020, p. 136.

public markets, the share price of crowdfunding projects is much less volatile from a short-term perspective.[50] Consequently, it should be claimed that the risk of speculation in equity crowdfunding is relatively low and should not be considered an obstacle in implementing a cooling-off period in equity crowdfunding markets.

The cooling-off period aims to protect the weaker side of the contract from manipulations and abuses from the stronger side, which distinguishes itself from a professional nature in a particular transaction. In the literature, it is often highlighted that cooling-off periods have two main functions: 1) reducing information asymmetry; 2) preventing the consumer from the consequences of decisions made under psychological pressure.[51] Those two functions can be straightforwardly observed in the example of distance selling. A consumer is receiving a product that he or she could not verify in person before making the purchase decision. That distance between the consumer and seller creates asymmetry information, which is reduced by giving the consumer a chance to resign from the transaction after receiving the product and verifying it in person. Purchasing on the Internet can also create psychological pressure as e-commerce websites use aggressive marketing tools that are often overwhelming for consumers.[52] The right to resign from the transaction for 14 days set out in the Directive 2011/83/EU on consumer rights gives consumers the ability to "cool off" and rethink the purchase.[53]

The question arises if the same two functions will be performed by cooling off period in applying this mechanism to equity crowdfunding. Undoubtedly, crowd investors are prone to incentives that significantly impact their behavior and can create psychological pressure. The most widely described in behavioral finance research on this type of financing is a phenomenon called "wisdom of the crowd".[54] Crowd investors, especially non-sophisticated ones, have strong preferences to invest in projects that have already collected the vast majority of the targeted amount of capital. Commonly, crowdfunding platforms

[50] Brejdak, J.: *Rynek wtórny finansowania społecznościowego*, Przeglad Prawa Handlowego, 3, 2022, p. 53.

[51] Rekaiti, P.: Van den Bergh, R.: *Cooling-Off Periods in the Consumer Laws of the EC Member States. A Comparative Law and Economics Approach*. Journal of Consumer Policy, 23, 2000., pp.381.

[52] Luzak, J.: *To Withdraw Or Not To Withdraw? Evaluation of the Mandatory Right of Withdrawal in Consumer Distance Selling Contracts Taking Into Account Its Behavioural Effects on Consumers*., Journal of Consumer Policy, 37(1), 2014, p. 91–111.

[53] Ibidem.

[54] Hossain, M.: et al.: *Wisdom of the Crowd and Stock Price Crash Risk: Evidence from Social Media*. Review of Quantitative Finance and Accounting, 58(2), 2022, p. 709–742.

present progress in raising funds with visual graphics highlighting how much is already collected and how close it is to reach the target or even becoming overfunded. As behavioral finance research shows, non-sophisticated investors have a strong preference for projects that have already reached the target.[55] Thereby, the non-sophisticated investor is following the "crowd". In addition, crowd investors receive regular notifications about passing time to invest in a particular project, which increases pressure on them. That is why implementing a cooling-off period for non-sophisticated crowd investors to minimize the negative consequences of investment decisions made under psychological pressure seems undoubtedly justified.

More questionable is if the cooling-off period in equity crowdfunding addresses the information asymmetry issue. In the distance selling example, consumers, through the cooling off period, were able to verify the product in person, so they were obtaining extra information about the product which they had not possessed at the moment of making the purchase decision. In the case of equity crowdfunding investment, the cooling-off period does not contribute any new information about the company or offered shares. It can be claimed that the asymmetry information issue is addressed by the requirements for the key investor information sheet and several other investor protection mechanisms discussed above like the entry-knowledge test. Those mechanisms increase crowd investors' awareness and educate them about the market before investing. The cooling-off period gives an investor a chance to change the decision about the investment without providing any new information. That shows that consumer protection mechanisms implemented in financial markets can address different issues.

## 7. CONCLUSIONS

Equity crowdfunding brought a new type of investor to the financial markets. Consequently, Regulation 2020/1503 introduced a new classification of investors, which differs from the categories used in MIFID II. The majority of crowd investor protection mechanisms reflect those already found in the application in traditional capital markets for retail clients with respect to the equity crowdfunding market characteristic. The novelty in investor protection is the cooling-off period, which enhances the investor protection level compared to MIFID II provisions. All implemented mechanisms of investor protection seem to be the epitome of a paternalistic approach, so the reduction of information asymmetry is not the main focus.

[55] Polzin, F.: et al.: *The Wisdom of the Crowd in Funding: Information Heterogeneity and Social Networks of Crowdfunders*. Small Business Economics, 50(2), 2018, p. 254.

The higher level of crowd investor protection and well-established consumer protection mechanisms introduced to the capital markets prove that non-sophisticated investors should be considered one of the most vulnerable groups in the financial markets. The paternalistic approach of the EU legislator seems to be justified and necessary to ensure further development of the European equity crowdfunding market. Investing is inherently risky, and the law certainly cannot guarantee positive returns, but the protection mechanisms should enable secure and stable market conditions for the most vulnerable and inexperienced investors who are dominating crowdfunding markets.

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