



Regulators' views on crowdfunding

Introduction

Crowdfunding becomes more and more a viable alternative manner of financing. Echoing the established example from the United States, crowdfunding already forms a serious alternative for funding small and medium sized enterprises in the United Kingdom. Other Member States have woken up as well resulting in a relatively fast growing crowdfunding market in continental Europe.¹ This rapid growth seems to have alerted the regulators, leading to the publication of a number of interesting views of the supervisory authorities.

Types of crowdfunding

The European Commission distinguishes three main models of crowdfunding:

- crowd sponsoring by means of donations or reward-based crowdfunding;
- crowd investing by means of the issuance of securities (such as debt-based securities and equity-based crowdfunding) or by sharing profits (profit-sharing crowdfunding); and
- crowd lending by means of the provision of credit either to consumers (P2P consumer lending) or to SMEs (P2B business lending).

Regulatory framework

Other than crowd sponsoring, crowd investing and crowd lending are generally forms of crowdfunding that are affiliated to the financial markets and therefore to the financial supervisory and regulatory framework. It should be noted, however, that money-handling - and therefore the regulations in respect of payment services providers - will also be an aspect that needs to be taken into account in crowd sponsoring. As such, none of the crowdfunding models is fully off the regulatory hook.

Until now, regulators of Member States have been operating in the dark and acting on their own as regards their interpretations of the different crowdfunding structures that they have been confronted with or that are being established in their respective jurisdictions. Some jurisdictions have developed, or are in the process of developing, crowdfunding specific national laws; some jurisdictions, like the Netherlands, have acknowledged the necessity of more guidance from the legislator and other jurisdictions have adopted a 'wait and see' policy.

The recent publication of the European regulators - the European Banking Authority ("EBA") and the European Securities and Markets Authority ("ESMA") - therefore was a welcoming development. In December 2014, ESMA published its [advice](#) and [opinion on investment-based crowdfunding](#). Recently, also EBA published its [opinion on lending-based crowdfunding](#).

ESMA considers a great number of European Directives and Regulations. These include the [Prospectus Directive](#) as regards issuers of securities, the [MiFID](#) as regards investment services and the [AIFMD](#) as regards collective investment schemes.

EBA mainly takes notice of the [Payment Services Directive](#) as regards payment services providers and concludes that the [Capital Requirements Regulation](#) and [Directive](#) as regards credit institutions is of less relevance to crowdfunding because platforms will generally not qualify as credit institutions/banks.

¹ Please see Zhang, Z., Wardrop, R., Rau, P.R. and Gray, M., '[Moving Mainstream](#)', University of Cambridge and EY, February 2015.

Naturally, both European regulators pay attention to the [Anti-Money Laundering Directive](#); due to the digital nature, crowdfunding platforms can be easily misused to launder money or finance terrorism.

The Dutch regulator, the Netherlands Authority for the Financial Markets (the "AFM"), published a [report on crowdfunding](#) in December of last year as well. The report provides some insight of the reasoning of the AFM and includes the AFM's recommendations how the crowdfunding market can develop into a sustainable one.

Conclusions of the regulators

The publications of the regulators provide a good overview of the different business models used as well as of the manner in which, in their respective views, the existing European regulatory regime applies to these models. Due to the fact that there is no specific European legislation on crowdfunding as yet, nor any Dutch laws specifically relating to crowdfunding structures, each of the regulators (needs to) take the existing legislation as a basis for its analysis. This results in a somewhat artificial manner of applying a regulatory regime with the aim to safeguard that the fund givers as investors can make an informed investment decision, are not being misled and understand the risks involved in investing in crowdfunding projects.

Each of the regulators focuses on the crowdfunding platform as the subject of such regulatory regime. As such, it is mainly the responsibility of the platform that the rules are complied with and that the goals as described above can be met.

There seems to be consensus that that convergence of legal interpretation and practice in the European Union is desirable in order for the crowdfunding market to grow to a stable alternative manner of financing.

Recommendations for the platforms

When summarizing the publications of the regulators, in the ideal world, a prudent crowdfunding platform would take into account the following recommendations when offering its services.

The platform should:

prior to publishing a project on the website:

- perform identification and background due diligence on the fund seeker;
- perform know your customer checks on the fund givers and apply a suitability test after having categorized them in type of fund giver on the basis of their expertise and experience in investing;
- conduct a risk analysis;

when publishing a project on the website:

- enable fund givers to make an educated investment decision and assess the risk-reward ratio of investing in a particular project by providing easily comprehensible, complete, accurate and not-misleading information about:
 - o the project;
 - o the fund seeker;
 - o the fund seeker's creditworthiness;
 - o the terms and conditions of the investment;
 - o the characteristics of the investment;
 - o the financing mechanisms;
 - o the rights and obligations of both the fund givers and fund seeker;
 - o the risks involved in the investment;

on the basis of the due diligence, know your customer checks and risk analysis as described above;

- provide draft transaction documents on the website;

prior to closing an investment in a project:

- only allow a fund seeker to invest in a particular project after it has explicitly acknowledged its understanding of the information provided and the risks involved;
- ensure that a fund giver does not exceed applicable investment limits upon investing in a particular project;

generally:

- be as transparent as possible in respect of itself including the platform's responsibilities, the fees and cost structure and publication of default rates;
- protect the funds by segregating accounts or having similar adequate arrangements in place;
- either obtain a license as a payment services provider or outsource the money-handling activities to a third party who is a licensed payment servicer provider;
- have in place corporate governance arrangements, robust and adequate procedures and policies, effective and appropriate internal controls (i) to ensure a sound and ethical business, in particular in respect of an adequate IT system, document handling, conflicts of interest, complaints and incidents; and (ii) to prevent fraud and terrorist financing;
- establish appropriate organizational arrangements to ensure that the investments can remain being administered if the platform itself goes out of business; and
- ensure that the persons behind the platform are competent, ethical, financially sound and have the relevant capabilities to perform the services.

Our view

It is our interpretation of the above mentioned opinions, advice and report of the regulators, that they hold the view that – in the long run – a crowdfunding specific regulatory framework is inevitable. It seems a matter of time when such regime embraces this alternative financing market. As such, it may be worthwhile for platforms to take notice of the recommendations set out above in anticipation of such regulatory framework.

On the basis of the recommendations provided by the regulators, we foresee such regulatory regime to distinguish between investment-based alternative financing on the one hand and lending-based alternative financing on the other hand. However, we expect the frameworks to be fairly similar to each other as the rationale behind the regulations will be equal: the primary aim will be to safeguard the position of the consumer investing in crowdfunding (either as a fund giver or as a fund seeker). However, the regulators should also aim for a regulatory framework that is proportionate in costs, administration, time and effort that a platform needs to put into complying with the regulations. Only a regulatory framework in which both interests are in perfect balance, will contribute to the crowdfunding market actually growing to a stable and lasting alternative manner of financing.

About us

[FG Lawyers](#) is a Dutch boutique law firm based in Amsterdam, the Netherlands, with a transaction, advisory and litigation practice focusing on corporate & (alternative) finance, providing for a good quality alternative to the established large (inter)national law firms.

The [author](#) of this newsletter recently joined FG Lawyers as a partner. Her area of expertise is Dutch financial, regulatory and securities laws and regulations and she has a special focus on alternative financing structures.