



MOST IMPORTANT REGULATORY OBSTACLES TO CROSS BORDER CROWDFUNDING

Introduction

As part of the CMU Action Plan, crowdfunding is now on the radar of both the European legislator and the local legislators and regulators of the EEA Member States. It is generally believed that crowdfunding is one of the alternative manners to divide capital within the European Union to start-ups and SMEs. The recent report on the European crowdfunding sector of the European Commission has shown however that crowdfunding is still mainly a local manner of alternative financing.

Although the original idea behind crowdfunding for a project owner of offering the direct relations and investors in its network or community the possibility to invest in its company may explain the initial local focus of crowdfunding. However, times have changed. Crowdfunding is moving mainstream and offering a serious alternative to bank facilities and other types of funding to start-ups and SMEs.

Due to the lack of a clear regulatory framework and guidance in respect of crowdfunding on an European level, crowdfunding business models are not treated on a harmonized level in the EEA Member States. Even if an investment-based crowdfunding platform is required to obtain a MiFID license in its home Member State, it may experience material issues when passporting such license due to current local law approaches of crowdfunding. It is questionable whether local Member States can subject such a MiFID licensed crowdfunding platform to a considerable set of local rules and regulations, especially if the platform is only offering its investment services on a cross border basis in the host Member State. However, due to the local regulatory approaches, this is a fact of life for crowdfunding platforms that currently try to offer their services on a cross border basis.

It is important to note that a crowdfunding platform offering its services on a cross border basis will, at all times, need to take into account the local laws of the host country. Within the European Union – for now – there still are two totally different systems of law (common law in the UK and civil law in the rest of the EU) resulting in a different legal approach. Also, irrespective of the attempts to harmonize these on a European level, the private laws, tax laws and insolvency laws within the EEA Member States are generally not based on European legislation.

This is, however, generally known to businesses that go abroad. They know and understand that they need to adhere to local laws and regulations and to take into account the local law peculiarities. To that extent, it is our understanding that crowdfunding platforms who consider to offer their services cross borders, do not encounter these local law differences as an absolute legal barrier. They will generally decide to expand within Europe taken into account those local laws and regulations.

This is different for deviating financial regulatory law approaches in the Member States. These do raise considerable legal barriers which – currently more often than not – prevent crowdfunding platforms from offering their services abroad and as such do not contribute to the real potential envisaged by the EC in the CMU. The regulatory laws and regulations are generally only relevant for crowd lending platforms and crowd investing platforms. It should be noted though that money-handling - and therefore PSD II - will also be an aspect that needs to be taken into account by crowd sponsoring platforms. As such, none of the crowdfunding models is fully off the regulatory hook.

The most relevant European legislation

As indicated by the European regulators (EBA and ESMA) in their advices and opinions on lending-based crowdfunding and investment-based crowdfunding respectively, a great number of European Directives and Regulations come into play when structuring a crowdfunding platform. The most important Level 1 European laws and regulations are in our view the following:

General (relevant for any type of crowdfunding)

- PSD II;
- Data Protection Regulation;
- Distance Marketing of Financial Services Directive; and
- Anti-Money Laundering Directive.

Investment based crowdfunding

- the Prospectus Directive as regards issuers of securities (project owners in investment-based crowdfunding);
- MiFID II and MiFIR as regards investment services provided by investment-based crowdfunding platforms;
- AIFMD as regards collective investment schemes initiated by crowdfunding platforms. In that respect also PRIIPS may become of relevance to crowdfunding platforms via whom PRIIPS are offered;

Lending based crowdfunding

- the Consumer Credit Directive and the MCD in respect of P2P consumer lending platforms; and
- CRD IV and CRR as regards credit institutions which could be of relevance to balance sheet lending platforms.

One could take the view that as long as a European Directive or European Regulation in place, crowd lending platforms and crowd investing platforms should not experience too many legal obstacles when expanding within the EEA. As noted above, currently this is unfortunately not in line with the experiences of the platforms.

Due to the fact that there is no specific European legislation on crowdfunding as yet, local regulators tend to take the existing legislation as a basis for the local crowdfunding regulatory framework. This often results in a somewhat artificial manner of applying a patchwork of regulatory rules with the aim to safeguard that the crowd can make an informed investment decision, is not being misled and understands the risks involved in investing in crowdfunding projects.

There seems to be consensus 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.

The main legal barriers

In our view, the main regulatory obstacles to the cross border development of crowd investing in the EU are raised by the Prospectus regime and the local law crowdfunding rules that undermine European legislation (such as MiFID II/MiFIR). Also the incredible broad scope of the AIFMD and the absence of passporting possibilities for an AIFM that falls under a

registration rather than a licensing requirement, causes issues for – mainly – crowd investing platforms.

Crowd lending

Crowd lending platforms on the other hand experience the problem of the lack of a harmonized European guidance approach in respect of crowd lending. There are no passporting possibilities for a crowd lending platform, except when the crowd lending platform qualifies as a credit institution within the meaning of CRD IV/CRR. Generally, however, a crowd lending platform will not qualify as a credit institution unless it is a balance sheet lender. In our view, crowd lending platforms can only expand their business within the EU in three ways. Either (i) it goes through a generally burdensome and expensive regulatory process in each Member State where it wants to expand to and, to the extent required, obtains a local law license, or (ii) it enters into a joint venture or other type of cooperation agreement with a local law crowd lending platform with the appropriate local law licenses; or (iii) it acquires a local crowd lending platform that already went through the local regulatory hurdles.

Crowd investing

Crowd investing platforms offer issuers the opportunity to offer tradable equity and debt securities as well as other types of profit sharing financial instruments, such as (non)tradable participation rights in an AIF or derivatives such as convertibles notes, to the crowd. The crowd can include both consumers and other types of non-professional investors, and professional investors.

MiFID II/MiFIR

Generally, in line with ESMA's opinion on investment based crowdfunding, the crowd investing platform that brings investors and issuer together, qualifies as a broker. Its activities generally qualify as the receipt and transfer of orders in financial instruments and acting as placement agent in the primary market on a best efforts basis. These are typical investment services offered by an investment firm within the meaning of MiFID II/MiFIR. Subject to the exact business model and services offered by the crowd investing platform, such services may qualify as different types of investment services. Not all Member States treat crowd investing platforms as an investment firm. Where Member States do require the crowd investing platform to obtain a MiFID license, the platforms experience local law issues when passporting their MiFID license to other EEA Member States. Especially when a crowd investing platform considers opening a branch office in the host Member State, local laws may result the crowdinvesting platform to 'back off'.

Local law barriers

In the Netherlands for example, the current inducement bans are much broader than the inducement bans provided under MiFID.¹ In April 2016, an exception was created to the inducement ban applicable to crowd investing platforms subject to a set of cumulative conditions. One of these conditions is for example that the crowd investing platform does not provide investment services 2, 4 and 5 as referred to under Annex I to MiFID II.

¹ We expect the same to be the case under MiFID II, but we are currently awaiting draft amendments to the lower regulation dealing with the inducement ban in connection with implementation of MiFID II.

Another example is the strict and broad Dutch requirement to have a controlled remuneration policy. These requirements apply to financial undertakings who are subjected to specific Dutch law provisions. Such financial undertakings are particularly not limited to financial undertakings with their statutory seat in the Netherlands. These rules also apply to incoming financial undertakings, including MiFID licensed crowd investing platforms who offer their services through a Dutch branch office for example.

Prospectus Directive

In addition to the regulatory regime applicable to the crowd investing platform itself, the manner in which the Prospectus Directive is implemented in the Member States may form a barrier to the issuer of securities (i.e. the fundraising project owner). Pursuant to the Prospectus Directive, an issuer can only offer securities to the public after having published a 'Prospectus Regulation proof' prospectus. The drafting and approval process of such a prospectus is a timely and costly barrier. Most start-ups and SMEs experience a prospectus obligation as not proportionate to their offering size. The Prospectus Directive foresaw such proportionality issues and offered the Member States an option to accept the offering of securities to the public in their respective Member States up a maximum annual offering size of €5 million. At first glance this seems sufficient for most start-ups and SMEs resulting in the conclusion that the Prospectus Directive should not form much of an issue. However, due to the fact that such higher exemption was a Member State option, this option was not implemented in an harmonized manner in the EEA.

In the Netherlands for example, an issuer – including any issuers within the same group - cannot reach or exceed an annual offering size of €2.5 million within the whole of the EEA. Moreover, the relevant Dutch regulator, the Netherlands Authority for the Financial Markets, requires the issuer to include a prescribed text and pictogram on any of its offering materials if it relies on this exemption when offering its securities to the public in the Netherlands. Due to the manner in which the Netherlands has implemented this Member State option, an issuer may decide not to include the Netherlands in its offer as this would limit its offering size to less than €2.5million and it will be subjected to local law prescribed warnings. The issuer may, however, encounter the same problem in many other Member States. An issuer, or the crowd investing platform through which the offer is made to the public in different Member States, would be required to obtain local law advice in all the relevant Member States to ensure the issuer complies with the local laws and regulations irrespective of it being exempt from the prospectus obligation.

Proposed Prospectus Regulation

In the last published draft to the revised Prospectus Regulation of 16 December 2016,² the issue described above becomes even worse. Although it is suggested to raise the generally accepted exception to a prospectus obligation from €100.000 (now) to €1 million, the proposal maintains a Member State option of exempting issuers from a prospectus obligation if their annual offering size is less than €8 million. If Member States wish to make use of this option, such exempt offering can only be performed to the public in that specific Member State where the issuer wants to rely on the exemption; i.e. an issuer cannot benefit from a passporting regime. We question whether this limitation is in line with the intentions of the

² Interinstitutional file 2015/0268 (COD).

CMU; by setting these limitations, there will not be any cross border securities offerings in excess of €1 million without a 'Prospectus Regulation proof' prospectus. We also fear for any cross border secondary market opportunities.

In our view, these limitations would only not raise even bigger legal obstacles to the cross border development of crowdfunding in the EU than issuers currently experience if level 2 EU legislation (such as RTS or ITS) in respect of the template EU Growth prospectus will be developed that does not cause a disproportionate hurdle for issuers from a cost and timing perspective. Moreover, regulators in Member States should be required to approve such SME growth prospectus considerably quicker than the current approval processes.

Secondary market

The potential of offering the crowd an exit by encouraging a secondary market or, at least, creating the possibility to trade the crowdfunding asset makes, in our view, crowd investing the most interesting form of crowdfunding. The individual investments, in particular of the retail investor, are generally fairly limited in value and volume, but it may well be relatively important to such a retail investor to be able to make his investment liquid again at any moment in time and for any reason. In our view, it fits the CMU shoe perfectly if the crowd, wherever residing within the EEA, can continuously invest and trade in their investments in start-ups and SMEs through the platforms.

A European crowdfunding regulatory framework

A key objective for the European Commission could be to develop a specific EEA wide regulatory framework which would be available to both crowd lending platforms and crowd investing platforms. Our preliminary ideas for such a specific EEA wide regulatory framework applicable to crowdfunding would be the following:

- offer start-ups and SMEs the possibility to offer tradable financial instruments (including SME loans and securities) to the public in any of the EEA Member States without the need to publish a 'Prospectus Regulation proof' prospectus up to a certain maximum offering size³ but subject to the publication of a minimum set of information in a complete, accurate, comprehensible and non-misleading manner which minimum set of information needs to be updated in a periodic manner on the website of the issuer and the platform to enable any investor, at any time, to make an informed investment decision before investing in the start-up or SME;
- offer a 'MiFID II' light license regime to crowd lending platforms and crowd investing platforms up to a certain size (e.g. as long as they are considered an SME themselves under MiFID II) that wish to intermedate in / provide investment services in respect of financial instruments (including SME loans, participation rights in investment vehicles / SPVs, simple derivatives such as convertible loans and securities) with the possibility to passport such license to other Member States without goldplating possibilities for the host Member States;

³ In respect of which we note that an maximum offering size of €1 million would be too low; crowdfunding projects tend to become bigger in size and, subject to ensuring an adequate level of investors protection, SMEs and start-ups should, in our view, be offered the opportunity to make an offering to the public up to the higher threshold of the Member State option of the exception limit (i.e. up to €8 million), though *with* passporting opportunities. If an issuer experiences a higher financing need that this upper threshold, it will generally be given the opportunity to publish an EU Growth prospectus instead of a full blown Prospectus Regulation proof prospectus.

- enable a platform with a MiFID II light license as described above to operate an SME growth MTF without being confronted with the current capital requirements applicable to investment firms operating an MTF (such as minimum equity of €730.000 and the solvency requirements). More importantly prevent such type of platform to be subjected to those CRD IV, CRR, BRRD provisions only because of being subjected to the minimum equity requirement of €730.000; and
- ensure actual convergence in the Member States and ensure that material terms are defined in the same manner in the Member States resulting in a real harmonized regime for crowdfunding.

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