Crowdfunding Regulation: Major Reform in the EU, No Change in the UK

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Although crowdfunding has existed in various forms since the late 1990s, the global financial crisis in 2008 accelerated the trend of channelling consumer and business lending through crowdfunding platforms. This mode of nonbank financing experienced significant growth in the period since the financial crisis, particularly for start-ups and early stage companies. Investment and financing through crowdfunding platforms has been subject to very different levels of regulation in the EU and the U.K., which divergent treatment has inhibited cross-border activity and allowed the concentration of crowdfunding businesses in a small number of jurisdictions. Some jurisdictions applied their existing regimes for alternative investment fund management, payment services or investment business to crowdfunding platforms, while others settled on the absence of any regulation, and some jurisdictions, such as the U.K., expanded the coverage of their existing licensing regimes to address gaps in consumer protection rather than develop an entirely new regulatory framework.

The EU has now belatedly implemented a bespoke regime in Regulation 2020/1503 on European crowdfunding services providers (the Regulation) to govern investment- and lending-based peer-to-peer or crowdfunding platforms. In the U.K., where the majority of crowdfunding platforms in Europe are established, the U.K. government has resolved to continue with the U.K. regime instituted in 2013 to cover electronic lending without making any amendment in response to the Regulation.[1] This is notwithstanding the replication and onshoring in the U.K. of the vast bulk of EU financial services regulation following Brexit. U.K. regulators have determined the existing regime to be adequate compared to the new EU regime, which position aligns with the post-Brexit trend for the U.K. to steer its own course in the regulation of fintech companies rather than mirror regulatory efforts in the EU.

Below we summarize the key provisions of the Regulation and address some points of contrast between the EU and U.K. regimes.

The EU Crowdfunding Regulatory Framework

The Regulation entered into force on November 9, 2020, but will apply from November 10, 2021. It does not replace national EU member state rules where they exist. As a transitional measure, existing crowdfunding service providers are permitted until the later of November 10, 2022, or they are granted authorization under the Regulation to continue operating under the relevant national framework.

The Regulation is directed at enabling businesses to raise equity or debt financing through crowdfunding platforms. It is distinct from consumer credit and mortgage-based lending and does not cover reward- or donation-based crowdfunding. The new regime is considered an important component of the Capital Markets Union initiative in the EU, the full realization of which continues to face difficult challenges.

The Regulation is intended to provide participants with confidence that certain minimum regulatory standards will be in place to protect parties against some of the mis-selling issues that have until now plagued some platforms. It will also provide a new EU label to harmonise the current fragmented regulatory landscape and help licensed

[1] The U.K. government has confirmed that the Regulation will not be transposed into U.K. law. In a November 3, 2020, letter, the U.K. economic secretary to the Treasury stated that the reason for not replicating the legislation in the U.K. is that "there is no evidence to suggest that [implementing the Regulation] would result in material benefit to the U.K. Crowdfunding sector" and that sufficient protections for users of crowdfunding services are already set out in U.K. legislation.

platforms to achieve scale throughout the EU. The European Securities and Markets Authority (ESMA) recently published Level 2 measures for consultation in the form of draft regulatory technical standards setting out detailed regulatory requirements to supplement the primary rules set forth in the Regulation.[2]

The Regulation sets out requirements under a number of headings that relate to investor protection, prudential obligations and the provision of ancillary services, including individual portfolio management, safeguarding and payment services by platforms.

Scope and Territorial Considerations

The Regulation applies to the provision of crowdfunding services that consist of matching the business funding interests of investors and project owners through a platform and involve either loans or the placing of equity or debt instruments by the project owner or a special purpose vehicle (SPV).[3] A "loan" is defined to include only those arrangements in which a defined amount of money is made available to a project for an agreed period of time and where repayment is made in accordance with an instalment payment schedule. Alternative or innovative loan products and even loans with well-known features (such as bullet repayments and revolving facilities) may fall outside the definition. The narrow scope of permissible services under the Regulation will likely limit the degree to which platforms can adapt to cater to clients' individual circumstances and offer innovative products to investors.

Any investment or loan sought above €5 million would not fall within the scope of the Regulation, although it could be subject to the Markets in Financial Instruments Directive regime and the Prospectus Regulation.[4] The Regulation does, however, apply to intermediaries arranging the placing of equity or debt instruments in projects on a platform.

Under the Regulation, only legal persons established in the EU can obtain authorisation to provide crowdfunding services to EU clients. Crowdfunding platforms and their intermediaries currently providing services to investors and project owners in the EU from establishments outside of the EU will therefore have to relocate or establish subsidiaries within the EU to access EU participants.

Investor Protection Measures

The Regulation establishes stringent new rules on investor protection. Notable measures include the following:

- **Credit risk assessment:** Where a platform determines the price of a crowdfunding offer, it is required to conduct a credit risk assessment of the project or project owner and to publish policies and procedures setting out how it conducts such assessments. The Regulation imposes an obligation to ensure the price is "fair and appropriate," including in situations where a lender wishes to exit prior to the maturity of the loan. In addition, the platform is required to carry out a valuation of each loan at the moment of origination, at the point of likely default without enforcement of security as well as following a default, and where a lender wishes to exit prior to maturity.
- **Due diligence:** Platforms are required to undertake at least "minimum level" due diligence with respect to each crowdfunding project and its owners. This must include an assessment of criminal records and infractions relating to commercial, insolvency, fraud or money laundering issues.
- **Individual portfolio management of loans:** Where a platform is given a discretionary mandate by an investor to allocate funds by way of loan to a project, this must be done in accordance with certain parameters specified by the investors relating to, for instance, interest rates, maturity, loan risk categories and a target rate of return. Also the platform must carry out a credit risk assessment of the selected project and the portfolio. In addition, these detailed provisions in the Regulation require platforms to provide investors with certain information regarding the selected loans, the portfolio and any contingency fund established by the platform.
- **Key Investment Information Sheet (KIIS):** Platforms must provide investors with a KIIS for each crowdfunding project. While the project owner is responsible for drafting the KIIS, the platform and its intermediaries are required to distribute it. The KIIS must include detailed information regarding the project and project owner, features relating to the borrowing or capital raising, risk factors, investor rights, complaints and fees, and portfolio management of loans, all as specified in Annex I of the Regulation, as well as a risk warning and disclaimers. Platforms must provide the KIIS in the language of each member state in which the project is marketed. The costs of translation may prove prohibitive for some project owners and platforms accustomed to simply posting details of a project on a more easily accessible web-based platform.

[2] See Consultation Paper ESMA35-36-2201 issued on February 26, 2021.

[3] The Regulation provides for the type of SPVs used for securitizations in order to provide investors with exposure to an underlying illiquid or indivisible asset (Article 3(6) of the Regulation). ESMA has sought to address uncertainty around the use of SPVs in its Q&A guidance on the Regulation (ESMA35-42-1088).

[4] EU Directive 2014/64/EU and EU Regulation 2017/1129, respectively.

- **Reflection period:** A pre-contractual "reflection period" applies to all offers to fund projects made by nonsophisticated investors (which are defined in detail in the Regulation). The reflection period applies for four calendar days, during which an investor may revoke his or her offer.
- **Appropriateness test:** Platforms must carry out an appropriateness test to assess nonsophisticated investors, which is required to be based on an investor's experience, financial situation, basic understanding of the investment risks and a simulation of the investor's ability to bear losses. The Regulation requires platforms to repeat such assessments every two years. Any determination of inappropriateness will require the issuance of a risk warning, which the investor must expressly acknowledge. Further, each time such an investor makes an investment exceeding 5% of his or her net worth, the platform must issue a risk warning requiring the investor's express consent, and the investor must respond by proving that he or she understands the investment and its risks.

The potential impact of these investor protection measures is significant. Due diligence assessments are not typically part of the current operational processes practiced by crowdfunding platforms and other related service providers. Notably, given the language requirements for the KIIS, distributing it will increase the administrative burden for a platform if it intends to make a project available to investors throughout the EU. Additionally, the reflection period may affect the security of funding for projects offered through EU platforms, and project owners will need to factor this uncertainty into plans to utilise any funds that are raised as part of a project.

Systems and Controls Requirements

The Regulation sets out quite detailed requirements for handling complaints, managing conflicts of interest, outsourcing, annual reporting to the regulator of certain details relating to projects and investors, and annual publication of project and loan default rates.

Prudential Requirements

Under the Regulation, prescriptive capital requirements apply to crowdfunding platforms and intermediaries. Firms will be required to hold the higher of €25,000 or one quarter of fixed overhead amounts as equity capital or coverage under an insurance policy (or a combination thereof). The equity capital must meet the requirements for classification as Common Equity Tier 1 capital under the Capital Requirements Regulation.[5] These qualitative criteria cannot be satisfied by some of the common capital structures employed by companies, including partly paid shares, preference shares or any instruments with principal amounts that can be reduced or repaid (other than in very limited circumstances).

The UK Regime

Operating an electronic system in relation to lending is a regulated activity under the U.K. regime,[6] and firms carrying out this activity in the territory of the U.K. are required to be authorised by the Financial Conduct Authority (FCA).[7] All firms authorised by the FCA are required to comply with FCA rules set out in the FCA Handbook of Rules and Guidance, which details various customer protection measures, systems and controls, and prudential requirements.

Only platforms that facilitate credit agreements where either (i) the lender is an individual (including within a partnership or unincorporated body) or (ii) the borrower is such an individual and the amount of credit is below £25,000 or otherwise is intended for a nonbusiness purpose fall within the scope of authorisation. The ambit of what is regulated in the U.K. is therefore more limited than what is covered by the EU Regulation — the Regulation is not confined to participation by an individual either as a lender or borrower, and it covers investment beyond the mere granting of loans. Given the narrower scope of the U.K. regime, many U.K.-based platforms are either unregulated (although some have obtained consumer credit licenses) or have business models that only partially fall within the scope of regulation. Those that do fall within the regime have the option of operating as an "appointed representative," which does not require obtaining a license since another firm acts as the principal with the requisite license and assumes the regulatory responsibility over the platform.

The U.K. regime is also much less onerous than the one set out by the EU Regulation, as the U.K. regime does not provide for any rules on due diligence, disclosure akin to a KIIS, a reflection period or an investor appropriateness test.

[5] Regulation (EU) No 575/2013.

[6] See Article 36H of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (as amended). Firms with this license are exempt from the requirement to be licensed for establishing or operating a "collective investment scheme" (Paragraph 6A of the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (as amended)).

[7] EU-authorised platforms should consider whether authorization in the U.K. is required to provide their services to U.K. customers on a cross-border basis. The U.K. territorial perimeter is generally limited to circumstances in which regulated activity is carried out from an establishment in the U.K. but there are exceptions to this principle, and each EU-authorised platform will need to assess on a case-by-case basis whether providing services on a cross-border basis breaches the U.K. regulatory perimeter.

Crowdfunding and Wider Regulation for Fintech Companies

The EU's new regulation forms part of a wider package of measures designed to bring the fintech sector into the scope of the financial services regulatory frameworks in the EU. Recently published proposals in the EU call for regulations to govern cryptoassets (including stablecoins and other cryptocurrencies), novel payment services, use of distributed ledger technology by financial market infrastructure providers and digital operational resilience. Meanwhile, the U.K. completed a significant review of the fintech regulatory landscape at the end of February 2021 (the Kalifa Review). While the Kalifa Review did not propose detailed legislation, it generated several conclusions regarding the requirement to reframe U.K. regulation to accommodate fintech companies, which will require an overhaul of various aspects of U.K. financial services legislation.

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