

Group Briefing

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Crowdfunding: Should it be regulated? Department of Finance begins industry consultation

On 21 April 2017, the Department of Finance announced the launch of a consultation on the regulation of crowdfunding in Ireland. The consultation will run until 2 June 2017.

WHAT IS CROWDFUNDING?

Crowdfunding is a method of raising finance from the public (individuals, companies and institutional investors) which is often used by start-up

businesses (in particular, small and medium enterprises (SMEs)) as an alternative to traditional bank finance.

A business looking to raise funds via crowdfunding will generally use an online crowdfunding platform, through which it can pitch its business plan, and raise amounts of money from multiple sources. Online crowdfunding platforms match potential investors with businesses seeking investment,

coordinate payments between the parties, and may be involved in setting the interest rates in loan-based crowdfunding, or the valuation in investment-based crowdfunding.

THE MAIN TYPES OF CROWDFUNDING

There are four main types of crowdfunding (see below), three of which are the subject of the Consultation Paper.

TYPE OF CROWDFUNDING	DETAIL
Peer-to-peer consumer lending: <i>(Expectation of financial return by investor)</i>	Investor loans money to an individual consumer, not a business. Investment is by way of loan and the investor expects the loan to be repaid with interest. Crowdfunding platforms match borrowers with potential lenders.
Peer-to-peer business lending: <i>(Expectation of financial return by investor)</i>	Multiple individuals or institutional investors lend money to a business. Investment is by way of loan and the investor expects the loan to be repaid with interest. Crowdfunding platforms match borrowers with potential lenders.
Investment model: <i>(Equity share)</i>	Individuals or institutional investors are given unlisted equity shares (or sometimes debt securities) in the company in return for their investment. Crowdfunding platforms match businesses with potential investors.
Donation/Reward-based crowdfunding: <i>(No financial return expected, so no lending/ investment takes place. As such, this type of crowdfunding is not the subject of the Consultation)</i>	Investors make small donations to support charitable causes or businesses. Investors do not expect to receive any financial return, but may receive a promotional gift.

This document contains a general summary of developments and is not a complete or definitive statement of the law. Specific legal advice should be obtained where appropriate.

CURRENT REGULATORY POSITION» ***Is crowdfunding currently regulated in Ireland?***

No, unless an online crowdfunding platform offers related services that are regulated such as, for example, payment services or MiFID investment services (in which case, it would need authorisation from the Central Bank). Apart from that, neither the relationship between the investor and the business, nor the online crowdfunding platform, is regulated.

» ***Is crowdfunding regulated at EU level?***

No, although some Member States have introduced, or plan to introduce, domestic legislation in this area. Consumer protection legislation, and financial services legislation generally, was developed before crowdfunding developed into a key source of finance. As a result, that legislation of itself is unlikely to adequately regulate the sector, but legislation such as MiFID, the Payment Services Directive, AIFMD and the Prospectus Directive could (if amended) provide the necessary framework.

» ***View of the European Commission***

In January 2017, as part of its consultation on its mid-term review of Capital Markets Union, the European Commission noted that crowdfunding is growing as a source of finance

but remains small, with market development taking place in only a few Member States, and little cross-border activity. The Commission also signalled that divergences in regulatory frameworks and in how EU legislation is interpreted in Member States could fragment the crowdfunding market, and make investor protection more difficult. It is not currently planning to introduce specific laws dealing with crowdfunding, but is continuing to monitor the sector.

» ***Views of EBA and ESMA***

The European Banking Authority (EBA) has concluded that regulatory convergence in the area of crowdfunding is desirable, using existing financial services legislation (notably the Payment Services Directive) as the starting point.

The focus of the European Securities and Markets Authority (ESMA) has been on investment-based crowdfunding (see its December 2014 opinion on investment-based crowdfunding in which it focused on how existing EU financial services legislation could apply to crowdfunding platforms). Earlier this month, in a letter to the European Commission, ESMA again indicated that it would like to see EU legislators examine crowdfunding in the context of the current EU legislative framework to ensure

that crowdfunding can reach its full potential. It attached the results of its November 2016 survey of national competent authorities (NCAs) (again in the context of investment-based crowdfunding only) which indicated that 10 NCAs have reported that investment-based crowdfunding platforms are operating in their jurisdictions. The results of the survey also indicate how those platforms are regulated in each of those jurisdictions.

» ***View of the Central Bank of Ireland***

In June 2014, the Central Bank issued a Consumer Notice on Crowdfunding, including Peer-to-Peer Lending, highlighting that crowdfunding on a standalone basis is not regulated in Ireland and flagged that, in light of this, Irish consumers who invest in crowdfunding projects do not benefit from the Central Bank's codes, are not protected by the Deposit Guarantee Scheme or the Investor Compensation Scheme, and cannot lodge a complaint with the Financial Services Ombudsman. Further, those who operate crowdfunding platforms are not subject to the Central Bank's client asset rules.

Some of the key risks highlighted by the Central Bank in that Consumer Notice are included in the list of disadvantages of crowdfunding in the table below.

ADVANTAGES AND DISADVANTAGES OF CROWDFUNDING

ADVANTAGES	DISADVANTAGES FOR INVESTORS	DISADVANTAGES FOR THE BUSINESS LOOKING TO RAISE FINANCE
Valuable source of finance for SMEs, in particular at start-up stage.	Consumers may not understand the risks involved, in particular the risk that they may lose some or all of their investment if the online crowdfunding platform fails, if the business being financed fails, or if the business fails to repay its loan.	Not protected by the Central Bank's SME Regulations.
Enables SMEs to finance themselves from diverse sources (not just from bank finance or venture capital) and promotes competition in the SME finance market.	Increased risk of fraud due to use of web-based platforms.	Funds promised by investors may not be paid over.
Fast and cost-efficient means of raising funds.	Risk of misleading or inadequate information, in particular in marketing material, where claims may not be capable of being independently verified.	Risk of payments not being processed promptly by the online crowdfunding platform.
Generates publicity for the business that is looking to raise funds.	Risk of unfair contract terms being imposed.	Risk that unprotected intellectual property could be copied by others.
	The potential absence of a secondary market for selling shares acquired as part of investment-based crowdfunding.	Lack of clarity on due diligence carried out by online crowdfunding platform.
	Lack of dispute resolution mechanisms.	

OBJECTIVES OF THE CONSULTATION

The Consultation Paper is focused on whether a regulatory regime should be put in place for the crowdfunding sector, or whether this would impede the development of crowdfunding in Ireland.

The Consultation Paper notes that the majority of investors in crowdfunding projects are expected to be consumers (i.e. individuals acting for personal, rather than business, purposes).

Views have been sought on the following points (which will be relevant if a decision is taken to regulate crowdfunding):

AREA	QUESTIONS
Risks	<ul style="list-style-type: none"> » What risks associated with crowdfunding should be considered and addressed by any potential regulatory regime? » How could those risks be mitigated?
Standards	<ul style="list-style-type: none"> » Should there be minimum standards of due diligence and disclosure for online crowdfunding platforms? » Should there be a process for what happens on an event of default, an insolvency or a bankruptcy in respect of the borrower who has received funds from investors?
Information	<ul style="list-style-type: none"> » Must businesses provide specific information if they are looking for funding via a crowdfunding platform? That information could include contact details, ownership details, the purpose of the loan, business plans, product details, financial projections and accounts. » What specific information should be provided? » Should that information differ between loan-based crowdfunding and investment-based crowdfunding?
Prudential rules	<ul style="list-style-type: none"> » Should crowdfunding platforms be subject to prudential rules (such as capital and liquidity requirements), client asset rules and conduct of business rules? » If so, what should those rules include?
SME Regulations	<ul style="list-style-type: none"> » Should these apply to crowdfunding platforms?
Investment restrictions ¹	<ul style="list-style-type: none"> » Should there be a cap on the amount that an individual can invest, or that a crowdfunding platform can accept from an individual, in a 12 month period in one or more crowdfunding projects? » Should there be other restrictions on retail investors before they can invest in crowdfunded businesses?
Costs ²	<ul style="list-style-type: none"> » Are there any points to consider in relation to the cost of regulation or the cost of regulatory compliance?
Conflicts of interest	<ul style="list-style-type: none"> » Should regulation address potential conflicts of interest such as where those involved in managing the crowdfunding platform also invest through the platform?

The Consultation Paper also seeks views as to whether, if a decision is taken not to regulate crowdfunding, Ireland should consider non-regulatory supports to encourage the development of crowdfunding as a source of finance in Ireland.

that the development of this exciting and innovative form of finance is facilitated for the benefit of the economy, while also ensuring adequate protection for consumers providing funds through crowdfunding platforms is of critical importance”.

NEXT STEPS

Depending on the responses received by the time the consultation closes on 2 June 2017, the Central Bank will decide whether to pursue a regulatory regime for crowdfunding in Ireland. In launching the consultation, the Minister for Finance commented that “[ensuring]

COMMENT

Crowdfunding is, if the UK experience is anything to go by, likely to become an increasingly important source of non-bank lending. A fit-for-purpose regulatory regime will provide comfort and confidence to investors/lenders and help to ensure that the industry grows on a stable and robust footing.

1. Investment restrictions are already imposed on individuals who invest using online crowdfunding platforms in both the UK and the US.

2. There would be costs for the Central Bank to regulate the industry (recoverable as an industry levy) and compliance costs for industry. These would likely be reflected in higher costs for those using online crowdfunding platforms.

KEY CONTACTS

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