

DIRECT LENDING

Arthur Cox Q&A: EU Crowdfunding Regulation

March 2021

The new EU Crowdfunding Regulation will apply across the EU from 10 November 2021 to providers of two key types of crowdfunding: investment-based crowdfunding, and peer-to-peer lending. Activity is ramping-up in advance of that date, with ESMA launching its [Q&A](#) and publishing a [Consultation Paper](#) on a number of Level 2 technical standards. This Q&A explores some key elements of the new regulatory framework for providers of crowdfunding services (**CSPs**).

WHY HAS A NEW REGULATORY FRAMEWORK BEEN INTRODUCED?

The European Commission's March 2018 [FinTech Action Plan](#) highlighted the need for a harmonised EU-wide regulatory regime for CSPs.

SMEs and start-ups can find it difficult to access traditional sources of finance and, as the economic impact of the COVID-19 pandemic on businesses becomes clear, the need for diversified funding options has become more pressing.

Crowdfunding, whereby a CSP operates an online platform that brings together businesses (project owners) and potential investors, has become a well-established alternative funding source. However, the fragmented approach to crowdfunding regulation across the EU has presented obstacles to CSPs who wish to provide their services on a cross-border basis, thereby making it more difficult for them to scale-up their activities.

WHAT DOES THE NEW FRAMEWORK CONSIST OF?

The new framework consists of an [EU Crowdfunding Regulation](#) together with [related amendments to MiFID II](#), and will apply from 10 November 2021. The Regulation will apply directly in EU Member States, while the changes to MiFID II will require domestic transposing legislation.

The new framework will require in-scope CSPs to be authorised, impose operational requirements on those CSPs and introduce investor protection measures (which will differ depending on whether an investor is '*sophisticated*' or '*non-sophisticated*'). Authorised CSPs will be able to provide in-scope crowdfunding services on a passported basis throughout the EU.

WHAT TYPES OF CROWDFUNDING ARE IN SCOPE?

The new framework will apply to two types of crowdfunding: **peer-to-peer business**

lending, and **investment-based crowdfunding** (the latter in respect of transferable securities only).¹ Where a CSP facilitates either or both types of in-scope crowdfunding, it must be authorised.

However if, in the course of providing those crowdfunding services, a crowdfunding offer (calculated over 12 months on a per-project owner basis) has a total consideration in excess of €5 million, that particular offer will be out-of-scope, and will instead be subject to the rules set out in MiFID II and the Prospectus Regulation.

Peer-to-peer consumer lending and donation/reward-based crowdfunding are out of scope.

WHEN WILL AUTHORISATION BE REQUIRED?

A CSP that facilitates either investment-based crowdfunding or peer-to-peer business lending via its platform will need to be authorised by the national

¹ Where the laws of a Member State allow for shares in a private limited company to be freely transferred on the capital markets, a CSP may be authorised to allow crowdfunding in respect of those shares on its platform. If a national competent authority allows this, it must inform ESMA and ESMA must collect the key investment information sheets for each such investment between 10 November 2021 and 10 November 2023.

competent authority (**NCA**) in the EU Member State in which it is established. The Central Bank of Ireland (**CBI**) is expected to be the NCA in Ireland.

As mentioned above, the new framework will allow authorised CSPs to **passport their services** across the EU without needing to have a physical presence in another Member State.

HOW WILL THE AUTHORISATION PROCESS WORK?

The Regulation lists the information that a CSP (which must be a legal person) will need to provide to its NCA in support of its authorisation application, and that list will be supplemented by regulatory technical standards from ESMA.

The NCA must decide whether to grant the authorisation, or refuse the application, within three months. The authorisation must specify the crowdfunding services that the CSP may provide and, if the CSP wants to provide further services at a later date, it must apply for an extension to the terms of its authorisation.

As mentioned above, we expect that the CBI will be the relevant NCA for Ireland and that it will publish details of its authorisation process in due course.

WILL AN AUTHORISATION COVER PASSPORTING?

Where an authorised CSP wants to provide its services on a cross-border basis into another EU Member State, it must provide the relevant details to its NCA which will operate as the *'single point of contact'* and in turn notify the NCAs in those other Member States.

The CSP will then be able to provide those services no later than 15 calendar days after it notifies its NCA of its wish to do so, and it will not need to have an establishment in those other Member States.

WILL THERE BE A TRANSITIONAL PERIOD?

Yes, for CSPs that are already engaged in activities that will require authorisation under the new framework. Those CSPs can continue to engage in those activities on a transitional basis until 10 November 2022, following which they will only be able to engage in those activities if they have been authorised to do so by their NCA.

WILL A CSP NEED TO BE AUTHORISED UNDER MIFID TOO?

To avoid a CSP needing to comply with

more than one regulatory regime, an in-scope CSP will be exempt from MiFID II if it is authorised under the Regulation. A CSP could still, however, be subject to the requirements of the Payment Services Directive if it provides payment services.

WHAT PRUDENTIAL REQUIREMENTS WILL APPLY?

Authorised CSPs will be subject to prudential requirements (equal to the higher of €25,000 and one quarter of its fixed overheads from the previous year) which can comprise own funds, an insurance policy or a combination of both.

WHAT LEVEL OF SUPERVISION CAN CSPS EXPECT?

A CSP will be supervised by the NCA that authorised it. The Regulation leaves it up to the individual NCAs as to how to assess compliance by their authorised CSPs with the new framework.

WHAT OPERATIONAL REQUIREMENTS WILL APPLY?

The Regulation sets out a number of operational requirements on authorised CSPs, including requirements relating to the following:

Acting honestly, fairly and professionally in the best interests of clients.	Conducting credit risk assessments of crowdfunding projects and project owners.	Implementing risk management systems and controls in respect of peer-to-peer business lending.
Not accepting inducements.	Avoiding conflicts of interest.	Avoiding additional operational risks when outsourcing.
Carrying out specified minimum levels of due diligence on project owners.	Implementing transparent complaints-handling procedures.	Providing asset-safekeeping and payment services.
Implementing effective policies and procedures for the segregation of duties.	Implementing effective business continuity policies and procedures.	Reviewing its prudential safeguards and business continuity plan every two years (at a minimum).

CAN CSPS PROVIDE TAILORED SERVICES?

CSPs will be allowed to propose specific projects to individual investors that match specific parameters or risk indicators chosen by that investor.

CSPs may also engage in *'individual portfolio management of loans'*. An investor can give the CSP a mandate to allocate a predetermined amount of funds between one or more projects on the CSP's platform. The CSP will be required *"to take all necessary steps to obtain the best possible result"*, must

disclose its decision-making process in respect of the investor's mandate to that investor, and must provide specific information on that investor's portfolio on a continuous basis and on request.

CAN AN SPV BE USED?

The Commission and ESMA want to avoid any regulatory arbitrage that could arise where a special purpose vehicle (**SPV**) (defined by reference to the ECB Regulation on Financial Vehicle Corporations) is interposed between

the project owner and the investor for the purposes of providing crowdfunding services.

The Regulation stipulates that an SPV can only be used for an investment-based crowdfunding project where it only allows investors to acquire an interest in one illiquid or indivisible underlying asset which could not otherwise be offered to investors easily.

The first edition of ESMA's [Crowdfunding Regulation Q&As](#) is dedicated to this issue, covering when an SPV can be

set-up for crowdfunding purposes, the types of instrument that can be offered to investors via an SPV, confirming that an SPV cannot give exposures to more than one underlying asset, and clarifying the nature of that asset and what is meant by “illiquid or indivisible”.

WHAT IS A ‘SOPHISTICATED’ INVESTOR?

The Regulation distinguishes between ‘sophisticated’ investors (i.e. a MiFID professional client, or a client that the CSP judges to be ‘sophisticated’ by reference to the criteria set out in Annex II to the Regulation) and ‘non-sophisticated’ investors.

WHAT INVESTOR PROTECTION REQUIREMENTS WILL APPLY?

The Regulation sets out a number of investor protection measures, summarised below. Notably, the requirements around assessments of appropriateness, simulation of loss and reflection periods only apply to ‘non-sophisticated’ investors.

ON-BOARDING	
‘Non-Sophisticated’ Investors: Appropriateness Assessment and Simulation of Loss	<p>CSP must carry out an appropriateness assessment before allowing the investor to invest via the CSPs platform. The appropriateness assessment must be reviewed every two years.</p> <p>As part of that assessment, a simulation of the investor’s ability to bear losses of up to 10% of their net worth must be carried out, and reviewed annually.</p> <p>If the CSP’s view is that investment may not be appropriate for an investor, it must provide a risk warning which must be expressly acknowledged by that investor.</p> <p>A CSP cannot prevent ‘non-sophisticated’ investors from investing, but must provide additional warnings, and obtain further consents, each time a ‘non-sophisticated’ investor invests above a particular amount (€1,000 or 5% of net worth – whichever is the higher).</p>
COMMUNICATIONS	
<i>(all of this information must be readily accessible on the CSPs website)</i>	
Fair, clear and not misleading	All communications relating to the CSP, costs, risks, charges and selection criteria must be clear, fair and not misleading, and must be provided to investors before they invest.
Clarity on schemes	CSPs must inform investors that their services are not covered by the EU Deposit Guarantee Scheme or by the EU Investor Protection Scheme.
Offers	When a crowdfunding offer is made, the CSP must make that information publicly available on the platform and via every relevant mobile application and webpage.
Credit scores and pricing	If the CSP applies credit scores or suggests pricing for crowdfunding offers, it must disclose its calculation methods.
Disclosure of default rates	CSPs that facilitate peer-to-peer business lending must publish information about the rates of default on the projects offered via their platforms.
ADVERTISING BY CLIENTS	
Bulletin boards	<p>CSPs can operate bulletin boards on which their clients can advertise their interest in buying and selling loans and transferable securities.</p> <p>The bulletin board cannot constitute a ‘matching’ system and cannot be operated in a manner which could lead to a contract being created.</p>
KEY INVESTMENT INFORMATION SHEETS	
<i>(these do not require NCA approval)</i>	
Key Investment Information Sheet	<p>A CSP must provide a key investment information sheet, prepared by the relevant project owner, to all prospective investors.</p> <p>The sheet must contain the information set out in Annex I to the Regulation, and the disclaimer and risk warning set out in Article 23 of the Regulation.</p> <p>The project owner is responsible for the information set out in the key information sheet, but the CSP must have procedures in place to verify that information and must raise omissions, inaccuracies or mistakes with the project owner.</p> <p>If the CSP raises issues with the sheet that are not corrected promptly, the CSP must suspend the corresponding crowdfunding offer by up to 30 calendar days. Thereafter, it must cancel the offer if it is not satisfied that the issues with the sheet have been resolved.</p>

Portfolio Management	Where the CSP is providing ' <i>individual portfolio management of loans</i> ', it can instead draw up a key investment information sheet at platform level for prospective investors. Responsibility for that information sheet rests with the CSP rather than the individual project owners.
REFLECTION PERIOD	
'Non-Sophisticated' Investors: 4 day withdrawal period	A ' <i>non-sophisticated</i> ' investor will have a reflection period of four calendar days within which it can revoke an offer or expression of interest without penalty, and without needing to give a reason. Where the CSP provides ' <i>individual portfolio management of loans</i> ', the reflection period only applies in respect of the initial mandate from the investor to the CSP, and not to the investments made on foot of that mandate.
MARKETING	
Communications	Marketing communications by a CSP must be fair, clear and not misleading and must be clearly identifiable as marketing communications.
Targeting	Marketing communications cannot disproportionately target particular crowdfunding offers or projects before the relevant fund-raising exercise has closed.

WILL THERE BE REPORTING OBLIGATIONS?

There are two key reporting obligations set out in the Regulation:

CSPs: Annual List of Projects: Each CSP must provide a confidential annual report to its NCA of projects funded through its platform. The NCA must in turn share that information (duly anonymised) with ESMA. ESMA will use that information to publish aggregated annual statistics.

NCAs: Authorisations: NCAs must notify ESMA of all CSP authorisations that are granted. These details will be included by ESMA on a public register.

IS AML RELEVANT?

The Commission must review the operation of the Regulation by 10 November 2023. One of the points that it must address as part of that review is whether CSPs should be brought into the scope of the Fourth Money Laundering Directive as obliged entities.

WAS THERE A PLAN FOR A PARALLEL IRISH FRAMEWORK?

Yes. Initial discussions on a regulatory framework for CSPs envisaged an EU-level authorisation regime for CSPs that wanted to passport their services in respect of investment-based crowdfunding and peer-to-peer business lending across the EU.²

In its [IFS 2020 Action Plan 2019](#), the Department of Finance proposed to regulate crowdfunding in Ireland by putting in place a domestic regulatory

regime, in parallel with the Commission's planned framework, "*to ensure sufficient consumer protection for unsophisticated investors and to facilitate the growth of crowdfunding as an alternative source of finance for Irish SMEs*".³

However, the scope of the EU's crowdfunding framework evolved. As outlined above, the framework now involves authorisations being managed at NCA level, with authorisation being required whether the CSP wants to operate at a domestic level only, or cross-border. As such, a bespoke Irish regime would no longer appear to be necessary, and that proposal did not appear in the recent [Ireland for Finance Action Plan 2021](#).

However, the Commission is required to assess (by 10 May 2022) the impact of the Regulation on CSPs that provide in-scope crowdfunding services on a national basis only. That may result in the transitional period under the Regulation being extended by a further 12 months.

WHAT HAPPENS NEXT?

ESMA must develop a number of technical standards in advance of 10 November 2021. On 26 February 2021, it published a [consultation paper](#) with draft technical standards on complaints-handling, conflicts of interest, business continuity plans, authorisation applications, providing information to clients on the default rates of projects, entry knowledge test and simulation of the ability to bear loss for '*non-sophisticated*' investors, the key investment information sheet, reporting by CSPs to NCAs and by

NCAs to ESMA, and the publication of national provisions concerning marketing requirements.

Further draft technical standards on cooperation between NCAs are due from ESMA in 2022.

Draft technical standards on the individual portfolio management of loans must be prepared by the European Banking Authority (**EBA**) by 10 November 2021. The EBA must also prepare draft technical standards in relation to credit scoring and suggested pricing of loans by 10 November 2022.

COMMENT

We welcome the clarity and certainty that has been brought by the Regulation and look forward to the technical standards being finalised - we anticipate that these will be consistent with the proportionate and low-cost framework established by the Regulation.

Ireland is an attractive location for the establishment of crowdfunding platforms and the Regulation will enable our clients to provide much needed liquidity for small business, not just in Ireland but on a pan-EU basis.

Our Financial Regulation Group has extensive experience of advising on licensing perimeter issues and on licensing applications to the CBI for a wide range of regulated firms, and would be very happy to assist with queries in relation to the scope of the new regime and the licensing process.

² See [Crowdfunding: Should it be regulated? Department of Finance begins industry consultation \(Arthur Cox, April 2017\)](#) and [Crowdfunding Update: European Commission proposal awaited; Department of Finance publishes Feedback Statement \(Arthur Cox, January 2018\)](#).

³ See [Crowdfunding: Domestic regulatory regime now likely \(Arthur Cox, March 2019\)](#).

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