

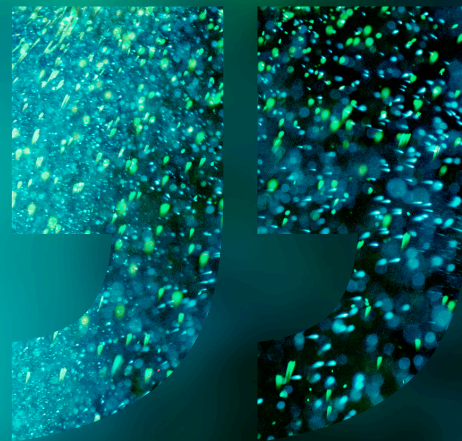
C L I F F O R D  
C H A N C E



European Bank  
for Reconstruction and Development



**REGULATING INVESTMENT-  
AND LENDING-BASED  
CROWDFUNDING:  
BEST PRACTICES**



OCTOBER 2018

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## EXECUTIVE SUMMARY

Crowdfunding can be seen as one part of the broader universe of technological innovations with potentially transformative implications for the financial system, its intermediaries and users. Because crowdfunding remains, to a large extent, a regional or local phenomenon, several EBRD countries of operations have already introduced, or are planning to introduce, domestic regulatory frameworks on crowdfunding which may be tailored to the characteristics and needs of local markets and investors. This Report contains an analysis of the current regulatory framework for lending-based and investment-based crowdfunding platforms in the following countries: Austria, Dubai<sup>1</sup>, France, Germany, the UK and the U.S. and recommendations for best practices for the regulation of lending-based and investment-based crowdfunding platforms.

In addition to the regulatory framework governing lending-based and investment-based crowdfunding in the countries examined, we have taken into account the views of a number of regulators and platform operators that are active in the market.

It is also important to acknowledge the backdrop to any regulatory framework for crowdfunding. It may, therefore, be necessary to identify and address certain pre-existing contextual elements which present barriers to the development of crowdfunding in any given jurisdiction.

What constitutes a best practice for the regulatory framework applicable to crowdfunding in any specific jurisdiction must necessarily take account of, and be informed by, the broad context particular to that jurisdiction. Consequently, there is unlikely to be a single regulatory framework that provides best practice for all jurisdictions and all contexts. However, this Report does identify those aspects of a regulatory framework which appear to provide a best practice which would likely be common for many jurisdictions

and contexts, as well as certain best practice elements or tools which may be deployed additionally and variably, as may be appropriate to the context.

It is clear from the range of platforms surveyed for this Report that there is a significant degree of variation in operating model even between crowdfunding platforms of the same type. A key design principle which has been reiterated by a number of regulators and platforms is the need for flexibility within the regulatory framework to accommodate this variance. In this vein, we make a series of recommendations which draw upon commonalities and best practices identified from across jurisdictions on the following principal themes: (i) type of authorisation(s) required for the operation of platforms; (ii) capital and liquidity requirements; (iii) KYC rules and AML checks required; (iv) maximum size of offer/loan; (v) maximum investable amount; (vi) consumer protection measures, including type of investor disclosures; (vii) risk warnings; (viii) due diligence/pre-funding checks.

### Our recommendations

Following the analysis based on the approach described, we have reached the following positive conclusions on measures that should be considered when developing a regulatory framework. This list is not exhaustive and does not include where we have reached a negative conclusion, i.e. that certain approaches should not be taken.

- Where platforms' activities align with existing regulated activities, that existing framework could be leveraged to regulate crowdfunding in a tailored manner. However, we recommend that a bespoke regime may often be more appropriate.
- We consider that minimum capital requirement should be imposed on platforms to ensure that, in the event of financial distress, platforms can continue to meet operational or compliance costs, and that these requirements should be based on the nature and scale of the activities undertaken by the platforms and be commensurate with their attendant risk.

<sup>1</sup> References to Dubai should be read as references to the Dubai International Finance Centre ("DIFC"), whose regulatory regime does not provide permissions to operate crowd-funding activities elsewhere in the UAE. This report focusses only on the DIFC regime.

- Platforms should be required to maintain such systems and controls as are necessary for their business and, in particular, to identify, manage, track, mitigate and report risks within and to their business. Risks may include operational risk, cybersecurity, protection of personal data and the risk that the platform may be used in the furtherance of financial crime. These risks should be identified, managed and tracked by platforms themselves as part of their overall risk management framework.
- We consider that it is appropriate to mandate platforms to ensure that their employees/officers are fit and proper to perform their role and that platforms are in the best position to make this assessment.
- We consider that platforms should have the primary responsibility for identifying, managing, mitigating and reporting conflicts of interests and that the financial services regulator should be empowered to bar investments by platforms where appropriate.
- We consider that there should be a specific business conduct requirement for a platform to provide adequate disclosure to investors and issuers/borrowers in order that they are able to understand how the platform operates, particularly in relation to how the platform earns its revenue.
- We consider that jurisdictions should ensure that risk warnings and disclosures to investors are tailored to the relevant product offered by the platform and that mandatory standards reflect this approach.
- We consider that there may be good reasons to differentiate between retail

investors and institutional investors when it comes to providing information and that retail investors may benefit from having clearer risk warnings and disclosures than those received by institutional investors.

- We consider that a regime which classifies investors is more appropriate than mandating detailed suitability checks for all investors and that financial services regulators are best placed to determine these categories.
- We consider that platforms should be required to enter into agreements with their clients governing the main terms of the client-platform relationship.
- We consider that jurisdictions should ensure that platforms are permitted, but not necessarily obligated, to offer automated tools relating to the diversification of investor portfolios.
- We consider it appropriate for lending-based platforms to provide information to investors on their post-investment rights/arrangements for loan

enforcement, whether this entails a trustee-type arrangement or other mechanism for enforcement.

- We consider that platforms should be required to carry out KYC checks on clients. The level of such checks could be tailored to a risk assessment performed by the platform. We believe that it is the financial services regulator who is best placed to set guidance for platforms in this regard. We would expect such requirements to be aligned with existing KYC requirements of a jurisdiction, and should be commensurate with the risk presented by clients.

The recommendations set out above are a non-exhaustive list of best practices which we have identified and consider to be mandatory. The full list of mandatory best practices and non-mandatory additional tools which may be employed are listed throughout the report and are set out in full in Appendix 1 to this report.





## DEFINITIONS AND SCOPE

### Introduction, objectives, definitions and scope

In the last few years, disruptive innovation in the form of financial technology has thrived in the financial services sector and is in many ways changing finance. This disruption presents challenges for existing financial sector actors but also opportunities for new entrants or for existing actors. By providing an online marketplace to match investors and investees or lenders and borrowers, investment-based and lending-based crowdfunding can bring more competition into retail and capital markets. Namely, in addition to providing an alternative source of financing directly, crowdfunding can offer a number of other benefits to companies: it can give a proof-of-concept and idea validation to the project seeker; it can help attract other sources of funding, such as venture capital and business angels; it can give access to a large number of people providing the entrepreneur with insights and information; and it can be a marketing tool if a campaign is successful. Crowdfunding can therefore be seen as one part of the broader universe of technological innovations with potentially transformative implications for the financial system, its intermediaries and users.

As with all investments, crowdfunding also entails a number of risks (such as project and liquidity risks, platform failure, cyber-attack) and concerns (for instance, investors' inexperience, reliability of the investment, lack of regulation or different regulatory regimes) for retail investors and SMEs. But, with appropriate safeguards concerning investor

**“...disruption presents challenges for existing financial sector actors but also opportunities for new entrants or for existing actors.”**

protection, crowdfunding can be an important source of non-bank financing in support of job creation, economic growth and competitiveness.

Because crowdfunding remains, to a large extent, a regional or local phenomenon, several EBRD countries of operations have already introduced, or are planning to introduce, domestic bespoke regimes on crowdfunding (most notably Estonia, Latvia, Lithuania, Morocco and Turkey). These countries are tailoring their regulatory framework to the characteristics and needs of local markets and investors, which results in differences on how the rules are designed and implemented. Consequently, cross-border project funding on crowdfunding platforms is still limited.

The European Commission has taken note of these developments and recognised crowdfunding as “*one of many technological innovations that have the potential to transform the financial system*”<sup>2</sup>. The Commission further recognised that, while there are a number of similarities between national regulatory regimes with respect to crowdfunding, there are also numerous differences. These include variations in licensing requirements, minimum capital requirements, consumer protection measures and platforms' organisational requirements.

However, the Commission concluded in May 2016 that: “*given the predominantly local nature of crowdfunding, there is no strong case for EU level policy intervention at this juncture.*

*Crowdfunding is still relatively small and needs space to innovate and develop. Given the dynamism of crowdfunding and the potential for future cross-border expansion, it will be important to monitor the development of the sector and the effectiveness, and degree of convergence of, national regulatory frameworks*”<sup>3</sup>.

More recently, the Commission indicated that it would introduce legislative proposals for an EU framework on crowdfunding aimed at addressing two problems with the EU market, namely market fragmentation and lack of scale and a perceived lack of reliability of crowdfunding and peer-to-peer platforms. In this regard, the Commission prepared an inception impact assessment and a report identifying market and regulatory obstacles to cross-border development of crowdfunding in the EU.

Following this, on 8 March 2018, the Commission, in connection with its 2018 Work Programme, issued a FinTech Action Plan and a draft Regulation on Crowdfunding (the “**New EU Crowdfunding Regulation**”) which will harmonise applicable rules and allow platforms to offer services both in their home jurisdictions and across the EU.<sup>4</sup> This will be accompanied by a new directive to amend the existing investment services

<sup>2</sup> [https://ec.europa.eu/info/system/files/crowdfunding-report-03052016\\_en.pdf](https://ec.europa.eu/info/system/files/crowdfunding-report-03052016_en.pdf)

<sup>3</sup> Ibid.

<sup>4</sup> [https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-113\\_en](https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-113_en)

regulatory regime in the EU under MiFID2, to take account of changes necessary for investment-based crowdfunding under the new specific regime under the New EU Crowdfunding Regulation. These proposals will go through the usual EU legislative process before their adoption

Similarly, IOSCO concluded in its Statement on Regulation of Crowdfunding on 21 December 2015 that, while there are benefits from crowdfunding, there is an important balancing role for regulators and policy-makers to play:

*"[W]hen developing or investing in crowdfunding, IOSCO believes it is important for regulators and policy-makers to balance the need for supporting economic growth and recovery with that of protecting investors."*<sup>5</sup>

However, IOSCO went on to note that *"[b]ecause crowdfunding is in its infancy, IOSCO has not yet proposed a common international approach to the oversight or supervision of crowdfunding. But the Statement encourages regulators to take into account possible cross border implications"*.<sup>6</sup>

In the meantime, this has left a vacuum for the identification of generally accepted best practices with respect to the regulation of crowdfunding.

This study was specifically commissioned by the EBRD with a view to positively contributing to the existing literature and thinking on crowdfunding as a new tool for SME financing whilst seeking to address the gap identified above with proposed best practice guidance for legislative reform work relating to crowdfunding in the EBRD countries of operation and beyond.

## Report objective

This Report contains:

- (a) an analysis of the current regulatory framework for lending-based and investment-based crowdfunding platforms in the following countries: Austria, Dubai (DIFC), France, Germany, the UK and the U.S. (the **"Countries"**). The Countries were selected to provide a cross-section of geographies, approaches and degrees of market maturity. The UK and the U.S. are considered as leaders in crowdfunding, whose regulatory regimes form the basis for highly developed markets. Austria, France, Germany and the DIFC are regarded as model jurisdictions for the EBRD's countries of operation and are therefore also included to provide additional perspective and to ensure an inclusive survey of pertinent jurisdictions.
- (b) recommendations for best practices for the regulation of lending-based and investment-based crowdfunding platforms, including, but not limited to, the following:
  1. type of authorisation(s) required for the operation of platforms
  2. capital and liquidity requirements
  3. KYC rules and AML checks required
  4. maximum size of offer/loan
  5. maximum investable amount
  6. consumer protection measures, including type of investor disclosures
  7. risk warnings
  8. due diligence/pre-funding checks
  9. conflict of interest
  10. platforms' governance requirements

This Report does not specifically tackle the issue of cross-border transactions, whether these are flows of capital between investors in one jurisdiction and investees in another, or whether these relate to platforms and/or platform operators operating across borders. This is, however, an important topic worthy of its own discussion and consideration and raises a number of issues including conflicts of law rules, issues regarding protection of participants and dispute management, and, in the broader context, whether and how financial services may be provided on a cross-border basis at all. Indeed, this is an important aspect that the New EU Crowdfunding Regulation seeks to address within the EU's internal market.

## Definitions and scope

This Report is concerned with the regulatory framework governing two types of crowdfunding:

1. **lending-based crowdfunding:**  
money is lent to individuals or businesses with a view to a financial return in the form of interest payments and a repayment of capital over time; and
2. **investment-based crowdfunding:**  
money is invested in unlisted shares issued by businesses. Investment-based crowdfunding also includes platforms where money may be invested in debt securities issued by businesses.

There are other forms of crowdfunding such as donation-based crowdfunding, whereby money is gifted to individuals or businesses with no right or expectation of financial or other returns, and reward-based crowdfunding, whereby money is gifted to individuals or businesses with a view to a non-financial return such as a product or service.

<sup>5</sup> <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD521.pdf>

<sup>6</sup> <https://www.iosco.org/news/pdf/IOSCONEWS415.pdf>

However, this Report does not consider these alternative forms of crowdfunding.

Within the broad categories of lending-based and investment-based crowdfunding, there is a diverse spectrum of operating models deployed by platforms. For example, within the investment-based crowdfunding category, some platforms may operate nominee company structures, others may mandate certain shareholder rights, and some may operate a default fund. Others still may not utilise any of these arrangements.

This report also takes into account the views<sup>7</sup> of certain regulators and platform operators active in those Countries, including, but not limited to those identified below:

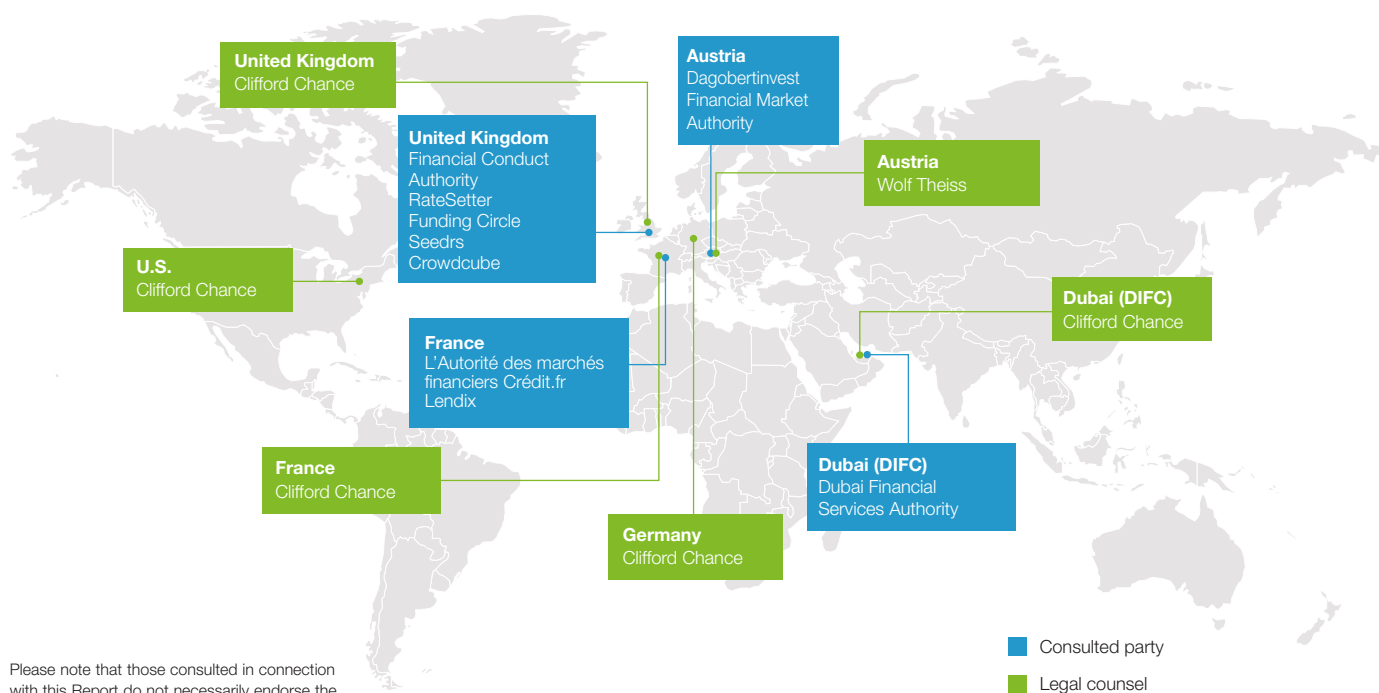
### Best practices

The best practices recommended in this Report are based on: (i) a qualitative assessment of the foregoing; and (ii) an understanding of the operational, commercial and technological needs and capabilities of crowdfunding platforms.

The best practices recommended in this Report are separated into: (i) those which we consider should be mandatory for all jurisdictions forming a core, common regulatory standard irrespective of context; and (ii) those which are not mandatory but are additional tools which could be afforded to the financial services regulator to deploy in jurisdictions where the regulator reasonably considers that there is a need to do so based on, for example, identified systemic or idiosyncratic risk. However, this should be subject to a policy-maker in a

relevant jurisdiction taking the view *ab initio* to deploy or to prohibit the deployment of such tools on the basis of the specific context of that jurisdiction, for example, identified systemic or idiosyncratic risks or social political or economic factors or because it achieves certain specific aims and objectives of the policy-maker.

This may well mean that the overall shape of the regulatory framework across jurisdictions should be broadly the same based on the core, common regulatory standards. However, some jurisdictions may opt to use a wider range of additional tools than others, and others may deploy additional tools in particular areas but not others, reflecting the nuances and broader context of that particular jurisdiction.



Please note that those consulted in connection with this Report do not necessarily endorse the content or the recommendations reached.

<sup>7</sup> These views have taken the form of general comments and observations on certain aspects of regulation, and do not include the review or verification of the descriptions of the regulation contained in this report.

## ISSUES, ANALYSIS AND RECOMMENDATIONS

### 1. Relevance of the Existing Framework

In order to be able to comment constructively on what may be appropriate best practice in respect of a regulatory framework for crowdfunding, it is necessary first to ask the question: “what is the problem to which crowdfunding is the answer?”. The answer to this should provide an illuminating backdrop against which

an appropriate framework could be developed.

#### What is the problem to which crowdfunding is the answer?

Certainly, historically, one answer to this question is that, in the wake of the 2008 financial crisis, crowdfunding was seen by policy-makers as a means of “encourage[ing] investment in small firms and start-ups [by seeking...] to leverage technology, *inter alia*, to provide an

*alternative channel for capital raising*”, and it is no coincidence that there has been rapid growth of crowdfunding since 2008. For example, an IOSCO paper cited a figure of 100% year-on-year growth in global peer-to-peer lending since 2009.<sup>8</sup>

However, there are a range of benefits which crowdfunding may bring. These benefits may include some or all of those set out in Figure 1.

Fig. 1 – Benefits of crowdfunding

Benefits to those seeking capital	Benefits to those deploying capital	Benefits to entrepreneurs generally	Benefits to economy/society
<ul style="list-style-type: none"> <li>• Accessible and competitive marketplaces for seeking capital</li> <li>• The ability to raise capital, in most cases without giving up large parcels of equity</li> <li>• Alternative to venture-and seed-capital (particularly, where access to the latter is limited)</li> <li>• Lower cost of capital</li> <li>• Quicker, lower-friction access to capital</li> </ul>	<ul style="list-style-type: none"> <li>• Higher returns on investment to lenders/investors</li> <li>• Mechanisms to spread risk (both in terms of a single defaulting borrower/investee among multiple lenders/investors but also in terms of lenders/investors having a range of potential borrowers/investees to fund)</li> <li>• An investable asset class for alternative credit providers (e.g. funds and other investors)</li> </ul>	<ul style="list-style-type: none"> <li>• Alternative route for proof-of-concept and idea validation</li> <li>• Diverse market for other sources of funding</li> <li>• Access to broader insights and information</li> <li>• Potential for a new marketing tool for businesses</li> </ul>	<ul style="list-style-type: none"> <li>• Boost to economic activity, particularly in relation to SMEs (account for large proportion of employment and added value – see also Figure 2 below)</li> <li>• Means of facilitating economic recovery</li> <li>• Increase in retail engagement in financial services</li> <li>• Possible social effect of increased female representation<sup>9</sup></li> </ul>

<sup>8</sup> <https://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>, 14.

<sup>9</sup> [Activist Choice Homophily and the Crowdfunding of Female Founders](#), Greenberg and Mollick, 2016.



Fig. 2 – Contribution of SMEs to EU employment and value added

	Micro	Small	Medium	SME	Large	Total
<b>Number of enterprises</b>						
In thousands	22,232	1,392	225	23,849	45	23,894
In % of total enterprise population	93.0%	5.8%	0.9%	99.8%	0.2%	100.0%
<b>Number of persons employed</b>						
In thousands	41,669	27,982	23,398	93,049	46,665	139,714
In % of total employment	29.8%	20.0%	16.7%	66.6%	33.4%	100.0%
<b>Value added</b>						
In EUR trillion	1,482	1,260	1,288	4,030	3,065	7,095
In % of total value added	20.9%	17.8%	18.2%	56.8%	43.2%	100.0%

**Source:** Eurostat, National Statistical Offices, and DIW Econ.

**Note:** Dated as at 30 June 2017. Totals may differ from sum of components due to rounding.

Clearly, a number of these benefits overlap and their importance and relevance will differ significantly depending on a range of factors, including the existing legal and regulatory framework as well as the economic climate in the relevant jurisdiction.

### The context for a crowdfunding regulatory framework

Whether governments and policy-makers of any given jurisdiction are able to germinate a successful crowdfunding industry will depend on an array of factors far beyond the legal and regulatory framework put in place to govern that industry – the social, political and economic environment and the existing legal and regulatory framework will be highly relevant, and we expand on these below. Some of these factors will amount to barriers to crowdfunding, which cannot be tackled by means of legislative or regulatory reform in financial services alone.

What constitutes best practice for the regulatory framework applicable to crowdfunding in any specific jurisdiction must necessarily take account of, and be informed by, the broad context particular to that jurisdiction. Consequently, there is unlikely to be a single regulatory framework that provides best practice for all

jurisdictions and all contexts. In other words, there is unlikely to be a one size that fits all. But it has to be acknowledged that any regulatory approach has to take into consideration the cross-border character of crowdfunding platforms to ensure that a market of sufficient size can be created, thereby ensuring an appropriate level of investor protection.

That said, this Report does identify those aspects of a regulatory framework which appear to establish a best practice which should be common across jurisdictions and contexts (we refer to these as “mandatory”), as well as certain best practice elements (which we refer to as “additional tools”), which we do not consider to be mandatory but which may be instead, deployed additionally and



variably, as may be appropriate to the particularities of a jurisdiction.

### Social, political and economic environment

The social, political and economic environment of any given jurisdiction will play a highly significant role in facilitating or, indeed, restricting the development of an effective crowdfunding industry. These contextual elements can range from the level of financial education of investors through to whether relevant tax policy acts as an incentive or disincentive to investment.

A full exposition of such factors is beyond the scope of this Report. However, it is sufficient to note that policy makers can change and/or influence these social,

political and economic factors through education, tax policy, or such other means as may be relevant.

As an example of the importance of these contextual elements, a number of crowdfunding platforms have pointed to favourable government support of crowdfunding as providing benevolent conditions in which crowdfunding was able to flourish within the UK. This government support in the UK has been manifested in a number of ways, including by the introduction, in 2016, of new tax policy which sought to incentivise investors to invest savings through lending-based crowdfunding platforms (interest and gains from peer-to-peer loans would qualify for

tax advantages where these loans are made through an Innovative Finance Individual Savings Account (ISA)<sup>10</sup>. Separately, the British Business Bank, a 100% government-owned enterprise, has made significant investments through certain crowdfunding platforms over the last three years (see Figure 3 below).

These factors, in the opinion of a number of UK platforms, have provided, at the very least, a tacit signal to investors and potential investors that the UK government is supportive of crowdfunding and, beyond this, definitive incentives for UK-resident investors to engage in investment activity via such platforms.

Fig. 3 – British Business Bank investments through lending-based crowdfunding platforms

In January 2017, British Business Bank Investments Ltd, the commercial arm of the government-owned British Business Bank, announced that it would lend a further £40mn to UK small businesses through Funding Circle, having already lent £60mn to more than 10,000 businesses across the UK through Funding Circle.<sup>11</sup>

The British Business Bank has made investments of approximately £130mn through lending-based crowdfunding platforms since November 2014.<sup>12</sup>

Platform	Total £m invested
Funding Circle	£100mn
Market invoice	£15mn
Zopa	£10mn
RateSetter	£10mn
<b>Total:</b>	<b>£135mn</b>

<sup>10</sup> <https://www.gov.uk/government/publications/income-tax-innovative-finance-individual-savings-account-and-peer-to-peer-loans/income-tax-innovative-finance-individual-savings-account-and-peer-to-peer-loans>

<sup>11</sup> <https://british-business-bank.co.uk/british-business-bank-investments-ltd-expands-partnership-funding-circle/>

<sup>12</sup> [http://bridgingandcommercial.co.uk/article-desc-11689\\_the-british-business-bank-invests-163135m-in-p2p-platforms](http://bridgingandcommercial.co.uk/article-desc-11689_the-british-business-bank-invests-163135m-in-p2p-platforms)

### Existing legal and regulatory framework

Another key contextual element is the existing legal and regulatory framework, including, among other things, that governing:

1. Company formation and governance
2. Financial services regulation, including:
  - Provision of regulated financial services (including credit and securities-related activities)
  - Provision of services ancillary to regulated financial services (including credit reference and information services)
  - Securities issuance and trading
  - Financial crime
3. Insolvency
4. Consumer protection
5. Electronic commerce
6. Tax
7. Enforcement and court process

While it is highly likely that the existing legal and regulatory framework will not have been specifically developed with crowdfunding in mind, it is important since it serves as the underpinning for any crowdfunding regulatory framework to be developed. It may be difficult, for example, for lending-based crowdfunding platforms to thrive in circumstances where lending to corporates is the preserve of banks only and/or where the court process for enforcing loans is cumbersome, expensive and/or lengthy. Platforms operating under such restricted

legal and regulatory frameworks are prohibited outright or deterred from providing their services, attracting and retaining investors.

The particular existing regulatory framework for each given jurisdiction will be necessarily unique. The development of any crowdfunding framework must therefore take account of, and, where necessary, correspond with or override, this existing legal and regulatory frameworks.

However, certain elements may be common, either as a result of (i) common historical legal heritage, e.g. jurisdictions with a common law tradition, or (ii) because of positive legislative harmonisation efforts, e.g. at an international or supranational level such as under the auspices of the European Union. As noted above, the

European Commission has proposed a New EU Crowdfunding Regulation, seeking to harmonise authorisation, conduct, administration and supervisory approach to crowdfunding platforms on a pan-EU basis. We have, throughout this Report, referred to certain aspects of this proposal where relevant to the issues examined.

Ideally, there would be international efforts to harmonise regulation; not necessarily specific to crowdfunding but, where possible, with a view to convergence on some of the key areas of law listed above. Ideally, this would follow something akin to the process that the EU follows in identifying barriers to international trade and targeted action to remove such barriers.



## 2. Macro-level Design Principles

When developing the best practice for a crowdfunding regulatory framework, there are some macro-level design principles which need to be considered. These will be driven, to some extent, by the contextual elements described above.

### Desirability of regulation

The first question which needs to be addressed is whether a specific regulatory framework for crowdfunding is required at all – either because the relevant activities are unregulated in a jurisdiction or because the activities are already sufficiently and appropriately catered for and/or regulated.

This will depend on what activities the crowdfunding platform is likely to carry out, and the extent to which these activities are already regulated in the jurisdiction concerned. However, the application of existing generally applicable rules may not serve the specifics of crowdfunding. This may hamper the facilitation of platforms' activities, where the standards set by existing rules may be unsuited to crowdfunding platforms. For example, in some jurisdictions, such as the UK, lending to corporates is unregulated. Therefore, regulating the intermediation of such loans via a platform would represent an increase in regulatory hurdles, i.e., be more burdensome. By contrast, in respect of investment-based crowdfunding, most jurisdictions already have an existing investment services regime which would be relevant. For example, in the EU, the activities of dealing in investments, receiving and transmitting orders and/or providing safeguarding and administration services are regulated under EU Directive 2014/65/EU (better known as MiFID2). Additionally, Regulation (EU) 2017/1129 (Prospectus Regulation) provides details on the EU Growth Prospectus which is

significantly lighter than the standard prospectus in terms of administrative burden and costs.

Adapting an existing regime to apply to crowdfunding platforms by means of creating exceptions to existing rules risks being more cumbersome and giving rise to the potential for interpretational difficulties. We prefer implementing a bespoke regime which would be permissive in nature. However it cannot be excluded that it may be more efficient to use an existing regime where platforms' activities align with existing regulated activities. Where this is the case, such an existing framework could be leveraged but tailored appropriately.

It should also be noted, in this context, that the failure to legislate or introduce regulation (at all, sufficiently and/or appropriately) may have a number of consequences – at best, it may simply give rise to a barrier to entry, meaning that platform operators have insufficient clarity and certainty of the legal and regulatory framework for their operations that they consider conducting the business to be too high risk. In turn, this may shut off a potentially helpful source of finance for SMEs and a potentially attractive outlet for capital deployment by investors and lenders.

However, non-existent, insufficient and/or inappropriate regulation may also lead to gaps which may be exploited and a lack of suitable protections for investors/lenders and investees/borrowers; for example, if there are no minimum standards to be adhered to by platforms, unscrupulous operators may establish platforms which are ill-managed, do not manage information asymmetry, continuity, etc. and which ultimately may not protect the interests of investors or investees.

### 2.2 Possibility to regulate

A second question is to determine the extent to which it is feasible to adopt a specific regulatory framework for crowdfunding and whether there may be constraints on doing so.

In the context of the EU, for instance, significant parts of the MiFID2 framework referred to above are so-called “maximum harmonising”. Under such a regime, the scope for EU Member States to introduce differing domestic legal or regulatory standards is highly restricted in given areas. A discretion they might ordinarily expect is limited with a view to ensuring a common rulebook insofar as possible. As a consequence of this, individual EU Member States will be limited in their ability to introduce a highly bespoke investment-based crowdfunding regulatory framework. Any such framework would need to complement and accord with the existing MiFID2 structure.

By contrast, jurisdictions outside the EU will not be bound by this framework and may, therefore, have more flexibility and autonomy to introduce a specific, tailored regime for investment-based crowdfunding.

That is not to say that the EU model is entirely disadvantageous; assuming the activities of an investment-based crowdfunding platform based in an EU Member State fall within the scope of MiFID2, that platform would potentially benefit from a so-called “passport” allowing it to provide its services on a pan-EU basis.

### Overriding the existing regulatory framework

Another design question will be the extent to which policy-makers may wish to override the existing regulatory framework (assuming this is possible – see above).



For example, in the UK, some platform providers indicated that the UK's client-money rules, while generally a useful and beneficial regime for the protection of client-money, could be potentially too extensive and cumbersome insofar as they relate to crowdfunding platforms. In other words, the existing regulatory framework may not be entirely fit for purpose and, ideally, an alternative would be developed or the existing rules tailored accordingly.

Similarly, in the U.S., the crowdfunding frameworks available there tend to operate by way of exceptions to generally applicable securities laws that may be overridden to provide certain exemptions for crowdfunding.

### **Distinguishing between crowdfunding types**

Consideration should also be given to whether and the extent to which the regulatory framework governing different types of crowdfunding should be tailored accordingly or whether the regulatory framework should be broadly the same for all types of crowdfunding. Our view, as further set out below, is that there are some common elements to the framework governing different types of crowdfunding. Notwithstanding, there are some elements of best practice which are specific to the type of crowdfunding that address particular risks or nuances of the relevant crowdfunding type.

That said, we note that there are jurisdictions where, in practice, lending-based crowdfunding is often structured in the form of debt securities. For example, Austrian regulations ensure that, in practice, qualified subordinated loans issued as debt securities are treated in the same way as equity-based securities. In such cases, the relevant framework

applicable to both lending-based and investment-based crowdfunding will be more closely-aligned than in other jurisdictions where lending-based crowdfunding takes the form of bilateral/syndicated loans.

### **Regulatory framework focus**

Another aspect of the overall blueprint for a crowdfunding regulatory framework is the extent to which the focus of that framework should be on the investor-investee relationship and, for example, address the information asymmetry between them. Whether regulation should envisage the role of the platform to be facilitative of the interaction between parties, or whether the framework should focus on the platform operator, as providing a financial service in its own right as an intermediary, is a fundamental question. If the latter is the case, regulation may require the platform operator to deal with potential conflicts of interest between it and its clients, as well as between different clients. In our view, as described in more detail below, best practice is served by balancing these approaches.

Our focus throughout this Report has been to identify those standards which we think are important to uphold and also to identify which actor within the ecosystem is best placed to achieve those standards – whether that is the platform, investors and/or regulators. Our approach to making recommendations as regards the activities that are best-suited to being performed by platforms is based on the market practice, taking into account that the structure of investments which take place through crowdfunding platforms will differ from jurisdiction to jurisdiction.

As an example, as regards the enforcement of lending-based investments, examined at Section 4.3.2 below, a key question is who, in the event of a failure to repay, is best-placed to take enforcement or administration action. The principal options available are that enforcement: (i) could be left to individual investors, (ii) the platform could take steps to enforce on behalf of investors, or (iii) a professional third-party enforcement provider could be appointed by the investors or the platform to take these steps.

In our view, the first option is likely to be cumbersome, duplicative and inefficient. By contrast, the second and third options provide for a coordinated, more efficient methodology and consequently, we would recommend that best practice is that either the platform should be mandated to determine and take the appropriate enforcement action on behalf of investors (taking into account their best interests) or should appoint a professional third party to do so on its behalf or on behalf of investors.

### **2.6 Necessity for framework flexibility**

It is clear from the range of platforms surveyed for this Report that there is a significant degree of variation in operating model even between crowdfunding platforms of the same type. A key design principle which has been reiterated by a number of regulators and platforms is the need for flexibility within the regulatory framework to accommodate this variance. For example, the UK Financial Conduct Authority (“FCA”) has stated that it was conscious, when designing its regime, of ensuring sufficient flexibility for firms to operate and arrange finance for small and medium-sized enterprises.



### 3. Specific Considerations: Platform Requirements

#### 3.1 Authorisation and licensing

Authorisation requirements are an important mechanism used by jurisdictions to help provide assurance to consumers that they are protected. They ensure that there is formal oversight by the regulator and usually come with enforcement arrangements which allow action to be taken if regulators believe that either a platform is operating without authorisation or that an authorised platform is not meeting required standards or offering sufficient consumer protections.

Operating as a regulated entity can also be beneficial for platforms as consumers may have more confidence in the platform itself and in the market as a whole. Of course, it is also vital within a robust regulatory framework that, when necessary, enforcement actions are taken against “bad actor” platforms which could threaten the integrity of the market through platform failure and loss of consumer confidence.

All Countries have imposed some form of licensing or authorisation requirements on crowdfunding platforms. Appendix 2 of this Report provides detail on the authorisation/licensing requirements of each Country, which vary considerably depending on the existing regulatory framework applicable to financial services and securities.

Some Countries have introduced bespoke authorisation requirements for crowdfunding platforms. The DIFC and France have introduced such requirements for investment-based and



lending-based crowdfunding, whereas the UK has done so only for lending-based, and the U.S. investment-based crowdfunding respectively.

Where, however, crowdfunding activities sit within an existing licensing and regulatory framework, jurisdictions often introduce some crowdfunding-specific adaptations (although not specifically relating to authorisation). For instance, the UK’s investment-based regime sits within the existing securities framework, and the FCA introduced restrictions on direct financial promotions to retail investors. Other Countries, notably Germany and Austria, have introduced exemptions or special rules which have allowed or encouraged platforms to operate within their existing regimes, e.g. the German crowdfunding exemption includes a higher threshold for certain types of loans brokered by platforms, below which a prospectus would not be not required.

Across all regimes, the authorisations required will depend on the activities of the platform. Several of the Countries prevent certain entity types from holding client-assets (e.g. *Conseils en Investissement Participatifs* (“CIPs”) in France,<sup>13</sup> Funding Portals<sup>14</sup> in the U.S.). The DIFC requires platforms to seek additional permissions if they are holding client-assets or providing services to retail clients. We consider that authorisations should be by reference to the activities of the platform, e.g. the particular products offered and the types of investors served.

While the type of authorisation or licensing will depend heavily on the existing legal and regulatory regimes in place, we consider that best practice is likely served by introducing a bespoke regime where possible. This allows for a framework to be developed in a way which is entirely tailored to crowdfunding business rather than retrofitting an existing authorisation framework (as well as the threshold and

<sup>13</sup> This status is obtained by meeting certain professional requirements, and with the registration of the platform operator with the *Registre Unique des Intermediaires en Assurance Banque et Finance*.

<sup>14</sup> An “intermediary” regulated status for platforms, which requires registration with the Financial Industry Regulatory Authority, and subjects platforms to less stringent controls than, e.g., broker-dealers.



ongoing requirements that come with that existing authorisation framework).

Another benefit of having a bespoke regime, certainly from a lending-based crowdfunding perspective, is so as to ensure that investors cannot be misled as to the type of institution and products (and consequently the protections they may be afforded) with which they are engaging. For example, deposits held with a bank are in many jurisdictions protected to some extent by deposit insurance or governmental guarantees, whereas loans made through a platform may not benefit from such protections.

However, it is evidently possible to tailor jurisdictions' existing regimes for lending and investment services pragmatically for the purposes of regulating crowdfunding platforms. For example, where the provision of credit or loans requires a banking licence, a restricted banking licence could be developed for crowdfunding platforms permitting a restricted set of activities. More onerous authorisation threshold requirements best suited to large credit institutions providing a range of services to a range of clients may be removed, bearing in mind that lending-based platforms are not, for instance, engaged in maturity transformation, and may not necessarily act as principal to loans but rather as a marketplace. Therefore, where platforms' activities align with existing regulated activities, such an existing framework could be leveraged but tailored. However, in our view, a bespoke regime is likely to be advantageous and would be more appropriate where platforms' activities fall outside the scope of existing regulated activities. In particular, a bespoke regime can be fully designed from first principles and would be less likely to suffer interpretational difficulties associated with

converting and applying a regulatory framework designed for one set of activities to another.

In terms of assessment criteria for authorisation, the New EU Crowdfunding Regulation would mandate platforms to apply to the European Securities and Markets Authority ("ESMA") for authorisation, which would be a bespoke authorisation for crowdfunding services. Like many of the bespoke and existing authorisation frameworks, the New EU Crowdfunding Regulation sets a number of transparent threshold conditions for authorisation such as requiring information regarding data security and business continuity and information on the fitness

and propriety of those running the platform in terms of knowledge, experience, etc.

From a procedural perspective, again, akin to other authorisation frameworks, the New EU Crowdfunding Regulation would establish a transparent and expeditious process for authorisation – it provides that an assessment should be made as to the completeness of the application within 20 working days of receiving a prospective application and a final response provided on authorisation within two months of receiving a complete application.

#### Best practice: Authorisation and licensing

##### Mandatory:

- The financial services regulator should be required to authorise the operator of a crowdfunding platform.
- Whilst it is possible to tailor jurisdictions' existing authorisation regimes for lending and investment services to regulate crowdfunding platforms, the platform operator authorisation framework would ideally be a bespoke regime.
- Authorisation of a platform should: (i) indicate whether it is for a lending-based or investment-based platform, and (ii) be made by reference to product categories and investor types, e.g. institutional or retail investors.
- Where an existing authorisation regime is to be used, it should be adapted to take into account the nature of crowdfunding business. Unduly burdensome requirements should be identified and eliminated or mitigated.
- The assessment of an operator should be based on criteria prescribed by the financial services regulator. These criteria should focus on the platform's: (i) safety, (ii) soundness, (iii) proposed systems, (iv) controls, and (v) personnel. The assessment of the operator should be tailored to the platform type, as well as product categories and investor types.
- Product categories and investor types should not be unduly narrow and any proposed expansion of product categories or investor types by the platform should require further regulatory approval.
- Where existing platforms are already operating, the introduction of the authorisation regime should be managed over a transitional period.

### 3.2 Platform continuity

Policy-makers should be conscious of the risks arising from platform failure which could arise due to financial distress of the platform, fraud, cyber-attack/IT system failure. This could be particularly relevant for investment-based platforms which operate a nominee structure and lending-based platforms which may well be involved in servicing the loan throughout its life-cycle, e.g. arranging for the reception and transmission of interest payments and collecting overdue loans. Platform failure could lead to the disruption of servicing functions and mean investors' interests are not adequately protected and may not, for example, receive capital or interest repayments. For this reason the New EU Crowdfunding Regulation mandates that a platform seeking authorisation for services by ESMA must reassure the regulator that the platform has business continuity arrangements in place which are to be maintained, the lack of which is grounds for refusal of authorisation.

The level of risk posed by platform failure will depend on the activities of, and services undertaken by, the platform, such as whether the platform holds or receives client-money or undertakes payment services. For example, in Germany, lending-based platforms broker agreements between credit institutions and borrowers with the credit institution going on to lend to the investor. Given this limited role of facilitation, it is unsurprising that strict platform continuity requirements are not imposed on these types of German lending-based platforms. This is reflective of the overall regulatory approach in respect of the German regulatory regime which imposes stricter requirements on the platform with respect to platform continuity and other

requirements, for instance with respect to due diligence (see further Section 4.2.5 below), as the platform's role becomes more than merely introductory as a broker.

By contrast to Germany, in the UK, lending-based platforms perform loan servicing activities and receive client-money. As such, the UK utilises two commonly used tools: prudential standards and mandatory administration arrangements in the case of platform failure. The UK imposes a capital requirement of between €50,000 and €730,000 depending on the activities of the platform for investment-based platforms, and the higher of £50,000 or a percentage of loaned funds, in respect of lending-based platforms (see further Section 3.2.2 below).

Risks, of course, also arise in the event of the failure of an investment-based platform, especially as some platforms are engaged with ongoing administration of the investment (e.g. via the nominee structure outlined at Section 4.4.2(c) below). Investment-based platforms are often subject to higher prudential

standards than lending-based platforms, often under the existing securities regimes, and may fall within the existing business continuity rules which apply to firms brokering securities.

#### 3.2.1 Ongoing administration plans

Several of the Countries impose requirements on platforms to put arrangements in place to ensure the ongoing administration of investments in the event of platform failure. We consider that this is an important tool to ensure platform continuity and note that the Countries specifically mandate that such plans be put in place. For example, the UK imposed a new specific rule for lending-based platforms which requires platforms to *"take reasonable steps to ensure that arrangements are in place to ensure that P2P agreements facilitated by it will continue to be managed and administrated, in accordance with the contract terms"* in the event of platform failure.<sup>15</sup> The FCA indicated that such arrangements could include entering into an agreement with a back-up service provider or a guarantor, holding sufficient collateral in a segregated account to

#### Best practice: Ongoing administration plans

##### Mandatory:

- Platforms should be required to put in place a credible ongoing administration plan.
- Platforms should have flexibility to determine the measures to be taken as part of their ongoing administration plans. This should be on the basis of achieving given outcomes prescribed by a regulator. These outcomes should provide guidance in the form of an indicative and non-exhaustive set of suggested measures which may be taken.
- When a platform originates an investment, it is necessary to draft ongoing administration plans and the measures required for their involvement.
- Platforms should submit ongoing administration plans to the financial services regulator, who will assess their credibility.

<sup>15</sup> SYSC 4.1.8AR.

cover the cost of winding down the loan book and managing the loan book in such a way as to ensure that income is sufficient to cover the costs of a wind-down.<sup>16</sup>

In the same sense, in the UK, investment-based platforms are subject to the existing FCA business continuity rules as applicable to investment firms generally; there are no such rules applicable to crowdfunding investment-based platforms specifically.

Similarly, in the DIFC, the DFSA provides that lending-based platforms should have a business cessation plan in place. The DIFC has imposed the same rule for investment-based platforms requiring a business cessation plan to ensure “the orderly administration of existing investments plus current and recently closed pitches, including holding and controlling client-assets (if applicable)”.<sup>17</sup> We do, however, note that Austria does not impose any specific requirements for platform continuity.

In our view, ongoing administration plans are important for both investment-based and lending-based platforms, and we consider that it is best practice that platforms are mandated to implement such plans. In our view, the UK approach of providing platforms with a menu of options provides a degree of flexibility which facilitates differences between crowdfunding models while still mandating the objective of consumer protection in the event of platform failure.

## **“ongoing administration plans are important for both investment-based and lending-based platforms.”**

### **3.2.2 Capital and liquidity requirements**

Minimum prudential standards can help minimise the risk of harm to consumers by aiming to ensure that platforms have sufficient prudential resources to cover operational and compliance failures and/or pay redress to clients.

According to the FCA, prudential standards also serve a wider purpose “by ensuring that firms behave prudently in monitoring and managing business and financial risks. Experience tells us that if a firm is in financial difficulty or it fails, it can cause harm and disruption for consumers. A firm under financial/prudential strain is more vulnerable to behaving in a way that increases the probability of consumers suffering loss.”<sup>18</sup>

The extent to which a certain level of capital is required by prudential regulation is coterminous with the extent to which the crowdfunding platform assumes the risk of the funding concerned, e.g. credit risk in the case of lending-based funding. All of the Countries we reviewed impose some minimum level of capital requirements on investment-based platforms. These capital requirements vary based on the activities of the platform and are generally based on existing capital requirements frameworks relating to securities activities.

Some investment-based entity types which are more “lightly” regulated, e.g. CIPs in France and Funding Portals in the

U.S., are not required to hold a minimum amount of capital. However, both these types of entities are barred from holding client funds and may only offer securities for limited amounts (see issuer caps at Section 7.1.1 below).

Figure 4 illustrates the various minimum capital requirements for platforms located in the Countries.

If the role of the platform is to take a substantive role in the process, for example to lend as principal and to receive repayments of the principal and interest on behalf of lenders, then its capital requirements will be more exercising than if the platform merely acts as an introducer, as per the model in Germany, between the borrower and the provider of finance. However, there are feasible models which sit between these two examples. Underpinning this continuum is the idea that capital is required to provide for persistence of the platform through risk. The greater the risk profile of the platform – as determined by its particular function – the more exacting the capital requirements.

Therefore, to take the FCA as an example, a principles-based framework of standards mandates that relevant firms should possess a certain base level of capital, above which additional capital, commensurate with the activities they are undertaking and the risk of those activities, is mandated by regulation.

We thus consider that it is sensible to base prudential requirements on the nature and scale of the activities undertaken by platforms.

<sup>16</sup> SYSC 4.1.8CG.

<sup>17</sup> DFSA, CP 111, Crowdfunding: SME Financing Through Investing, 13 February 2017, p.32.

<sup>18</sup> FCA – CP13/13, The FCA’s regulatory approach to crowdfunding (and similar activities), October 2013, para 3.16.

Fig. 4 – Minimum capital requirements

Country	Investment-based	Lending-based
<b>Austria</b>	Various requirements – however, in Austria the most common crowdfunding products are offered on lending-based platforms	<i>Commercial investment consultants:</i> Liability <b>insurance</b> covering at least €1.16mn for an individual case and €1.67mn for all cases per year
<b>DIFC</b>	Capital requirement of <b>the higher of (i) USD140,000<sup>19</sup></b> and <b>(ii) c. 35% of annual expenditure</b> if a platform has permission to hold client-assets or <b>c. 12%</b> if not Plus professional indemnity insurance cover commensurate with the nature, size, complexity and risk profile of the Authorised Firm's business	
<b>France</b>	<b>Insurance</b> – CIPs (more lightly regulated) require civil liability cover for at least €800,000 per year, and which provides cover for at least €400,000 per claim ISPs (more heavily regulated) – <b>€50,000</b> minimum share capital or €125,000 if client funds are held Also MiFID requirements if MiFID activities undertaken	<b>Insurance</b> – IFPs require civil liability cover for at least €500,000 per year, and which provides cover for at least €250,000 per claim.
<b>Germany</b>	Capital requirement varies from <b>€50,000 to €5mn</b> depending on activities	There is no capital requirement; the platform does not lend as principal and brokers loans between a borrower and a credit institution
<b>UK</b>	Capital requirement varies from <b>€50,000 to €730,000</b> depending on activities	The higher of (i) £50,000 or (ii) a percentage of loaned funds <sup>20</sup>
<b>U.S.</b>	Broker dealers: Net capital requirements vary from <b>USD5,000 to USD250,000</b> depending on activities. Funding Portals: <b>no minimum requirements</b>	There is no practical distinction between lending-based and investment-based crowdfunding in the U.S.; any loan that is divided up and sold to investors will ultimately fall within the definition of a security This report focuses on the U.S. Regulation Crowdfunding regime

<sup>19</sup> The base capital requirement is USD140,000 if the platform holds client-assets and USD10,000 if the platform does not hold client-assets.

<sup>20</sup> (0.2% of the first £50mn of the total value of loaned funds) + (0.15% of the next £200mn of the total value of loaned funds) + (0.1% of the next £250mn of the total value of loaned funds) + (0.05% of any remaining balance of total value of loaned funds outstanding above £500mn).



### Best practice: Minimum prudential standards

#### Mandatory:

- The financial services regulator should require minimum capital requirements for both investment-based platforms and lending-based platforms.
- Alternatives to capital should be permitted, e.g. insurance or guarantees.
- Additional capital requirements should be based on the nature and scale of the activities undertaken by the platform and commensurate with their attendant risk.
- If a platform must remain functional with respect to investments it has originated, any additional capital requirements should relate to the extent that the platform needs to play a continuing role following investment.

In relation to lending-based platforms, several of the Countries impose lighter requirements than the rules applicable to investment-based platforms, e.g. only requiring liability insurance (Austria, France). The UK introduced specific rules for lending-based platforms based on the total amount of loan funds (and also a base level of £50,000).

The FCA commented that it believes the total amount of loaned funds metric *“is the most appropriate in aligning a firm’s prudential requirement with the risk of harm that the firm poses to consumers. For example, the metric captures the likelihood of firms holding large amounts of client-money at any point in time, the length of time it will take to wind-down a firm, and the complexity of the firm including its size and number of customers”*<sup>21</sup>.

We do not take a view on the exact metric that should be used, but we do consider that it is best practice to impose a minimum capital requirement on investment-based and lending-based platforms to ensure that, in the event of financial distress, or platform failure, the platform can continue to meet operational or compliance costs and that these requirements should be based on the nature and scale of the activities undertaken by the platform and be commensurate with their attendant risk. Above this minimum, any additional capital

requirement should reflect the nature and scale of the activities performed by the platform. Many jurisdictions approach this by imposing a “greater of” test, setting one limb as a minimum requirement and the other limb by reference to expenditure or loaned funds, for example.

There may be some limited exceptions to this where, for example, a platform’s activities are limited to acting as a broker between a licensed credit institution and a borrower. Nonetheless, even in such circumstances, we would expect that a minimum level of capital is imposed. This is the case, for example, in Germany.

#### 3.2.3 Systems and controls

Many of the Countries impose requirements on platforms to establish and maintain systems and controls that help platforms address risk, protect customers and comply with relevant laws and regulations. For example, the UK provides that firms must take reasonable care to establish and maintain systems and controls that are appropriate to its business. The New EU Crowdfunding Regulation allows authorisation to be withdrawn where internal systems and

controls have been deemed to have failed. We consider that this is a best practice and, from our review, have identified certain areas which should be appropriate for crowdfunding platforms.

As outlined above, a key risk for crowdfunding platforms is platform failure. One reason platforms may fail could be due to IT failure or cyber-attack. Some of the Countries impose requirements on platforms to require that they maintain a certain level of IT system resilience. For example, the DIFC implements a requirement on platforms to have adequate measures in place to ensure that their IT systems are resilient and protected against damage or unauthorised access, and that business can continue in the event of IT failure.

In the UK, platforms are subject to existing FCA rules on maintenance of appropriate systems and controls to manage operational risks arising from failures in its systems and for countering the risk that the platform might be used to further financial crime, and the FCA states that those systems and controls should *“adequately reflect and support the complexity of its business model.”*<sup>22</sup>

Platforms should also be aware of the need to protect customer data. For example, Germany requires that platforms institute an appropriate internal control system and adequate security precautions with respect to electronic data processing.

In our view, the examples given by the different Countries help illustrate some of the areas that should be covered by the systems and controls of platforms.

**“the total loaned funds metric is the most appropriate in aligning a firm’s prudential requirement with the risk of harm that the firm poses to consumers. ”**

<sup>21</sup> FCA – CP13/13, The FCA’s regulatory approach to crowdfunding (and similar activities), October 2013, para 3.26.

<sup>22</sup> FCA, CP18/20 Feedback and proposed changes to the regulatory framework, July 2018, paragraph 4.57.

### 3.3 Platform governance requirements

Existing regulatory regimes in the Countries generally impose requirements on firms to meet minimum professional and organisational standards, such as minimum standards for employees or officers, rules on system resilience (see Section 3.2.3 above) and other administrative requirements, e.g. on record-keeping. These required standards help mitigate the risk that conduct by the platform or its employees/officers might lead to customer detriment as set out below.

#### 3.3.1 Standards for employees/officers

Minimum standards for employees in key management roles or for officers of the platform aim to ensure that the platform is managed by competent individuals and to reduce the risk of fraud perpetrated by platform insiders. We note that, across the Countries, there are requirements for employees or officers to meet certain fitness/propriety requirements. This requirement is also reflected in the New EU Crowdfunding Regulation, which requires that management of the platform be of good repute and have adequate knowledge and experience. EU jurisdictions such as Austria, which currently do not make provision for such standards, will therefore have to implement these requirements when the Regulation is brought into effect.

From our review, existing securities and investment services regimes generally already impose requirements on individuals holding significant management functions. However, whether or not existing regimes apply will depend on the scope of the

#### Best practice: Systems and controls

##### Mandatory:

- Platforms should be required to maintain such systems and controls as are necessary for their business. These systems should identify, manage, track, mitigate and report risks within and to their business, including operational risk, cybersecurity, protection of personal data and the risk that the platform may be used in the furtherance of financial crime.
- These risks should be identified, managed and tracked by platforms themselves as part of their overall risk management framework.
- Financial services regulators should perform periodic and *ad hoc* assessments to ensure that outcomes are being achieved and platform systems and controls are adequate. This could be as part of their usual supervisory function, a thematic industry-wide review or as a result of any specific concerns.

platform's activities. In Germany, while fit and proper person requirements under CRD IV or MIFID2 would apply if the platform was providing lending business or investment brokerage, the common business model in Germany involves brokerage of a loan between a credit institution and a borrower to which no specific requirements apply.

Similarly, the U.S. Regulation Crowdfunding regime imposes different requirements, reflecting the activities of the platform. "Associated persons", i.e. individuals working for broker-dealers (entities that are more heavily regulated than Funding Portals and can conduct a wider range of activities that can hold client-money) must pass securities qualifications exams; whereas "associated persons" of Funding Portals are not subject to particular professional requirements.<sup>23</sup> A similar two-tiered approach is taken for French investment-based platforms.<sup>24</sup>

Other Countries apply the same rules to both lending-based and investment-

based platforms. For example, the Dubai Financial Services Authority's bespoke regime extends the existing rules applicable to other financial institutions operating in the Dubai International Financial Centre to lending-based and investment-based platforms: senior managers and directors of the platform must pass fitness and propriety tests, meaning they must have recognised knowledge, experience and professional repute.

In the UK, the widely applicable Senior Managers and Certification Regime (due to be fully implemented at some point during 2018) will require employees/directors with senior manager functions to be pre-approved by the FCA, and individuals that can have a significant impact on customers, markets or the platform to be certified at least annually by the platform to ensure that they are fit and proper to perform their role. In addition, all employees will be subject to conduct rules.

<sup>23</sup> However, Funding Portals must make reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

<sup>24</sup> ISPs (which are more heavily regulated than CIPs) must designate two effective managers who are subject to enhanced fit and proper requirements. Managers at CIPs are subject to fit and proper requirements.

### Best practice: *Employees/officers*

#### **Mandatory:**

- Platforms should be required to have suitable processes to ensure that their employees and officers are fit and proper relative to their roles.
- To ensure that senior management has proper oversight and control of the activities of the platform, the platform should require senior management to be suitably experienced and qualified.
- Financial services regulators should conduct an assessment of senior management to satisfy themselves of experience and qualification as well as the effectiveness of its oversight and control. This could be as part of its usual supervisory function, a thematic industry-wide review or as a result of any specific concerns. Guidance on criteria for suitable qualification, for example relevant skills, knowledge and experience, may be published by the regulator.
- Platforms should be required to ensure that employees/officers have appropriate training and are made aware of their roles, responsibilities and any policies and procedures that apply to them. What training is appropriate would fall to platforms to determine.
- Financial services regulators should perform periodic and *ad hoc* assessments to ensure the adequacy of training. This could be as part of its usual supervisory function, a thematic industry-wide review or as a result of any specific concerns.

Clearly, a range of approaches is taken across the Countries surveyed and we do not consider that we need to favour one approach over another. We do consider that it is appropriate to mandate platforms to ensure that their employees/officers are fit and proper to perform their role (we think platforms are in the best position to make this assessment, although it is not unreasonable to expect that the financial services regulator may also conduct certain fitness and probity checks of its own). For many reasons, including that crowdfunding platforms will play a potentially important role in the financial system, we also consider that the senior management of platforms should be suitably experienced and qualified to discharge their role and, with regard to the operation of the platform, should have proper oversight and control

of, and should ultimately be held accountable to the financial services regulator for, its activities.

Furthermore, we think it is important from a risk control perspective that platforms should have an obligation to ensure that employees and officers have appropriate training (for example, regarding financial crime) and are made aware of their roles, responsibilities and any policies and procedures that apply to them.

### **3.3.2 Other governance requirements** **(a) Record-keeping**

Rules requiring the retention of records are an important tool that can enable regulators to monitor the compliance of a platform with certain regulatory requirements, e.g. minimum capital requirements or client classification. In

this way, sufficient record-keeping also forms an important component of the client protection framework by allowing regulators to verify that platforms are, for example, performing required checks on investors and putting in place required client-platform agreements. As a general business organisational tool, good record-keeping practices are also important in ensuring that platforms operate effectively, e.g. keeping accurate records of transactions and, where client assets are handled, that client asset protections are adhered to.

From our review, we note that several jurisdictions, e.g. Germany, the UK and the DIFC, bring platforms within the scope of existing record-keeping regulatory rules. Where new regimes or new entity types are introduced, it may be appropriate to introduce specific rules. For example, we note that, in the U.S., Funding Portals, which were introduced as a new crowdfunding-specific entity type under the U.S. Regulation Crowdfunding regime, are subject to new, bespoke record-keeping rules.

In relation to the type of records which must be kept, we note that some Countries follow an outcomes-based approach. For example, in both Germany and the UK the rules state that records should be retained which allow the relevant competent authority to fulfil its role of monitoring and supervising the compliance of platforms with the regulatory regime. We consider that this is a sensible approach and that it would also be helpful to ensure that guidance is given to platforms for the types of records this would include (as is the case in the DIFC and under MiFID2).

In relation to mandatory retention lengths, it is common to see a required minimum period for retention of relevant records. For example, EU platforms may be subject to MiFID2 record-keeping in relation to any MiFID business they undertake, including retention of records of all services, activities and transactions for five years (with the option for extension to seven years). The U.S. Regulation Crowdfunding regime requires funding portals to keep records for five years and broker-dealers for between three and six years. However, the UK is less prescriptive in relation to non-MiFID business, as the general principle under

FCA rules is that records should be retained for as long as is relevant for the purposes for which they are made.

In our view, it is best practice to impose a minimum retention length for both lending-based and investment-based platforms. From our review, a time period of around five years running from the end of the relevant relationship or following the completion of the relevant investment seems sensible; however, we believe financial services regulators are best placed to make the detailed decisions on this point based on their needs for supervision.

#### Best practice: *Record-keeping*

##### Mandatory:

- Platforms should be required to retain records of the business they undertake, including all contracts entered into, and all transactions and services.
- The records retained must be sufficient to enable the relevant financial services regulator to monitor and supervise the platform's compliance with the regulatory regime.
- There should be a minimum retention length to be determined by the financial services regulator. However, the platform should provide sufficient records for the financial services regulator to investigate compliance. Record-retention should run from the end of the relevant relationship or following the completion of the relevant investment.

##### Additional tools:

- The financial services regulator should have the power to determine a minimum period for retention of records.
- The financial services regulator should provide guidance of the types of records that platforms should be required to retain. These should include contractual arrangements and details of transactions at a minimum. The financial services regulator may also stipulate retention of correspondence relating to complaints, for example.

#### (b) Outsourcing

Outsourcing of functions to third-party service providers is a common business practice and we understand that many platforms may outsource at least some functions. For example, one lending-based platform indicated that it may make use of external providers, including law firms and debt collection agencies. Outsourcing enables platforms to employ skilled third parties to perform functions more effectively or efficiently.

Where platforms rely on third parties to perform operational functions which are critical to the performance of their activities, however, there is the possibility that the third party could create additional operational risk for the platform. For example, if a third party providing payment services to a lending-based platform becomes insolvent, it may threaten the continuation of loan servicing. A third-party service provider which provides cloud computing services may be subject to a cyber-attack which compromises some of the platforms' customer data.

In Germany, outsourcing is generally possible subject to specific outsourcing requirements; for example, risk management, compliance and internal audit. This is a requirement on the platform, which must ensure that it does not become dependent on such outsourcing. In addition, the outsourcing of functions which the platform considers as material from a risk perspective requires a written outsourcing

agreement. However, outsourcing must not result in the platform becoming a “virtual” entity which has no substance and is dependent on the services of other parties.

In the UK, platforms that outsource critical operational functions should take reasonable steps to avoid undue additional operational risk and should not outsource important operational functions in such a way as to impair materially the quality of its internal control and the ability of the regulator to monitor its compliance with regulatory obligations. This requirement is almost identical to the one adopted by the New EU Crowdfunding Regulation.

In our view, it is sensible to permit outsourcing generally, subject to some risk control requirements for critical functions. In our view, the FCA definition of critical functions<sup>25</sup> is sensible but it should be left to regulators to determine the exact scope and detail of the obligation. It may well be that the existing

regulatory regime already has outsourcing rules which can be appropriately extended to platforms.

To ensure that a platform does not become a “virtual entity”, it should not

be permissible to outsource management and risk functions of the platform, as these functions constitute critical functions of decision-making, responsibility and oversight controls, which should remain with the entity.

### **Best practice: Outsourcing**

#### **Mandatory:**

- Platforms should be permitted to outsource functions, subject to taking all necessary steps to avoid undue risk when outsourcing functions to a third-party. These steps should include: (i) putting in place an agreement with the third-party establishing respective responsibilities, (ii) having appropriate resources to monitor and manage the outsourced functions, and (iii) maintaining the ability to insource the functions in case of third-party failure or deficiency, when functions are critical to the performance of the platform and its business.
- Platforms should be prohibited from outsourcing critical functions where to do so would (i) materially impair the ability of a regulator to monitor the platform's compliance with its regulatory obligations or (ii) result in the platform becoming a “virtual entity”. These critical functions include management and risk functions of the platform.

#### **Additional tools:**

- The financial services regulator should determine the scope of functions which are likely critical to the performance of the platform and its business. The regulator should also issue non-prescriptive guidance on the reasonable steps that platforms could take.

<sup>25</sup> The FCA definition in relation to non-MiFID firms: an operational function is regarded as critical or important if a defect or failure in its performance would materially impair the continuing compliance of a firm (other than a common platform firm) with the conditions and obligations of its authorisation or its other obligations under the regulatory system, or its financial performance, or the soundness or the continuity of its relevant services and activities. SYSC 8.1.4R.



### 3.4 Conflicts of interest

There is a risk that platforms could have conflicts of interest which lead to customer detriment, e.g. if platforms' fees are linked to transactions (which is common) or if employees of platforms – who may have enhanced levels of information on investments – are permitted to invest.

#### 3.4.1 Conflicts of interest rules

Any EU platforms operating as MiFID regulated entities (e.g. possibly ISPs in France and investment-based platforms in the UK) will be subject to stringent conflicts of interest rules under MiFID2, e.g. taking all appropriate steps to manage conflicts of interest and maintaining a written conflicts of interest policy which is reviewed at least annually. Similar rules apply to all licensed platforms in the DIFC.

The New EU Crowdfunding Regulation also mandates that a crowdfunding service provider must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest from adversely affecting the interests of its clients. Under the New EU Crowdfunding Regulation, crowdfunding service providers are also required to take all appropriate steps to identify and prevent or manage conflicts of interest between themselves, including their managers and employees, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any services.

The nature of the conflicts of interest rules will, of course, need to be suitably adjustable to reflect the activities of a platform. As outlined above, however, there are a number of approaches. Several Countries provide that platforms should

### “EU platforms operating as MiFID regulated entities will be subject to stringent conflicts of interest rules under MiFID2.”

disclose information on fees and costs to clients (this is considered at Section 3.5 below). Some Countries, e.g. the UK and the DIFC, also require that platform clients routinely receive information on the platform's conflicts of interest policy. We consider that conflicts of interest should be mitigated as far as possible, and that disclosure of any conflicts to transaction parties should not be solely relied upon as discharging the platform's obligations under conflicts of interest rules.

#### 3.4.2 Investment by the platform or its employees

In the DIFC, the Dubai Financial Services Authority (“DFSA”) restricts an officer or employee of a crowdfunding platform (or their family members) from investing or borrowing/issuing via the platform or from

having a financial interest in any borrower/ issuer or investor. The DFSA commented that *“we believe this measure is necessary in order to prevent potential conflicts of interest, or an operator exploiting the use of privileged information it has, to obtain access to the best investment or to exit an investment”*.<sup>26</sup> We agree with this approach and consider that regulators should have the power to ban investments by platform staff (or their close family members) in investments listed on the platform.

In relation to an investment by the platform itself, the DFSA has invited views on whether a platform itself should be able to invest in securities of the issuer selling securities through such a platform. Some may consider this to be a conflict of interest but, as noted above, it may be desirable to

#### Best practice: Conflicts of interest

##### Mandatory:

- Platforms should be required to identify, manage, mitigate and report conflicts of interest that arise between the platform and a client, or between clients of the platform. This may be done by balancing the potential risk of conflicts with the benefits of allowing the investment.
- Platforms should be required to have a conflicts of interest policy which is reviewed regularly and made easily available to clients, e.g. on the platform website.
- Platforms should be required to disclose to clients how the fees and costs associated with investments on the platform are earned/levied.
- Platforms should disclose potential conflicts of interests to platform participants.
- Employees/officers (and their close family members) should be prohibited from investing in investments offered via the platform.

##### Additional tools:

- Platforms may be permitted to invest in investments offered by the platform, however financial services regulators should have the ability, (through powers of direction), to prohibit such investments, where the regulator identifies material risks to customer outcomes as a result of conflicts of interest.

<sup>26</sup> DFSA, CP 111, Crowdfunding: SME Financing Through Investing, 13 February 2017, pp.26-27.

mandate that the platforms should co-invest in order that interests of the platform and investors are aligned. In the U.S., both broker-dealer and Funding Portals (but *not* their directors or officers) may invest in issuers selling securities through their platform so long as they receive the financial interest as compensation for their services and it consists of the same class of securities with the same terms that the public is receiving. In addition, compensation paid to the platform is required to be disclosed by the issuer.

At Section 4.3.5 below, we have considered the possible benefits of permitting/requiring co-investment by platforms (although this is a relatively untested idea). However, we do consider that this raises potential conflicts of interest which could lead to consumer detriment. In particular, the FCA notes that “platforms (sometimes through parent companies) that hold ‘skin in the game’ (ie they buy a part of the loans they help originate). Even though this can lead to a better standard of due diligence, it can also lead to conflicts of interest if they are able to use the secondary market to sell out early (possibly based on greater access to information), rather than holding to maturity”<sup>27</sup> We have therefore concluded that barring investments by platforms should be a tool available to financial services regulators who could choose to use it where appropriate. This will generally be where there are unmanageable conflicts of interest and/or the financial services regulator identifies through review that there may be detrimental outcomes for platform participants.

Ultimately, we are convinced that platforms should have the primary responsibility for identifying, managing, mitigating and reporting conflicts of interest.

### 3.5 Disclosures to clients about the platform

Several Countries have required platforms to adopt a certain level of transparency with consumers regarding the platform’s own operations. A relatively straightforward way of doing this is requiring that platforms display information on their websites. For example, the DIFC sets out a detailed list of information that must be displayed prominently on the platform’s website, including how the platform functions, how it deals with borrower/issuer default, safeguards for client-assets and how the platform is remunerated, including the fees and charges it imposes.<sup>28</sup> The UK requires that similar information must be received by clients (but does not specify the form through which it must be delivered). We think that, in terms of mandatory obligations, it is sensible to require similar disclosure without specifying the method of delivery.

In relation to fees, several of the Countries require disclosure of how the platform earns its revenue. For example, in France, lending-based platforms must inform borrowers and lenders of the amount and calculation methods of the platform’s fees and costs.

We consider that, as a matter of best practice, there should be a specific business conduct requirement for a platform to provide adequate disclosure to investors and issuers/borrowers in order that they are able to understand how the platform operates, particularly in relation to how the platform earns its revenue (which is relevant in identifying conflicts of interest) and how, what and when fees/costs will be charged.

According to the FCA, “*what constitutes adequate provision of information depends on the business model a platform operates, more so than whether it is an investment based platform or a P2P platform.*”<sup>29</sup>

#### Best practice: Disclosures to clients about the platform

##### Mandatory:

- Platforms should be required to make certain information about the platform available to clients. This includes: (i) basic details about the platform, e.g. its legal name, contact details and regulated status, (ii) the platform’s conflicts of interest policy, (iii) how client-assets and money are safeguarded (if relevant), (iv) how clients can make complaints, (v) how the platform earns its revenue (particularly with a view to identifying any conflicts of interest), and (vi) the nature and extent of the due diligence it undertakes in respect of borrowers/issuers.
- It is not necessary to mandate the means by which such information is made available but it should be easily accessible and written in a way which is fair, clear and not misleading. The financial services regulator may, however, provide a non-exhaustive “menu” of communication channels which are acceptable in a given jurisdiction, e.g. a dedicated web page, or email communication.
- Platforms should be required to disclose to clients the fees and costs associated with the investments they make/offer on a platform prior to such an investment being made or offered.

##### Additional tools:

- Financial services regulator should have the ability to require additional information to be provided.

<sup>27</sup> FCA, CP18/20 Feedback and proposed changes to the regulatory framework, July 2018, paragraphs 5.40.

<sup>28</sup> A market participant in the DIFC informed us that, in its view, compliance with the comprehensive DFSA standards had not been too onerous on platforms.

<sup>29</sup> FCA, CP18/20 Feedback and proposed changes to the regulatory framework, July 2018, paragraph 4.16.

## 4. Specific Considerations: Investor Protection and Business Conduct

A principal concern for most jurisdictions will be ensuring the adequate protection of investors using crowdfunding platforms.

By its nature, crowdfunding aims to broaden access to finance, usually for SMEs, by facilitating investment (whether by loans or via equity investments) by a wide body of investors, including retail investors who may lack knowledge and experience in investing.

Investors using investment-based platforms should understand that these investments could result in loss of capital. Investments, which are often made in unlisted start-up companies can fail. Even equity investments in successful companies can prove to be highly illiquid, particularly as start-ups rarely pay dividends during their growth stage and there may be little or no opportunity to transfer equity interests, e.g. via a secondary market.

Loans originated on lending-based platforms are subject to the usual risk that lenders will not receive their money back in the event of borrower default, or platform failure. In addition, some loans could lock in investors' money for a long period of time with limited or no opportunity to transfer their rights to another party, e.g. via a secondary market.

In both cases, there is a risk that investors will likely know relatively little about the loan/investment compared to the information retained by the borrower/issuer and/or the platform, but this will depend on the degree to which the platform performs any more than a mere introductory role, as is the case in Germany, where the transaction parties

**“there is a risk that investors will likely know relatively little about the loan/investment compared to the information retained by the borrower/issuer and/or the platform.”**

would retain more information than the platform itself. It may also be the case that some investors, e.g. institutional lenders, may be able to obtain more information than retail lenders, which the FCA has identified as potentially leading to poorer outcomes for retail investors (see Section 4.2.2 below). Regulators have recognised this. The DFSA has commented that *“in most cases there will be a significant degree of information asymmetry in place with the consumer knowing very little about the investment on offer”*.<sup>30</sup>

Risks to investors also arise where there is the potential for fraud, e.g. personal details being stolen, or where platforms are subject to conflicts of interest which could result in investors receiving lower-quality investment opportunities.

Through the review of the Countries, certain common tools used to address investor protection concerns were identified. These are examined in detail below.

### 4.1 General business conduct requirements

#### 4.1.1 General principles

In our view, it is important and helpful to set certain general overarching principles to shape the customer protection framework. This is similar to the FCA Principles for Business<sup>31</sup> which shape the overall UK regulatory regime.

We consider that platforms should be subject to general duties to pay due regard to the interests of their customers

and treat their customers fairly. In addition, platforms should communicate with their clients in a way that is fair, clear and not misleading.

In our view, these general principles will strengthen the customer protection framework by providing core guidance on how customers should be treated that will underpin the range of other investor (and issuer/borrower) protection tools adopted by jurisdictions.

#### Best practice: General principles Mandatory:

- Platforms should be required to pay due regard to the interests of their customers, treat their customers fairly and communicate with clients in a way that is fair, clear and not misleading.

## 4.2 Pre-investment

### 4.2.1 Risk warnings/disclosures to investors about the investment

Crowdfunding has opened up a wider landscape of investment opportunities to investors who may lack experience or knowledge of investments. Some of these opportunities are relatively high risk due to lack of liquidity and the potential for loss of capital.

In our view, it is best practice to mandate that platforms give disclosures and risk warnings to investors with the aim of ensuring that investors understand the risks of investing. In our view, irrespective of whether other investor protection tools

<sup>30</sup> DFSA, CP 111, Crowdfunding: SME Financing Through Investing, 13 February 2017, p.6.

<sup>31</sup> <https://www.fca.org.uk/about/principles-good-regulation>

are adopted, e.g. investment caps or investor suitability checks, risk warnings/disclosures perform the core function of the investor protection framework.

#### (a) Lending-based

Most of the Countries imposed requirements on borrowers and/or platforms that aim to ensure that investors understand: (1) the general risk of investing in a loan; and (2) the details of the loan being offered. We agree with this approach.

In relation to general risk, Austria requires that the main risks to a lender be prominently displayed on a platform's website, e.g. that the lender may lose all or part of its money. Similar rules apply in the DIFC.<sup>32</sup> We consider that, in relation to fundamental risks such as the loss of capital, some standardisation of the wording of risk warnings may be helpful to ensure consistency across platforms.

Several Countries require certain specific disclosures about the details of a loan and the borrower. For example, in France, platforms are required to inform potential investors about the loan's features (including applicable interest rate, duration of the loan, repayment conditions) and in the DIFC there is a comprehensive list of required disclosures on the details of the loan and the borrower (including the creditworthiness of the borrower, details of the loan, etc.) In the UK, the FCA decided not to mandate the exact content of investor disclosures; however, it expects platforms to provide appropriate information to investors on the nature and risks of an investment. The FCA sets out specific examples of information that lending-based platforms should provide, such as a description of how loan risk is

assessed, actual and expected default rates and what happens in the event of platform failure.

In our view, it is the right approach for regulators to set out examples of what risk warnings should cover, without being prescriptive in the exact wording that is used (except, perhaps, standardised wording for fundamental risks, such as loss of capital).

#### (b) Investment-based

As with lending-based platforms, we have seen that a common approach in the Countries is to impose rules that aim to ensure that investors understand the risks of investing in securities. We agree with mandating that such disclosures be made with the aim of ensuring that investors understand the risks of investing and the details of the investment.

##### (i) Prospectus vs. other tools

In many jurisdictions, the issuance of securities to the public triggers an obligation to publish a prospectus. In many cases, this is a time-consuming and costly exercise. The UK regulator pointed out that the question of whether to require a prospectus involves a complex trade-off between ensuring that the information asymmetry problem is addressed and not imposing significant costs on issuers/platforms which make the crowdfunding model unworkable.

In Austria, only the brokerage of alternative financial instruments (a limited class, usually qualified subordinated loans) allows platforms to take advantage of the more generous €1.5mn prospectus threshold, which means that platforms can hold a more lightly regulated trade licence. Similarly, the German crowdfunding exemption (providing a

higher prospectus threshold of €2.5mn) is limited to subordinated or profit-participating loans. It is our understanding that many of the platforms operating in Austria and Germany try to take advantage of these regimes.

We understand that, for example, in Germany the pure equity crowdfunding model is unusual due to a very low prospectus threshold (€100,000), and this was historically the case for Austria, before the introduction of a new €1.5mn prospectus exemption and the requirement of a simplified prospectus for an issue volume of between EUR 1.5mn and EUR 5mn by the Austrian Alternative Finance Act.

Prospectus production can impose a particularly burdensome cost in the context of crowdfunding, given that most issuers will be SMEs looking to raise a relatively small amount of money (usually under €1mn).

In our view, jurisdictions should be conscious of striking the right balance between investor disclosure and ensuring that the costs of compliance by issuers are not so high that the marketplace is stifled.

A recurring theme in the regimes we have reviewed is the introduction of a specific exemption which raises the prospectus threshold for offers which meet certain conditions, including investor disclosures/risk warnings. For example, in France, any platform looking to take advantage of a higher €2.5mn prospectus threshold needs to have a progressive access website. An investor should not be able to access the details of offers on the platform's website unless he or she answers "yes" to certain questions which pertain to the knowledge

<sup>32</sup> DFSA, COB 11.3 states that an operator must disclose prominently on its website the main risks to lenders or investors of using a crowdfunding platform, including that: the lender or investor may lose all or part of their money or may experience delays in being paid. <https://www.fca.org.uk/about/principles-good-regulation>



and experience of the investor and indicate comprehension of risk warnings, e.g. in relation to the investor's financial resources, investment objectives, and resilience to losses. Similarly, Austria requires that issuers under the Alternative Financing Act (which offers an advantageous prospectus regime and under which crowdfunding platforms typically fall) issue risk warnings to investors in a standardised form.

Jurisdictions should also consider the right form for disclosures specifically to retail investors. A UK platform commented that insisting on prospectuses can be counterproductive for retail investors who are unlikely to read the document, and it could be preferable to adopt a more tailored approach to ensure that retail investors understand the risks. This does not necessarily entail an approach of bespoke information for each customer, but rather the provision of a level of information commensurate to a class of customers (e.g. retail) based on, for example, sophistication.

This approach has been taken in the EU with Key Information Disclosure ("KID") documents for insurance based investment product transactions, which must be up to a maximum of 3 sides of A4-sized paper, and must provide information on the product, its risks and possible returns, potential costs, and complaints procedures along with any other applicable information. KIDs may refer to other documents such as a prospectus if the cross-reference is related to the information required to be included in the KID, or refer to where detailed information can be found elsewhere. We are persuaded by the arguments that prospectuses may be an unnecessarily expensive way of dealing with the information asymmetry possibly without tangible benefits to retail investors who may not use the prospectus in any case. We consider it best practice that

jurisdictions with relatively low prospectus thresholds consider introducing a specific prospectus exemption for crowdfunding. Jurisdictions could design the exemption to fit with the types of companies that the relevant policy-makers are seeking to benefit from crowdfunding. Jurisdictions would then rely on disclosures and risk warnings to alert investors to the risks of investment,<sup>33</sup> with an emphasis on investor understanding. Jurisdictions should mandate (or allow the financial services regulator to do so) the types of information that should be made available without necessarily being prescriptive as to the form or content, as this may be unnecessarily rigid. However, at a basic level, investors require information sufficient to assess the likelihood of repayment or return on investment (i.e. risk of success/failure). Such information might include a business plan, financial information, details of existing assets and liabilities, proposed purpose for funds, etc.

#### (ii) The risks of investment in securities vs. investment in loans

It is worth considering the different risks relevant to investments in securities vs. investments in loans at this point as some jurisdictions impose more extensive disclosure requirements on investment-based platforms than on lending-based platforms. For example, The DIFC requires platforms to ensure that retail clients sign a risk acknowledgement form for each investment made via the investment-based platforms, which sets out risk warnings and confirms that the investor understands those risks. It seems that most Countries share this approach, relying on risk warnings and disclosures that aim to ensure that investors understand dilution and any limitations on the rights attaching to their shares. For example, in The DIFC, the DFSA mandates disclosure by the issuer of whether investors have any protection from their shareholding being

diluted by the issue of further shares. However, this is not a requirement for retail investors making investments via lending-based platforms.

Investments in loans generally constitute an enforceable debt obligation under which scheduled interest and capital repayments are made over a finite period. Lenders are at risk of loss of capital, e.g. in the event of borrower default (or, where the platform intermediates the loan, platform failure<sup>34</sup>), but possess contractual rights to be repaid at fixed dates. By contrast, equity investments in unlisted companies made via investment-based platforms may give no guarantee that shareholders will receive dividend payments or be able to realise their investment by selling their shares on a secondary market. Many shareholders without access to secondary markets would have to wait for a specified event, e.g. the flotation of the company, to realise their investment. In addition, while lenders possess the contractual right to be repaid, investments in unlisted equities may carry few post-investment rights and shareholders may also be at risk of dilution of their shareholding by subsequent investment rounds.

The FCA, for example, sets out the following risk warnings on its website:

*"Consumers who invest via loan-based crowdfunding platforms need to be aware that:*

- *you won't have access to the Financial Services Compensation Scheme (link is external) (FSCS)*
- *although some platforms have a way of cashing in your investment (a secondary market), you may not always be able to cash it in quickly or for as much money as you paid*
- *loan-based crowdfunding is higher risk than holding money on deposit. You*

<sup>33</sup> The FCA mandates that risk warnings such as *"the value of your investments can go down as well as up, so you could get back less than you invested. Your capital is at risk"* is clear, with due prominence in the relevant communication channel.

<sup>34</sup> In such a circumstance, should the platform default, the lender would have subrogation or step-in rights.



*may lose some or all of the money that you invest.*

*Due to the potential for capital losses, we regard investment-based crowdfunding in particular to be a high-risk investment activity. As well as the risks associated with loan-based crowdfunding, for equity crowdfunding you should also be aware that:*

- *It is very likely that you will lose all your money. Most investments are in shares or debt securities in start-up companies and will often result in a 100% loss of capital as most start-up businesses fail.*
- *Your capital will not be repaid and/or dividends will not be paid if the company you invest in defaults or there is a fraud.*
- *If you hold shares in a business or project, it is unlikely that income in the form of dividends will be paid. The value of your investment may be diluted if more shares are issued, and this is*

*likely as many start-up businesses undergo multiple rounds of funding.*

- *You should be prepared to wait for a return on your investment, as even successful start-up businesses tend to take time to generate income.*
- *If firms do handle clients' money without our permission or authorisation, there will be no protection for investors in place. This is a particular risk if a platform fails and becomes insolvent.*
- *Most platforms do not have a way you can cash in your investment (a secondary market).*

*For debt security crowdfunding:*

- *It is likely that you will lose some or all your money. Most debt securities on offer through such platforms are issued by start-up companies and can result in capital loss if the businesses fail.*
- *Your capital will not be repaid and/or expected coupon payments will not be*

*paid if the company you invest in defaults or there is fraud.*

- *The company can become more likely to default over time, increasing the risk of the investment.*
- *If firms do handle clients' money without our permission or authorisation, there will be no protection for investors in place. This is a particular risk if a platform fails and becomes insolvent while holding client-money.*
- *Securities offered on such platforms are not usually traded on a secondary market and most are not transferable, this means you may be unable to cash in your investment. You should be prepared to hold any securities you buy until maturity."*

To reflect these differing risks, we consider that it is best practice that jurisdictions ensure that risk warnings and disclosures to investors are tailored to the relevant product offered by the platform.

### **Best practices: Risk warnings/disclosure to investors**

#### **Mandatory:**

- Prospectuses should not be required for investment-based crowdfunding (with the parameters of the exemption to be determined by the financial services regulator in line with existing exemptions from prospectus requirements). This does not obviate the need for disclosure, the level of which should be commensurate with investor sophistication.
- Financial services regulators should have the ability to require certain information to be provided instead of a prospectus. Investors should have sufficient information to make a reasonable assessment of the likelihood of repayment or return. Financial services regulators should test this information provision and provide guidance to this effect.
- Platforms should be required to provide risk warnings to investors regarding the nature, and the key risks, of an investment as well as how the platform has assessed the risk. We take the view that the risk warnings that the FCA sets out provide a good base level of disclosure.
- Risk warnings should be clear, fair and not misleading, and should be prominently displayed.
- Given their importance, platforms should be required to display risk warnings to investors at least at the inception of the relationship and, at least, prior to each investment made thereafter.
- Risk warnings should be tailored to the relevant product category, whether loans or securities. Such warnings should be generic and not individualised to a particular customer, but rather to a customer group. As a minimum, this should amount to a distinction between retail and institutional customers, but may reflect existing customers' segmentations in the relevant market.
- Financial services regulators should provide guidance on the information to be included in risk warnings without prescribing precise wording.
- For certain fundamental risks (such as that an investor may lose some or all of its investment), the financial services regulator should provide standardised wording to ensure consistency across platforms.

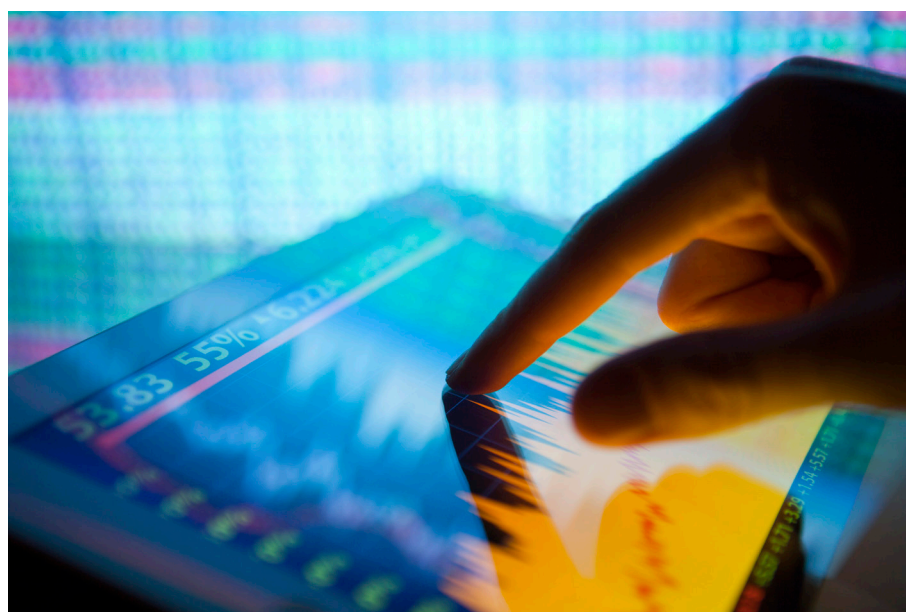
#### 4.2.2 Measures to address the differing treatment of retail investors vs institutional investors

Where both institutional and retail investors invest via platforms,<sup>35</sup> there is a risk that institutional investors can (1) gain preferential access to investments or (2) obtain greater access through the platform to information about investments, e.g. because of the platform's policies of providing broader/more detailed information sets, possibly in machine-readable formats, to institutional investors. This could disadvantage retail investors who may be left with a lower quality choice of investments, or be less well, or later, informed.

The FCA highlighted this as a potential concern as part of its post-implementation review of lending-based rules, noting examples where institutional lenders gained exclusive or early access to loans, greater access to information about the loans or the option to opt out from lending to segments of the market.<sup>36</sup>

In considering this issue, the FCA has noted that this indicates that firms may not be managing conflicts of interest adequately. In our view, conflicts of interest rules are highly relevant here. We consider conflicts of interest rules at Section 3.4 above.

We consider that it is best practice to prohibit one type of investor from effectively “cherry picking” investment opportunities. Platforms should not be permitted to maintain structures that



would result in higher-quality investment opportunities being made available to one class of clients, e.g. institutional investors. We agree with the FCA that “*it is unlikely to be possible to employ such arrangements and treat customers fairly*”.<sup>37</sup> Any difference in treatment should be in order to make available adequate information to retail, or less sophisticated, investors, and to ensure that they are equally well-informed, rather than to give preference to institutional investors with more

in-depth, granular information. At the very least, platforms must ensure that retail investors are no worse off.

There are several ways in which platforms may be able to serve an institutional and retail client base and also mitigate the risk of giving one class preferential access to investments. For example, some marketplace lending platforms in the U.S. utilise a retail “peer-to-peer” funding channel in conjunction with significant institutional investments

**“Platforms should not be permitted to maintain structures that would result in higher-quality investment opportunities being made available to one class of clients, e.g. institutional investors.”**

<sup>35</sup> Not all Countries permit institutional investors to invest via platforms. See Section 7.1.2 below.

<sup>36</sup> FCA, FS16/13 Interim feedback to the Call for Input to the post-implementation review of the FCA's crowdfunding rules, December 2016, p12.

<sup>37</sup> Ibid.

via whole-loan sales and fund structures.<sup>38</sup> We understand that such platforms randomly allocate loans on origination between their different funding channels so that a whole-loan or fund channel would not receive higher quality loans than the retail peer-to-peer channel. Similarly, we understand that some UK platforms randomly allocate loans between retail investor and institutional investor marketplaces.

It is also possible that retail investors could be disadvantaged if platforms give additional information about investments to institutional investors. The UK FCA has raised concerns that a commercial preference for institutional investors by some platforms may be present, giving rise to preferential access provision to information and/or investment opportunity. This may be given on the basis that such investors have greater institutional capacity than individuals to process more granular or certain formats of information, for example. However, as above, this should not be to the detriment of retail clients.

The DIFC has imposed specific rules which require the fair treatment of lenders through symmetrical information requirements. These rules require that all lenders have access to the same information or, where the platform uses systems which allow lenders to lend money ahead of other lenders, that platforms disclose prominently that some lenders have preferential access to better proposals.<sup>39</sup> The DFSA comments that *“we appreciate that not all lenders will in fact access this information, but regardless, they must*

## **“A difference in treatment between investor types should not entail merely reducing or increasing the amount of information available.”**

*have equal access to all information”*.<sup>40</sup> From our discussions with platforms, we consider that some operators would be opposed to mandating symmetrical information requirements, with one lending-based platform commenting that such requirements could actually be detrimental to retail customers who may not actually read dense or certain formats of information and who would benefit from more targeted, comprehensible information. The platform commented that, in its view, it is platforms that are best placed to judge the level of granularity necessary for investors based on their level of investment experience.

We are largely persuaded by the arguments that identical information requirements may well not always meet the aim of ensuring that lenders understand the risks of investing.

We consider that there may be good reasons to differentiate between retail investors and institutional investors when it comes to providing information, e.g. retail investors may benefit from having more comprehensible risk warnings and disclosures than those received by institutional investors. That differentiation between categories of clients and how they are treated, however, should not necessarily mean that those clients are treated unfairly.

It should be noted that a difference in treatment between investor types should not entail merely reducing or increasing the amount of information available to certain investors, but rather tailoring the level of detail or format according to investor sophistication as assessed by the platform and tested by the regulator, who may publish guidance to this effect.

### **Best practice: Differing treatment of retail investors vs. institutional investors** **Mandatory:**

- Platforms should not be permitted to maintain structures that would result in higher-quality investment opportunities being made available to one class of clients (e.g. institutional investors) to the detriment of another class (e.g. retail investors).
- Platforms should provide information which is suitable to the needs of its clients in general. We do not consider that mandating identical information requirements for all clients is appropriate, nor do we recommend an individualised approach to each client. Rather, a commensurate level of information provision based on each customer category should be mandated. This should be outcome-based and left to platform discretion as to how customers are appropriately informed, but subject to review by the regulator and sanction in the event of failure.

<sup>38</sup> In the United States loans that are sold to investors fall within the definition of a security. Platforms which deal in these securities are generally outside the scope of the U.S. Regulation Crowdfunding regime, which is otherwise the focus of this Report.

<sup>39</sup> DFSA, CP 109, Crowdfunding: SME Financing Through Lending, 31 January 2017, p.25.

<sup>40</sup> *ibid.*

#### 4.2.3 Investor suitability

There is a risk that a crowdfunding platform allows retail investors with little experience or knowledge of investing easier access to potentially risky investments. There is a concern that these investors could put significant amounts of their investible assets into an investment without properly understanding the risks and lose all or much of their investment.

A common tool used across the Countries to address this risk are processes to assess the suitability of investors. These are more commonly used for investments in securities, perhaps reflecting the potentially riskier nature of equity investments. An investor looking to make an equity investment would be subject to suitability rules or an investor risk-assessment in the UK, France, the U.S.<sup>41</sup> and The DIFC.<sup>42</sup> The obligation is normally placed on the platform to conduct the assessment.

For example, in line with its principles-based regime, the UK requires investment-based platforms (but not lending-based platforms) to check that a client has sufficient knowledge and experience to understand the risks of the investment but does not place detailed requirements on platforms. Sophistication in the UK is determined by an investor's knowledge and experience – for example, whether the investor has recently made similar investments, whether they are a director of a company with a reasonable turnover, etc. The UK also introduced a

### “A common tool used across the Countries ... is to assess the suitability of investors.”

new rule which requires investment-based platforms to assess the sophistication of potential investors: those classified as retail investors can only receive direct-offer promotions from platforms if they are certified/self-certify as sophisticated<sup>43</sup> or high-net worth investors, or who confirm that they will receive professional investment advice, or who say that they will not invest more than 10% of their net investible portfolio in unlisted shares/debt securities. According to the FCA, *“this should ensure that clients are assessed as having the knowledge or experience to understand the risks involved before they can invest”*.<sup>44</sup>

The New EU Crowdfunding Regulation also requires an “entry knowledge test” to assess the prospective investor's basic knowledge and understanding of risk in investing in general and in the types of investments offered on the crowdfunding

platform. If certain criteria are not met, platforms would then give the prospective investor a risk warning which would not prevent investment, but would provide risk information to the person concerned. The platform should also assess the potential investor's ability to bear loss, based on certain income statements and financial commitments.

In relation to lending-based platforms, none of the Countries require suitability assessments for potential lenders. However, other tools are used in relation to the protection for lending-based platforms. For example, in The DIFC, lending platforms are required to assess whether a potential lender is a retail investor and, if so, that investor will be subject to enhanced consumer protection mechanisms (including limits on the amount that such investors may lend).



41 Suitability rules in the U.S. apply where investments are made via a broker-dealer. Suitability rules do not apply where investments are made via Funding Portals (which have a more limited range of activities under their authorisation).

42 We understand that the common crowdfunding activities in Austria (brokerage of Alternative Financial Instruments) and Germany (pure loan brokerage) do not fall within the scope of MiFID2.

43 The FCA allows an individual to be designated as sophisticated on the basis of professional or other investment experience and a consequent understanding of risk. See COBS 4.12.7; 4.12.8.

44 FCA – CP13/13, The FCA's regulatory approach to crowdfunding (and similar activities), October 2013, paras. 4.16, 4.17.



We are persuaded that a regime which classifies investors is more appropriate than mandating detailed suitability checks for all investors who, for example, invest via an investment-based platform. We consider that financial services regulators are best placed to determine these categories. Regimes can then adapt investor protection tools shaped to the risk level of a particular investor, e.g. the UK financial promotion regime and the DIFC protections outlined above. These further tools may include more detailed suitability checks on certain investors.

aim to address the concern that investors, particularly inexperienced retail investors, could invest a significant proportion of their investible assets in a risky, illiquid investment without fully understanding the risks.

#### (a) Opposition to caps from some platforms

It is notable that, within the European context, the UK is by far the most successful and vibrant crowdfunding jurisdiction in Europe with around 81% of the total European market share in

For example, in France there is a €2,000 per-project per-investor cap for lending-based platforms. French market participants have indicated a desire to increase this cap amount, on the basis that the cap is not market-efficient and that a self-declaration of financial resources would be preferable. A UK platform pointed out that for some high-net worth investors (who may still be considered “retail” in some jurisdictions), a suitable investment within an appropriately diversified portfolio could easily exceed some jurisdictions’ caps.

#### Best practice: *Investor suitability*

##### Mandatory:

- Financial services regulators should set certain categories of investor based on factors that may include investor knowledge and experience and/or investible assets/income. These categories could be designed by reference to existing financial services categorisation approaches (if appropriate).
- Categories should not be overly complex (they could be as simple as retail and non-retail).
- Platforms should be required to assess investors and categorise them in accordance with the categories set by the financial services regulator.
- Platforms should be permitted to re-categorise if the investor’s knowledge and experience change.
- Once investors are categorised, applicable investor protection measures should be tailored accordingly, (e.g. information and communication restrictions), with limits to the amount able to be lent to retail investors (if deemed appropriate by the financial services regulator).
- Platforms should be required to take into account the client categories to which it provides services. This includes overall platform design, (e.g. investment process), information availability content, and availability of support. In broad terms, the ease of access to information (and the extent to which detailed investment information is provided) should be determined by the degree of sophistication of the investor.

We tend to agree with this argument, and are also concerned that caps can hamper the development of the marketplace. As such, we do not necessarily consider it best practice to mandate per-project caps (although, they may be suitable for some regimes depending on the aims of policy-makers and the other investor protection measures adopted, e.g. restrictions on product types offered, as in The DIFC, as well as generic information and communication measures).

One respondent in a regime with per-project, per-investor caps on loans indicated that these caps could be a mechanism to ensure the diversification of risk. While such a cap would force investors to spread their money across several projects, we are persuaded that there are other tools which jurisdictions could consider to ensure the appropriate diversification of risk (see Section 4.3.3 below).

The table at Figure 5 sets out a summary of investment caps. Caps imposed on issuers/borrowers/platforms will be addressed later in this Report as we consider that the motivations of imposing these caps are different to the motivations for imposing caps on investors.

#### 4.2.4 Investment caps on investors

Caps on the amount an individual investor can lend, either per-project or over the course of a year, are a widely used investor protection tool. These caps

2015.<sup>45</sup> In our discussions with some platforms in jurisdictions which impose caps, the limits were dismissed as blunt tools which stifled market efficiency.

45 European Commission, Identifying market and regulatory obstacles to cross-border development of crowdfunding in the EU, December 2017 report, Annex A4, p.5.



Fig. 5 – Summary of Investments Caps

Country	Investor cap: per-project	Investor cap: annual	Issuer cap: annual across platforms	Issuer/borrower cap: per-project
<b>Austria</b>	<b>€5,000</b> (alternative financial instruments). This threshold can be surpassed if the investor earns a net salary of more than €2,500 per month. In this case, the investor is allowed to invest double his/her net monthly earnings.		None	<b>€1.5mn</b> (alternative financial instruments)  Issuers may not raise more than €5mn in capital over a seven year period, less the amounts already paid back to investors.
<b>DIFC</b>	<b>USD5,000</b> (loans – retail investors only)  No cap on securities	<b>USD50,000</b> (loans – retail investors only)  <b>USD50,000</b> (securities – retail investors only)	<b>USD5mn</b>	None
<b>France</b>	<b>€2,000</b> in respect of interest bearing loans; <b>€5,000</b> for non-interest bearing loans  No cap on securities	None	None	<b>€1mn</b> (loans) <b>€2.5mn</b> (securities)
<b>Germany</b>	<b>€10,000</b> (subordinated/ profit-participating loans <u>if</u> within the crowdfunding exemption)  No cap on securities <sup>46</sup>	None	None	None
<b>UK</b>	None	None	None	None
<b>U.S. (Regulation Crowdfunding regime)</b>	None	Annual cap based on income and net worth, e.g. investor with income and net worth of USD50,000 would have cap of USD2,500	<b>USD1.07mn</b> (inflation-linked)	None

<sup>46</sup> There is no specific cap in Germany; however, the prospectus exemption threshold is set at EUR100,000, above which a prospectus would be required.

### (b) Per-project caps unusual for securities

We note that, in the Countries which restricted how much an investor could invest, per-project caps were more common for loans than for securities, e.g. see France and the DIFC, which both impose such caps on investments in loans but not securities. While this may seem counterintuitive, as equity investments generally carry more risk, the DFSA has imposed this restriction so as not to impede securities investment; in its consultation paper, the DFSA assessed that imposition of a per-project cap for securities could impede the growth of the sector as issuers would need a large number of investors to be able to close a pitch.<sup>47</sup> We agree that per-project caps for securities are not best practice.

### (c) Annual caps

The U.S., Austria and the DIFC impose annual investment caps on investors. Such caps can be difficult to police, e.g. the DFSA recognised that “a Retail Client’s risk exposure could be increased if they chose to invest through multiple other platforms”.<sup>48</sup> While the DIFC regime imposes an obligation on platforms to ensure that they have systems and controls in place to ensure that these investor limits are adhered to, we understand that, in the U.S., platforms are entitled to rely on investors’ representations regarding compliance with caps. In Austria, the Alternative Financing Act (“**AFA**”) regime (under which most Austrian platforms operate) provides that it is an administrative offence to violate the investment caps and allows both the platform and the investor to be subject to a fine of up to €30,000. We do not necessarily consider any investment cap to be best practice due to concerns that

### Best practice: Caps on investors

#### Additional tools:

- While we recognise that caps can be an effective tool that help restrict an investor’s investment amount, we do not consider that it is best practice in all cases. Caps can hamper the development of the marketplace and bar suitable investments.
- Financial services regulators should be permitted to introduce caps if they identify poor investment behaviours that are not sufficiently addressed by risk warnings/disclosures.
- Caps could be applied to retail investors only (or to sub-groups within the retail investor category).
- Any introduction of caps should have regard to the adaptation of the technical and operational build of the platform, i.e. time should be provided to adapt.

they may restrict the development of the crowdfunding market and note that these caps can be particularly difficult for platforms to enforce. We do think the U.S. approach of linking the annual cap to an investor’s income and/or assets, as declared by the investor, mitigates some concerns about barring suitable investments. Platforms should be able to rely on annual income and asset value declarations and should not be expected to police or enforce these themselves.

#### 4.2.5 Due diligence on investments or borrowers/issuers (beyond financial crime checks)

Another tool used by some Countries is requiring the platform to carry out a certain level of due diligence on potential investments or on the borrower/issuer that goes beyond financial crime checks, for example examining the soundness of an investment or financial strength of the issuer. A range of approaches is taken on this point.

On the less interventionist end of the scale, the U.S. Regulation Crowdfunding regime does not require specific due

diligence checks to be performed (although platforms must deny access to issuers they believe pose a fraud risk). In the UK, however, the focus is on ensuring that investors understand the amount of due diligence that has been undertaken by the platform, rather than imposing minimum standards.

More stringent requirements are imposed in the DIFC, where a platform must conduct due diligence on each borrower or issuer which goes beyond simple KYC identity<sup>49</sup> checks (see Section 5.2 below for further detail), and including, for example, requirements for verification that the business is compliant with applicable laws. The platform must also check the borrower’s/issuer’s fitness and propriety, financial strength and history, business valuation and business proposal. According to the DFSA, “*these checks are very important because investors/[lenders] are unable to carry out individual checks on the issuers/[borrowers]*”.<sup>50</sup> In The DIFC, the same rules apply for lending-based and investment-based platforms.

<sup>47</sup> DFSA, CP 111, Crowdfunding: SME Financing Through Investing, 13 February 2017, p.28.

<sup>48</sup> Nevertheless, the DFSA commented that it felt that other regulatory protections provided a suitable balance of protection for retail clients. DFSA, CP 109, Crowdfunding: SME Financing Through Lending, 31 January 2017, p.24 (lending), DFSA, CP 111, Crowdfunding: SME Financing Through Investing, 13 February 2017, p.29 (investment).

<sup>49</sup> Customer due diligence is required on the issuer and investors based on a risk assessment. This may include obtaining a trade licence or articles of association.

<sup>50</sup> DFSA, CP 111, Crowdfunding: SME Financing Through Investing, 13 February 2017, p.25 and DFSA, CP 109, Crowdfunding: SME Financing Through Lending, 31 January 2017, p.22.

We are persuaded that best practice sits in taking a middle path, which protects investors, but does not, however, place an undue burden on platforms. Jurisdictions may decide to mandate due diligence checks (that go beyond financial crime checks) on issuers/borrowers or investments. However, we agree with the UK approach in mandating that the level of due diligence be disclosed to investors without requiring minimum standards. This, in our view, sits with the concept of a platform as a facilitative entity.

Where jurisdictions intend for the platform to be regulated as providing a financial service itself (perhaps with the extended permissions which accompany these aims), it may be appropriate to impose more extensive requirements. In light of this, we do consider it sensible to give regulators the additional tool of being able to mandate due diligence checks when they consider it appropriate to do so. Where appropriate, this might take into consideration credit information services provided in the jurisdiction. Where certain basic or standard information on the credit history of borrowers/investees might be available from credit bureaus, regulators might consider whether it is appropriate for the platform operator to obtain and make this information available or, at least, to indicate to lenders/investors how they may obtain such information. Given the platform's role as an intermediary, however, it may make sense for this information to be obtained and made available once rather than by each individual lender/investor separately.

**“...regulators might consider whether it is appropriate for the platform operator to obtain and make basic credit information available to lenders / investors.”**

#### **Best practice: Due diligence on investments or borrower/issuers**

##### **Mandatory:**

- Platforms should be required to disclose clearly to investors the level of due diligence that has been performed (with a focus on investor understanding including how the platform has assessed the risk of the investment).

##### **Additional tools:**

- Financial services regulators should have the ability to require due diligence on investments and/or issuers/borrowers, when they consider it appropriate to do so.
- Financial services regulators should have the ability to require platforms to make certain basic or standard form credit information on borrowers/investees available to lenders/investors or, at least, to provide lenders/investors an indication on how to obtain such information.

#### **4.2.6 Restrictions on product type**

There is a risk that investors using crowdfunding platforms are able to access risky and complex products which are more difficult for retail investors to understand. Some jurisdictions impose product limitations as an investor protection measure; e.g. in The DIFC, all platforms are restricted from facilitating investments in products considered to be higher risk: (a) warrants, certificates, units in collective investment schemes or structured products; or (b) derivatives.

Neither the U.S. Regulation Crowdfunding regime nor the UK imposes specific restrictions on the types of products that can be offered, but platforms will be limited to offering product categories that fall within the scope of their authorisation. In our view, this approach is preferable to specifically restricting certain products. Where crowdfunding activities fall within existing regimes, the authorisation parameters may already be in place (and jurisdictions should analyse whether they

are appropriate). Where a bespoke authorisation is introduced, jurisdictions may need to design specifically the product category range. For example, in France, entities holding the crowdfunding-specific CIP status (which is more “lightly” regulated than the ISP status) can only offer ordinary shares, “plain vanilla” fixed rate bonds and minibonds.

In our view, jurisdictions should ensure that product categories are not unduly narrow, e.g. a platform may be authorised to intermediate bilateral loans, but if it wanted to intermediate bonds then the new product would need to go through the regulatory permission process. By contrast, no new authorisation would be required for a five-year bilateral loan with A+ borrowers when the platform is authorised to offer the same loans but over a seven-year period.

#### **Best practice: Restrictions on product type**

##### **Mandatory:**

- Financial service regulators should authorise the scope of activities offered by platforms by reference to product.
- See further recommendations in Section 3.1 above.

### 4.3 During Investment

There are certain tools used by different jurisdictions aimed at the protection of the investor during the term of the loan and/or the duration of the investment in securities.

#### 4.3.1 Contracts

There is a risk that platforms may fail to ensure that appropriate agreements are put in place, governing the rights and obligations of the platform-client and the investor/investee. This could lead to consumer detriment if, for example, a loan was found not to be legally enforceable.

##### (a) Agreement governing the relationship between the platform and its client

Several Countries require that the relationship between the platform and clients be set out in a written contractual agreement. This generally applies to both lending-based and investment-based platforms, e.g. the UK applies this requirement to all clients using investment-based platforms and to retail clients using lending-based platforms. Additionally, in The DIFC, platforms are required to enter into client agreements with issuers and with lenders, which must include certain core information as to the scope of the service required.

The DFSA has proposed that further mandatory information should be included in this agreement for lending-based platforms, e.g. interest repayments, and rights and obligations of the borrower and lender.

We consider that it is best practice to require that platforms enter into agreements with their clients governing the main terms of the client-platform

relationship. Such agreements should set out key terms, including the parties, the nature and duration of the relationship, a description of the services provided and any limitations thereto, fees and costs to the investor, e.g. interest payments in the case of loans.

##### (b) Agreement governing the relationship between the investor and the investee

We have generally noted that, in relation to agreements governing the lender/borrower or investor-issuer relationship, there are more contractual requirements in place for lending-based platforms. This is unsurprising, given that platforms may play more active roles in the life cycle of a loan, e.g. dealing with borrower default, overseeing interest payments. Generally, the role of a platform in relation to securities is more “hands-off” once the investment is completed, although this varies across and within jurisdictions.

Examples of contractual requirements in lending-based regimes include France where lending-based platforms are required to provide a standard contract that contains, *inter alia*, the amount of

the loan, its duration, the applicable interest rate, the maturity date of the loan, the repayment terms, and, if applicable, the right to withdraw<sup>51</sup> and the procedure thereof.

Similarly, in The DIFC, the DFSA requires that the platform ensures that there is a written and legally enforceable loan agreement in place between its borrowers and lenders, which should include minimum requirements (details of the agreed loan, interest repayments, rights and obligations of the borrower and lender).

We consider that it is sensible to impose some requirements on lending-based platforms to take reasonable steps to ensure that the loan agreement is legal, valid, binding on and enforceable by the parties since the platform is likely to prepare the standard form loan agreement which the parties will use. Similarly, it is logical that typical documents for equity offers on investment-based platforms such as share purchase agreements, should be binding, and legally enforceable.

#### Best practice: Contracts

##### Mandatory:

- Platforms should be required to put agreements in place with their clients, setting out the relationship between the platform and the client. Such agreements should set out at the minimum the key terms, including (i) the parties, (ii) the nature and duration of the relationship, (iii) a description of the services provided and any limitations thereto, (iv) fees and costs to the investor, e.g. interest payments in the case of loans, (v) any rights to complain, and (vi) appropriate risk warnings.
- In the case of both investment-based and lending-based platforms, platforms should be required to take reasonable steps to ensure that transaction documentation is (i) legal, (ii) valid, (iii) binding, and (iv) enforceable, or otherwise make clear the risks of non-enforcement assumed by the investor.

<sup>51</sup> The *droit de retraction*, is a right to withdraw from committing investment through a platform, akin to a cooling-off period.

#### 4.3.2 Loan enforcement (lending-based platforms)

We consider that it is important that lending-based platforms which intermediate between borrowers and individual lenders<sup>52</sup> play an active role in collecting and enforcing loans made through the platform. The principal options available are that (i) enforcement could be left to individual investors, (ii) the platform could take steps to enforce on behalf of investors, or (iii) a professional third-party enforcement provider could be appointed by the investors or the platform to take these steps. In our view, the first option is likely to be cumbersome, duplicative and inefficient (and the likely small amount of investment means individual investors may not have the incentive to pursue defaulting borrowers). By contrast, the second and third options provide for a coordinated, more efficient methodology and consequently, we would recommend that best practice is that either the platform should be mandated to determine and take the appropriate enforcement action on behalf of investors (taking into account their best interests) or should appoint a professional third-party to do so on its behalf or on behalf of investors. At the very least, the platform should assume a supporting role in the administration and coordination of the enforcement of investments. Whether security is taken will depend on the particular market practice in a given jurisdiction but we would anticipate that whether or not the platform holds the security, it would nonetheless coordinate on behalf of investors.

For example, in France, enforcement through the collection of payments requires a specific payment services

**“The centralised “hub” provided by the platform for possibly hundreds of lenders with interests in one loan means that it is logical for platforms to bear the responsibility for enforcing the loan on behalf of lenders.”**

licence, and as such we understand that platforms tend to appoint a duly licenced entity to act as their agent in order to intermediate enforcement services. Likewise, where securities are issued, we understand that platforms would not hold these themselves, but appoint a duly licenced investment service provider by means of contractual agreement to do so; if the platform were to become insolvent, then any assets held by the agent would therefore not be affected by the insolvency.

The DFSA commented that leaving it to individual lenders to obtain repayments on loans *“could be difficult, especially for individual retail lenders”*.<sup>53</sup> This leaves a risk that, if a borrower defaults, no one is responsible or able to pursue the

borrower for payment. The centralised “hub” provided by the platform for possibly hundreds of lenders with interests in one loan means that it is logical for platforms to bear the responsibility for enforcing the loan on behalf of lenders. These arrangements should be described by platforms to both borrowers and lenders.

From our review, we note that The DIFC requires platforms to disclose to lenders how the platform will deal with late payments or total default on a loan. In addition, we consider that both the borrower and the lender should be clear about whether the platform imposes additional charges for enforcement activities (and, if so, how much these are).

#### **Best practice: Loan enforcement** **Mandatory:**

- Lending-based platforms that intermediate between lenders and borrowers should be required to have arrangements or to make arrangements for the enforcement of loans on behalf of platform investors whether by the platform or by a third-party on behalf of investors.
- These arrangements should be described to both borrowers and lenders and any additional costs of enforcement disclosed. Where the platform itself may be a lender, should regulations permit platform co-investment, this may give rise to a conflict of interest. Such conflicts should be managed in accordance with the platform’s conflicts of interest policy (see further Section 3.4).

<sup>52</sup> In some jurisdictions, this may not strictly be the role of the platform. For example, in Germany, the prominent business model for lending-based platforms involves brokerage of a loan between a credit institution and a borrower with the credit institution then selling parts of the loan to investors. In this model it may be more appropriate for the credit institution to take on the role of loan-servicing and enforcement.

<sup>53</sup> DFSA, CP 109, Crowdfunding: SME Financing Through Lending, 31 January 2017, p26.



**“...by diversifying, investors profit from the quality of the loans offered and the quality of a credit platform’s risk-assessment and reduce the risk of being hit severely if a single loan defaults.”**

#### 4.3.3 Diversification

The diversification of investments is a key tool in mitigating the risk of potential capital loss. In relation to loans, one platform commented: *“by diversifying, investors profit from the quality of the loans offered and the quality of a credit platform’s risk-assessment and reduce the risk of being hit severely if a single loan defaults.”*

As noted above, one respondent in a Country with per-project, per-investor caps has commented that such caps can be a tool to mandate diversification. A UK lending-based platform informed us that it believed the right approach was to focus on warnings about the risks of investments and to educate investors about the benefits of diversification. We tend to agree with this statement in accordance with our recommendations above that risk warnings form the core component of the investor protection framework. We therefore consider it best practice to require information on the importance of diversification to be delivered to investors via investor disclosures. In addition, financial services regulators should have the ability to require further action from platforms which consider that their investors have not sufficiently diversified their investments.

We also consider that platforms can play an additional role in encouraging

diversification. A lending-based platform stated that, in its opinion, platforms should offer automated diversification tools to *“enable investors to spread even relatively small amounts over a high number of loans and build a diversified portfolio conveniently”*. Indeed, in the UK, some platforms use “automated diversification” tools, which means a lender’s money is spread across many loans. These tools operate on the basis of pre-designated risk categories and either automatically, or taking into account investor preference, allocate investments over a portfolio without direct investor control.

Furthermore, diversification tools may be analytical in nature, in order to show investors or lenders how their capital is spread across different assets. In whichever way such tools are used by

a platform, we recommend that platforms should fully explain how such tools operate, and allow users to select the parameters of the investment diversification as appropriate to the tool. Tools should be made available and recommended to all investors. Discretion on the part of the platform, particularly in the context of investments in securities, risks platforms’ activities straying into those of an asset manager, which would entail triggering additional obligations to act in the best interest of customers in making diversification decisions, and additional risk warnings. If such a service were to be provided, we anticipate that the platform operator would also need to be licensed in accordance with the jurisdiction’s investment services regime to provide asset management services and possibly also to provide investment advice. These could be avoided by implementing rules-based diversification on the basis of client instruction with no discretion on the part of the platform.

We therefore consider that jurisdictions should ensure that platforms are permitted, but not necessarily obligated, to offer automated diversification tools.

#### **Best practice: Diversification** **Mandatory:**

- Investor disclosures should include information on the importance of diversification of investments.
- Platforms should be permitted to offer automated diversification tools that should be made available and recommended to clients at the outset. Diversification tools should only permit platform discretion where asset management and/or investment advice is also authorised.

#### **Additional tools**

- Financial services regulators should be permitted to require that platforms monitor investors’ diversification and deliver risk warnings or engage with investors when they consider that the portfolio is not sufficiently diversified.

#### 4.3.4 Default funds (lending-based platforms)

One approach taken by some lending-based platforms to mitigate the risk of capital loss for borrowers is the operation of a “provision fund” which is intended to cover losses that cannot be recovered from borrowers. These can operate by diverting a proportion of a customer’s fee to a separately held fund which pays out upon the default of a borrower. Of course, there is the risk that capital is not sufficient to cover losses, particularly if there was a market-wide downturn with high levels of borrower default. The management of the fund is a commercial choice of the platform.

No Country has mandated such tools and we do not consider that it is best practice to do so. There is a risk, of course, that such tools might give investors a false sense of security and the FCA has stated that it is “*concerned that [default funds] can obscure the underlying risk to investors...they can lead investors to believe that platforms provide a guaranteed rate of return on the loans they facilitate*”.<sup>54</sup> We therefore, consider that, where such funds are used, the level of risk of default should be accurately described and platforms should be required to warn that lenders’ capital is at risk as well as provide certain information about the default fund. Default rates should be published, so that the existence or use of the default fund in particular does not obscure this information. As set out above, communications to clients should always be fair, clear and not misleading.

#### 4.3.5 Co-investment by platforms

One possible measure that is not (yet) adopted in any of the Countries is to require an amount of co-investment by platforms to ensure that the interests of

#### Best practice: Default funds

##### Mandatory:

- Platforms using default funds should ensure that default rates published to investors remain accurately described; the default fund should not be used as a means of obscuring actual underlying default rates.
- Platforms using default funds should accurately describe: (i) how and when the default fund will pay out (and when not), (ii) how the default fund is funded, (iii) the funding level.
- Default funds should be held in a way which ensures that they are ring fenced from insolvency of the platform.

the platform and the investor are aligned. The DFSA has invited views on this – asking whether platforms should be mandated to take a small (perhaps 2.5% – 5%) interest in each security administered.

We note that this type of tool is used in other fairly limited contexts, e.g. risk retention rules are used in connection with securitisations. We also consider that it could raise conflicts of interest concerns (see Section 3.4.2 above). Co-investment by platforms is a somewhat untested idea that warrants further study (including consultation with market participants).

#### Best practice: Co-investment

None at present, but jurisdictions may consider further consultation on this.

#### 4.3.6 Client assets and client money

A key tool that jurisdictions should consider in relation to investor protection (and indeed borrower/issuer protection) is ensuring that any client assets (including client money and securities in the investment context) received by the platform are appropriately protected. The primary concern here is insolvency of the platform. Money or securities which are handled by platforms but not beneficially

owned by platforms should not form part of the insolvency estate in the event of platform failure.

From our review, it seems that most Countries implementing bespoke regimes have brought platforms within the scope of existing client assets requirements with some adaptations specific to crowdfunding.

For example, in The DIFC, an additional permission is required to hold or control client assets (cash and/or securities) on behalf of any participant in the platform at any time. Similarly (in relation to client money), the UK has brought its bespoke lending-based regime within its existing client-money rules, including the requirement to open segregated client bank accounts, but has also prohibited lending-based platforms from taking on full ownership of lender monies under title transfer.

Some jurisdictions will require stricter rules for entities which are otherwise subject to “lighter” regulation. For example, in the U.S., the more heavily regulated investment-based platforms, broker-dealers, can hold client money under existing rules, whereas Funding Portals, crowdfunding-specific entities which are more lightly regulated than

<sup>54</sup> FCA, CP18/20 Feedback and proposed changes to the regulatory framework, July 2018, paragraphs 4.66-4.67.

broker-dealers, are barred from holding client funds (and usually engage a third-party broker-dealer to deal in client payments on their behalf).

France takes a stricter approach, requiring that none of its crowdfunding entity types (CIPs, ISPs, IFPs) can receive funds from investors unless they are specifically authorised to provide payment services (for example, as a payment institution, electronic money institution, credit institution, etc.) or mandated as an agent of a payment services provider, in which case they may receive funds from investors subject to additional requirements, e.g. opening a dedicated bank account for payment and subjecting these funds to segregation.

In principle, provided client money protections are suitably robust, there is no reason why crowdfunding platforms could not handle client assets or client money.

In our view, this consideration should be addressed when considering the macro design principles and authorisation requirements. Jurisdictions may decide to

#### **Best practice: Client assets**

##### **Mandatory:**

- A framework should be established to ensure that client money and client assets are protected on the insolvency of a platform
- Platforms permitted to hold or handle client money or client assets must do so in a way which ensures the protection of such client money or client assets in accordance with the relevant framework.
- Platforms holding client money should be required to hold that client money with an appropriately authorised entity that is sufficiently insolvency remote from the platform.

raise prudential requirements (as with The DIFC) or impose heavier regulatory authorisation requirements (as with France and the U.S.) when platforms handle client assets.

As best practice we consider that when jurisdictions make the decision to permit platforms to handle client assets and client money, they should ensure these activities fall within a new or existing framework which ensures the protection of client assets and client money including, in particular, in the event of insolvency of the platform. This may take different forms depending on the existing

framework, e.g. in the UK funds are held in separate bank account subject to a client money trust.

In relation to client money, when designing client-money rules, jurisdictions should consider the relevant credit risk of the client-money-holding-entity, e.g. requiring client money to be held by a licensed credit institution that is not in the same corporate group as the platform.

Whilst client assets and client money are important, consideration should also be given to whether the existing insolvency framework provides for an appropriate ranking of lenders and investors in the insolvency of the borrower/investee. In our view, however, this is something which needs to be considered in the broader context of lending and investments and not solely within the sphere of crowdfunding.

#### **4.4 Post-Investment**

##### **4.4.1 Cooling-off periods**

There is a risk that investors may change their mind about an investment and, therefore, in some cases, it may be appropriate to allow for a period of time for investors (or certain investors) to change their minds. However, in some circumstances, it may be difficult to allow an investor to withdraw from a loan or equity investment after agreeing to fund it.



In the U.S., investors have unconditional rights to cancel until 48 hours before the deadline identified in the issuer's offering materials. Similarly, The DIFC provides for mandatory cancellation rights for investors who have made an investment via an investment-based platform. The DFSA rules require a "cooling-off" period of 48 hours during which an investor can withdraw its commitment without penalty and without giving a reason. The DFSA decided not to extend this rule to investments made via lending-based platforms, but "rather leave it up to the platforms to decide whether or not they will provide cancellation rights. If it is offered, then the operator is required to reflect that as part of its disclosure requirements."<sup>55</sup> In our view, this different approach relates to the perceived higher risk nature of equity investments and the illiquidity of such investments.

It is notable that the UK Crowdfunding Association (of which several leading UK platforms are members) provides a Code of Conduct for member platforms which

#### Best practice: Cooling-off periods

##### Mandatory:

- Some form of "cooling-off period" should be offered to (at least retail) investors in both lending-based and investment-based platforms.
- The precise parameters of such period should not be mandated, but any required period could be relatively short, e.g. 48 hours, as in The DIFC regime.
- A required "cooling-off period" could be curtailed at a certain point in the investment timeline where withdrawal could prejudice other investors or lead to undue uncertainty, etc.

includes a commitment to "provide a 'cooling-off period', during which users can cancel or redeem their investment or donation, in accordance with applicable regulatory requirements."<sup>56</sup>

In our view, it is important to allow investors (at least retail investors) the opportunity to change their minds in a short period after making the investment, particularly given the potentially inexperienced nature of some investors. However, this needs to be balanced against the certainty required by issuers/borrowers to be able to close the investment.

#### 4.4.2 Post-investment arrangements for holding shares and exercising rights (investment-based platforms)

One area in which, from our review, there are few regulatory requirements is the area of post-investment protection for shareholders. Investors purchasing shares via investment-based platforms can face particular risks as investments are highly illiquid. Investors will generally become minority shareholders, often with very small percentage holdings, in unlisted companies subject to significantly less stringent financial reporting and audit standards than listed firms. The rights attaching to shares may not provide for voting rights or any protection against dilution.

On the issuer side, issuers may be SMEs with little knowledge of corporate law or shareholder rights. Issuers using crowdfunding platforms will usually raise relatively small amounts of capital from a large number of investors. This could impose significant administrative burdens on issuers, e.g. communicating with investors and dealing with documentation relating to potentially hundreds of shareholders. Issuers should be aware that, where shares contain voting rights, they may need to seek approval from a large number of shareholders for certain corporate actions.



<sup>55</sup> DFSA, CP 111, Crowdfunding: SME Financing Through Investing, 13 February 2017, p.29.

<sup>56</sup> <https://www.ukcfa.org.uk/join-us/code-of-conduct/>



We consider that there is a balance to be struck here between post-investment shareholder rights and administrative burden and possible corporate action restrictions faced by issuers. There are a number of different options that could be adopted to strike that balance but, in our view, none are necessarily the ideal solution, and all involve trade-offs for the investor and/or the issuer.

Some possibilities are:

- (a) All shareholders who invested via the platform hold shares themselves with shares containing post-investment shareholder rights.<sup>57</sup>

Shareholders themselves would hold some rights over how the company is run, e.g. through voting at shareholder meetings. However, small minority shareholders may not wish to deal with the administrative burden of overseeing their investment. On the issuer side this can lead to the burden of trying to deal with possibly hundreds of disengaged shareholders. Some companies may find it difficult to obtain the large number of shareholder approvals necessary for certain key corporate actions.

- (b) All shareholders who invested via the platform hold shares themselves. These shares are “Class B” and contain no post-investment shareholder rights. This option reduces the administrative burden for issuers who can take decisions which otherwise require shareholder resolutions. However, this also limits the rights of shareholders. Shareholders would benefit from any protection offered by the jurisdiction’s corporate law framework so post-investment protection may vary significantly in different jurisdictions.



For example, in the UK shareholders would have recourse to the rights under the Companies Act 2006, e.g. actions for unfair prejudice. However, such court actions can be time-consuming, expensive and have an uncertain outcome. Crowdfunding equity investments can often be small, and it is worth considering whether, where a relatively low amount is invested, investors would have the incentive to pursue court actions to enforce their rights. We understand that several platforms operate using this model, and investors may nonetheless be able to take an informed decision on these risks through the use of risk disclosures (see below).

- (c) A nominee company is the legal shareholder on behalf of all crowdfunding investors in the investment. The nominee puts in place an investment agreement which requires that investors have post-investment shareholder rights. The nominee will generally administer the investment as legal shareholder, including voting on investors’ behalf at shareholder meetings.

This option poses little administrative burden on the issuer, who can deal directly with the nominee rather than a large number of individual shareholders. However, from the investors’ perspective, they generally cede their decision-making to the nominee, and some investors may wish to be more directly involved. In addition, this structure may rely on the platform being involved in the investment on an ongoing basis. The risk of platform (and nominee) failure is therefore particularly relevant in this context to fund and operate the nominee, as it could result in shareholders being unable to effectively exercise their rights. We understand that as a result, where this structure is operated by platforms in the UK, by way of example, it is essential that a shareholder agreement is entered into.

We would note that these possibilities do not represent an exhaustive range of options, and hybrid models are possible both with and without nominee arrangements. It is also possible for shareholders to hold interests in a trust fund constituted by their shares, where the trustee may also act as a nominee.

<sup>57</sup> For these examples we consider this to include voting rights, pre-emption rights, and “tag” and “drag along” rights.





We do not necessarily consider it to be best practice to mandate any one of the options above to be adopted by investment-based platforms. As outlined in our recommendations, jurisdictions should ensure that investors are informed of and can understand the risks of their investment, which for equities would include the rights (or lack thereof) attaching to shares. We, therefore, agree that information regarding the shareholding structure and any vehicles employed is covered in investor disclosures provided by the platform.

We do consider that it is appropriate to give regulators the ability to decide whether to require that certain post-investment shareholder rights attach to shares offered via an investment-based platform (but do not recommend that it should be mandated in all jurisdictions). Where such protections are in place, it is essential that jurisdictions monitor that the level of protection is accurately presented to investors.

One regulator mentioned an interesting idea, not adopted in any of the Countries, of requiring a minimum level of

investment (whether a proportional shareholding or other measure, depending on corporate governance requirements in the particular jurisdiction). This could ensure that investors have enough “skin in the game” to be incentivised to enforce their rights, but could close off crowdfunding investments to certain investors and potentially discourage diversification.

Once again, the idea of co-investment by platforms could provide for the alignment of the interests of platforms and shareholders, particularly if platforms were required to co-invest in the same class of shares as investors. As discussed above, we do not consider it best practice to mandate anything relating to co-investment, particularly as we consider that conflicts of interest issues may arise, but it may be an idea worthy of further discussion.

#### 4.4.3 Post-investment arrangements for creditors (lending-based platforms)

As noted above at Section 4.3.2, similar concerns also arise in the case of lending-based platforms and the enforcement of loans made.

We would therefore consider it appropriate for lending-based platforms to provide information to investors on their post-investment arrangement rights/arrangements, whether this entails a trustee-type arrangement or other mechanism for enforcement such as appointing a duly licenced third-party entity as agent.

#### Best practice: Post-investment arrangements

##### Mandatory:

- Platforms should be required to provide information to investors which includes a clear and understandable explanation of the investor’s post-investment rights.
- Investment-based platforms should be required to disclose to investors the implications of the platforms’ arrangements for holding the shares and exercising the rights.

##### Additional tools

- Financial services regulators should be permitted to require that securities offered via crowdfunding platforms should have certain rights attached, e.g. voting rights or pre-emption rights (where the class of shares issued have such rights).
- Other innovative tools, e.g. levels of minimum investment or required co investment by platforms should be permitted. From our review, these appear to be relatively untested, and financial services regulators would therefore benefit from consulting market participants on these measures prior to their adoption.

## 5. Specific Considerations: Market Integrity and Financial Crime

The Countries have employed many tools aimed at ensuring that investors, investees and the public at large have confidence in the crowdfunding market. Many of the tools outlined above, addressing investor protection, form a vital component of the Countries' efforts to bolster the integrity of crowdfunding, and this section focuses on the other components which make up these efforts.

### 5.1 Market abuse (investment-based platforms)

Some conduct by investment-based platforms may constitute abuse of securities markets depending on the laws and rules on market abuse applicable in the jurisdiction. In The DIFC, the market abuse regime applies to a broad range of investments, including those not admitted to trading on an exchange. As such, the DFSA decided to add further guidance to its Code of Market Conduct, giving some examples of conduct that may constitute market abuse for investment-based crowdfunding operators, including fraud, and dissemination of false or misleading information.<sup>58</sup> The DFSA also prescribed a loan agreement on a platform as a Financial Product, subject to the generally applicable DFSA laws prohibiting market abuse, and made amendments to its conduct of business rules such that employees and their family members are prohibited from lending to a borrower, or holding interest in the borrower or lender, with a view to preventing insider-dealing. It did not, however, incorporate wholesale

**“It seems likely that most of the instruments currently offered through crowdfunding platforms would be outside the scope of the [Market Abuse] Directive.”**

elements of securities regulation relevant to market abuse, preferring an incremental approach.

In relation to EU jurisdictions, the European Securities and Markets Authority's opinion sets out that it “*seems likely that most of the instruments currently offered through crowdfunding platforms would be outside the scope of the [Market Abuse] Directive*”.<sup>59</sup>

However, in our view, despite securities not being listed on a public market, the crowdfunding structure is akin to a type of (small) public market. From an investor-confidence and market-integrity perspective, maintaining a high standard, including adopting disincentives to market abuse, seems an important principle.

#### Best practice: Market abuse Mandatory:

- A market abuse or similar framework should be established that covers at least fraud and the dissemination of false or misleading information in relation to investments offered through a crowdfunding platform. This may be narrower in scope than regulations which are generally applicable outside of the crowdfunding context.

### 5.2 Countering financial crime

There is a risk that platforms could be used by bad actors to launder money or to facilitate the use of money for the funding of criminal (including terrorist) activities. A report from the European Commission from June 2017 designated the vulnerability of crowdfunding to money-laundering and terrorist financing as “significant”.<sup>60</sup> The analysis of the Countries demonstrates that regulatory regimes generally incorporate platforms into the ambit of existing laws and rules on anti-money laundering (“**AML**”) and countering the financing of terrorism (“**CFT**”). Most Countries required some level of customer due diligence/KYC on clients of the platform. However, we understand there can be gaps in coverage. For example, one lendingbased platform which operates in the Netherlands informed us that some Dutch credit platforms can originate loans for which no KYC checks apply. Indeed, platforms were prohibited from carrying out checks as they were not authorised financial institutions. This platform commented that there is a risk of the use of crowdfunding activities for money laundering activities and that this risk will increase if crowdfunding is “perceived as a convenient way to bypass AML legislation”.

<sup>58</sup> The DFSA also commented that it has taken the view that the provisions of the market abuse law would not apply to those operating a lending-based platform due to the nature of the services provided ([http://dfsa.complinet.com/net\\_file\\_store/new\\_rulebooks/2/0/20170130\\_loan-based\\_CF\\_CP.pdf](http://dfsa.complinet.com/net_file_store/new_rulebooks/2/0/20170130_loan-based_CF_CP.pdf))

<sup>59</sup> The Directive prohibits insider-dealing and market manipulation in relation to financial instruments which have been admitted to trading on at least one regulated market or for which a request for such admission has been made. [https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1378\\_opinion\\_on\\_investment-based\\_crowdfunding.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-1378_opinion_on_investment-based_crowdfunding.pdf), p.20

<sup>60</sup> European Commission, Supranational risk assessment report from the Commission to the European Parliament and the Council on the assessment of the risks of money laundering and terrorist financing affecting the internal market and relating to cross-border activities, 26 June 2017.

However, the extent of AML/CFT checks will depend on the scope of the platforms' activities. One UK platform mentioned that some checks felt duplicative as the source of funds was usually from a UK bank which was already subject to anti-financial crime standards. In Germany, pure loan brokering entities (a common platform business model in the German market) are unlikely to fall within the scope of the German Anti-Money Laundering Act. However, the business model involves the brokering of a loan between a borrower and a credit institution which will be subject to the provisions of the Act. From our review, this seems to be a relatively unusual model.

Overall, we do consider it best practice to require platforms to carry out KYC checks on all clients given the risk of financial crime that arises from crowdfunding. The level of such checks could be tailored to a risk-assessment performed by the platform (e.g. enhanced checks for higher-risk clients or activities) and should involve some ongoing monitoring of customers and transactions. In our view, it is the financial services regulator who is best placed to set guidance for platforms on this process, which would be in keeping with the current KYC requirements of a

jurisdiction, and which should be commensurate with the risk presented by clients. Platforms in jurisdictions in which KYC regulation has primarily concerned institutional entities have indicated that they have encountered some resistance from regulators in on-boarding retail clients with a proportionate level of KYC which permits platform growth. We

therefore recommend that regulators should permit a level of KYC which is commensurate with the clients concerned and their relevant risk profiles. More enhanced due diligence could be applied subsequently based on risk factors such as size of transactions, source of funds, etc.

#### **Best practice: Countering financial crime**

##### **Mandatory:**

- Platforms should be required to perform customer due diligence checks on all clients.
- Customer due diligence checks should be tailored to a risk-assessment performed by the platform using guidance set by the financial services regulator. Guidance should be based on the factors that may be taken into account when formulating an appropriate customer due diligence process. More enhanced due diligence could be applied subsequently based on risk factors, such as size of transactions, source of funds, etc.
- The risk-assessment and guidance should take account of client and activity type. This need not be tailored to each individual client but rather risk categories. These categories could be designed by reference to existing financial services categorisation approaches (if appropriate), set by the regulator.
- Platforms should be required to perform a certain level of ongoing monitoring commensurate to risk of both its customers and transactions in order to identify suspicious activity.
- Platforms should be required to promptly notify financial services regulator (or other appropriate authority) in the event that it identifies any suspicious activity.

Also see Section 3.2.3 above on Systems and Controls.



## 6. Specific Considerations: Regulatory Engagement

We consider that effective engagement between regulators and platforms is a key principle which underpins a well-functioning regulatory regime. In relation to platforms, we consider that it is best practice for platforms to comply with the standard imposed by FCA Principle 11: platforms should be required to deal with regulators in an open and cooperative way and to disclose to the regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.

We also consider that platforms should be subject to specific regulatory reporting requirements. Jurisdictions can leave it to regulators to design the exact content of reports that regulators wish to receive both on a regular and an *ad hoc* basis. We consider that regulators will likely wish to receive regular reports on capital holdings (particularly to monitor whether platforms are meeting minimum prudential requirements) and on events which pose particular risks, e.g. events which may indicate platform failure is imminent or that a cyber-breach has occurred which may put client-money or customer data at risk.

Effective engagement is, of course, a two-way street. While this Report focuses on requirements placed on platforms, it is essential that platforms are able to deal with an engaged and responsive regulator. We discussed the role of the regulator with platforms across jurisdictions and generally received positive responses on platforms' experiences of the levels of engagement with regulators.

### Best practice: Regulatory engagement

#### Mandatory:

- Platforms should be subject to a general obligation to deal with regulators in an open and cooperative way and should disclose to the regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice.
- Platforms should provide specific reporting as set out below:
  - (i) Regular reporting on key metrics to be specified by the financial services regulator with a view to identifying either systemic or idiosyncratic risk. For example, this might include reporting on capital, level of default fund, number and type of complaints, etc.
  - (ii) *Ad hoc* reporting on specific eventualities to be specified by the regulator with a view to identifying either systemic or idiosyncratic risk. For example, this might include cyber-breach, platform failure, breach of regulatory rules, client-money reconciliation breaks.

## 7. Specific Considerations: Competition and Liquidity of the Market

### 7.1 Shaping the market in favour of SME investment

As outlined in Section 2 above, it is a key consideration for jurisdictions to ensure that the crowdfunding marketplace is shaped to address the areas of need within their markets. If the reason for encouraging crowdfunding is to encourage investment in SMEs rather than larger businesses, or to target start-ups rather than mature companies, then several tools are at the disposal of regulators.

#### 7.1.1 Caps on issuers/borrowers/platforms

Three Countries impose caps on the amount that can be issued/borrowed via a platform (see Figure 6).

The Austrian cap on alternative financial instruments and the French cap on

securities align with more generous prospectus requirements, e.g. in France issuers issuing via platforms can only raise USD2.5mn<sup>61</sup> per year, and the regime also provides for an exemption from the prospectus requirement for such issuances (as long as the platform has a progressive access website which provides risk warnings to investors).

The aim is likely to limit the market in Austria and France to SMEs that struggle to access finance elsewhere.

#### 7.1.2 Barring institutional investors

In France, investment via lending-based platforms is restricted to lenders acting in a non-professional capacity, i.e. who are not individuals investing as professionals in a commercial pursuit. France created an exception to its banking monopoly to allow investment in lending-based platforms. However, lenders must not be acting in a professional or commercial capacity, which largely restricts lending-based crowdfunding to retail investors.

This is likely a result of the otherwise strict banking laws in France and, once again, we can see that the shape of the crowdfunding marketplace will be heavily influenced by the existing framework in place within a jurisdiction and the aims of the regime.

#### 7.1.3 Barring certain issuers/borrowers

We understand that in the U.S., the Regulation Crowdfunding regime is intended to be targeted at start-ups looking for operational financing. One of the tools the U.S. regime has used is to provide that certain issuers are ineligible to use the Regulation Crowdfunding regime, e.g. investment companies and certain private investment funds. The DIFC also prevents individuals from borrowing via a lending-based platform, meaning this regime is restricted to the supply of finance to businesses rather than individuals (sometimes termed P2B vs. P2P). This aligns with the stated aims of The DIFC regime of supporting financing for SMEs.

Fig. 6 – Summary of Caps

Country	Issuer cap: annual across platforms	Issuer/borrower cap: per-project
Austria	€5mn over a 7-year period	€1.5mn (alternative financial instruments)
DIFC	USD5mn	None
France	None	€1mn (loans) €2.5mn (securities)
Germany	None	None
UK	None	None
U.S. (Reg. CF regime)	USD1.07mn (inflation-linked)	None

<sup>61</sup> It is worth noting that the French annual per-issuer cap for securities issuance was raised in October 2016 from €1mn to €2.5mn. We understand that the securities cap was raised to accommodate the capital-raising requirements of both existing mature companies and start-ups.





### Best practice: *Shaping the market in favour of SME Investment.*

#### Mandatory:

- No specific best practice. These tools have been used by jurisdictions to shape their regimes towards (or away from) certain market participants. The use of these tools will heavily depend on the aims and desired outcomes of a particular jurisdiction's crowdfunding regime. The starting point should be the macro-level design considerations outlined at Section 2 above.

The answers to these considerations should help jurisdictions make a decision about whether to use any of the tools outlined above.

## 7.2 Balance between the buy-side and sell-side

The key risk for investors is the default of the borrower, or insolvency/bankruptcy of the issuer as this can lead to loss of capital and/or interest or dividend payments. This risk is exacerbated by the mispricing of credit or investment risk by the platform.

As with any market, accurate pricing of credit or investment risk requires a robust market of buyers and sellers to settle on prices that accurately reflect the underlying risk involved. Too few investors or investees could lead to interest rates shifting too far towards being priced according to market demand and failing to accurately reflect the risk of the security/loan. The FCA addressed this issue in its 2013 Consultation Paper and commented that *"the platform provider needs to acquire a sufficiently large number of investors and borrowers/issuers, which it can only do by building reputation."*<sup>62</sup> From our discussions with platforms we have the sense that this issue is well understood. A UK lending-based platform told us that striking the right balance of investors and investees underpinned

their entire business model and they were very conscious of the importance of getting it right.

The more general risk of mispricing of interest rates or securities pricing interlinks with the issues outlined above, e.g. the information asymmetry between the investor and investee, and between the platform and the investee; and the risks arising from retail investors failing to understand the risks of certain investments.

We agree with the general conclusions of the FCA that the best approach for avoiding mispricing of credit and investment risk is to ensure adequate due diligence checks are carried out on the borrower/issuer. These checks should ensure that adequate information is obtained and made available to platforms; this may include business plans or other financials. The overriding objective of the information should be to illustrate the purpose of funds sought, ability to pay, and creditworthiness in the case of a borrower, or value of the equity in the case of an issuer, where the expertise of the management and

the extent of any existing assets or liabilities can be ascertained.

This would allow platforms to address information asymmetries through disclosures and risk warnings to investors and emphasise transparency over platform performance, e.g. previous default levels. We would expect that platforms would normally monitor this balance to identify any occurrence of material investor detriment that leads to the mispricing of risk, as ultimately this will be determinative of platform success.

The general business conduct principle of treating customers fairly (see Section 4.1.1) means that, in practice, we would expect platforms to be monitoring outcomes for investors and investees, to give assurances that the market is operating effectively and achieving good outcomes.

### Best practice: *Buy-side vs. sell-side balance*

#### Mandatory:

- Platforms who set pricing must:
  - (i) completely assess credit risk in a systematic and methodical way;
  - and (ii) set prices to reasonably reflect such credit risk.

#### Additional tools:

- Use other transparency tools to aid investors to understand possible future returns on investment based on historical data, including default rates, with a clear indication that historical performance is no guarantee of future returns.

<sup>62</sup> FCA – CP13/13, The FCA's regulatory approach to crowdfunding (and similar activities), October 2013, p.43.

### 7.3 Ability of investors to be able to dispose of or transfer their investment

#### 7.3.1 Securities

Investors generally purchase shares in unlisted SMEs that are often in the early stages of growth. Indeed, as outlined above, some investment-based crowdfunding markets are designed specifically to provide funding for start-up businesses. As recognised by the DFSA, *“in the absence of a secondary market for trading in the securities, investors face the risk of not being able to sell their securities or having to sell them at a significant discount”*.<sup>63</sup> An investor in unlisted securities could potentially have its investment locked up in shares for an indefinite period of time. As the FCA comments, *“Consumers investing in such equity need to understand that they will probably have to wait until an event occurs, such as the sale of the company, a management buy-out or a flotation, before getting a return”*.<sup>64</sup> This is, of course, not an issue unique to investments made via crowdfunding platforms, but such platforms have opened up the market to investments in unlisted securities to a wider “crowd” of investors.

None of the Countries reviewed mandated the provision of a secondary market, with most relying on disclosures and risk warnings to investors on the illiquidity of products. In some Countries there has been an emergence of secondary markets. For example, a UK investment-based platform, Seedrs, introduced a secondary market in 2017 and recently widened access to allow any investor to purchase shares that were initially offered on the platform (previously, shareholders could only sell to other existing shareholders in the same

#### Best practice: Ability of investors to dispose of or transfer their investment

##### Mandatory:

- Platforms should be required to ensure disclosures or risk warnings to investors address the liquidity of investments. Such disclosures may be different for retail investors vs. non-retail investors and retail risk warnings may require more description of any restrictions on the transfer/disposal of securities.
- The duration of loans should be clearly disclosed to investors.

##### Additional Tools:

- Policy makers may wish to consider making regulatory provision for secondary market trading in the context of crowdfunding platforms.

company). A similar approach was taken by the Estonian-based Funderbeam platform which offers a secondary market based on blockchain technology.

Of course, secondary markets can pose regulatory challenges of their own depending on the scope of activities and the existing regime for securities exchanges. In The DIFC, the DFSA allows both lending-based and investment-based platforms to set up secondary markets, but sets out that *“[i]t is not anticipated that it would be used as a venue for active trading, or by the platform operator to raise further funds, nor should the platform operator try and act in any other capacity that may stray into other regulated Financial Services”*.<sup>65</sup>

#### 7.3.2 Loans

Lack of liquidity is generally less of a risk for loans, which will usually have a fixed duration. Nevertheless, some lenders may wish to transfer their loans. A French market participant expressed the view that the lack of secondary market for loans negatively impacts the liquidity of lending-based platforms.

Some Countries impose limits on the term of loans offered by lending-based

platforms, e.g., in France, interest-bearing loans offered via a crowdfunding platform can have a maturity of up to seven years.<sup>66</sup> Such restrictions could limit loan terms and the potential risk of lack of liquidity. However, we consider that, provided investors are duly notified of the risk through risk warnings, investment decisions would be informed.

#### 7.4 Barriers to entry for new platforms

One risk prevalent across markets is that regulatory rules could be overly favourable to established market operators to the detriment of new entrants. Lack of competition can be detrimental to consumers.

However, we generally received positive feedback from market participants across jurisdictions on the competitiveness of the market. Feedback from Austrian platforms was that the AFA regime had been beneficial for the competitiveness of the market. One market participant in the U.S. informed us that the barriers to entry were low: *“that means, of course, there are too many [platforms] for a limited market”*. Similarly, French market participants have indicated that they were expecting a consolidation of the market. For example, we were informed that

63 DFSA, CP 111, Crowdfunding: SME Financing Through Investing, 13 February 2017, p.6.

64 FCA, CP13/13, The FCA's regulatory approach to crowdfunding (and similar activities), October 2013.

65 DFSA, CP 111, Crowdfunding: SME Financing Through Investing, 13 February 2017, p.33.

66 There is no limitation on duration for non-interest-bearing loans offered via French lending-based platforms.



when the new lending-based platform status was introduced (IFP), “about 69 new platforms registered but many never exercised any activity. The number of platforms is likely to shrink”.

Where markets were limited in growth, e.g. the “pure” equity crowdfunding market in Germany, this did not, in our view, arise from characteristics of crowdfunding regimes themselves but instead from the strictures of the wider regulatory framework.

#### Best practice: *Barriers to entry for new platforms*

##### **Mandatory:**

- No specific best practice is recommended. However, market competitiveness is an important design principle and crowdfunding regulatory frameworks should not overly favour existing market participants over new entrants.



## About EBRD

EBRD's Legal Transition Programme helps to establish laws, regulations and institutions that support the development of a predictable investment climate in our region, which includes central Asia, central Europe and the Baltic states, eastern Europe and the Caucasus, south-eastern Europe, the southern and eastern Mediterranean and Turkey. Its lawyers advise lawmakers and regulators on numerous areas of commercial and financial law, including legal and regulatory aspects of crowdfunding, blockchain, smart contracts and payment services.

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## GLOSSARY

<b>AFA</b>	Austrian Alternative Financing Act
<b>AML</b>	Anti-money laundering
<b>BaFin</b>	Germany Federal Financial Supervisory Authority
<b>CFT</b>	Countering the financing of terrorism
<b>CIPs</b>	Conseil en investissement participative (French investment-based platform)
<b>CP</b>	Consultation paper
<b>DFSA</b>	Dubai Financial Services Authority
<b>DIFC</b>	Dubai International Financial Centre
<b>ESMA</b>	European Securities and Markets Authority
<b>FCA</b>	UK Financial Conduct Authority
<b>FINRA</b>	U.S. Financial Industry Regulatory Authority
<b>IFPs</b>	Intermédiaire en financement participative (French lending-based platform)
<b>ISPs</b>	Investment service providers (French investment-based platform)
<b>KYC</b>	Know your customer
<b>PS</b>	Policy Statement
<b>P2P</b>	Peer-to-peer
<b>SMEs</b>	Small and medium-sized enterprises
<b>UK</b>	United Kingdom
<b>U.S.</b>	United States of America
<b>EU</b>	European Union



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