



## The new EU regulatory regime on crowdfunding

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Crowdfunding is the raising of funds via an internet-based platform by matching multiple retail investors with a fundraiser's request for investment, loan or other finance model on a one-to-one basis without the issuance of a prospectus. This model of raising funds has become more widespread in recent years, and as a result of its potential as an important source of non-bank financing and to mitigate the risks attached with crowdfunding, the European Commission has published legislation regulating crowdfunding activity.

### OVERVIEW

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On 20 October 2020, the European Commission published two pieces of legislation to regulate crowdfunding, namely:

- Regulation EU (2020/1503) on European crowdfunding service providers for business ("**Crowdfunding Regulation**"); and
- Directive 2020/1504 amending Directive 2014/65/EU on markets in financial instruments ("**MiFID Amending Directive**").

The legislation forms part of the EU Fintech Action Plan 2020 and aims to promote crowdfunding by creating harmonised rules applicable to crowdfunding activities across the EU and to support and encourage cross-border crowdfunding by providing a single set of rules.

Broadly speaking, the legislation applies to all crowdfunding platforms for offers of up to EUR 5 million, calculated over a period of 12 months per project owner (the recipient of the funds). The legislation covers both investment-based (consisting of transferable securities, such as shares and bonds) issued by the project owner) and lending-based (consisting of entering into a loan agreement) business models.

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## TIMELINE

The Crowdfunding Regulation will become directly applicable to firms from 10 November 2021. Member States are required to implement the Directive into national law by 10 May 2021 with those laws becoming applicable to firms from 10 November 2021 (the same date as the Crowdfunding Regulation).

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## WHAT ENTITIES ARE IN-SCOPE?

The Crowdfunding Regulation creates a new category of regulated entity called European Crowdfunding Service Providers ("**ECSPs**"). ECSPs are essentially crowdfunding platforms that fall into either of the below two categories based on the method by which the platform raises funds:

- **Loan based crowdfunding platforms:** Peer-to-peer platforms whereby individuals and firms lend money to a project owner in the expectation of financial return via interest payments and the repayment of capital. Lending to consumers is excluded.
- **Investment based crowdfunding platforms:** Peer-to-peer platforms whereby transferable securities (such as shares and bonds) are issued by the project owner.

The Crowdfunding Regulation applies to ECSPs in respect of offers up to EUR 5 million, calculated over a period of 12 months per project owner. Offers that exceed that threshold are to be regulated under the Second Markets in Financial Instruments Directive ("**MiFID II**") and the Prospectus Regulation.

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## AUTHORISATION REQUIREMENTS

ECSPs must become authorised by the competent authority of their home Member State, which in Ireland, is the Central Bank of Ireland. Entities authorised as ECSPs may avail of the European passporting regime.

The Crowdfunding Regulation provides the content of the application form, which is similar to that required for other financial services authorisations. Namely, the ECSP must provide its name, legal form, constitutional documents, programme of operations, description of governance arrangements and risk policies, as well as complaints management and business continuity procedures. Member State competent authorities must inform the European Securities and Markets Authority ("**ESMA**") of all ECSP authorisations and ESMA is to maintain a public register of such ECSPs.

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## **CROWDFUNDING AND MIFID**

In order to promote legal certainty and to remove the possibility that the same financial service is subject to multiple legislative regimes, the Crowdfunding Directive excludes entities authorised as ECSPs from being subject to MiFID II – unless the entity’s crowdfunding operations exceed the Crowdfunding Regulation thresholds triggering the requirement for a MiFID authorisation as stated above.

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## **ECSPS AND PAYMENT SERVICES**

An ECSP authorisation does not allow an ECSP to handle payments absent a separate payment institution or electronic money institution authorisation and ECSPs that wish to handle payments themselves must become separately authorised as a payment institution or an electronic money institution, or involve a third-party provider that is authorised to provide payment services. Similarly, an ECSP may not operate as a multilateral trading facility or organised trading facility without an investment firm authorisation, or receive deposits from the public absent a credit institution authorisation.

Crowdfunding platforms that are already authorised as an investment firm, a payment institution, electronic money institution or credit institution are to benefit from a simplified authorisation procedure on the basis that that their Member State competent authority should not require the resubmission of information already at their disposal.

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## **OPERATIONAL REQUIREMENTS ON ECSPS**

The Crowdfunding Regulation imposes various operational requirements on ECSPs. Those requirements are summarised below. The legislation uses the term ‘investor’ for the suppliers of funds regardless of the funding model (i.e. loan or equity based) and as previously stated, the term ‘project owner’ refers to the recipient of funds via an ECSP.

**BEST INTEREST REQUIREMENTS**

- ECSPs must act honestly, fairly and professionally and in the best interests of investors.
- ECSPs must not accept any pay or remuneration for routing investors to a particular investment offer.
- ECSPs may propose to investors specific investment offers where the proposed project corresponds to a set of parameters or risk indicators chosen by the investor, amongst other requirements.

**EFFECTIVE AND PRUDENT MANAGEMENT**

- ECSP management bodies must ensure the firm has policies and procedures that effectively segregate duties, provide for business continuity, prevent conflicts of interest and promote the integrity of the market and the interests of clients.
- ECSP management must establish and oversee systems and controls that assess the risks related to loans intermediated via the platform.
- Where an ECSP determines the price of a crowdfunding offer, it must assess the credit risk based on a number of prescribed criteria and amongst other requirements, ensure that the price is fair and appropriate.

**DUE DILIGENCE REQUIREMENTS**

- ECSPs must undertake due diligence in respect of project owners which, at a minimum, verifies that the project owner does not have a criminal penalty for various infringements and that the project owner is not a legal entity established in a 'high risk third country' or 'non-cooperating region'.

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**KEY INVESTMENT  
INFORMATION SHEET**

- An ECSP must provide a 'key investment information sheet' ("**KIIS**") about each proposed project (similar to a prospectus) to be drawn up by the project owner which must contain:
    - › details of the investment project;
    - › a responsibility statement by the project owner;
    - › details of the crowdfunding process; and
    - › descriptions of risk factors and investor rights.
  - Although the KIIS is drawn up by the project owner, ECSPs must have in place procedures to verify the accuracy and completeness of the information contained in the KIIS and is ultimately responsible for ensuring that the KIIS is clear and complete.
  - Member States are required to ensure the responsibility of at least the ECPS for the information provided in the KIIS by ensuring that their laws, regulations or administrative sanctions procedures reflect that responsibility.
  - Where the ECSP identifies misleading or missing information in the KIIS, the ECSP must inform the project owner and if necessary, suspend the crowdfunding offer for up to 30 days until the project owner rectifies the KIIS. If the KIIS is not rectified, the ECSP must cancel the offer.
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**ADDITIONAL KIIS IN INSTANCES WHERE THE ECSP IS PROVIDING INDIVIDUAL PORTFOLIO MANAGEMENT OF LOANS**

- Where ECSPs offer the individual management of loan portfolios, the investor is required to provide a mandate to the ECSP specifying parameters for the service which are provided for in the Crowdfunding Regulation.
- The ECSP must provide with respect to each loan, the following information:
  - › the minimum and maximum interest rate payable under each loan; and
  - › the range and distribution of any risk categories applicable to the loans.
- An ECSP must also provide on a continual basis by electronic means to the investor the following:
  - › list of loans of which a portfolio is comprised of;
  - › the weighted average annual interest rate on loans in a portfolio; and
  - › any default on credit agreements by the project owner in the last five years and other information.
- ECSPs providing the above service must also have robust methodologies and use appropriate data to determine the credit risk of the crowdfunding projects selected for the investor's portfolio; the credit risk of the investor's overall portfolio; and the credit risk of the project owners by verifying the prospect of the project owner meeting their obligations under the loan.
- Although it is not a requirement for an ECSP to have a contingency fund in place, where it does have such a fund, the ECSP must attach a risk warning to the fund (the text of which is prescribed) and a description of the policy of the contingency fund including, for example, an explanation of to whom the money belongs and the size of the contingency fund compared to the total amounts outstanding on loans.

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**REQUIREMENT TO  
CATEGORISE INVESTORS**

- Before granting a client access to the platform, ECSPs must categorise potential investors as either “sophisticated investors” or “non-sophisticated investors” (similar to the requirement for MiFID authorised investment firms to classify clients as retail or professional clients) by reference to the client’s knowledge and ability to bear losses.
- The classification of the client must be carried out periodically following the granting of access to the client.
- Where the investor is classified a “non-sophisticated investor”, the ECSP must:
  - › conduct an “entry knowledge test”;
  - › provide explicit warnings for certain services deemed inappropriate; and
  - › impose a maximum threshold for the amount non-sophisticated investors can invest through the ECSP.
- ECSPs must also extend to “non-sophisticated investors” a cooling-off period of four days following their investment, during which time the investor may withdraw their investment offer or interest in the crowdfunding offer without providing a reason and without incurring a penalty.

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**COMPLAINTS HANDLING**

- ECSPs must provide a standard method for clients to lodge complaints; keep records of all complaints; and have in place effective and transparent procedures for the prompt, fair and consistent handling of complaints received from clients and shall publish descriptions of those procedures.

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**CONFLICTS OF INTEREST**

- ECSPs are prohibited from participating in any crowdfunding offer available on their platform.
- ECSPs are prohibited from having as project owners any shareholders (20% or more of the capital or voting rights in the platform), managers or employees, or a person linked to those shareholders employees or managers within the meaning of linked persons under article 4(1) of MiFID II.
- ECSPs are not prohibited from having as investors shareholders (holding 20% or more of the capital or voting rights in the platform), managers or employees or linked persons as described above, however, where such persons do occupy such positions with respect to the ECSP that ECSP must disclose on their website that they accept such persons as investors and include information on the investments such persons have made.
- ECSPs must ensure that investors that fall into one of the categories listed above do not receive any preferential treatment or privileged access to information.
- ECSPs must disclose to clients conflicts of interest and any steps taken to mitigate those conflicts.

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**OUTSOURCING**

- ECSPs are not prohibited from outsourcing any aspect of their operations but remain fully responsible for compliance with the Crowdfunding Regulation with respect to outsourced activities.
- ECSPs are to take all reasonable steps to avoid additional operational risk when relying on outsourced service providers.

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**PRUDENTIAL REQUIREMENTS**

- ECSPs must adhere to prudential requirements (unless it is already subject to higher capital requirements) which includes the requirement to hold funds or have an insurance policy in place that is equal to the higher off either:
  - › EUR 250,000; or
  - › One quarter of the fixed overheads of the previous year (including the cost of servicing its loans for three months where the ECSP facilitates the granting of loans), reviewed annually.

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**RECORD KEEPING**

- ECSPs are to maintain all records related to their services and transactions for a period of five years and ensure that their clients have immediate access to records of the services provided to them.

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## THE CROWDFUNDING REGIME AND BREXIT

The Crowdfunding Regime does not include any 'equivalence' provision. If an equivalence provision were present, this would enable the European Commission to declare the UK's regulation of crowdfunding platforms as equivalent to the EU Crowdfunding Regime and would permit any firms authorised under the UK regime to provide services throughout the EU on that basis. However, as such a provision is absent, UK-authorised firms providing crowdfunding services post-Brexit will be required to obtain authorisation in an EU Member State in order to service EU clients.

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## ADVICE FOR FIRMS

Firms that provide crowdfunding services are advised to determine whether they fall within scope of the Crowdfunding Regulation by reference to the qualifying criteria.

Potentially in-scope firms should also consider whether they will separately require authorisation as a payment institution or an electronic money institution (unless the firm already holds such an authorisation or plans to outsource this aspect of their service to a third-party).

In-scope firms should begin the process of organising their operations in such a manner as to meet the various governance, prudential and other requirements of the Crowdfunding Regulation bearing in mind that the Crowdfunding Regulation is applicable from 10 November 2021 with firms being required to obtain their authorisation within 12 months from that date.

## CONTACT US

Please contact Shane Kelleher for further information, or your usual William Fry contact.



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