DELIVERABLE D.T4.2.2

Recommendations for Unification of Legislation and Implementation Procedures

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CONTENT

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Introduction

The present deliverable lists some proposals with a view to reaching a more common legal context to the evolution of cross-border crowdfunding over time.

DT 4.2.2 does not lay down concrete proposals to urge decision makers to take sudden specific initiatives. However, it contains some indications that might be taken into account to foster cross-border crowdfunding in Europe (with a major focus on the Central-Eastern area of the EU) and to make sure that its evolution targets key goals. The proposal of DT 4.2.2 are addressed to relevant decision makers, in particular (although not exclusively) at the EU level.

The reasons for this are mainly two:

- due to the lack of common national regulations on crowdfunding in the EU Member States, the development of cross-border crowdfunding is likely to be excessively slow, while the presence of EU binding norms might boost the envisaged transition;
- after launching dedicated consultations, on 8 March 2018 the European Commission delivered its "Proposal for a Regulation on European Crowdfunding Service Providers (ECSP) for Business", which has suddenly become the most important input to consider (hereinafter, "the proposal" or "the Commission's proposal").

Against this background, the present deliverable tackles the core aspects of the Commission's proposal and moves from them to identify needs to be addressed by EU and, where appropriate, by national competent bodies/authorities. Indeed, the needs detected in dt 4.2.2 underpin proposal for unification of legislation and implementation procedures.

1. Envisaged act: type and harmonization potential

The European Commission proposed the adoption of a regulation by the European Parliament and the Council. As is well known, this type of legislative act has general applicability, is directly applicable in each Member State and is and mandatory in its entirety.

Due to the lack of a uniform legal context on crowdfunding in Europe (included Central-Eastern Member States), a regulation seems to be an appropriate starting point to move forward the unification of certain rules.

However, as it will be specified later, the act proposed by the Commission covers only a few crowdfunding models and provides for the possibility for crowdfunding service providers to operate cross-border in case they get the authorization at the EU level. What is more, the Commission's proposal sets forth a voluntary basis regime (opt-in for crowdfunding service providers); it means that no EU law obligations would arise for all crowdfunding service providers who do not ask for – and obtain – the authorization at the EU level.

Possibly, at this stage the time is not yet ripe to set up a legal regime aimed at achieving a higher level of harmonization. Nevertheless, the evolution of crowdfunding across the EU will depend on the adoption of multiple common rules. This seems, at least, what had been suggested by means of many feedbacks to the consultation launched by the EU Commission in November 2017. In this regard, if the envisaged regulation is adapted the effects of it should be monitored in a way that further legal initiatives can be taken in a reasonable timeframe.

In particular, further binding common obligations could be set up by means of specific (harmonization) directives/amendments to already applicable directives. In so doing, Member States would be compelled to adapt to a more robust EU legal framework within a reasonable time-limit. Not by chance, Art. 38 of the proposal clarifies that the Commission will have to "present a report to the European Parliament and the Council on the application of this regulation, accompanied where appropriate by a legislative proposal".

Therefore, we recommend the European Commission to keep working on further binding instruments, such as harmonization directives governing certain issues that would keep proving prohibitive to the evolution of cross-border crowdfunding due to the presence of different national regimes. That should be done regardless of the adoption of the proposed regulation. Perhaps, if the regulation is adopted, the Commission could still frame a legislative proposal based on Art. 38 of the present proposal.

2. Scope and types of crowdfunding models covered

The Commission's proposal does not refer to all crowdfunding models but only to lending and equity-based crowdfunding. These are the main examples of business crowdfunding models and thus need to be tackled in order to facilitate access to finance to many economic actors.

For sure, it is essential to start taking action under the legal point of view at least with regard to those crowdfunding models, since just a few Member States adopted bespoke regimes so far and some of them adopted regulations whose scope of application is quite narrow.

Nevertheless, the first recital of the proposal states that lending-based crowdfunding and investment-based crowdfunding are comparable business funding alternatives. This assumption seems to be quite controversial, as multiple remarkable differences between equity and lending-base crowdfunding exist and concern aspects of different nature; intrinsic characteristics, activities carried out by the subjects involved, applicable legal regimes, potential risks and effects for clients, investors and project owners.

Additionally, in some EU Member States (most notable Czech Republic and Slovakia) predominant company legal form – limited liability company – issues shares are not considered a MiFID instrument, therefore these companies would be completely left out of the regulation's scope (in terms of equity-based crowdfunding). In fact, this relates to the vast majority of companies in Czech Republic and Slovakia. Should the companies be eligible for crowdfunding, they would have to change the legal form to capitally more substantive legal form of a joint-stock company (in Slovakia, the registered share capital would be 25.000 EUR instead of 5.000 EUR for an LLC). This represents a huge hurdle for companies to raise money via equity crowdfunding in these countries.

Therefore, we recommend national decision makers, being them institutions/bodies provided by national constitutions or authorities established by the law, to start regulating/adopt broader scope regulations on equity and lending-based crowdfunding services. In addition, any EU legislative act on equity and lending based crowdfunding should clarify the differences between both models, especially where the platform is entitled to operate within the EU internal market, hence by providing cross-border services; so, we recommend the European Parliament (or the European Commission, should it propose further legislative acts in the near future, as that seems appropriate), to adequately consider this issue. Last, we suggest that not only simple MiFID instruments be allowed for crowdfunding, but also other legal forms issuing transferable equity instruments.

3. Suitability of the proposal with regard to the EU innovation strategy

The EU considers crowdfunding as an useful tool for innovation, given the innovation gap that the EU and its Member States are currently experiencing compared to other economies. In a nutshell, crowdfunding should develop as an additional means to foster growth and employment by providing support especially to SMEs.

In the explanatory memorandum to its proposal, the Commission stresses that the initiative is linked to the priority of establishing a Capital Market Union ("CMU"), which aims, among the other things, to broaden access to finance for innovative companies, start-ups and other unlisted firms. The Commission also indicates that "the implementation of the technological innovation in the crowdfunding sector, including the application of the new innovative business models and technologies" shall be assessed through the report mentioned in Art. 38.

Despite that, the proposal's recitals do not make explicit reference to that crucial goal; should the regulation be adopted, that lack could affect an innovation-oriented interpretation of the act.

Furthermore, enabling key economic actors to better access finance also depends on their possibilities to resist some major competitors performing cross-border crowdfunding services.

Therefore, we recommend the European Central Bank and the European Economic and Social Committee to outline the connection between the envisaged regulation and the need to spur innovation at the EU level by supporting the aforementioned players. Accordingly, we recommend the European Parliament to amend the text of the regulation so that such pivotal aspect is adequately specified. Finally, we urge the European Parliament to consider whether the proposal truly allows SMEs to access finance in order to make a positive impact in terms of innovation on the EU internal market.

4. Maximum project size

A major concern is represented by art. 2, para. 2, let. d). This disposition states that the opt-in regime established under the regulation shall not apply to "crowdfunding offers with a consideration of more than EUR 1 000 000 per crowdfunding offer, which shall be calculated over a period of 12 months with in regard to a particular crowdfunding project".

In sum, the Commission introduced a maximum cap, to be calculated within a given time limit, to which the operations covered by the authorized service providers are subject. This limit is too strict. At least the EUR 1 000 000 cap should be much increased, otherwise the very goals envisaged by the Commission are not likely to be achieved.

Limiting lending and equity-based cross-border crowdfunding campaigns to considerations of EUR 1 000 000 or less would probably reduce the possibility of many crowdfunding service providers to compete with the biggest players on this market share. As a consequence, many crowdfunding service providers, like a huge number of SMEs, would not be able to withstand the competition and are expected to get cut off.

Apparently, one of the aims of the Commission is to align this proposal with art. 1, par. 3, on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC (the so called "Prospectus Directive"). Nevertheless, art. 1, par. 2, let. b) of Regulation (EU) n. 2017/1129, amending the Prospectus Directive (the so called "Prospectus Regulation"), allows Member States to decide to exempt offers of securities to the public from the obligation to publish a prospectus provide that, among the other things, the total consideration of each such offer in the Union is less **that** monetary amount calculated over a period of 12 months which shall not exceed EUR 8 000 000. We do not see any reason to deviate from that threshold.

Therefore, we recommend the European Parliament to amend this limit. Perhaps, a fair threshold could be EUR 8 000 000.

5. ESMA powers

- The proposal introduces an obligation for crowdfunding service providers to be authorized by the European Securities and Markets Authority – "ESMA" (Articles 10-13 and 21-33), granting the latter investigating (inspection, request for information) and sanctioning powers, among which the possibility to withdraw the authorization in case of serious violations.
- Articles 23 and 29 also provide for periodic penalty payments, applicable also against the persons listed in Article 22(1), to compel the latter to provide complete and correct information, in case what they provided upon ESMA's request is incorrect or misleading. When these subjects are natural persons, the amount of the periodic penalty payments shall be 2 % of the average daily income in the preceding calendar year for each day of delay.
- Moreover, in case a person, intentionally or negligently, commits one of the infringements listed in Chapter I to V, ESMA may apply rather severe penalties, which may amount up to 5% of the annual turnover of the crowdfunding service provider during a calendar year (Article 28(3)).
- This parameter, together with the fact that the degree of responsibility of the person responsible for the infringement shall be taken into account in deciding the amount of the penalty (Article 27(2)(d)) raises several issues as to whether the nature of the sanctions applicable by ESMA could be considered "punitive" or "criminal" in light of the case-law developed by the European Court on Human Rights, as adopted by the Court of Justice (based on the *Engel* criteria), regardless of any different statement contained in the regulation (which according to the applicable case-law, is irrelevant in determining the nature of a sanction).
- In this sense, it should be however welcomed the fact that the proposal clearly takes into account some of the main critical issues emerging from this potential substantial punitive nature, such as the protection from bis in idem (Article 31(11) indicates that ESMA «shall refrain from imposing fines or periodic penalty payments where a prior acquittal or conviction arising from identical fact or facts which are substantially the same has already acquired the force of res judicata as the result of criminal proceedings under national law») and unlimited jurisdiction (Article 33 confers unlimited jurisdiction to the Court of Justice).

- **Therefore, we recommend the European Parliament to clarify the nature of the sanctions at stake, either strengthening the fair trial rights for the parties involved (accepting that such sanctions are only formally administrative, but own a substantial criminal nature), for instance concerning the privilege against self-incrimination of the persons involved (at least natural persons) or reducing the severity of the fines, so as not to trigger the application of the *Engel* criteria (i.e. the recognition of substantial criminal nature to the sanctions) in this field.**

6. Obligations imposed on platforms

First of all, to be admitted as a European Platform, the service provider must apply for the ESMA's authorization. In order to gain such authorization the service provider has to:

- identify itself (name and legal form of the service provider);
- communicate the commercial name and internet address of the crowdfunding platform operated by the service provider:
- offer the information about the services for which the provider has already been authorized;
- communicate any sanction that has been previously imposed to the service provider or its manager.

The service provider must also offer a "Key Investment information sheet" ("KIIS"), which is indeed an important requirement to ensure transparency of information given to all potential investors and should be sufficiently detailed and harmonised to enable the comparison of projects to promote sound investment decisions.

The same document could be much more useful or interesting to ground the decision of participating to a loan. To this end, it should be drafted according to completely different assumptions, also considering that in practice Lending platforms are not providing to lenders the same information that are usually available with reference to investment projects, neither the same documents.

If, over a certain amount of the loan, a document shall have to be prepared to provide information about loans participation, it would rather be more interesting that this documents is drafted for the purpose to: (i) better explain to the lenders, the credit risk associated with the borrowers, with its projects, (ii) how the platform is calculating such risk (analysis of past performances, current overall debt of the SME, public available credit ratings, etc.) and, for loan exceeding a certain threshold (by way of example, 1 million Euro), (iii) including some key financial figures of the last three years (as available from public filed year-end balance sheets).

Therefore, we suggest that this document be used also to provide lenders with a comparable set of information for all offers on a given platform, thereby facilitating the comparison of one loan with another for lenders. We also suggest that to take steps forward on the digitisation of the procedures to be completed in order to comply with all the obligations connected with the KIIS; that would be helpful to crowdfunding service providers, especially if one considers the digital nature of the activities they perform.

7. Consumer protection

The Commission's proposal tackles consumer protection in a quite complete way with regard to information issues. In fact, one of the main aims of the proposal is to provide investors (including consumers) with all the necessary information on crowdfunding, including the information on the risks. In particular, the "Key Investor Information Sheet" ("KIIS") (see art.16), is supposed to be a decisive innovation to better safeguard the position of potential investors. Besides, according to art.14(1) of the proposal, the extensive set of information to be provided to clients (including marketing communication) shall be "clear, comprehensible, complete and correct" and provided before they enter into the transaction (art.14(2)).

However, as already noted in section 2, the Commission's proposal does not refer to all crowdfunding models but only to lending and equity-based crowdfunding. This would exclude consumers dealing with donation and reward based crowdfunding from the protection ensured by the proposal. On this regards, the Commission considers that in the last two types of crowdfunding the information asymmetries are less relevant, since they do not deal with financial products, and that the EU consumer protection legislation already provides sufficient safeguard to consumers in reward based crowdfunding.

Besides, the proposal does not cover or mention another important aspect of consumer protection, that is the right of withdrawal, established in EU consumer protection legislation (see art. 9 of Directive 2011/83/EU on consumer rights) and usually associated to e-commerce and online transactions involving consumers.

Therefore, we recommend the European Parliament to clarify this point, making an explicit choice over the inclusion or the exclusion of the right of withdrawal, and justifying it.

8. Conflicts of Interest

A brand new element offered in the Commission's proposal is the prohibition of conflicts of interest between the service provider of the platform and the participation in crowdfunding platforms.

It is considered sensitive within the scope of the conflict of interest any shareholders holding 20% or more of share capital or voting rights, as well as managers or employees. The responsibility for maintaining and enforcing effective internal rules to prevent conflict of interest is given to the service provider of the platform.

It seems that such strict regulation of the matter is particularly effective for those who operate on a larger scale, where the effect of a conflict of interest may be an impairment of the competition between campaigns and promoters beneath the same platforms market.

At the same time, for those service providers that operate in a more local or tailor-made dimension such form of direct investment, made by the platform shareholders or managers, may be intended as a guarantee of the feasibility of the campaign.

It is important to recognise that many shareholders of the platforms, by means of AIF (Alternative Investment Funds), ELTIF (European Long-Term Investment Funds) or other SPV (Special Purpose Veichle) are also attracting institutional investors and are indirectly investing in the projects launched by SMEs on their own platform, with the purpose to speed up their completion or completing the loans/investments. So it is a main point to allow these investment schemes to continue to operate and avoid that they are blocked by reason of a non-existing conflict of interest.

Therefore, we recommend the European Parliament to include a separate provision for those that may be qualified as "institutional investors", coupled with a strict policy to prevent conflict of interests, allowing them to overcome such prohibition, in order to evaluate the peculiar activities carried on by these specific players.

9. Room for prospectus and MIFID directives protection

Crowdfunding service providers have been adapting their business models to very different national frameworks and are subject to the implementation of existing EU and national regimes by national competent authorities. The dynamic nature of business models and different interpretations across Member States of existing EU legislation has led to a large variety of regulatory frameworks for crowdfunding service providers ranging from no regulation to strict application of investor protection rules. Some Member States have to date introduced national bespoke regimes for crowdfunding, while others require crowdfunding platforms to get licensed and operate under existing EU frameworks, such as the Markets in Financial Instruments Directive (MiFID II), the Payment Services Directive (PSD) and the Alternative Investment Fund Managers Directive (AIFMD).

The Commission proposal apparently does not intend to interfere with national bespoke regimes or existing licenses, including those under the MiFID II, the PSD or the AIFMD, but rather to provide crowdfunding service providers with the possibility to apply for an EU label that empowers them to scale up their operations throughout the Union under certain conditions.

So, the main problem for a platform which is identified, for the purpose of the envisaged regulation, in a Member State where there is no MiFID requirements to start a crowdfunding campaign, is if it is possible for it to start an equity crowdfunding campaign in another Member State where such standards are required.

Therefore, considering that the Commission's proposal offers a minimum standard to access the EU identification, we suggest that the all the EU institutions involved in the legislative procedure focus on the issue of how to regulate the coexistence with a stricter national regime, as the application of MiFID II, PSD or AIFMD requirements.

10. Criminal law issues

The Proposal contains:

- an obligation for the platform to have crowdfunding transactions taking place via entities authorised under the Payment Service Directive and, therefore, subject to the 4th Anti-Money Laundering Directive (AMLD) (Article 9).
- requirements for the 'good repute' for all the persons involved in the management of the prospective crowdfunding service provider, including the absence of any criminal record in respect of convictions or penalty under commercial law, insolvency law, financial services legislation, anti-money laundering legislation, fraud or professional liability (Article 10(3))
- an obligation for national competent authorities to notify ESMA of any issue relevant under AMLD (on which information, ESMA may decide to withdraw the license of a crowdfunding service provider) (Article 13)
- an invitation for the Commission to further assess the necessity and proportionality of subjecting crowdfunding service providers to obligations for compliance with the national provisions implementing AMLD and adding such crowdfunding service providers to the list of obliged entities under that Directive (so far not including donation and reward based crowdfunding) (Article 38).

The Proposal can be welcomed as an improvement to the current situation (Recital 24), but some areas continue to remain highly unregulated, posing legal uncertainty that increases investor's distrust to engage cross-border via crowdfunding platforms.

For instance, while good repute is an essential requirement, leaving the decision of which level of "criminal record" (final decision, first grade conviction…) is needed at the national level may substantially impair the efficacy of the provision (as demonstrated, for instance, in the fit and proper assessment carried out by the European Central Bank under its supervisory functions).

On the other side, if directly applying AMLD to donation and reward based crowdfunding is considered now still disproportionate, that should not automatically mean that no form of supervision should be performed on the latter (similarly to other forms of alternative financing).

Therefore, we recommend the European Parliament to amend Article 10(3), to better specify (given the use of a regulation rather than a directive) which "threshold" shall be considered "criminal record in respect of convictions or penalty". We also recommend the Commission to keep working on the creation of flexible supervisory mechanisms, perhaps located at the national, rather than in a centralized form.