Regulating Crowdlending: A Critical Analysis of the European Union’s ECSPR

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VOLUME I
Declaration

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Summary

In 2020, the EU made its first foray into crowdlending regulation with the ECSPR. This thesis explores whether the ECSPR has adequately responded to its regulatory goals. This central research question is answered in three steps. First, using regulatory theory and financial regulatory theory, the ECSPR’s regulatory goals are mapped against the financial regulatory goals and regulatory goals. Second, the ECSPR itself is examined to see how the ECSPR has responded to its regulatory goals. Third, the ECSPR’s response to each of its regulatory goals is compared to crowdlending regulatory frameworks internationally to find how other jurisdictions have achieved goals that are similar or closely related to the ECSPR’s goals. These jurisdictions are Australia, New Zealand, the UK, and the US. The comparative analysis answers whether the ECSPR is adequate in responding to its regulatory goals.

This thesis concludes that there is no definitive yes or no answer to the central research question. The ECSPR is somewhat adequate in addressing its goal to ensure seamless and expedient access to capital markets for SMEs, reducing financing costs and avoiding delays and costs for crowdlending. The ECSPR is adequate in ensuring seamless and expedient access to capital markets for SMEs through the ECSPR’s passporting and authorisation mechanisms. Though, this adequacy is hindered by the €5 million limit and possibly the bulletin board. The ECSPR is also adequate in enabling the cross-border provision of services by harmonising rules through its passporting mechanism. However, full harmonisation was not achieved regarding enforcement and marketing requirements. Then the ECSPR is relatively adequate in addressing legal uncertainty. Throughout the entire examination of the ECSPR, it was found that
the ECSPR is a highly detailed regulatory framework. Although the other jurisdictions do not appear to endorse the same level of detail as found in the ECSPR. Uncertainties remain within the ECSPR itself and because all the Level 2 measures have not been finalised. It is difficult to say whether the ECSPR is adequate in reducing risk. The analysis of the ECSPR demonstrates that the ECSPR responds to risks but there are some improvements needed. Then ECSPR is principally adequate in protecting investors using behavioural-science-informed default measures based on a self-responsibility principle. Finally, the ECSPR is by and large adequate in protecting clients also using indirect business conduct measures combined with a self-responsibility principle to protect clients.

This is the first study to examine the ECSPR by comparing the ECSPR to the crowdlending regulatory frameworks in Australia, New Zealand, the UK, and the US.
Acknowledgement

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One person may write a PhD, but it takes a village to support them. I am no exception to this and have relied on innumerable kindnesses on my journey.

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Finally, to Paul. Without you, these heights would not be reached.

I have endeavoured to state the law as of 7 March 2023. Any errors and omissions are my own.

Go raibh maith agaibh.
To future researchers reading while trying to untangle your research. Yes, you can.
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<td>AFS</td>
<td>Australian Financial Services Licence</td>
</tr>
<tr>
<td>AI</td>
<td>Artificial Intelligence</td>
</tr>
<tr>
<td>ASIC</td>
<td>Australian Securities and Investments Commission</td>
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<tr>
<td>AUSD</td>
<td>Australian Dollars $</td>
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<tr>
<td>B2B</td>
<td>Business to business</td>
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<td>CASS</td>
<td>Client Assets Sourcebook (UK FCA Handbook)</td>
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<td>CFR</td>
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<td>CLO</td>
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<td>EBA</td>
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<td>ECN</td>
<td>European Crowdfunding Network</td>
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EFIF  European Forum for Innovation Facilitators

EIOPA  European Insurance and Occupational Pensions Authority


ESMA  European Securities and Markets Authority

ESRB  European Systemic Risk Board

FCA  Financial Conduct Authority (UK)

FINRA  Financial Industry Regulatory Authority (US)

FMA  Financial Markets Authority (UK)

FSA  Financial Services Authority (UK)

FSMA  Financial Services and Markets Act 2000 (UK)

FSOC  Financial Stability Oversight Council (US)

IOSCO  International Organization of Securities Commissions

IPRU-INV  Interim Prudential sourcebook: Investment Business (UK FCA Handbook)
KIIS: Key Investment Information Sheet (ECSPR)

MTF: multilateral trading facility (MiFID II)

NZD: New Zealand Dollars $


P2P: Peer to Peer

PDS: Product Disclosure Statement (Australia)


SDS: Standardised Disclosure Statement (New Zealand)

SEC: US Securities and Exchange Commission

SYSC: Senior management arrangements, Systems and Controls (UK FCA Handbook)

United States Code

US Dollars $
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CHAPTER I. INTRODUCTION

Innovation, including financial innovation and “fintech”, holds enormous potential even as it carries risks. Certainly, we need to be alive to the risks [...but] consider also the positive influence.¹

A. Introduction
Crowdlending is a 21st-century invention. Crowdlending can not only directly intermediate between those seeking loans and those seeking to invest but it can service risk profiles that are underserved by the traditional banking sector. Growing from the Global Financial Crisis, crowdlending represented a new way to think about finance. The Global Financial Crisis had many effects. Not in the least were the discussions that ensued about issues, such as systemic risk. Pertinent for this thesis is the impact the Global Financial Crisis had on the availability of credit for Small and Medium-Sized Enterprises (‘SMEs’). Simply put, start-ups and SMEs represented a risk profile that banks could no longer cater for in the same way as before the Global Financial Crisis.

With limited or no access to credit, start-ups and SMEs would struggle to succeed.² The Commission considered ‘SMEs and entrepreneurship as key to ensuring economic growth, innovation, job creation, and social integration in

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the EU’. Crowdfunding service providers (‘CSPs’) saw a gap in the market and acted as an intermediary to finance those whose risk profile was not being provided for by banks. Nevertheless, CSPs faced challenges in the EU. Chief among the challenges was the lack of clarity surrounding the regulatory treatment of crowdlending and market fragmentation. It was uncertain how the EU regulatory framework before the ECSPR would apply to crowdlending.

Some Member States formulated a clear regulatory response to crowdlending, such as France and Germany. Other Member States, such as Ireland, were largely silent on the issue. This was a challenging environment for

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Introduction

Despite the patchwork of financial services regulation in the EU, European crowdlending market volumes were quite large before the ECSPR. In the region of Europe, excluding the UK, the combination of business and consumer crowdlending volumes in 2020 were $4,745 million (USD).\footnote{Tania Ziegler and others, ‘The 2nd Global Alternative Finance Market Benchmarking Report’ (University of Cambridge, University of Agder, Invesco and CME Group Foundation, IDB, IDB Invest, 2021) 74 <www.jbs.cam.ac.uk/wp-content/uploads/2020/08/2020-04-22-ccaf-global-alternative-finance-market-benchmarking-report.pdf> accessed 7 March 2023.} Consumer crowdlending makes up the majority of that figure at $2,901 million (USD) with business crowdlending coming in behind at $1,844 million (USD).\footnote{It is noted that there were challenges in classifying consumer crowdlending ‘as some consumer loans involve persons lending by entrepreneurs for business-related spending’. ibid.}


Crowdlending is equated with many terms which can be used interchangeably.\footnote{See also Johannes Ehrentraud and others, FSI Insights on Policy Implementation No 23 Policy Responses to Fintech: A Cross-Country Overview (Bank for International Settlements 2020) 6 <www.bis.org/bsi/pbl/insights23.pdf> accessed 7 March 2023.} Sometimes it is called ‘Consumer to Business Lending’, or ‘C2B Lending’, or ‘creditfunding’. Some chose to use the term ‘Peer to Peer Lending’ or ‘P2P Lending’. At other times crowdlending is called ‘marketplace lending’.
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This thesis uses the terminology as set out in the ECSPR because the focus of this thesis is on the EU’s treatment of crowdlending. As a result, the intermediary is referred to as the CSP. A CSP is the legal entity that matches, in the case of the ECPSR, business interests with funding opportunities.\textsuperscript{15} The individual seeking credit is referred to as the project owner\textsuperscript{16} and the person providing the finance is referred to as an investor.\textsuperscript{17} This thesis only deviates from the ECSPR’s terminology when referring to the activity of crowdlending. In the ECSPR, the activity is referred to as the crowdfunding service for the facilitation of loans\textsuperscript{18}, whereas this thesis uses the term crowdlending.

The lack of a settled taxonomy for crowdlending is challenging because this thesis conducts an international comparative analysis where each jurisdiction has its distinct taxonomy. This thesis has dealt with this challenge by introducing each jurisdiction using its terminology, but the remainder of the analysis is conducted using the terms set out above.

This thesis is a work in financial regulatory theory and regulatory theory. It applies financial theory and regulatory theory to the EU’s crowdlending regulation. The purpose of this application is to understand, critique and resolve the problems raised with regulating the EU’s fast-evolving crowdlending market.

This chapter is structured as follows. First, in Section B the scene is set by providing some background on crowdlending. Section C outlines the taxonomy

\textsuperscript{15} ECSPR article 2(1) (a), (e).
\textsuperscript{16} ECSPR article 2(1)(h).
\textsuperscript{17} ECSPR article 2(1)(i).
\textsuperscript{18} ECSPR article 2(1)(a).
Introduction

of this thesis. Section D explores the motivations and purpose of this research. Section E identifies the central research questions and aims of this research. Section F describes the methodology this thesis develops and deploys, and outlines the sources of law upon which this thesis draws. Section G outlines the contribution to scholarship that this thesis will make. Section H explores the scope of this research. Before concluding, section I provides an outline of the structure of the thesis, describing the contribution each chapter makes to the overall argument of the thesis. Section J concludes the chapter.

B. What is Crowdlending?

1. Definition of Crowdlending

A crowdlending service is defined in the ECSPR as:

the matching of business funding interests of investors and project owners through the use of a crowdfunding platform and which consists of any of the following activities:

(i) the facilitation of granting of loans.¹⁹

Crowdlending brings together those with funds and those seeking funds and enables those seeking funds to borrow funds from those with funds and return the funds over a set time with interest.

2. Main Business Models

CSPs generate income in the form of fees imposed on investors and project owners, which vary from origination fees to repayment fees to late payment

¹⁹ ECSPR article 2(1) (a).
Introduction

fees.\textsuperscript{20} The CSPs’ role varies from business to business. Some CSPs allow the investors and borrowers to directly engage with each other\textsuperscript{21} and price loans in an auction-style setting.\textsuperscript{22} Some CSPs allow their investors to exit their investments early by selling their investments to other investors. Other CSPs have a more active role, which can vary from making a creditworthiness assessment and pricing the loans to providing individual portfolio management services.\textsuperscript{23}

CSPs price loans and make creditworthiness assessments based on a range of information including audited accounts, the project owner’s financial position, the ‘business model and strategy’ of crowdfunding project and credit protection arrangements.\textsuperscript{24} Credit protection under the ECSPR can be financial or physical collateral or the provision of a guarantee.\textsuperscript{25} Collateral ‘is an item of


\textsuperscript{22} Macchiavello and Sciarrone Alibrandi, ‘Marketplace Lending as a New Means of Raising Capital in the Internal Market: True Disintermediation or Reintermediation?’ (n 20) 46 Macchiavello.

\textsuperscript{23} For example, Flender, ‘Frequently Asked Questions’ (Flender) <https://flender.ie/faq> accessed 7 March 2023.


value that a lender can seize from a borrower’ if they fail ‘to repay a loan according to the agreed terms’. Credit protection is a way investors can be insulated from a project owner default. Investors rely on a CSP’s due diligence when the CSP prices the loans and makes a creditworthiness assessment. It may not be within an investor’s capacity to review the due diligence undertaken by the CSP as they may have insufficient knowledge and skills to ascertain whether the due diligence is sufficient or correct.

Individual portfolio management services are where a ‘pre-determined amount of funds’ are allocated ‘in accordance with a specific mandate’ by the CSP ‘to one or multiple crowdfunding projects’. The mandate includes the ‘minimum and maximum interest rate payable’, the ‘minimum and maximum maturity date’, and the ‘range and distribution’ of the risk categories. The benefit of individual portfolio management is that the investor benefits from risk diversification. The investor is reliant on the CSP’s expertise in selecting loans that comply with the investment mandate.

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29 ECSPR article 6(1).
Introduction

3. Advantages of Crowdlending
Crowdlending allows investors to see where their investment goes and potentially see the positive impacts on the project owner. Crowdlending can act as additional market testing and marketing tools but a key role that crowdlending can play is by filling the SME credit gap. Frequently SMEs rely on internal cash flow, informal credit, or personal loans. Traditional bank loans are designed to provide credit to large enterprises or the public sector and are not designed to provide credit to SMEs. Although bank lending is the most common source of financing for SMEs, banks lend depositors money using the principle of fractional banking. Banks conduct the creditworthiness assessment, originate, and service the loans. Due to increased regulatory requirements, banks have increasingly been unable to provide loans to SMEs as SMEs have a high risk of failure. This is the credit gap that crowdlending can fill.

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4. Crowdlending and its Larger Family: Crowdfunding
Crowdlending comes under many umbrella terms. It is an example of alternative finance\(^{37}\) and FinTech. For this thesis, crowdlending comes under the umbrella term crowdfunding. Crowdfunding consists of a ‘triangular relationship’ between a funding provider, a project, and an intermediary.\(^{38}\) Crowdfunding is available in four main forms. These four types of crowdfunding are:

1. reward crowdfunding,
2. donation crowdfunding,
3. crowdequity
4. and crowdlending.

In each form of crowdfunding, funds are electronically transferred via a platform operated by the CSP. The difference between each of the models’ concerns whether something (if anything) is given in return. Only in donation crowdfunding is nothing given in return. In the other three forms, the crowdfunder gets a return. In reward crowdfunding, for example, one could pre-pay for an album or gain membership to an exclusive club. If money is given in return for shares, this falls into the category of crowdequity.

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Introduction

Crowdlending has some surprising ancestry that goes further back than imagined. Crowdlending:

is a new way to do something old. It uses the Internet to facilitate capital formation in much the same way that communities financed transactions as far back as 3000 BC. Before the advent of banks and other financial institutions, wealthy families and rulers provided loans to individuals in communities to finance everything from business to infrastructure.\(^{39}\)

In sum, crowdlending is a new way to facilitate the time-old financial product of loans.

C. EU Policy and Regulatory Agenda

The ECSPR forms part of the programme for a deepening of the Capital Markets Union\(^{40}\) in the EU and the EU’s FinTech Action Plan.\(^{41}\) The Commission first indicated its interest in possibly enabling crowdlending with regulation in the wake of the Global Financial Crisis as a means to promote long-term finance specifically for SMEs.\(^{42}\) With limited or no access to credit, start-ups and SMEs


struggled to succeed. The Commission considered ‘SMEs and entrepreneurship as key to ensuring economic growth, innovation, job creation, and social integration in the EU’ and crowdlending had the potential to fill this gap.

However, CSPs faced challenges in the EU. A significant challenge was the lack of clarity surrounding the regulatory treatment of crowdlending. There was a high degree of regulatory fragmentation in the EU with a patchwork of Member State regulation. Crowdlending also did not neatly fit within the existing EU regulatory frameworks. For example, in the EU questions abounded as to whether crowdlending came within the Consumer Credit Directive or MiFID II.

Some CSPs provide a space where investors can sell their investments and exit the investment early. These spaces were a challenging issue before the ECSPR because of the parallels that could be drawn between bulletin boards and


See further: Commission, ‘Unleashing the Potential of Crowdfunding in the European Union’ (n 2).

Commission, ‘Report on Crowdfunding in the EU Capital Markets Union’ (n 3); Papadopoulos and others (n 3).


Countries such as France and Germany had a crowdlending regulatory framework, but Ireland did not. Gajda (n 8); Department of Finance (n 11); Dáil Deb (n 11).


multilateral trade facilities (‘MTF’) which are regulated by MiFID II. If bulletin boards provided a space where interests were bought and sold, this activity aligned with the definition of an MTF under MiFID II. The Commission in 2017 was certain that the financial product in crowdlending ‘does not make use of (debt) securities at all’. This statement could be debated. The transferability of loans raises issues of whether they can be characterised as transferable securities.

Varying classifications from Member States resulted in wide-ranging regulatory treatment. For example, some jurisdictions included CSPs in the definition of a creditor to apply the Consumer Credit Directive. Crowdlending presented risks of default, information asymmetry, liquidity risk, investor inexperience, systemic risk, CSP failure, fraud risk, and pricing risk. All of which necessitated some form of a regulatory response.

The Commission considered various options such as no action, minimum standards, a product-based approach, a service-based solution, and an optional

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50 MiFID II article 4(1)(22).
52 Macchiavello and Sciarrone Alibrandi (n 20).
53 Macchiavello and Sciarrone Alibrandi (n 20) 52.
54 For example, in the Netherlands CSPs are regarded as creditors under their national implementation of the Consumer Credit Directive. Martha Elisabeth Buit, ‘Consumer Peer-to-Peer Lending and the Promise of Enhancing Access to Credit: Lessons from the Netherlands’ in Cătălin-Gabriel Stănescu and Asress Adimi Gikay (eds), Discrimination, Vulnerable Consumers and Financial Inclusion: Fair Access to Financial Services and the Law (Routledge 2020) citing Netherlands - Wet Financieel Toezicht 2006 (Financial Supervision Act) article 2:60.
Introduction

regulatory framework.\(^{55}\) Ultimately, the ECSPR came into force on 10 November 2021 with a new extended transitional period ending on 10 November 2023.\(^{56}\)

The ECSPR relies on Level 2 instruments which provide further detail on the application for authorisation,\(^{57}\) the Key Investment Information Sheet (‘\(\text{KIIS}\)’),\(^{58}\) business continuity plan,\(^{59}\) calculating default rates,\(^{60}\) complaints handling,\(^{61}\) conflicts of interest,\(^{62}\) forms for exchange of information such as between


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National Competent Authorities (‘NCAs’), individual portfolio management, and the entry knowledge test and the simulation of ability to bear loss. These Level 2 measures are not expected to come into force before the end of 2022.

In sum, a large policy driver for regulating crowdlending in the EU was enabling SME financing by addressing regulatory uncertainties surrounding crowdlending in the EU.

D. Motivations and Purpose of this Research

Crowdlending presents the EU with unique and interesting regulatory challenges along with fascinating possibilities. As crowdlending is web-based, it brings with it cyber-security risks such as hacking. Crowdlending can service populations with higher risk profiles which are currently underserved by the traditional bank loan sector. Thus, crowdlending can help economies grow by increasing access


64 Commission Delegated Regulation (EU) 2022/2118 of 13 July 2022 supplementing Regulation (EU) 2020/1503 of the European Parliament and of the Council with regard to regulatory technical standards on individual portfolio management of loans by crowdfunding service providers, specifying the elements of the method to assess credit risk, the information on each individual portfolio to be disclosed to investors, and the policies and procedures required in relation to contingency funds C/2022/4841 [2022] OJ L287/50.


to credit. As with any loan, there is a risk of default in crowdlending. In practice, the potential impact of default on investors can be ameliorated by diversifying the investment rather than investing in one loan. There is a risk that the CSP will fail, resulting in questions as to whether outstanding CS loans will continue to be serviced. Information asymmetry and inexperience are two risks that can negatively impact investors. There is a risk of money laundering and crime. Investors are exposed to liquidity risk that the investors will not be able to access the funds invested when the investors need them. Crowdlending has unique abilities to speed up access to finance. For example, crowdlending has leveraged financial innovations such as automated credit scoring. The automation speeds up the process that price the CS loans. Although the automation brings with it inherent risks and questions as to whether the automation takes into account appropriate and necessary information.

The motivation and purpose of this thesis are linked to the research contribution of this thesis to address the gaps in the literature examining crowdlending regulatory frameworks. The majority of the research available focused on the EU and US regulatory treatment of crowdlending. There was

67 Kirby and Worner (n 36)
68 See further G. Research Contribution
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some research analysing the UK's\textsuperscript{71} responses but there was a limited analysis of the regulatory frameworks in New Zealand and Australia.\textsuperscript{72} Furthermore, this thesis was motivated by the gap in the literature comparatively examining crowdlending regulatory frameworks internationally.

E. Research Questions and Aims

Crowdlending is a novel way to provide financial services and access to credit.

The ECSPR is the EU's first foray into crowdlending regulation. The EU must strike a balance between encouraging a pan-EU crowdlending market to grow and protecting investors. The EU needs to tread lightly between harmonising


the EU crowdlending market and respecting Member State sovereignty. The EU needs to address risks in the crowdlending business model by prescribing standards in how CSPs conduct their business without stunting the market with onerous regulatory obligations.

A regulatory framework should be built upon the following steps: choose the objectives, examine the methods to obtain the objectives and choose the best method to do so. Inefficient regulation is ‘often the result of a mismatch between the regulatory objective and regulatory instrument’. The central research question of this thesis is to examine whether the ECSPR is adequate in achieving its regulatory goals for crowdlending.

The ECSPR has one primary goal and four secondary goals. The ECSPR aims to achieve its primary goal by achieving the other secondary goals. The ECSPR’s primary regulatory goal is to ensure seamless and expedient access to capital markets for start-ups and SMEs, reduce financing costs and avoid delays and costs for crowdlending (‘primary goal’).

The ECSPR aims to achieve its primary goal by achieving its secondary goals: (1) enabling the cross-border provision of services by harmonising rules, (2) protecting investors and clients, (3) providing legal certainty, and (4) reducing risk.

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74 Cento Veljanovski, ‘Economic Approaches to Regulation’ in Robert Baldwin and others (eds), The Oxford Handbook of Regulation (Oxford University Press 2012) 27.
75 This is fully explored in chapter 2.
76 ECSPR recitals 3, 27, 54, 60.
77 ECSPR recitals 6, 8, 30, 33, 61-66.
78 ECSPR recitals 7, 16, 18, 24, 36, 42-47, 50-54, 56.
79 ECSPR recitals 58, 76.
80 ECSPR recitals 18, 23, 30, 24.
Introduction

Many ancillary research questions follow the central research question:

- How do the ECSPR’s goals align with those in financial regulatory theory and regulatory theory?
- How does the ECSPR act upon its goals?
- What are the comparator jurisdictions’ goals? Are they similar to the ECSPR’s goals?
- Is there an overlap between the ECSPR’s goals and the comparator jurisdictions’ goals?
- How do the comparator jurisdictions act upon the goals?
- Is the ECSPR by comparison adequate in addressing its goals?
- What are the risks that the ECSPR intends to reduce and protect investors and clients from?

F. Research Methodology

This thesis is literature-based to study whether the ECSPR has been adequate in achieving its regulatory goals for crowdlending. While empirical data is relied on, no original empirical research has been conducted. Existing theories on regulation and financial regulation goals provide the examination framework.
Introduction

Theories regarding hard law, soft law and optional law. Theories regarding principals-based, business conduct, and risk-based regulatory models are

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explored. The ECSPR’s goals are mapped out on these theories to examine what the ECSPR seeks to achieve and then how the ECSPR has implemented those goals in its regulatory framework.

Functional-institutional comparative analysis is adopted to examine other jurisdictions’ regulatory approaches to crowdlending. The functional-institutional comparative method asks which ‘institution in system B performs’ ‘an equivalent function in system A’? This comparative examination will compare the different regulatory tools that perform equivalent functions in the comparator jurisdictions. This comparative examination will include that these tools tackle similar goals. This thesis uses this legal-comparative method to study whether the ECSPR is adequate in achieving its regulatory goals for crowdlending. The external comparative method is used to analyse the differences and similarities in measuring the adequacy of the ECSPR in achieving its regulatory goals against the approach in Australia, New Zealand, the UK, and the US in achieving goals that are similar to the ECSPR’s goals.


Introduction

This study uses the doctrinal research\textsuperscript{90} method to determine the content of the ECSPR and the laws in Australia, New Zealand, the UK, and the US. This entails a comprehensive analysis of the legislative text of the ECSPR, the crowdlending regulatory frameworks in Australia, New Zealand, the UK, and the US, and policy documents, guidelines, and recommendations of supervisory bodies.

This thesis attempts to answer the central research question and the ancillary research questions in several steps:

1) The ECSPR’s regulatory goals are examined in the context of financial regulatory theory and regulatory theory, thus providing a framework for the analysis in financial regulatory and regulatory theory terms.

2) Then the internal consistency of the ECSPR is examined to see how the ECSPR’s regulatory actions meet the ECSPR’s regulatory goals.

3) Following this, an international comparative analysis is conducted of various regulatory instruments performing a similar function. There are two steps to the international comparative analysis:
   a. to find how other jurisdictions have achieved goals that are similar or closely related to the ECSPR’s goals and
   b. whether, by comparison, the ECSPR is adequate in achieving its regulatory goals for crowdlending.

4) Finally, recommendations are provided.

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Introduction

1. Comparators
This section explores and introduces the comparator jurisdictions.

a) Australia
In 2020 Australian consumer crowdlending represented $183.7 million (USD) in market volume.\(^91\) In 2020 business crowdlending did not rank in the top three of the report.\(^92\) Nonetheless, it can be said that in 2020 Australian business crowdlending was significantly smaller than consumer crowdlending.

The Australian Securities and Investments Commission (‘ASIC’) is the regulator responsible for crowdlending. ASIC uses the term marketplace lending instead of crowdlending.\(^93\) There is no specific legal framework in Australia. Marketplace lending is regulated by the Corporations Act 2001. ASIC relies regulatory guides and information sheets to communicate further information to regulated entities. The regulatory guides explain for example ‘when and how ASIC will exercise specific powers’, ASIC’s interpretation of the law, and the

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principles underlining ASIC’s approach. The information sheets provide ‘concise guidance on a specific process’. ASIC found the commonly used marketplace lending business model was structured as a managed investment scheme. Those operating a managed investment scheme must have an Australian Financial Services Licence (‘AFS Licence’).

The remainder of the Australian marketplace lending regulatory framework is complicated. Completely different regulatory frameworks apply depending on the types of parties engaging with marketplace lending.

If marketplace lending is offered to non-sophisticated investors (termed ‘retail clients’ in Australia) the managed investment scheme must be registered. Registered managed investment schemes are subject to requirements under Chapter 4C of the Corporations Act 2001. Registered managed investment schemes must hold an AFS Licence and have a constitution and compliance plan.

96 ASIC INFO 213 (n 108). Nevertheless, some marketplace lending business models are deemed to issue securities, and the marketplace lender may be required to issue a prospectus under Chapter 6D of the Corporations Act 2001.
97 There are exemptions to the AFS licence requirement such as the authorised representative exemption and intermediary exemption. Nevertheless, if these two exemptions are used the business cannot operate as a managed investment scheme. Australia - Corporations Act 2001 s 911A(2)(a), (b); ASIC INFO 213 (n 47).
98 Australia - Corporations Act 2001 s 601ED.
99 Australia - Corporations Act 2001 s 601FA.
100 Australia - Corporations Act 2001 s 601EA.
Introduction

Consumer borrowers in marketplace lending are protected under the National Consumer Credit Protection Act 2009. An Australian Credit Licence is also necessary if the marketplace lender deals with consumer borrowers. This thesis focuses on the regulatory treatment of marketplace lenders in Australia that are treated as registered managed investment schemes.

Despite this less than straightforward regulatory infrastructure, 85% of the debt-based platforms of which crowdlending is a type ‘responded that the current regulation was adequate and appropriate’ while 8% found the ‘regulation to be excessive’. This is an unexpected statistic because the regulatory framework is a one-size-fits-all regulatory response. The statistic raises questions as to why the market rates the Australian crowdlending regulatory framework so highly.

This information leads to questions as to whether there is a feature of Australia’s regulatory framework that makes it markedly different to the other jurisdictions, or is it the case that being regulated is a noticeable improvement on the previous regulatory treatment of crowdlending.

b) New Zealand

Consumer crowdlending in New Zealand generated $275.6 million (USD) in 2019 in market volumes. However, New Zealand’s market volumes in 2020 for both

consumer and business crowdlending and 2019 for business crowdlending were insufficient to be ranked in the top three in the Asia Pacific region.


If a peer-to-peer lending service provider in New Zealand wishes to deal with retail clients, the peer-to-peer lending service provider must register as a Financial Service Provider under the Financial Service Providers (Registration and Dispute Resolution) Act 2009. The Financial Service Providers (Registration and Dispute Resolution) Act 2009 requires financial service providers to belong to a dispute resolution scheme.

Peer-to-peer lending service providers may choose whether or not to be licenced. The benefit of registration is that less onerous disclosure requirements apply where peer-to-peer lending service providers have a

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Introduction

Importantly where a peer-to-peer lending service provider is licenced, the borrowers do not have to give a Product Disclosure Statement ('PDS') under Part 3 of the Financial Markets Conduct Act 2013. This thesis examines the regulatory position in New Zealand where the peer-to-peer lending service provider is licenced and as such this PDS requirement for the borrowers falls outside the scope of this examination. Consumer borrowers are protected under the Credit Contracts and Consumer Finance Act 2003, with certain exemptions made for peer-to-peer lending service providers.

In New Zealand, for peer-to-peer lending services little seems to fall on the distinction made between sophisticated and non-sophisticated investors (termed ‘retail and wholesale investors’ in New Zealand). The two main protective measures taken by New Zealand are the Standardised Disclosure Statement ('SDS') and the client agreement. It is not specified to whom the SDS must be given. Thus, the SDS seems to be for all investors.

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108 New Zealand - Credit Contracts and Consumer Finance Regulations 2004 s 18C(7); New Zealand - Credit Contracts and Consumer Finance Act 2003.
109 New Zealand - Financial Markets Conduct Act 2013 s 6(1), schedule 1 clause 3, 35.
Introduction

the protections afforded by the client agreement requirements apply to both investors and issuers.\textsuperscript{114}

The perception of the adequacy of the regulatory framework is high in New Zealand. 91\% of platforms rate the regulatory framework as being adequate and appropriate for their platforms’ activities.\textsuperscript{115} Nevertheless, this data represents both debt and equity platforms. As such, it is less informative for this research.

c) United Kingdom

Business crowdlending in 2020 represented $5,769 million (USD) in total market volume, and consumer crowdlending in 2020 represented $255 million (USD) in total market volume.\textsuperscript{116} The consumer crowdlending market ‘recorded the most significant drop’ in 2020 as the market volume was $2,161 million (USD) in 2019.\textsuperscript{117} However this decline ‘is mainly related to a prominent UK-based platform, Zopa, getting a full banking licence and becoming a ‘digitally native bank in 2020’.\textsuperscript{118}

One of the leaders in financial regulation, the UK has regulated crowdlending since 2014.\textsuperscript{119} The Financial Conduct Authority (‘FCA’) has regulatory responsibility for crowdlending. In the UK’s regulatory framework,

\textsuperscript{114} New Zealand - Financial Markets Conduct Regulations 2014 reg 224; See also Financial Markets Authority, ‘Peer-to-Peer Lending Borrowers’ (n 126).
\textsuperscript{115} Ziegler and others, ‘The 2nd Global Alternative Finance Market Benchmarking Report’ (n 11) 208.
\textsuperscript{116} Ziegler and others, ‘The 2nd Global Alternative Finance Market Benchmarking Report’ (n 11) 75.
\textsuperscript{117} ibid.
\textsuperscript{118} ibid.
crowdlending is termed as operating an electronic system in lending.\textsuperscript{120} Although, P2P lending is the common term used in the FCA’s guidance material. The agreements entered into are P2P agreements. The regulatory framework for crowdlending is a mix of sui generis and one size fits all responses. For example, the regulatory framework on credit risk assessments is tailored to operating an electronic system in lending\textsuperscript{121} while operating an electronic system in lending has been added to the fold for enforcement measures, a one-size fits all approach.\textsuperscript{122} The UK’s regulatory framework is largely found in the FCA Handbook which is an amalgamation of the FCA’s secondary legislation which uses a mix of rules indicated with an ‘R’ beside the measure\textsuperscript{123} and guidance indicated with a ‘G’ beside the measure.\textsuperscript{124} G measures lack the ‘binding nature’ of rules.\textsuperscript{125} Both R and G measures are examined in this thesis because while G measures are not binding it would not be advisable to fly in the face of the G measures which are there to help navigate the rules. Furthermore, an examination of the UK’s regulatory framework without the G measures would be an incomplete examination of the regulatory framework.

\begin{itemize}
\item \textsuperscript{120} UK - Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) article 36 H.
\item \textsuperscript{121} UK - FCA Handbook COBS 18.12.
\item \textsuperscript{122} UK - FCA Handbook DEPP.
\item \textsuperscript{123} UK - Financial Services and Markets Act 2000 s 137A.
\item \textsuperscript{124} UK - Financial Services and Markets Act 2000 s 139A.
\item \textsuperscript{125} Gerard McMeel, ‘Crowdfunding and UK Law’ in Pietro Ortolani and Marije Louisse (eds), \textit{Crowdfunding and the Law} (Oxford University Press 2021) 76.
\end{itemize}
Introduction

In the UK, crowdlending consumer borrowers are protected under the Consumer Credit sourcebook, with parts of the Consumer Credit sourcebook specifically addressing crowdlending issues.

The UK provides different protections depending on whether the person is a retail client, professional client or an eligible counterparty (entities that are not from the UK). Retail clients receive higher protections, such as communication requirements and an appropriateness assessment.

The perception of the UK’s existing regulation of debt-based platforms is high. 83% of debt-based platforms reported that the regulatory framework is adequate and appropriate for their debt-based platforms’ activities.

d) United States of America

Consumer crowdlending dominates the US market; rising to $28.08 billion (USD) of the total market volume in 2020. Business crowdlending represents a smaller portion of the market with $8.27 billion (USD) of the total market volume in 2020.

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127 UK - FCA Handbook CONC 4.3.4.
128 UK - FCA Handbook COBS 3.1.1R.
129 UK - FCA Handbook COBS 4.7.7R.
130 UK - FCA Handbook COBS 10.
Introduction

Crowdlending in the US has been regulated under Regulation Crowdfunding since 2016. This thesis solely focuses on Regulation Crowdfunding and State regulation is outside the scope of this analysis. The US Securities and Exchange Commission (‘SEC’) bears regulatory responsibility under Regulation Crowdfunding. Crowdlending comes under Regulation Crowdfunding because the SEC in 2008 interpreted crowdlending as a security. In this instance, the SEC issued a cease-and-desist order to Prosper a crowdlending platform in the US. The SEC in its analysis examined the test for security in SEC v WJ Howey Co (‘Howey’), the definition of security in the Securities Act, and the presumption that notes are securities from Reves v Ernst and Young (‘Reves’). Howey states that the test ‘is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others’. The Securities Act states that an investment contract is a security. The SEC found that there was a common enterprise for several reasons such as the lenders and borrowers were both dependent on Prosper to onboard new loans and complete repayments of loans. Furthermore, SEC noted that the

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136 328 US 293 (1946).
139 Howey 301.
borrowers and lenders are reliant on Prosper to execute the transaction as the borrowers and lenders cannot directly engage with each other.\textsuperscript{142}

\textit{Reeves} sets out the presumption that notes are securities unless it is specifically identified as a non-security. The Court listed types of non-security notes such as a mortgage on a home. If a note is not on the list, it must be examined under the family resemblance test. The family resemblance test has four parts (1) the buyer and seller’s motivations, (2) the distribution plan, (3) the investing public’s reasonable expectations and (4) the existence of an alternative regulatory regime.\textsuperscript{143} The SEC stated that the notes were securities under \textit{Reeves} because:

(i) the Prosper loans are motivated by an expected return on their funds

(ii) the Prosper loans are offered to the general public

(iii) a reasonable investor would likely expect that the Prosper loans are investments

(iv) there is no alternate regulatory scheme that reduces the risks to investors presented by the platform.\textsuperscript{144}

Since the SEC order in 2008, crowdlending intermediaries have either closed for business or complied with securities law in the US.\textsuperscript{145} However, some

\textsuperscript{142} ibid.
\textsuperscript{143} \textit{Reeves} paras 66-67.
\textsuperscript{145} Andrew Verstein, ‘The Misregulation of Person-to-Person Lending’ (2012) 45 University of California Davis Law Review 445, 476; Chang-Hsien Tsai, ‘To Regulate or Not to Regulate: A Comparison of Government Responses to Peer-to-Peer Lending among the United States, China, and Taiwan’ (2019) 87 University of Cincinnati Law Review 1077, 1085; Brage Humphries,
crowdlending intermediaries operate under different regulatory regimes in the US such as Regulation A. Regulation Crowdfunding operates as an exemption from US securities laws. Crowdlending intermediaries that wish to operate in the US must register as a funding portal. Regulation Crowdfunding places requirements on crowdlending intermediaries as an intermediary and then separately as a funding portal. While Regulation Crowdfunding does not explicitly ban consumer borrowers from dealing with crowdlending, the requirements placed on borrowers in Regulation Crowdfunding imply an understanding that only business borrowers are covered under Regulation Crowdfunding. For example, Regulation Crowdfunding states that it shall not apply to transactions by any borrower without a specific business plan. In other words, Regulation Crowdfunding is for business borrowers only. Consumer borrowers receive protection in the US under separate regulatory regimes and the Consumer Financial Protection Bureau (‘CFPB’) is tasked with the enforcement of federal consumer financial protection.
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laws. In the US there is a swathe of laws applicable to consumer borrowers. An example is the Truth in Lending Act.\textsuperscript{151}

Investors can either be retail or non-retail investors (termed ‘accredited or non-accredited investors’ in the US).\textsuperscript{152} Retail investors (termed ‘non-accredited investors’ in the US) are subject to aggregate 12-month investment limits, the crowdlending intermediary and borrower that non-accredited investors deal with must comply with Regulation Crowdfunding.\textsuperscript{153}

Nevertheless, crowdlending intermediaries are also required to register with one of the registered securities associations, such as the Financial Industry Regulatory Authority (‘FINRA’).\textsuperscript{154} Bodies such as FINRA have their own rules and regulations with which their members must comply.

In the US, 76\% of debt-based platforms reported that the regulatory framework was adequate and appropriate for their platform’s activities.\textsuperscript{155} The following analysis will show why a jurisdiction with a sui generis regulatory framework has the lowest rating of the jurisdictions examined.

\begin{footnotesize}
\begin{enumerate}
\item US - Rule 100(a)(2) Regulation Crowdfunding, 17 CFR § 227.100(a)(2).
\item US - Rule 400(a) Regulation Crowdfunding, 17 CFR § 227.400(a) (2021).
\end{enumerate}
\end{footnotesize}
Introduction

2. Justification of Comparators
This thesis focuses on Australia, New Zealand, the UK, and the US for a few different reasons. The first reason was the availability of primary and secondary sources in the English language. The second reason was that each common law jurisdiction had a compulsory crowdlending regulatory framework that applied across the entire jurisdiction.

Canada is a jurisdiction with materials available in the English language. However, Canada was not included in the comparative analysis because there is no crowdlending regulatory framework that applies in all the provinces. Canada has the Canadian Securities Administrators (‘CSA’) and some of the provincial securities regulators are members of the CSA. The CSA enables passporting between Canadian provinces. Furthermore, the CSA acts as a coordinator between the various province regulators to harmonise securities regulation in Canada.

One such effort was the CSA’s securities crowdfunding regulatory framework. There are two options within the CSA’s framework. One is called the start-up exemption with smaller financial limits. The other is the crowdfunding exemption where larger amounts can be borrowed or invested. CSA members can choose to apply one or both options in the CSA’s regulatory framework.

156 Canada - National Instrument 45-110 Start-up Crowdfunding Registration and Prospectus Exemptions.
158 Alberta does not have the start-up exemption. Alberta only has the crowdfunding exemption. See further ibid.
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Canadian regulators have indicated that crowdlending deals with securities.\textsuperscript{159} For example, in Quebec, the Autorité des Marchés Financiers has been clear that crowdlending is a security.\textsuperscript{160} Therefore, Canada does not have a crowdlending regulatory framework that applies in all provinces. As a result, Canada is excluded from the comparative analysis.

Another reason is that the analysis of these jurisdictions significantly adds to the originality of this thesis. There is little if any academic commentary available on Australia and New Zealand’s crowdlending regulatory frameworks.\textsuperscript{161} There is more academic commentary available for the UK\textsuperscript{162} and US.\textsuperscript{163} There is some academic commentary on the UK crowdlending regulatory framework, but few examine the regulatory requirements in great detail.

G. Research Contribution

This thesis makes an early-stage developmental contribution to policy and scholarly discussion in advancing the current understanding of crowdlending and crowdlending regulation. Crowdlending regulation is an emerging field where literature is scant. This area of alternative finance regulation intersects


\textsuperscript{161} One of the few examples are Sophie Grace (n 77); Pekmezovic and Walker (n 75); Jacob (n 77); AA Schwartz, ‘The Gatekeepers of Crowdfunding’ (n 77); DLA Piper (n 77); Roth-Biester and Pearce (n 77).

\textsuperscript{162} For example, Osuji and Amajuoyi (n 76); Milne and Parboteeah (n 76); Lenz (n 76); Rogers and Clarke (n 76); Lu (n 76); Cicchiello, ‘Harmonizing the Crowdfunding Regulation in Europe Need, Challenges, and Risks’ (n 74).

\textsuperscript{163} For example, Slattery (n 75); Pekmezovic and Walker (n 75); Bradford, ‘The Regulation of Crowdfunding in the United States’ (n 75); Won (n 75).
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with other allied fields, namely FinTech innovation, regulatory policy and
type, and financial regulatory theory. The combination of the existing
literature from these areas is used to inform this research. The original
contribution of this thesis is its comparative examination of EU crowdlending
regulation.

In terms of locating this research in the existing conversations on crowdlending
regulation, this thesis’ original contribution fills the gap in the literature by
comparatively examining the ECSPR to other regulatory frameworks across the
world. Many have commented on individual crowdlending regulatory
frameworks. Some have conducted comparative examinations using two or
perhaps three jurisdictions.

Other academics who have led the way in the discourse on crowdlending
regulation are my supervisor Deirdre Ahern, Schwartz in the US,

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164 See for example Slattery (n 75); Bradford, ‘Shooting the Messenger: The Liability of
Crowdfunding Intermediaries for the Fraud of Others’ (n 75); Tanja Jørgensen, ‘Peer-to-Peer
Lending-A New Digital Intermediary, New Legal Challenges’ (2018) 1 Nordic Journal of
Commercial Law 231; Won (n 75); Lu (n 76); Serdaris (n 74).
165 See for example Milne and Parboteeah (n 76); Ferrarini (n 76); Ding Chen and others,
<https://ssrn.com/abstract=3315738> or <http://dx.doi.org/10.2139/ssrn.3315738> accessed
7 March 2023.
166 Christoph Busch and Vanessa Mak, ‘Peer-to-Peer Lending in the European Union’ (2016) 5
Journal of European Consumer and Market Law 181; Dirk Zetzsche and Christina Preiner, ‘Cross-
Border Crowdfunding: Towards a Single Crowdlending and Crowdfunding Market for Europe’
(2018) 19 European Business Organization Law Review 217; Antonella Francesca Cicchiello,
‘Building an Entrepreneurial Ecosystem Based on Crowdfunding in Europe: The Role of Public
Policy’ (2019) 8 Journal of Entrepreneurship and Public Policy 297; Cicchiello, ‘Harmonizing the
Crowdfunding Regulation in Europe Need, Challenges, and Risks’ (n 74); Pietro Ortolani and
Marije Louisse (eds), Crowdfunding and the Law (Oxford University Press 2021); Serdaris (n 74).
167 Deirdre Ahern, ‘Regulatory Arbitrage in a FinTech World: Devising an Optimal EU Regulatory
168 See further Andrew A Schwartz, ‘Rural Crowdfunding’ (2013) 13 University of California Davis
Business Law Journal 283; Andrew A Schwartz, ‘Crowdfunding Securities’ (2013) 88 Notre Dame
Law Review 1457; Schwartz, ‘The Gatekeepers of Crowdfunding’ (n 77); Andrew A Schwartz,
‘Crowdfunding Issuers in the United States’ (2020) 61 Washington University Journal of Law and
Policy 155.
Pekmezovic and Walker\textsuperscript{169} and Kirby and Worner\textsuperscript{170} in their early international comparison on crowdlending regulatory models. Much of the discussion on crowdlending regulation found concerns the US\textsuperscript{171} and the EU.\textsuperscript{172} There was some analysis available on the UK\textsuperscript{173} but limited analysis has been found examining the Australian and New Zealand crowdlending regulatory frameworks.\textsuperscript{174} There is even less analysis comparing the crowdlending regulatory frameworks.\textsuperscript{175}

One of the leading academics on the EU’s regulatory treatment of crowdlending is Eugenia Macchiavello.\textsuperscript{176} Macchiavello has written extensively on

\footnotesize{\textsuperscript{169} Pekmezovic and Walker (n 75); Gordon Walker and others, ‘Crowdfunding North and South: Australia and the European Union’ [2016] Journal of International Banking Law and Regulation 338.\
\textsuperscript{170} Kirby and Worner (n 36).\
\textsuperscript{171} Slattery (n 75); Bradford, ‘Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others’ (n 75); Pekmezovic and Walker (n 75); Bradford, ‘The Regulation of Crowdfunding in the United States’ (n 75); Won (n 75); Lo (n 75); See also for comment on limited available analysis on crowdfunding regulation more generally Stefano Cattelan and Thomas Neumann, ‘Status Artis: Research in the Law and Practice of Crowdfunding’ (2022) 2 Nordic Journal of Commercial Law 47.\
\textsuperscript{172} Cicchiello, ‘Building an Entrepreneurial Ecosystem Based on Crowdfunding in Europe: The Role of Public Policy’ (n 171); Hrdlička and Šmírausová (n 74); Cicchiello, ‘Harmonizing the Crowdfunding Regulation in Europe Need, Challenges, and Risks’ (n 74); Staikouras (n 74); Brand (n 74); Serdaris (n 74); Soren Brinkmann and Mads Ebert Rasmussen, ‘The New EU Crowdfunding Regulation -Explanations and Perspectives’ (2022) 2 Nordic Journal of Commercial Law 54.\
\textsuperscript{173} Osuji and Amajuoyi (n 76); Milne and Parboteeaw (n 76); Lenz (n 76); Rogers and Clarke (n 76); Ferrarini (n 76); Lu (n 76); Cicchiello, ‘Harmonizing the Crowdfunding Regulation in Europe Need, Challenges, and Risks’ (n 74).\
\textsuperscript{174} Some examples are: Sophie Grace (n 77); Pekmezovic and Walker (n 75); Jacob (n 77); AA Schwartz, ‘The Gatekeepers of Crowdfunding’ (n 77); DLA Piper (n 77); Roth-Blester and Pearce (n 77).\
\textsuperscript{175} Examples of the current comparative crowdlending literature are: Pekmezovic and Walker (n 105); AA Schwartz, ‘The Gatekeepers of Crowdfunding’ (n 77).\
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crowdlending regulation in the EU in the years leading up to the ECSPR and after the ECSPR was brought into force. What emerges from Macchiavello’s work was a close examination of the ECSPR and its development. Macchiavello is the first to comment on the self-responsibility principles used for investor protection in the ECSPR. This combined with Serdaris’ examination of the ECSPR’s investor protection mechanism as behavioural science-informed investor protection provided a key conceptual lens with which to analyse the ECSPR and further inform the international comparative analysis.

This thesis fills the gap by drawing together the existing literature to critique the ECSPR using an international comparative lens. There is limited analysis critiquing the ECSPR by comparing it to the regulatory frameworks in Australia, New Zealand, the UK, and the US.

H. Scope and Limitations of Research
The scope of this thesis is determined by reference to the ECSPR. The reason why the scope of this thesis is determined by the ECSPR is that the main goal of this work is to examine whether the ECSPR is adequate in achieving its regulatory goals for crowdlending.


177 Macchiavello, ”What to Expect When You are Expecting” a European Crowdfunding Regulation: The Current “Bermuda Triangle” and Future Scenarios for Marketplace Lending and Investing in Europe’ (n 191) 33.
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I. Thesis Structure
The broad structure of this thesis is as follows. Chapter 1 has set out the definitions and terminology. It has also explored the motivations and purpose of this research, research questions and aims, research methodology and research contribution. Chapter 1 has also provided the scope and limitations of this research and the thesis structure.

Chapter 2 commences the analysis of financial regulatory goals, models and regulatory goals which provide the framework of analysis for the thesis. It examines the ECSPR’s regulatory goals in the context of financial regulatory and regulatory theory.

Chapter 3 examines the ECSPR in the context of the framework provided by chapter 2. It evaluates the ECSPR’s regulatory response to inform the comparative work in chapter 4.

Chapter 4 compares the findings of chapter 3 with the response in Australia, New Zealand, the UK and the US. The findings form the recommendations in chapter 5.

Chapter 5 reflects on the findings in chapter 4 and discusses the findings of the assessment of the ECSPR’s adequacy.

Chapter 6 concludes and summarises the key findings. It also provides suggestions for further research, outlines the limitations, and the research contribution.

J. Conclusion
The objectives of this thesis have been established in this chapter. The central research question, ancillary questions and justifications have been delineated.
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The aim, central research question and ancillary questions of this thesis have also been located within the academic literature. Further, the gaps within the literature that this thesis seeks to address have been highlighted.

This thesis attempts to answer the central research question and the ancillary research questions in four steps. The first step is to examine the ECSPR’s regulatory goals in the context of financial regulatory theory and regulatory theory, thus providing a framework for the analysis in financial regulatory and regulatory theory terms. The second step is to analyse the ECSPR to see how the ECSPR acts upon the regulatory goals set out. The third step conducts the functional institutional comparative investigation. There are two steps to the comparative analysis:

a. to find how other jurisdictions have achieved goals that can be described to be similar or closely related to the ECSPR’s goals and
b. whether, by comparison, the ECSPR is adequate in achieving its regulatory goals for crowdlending.

Finally, conclusions are provided.

This chapter has highlighted the diverse range of jurisdictions that form part of the comparative examination in this thesis. It has also given a guide to the reader of the overall structure of this thesis. Now the thesis will move to respond to the questions posed in this introduction.
CHAPTER II. THEORETICAL FRAMEWORK

A. Introduction
This chapter is the first step in answering the central research question of whether the ECSPR adequately achieves its regulatory goals for crowdlending. This chapter examines the ECSPR to see what the ECSPR’s regulatory goals are and then examines the ECSPR’s goals in the context of financial regulatory theory and regulatory theory. This chapter also investigates the comparator jurisdictions’ goals for crowdlending regulation.

First, section B examines the ECSPR to find what the ECSPR sets out as its regulatory goals. Then, section C analyses most of the ECSPR’s goals in the context of financial regulatory theory namely; the primary goal to increase seamless access to the EU crowdlending market for start-ups and SMEs, reduce costs and avoid delays and the secondary goals (1) enabling the cross-border provision of services by harmonising rules, (2) protecting investors and clients, and (3) reducing risk. Section D explores the ECSPR’s secondary goal of legal certainty in the context of regulatory theory and examines hard, soft, opt-in and opt-out measures. Section E analyses the financial regulatory and regulatory goals of the comparator jurisdictions. Section F concludes the chapter.

B. The ECSPR’s Goals
The ECSPR’s goals are found in the 79 recitals of the ECSPR. Not all 79 recitals are relevant. Some recitals relate to matters that are purely for noting such as
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the fact that the European Data Protection Supervisor was consulted.\(^1\) Other recitals elaborate further on the articles of the ECSPR such as the consequences for crowdfunding service providers (‘CSPs’) who fail to obtain authorisation\(^2\) and the NCAs’ powers to detect infringements.\(^3\)

There are however four themes that recur throughout, and these are considered the ECSPR’s goals. I categorise these goals into primary and secondary goals. The ECSPR’s primary goal is to increase seamless access to the EU crowdlending market for start-ups and SMEs, reduce costs and avoid delays.\(^4\) The ECSPR aims to achieve its primary goal by achieving other secondary regulatory goals of (1) enabling the cross-border provision of services by harmonising rules,\(^5\) (2) protecting investors and clients,\(^6\) (3) providing legal certainty,\(^7\) and (4) reducing risk.\(^8\)

Questions arise as to why this goal is elevated as a primary goal above the secondary goals. This is particularly important as harmonisation, protection, legal certainty and reducing risk are all important goals. There is a combination of reasons for the decision to elevate the goal to increase seamless access to the EU crowdlending market for start-ups and SMEs, reduce costs and avoid delays as the ECSPR’s primary goal. The ECSPR’s main focus is the provision of crowdlending services to businesses.\(^9\) This focus is seen in not only the recitals\(^10\)

\(^1\) ECSPR recital 79.
\(^2\) ECSPR recital 77.
\(^3\) ECSPR recital 63.
\(^4\) ECSPR recitals 3, 27, 54, 60.
\(^5\) ECSPR recitals 6, 8, 18, 30, 33, 58, 61-66.
\(^6\) ECSPR recitals 7, 16, 18, 24, 36, 42-47, 50-54, 56.
\(^7\) ECSPR recitals 58, 76.
\(^8\) ECSPR recitals 18, 23, 30, 24.
\(^9\) ECSPR article 1(2)(a).
\(^10\) ECSPR recitals 3, 27, 54, 60.
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but the title of the ECSPR which relates to crowdfunding for business. In addition, the 2015 Capital Markets Union Action Plan identified the policy goals behind the ECSPR as the promotion of business crowdlending and an aim to connect SMEs with a range of funding sources.\textsuperscript{11} The Commission first indicated its interest in introducing regulation to support crowdlending, and especially promote long-term finance for SMEs, in the wake of the Global Financial Crisis.\textsuperscript{12} These collectively justify the focus and identification of the ECSPR on the primary goal.

The secondary goals are viewed as a means to achieving the primary goal. Investors and clients are only protected in business crowdlending. Harmonisation efforts and cross-border provision of services only occur in the context of business crowdlending. Legal certainty and risk reduction only apply to business crowdlending. All these actions are seen as driving the promotion of business crowdlending and hence secondary goals of the ECSPR.

\textbf{C. Financial Regulatory Theory}

Financial regulatory theory is the default framework of analysis and theoretical underpinning of this thesis. Regulatory theory is the auxiliary framework. As a result, this section explores the financial regulatory goals and then matches the ECSPR’s primary and secondary goals with the financial regulatory goals

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explored in this section. The analysis maps out the ECSPR’s goals in terms of financial regulatory theory and provides the framework of analysis for this thesis.

Due to one of the ECSPR’s goals being risk reduction and this being similar to the risk-based financial regulatory model, the discussion delves into financial regulatory models and their relation to the ECSPR.

1. Financial Regulatory Goals

This thesis uses Armour and others’ list of six goals of financial regulation: investor protection, consumer protection in retail finance, financial stability, market efficiency, competition, and preventing financial crime.13

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Financial regulators cite other goals such as ‘promoting “capital formation” [...] flow[s] from [...] the enhancement of market efficiency’. However, an argument is rightly made that the extra financial regulation goals cited by regulators can be achieved by the pursuit of one of the six financial regulatory goals enumerated. Below each of the six financial regulatory goals are set out and then the ECSPR’s goals are explored in terms of the six regulatory goals.

a) Investor Protection and Other Users

Investor protection is viewed as one of the goals of financial regulation and this is seen in different facets of financial services including securities markets, insurance services, pensions, and banking. The category of persons who are deemed to be protected includes investors and other users. The term ‘other users’ is used to encapsulate the category of persons protected by regulators in specific sectors. For example, Amour uses it to demonstrate the UK’s usage of consumer protection as protecting all users of the financial system. As a result, the ECSPR’s client protection measures are examined under this heading. Clients are defined broadly in the ECSPR. Clients under the ECSPR include both prospective and actual investors. Furthermore, the definition of clients under the ECSPR includes the protection of project owners to whom crowdlending is provided.

15 ibid.
16 Armour and others (n 13) 62.
17 ibid.
18 ECSPR article 2(1)(g).
19 ibid.
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Investors are classified under the ECSPR as sophisticated, or non-sophisticated investors based on the results of the knowledge test and a simulation of loss.\(^{20}\) An investor is classified as a sophisticated investor if they meet the fiscal and experience criteria set out in Annex II(I) of the ECSPR.\(^{21}\) This investor classification established by the ECSPR does not use the investor classifications in MiFID II.\(^{22}\) The investor classifications in the UK’s crowdlending regulatory framework closely mirror the investor classifications in MiFID II.\(^{23}\)

The use of *sui generis* investor classification under the ECSPR has led to commentary that the deviation has reduced standards of investor protection.\(^{24}\) This is because the new category of non-sophisticated investor results in a considerably smaller group of persons enjoying increased investor protections than retail investors would under MiFID II.\(^{25}\)

The financial services sector is heavily interested in investor protection, making the concept a ‘knee-jerk reaction’ in financial regulation and almost a given.\(^{26}\) The basis and application of investor protection have evolved. Initially, investors were conceived as ‘simply risk-takers and asset accumulators’.\(^{27}\) At

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\(^{20}\) ECSPR articles 2(1)(j), (k), 21; See further chapter 3.
\(^{21}\) See further chapter 3.
\(^{23}\) UK - FCA Handbook COBS 10.2.9G; UK - FCA Handbook Glossary retail client, professional client, eligible counterparty.
\(^{24}\) De Smet and Colaert (n 22).
\(^{25}\) De Smet and Colaert (n 22) [15].
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the same time, investor protection was seen as a restrictive measure on business.

More recently, the EU shifted to a ‘quasi-market’ strategy\textsuperscript{28} using investor protection to promote markets, rebuild investor confidence and allow investors to save and invest.\textsuperscript{29} For example, MiFID\textsuperscript{30} was a first for the EU in imposing conduct of business rules to encourage retail investment.\textsuperscript{31} MiFID II further encouraged retail investment by strengthening non-sophisticated investor protection.\textsuperscript{32} There has also been a shift towards the increased consumerisation\textsuperscript{33} of investors, which has been identified by Moloney.\textsuperscript{34} Consumerisation has been viewed as a welcome development,\textsuperscript{35} as it:

\[\text{is the implicit recognition that retail investors cannot simply be seen as risk-takers and asset accumulators, but should be}\]

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\footnotesize
\textsuperscript{28} Moloney, How to Protect Investors: Lessons from the EC and the UK (n 26) 51.
\textsuperscript{29} Moloney, How to Protect Investors: Lessons from the EC and the UK (n 26) 51-53.
\textsuperscript{33} Moloney describes consumerisation as the replacement of the idea ‘of the empowered, autonomous retail investor with the vulnerable consumer of financial services’. Moloney, ‘Large-Scale Reform of Investor Protection Regulation: The European Union Experience’ (n 31) 177.
\textsuperscript{34} Moloney, ‘The Investor Model Underlying the EU’s Investor Protection Regime: Consumers or Investors?’ (n 27).
\textsuperscript{35} Moloney, ‘The Investor Model Underlying the EU’s Investor Protection Regime: Consumers or Investors?’ (n 27) 193.
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regarded as purchasers of products which are increasingly essential for welfare.\footnote{\textit{ibid.}}


Regardless of the measure used, the aim of all measures remains the protection of investors and other users from irrationalities.\footnote{See further Rainer Baisch and Rolf H Weber, ‘Investment Suitability Requirements in Light of Behavioural Findings’ in Klaus Mathis, \textit{European Perspectives on Behavioural Law and Economics: Economic Analysis of Law in European Legal Scholarship} (Vol 2, Springer Cham 2015).}

Broadly, investors are categorised into non-sophisticated and sophisticated investors, but the terminology and definitions differ from jurisdiction to jurisdiction. Some jurisdictions further break down the sophisticated investor category into various types of professionals such as the UK.\footnote{UK - FCA Handbook COBS 3.1.1R.} Generally, the categorisation process considers similar financial and experience factors...
although unsurprisingly, differences arise in the detail of those factors. For example, all the jurisdictions examined set some form of limit or threshold and if the investment stays within the limit or threshold, non-sophisticated investor protections may apply.\(^{45}\) However, the figure for the limit or threshold varies from jurisdiction to jurisdiction. In Australia, if the investment price is over $500,000.00 (AUSD) the investor is categorised as a sophisticated investor,\(^{46}\) while in the EU, the investment threshold is the higher of €1,000.00 or 5% of the investor’s net worth.\(^{47}\) As result, a non-sophisticated investor in Australia may not fit the category of non-sophisticated investor in the EU.\(^{48}\)

Investor protection as a goal raises various issues. Central to these is the potential inexperience of the investors or other users. Crowdlending is unique since both parties to the transaction, the project owner and investor, may be inexperienced. There is no requirement that both parties have a certain level of experience and hence making it easy for unsophisticated and inexperienced persons to engage in crowdlending. The challenge with this is that lack of experience may lead to unwise and wrong financial decisions and lead to financial losses.\(^{49}\) Inexperienced project owners might default on a loan

\(^{45}\) Australia - Corporations Regulations 2001 reg 7.1.18; ECSPR article 21(7); New Zealand - Financial Markets Conduct Regulations 2014 Schedule 8 Clauses 3-5; UK - FCA Handbook COBS 4.7.7R-13G; US - Rule 100(a)(2) Regulation Crowdfunding, 17 CFR § 227.100(a)(2)

\(^{46}\) Australia - Corporations Regulations 2001 reg 7.1.18.

\(^{47}\) ECSPR article 21(7).

\(^{48}\) In New Zealand where an investment is at least $750,000.00 (NZD), the investor will be a sophisticated investor. Non-sophisticated investors in the UK can only invest 10% of their net assets. The US non-sophisticated investor limits vary according to the investor’s income and net worth. Depending on the circumstances, the limit will be based on a percentage of income, net worth or $2,200 (USD). New Zealand - Financial Markets Conduct Regulations 2014 Schedule 8 Clauses 3-5; UK - FCA Handbook COBS 4.7.7R-13G; US - Rule 100(a)(2) Regulation Crowdfunding, 17 CFR § 227.100(a)(2).

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because they overestimated their ability to repay the loan. Although CSP credit risk assessments and loan pricing ought to address this risk, the inexperience of the project owner is still a challenge.

Crowdlending is a high-risk activity. Investors may lose all or some of their investments because of a project owner’s default. Investors may not receive the expected return on their investment or risk no return because for example a borrower might repay early or might only be able to pay the principal amount. CSPs themselves may fail which may have a knock-on effect on...
project owners. Project owners may be deemed guilty by association with a failed CSP.\textsuperscript{54} The much-needed loan may not eventuate which could result in the project owners seeking shorter-term credit with significantly higher interest rates. The more expensive credit could dampen the project owner’s potential for growth. Other risks such as liquidity risk,\textsuperscript{55} fraud risk,\textsuperscript{56} information asymmetries,\textsuperscript{57} inexperience,\textsuperscript{58} and systemic risk\textsuperscript{59} may also arise.

Financial regulation considers how to protect the investor and other users from these challenges. As the list of risks grows, investor protection measures must respond accordingly. This leads to tension as investor protection swings from the caveat emptor stance towards the paternalistic end of the spectrum. This swing towards paternalism may be viewed as restricting the business of crowdlending but on the other hand, it can build investor confidence, attract investors to the field and pursue them to partake in the financial services sector.

\textsuperscript{54} See also European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 17; Commission, ‘Report on Crowdfunding in the EU Capital Markets Union’ (Staff Working Document) SWD (2016) 154 final.

\textsuperscript{55} See also Kirby and Worner (n 49) 27-28; European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 16; The Board of the International Organization of Securities Commissions (n 49) iv; Commission, ‘Report on Crowdfunding in the EU Capital Markets Union’ (n 47) 154; Financial Conduct Authority CP18/20 (n 53) 32; Zetzsche and Preiner (n 53) 223.

\textsuperscript{56} See also Commission, ‘Consultation Document - Crowdfunding in the EU - Exploring the Added Value of Potential EU Action’ (n 12) 7; Financial Conduct Authority CP13/13 (n 49) 14; Kirby and Worner (n 49) 26; European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 14; Milne and Parboteeah (n 49) 23; Commission, ‘Report on Crowdfunding in the EU Capital Markets Union’ (n 47); Zetzsche and Preiner (n 53) 223.

\textsuperscript{57} Kirby and Worner (n 49) 26-27; The Board of the International Organization of Securities Commissions (n 49) v; Paul Belleflamme and others, ‘The Economics of Crowdfunding Platforms’ (2015) 33 Information Economics and Policy 11, 46; Zetzsche and Preiner (n 53) 222.

\textsuperscript{58} Financial Conduct Authority CP13/13 (n 49) 13; Kirby and Worner (n 49) 27; The Board of the International Organization of Securities Commissions (n 49) v; Milne and Parboteeah (n 49) 22; Jørgensen (n 49), 259.

\textsuperscript{59} Milne and Parboteeah (n 49) 22-24; Zetzsche and Preiner (n 53) 13-15.
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**b) Consumer Protection in Retail Finance**

This goal principally relates to consumers in the consumer credit context and presents itself in the Consumer Credit Directive. As the ECSPR is only concerned with business project owners, this goal will receive limited attention in this thesis.

There is some overlap between this goal and the protection of investors and other users goal above. Consumers are those individuals who act outside the course of their normal business. There are significant similarities in the issues explored concerning non-sophisticated investors and consumers in retail finance. Consumers fall prey to similar risks that non-sophisticated investors are subject to, such as information asymmetry risk and herding. Consumer protection in retail finance has paternalism running through it like investor protection. Consumer protection in retail finance attempts to insulate the vulnerable from harm. The overlap is notable considering the increasing consumerisation of investor protection in recent years. Meaning there may be merit in considering consumer protection in retail finance together with non-sophisticated investor protection.

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60 Armour and others (n 13) 64.


62 The definition of project owner and the placement of providing crowdclending services to consumers outside the scope of the ECSPR means business project owners are only within the scope of the ECSPR. ‘“[P]roject owner” means any natural or legal person who seeks funding through a crowdfunding platform’ ECSPR article 2(1)(h). The ECSPR does not apply to ‘crowdfunding services that are provided to project owners that are consumers, as defined in point (a) of Article 3 of Directive 2008/48/EC’. ECSPR article 1(2)(a).

63 Armour and others (n 13) 64.
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Setting the similarities aside, there are grounds for examining consumer protection in retail finance separately from investor protection and other users regulatory goal. For example, under consumer protection in retail finance, the financing may be used to purchase a home. If the mortgage is unsuccessful, a consumer could lose their home. On the other hand, the safety of an investor is less likely to depend on the investment decision of the investor. In addition, there are generally different protections and rights accorded to a consumer in retail finance. For example, the Proposal for a Consumer Credits Directive explicitly sets out that the consumer can at any time repay the amount borrowed early and knowledge and competence requirements for staff. These are not included in the ECSPR.

c) Financial Stability

Financial stability, as a regulatory goal, came to the forefront in the aftermath of the Global Financial Crisis. The Global Financial Crisis showed that regulators had to pay increased focus on the stability of the financial sector. This led to the formulation of bodies such as the Financial Stability Oversight Council in the US and the European Stability Mechanism in the EU. As the analysis of the ECSPR’s regulatory goals shows, financial stability is not a focus


65 Proposal for a Consumer Credits Directive article 33.

Theoretical Framework

of the ECSPR at this moment in time. However, it may become an area of scholarship in time to come.

d) Market Efficiency
Market efficiency is a financial regulatory goal with many connotations and meanings.67 Three of these different meanings are explored in this section.

First, the efficiency of markets is concerned with the functionality and operation of markets. Principally, it concerns itself with both operational and informational efficiency. Fama, for example, deems a market to be efficient when the prices ‘always “fully reflect” available information’.68 This creates a nexus between available information and its impact on the market. However, Fama’s classification is a narrow view of efficiency.

The next idea of market efficiency has three layers: productive, allocative, and dynamic.69 This three-layer idea of market efficiency is that resources are scarce and ought to be used optimally by the correct people or activities over time.70 Productive efficiency is concerned with producing as much as possible with the available resource.71 Allocative efficiency is defined as where:

  economic agents act with perfect “rationality” to maximise

  [...the utility of resources] under conditions of costless

69 Armour and others (n 13) 53.
70 Ibid.
71 Ibid.
Theoretical Framework

contracting, where information and resources are able to flow freely in response to changes in prices.\textsuperscript{72}

It centres on placing the resource with the person who will benefit the most from the resource.\textsuperscript{73} Dynamic efficiency, on the other hand, is concerned with generations as opposed to resources.\textsuperscript{74} It considers the impossibility of making one generation better off without making any other generation worse off.\textsuperscript{75} Despite the difference in the assertions between Fama and Amour on efficiency, both have resources at the core.

A different way of defining market efficiency extends the concept beyond information and resource allocation to include market quality and social efficiency.\textsuperscript{76} The broader conception of markets:

is a means by which the expertise of the intermediary enables savers to derive the benefits of diversification and liquidity while minimizing the disadvantages resulting from the loss of information and control.\textsuperscript{77}

Thus, equality, bias, and incentives should be considered when examining market efficiency.\textsuperscript{78}

\textsuperscript{72} Deakin and Hughes (n 67) 172.
\textsuperscript{73} Armour and others (n 13) 53.
\textsuperscript{74} ibid.
\textsuperscript{75} ibid.
\textsuperscript{76} David C Donald, ‘“Market Quality” and Moral Hazard in Financial Market Design’ in Ross P Buckley and others (eds) \textit{Reconceptualising Global Finance and Its Regulation} (Cambridge University Press 2016).
\textsuperscript{78} Donald (n 76) 235.
Theoretical Framework

The final part of this section will analyse the ECSPR’s regulatory goals to see whether the ECSPR seeks to address any one of the forms of market efficiency explored here.

e) Competition

Championed by the West, competition is seen as the antithesis of monopolies. Competition is a focus in the UK. The promotion of competition is also seen as a theme in the EU. The EU’s harmonisation and passporting efforts not only increase access to services and goods but increase competition in the pan-EU market. Competition can encourage more efficient pricing. As such it is closely linked to the market efficiency financial regulatory goal. Although this concept is condemned for its inability to ‘generally le[a]d to welfare improvements’.

Armour and others explore competition in the context of EU policy in two ways:

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83 Baldwin and others, Understanding Regulation: Theory, Strategy, and Practice (n 79) 454.
84 Ogus, ‘Corruption and Regulatory Structures’ (n 79) 340.
Theoretical Framework

1. promoting competition by removing barriers to international competition; in other words, allowing the passporting of services in the EU and
2. agreeing minimum standards that have been harmonised across the EU by legislation.  

This is a rather process-oriented concept of competition. This conception of competition concerns how a competition goal can be achieved. The means in this scenario being harmonisation and removal of barriers.

For the ECSPR to promote competition, the ECSPR will need to fully harmonise crowdlending regulation across the EU and enable the passporting of services. As this conception of competition focuses on harmonisation, the concept of regulatory competition will also be discussed. Regulatory competition:

is the alteration of national regulation in response to the actual or expected impact of internationally mobile goods, services, or factors on national economic activity.

5 Armour and others (n 13) 68.


7 Sun and Pelkmans (n 91) 68-69.
Regulatory competition can also mean that there is lax enforcement of regulatory requirements or regulatory arbitrage. Therefore, where a market is fully harmonised, it would be expected that there would be no room for regulatory competition. However, as the analysis in chapter 3 shows the ECSPR has not completely harmonised crowdlending regulation. This thesis focuses on the lack of harmonisation regarding (1) enforcement and (2) marketing communications. Thus, the opportunity for regulatory competition is discussed.

To identify the recipients of the enforcement measures, the thesis references Baldwin’s paradigm. Baldwin’s paradigm examines the intention of the recipients of the enforcement measures and their intention. In doing so, it considers different possibilities when it comes to the recipients. They could be well-intentioned and well-informed, ill-intentioned, and ill-informed, ill-intentioned and well-informed or well-intentioned and ill-informed. The classification is important in determining enforcement measures. A financial penalty for a breach by a well-intentioned and ill-informed market actor such as a non-sophisticated investor might be a sub-optimal enforcement mechanism, but education initiatives and information might be more useful. A well-informed and ill-intentioned market actor requires a range of strategies,

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88 Trachtman, 'International Regulatory Competition, Externalization, and Jurisdiction' (n 91) 54; Geradin (n 91) 21-22; Dan L Burk, 'Law as a Network Standard' (2005-2006) 8 Yale Journal of Law and Technology 63, 67.
Theoretical Framework

which include a mix of detailed and general principles and a myriad of sanctions, to target deliberate breaches or avoidance.\textsuperscript{93} Finally, a financial penalty or criminal sanction might be a higher priority for an ill-intentioned and ill-informed market actor.\textsuperscript{94}

The categorisation of the recipient decides the recommended course of action for the enforcement mechanisms. The most challenging type of infringer is well-informed and ill-intentioned. This type of infringer is likely to creatively comply with the regulatory framework or commit tactical infringements.\textsuperscript{95} A tactical infringement views for example fines as not a deterrent but the price for committing the infringement.\textsuperscript{96} If in the circumstances it is still profitable to infringe even with the fine, the well-informed and ill-intentioned individual may choose to infringe as a business risk.\textsuperscript{97}

Therefore, for competition to achieve regulatory objectives, it must incorporate harmonised enforcement mechanisms. These mechanisms should be alive to the classification of the offender to establish similar and equal market conditions. Enforcement is not restricted to CSPs only but includes project owners and investors.

\textsuperscript{93} ibid.
\textsuperscript{94} ibid.
\textsuperscript{95} ibid.
\textsuperscript{96} ibid.
Theoretical Framework

Both public and private actors can have enforcement roles. To identify public and private actors this thesis uses Shavell’s conception of public actors. Public actors are ‘anyone who devotes the major faction of his work effort to enforcement and who is paid by the state - whether in the form of rewards or in a salary - is a public enforcement agent’. Private actors for this thesis are negatively defined as not public actors and therefore are anyone or anything that falls outside of Shavell’s conception of public actors. Public actors tend to be equipped with strong enforcement powers; they are not by any means the perfect enforcer. Public actors have significant resource demands and are likely to be tasked with the enforcement of a myriad of different areas. Public actors cannot monitor every transaction on the market for compliance. Private actors are a heterogeneous group with variable amounts of resources. Private actors also have varying degrees of motivation and in some ways are more prone to free-rider problems owing to the size and heterogeneity of the group. As such neither private actors nor public actors are enforcement paragons. Each has its strengths and weaknesses making it important that enforcement relies on a portfolio of different actors and mechanisms.

f) Preventing Financial Crime

Financial regulation views financial crime as a deterrent to market integrity. Financial crime takes many forms which may include the financing of criminal

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100 Ibid.
101 Ibid.
activities or the laundering of the proceeds of crime or tax evasion. The EU has legislation specifically focused on the prevention of financial crimes. It is worth noting that Armour and others are uncertain about whether preventing financial crime is an independent financial regulatory goal. This is because the prevention of financial crime could be seen as an instrument for achieving the other regulatory goals which the criminal sanctions support.

g) Application to the ECSPR
As previously set out in section B, the ECSPR’s primary goal is to increase seamless access to the EU crowdlending market, reduce costs and avoid delays. The ECSPR aims to achieve its primary goal by achieving other secondary regulatory goals of (1) enabling the cross-border provision of services by harmonising rules, (2) protecting investors and clients, (3) providing legal certainty, and (4) reducing risk.

The ECSPR does not have a consumer protection in retail finance, financial stability or preventing financial crime goals. As a result, these goals are not examined any further in this thesis. The ECSPR’s goals do, however, align with investor protection and other users, market efficiency, and competition.

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102 Armour and others (n 13) 69.
104 Armour and others (n 13) 69.
105 ibid.
106 ECSPR recitals 3, 27, 54, 60.
107 ECSPR recitals 6, 8, 18, 30, 33, 58, 61-66.
108 ECSPR recitals 7, 16, 18, 24, 36, 42-47, 50-54, 56.
109 ECSPR recitals 58, 76.
110 ECSPR recitals 18, 23, 30, 24.
Theoretical Framework

Competition linked to market efficiency is at the core of the ECSPR’s financial regulatory goals. The ECSPR’s primary goal is a mix of competition and market efficiency financial regulatory goals. The ECSPR’s aim to increase seamless access to the EU crowdlending market for start-ups and SMEs, reduce costs and avoid delays are either barriers to a competitive market or are conducive to creating a competitive market and blurs into the secondary goal of harmonising rules. Importantly, when the primary goal is taken into account this promotion of competition is for the benefit of start-ups and SMEs. This promotion of competition is to increase start-up and SME access to credit. However, the analysis above of competition noted that consumer welfare is a significant part of EU competition law and the UK financial regulator’s goals, the ECSPR focuses on the business seeking capital in its conception of competition. However, the ECSPR’s primary goal can also be construed as a market efficiency goal as it seeks to enable access to a resource, capital. Thus, the EU has made a policy decision that SMEs and start-ups would benefit from access to capital. In short, the EU seeks out allocative efficiency. Thus, success or failure in terms of market efficiency for the ECSPR will be determined based on whether capital is being placed in the hands of SMEs and start-ups. From this point of view, the ECSPR’s main goal is a mix of competition promotion and allocative efficiency.

What would the failure of the ECSPR’s primary goal look like? The ECSPR could be considered a failure if it enabled the slow allocation of funds to project owners so that they were exposed to excessive liquidity risk which could even lead to the failure of the project owner’s business A failure under this regulatory goal would result in the cost of regulatory compliance being passed
on to the clients and a service that is too expensive for SMEs. Failure could also be the creation of barriers for SMEs to access finance.

The first of the ECSPR’s secondary goals is a competition goal also. By seeking to enable the cross-border provision of services through the harmonisation of rules, the ESCPR strives to create competition which points to a competition goal. Harmonisation increases the ease of providing cross-border services and helps to ensure seamless access to the market which could attract participants to the crowdlending market. A failure in this context for crowdlending would be an EU business crowdlending market that is very localised and prohibits or makes passporting of services across the EU impossible and/or difficult.

The ECSPR’s second secondary goal is the protection of investors and clients. This protection goal sits squarely into the protection of investors and other users financial regulatory goal. This is a distinct departure for the ECSPR. A failure of investor protection in the context of crowdlending under the ESCPR could manifest in the lack of information to investors on the risks associated with the investment which could be addressed through disclosures, counter-impulse measures, or nudges. A failure to indicate that an investment is not guaranteed would certainly be a failure to protect investors. Other manifestations include a lack of disclosure to clients on the process of crowdlending or the lack of business conduct requirements to dictate the minimum standard of conduct of the CSP.

The ECSPR’s reference to legal certainty and reduction of risk merit a brief discussion. Risk reduction is a component of almost all the other six financial regulatory goals. However, the analysis in the next section on financial
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regulatory models will demonstrate that reduction of risk aligns more closely with a risk-based regulatory model. Legal certainty fits into the broader landscape of regulatory theory and is explored in the next section on regulatory theory.

2. Financial Regulatory Models

Now the analysis turns to examine financial regulatory models and their application to the ECSPR’s risk reduction goal. There are many different types of financial regulatory models, and this thesis delves into some of the models available. From the onset, it is important to note that there has been a shift in the regulatory models, for example, principles-based regulatory frameworks were popular in the past. With principles-based regulation, regulators used a hands-off approach which allowed market participants to govern themselves as they see fit. For example, pre-2008, the UK financial regulator, the Financial Services Authority, gave ‘greater recognition to firms’ own management and controls in its supervisory strategy’. The regulator trusted that firms would be able to govern themselves without close monitoring and supervision.

The Global Financial Crisis marked a shift in the financial regulatory approach. Australia and Canada had both employed risk-based approach models and weathered the Global Financial Crisis better than the UK and the

112 Black, ‘Regulatory Styles and Supervisory Strategies’ (n 118) 230.
113 Ibid.
Theoretical Framework

Netherlands (who did not use risk-based regulatory models).\textsuperscript{115} Since then, risk-based regulatory models have become ‘mainstreamed into regulatory processes around the world’.\textsuperscript{116} ‘[R]isk-based frameworks can be useful for a regulator in providing clear, well-articulated set of priorities which the regulator can use to develop regulatory strategy and manage its resources’.\textsuperscript{117}

Particular attention is paid in this section to the risk-based regulatory model. The ECSPR in its regulatory goals states that it aims to reduce risk.\textsuperscript{118} The reduction of risk can be aligned with the market efficiency regulatory goal. Risk reduction requires the identification of risks in the market and designing the regulatory model to address those risks.

\textit{a) Principles-Based Regulatory Model}

The UK was a strong proponent of principles-based regulatory models before the Global Financial Crisis.\textsuperscript{119} Previously, the principles-based regulatory model evoked ‘images of outcome-oriented, flexible regulators harbouring ethical

\begin{footnotes}
\item Black, ‘Regulatory Styles and Supervisory Strategies’ (n 118) 244.
\item Black, ‘Regulatory Styles and Supervisory Strategies’ (n 118) 223.
\item ECSPR recitals 24, 76.
\end{footnotes}
Theoretical Framework

standards in largely responsible corporations’. Principles-based regulatory models should operate as the ‘backstop’ to detailed regulatory requirements. Principles-based regulatory models at the time did not favour red tape and opened up markets for business.

The ECSPR does not have a principles-oriented goal. However, as the analysis shows in chapter 3 the ECSPR at times uses principles in combination with its other regulatory requirements.

b) Business Conduct Regulatory Models

The business conduct or management-based regulatory model is a means rather than an ends oriented regulatory model. The business conduct regulatory model is not specific and the regulated must interpret the principles according to their context. The decision to allow regulated entities to determine their interpretation causes unique challenges. First, it presupposes that all interpretations are correct. Second, the entities are more likely to


\[\text{\footnotesize 121 Black, ‘Paradoxes and Failures: “New Governance” Techniques and the Financial Crisis’ (n 126) 1043.}\]

\[\text{\footnotesize 122 Black, ‘The Rise, Fall and Fate of Principles Based Regulation’ (n 127).}\]


\[\text{\footnotesize 125 Neil Gunningham and Richard Johnstone, Regulating Workplace Safety: System and Sanctions (Oxford University Press 1999); Cary Coglanese and David Lazer, ‘Management-Based Regulation: Prescribing Private Management to Achieve Public Goals’ (2003) 37 Law and Society Review 691; Coglanese, ‘Management-Based Regulation: Implications for Public Policy’ (n 131); Black, ‘Regulatory Styles and Supervisory Strategies’ (n 118) 226-227; Armour and others (n 13) 264-267 and ch 9, 11.}\]
Theoretical Framework

choose interpretations that are less onerous to them. Third, it might lead to an unequal playing field where different regulated entities apply different interpretations to similar rules.

Business conduct regulatory models can be viewed as being related to principles-based regulatory models. Neither are overly prescriptive. Business conduct does, however, have more detail than a principles-based regulatory model. A business conduct regulatory model focuses on matters such as prescribing training requirements for the staff of a financial services firm\textsuperscript{126} or the need for a business plan to cushion business failure. The business conduct regulatory model does not prescribe in great detail the contents of the business plan. It does however make it clear that a business plan is required. Business conduct regulatory models can be found in MiFID and a stricter version in MiFID II.\textsuperscript{127}

Management-based or business conduct regulatory models have been subject to critique. Critics argue that a general overarching principle of fiduciary duty ought to apply instead of the swathes of regulation outlining business conduct.\textsuperscript{128}

The ECSPR does not have a business conduct goal. However, as the analysis shows in chapter 3 the ECSPR at times uses business conduct requirements


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indicative of a business conduct model in combination with its other regulatory requirements.

c) Risk-Based Regulatory Models
Risk-based regulatory models allow regulators to calibrate regulation to specifically respond to set market failures or risks. As a result, risk-based regulatory models can be more granular and dynamic than broad principles-based regulation. However, identifying the important risks can be challenging.

When the ECSPR was in its development phase there was a diverse range of risks extant in the EU crowdlending market. The risks in the EU crowdlending market before the publication of the ECSPR have been expertly explored by other academics and organisations. The risks varied from cyber risks to default

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130 ibid.
131 Commission, ‘Consultation Document - Crowdfunding in the EU - Exploring the Added Value of Potential EU Action’ (n 12) 7; Financial Conduct Authority CP13/13 (n 49) 14; Kirby and Worner (n 49); Commission, ‘Responses to the Public Consultation on Crowdfunding in the EU’ (n 50); European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50); The Board of the International Organization of Securities Commissions (n 49); Belleflamme and others (n 50); Milne and Parboteeah (n 49); Rainer Lenz, ‘Peer-to-Peer Lending: Opportunities and Risks’ (2016) 7 European Journal of Risk Regulation 688; Christoph Busch and Vanessa Mak, ‘Peer-to-Peer Lending in the European Union’ (2016) 5 Journal of European Consumer and Market Law 181; Commission, ‘Report on Crowdfunding in the EU Capital Markets Union’ (n 47); Chris Rogers and Chris Clarke, ‘Mainstreaming Social Finance: The Regulation of the Peer-to-Peer Lending Marketplace in the United Kingdom’ (2016) 18 The British Journal of Politics and International Relations 930; Jørgensen (n 75); Commission, ‘FinTech Action Plan: For a More Competitive and Innovative European Financial Sector’ (Communication) COM (2018) 109 final; Financial Conduct Authority CP18/20 (n 53); Zetzche and Preiner (n 53); Saman Adhami and others, ‘Risks and Returns in Crowdlending’ (3 March 2019) 19-20 <https://ssrn.com/abstract=3345874> or <http://dx.doi.org/10.2139/ssrn.3345874> accessed 7 March 2023.
132 Kirby and Worner (n 49) 28.
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risks\textsuperscript{133} to systemic risk.\textsuperscript{134} Some risks were specific to the CSP itself such as CSP failure.\textsuperscript{135} Other risks affected all the parties in a crowdlending transaction such as inexperience,\textsuperscript{136} and fraud risk.\textsuperscript{137} There were conflict of interest concerns, liquidity risk,\textsuperscript{138} legal uncertainty,\textsuperscript{139} and reputational risk.\textsuperscript{140} CSPs also began designing their responses to the risks in the market such as contingency funds which responded to default risk.\textsuperscript{141}

One of the challenges with the risk-based analysis of the ECSPR regulatory model is that there was a myriad of risks identified in the EU crowdlending market before it was regulated. As a result, this thesis focuses on eight of the

\textsuperscript{133} See also Commission, ‘Consultation Document - Crowdfunding in the EU - Exploring the Added Value of Potential EU Action’ (n 12) 7; Financial Conduct Authority CP13/13 (n 49) 14; Kirby and Worner (n 2) 23-26; Commission, ‘Responses to the Public Consultation on Crowdfunding in the EU’ (n 50); European Banking Authority (n 32) 12-14; The Board of the International Organization of Securities Commissions (n 49) iv; Milne and Parboteeah (n 49) 22.

\textsuperscript{134} Milne and Parboteeah (n 49) 22-24; Zetzsche and Preiner (n 53) 13-15.

\textsuperscript{135} Financial Conduct Authority CP13/13 (n 49) 14; The Board of the International Organization of Securities Commissions (n 49) iv; Milne and Parboteeah (n 49) 23; Financial Conduct Authority CP18/20 (n 53) 22; Zetzsche and Preiner (n 53) 222.

\textsuperscript{136} Financial Conduct Authority CP13/13 (n 49) 13; Kirby and Worner (n 49) 27; The Board of the International Organization of Securities Commissions (n 49) v; Milne and Parboteeah (n 49) 22; Jørgensen (n 49) 259.

\textsuperscript{137} See also Commission, ‘Consultation Document - Crowdfunding in the EU - Exploring the Added Value of Potential EU Action’ (n 12) 7; Financial Conduct Authority CP13/13 (n 49) 14; Kirby and Worner (n 49) 26; European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 14; Milne and Parboteeah (n 49) 23; Commission, ‘Report on Crowdfunding in the EU Capital Markets Union’ (n 47); Zetzsche and Preiner (n 53) 223.

\textsuperscript{138} See also Kirby and Worner (n 49) 27-28; European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 16; The Board of the International Organization of Securities Commissions (n 49) iv; Commission, ‘Report on Crowdfunding in the EU Capital Markets Union’ (n 47) 154; Financial Conduct Authority CP18/20 (n 53) 32; Zetzsche and Preiner (n 53) 223.

\textsuperscript{139} Commission, ‘Responses to the Public Consultation on Crowdfunding in the EU’ (n 50) 8; European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 16.

\textsuperscript{140} European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 17.

\textsuperscript{141} See also Commission, ‘Commission Roadmap to Meet the Long-Term Financing Needs of the European Economy’ (n 12) 7; Financial Conduct Authority CP13/13 (n 49) 14; Kirby and Worner (n 49) 23-26; Commission, ‘Responses to the Public Consultation on Crowdfunding in the EU’ (n 50); European Banking Authority (n 32) 12-14; The Board of the International Organization of Securities Commissions (n 49) iv; Milne and Parboteeah (n 49) 22.
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risks found in the literature: liquidity risk, default risk, CSP failure, information asymmetry, inexperience, fraud risk, pricing, and systemic risk. The reason for the focus on these eight risks in this thesis is that they represent the main concerns attached to crowdlending and hence deserve a substantive and focused discussion.

(1) Liquidity Risk
Liquidity risk arises when ‘revenues and outlays are not synchronised’.142 An investor, CSP and a project owner can be exposed to liquidity risk:

1. Investor

An investor may be exposed to liquidity risk and wish to liquidate their investment before loan maturation.143

2. Project Owner

There may be delays in providing funds to the project owner, thus exposing the project owners to liquidity risk.144 This delay in providing funds to the project owner may be caused by the pre-contractual reflection period which allows non-sophisticated investors to revoke their offer to invest or expression of interest without a reason or incurring a penalty.145

143 European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 13.
144 ibid.
145 ECSPR article 22(2).
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3. CSP

CSPs may be exposed to liquidity risk if there is insufficient funding availability which could lead to failure.146 Some CSPs have responded to liquidity risk by creating an early exit mechanism or a ‘buy-back’. One type of ‘buy-back’ offered is where the CSP will cover the late repayments.147 Another early exit mechanism comes in the form of a secondary market in many instances. The secondary market enables investors to sell their investments before loan maturation if another investor is interested.148 Both ameliorate some liquidity risk for investors. Both may create a false sense of security for the investor and may encourage investment where otherwise the investor may not have invested. Nevertheless, creating a secondary market comes with risks in and of itself. One risk is that investors may not understand how the secondary market operates. Investors, particularly non-sophisticated investors, may construe the secondary market as a way to instantly liquidate their investments. Yet, the liquidation of the investment is contingent on the presence of an investor willing to purchase their investment.

The creation of a secondary market partially addresses the liquidity risk for the CSP also. Providing a mechanism that addresses the investor’s liquidity risk makes investing using a CSP more attractive. Therefore, the secondary market can act as an incentive to invest and increases the pool of potential investors.

146 European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 13.
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By increasing the pool of potential investors, the CSP has taken steps to address the CSP’s own liquidity risk.

All investors will have a varying capacity for liquidity risk. Typically, non-sophisticated investors have short-term liquidity needs because for example ‘they might overreact in times of stressed market conditions or difficult circumstances’\(^{149}\) Thus, there is a variable investor need to liquidate the investment before maturation.

The market had attempted to address liquidity risk before the ECSPR was brought into force. CSPs created secondary markets where investors sell their investments and exit before loan maturation. Secondary markets raise legal uncertainty concerns and send potentially misleading trust signalling.\(^{150}\) The presence of a secondary market may lead investors to believe the investment is quick and easy to liquidate.\(^{151}\) The sale will depend on the demand for the investment and the presence of interested buyers in the market. Where there is liquidity in the market and it is easy to sell investments, investors might be induced to participate in crowdllending due to the ease of doing business.

The secondary market’s inducement to invest and trust signalling also offers benefits to the project owners. The inducement has the potential to indirectly increase the funding pool for platforms and project owners. The regulatory challenge is how and to what extent to intervene to protect investors.

\(^{149}\) Kirby and Worner (n 49) 36-37.
\(^{150}\) Financial Conduct Authority CP18/20 (n 53) 32.
\(^{151}\) ibid.
(2) Default Risk

Default risk arises when the project owner is 90 days past due on their repayment obligation or is unlikely to fulfil their repayment obligations.\textsuperscript{152} Default risk poses significant challenges. If a project owner does not honour his financial obligations, an investor may lose all or part of their investment. This negative experience might mean that the investor does not use that CSP or crowdlending again. If repeated defaults happen with one CSP, it could have reputational impacts for the CSP regardless of whether they are warranted or not.

To guard against and reduce the risk of default, some CSPs have responded by using contingency funds or including a buy-back obligation. The buy-back obligation means that when there is a late repayment, investors can recover their investments.\textsuperscript{153} CSPs that offer a buy-back obligation are paired with a lending company that originates and buys back the loan in the case of late repayment. Then a lending company seeks repayment from the project owner. However, despite being termed a buy-back obligation, it is no guarantee of the investment. It is not compulsory for the lending company to buy back the loan in all circumstances. Therefore, the investor might still lose their investment. Contingency funds, on the other hand, are a discretionary source of money,


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which is funded through fees imposed by the CSP. The CSP can use the contingency fund to cover all or some of the losses suffered by the investor if a project owner defaults. The problem with contingency funds is that investors, especially non-sophisticated investors, may misconstrue a contingency fund as a guarantee of the investment which creates a false sense of security. The contingency fund may encourage investment where an investor may otherwise have decided against the investment.

(3) CSP Failure

While crowdlending as a sector has a short history, some CSPs have already failed such as FundingSecure and Lendy. CSP failure is one of the substantial risks in crowdlending. CSP failure occurs when the CSP is or will become insolvent or where there is a ‘significant defect or default that materially impairs the performance of critical services’. CSP failure impacts both investors and project owners. The CSP may not be able to continue servicing outstanding loans which put the investor at risk of losing the entirety of their investment. Further, it may not, financially, be in the investor’s interest to

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155 Financial Conduct Authority CP18/20 (n 53) 31.
156 ibid.
158 Financial Conduct Authority CP13/13 (n 49) 14; The Board of the International Organization of Securities Commissions (n 49) iv; Milne and Parboteeh (n 49) 23; Financial Conduct Authority CP18/20 (n 53); Zetzsche and Preiner (n 53) 222.
service the loans themselves. The time required to establish the processes involved in servicing their investment might be more than the investment is worth. The project owner may become ‘entangled’ in the CSP failure, particularly if it is a start-up. ‘Disentangling the relationship between an insolvent [CSP...] and an SME may be costlier than the SME is able to afford’. (4) Information Asymmetry

Information asymmetry is where the ‘sellers know the quality of the goods’ offered and the ‘buyers do not’. Information asymmetry if it is not addressed can lead to a market for lemons where high-quality products are no longer offered, and lemons are left because buyers will only pay an average price. Inexperienced individuals suffer most from information asymmetry regardless of whether they are an investor or a project owner.

The project owner and CSP are less exposed to information asymmetry as they have knowledge about their activities. CSPs will likely be knowledgeable about crowdlending and how their business operates. Project owners will likely be knowledgeable about their business and the market within which it operates. However, inexperienced investors or non-sophisticated investors are likely to have the least amount of information about crowdlending and the project owner’s business. CSPs will likely have less information about the project.

160 Financial Conduct Authority (n 49) 14.
161 ibid.
162 Zetzsche and Preiner (n 53) 227.
163 ibid.
Theoretical Framework

owner’s business than the project owner. Similarly, the project owner will likely have less information about crowdlending.\textsuperscript{165}

Disclosures can target information asymmetries.\textsuperscript{166} However, a balance will need to be struck between providing sufficient information to facilitate the investment and protecting their commercial interests, trade secrets and potentially intellectual property.

The Commission has conducted studies on how information can be packaged and presented.\textsuperscript{167} Increasing the comparability of information\textsuperscript{168} and using a

\textsuperscript{165} Valeria Stefanelli and others, ‘Exploring the Lending Business Crowdfunding to Support SMEs’ Financing Decisions’ (2022) 7 Journal of Innovation and Knowledge 1

\textsuperscript{167} See further Commission, Consumer Testing Study of the Possible New Format and Content for Retail Disclosures of Packaged Retail and Insurance-Based Investment Products (n 173); Commission, ‘Behavioural Study on the Digitalisation of the Marketing and Distance Selling of Retail Financial Services Final Report’ (n 173).

\textsuperscript{168} Commission, ‘Behavioural Study on the Digitalisation of the Marketing and Distance Selling of Retail Financial Services Final Report’ (n 173) 130.
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simple approach\textsuperscript{169} in disclosure documents has been found to be effective. Disclosures can come in many forms such as standardised disclosure documents and risk warnings. Standardised disclosure documents vary in their prescription.\textsuperscript{170} Common features of standardised disclosure documents are that a set amount of key information is delivered in a set way at a set length. Standardised disclosure documents aim to ‘increase product transparency and investor understanding, and allow investors easy comparison’.\textsuperscript{171} Some jurisdictions place length and presentation requirements on their standardised disclosure document.\textsuperscript{172} Risk warnings, on the other hand, tend to contain a short message\textsuperscript{173} be a paragraph in length.\textsuperscript{174}

In the case of the ECSPR, the standardised disclosure document is called the Key Investment Information Sheet or the KIIS.\textsuperscript{175} In the KIIS the project owner is responsible for the veracity of the information disclosed and the CSP is ‘responsible for the procedures in place to verify that the information provided is complete, correct and clear’.\textsuperscript{176} The ECSPR has other disclosure

\textsuperscript{169} Commission, Consumer Testing Study of the Possible New Format and Content for Retail Disclosures of Packaged Retail and Insurance-Based Investment Products (n 173) xii.
\textsuperscript{171} Veerle Colaert, ‘MiFID II in Relation to Other Investor Protection Regulation’ in Danny Busch and Guido Ferrarini (eds) Regulation of the EU Financial Markets: MiFID II and MiFIR (Oxford University Press 2017) 600.
\textsuperscript{172} See for example Australia the standardised disclosure document must use a set template, length requirements, examples of how fees would work in practice, which fees are negotiable, font size and more. Australia - Corporations Regulations 2001 Schedule 10E.
\textsuperscript{174} For example, UK - FCA Handbook COBS 18.12.33R.
\textsuperscript{175} ECSPR article 23; See further chapter 3.
\textsuperscript{176} A question asked by ESMA and answered by the European Commission. European Securities and Markets Authority, ‘Questions and Answers: On the European Crowdfunding Service Providers for Business Regulation’ (ESMA35-42-1088, European Securities and Markets Authority
Theoretical Framework

requirements; some are aimed at clients,\(^{177}\) and others are aimed at investors.\(^{178}\) The ECSPR also requires risk warnings in certain circumstances.\(^{179}\) Information is important and the disclosure of information is important. In fact, disclosure requirements were a key part\(^ {180}\) of financial regulation historically.\(^ {181}\) Nevertheless, simply disclosing more complex information does not help matters. Disclosing more information and more complex information increases transaction costs for the market actor.\(^ {182}\) The Global Financial Crisis was a prime example of the risk of inundating the market with information.\(^ {183}\)

Individuals can make investment decisions based on inadequate or inappropriate information. Research shows that narratives influence decision-makers even when credit scores are poor.\(^ {184}\) Some research shows that inexperienced individuals may be better at estimating creditworthiness using

\(^{177}\) ECSPR articles 8(2), 14, 19(3); See further chapter 3.
\(^{178}\) ECSPR article 6(5); See further chapter 3.
\(^{182}\) Spindler, ‘Finance and Investor Protection Regulations’ (153) 322.
Theoretical Framework

soft information that experienced individuals would not take into account.\textsuperscript{185} Furthermore, the packaging of information matters and hence the use of easy-to-understand signals is important.\textsuperscript{186} However, disclosures cannot remedy information asymmetry in isolation and need to be supported by education initiatives.\textsuperscript{187}

\textit{(5) Inexperience}

Crowdlending deals with a range of different actors with varying levels of experience engaging with financial products and services. As a result, inexperience can lead to insufficient risk awareness of the investment. Thus, parties expose themselves to unnecessary and inappropriate risk which has financial impacts as well. For example, where a non-sophisticated investor is partially experienced or fully inexperienced, they may expose themselves to a project owner with a significant default risk or engage in a transaction that is not appropriate for their risk appetite and or portfolio.

Evidence shows inexperienced investors are likely to take on inappropriate risks for their needs, suffer more so from information asymmetry, struggle to decipher the nuance of information when provided and have a lesser capacity

\textsuperscript{185} Rajkamal Iyer and others, ‘Screening Peers Softly: Inferring the Quality of Small Project owners’ (2016) 62 Management Science 1554.
\textsuperscript{187} Ben-Shahar and Schneider, ‘The Failure of Mandated Discourse’ (n 173) 670.
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to bear loss. Inexperienced parties are also more likely to be swayed by factors such as peer recommendations, herding or investor-free-riding. Where parties are inexperienced, regulators have to design regulatory and policy interventions to protect them from themselves, the market and other participants. Recent research further shows that defaults or opt-out frameworks matter because inert and inattentive inexperienced individuals are ‘likely to stick with the default’ position. Inexperienced individuals are at risk of impulse buying, necessitating measures such as postponement or cancellation periods. They are also likely to suffer from disadvantages flowing from information asymmetry.

As a result, measures employed in financial regulation to combat inexperience are measures such as disclosures, investment limits, anti-impulse measures, and advertising requirements. Since individuals ‘weigh losses about twice as much as gains’, financial education is a necessary form of investor and project owner protection.

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188 Zetzsche and Preiner (n 53) 10.
189 Zetzsche and Preiner (n 53) 224.
190 Belleflamme and others (n 50) 30-37, 40.
191 Financial Conduct Authority, ‘Applying Behavioural Economics at the Financial Conduct Authority’ (n 41) 46.
193 Spindler (n 115) 323.
194 Ben-Shahar and Schneider, ‘The Failure of Mandated Disclosure’ (n 173) 670. Although the benefit of financial education is questioned Lauren E Willis, ‘The Financial Education Fallacy’
Theoretical Framework

Experienced investors such as institutional investors, and strategic investors require less protection as they conduct their due diligence before investing. Anecdotal evidence states these due diligence processes force CSPs to take on certain standards in business management, systems, and procedures to attract experienced investors. As such, experienced investors are less likely to require paternalistic protection measures.

(6) Fraud Risk
As with any component of financial services, fraud is a risk that has to be anticipated. Fraud presents itself in various forms. First, one may misrepresent the purpose of the funds. Second, a party may misrepresent information or outrightly deceive in the disclosures. Third, a party may engage in market manipulation of some sort on the secondary market. Regardless of the type of fraud, high instances of fraud will impact consumer confidence in crowdlending. There is a higher chance of fraud in crowdlending because of the internet’s inherent anonymity.

(7) Pricing, Credit Risk Assessment and Credit Scoring
Pricing is an issue in crowdlending because of the amount and complexity of information necessary to conduct a price assessment of a loan. Before the

195 European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 15.
197 ‘money collected is not used for stated purposes’ Commission, ‘Consultation Document - Crowdfunding in the EU - Exploring the Added Value of Potential EU Action’ (n 12) 7.
198 Financial Conduct Authority CP13/13 (n 49) 14.
199 Kirby and Worner (n 49) 26; European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 50) 14.
200 Belleflamme and others (n 50) 20; Adhami and others (n 138) 19-20.
Theoretical Framework

ECSPR, evidence showed that loans on CSPs were mispriced. The presence of non-sophisticated investors and the varying degrees of CSPs’ involvement in pricing also further complicates matters.

There are multiple factors involved in pricing an investment in crowdlending. The loan price should reflect the risk. Credit risk assessments consider various factors and information in making calculations to guard against potential mispricing by CSPs. Since non-sophisticated investors have access to crowdlending, the form, delivery, language, and timing used in the pricing-related disclosures are important.

Some pricing risks arise from the way the CSP has structured its revenue sources. For example, CSP could allow the market to price the loans offered in an auction-style setting. Yet if the CSP does not have in place appropriate systems addressing information asymmetry and investor inexperience, the market will not operate efficiently to price the investment. Another example

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201 Adhami and others (n 138) 19-20.
203 Belleflamme and others (n 50) 20; Lenz (n 138) 696; Jørgensen (n 49) 258-259.
204 See for example which proposes an improved method of calculation to that used in practice Yanhong Guo and others, ‘Instance-based Credit Risk Assessment for Investment Decisions in P2P Lending’ (2016) 249 European Journal of Operational Research 417
205 Adhami and others (n 138) 19-20.
206 Ben-Shahar and Schneider, ‘The Failure of Mandated Disclosure’ (n 173); Spindler (n 115); Solaiman (n 173); Commission, ‘Behavioural Study on the Digitalisation of the Marketing and Distance Selling of Retail Financial Services Final Report’ (n 173) 129.
207 Belleflamme and others (n 50) 20.
208 Some funders may not provide a full credit history but provide other types of information Belleflamme and others (n 50) 24-30, 46.
Theoretical Framework

is if the CSP conducts inadequate credit assessments which leads to loans being priced inefficiently.

Academics like Gabison have warned of investor’s ability to conduct their due diligence and the impact of the herd mentality. Nevertheless, there is research to support the fact that non-expert individuals ‘predict an individual’s likelihood of defaulting on a loan with 45% greater accuracy than the borrower’s exact credit score’. There is also some evidence that non-expert individuals are better able to incorporate soft or non-standard information that traditional credit score methods have been thus far unable to capture. While this does not eliminate the risk of investor biases, non-sophisticated investors may be better able to price loans than previously thought.

(8) Systemic Risk
Systemic risk is where:

- a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences, which causes a chain of financial institution and/or market failures.

210 Iyer (n 192).
211 There is also scope to support traditional credit scoring using for example digital footprints Tobias Berg and others, 'On the Rise of FinTechs: Credit Scoring Using Digital Footprints' (2020) 33 The Review of Financial Studies 2845.
212 Iyer (n 192) 1576.
213 See further: Laura Gonzalez and Yuliya Komarova Loureiro, 'When Can a Photo Increase Credit? The Impact of Lender and Borrower Profiles on Online Peer-to-Peer Loans' (2014) 2 Journal of Behavioural and Experimental Finance 44.
Theoretical Framework

Currently, CSPs are unlikely to present systemic risk concerns as it is thought that they are insufficiently connected at present. In the future, it may be a concern with increasing investor institutionalisation meaning greater interconnections are created between the crowdlending world and the broader world of finance.

3. Conclusion
The ECSPR’s goals have now been examined in light of financial regulatory theory. It was found that the ECSPR’s primary regulatory goal aims to increase the market efficiency and competition of the crowdlending market to enable finance for start-ups and SMEs. The ECSPR’s secondary regulatory goals are a competition regulatory goal and an investor and other users protection financial regulatory goal, while the final secondary goal is partly a goal to create a risk-based financial regulatory model. The remaining part of the ECSPR’s regulatory goals, legal certainty, is analysed in the next section on regulatory theory.

D. The ECSPR and Regulatory Theory
Although this thesis is premised on financial regulatory theory, it is not entirely possible to not refer to a more general regulatory theory foundation. With the result that where there are gaps in financial regulatory theory, general regulatory theory may offer some answers or explanations.

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215 Zetzsche and Preiner (n 53) 226; Eugenia Macchiavello and Antonella Sciarrone Alibrandi, ‘Marketplace Lending as a New Means of Raising Capital in the Internal Market: True Disintermediation or Reintermediation?’ in Emilios Avgouleas and Heikki Marjosola (eds), Digital Finance in Europe: Law, Regulation, and Governance (De Gruyter 2022) 51 Macchiavello.
216 ibid.
Theoretical Framework

As a result, the regulatory theory section of this chapter has three important roles: 1 background and regulatory options, and 2 an auxiliary framework of analysis.

1. Background and Regulatory Options

a) Background

This section provides a brief overview of the development of regulatory theory and models. Regulatory theory is an ever-evolving field. At one point, for example, it was thought that enforcement solely comprised the binary option compliance or deterrence approaches. There are also ideas of smart regulation and problem-centred regulation. There are theories of responsive regulatory theory or autopoiesis where a system would self-sustain balance. Autopoiesis:

“does not mean simply letting things run their course. What autopoietic control in fact means is arranging the interaction and the systems which are to be controlled and developed in

\[\text{\footnotesize{\textsuperscript{217}} Baldwin and others, \textit{Understanding Regulation: Theory, Strategy, and Practice} (n 79) 9.}\]
\[\text{\footnotesize{\textsuperscript{219}} An idea espoused by Sparrow and equated to risk-based regulation. Although Baldwin and Black argue that there are nuanced differences but that both form the building blocks of regulation. Malcolm Sparrow, \textit{The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance} (Brookings Institution Press 2011); Baldwin and others, \textit{Understanding Regulation: Theory, Strategy, and Practice} (n 79) 9; Baldwin and Black, ‘Driving Priorities in Risk-Based Regulation: What’s the Problem?’ (n 136).}\]
\[\text{\footnotesize{\textsuperscript{220}} Ian Ayres and John Braithwaite, \textit{Responsive Regulation: Transcending the Deregulation Debate} (Oxford University Press 1995); Elizabeth Buff, ‘Regulatory Theories and Frameworks’ in Mark Fabian and Robert Breunig (eds), \textit{Hybrid Public Policy Innovations: Contemporary Policy Beyond Ideology} (Routledge 2018).}\]
Responsive regulation is where there are ‘escalating’ levels of government intervention that allow for ‘less intrusive and delegated regulation’. Ayres and Braithwaite explore what these interventions might look like such as tripartism and partial regulation by way of monopsony standards.

In regulatory theory, there is limited consensus on the goals of regulation. Largely, regulatory goals can be described as falling into two categories: public interest goals and market risk goals. However, Prosser further divides public interest goals into human rights and social solidarity.

When these distinctions are applied to the ECSPR, it emerges that there is no clear-cut distinction as one goal can fall into either category. For example, the cross-border provision of services by harmonising rules and protecting investors and clients comes within the public interest category. However, as the analysis under the heading of investor protection and other users demonstrates, protecting investors and clients can be viewed from a market-making perspective that aims to mitigate risk rather than public interest concerns.

222 Ayres and Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (n 227) 4.
223 ibid ch 3.
224 ibid 134.
227 Baldwin and others, Understanding Regulation: Theory, Strategy, and Practice (n 74) 15.
228 Prosser (n 209) 365.
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Thus, protecting investors and clients can be categorised as a public interest and market risk goal or, in Prosser’s terms, social solidarity and market risk goals.\textsuperscript{229}

\textit{b) Regulatory Options}

Over the course of this thesis, there are instances where opt-out regulatory requirements are used. Opt-out measures have a different impact than hard measures and therefore impact the adequacy of addressing the regulatory goal in question. For this reason, it is necessary to explore the theoretical foundations of opt-out regulatory measures.

One of the concepts from regulatory theory is whether the regulatory framework is hard, opt-in, opt-out, or soft. Hard, opt-in, opt-out, and soft are not so much hermetically sealed silos but more of a spectrum.\textsuperscript{230} The analysis in chapters 3 and 4 explores this in the context of investor protection where frequently non-sophisticated investor protection is configured on an opt-out basis. For example, non-sophisticated investors in Australia, New Zealand, and the UK, can self-certify to become categorised as sophisticated investors.\textsuperscript{231} In the EU non-sophisticated investors may request to be treated as sophisticated investors if certain conditions are met.\textsuperscript{232}

\textsuperscript{229} Prosser (n 209) 365.
\textsuperscript{231} Australia – Corporations Act 2001 s 761G(7)(c); New Zealand - Financial Markets Conduct Act 2013 Schedule 1 Clause 41; UK - FCA Handbook COBS 4.12.7R-11G.
\textsuperscript{232} ECSPR annex II part I(1).
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A key component of any definition of hard measures is that it is legally binding. Soft measures may be defined as obligations contained in legal and non-legal instruments with which reasons may be given for non-compliance. Due to the comply or explain nature of soft measures, they are deemed to have choice as an element.

With roots in Economics, opt-in and opt-out measures encourage ‘efficient contracting’. Opt-in is where a choice is required to be governed. Opt-in requires an action to be governed by the regulation. Opt-in harnesses active choosing in that opt-in requires an active choice to participate and makes clear how many are choosing to comply with the law.

Opt-out is defined as when a choice must be made not to be governed. In opt-out, an active choice must be made to stay outside the remit of the

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regulation.\(^{238}\) These opt-out structures apply by default but there is still a choice to be governed by them. Opt-out captures at the outset all passive and proactive market participants. In some instances, the most passive participants will remain within the power of an opt-out. As the most passive participants will not opt-out because the incentive of no regulatory compliance does not work as it requires action. However, the moderately passive market participants will choose to opt-out. What remains is the very passive and those who proactively decide to remain under the remit of the opt-out.

2. Auxiliary Framework - Regulatory Goals

It is at this point that regulatory theory is relied upon as an auxiliary framework. As the financial regulatory theory analysis shows, all but part of one of the ECSPR’s secondary goals can be accounted for in the financial regulatory framework, namely legal certainty.

Legal certainty is a notion that is tangentially referred to in financial regulatory theory but is not explored in depth. Regulatory theory does, however, explore legal certainty as a goal of regulation.\(^{239}\) Even so regulatory theory significantly relies upon legal theory and jurisprudence’s exploration of legal certainty.\(^{240}\)

\[^{238}\text{In some cases, ‘[a]s the cost of contracting around a default rule becomes extremely large, the default [or opt-out] starts to look like an immutable [or mandatory] rule’ Ian Ayres and Robert Gertner, ‘Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules’ (1989) 99 Yale Law Journal 87, 121 footnotes omitted.}\]


Theoretical Framework

Overall in regulatory theory, there is no set agreed list of regulatory goals but legal certainty can be counted as a regulatory goal or outcome.\textsuperscript{241} Black in her article titled ‘Critical Reflections on Regulation’ summarises the matter of regulatory goals as follows: there is little consensus in regulatory theory on the goals of regulation.\textsuperscript{242} Black states that regulatory goals can vary from goals that aim to correct market failures or manage risk.\textsuperscript{243} Others have socio-legal roots such as ‘access to justice, or legitimacy, or achievement of social justice’.\textsuperscript{244} Black further states that there are also normative goals that seek to create Teubner’s ‘conditions for responsiveness’ or responsive regulatory theory.\textsuperscript{245}

This thesis examines whether the ECSPR is adequate in achieving its regulatory goals for crowdfunding and responsive regulation is not a goal set within the ECSPR’s sights. The ECSPR has some element of ‘escalating’ levels of government intervention that allow for ‘less intrusive delegated regulation’.\textsuperscript{246} The tools utilised by the ECSPR are common and well-established measures. One such measure is the gatekeeper function\textsuperscript{247} that CSPs fill. The CSPs’

\textsuperscript{241} Braithwaite (n 223).

\textsuperscript{242} Black, ‘Critical Reflections on Regulation’ (n 232) 9.

\textsuperscript{243} ibid.

\textsuperscript{244} ibid 10 footnotes omitted.

\textsuperscript{245} ibid citing Gunther Teubner, ‘Substantive and Reflexive Elements in Modern Law’ (1983) 17 Law and Society Review 239; Teubner, Law as an Autopoietic System (n 228).

\textsuperscript{246} Ayres and Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (n 227) 4.

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gatekeeping role is concerned with who or what gains access to CS loans and protection measures. For example, knowledge tests,\(^2\) investor classification,\(^3\) pre-contractual reflection period,\(^4\) the bulletin board measures,\(^5\) conflict of interest measures,\(^6\) and asset safekeeping service and payment services measures.\(^7\)

Another tool is the inbuilt review mechanism\(^8\) which allows the EU to query the interventions made under the ECSPR and calibrate them to allow for a less intrusive intervention. The ECSPR could in a way be interpreted to be experimenting with tripartism.\(^9\) While the ECSPR does not go as far as to appoint consumer associations to represent consumers’ interests,\(^10\) it does allow consumer associations to make complaints to National Competent Authorities (‘NCAs’),\(^11\) while the ECSPR requires CSPs to have a complaints mechanism in place for its clients.\(^12\)

As a result, the ECSPR is somewhat responsive by utilising tools such as the gatekeeper role and complaints mechanisms. The review mechanism allows

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248 ECSPR article 21.
249 ibid.
250 ECSPR article 22.
251 ECSPR article 25.
252 ECSPR article 8.
253 ECSPR article 10.
254 ECSPR article 45.
255 Ayres and Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (n 227).
257 ECSPR article 38.
258 ECSPR article 7.
Theoretical Framework

limited responsiveness to the market as it develops but only allows a single interaction. The ECSPR does not reach the state of autopoietic control where the interaction and systems are arranged so that they can regulate themselves and control each other.\(^{259}\) There have been significant innovations since Teubner authored *Law as an Autopoietic System*. The UK for example is notably innovating with various regulatory tools: innovation hubs, sprints, regulatory sandboxes, and digital sandboxes.\(^{260}\) Each of these regulatory tools allows responsiveness to some extent. For example, the digital sandbox enables the regulator to seek a response from the market to a particular challenge. Now the examination focuses on the ECSPR’s goal of legal certainty.

**a) Legal Certainty**

Legal certainty has been examined by legal philosophers such as Dworkin,\(^{261}\) Driver,\(^{262}\) and Raz\(^ {263}\) arguing as to precision in law. The challenge of specificity is that while it brings clarity, specific legal frameworks struggle as the subject

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\(^{259}\) Teubner, *Law as an Autopoietic System* (n 228) 68 citing Bühl, ‘Grenzen der Autopoiesis’ (n 228) 247.


\(^{261}\) Dworkin (n 223) 27.


\(^{263}\) Raz (n 223).
Theoretical Framework

matter evolves.\textsuperscript{264} Thus over time, this creates a ‘smorgasbord of rules [engendering...] a cat and mouse legal drafting culture - of loophole closing and reopening by creative compliance’.\textsuperscript{265}

Regulatory theory explored legal certainty in terms of principles-based regulatory models as against detailed rules-based regulatory models.\textsuperscript{266} Braithwaite sets out a theory of legal certainty as where, in the beginning, clarity and specificity are first needed, but once the subject matter evolves general principles are instead necessary.\textsuperscript{267} When Braithwaite’s theory of legal certainty is applied to crowdlending, it follows that to achieve the ECSPR’s goal of legal certainty, the ECSPR will need to be specific as it is the first foray into crowdlending regulation.

Without delving further into the labyrinth of philosophical arguments as to rule specificity and legal certainty,\textsuperscript{268} we explore the broader context within which the ECSPR operates. Crowdlending is a new phenomenon that was unregulated at EU level. Before the ECSPR, it was unclear which EU Directives and Regulations applied and which did not apply.\textsuperscript{269} Crowdlending was left to individual Member State responses. Further, even where it could be said that

\textsuperscript{264} Braithwaite (n 223).
\textsuperscript{265} Braithwaite (n 223) 57.
\textsuperscript{266} Korobkin, ‘Behavioral Analysis and Legal Form: Rules vs. Standards Revisited’ (n 246); Schauer, ‘The Convergence of Rules and Standards’ (n 246); Schauer, ‘The Tyranny of Choice and the Rulification of Standards’ (n 246); Black, ‘Critical Reflections on Regulation’ (n 232); Ford, ‘New Governance, Compliance, and Principles-Based Securities Regulation’ (n 89).
\textsuperscript{267} Braithwaite (n 223) 47.
\textsuperscript{268} Ibid.
\textsuperscript{269} See chapter 1 C. EU Policy and Regulatory Agenda.
Theoretical Framework

certain EU Directives and Regulations applied, at times the application was context specific to certain crowdlending business models.\textsuperscript{270}

Before the ECSPR, there was significant market fragmentation which reduced legal certainty for CSPs. Crowdlending was regulated on a national basis across the EU. Crowdlending was first regulated in France in 2014.\textsuperscript{271} In France, a CSP could choose to be called \textit{intermédiaire en financement participatif} (crowdfunding investment intermediary) or IFP.\textsuperscript{272} On the other hand, Germany has regulated crowdlending since 2015\textsuperscript{273} but due to the regulatory framework, CSPs had to pair with banks which in turn originated the loan.\textsuperscript{274} In Italy, crowdlending was recognised by the Bank of Italy and CSPs had to apply for licences under Legislative Decree 385/1993 - \textit{Testo unico delle leggi in materia bancaria e creditizia} or the Italian Consolidated Law on Banking.\textsuperscript{275} In Belgium, crowdlending was not legally possible before the ECSPR.\textsuperscript{276} The laws in Belgium required each of the investors to have a banking licence before contributing to crowdlending. Yet other Member States such as the Republic of Ireland stated that they would wait for the EU to address crowdlending’s regulatory issues.\textsuperscript{277}

\textsuperscript{270} See further Commission, ‘Unleashing the Potential of Crowdfunding in the European Union’ (n 11) 7.
\textsuperscript{272} France - Code Monétaire et Financier article L548-1; Gajda (n 278) 216.
\textsuperscript{273} Germany - Kleinanlegerschutzgesetz; Gajda (n 278) 238.
\textsuperscript{274} ibid.
\textsuperscript{275} Gajda (n 278) 369.
The difference in Member State approaches to crowdlending resulted in legal uncertainty and market inefficiency across the EU.\textsuperscript{278} It also posed a challenge for CSPs seeking to establish themselves in multiple Member States due to diverse regulatory regimes for crowdlending. The potential for regulatory arbitrage was greater as CSPs could cherry-pick\textsuperscript{279} jurisdictions where regulatory intervention was minimal or the least onerous. The lack of regulatory intervention from the EU may have reduced investor uptake of crowdlending. The risk of participating in an unregulated market led many to wait for certainty in the sector and in the meantime, investors invested in other areas. As a result, the possibility of fraud and money laundering was also increased in those Member States where active steps to apply existing frameworks to crowdlending were not taken.

There remained uncertainty at the time as to which EU laws covered crowdlending. For example, it was not entirely covered under MiFID II\textsuperscript{280} and did not come directly within the Consumer Credit Directive\textsuperscript{281}. Notwithstanding this, Member States’ individual implementation of the Consumer Credit Directive may broaden the Consumer Credit Directive’s scope.\textsuperscript{282} For example, the Netherlands, Finland and Lithuania expressly extended the national

\begin{footnotesize}
\textsuperscript{278} For further exploration of EU laws application to crowdlending prior to the ECSPR see Commission, ‘Report on Crowdfunding in the EU Capital Markets Union’ (n 47) 25-30.
\end{footnotesize}
Theoretical Framework

implementation of the Consumer Credit Directive to consumer crowdlending. However, the Commission noted that ‘there are uncertainties as to whether the definition of “creditor” is entirely fit for purpose to address new forms of lending that have appeared online (peer-to-peer lending, crowdfunding)’. Only in certain circumstances would crowdlending come within the scope of the Consumer Credit Directive. This made the need for regulation all the more pressing. More specifically it made the need for the ECSPR even more pressing to address the regulatory uncertainty.

Crowdlending would only be regulated under the Consumer Credit Directive if the entity or person granting the credit grants ‘credit in the course of his trade, business or profession’. Whether the Consumer Credit Directive applies depends on who grants the credit in the crowdlending transaction and whether they grant credit in the course of their business. If the CSP grants credit in the course of their business, crowdlending would come under the Consumer Credit Directive. Yet, if the CSP’s business model is constructed so that the investors

285 Sebastiaan Niels Hooghiemstra, ‘Will the Proposed European Crowdfunding Regulation Lead to a “True” European Market for Crowdfunding?’ (25 July 2019) 5. See also Jørgensen (n 49) 249.
286 Consumer Credit Directive article 3(b).
287 Consumer Credit Directive; See also Jørgensen (n 49) 249.
Theoretical Framework

grant the credit, crowdlending is not within the Consumer Credit Directive.\(^{288}\)

The application of the Consumer Credit Directive would depend on whether the investor grants credit in the course of their business.\(^{289}\)

Other EU laws might have covered crowdlending, for example, the UCTD\(^ {290}\). However, the UCTD, as with most EU consumer laws, envisages a B2C contract. Crowdlending did not neatly fall into this box as the contracts could easily be C2C. Similar challenges arise in the context of the Distance Marketing Directive.\(^ {291}\)

Before the ECSPR, there was no contribution to single market objectives. There was no pan-EU regime that enabled for example passporting, a single investor protection framework, an approach to information obligations and credit risk assessment methodologies. As will be shown in the analysis in chapter 3, the ECSPR has made a significant contribution to single market objectives. As a result, failure under the regulatory goal of legal certainty would be if the ECSPR’s scope was not clear and if the ECSPR was not sufficiently detailed according to Braithwaite’s framework.\(^ {292}\)

In summary, the main legal uncertainty issue crowdlending faced before the ECSPR was the lack of an EU legal framework.\(^ {293}\) The lack of an EU legal framework specifically catering for the EU crowdlending market combined with

\(^{288}\) Consumer Credit Directive.

\(^{289}\) Consumer Credit Directive article 3(b).


\(^{292}\) Braithwaite (n 223) 47.

\(^{293}\) Commission, ‘Responses to the Public Consultation on Crowdfunding in the EU’ (n 50) 16.
Theoretical Framework

crowdlending falling between the existing EU regulatory responses reduced market clarity.

Thus, while it is important to refer to the philosophical debates in regulatory theory on legal certainty, it is worth acknowledging that for crowdlending legal certainty operates at a basic level also; crowdlending has never been regulated at an EU level before. True the granular philosophical debates as to legal clarity, certainty and specificity remain. Nevertheless, legal certainty will be provided in part for crowdlending by having a crowdlending regulatory framework in the first instance.

3. Conclusion
To conclude the regulatory frameworks will also be analysed according to whether they are adequate in addressing legal certainty. Braithwaite’s theory of legal certainty will be used to frame the legal certainty analysis.294

E. Application to the Comparator Jurisdictions’ Goals
This section sets out and examines the crowdlending regulatory goals in the comparator jurisdictions (Australia, New Zealand, the UK, and the US) in light of the financial regulatory and regulatory theory framework outlined in this chapter.

There are varying degrees of clarity in the comparator jurisdictions as to the goals underpinning their crowdlending regulatory frameworks. In many of the jurisdictions examined, the regulators’ mandates form the basis of the goals for

294 Braithwaite (n 223).
Theoretical Framework

the crowdlending regulatory response. This is true for Australia, the UK, and the US.

In Australia, one of ASIC’s objectives is ‘to promote investor and financial consumer trust and confidence’.

This goal is an investor protection goal. The UK regulator has two mandates: one to protect consumers and the other to promote ‘effective competition in the interests of consumers’. In terms of the goals explored in this chapter, the UK has an investor protection and other users goal and a competition goal.

Australia and the UK have relatively clear indicators of the goals underpinning their regulatory frameworks whereas the US is not as clear. The US White Paper on crowdlending and the US Government Accountability Office Report (‘US GAO Report’) each set out different goals for crowdlending regulation. The US GAO Report focuses on consumer protection. However, the US White Paper targets SME borrower protection, sound borrower experience and backend operations, a transparent marketplace and expanding access to

297 Financial Conduct Authority PS14/4 (n 88) 6.
300 GAO Report (n 306) 3.
Theoretical Framework

credit.\textsuperscript{301} The analysis in chapter 4 shows neither of these statements aligns with the US crowdlending regulatory framework. Nevertheless, the analysis in chapter 4 shows that Regulation Crowdfunding does align with the SEC’s mandate of investor protection.\textsuperscript{302} Ultimately, the US uses the same approach as Australia and the UK, where the regulator’s mandate becomes the basis for the crowdlending regulatory framework.

New Zealand has a different approach. New Zealand developed its crowdlending regulation goals as part of its development of the goals for Financial Markets Conduct Act 2013 which is wide-ranging in its remit.\textsuperscript{303} The overarching goals for the entirety of the Financial Markets Conduct Act 2013 are to ‘promote the confident and informed participation of businesses, investors and consumers in the financial markets’ and to ‘promote and facilitate the development of fair, efficient, and transparent financial markets’.\textsuperscript{304} Both goals are market efficiency goals as they concern increasing information in the market. New Zealand specifically sets out a legal certainty regulatory goal for crowdlending by stating that New Zealand seeks to address inconsistent and inadequate product regulation and clarity on disclosure requirements.\textsuperscript{305} New Zealand also assessed the impact of the crowdlending element of the regulatory framework according to other regulatory goals: (1) investor information, (2) appropriate governance, (3) compliance costs, and (4) innovation and flexibility.\textsuperscript{306} Thus,

\textsuperscript{301} US Department of the Treasury White Paper (n 305) 2.
\textsuperscript{302} GAO Report (n 306) 4.
\textsuperscript{304} Ministry of Business, Innovation and Employment (n 310) [20].
\textsuperscript{305} Ministry of Business, Innovation and Employment (n 310) [16].
\textsuperscript{306} Ministry of Business, Innovation and Employment (n 310) [197].
New Zealand also has investor protection and market efficiency goals and seeks to create a business conduct regulatory model. The final goal of innovation and flexibility is gaining traction in the financial regulatory sphere, particularly in the context of innovation hubs, regulatory sandboxes, and digital sandboxes.\(^{307}\) The innovation and flexibility goals are not financial regulatory goals as explored in this chapter. However, considering the overarching goal of market efficiency, they are a means to serve the market efficiency goal. It appears that New Zealand’s view is that by supporting innovation and allowing flexibility that the allocative efficiency of the market can be increased.

Taken in combination all the comparator jurisdictions align with the financial regulatory and regulatory theory goals identified in the ECSPR. The below table outlines where the goals overlap:

<table>
<thead>
<tr>
<th>ECSPR’s Goals</th>
<th>Countries where the Goals are Present</th>
</tr>
</thead>
</table>

Theoretical Framework

<table>
<thead>
<tr>
<th>Competition</th>
<th>The UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market efficiency</td>
<td>New Zealand</td>
</tr>
<tr>
<td>Investor protection and other users</td>
<td>Australia, New Zealand, the UK, the US</td>
</tr>
<tr>
<td>Risk-based regulatory model</td>
<td></td>
</tr>
<tr>
<td>Legal Certainty</td>
<td>New Zealand</td>
</tr>
</tbody>
</table>

The only goal where there is no overlap between the ECSPR and the comparator jurisdictions is the goal to create a risk-based regulatory model. However, as the analysis shows in chapter 4, this is not a problem for the comparative analysis. It seems that while the comparator jurisdictions have not enumerated a risk-based regulatory model as a goal, many have designed their crowdlending regulatory framework using at the very least in part a risk-based regulatory model.

The above table shows that the UK and the ECSPR both have a competition goal. However, the UK configures its competition goal differently from the ECSPR. The UK focuses on ‘effective competition in the interests of consumers’.\(^{308}\) Yet the ECSPR uses a competition goal that focuses on the benefits for start-ups and SMEs.\(^{309}\) Both aim to encourage cost efficiencies, lower prices, and innovation.

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\(^{308}\) Financial Conduct Authority PS14/4 (n 88) 6.

\(^{309}\) See further g) Application to the ECSPR.
Theoretical Framework

**F. Conclusion**
This chapter has addressed the first step outlined in chapter 1 which constitutes part of the answer to my central research question to examine the ECSPR’s regulatory goals in the context of financial regulatory theory and regulatory theory. This provides a framework for the analysis of the ECSPR. The examination of the comparator jurisdictions’ goals demonstrates that both the ECSPR and the comparator jurisdictions have similar goals. These similar goals form the basis of the comparative analysis. The exception to this is the risk-based regulatory model. However, the analysis in chapter 4 demonstrates that while a risk-based regulatory model may not be enumerated as a specific goal the comparator jurisdictions appear to have nonetheless responded on a risk-based regulatory model basis. Conducting this part of the examination of the ECSPR’s regulatory goals has led to several important conclusions.

The ECSPR’s primary goal is to ensure seamless and expedient access to capital markets for start-ups and SMEs, reduce financing costs and avoid delays and costs for crowdlending (‘primary goal’). The ECSPR aims to achieve its primary goal by achieving other secondary goals namely (1) enabling the cross-border provision of services by harmonising rules, (2) protecting investors and clients, (3) providing legal certainty, and (4) reducing risk.

First, the ECSPR’s primary regulatory goal aims to increase the market efficiency and competition of the crowdlending market to enable finance for

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310 ECSPR recitals 3, 54, 60.
311 ECSPR recitals 6, 8, 18, 30, 33, 58, 61-66.
312 ECSPR recitals 7, 16, 18, 24, 36, 42-47, 50-54, 56.
313 ECSPR recitals 58, 76.
314 ECSPR recitals 18, 23, 30, 24.
Theoretical Framework

start-ups and SMEs. The ECSPR’s secondary regulatory goal (1) is a competition regulatory goal and (2) is an investor and other users protection financial regulatory goal. Yet (3) is a mix of a risk-based financial regulatory model and a broader regulatory theory goal of legal certainty. It is now necessary to consider how the ECSPR acts upon these regulatory goals in the next chapter.

As a result, the framework of analysis of this thesis in chapters 3 and 4 examining the ECSPR and the regulatory frameworks internationally will begin with a financial regulatory goal analysis, then move to a financial regulatory model analysis and close with a regulatory theory analysis. The financial regulatory goal analysis will examine competition, market efficiency, and investor protection and other users. The financial regulatory model analysis will focus on a risk-based regulatory model using the risks identified in this chapter namely: liquidity risk, default risk, CSP failure, information asymmetry, inexperience, fraud risk, pricing, credit risk assessment and credit scoring, and systemic risk. Finally, the regulatory theory analysis will close with the examination of legal certainty.
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CHAPTER III. EU’S REGULATORY RESPONSE TO CROWDLENDING

A. Introduction
This chapter explores the EU’s response to crowdlending in light of the ECSPR’s regulatory goals using the framework set out in chapter 2\(^1\) which begins with a financial regulatory goal analysis in Section B, then moves to a financial regulatory model analysis in Section C, and closes with a regulatory theory analysis in Section D. In Section B financial regulatory goal analysis will examine competition, market efficiency, and investor protection and other users. The Section C financial regulatory model analysis will focus on a risk-based regulatory model using the risks identified in this chapter: liquidity risk, default risk, CSP failure, information asymmetry, inexperience, fraud risk, pricing, credit risk assessment and credit scoring, and systemic risk. Finally, in Section D the regulatory theory analysis will close with the examination of legal certainty.

This chapter carries out step 2 of the research methodology - how the ECSPR acts upon its regulatory goals. This analysis is then used in chapter 4 to answer whether, by comparison, the ECSPR is adequate in achieving its regulatory goals for crowdlending against the approach in Australia, New Zealand, the UK, and the US in achieving goals that are similar to the ECSPR’s goals.

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EU’s Regulatory Response to Crowdlending

Section B sets out the ECSPR’s taxonomy. Section C explores the ECSPR’s scope. Once this is completed, the goal analysis commences. Section D examines the ECSPR’s response to its financial regulatory goals of competition, market efficiency and investor protection and other users. Section E examines how the ECSPR acts upon its goal to be a risk-based regulatory model. Section F explores the regulatory goal of legal certainty and examines whether the ECSPR has addressed legal certainty in its regulatory framework for crowdlending. Section G provides comments and Section H offers conclusions.

**B. ECSPR Taxonomy**

The ECSPR has established its taxonomy for crowdfunding and crowdlending.

The below table sets out the taxonomy and its meaning:

<table>
<thead>
<tr>
<th>ECSPR Language</th>
<th>Meaning</th>
<th>Thesis Taxonomy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crowdfunding service for the facilitation of granting of loans (‘CS loans’)²</td>
<td>Crowdlending</td>
<td>Crowdlending</td>
</tr>
<tr>
<td>Loan³</td>
<td>Loan</td>
<td>Loan</td>
</tr>
<tr>
<td>Investor⁴</td>
<td>Person who gives funds with the expectation of a financial return. These persons can be investor or non-sophisticated investor</td>
<td>Investor - non-sophisticated</td>
</tr>
</tbody>
</table>

² ECSPR article 2(1)(a).
³ ECSPR article 2(1)(b).
⁴ ECSPR article 2(1)(i)-(k).
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<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>experienced or inexperienced</td>
<td>and are split into sophisticated and non-sophisticated investors. Generally, a sophisticated investor is experienced, and a non-sophisticated investor is inexperienced.</td>
</tr>
<tr>
<td>Project Owner</td>
<td>Person who receives the funds as a loan with the intention of returning the funds over time with interest</td>
</tr>
<tr>
<td>Client</td>
<td>Any prospective investor or prospective project owner</td>
</tr>
<tr>
<td>Crowdfunding platform</td>
<td>Online system of intermediation where crowdlending occurs</td>
</tr>
</tbody>
</table>

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5 ECSPR article 2(1)(h).
6 ECSPR article 2(1)(g).
7 ECSPR article 2(1)(d).
EU’s Regulatory Response to Crowdlending

<table>
<thead>
<tr>
<th>Crowdfunding service provider (‘CSP’)</th>
<th>The legal person providing for this thesis a crowdlending service</th>
<th>CSP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crowdfunding project</td>
<td>The activity for which the funds are being given such as a Gin distillery.</td>
<td></td>
</tr>
<tr>
<td>Crowdfunding offer</td>
<td>Communications and information and terms that relate to the loan that potentially lead to a contract</td>
<td>Crowdfunding offer</td>
</tr>
</tbody>
</table>

**Figure 1 ECSPR Terminology**

**C. Scope**

The ECSPR negatively defines its scope. Explicitly excluded from the ECSPR are crowdfunding services provided to consumer project owners, non-financial return crowdfunding, and crowdfunding offers of more than €5 million over 12 months. As a result, the ECSPR applies to crowdfunding service providers for the facilitation of granting loans to business project owners. Further, credit

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8 ECPSR article 2(1)(e).
9 ECSPR article 2(1)(l).
11 ECSPR article 2(1)(f).
12 ECSPR article 1(2)(a).
13 ECSPR article 1(2)(b).
14 ECSPR article 1(2)(c).
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institution regulation does not apply to the crowdfunding service provider for the facilitation of granting of loans. In other words, crowdlending comes within the scope of the ECSPR for those who do not conduct banking activities. The ECSPR’s scope is largely adequate in ensuring business funding falls within the scope of permitted activities. However, very early-stage businesses frequently rely on personal finance and loans. Currently, this is not regulated on a pan-EU level and is left to individual Member State responses.

1. Crowdlending Definition
Crowdfunding service in the ECSPR is defined as:

the matching of business funding interests of investors and project owners through the use of a crowdfunding platform and

which consists of any of the following activities:

(i) the facilitation of granting of loans; [...] 17

There is no definition for the facilitation of granting of loans in the ECSPR. 18

Recital 11 of the ECSPR distinguishes the facilitation of granting of loans from credit institutions’ activities i.e., granting credit on its own account and taking deposits. Recital 11 of the ECSPR also refers to the fact that the definition of

15 ECSPR article 1(3).
17 ECSPR article 2(1)(a)(i).
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CS for lending should accommodate different business models that enable loan agreements.

There is however a definition for loans in article 2(1)(b) of the ECSPR as:

an agreement whereby an investor makes available to a project owner an agreed amount of money for an agreed period and whereby the project owner assumes an unconditional obligation to repay that amount to the investor, together with the accrued interest, in accordance with the instalment payment schedule;

[...]

In summary, loans under the ECSPR are not bank loans because recital 11 of the ECSPR distinguishes loans under the ECSPR from credit institutions’ activities. Interest-free loans such as those provided by Kiva are not within the scope either. Confusingly the definition of a loan in the ECSPR leans toward traditional credit agreements while the overall thrust of the ECSPR leans toward relationships with an investment rather than a traditional loan. Furthermore, while CSPs are obliged to report to ESMA, the ECSPR requires ESMA and EBA to collaborate to draft the regulatory technical standards. This need for collaboration recognises that crowdlending is difficult to situate and does not neatly fall within the expertise of ESMA or EBA. The crowdlending challenge

19 This is challenging for instruments such as hybrid equity and debt securities and non-transferable debt instruments because crowdlending is a form of debt that is transferrable, but it is not a security under the ECSPR. See further Konstantinos Serdaris, ‘Behavioural Economic Influences on Primary Market Disclosure - The Case of the EU Regulation on European Crowdfunding Service Providers’ (2021) 18 European Company and Financial Law Review 428, 457.
20 ECSPR article 16.
21 ECSPR articles 6(7), 19(7), 20(3), 21(8).
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requires the skill sets of both ESMA and EBA. This explicitly recognises the different regulatory capacities and resources\textsuperscript{22} of ESMA and EBA. Both ESMA and EBA have discrete experiences reflecting the traditional divide in finance that of securities and markets on one hand and banking on the other. The challenge is that crowdlending sits neatly in this divide calling into question the definition of a loan and security.

2. Consumer Credit
The ECSPR does not include crowdlending for consumer project owners in its scope.\textsuperscript{23} This is because the overall aim of the ECSPR is ‘to foster cross-border funding of business’.\textsuperscript{24} What can be extrapolated from this, is that the EU is well aware that consumer project owners are a grey area, and a policy decision was made to solely address business crowdlending. It also implies that consumer borrowers represent a different regulatory challenge because when consumer crowdlending was still included in the Proposal for a Consumer Credits Directive different protections were afforded to consumer borrowers such as the possibility of early repayment.\textsuperscript{25} It has led to some academics recommending

\begin{footnotesize}
\begin{itemize}
\item This point is made clear in article 1(2)(a) of the ECSPR that the ECSPR does not apply to ‘crowdfunding services that are provided to project owners that are consumers’ as defined in article 3(a) of the Consumer Credit Directive.
\end{itemize}
\end{footnotesize}
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not only that the ECSPR should be expanded to cover consumer loans but also an ‘extension of most [...] Consumer Credit Directive] protections’.26

3. €5 Million Limit
The ECSPR sets a €5 million limit on crowdlending offers provided.27 The €5 million limit is calculated over 12 months as the sum of the loans raised through a CSP ‘by a particular project owner’.28 However, the 12-month calculation also includes any amounts raised through crowdequity under the ECSPR and any funds raised under the exemptions under articles 1(3) or 3(2) of the Prospectus Regulation.29 Article 1(3) of the Prospectus Regulation exempts public offers of securities under €1 million from prospectus requirements. Article 3(2) of the Prospectus Regulation allows Member States to exempt public offers of securities up to €8 million. Furthermore, article 49 of the ECSPR means that Member States if they have a lower threshold than €5 million for their prospectus exemption may continue to apply this exemption for 24 months from 10 November 2021.30

27 ECSPR article 1(2)(c)(i).
28 ibid; See also Marika Salo-Lahti and Vesa Annola, ‘Investor Protection Strategies in Crowdfunding Regulation: The 4-I’s Model’ in Panu Kalmi and others, Responsible Finance and Digitalisation: Implications and Developments (Routledge 2023) section 11.4.2.
30 Serdaris (n 19) 444.
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As a result, article 1(2) of the ECSPR is quite restrictive and will require careful communication to project owners. Anything raised by the project owner using the ECSPR and one of the two exemptions in the Prospectus Regulation will count towards the calculation of €5 million over the course of 12 months.

The €5 million limit set by the ECSPR has been questioned. In the ECSPR development stages, an €8 million limit was proposed following European Crowdfunding Network’s recommendation. Nevertheless, this idea was discarded. One reason for the €5 million limit was because it ‘is the threshold used by most Member States to exempt’ securities offers from prospectus requirements. The EU was conscious of the potential overlap between the ECSPR and EU prospectus requirements and made provision for temporary derogations to lessen disturbance to the internal market’s functioning.

4. Other Services

Article 1(2)(b) of the ECSPR states ‘other services related to those defined in point (a) of Article 2(1) and that are provided in accordance with national law’ are outside the scope of the ECSPR. Considering the draft Delegated

31 ECSPR article 1(2)(c)(i).
32 Serdaris (n 19) 455-456.
35 ECSPR recital 16; Prospectus Regulation.
36 ECSPR recital 17.
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Regulation’s general usage of the phrase ‘other services’,\textsuperscript{37} it might be taken to mean the services that might be provided in conjunction with crowdrlending that is regulated by national law. It is not clear.

D. Financial Regulatory Goals
This section provides the financial regulatory goal analysis that will examine competition, market efficiency, and investor protection and other users.

1. Competition
a) Passporting
One of the key components of the ECSPR that contributes to the competition financial regulatory goal is the ECSPR’s passporting mechanism.\textsuperscript{38} As explored in chapter 2, Armour and others’ configuration of competition includes removing the barriers to international competition by allowing the passporting of services in the EU.\textsuperscript{39} The passporting mechanism in the ECSPR allows CSPs to provide their services in more than one Member State.

If a CSP wishes to provide their services in another Member State, the CSP must comply with certain information obligations. The CSP must inform the NCA that granted authorisation of the Member States that:

- where the CSP intends to provide its services,


\textsuperscript{38} ECSPR article 18.

\textsuperscript{39} See also chapter 2; John Armour and others, Principles of Financial Regulation (Oxford University Press 2016) 68.
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- the identity of the persons responsible for the services in each of the Member States,
- the date from which the CSP intends to provide the services, and
- list the CSPs’ other activities provided that are outside the scope of the ECSPR.  

The CSP may provide those services in the listed Member States once the authorising NCA has communicated the information to the relevant NCAs and ESMA and confirms to the CSP that this communication has taken place.  

The CSP may also provide its services in the listed Member States if 15 calendar days have passed since the information was provided to the authorising NCA. The administrative burden involved in the passporting mechanism is minimal, but it is nonetheless present. The fact that a CSP is authorised in the EU does not mean it can on an impulse commence providing services in another Member State.

Importantly, CSPs are not required to have a physical presence in all the Member States the CSP provides its services. A CSP is only required to have a physical presence in the Member State that granted the authorisation.

The ECSPR passporting mechanism significantly contributes to the competition financial regulatory goal. Before the ECSPR, pan-EU passporting of crowdlending services was not possible. There were significant barriers to

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40 ECSPR article 18(1)(a)-(d).
41 ECSPR article 18(4).
42 ibid.
43 See further a) Authorisation.
44 ECSPR article 12(12).
45 ibid; See further a) Authorisation.
providing crowdlending services in multiple Member States. For example, in 2018 if a CSP wished to provide their services between two Member States such as Ireland and the UK it would not have been possible. There was a clear authorisation regime in the UK.\textsuperscript{46} However, in Ireland, the legislature was waiting for the EU to regulate crowdlending.\textsuperscript{47} While it may have been impressive for a CSP who already had an authorisation in the UK to seek to provide their services in Ireland there was no possibility of passporting their services between the two jurisdictions. Now, on the condition the authorising NCA has given the required information, CSPs can easily passport their services across the EU such as Crowdcube Europe which was authorised by the Spanish NCA, and began providing its services across the 27 Member States in 2022.\textsuperscript{48}

\textbf{b) Harmonisation}

As explored in chapter 2, for the ECSPR to promote competition using Armour and others’ conception of competition\textsuperscript{49} the ECSPR will need to fully harmonise crowdlending regulation across the EU and enable the passporting of services. Section a) examined the passporting of services in the ECSPR.

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\textsuperscript{46} See further chapter 4.


\textsuperscript{49} John Armour and others, \textit{Principles of Financial Regulation} (n 39) 68.
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The analysis in this section shows that the ECSPR has not fully harmonised crowdlending regulation. This section analyses two parts of the ECSPR which are left to Member States namely 1 sanctions and 2 marketing communications.

(1) Enforcement
As explained in chapter 2, this section analyses the enforcement mechanisms. Part (a) explores the natural persons that can constitute the CSP’s management board. Part (b) examines the persons that can be project owners and investors in crowdlending. Part (c) investigates the ECSPR’s enforcement mechanisms and roles. Part (d) considers how the ECSPR addresses cross-border infringements. Part (e) probes the questions of regulatory arbitrage and jurisdiction shopping in the context of enforcement. Part (f) concludes.

(a) CSPs
This section examines the natural persons that can constitute the management board of the CSP. The ECSPR’s authorisation process requires CSPs to prove that the ‘natural persons’ on the CSPs’ management board have no criminal record and have enough skills, knowledge, and experience. The knowledge and absence of criminal record requirements mean that the persons that form the management board of the CSP are relatively well-informed and relatively well-intentioned. This also means that CSPs are more likely to be well-informed and well-intentioned. Regardless, there is still a margin for creative compliance where the spirit of the law is obfuscated by the CSP. For example, bulletin

50 See further a) Authorisation.
51 ECSPR article 12(3).
EU’s Regulatory Response to Crowdlending

boards\textsuperscript{53} must only be used to advertise an interest in buying and selling loans.\textsuperscript{54} Bulletin boards must not match interests.\textsuperscript{55} A CSP could create a separate company that is not a CSP that matches buying and selling interests advertised on the bulletin board. While MiFID II might apply to this separate company,\textsuperscript{56} it would be a case of a potential case of creative compliance with the ECSPR.

\textit{(b) Project Owners and Investors}

How does the ECSPR ensure that project owners and investors comply with the ECSPR? Unfortunately, Baldwin’s paradigm\textsuperscript{57} provides little assistance in examining project owners and investors. It is difficult to ascertain what sort of intention the project owners and investors might have and how well-informed the project owners and investors are. Under the ECSPR, project owners can only seek funding for a business while ‘natural persons’ and businesses can be investors.

\textit{(i) Investors}

Under the ECSPR investors can be categorised as sophisticated or non-sophisticated investors. Investors do not need to pass any criteria that determine their intention. Be it good intentions or otherwise. Sophisticated investors must be aware of the risks associated with investing in capital markets and have adequate resources to undertake the risk without exposing themselves

\textsuperscript{53} See further b) Secondary Market.
\textsuperscript{54} ECSPR article 25(1).
\textsuperscript{55} ECSPR article 25(2).
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to excessive financial risk. If the investor is a legal person, the classification as a sophisticated investor falls under one of three fiscal criteria. If the investor is a ‘natural person’, the categorisation falls on whether the ‘natural person’ has experience in investing in or of the financial sector. However, the categorisation as a sophisticated investor can also fall on the personal wealth of the ‘natural person’ or that an investor has opted out of the non-sophisticated investor status.

The classification of a non-sophisticated investor is based on the results of the knowledge test and the simulation ability to bear loss. If the non-sophisticated investor does not provide the information or in the CSP’s opinion lacks the experience, they are provided with a risk warning which must be acknowledged by the non-sophisticated investor.

It is possible to change from being classified as a non-sophisticated investor to a sophisticated investor. An acknowledgement of the risk warning appears sufficient, and the investor may proceed with the investment as a sophisticated investor. This, however, is implied from the ECSPR. If it is true, the knowledge

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58 ECSPR annex II(l).  
59 ECSPR annex II(l)(1); See also (a) Investor Classification.  
60 ECSPR annex II(l)(2)(b), (c); See also (a) Investor Classification.  
61 ECSPR annex II(l)(2)(a).  
62 ECSPR annex II part I(1).  
63 See further (b) Knowledge Test and Risk Warning; See also (a) Investor Classification.  
64 ECSPR articles 2(1)(j), (k), 21; See further (a) Simulation of Loss Test.  
65 Research shows that consumers ‘may misunderstand the relative riskiness between high-risk products’ and generally, changing the content of risk warnings ‘can have a measurable impact on consumer comprehension of investment risk’. Maura Feddersen and others, ‘Choosing Wisely: Preferences, Comprehension and the Effect of Risk Warnings on Financial Promotions for Investment Products’ (Financial Conduct Authority, 18 June 2020) 6 <www.fca.org.uk/publication/research/research-note-choosing-wisely-preferences-comprehension-effect-risk-warnings-financial-promotion-investment-products.pdf> accessed 7 March 2023; See further (b) Knowledge Test and Risk Warning.  
66 ECSPR article 21(4).  
67 See further (b) Knowledge Test and Risk Warning.
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test\textsuperscript{68} can be ignored so long as an acknowledgement of the warning is received. This makes the knowledge test similar to an opt-in requirement. Yet, the acknowledgement of the warning complicates the classification\textsuperscript{69} as opt-in because some form of response from the investor is necessary. A non-sophisticated investor may request to be treated as a sophisticated investor if certain conditions are met.\textsuperscript{70} The request to be treated as a sophisticated investor must be in a prescribed template which includes an attestation setting out either the fiscal or experience criteria they meet from Annex II(I) of the ECSPR, state that they are aware of the consequences of losing the non-sophisticated investor protection, and state that they will remain liable for the veracity of the information provided.\textsuperscript{71} In other words, non-sophisticated investors can apply to opt-out of their classification.\textsuperscript{72}

By virtue of the experience requirements in Annex II of the ECSPR for natural sophisticated investors and the knowledge test\textsuperscript{73} for non-sophisticated investors, a certain level of knowledge can be inferred for most investors. Sophisticated investors that are natural persons can be described as well-informed. However, the possibility for non-sophisticated investors to change their status to sophisticated investors makes it challenging to describe all non-sophisticated investors as well-informed. The knowledge test\textsuperscript{74} for non-sophisticated investors does not mean that non-sophisticated investors are as

\textsuperscript{68} See further (b) Knowledge Test and Risk Warning.
\textsuperscript{69} See also (a) Investor Classification.
\textsuperscript{70} ECSPR annex II part I(I).
\textsuperscript{71} ECSPR annex II(II).
\textsuperscript{72} See also (a) Investor Classification
\textsuperscript{73} ECSPR articles 2(1)(j), (k), 21; See further (b) Knowledge Test and Risk Warning.
\textsuperscript{74} See further (b) Knowledge Test and Risk Warning.
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well-informed as natural sophisticated investors. It does mean that the non-
sophisticated investors are sufficiently informed to engage with a risky
investment such as crowd-lending.

Sophisticated investors that are legal persons are the exception as they are only
required to meet fiscal criteria. This indicates a policy decision that
sophisticated investors that are legal persons will either be able to afford legal
and financial advice or that the legal person will have sufficient experience
itself to make its/their judgment. This policy decision may not hold true for all
legal persons. A small legal entity with inadequate experience that decides
against seeking advice but meets the fiscal criteria may make an unwise
investment through crowd-lending. However, further intervention where a legal
person wishes to invest may step too far towards paternalism. Further
intervention would be contrary to freedom of contract considerations. Then,
questions also arise as to whether the ‘awareness of the risks’ requirement
implies a knowledge test for all sophisticated investors. This is unclear. Thus,
sophisticated investors that are legal persons do not neatly sit in the well-
informed box in Baldwin’s system.

A certain amount of awareness can be inferred for non-sophisticated investors
but nothing further. Passing the knowledge test may mean that the investor
has sufficient awareness, but it does not mean that they are well-informed.
Furthermore, non-sophisticated investors are not as well-informed as natural
sophisticated investors. The diversity in the investors in crowd-lending means

75 ECSPR annex II(I).
76 See also b) Legal Uncertainties within the ECSPR.
77 See further (b) Knowledge Test and Risk Warning.
that a diverse range of enforcement mechanisms are needed to address the potential infringements that investors might commit.

(ii) Project Owners
Under the ECSPR project owners may be legal or natural persons\(^78\) that seek funding for a business.\(^79\) Little can be implied or inferred from the ECSPR as to whether the project owners will be well-informed or not, well-intentioned or not. It cannot be said that the ECSPR is solely for the use of SME project owners as the ECSPR does not place an outright ban on large businesses using crowdlending or put large business project owners outside the scope of the ECSPR. Many of the references to SMEs are found in the recitals where the recitals explicitly outline the ECSPR’s goal for crowdlending to be used by SMEs.\(^80\) One of the few references to SMEs in the operative part of the ECSPR is the review in article 45 of the ECSPR which requires an evaluation of the ECSPR’s impact on SMEs’ access to finance.\(^81\) More accurately crowdlending under the ECSPR is limited to businesses whose financing needs are met within the €5million limit\(^82\) set by the ECSPR. Theoretically, Google could seek a loan through a CSP for an amount under €5 million. This possibility is, however, unlikely to occur. It is more likely that large businesses will be able to source more cost-efficient financing suitable to their needs for significantly larger amounts through other product offerings on the market that SMEs would never be able to access.

\(^{78}\) ECSPR article 2(1)(h).
\(^{79}\) ECSPR article 1(2)(a).
\(^{80}\) ECSPR recitals 1, 3, 54.
\(^{81}\) ECSPR article 45(2)(g).
\(^{82}\) ECSPR article 1(2)(c).
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Project owners with a bad credit history are not necessarily prevented from accessing crowdlending. Where the CSP has no involvement in pricing the loans, project owners are only required to disclose in the Key Investment Information Sheet (‘KIIS’) any defaults on credit agreements in the past five years. Where a CSP prices the loans, the CSP uses information from various sources including the project owner to assess the price of the loan. The project owner’s knowledge of the business sector and experience are one of the many factors that feed into assessing the price of the loan also. Therefore a part of the assessment is informed by how well-informed the project owner is. The assessment of the project owner’s knowledge and experience is however one of the many information requirements in chapter 3 of EBA’s draft regulatory technical standards on pricing loans. The increased level of scrutiny where the CSP prices the loans falls short of being a mechanism to screen project

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83 See also (a) KIIS.
87 European Banking Authority, ‘Final Report Draft Regulatory Technical Standards on Credit Scoring and Pricing Disclosure, Credit Risk Assessment and Risk Management Requirements for Crowdfunding Service Providers under Article 19(7) Regulation (EU) 2020/1503’ (n 85); See also f) Pricing, Credit Risk Assessment, and Credit Scoring.
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owners. It does, however, mean that there is some level of scrutiny for project owners where the CSP prices the loans.

What can be inferred from the ECSPR is that the project owners must not have a criminal record and must not be established in a non-cooperative jurisdiction according to article 9(2) of AMLD V. As a result, some level of good intention can be inferred for project owners.

The ECSPR could have imposed project owner screening requirements to ensure that the project owners were only SMEs or that the project owners only represented a certain risk profile. However, this would have added a burden on the CSP and therefore regulatory compliance costs. It is possible that the EU could change this requirement in the future to further ensure that CSPs are only financing SMEs. Although it is not a ground that is explicitly included in the review clause in article 45(2) of the ECSPR.

The decision to only screen for criminal records and non-establishment in non-cooperative jurisdictions indicates a policy decision to try to keep the regulatory compliance burden smaller for CSPs. On one hand, a significant burden would indeed have been placed on CSPs that do not price loans to require these CSPs to only permit project owners that fit certain profiles. On the other hand, it would not have been a significant burden for CSPs who already price loans. Nevertheless, the idea of only permitting project owners that represent a certain risk profile would however have been contrary to the primary goal of the ECSPR. Part of the motivation for creating the ECSPR was

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88 ECSPR article 5.
89 Ibid.
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to regularise a financial product that could cater for the risk profiles SMEs present. Traditional bank lending could not cater for SMEs’ needs.

(iii) Conclusion
The combination of the authorisation process, knowledge requirements and absence of criminal record requirements means that the persons who form the management board of the CSP are relatively well-informed and relatively well-intentioned. This also means that CSPs are more likely to be well-informed and well-intentioned.

The ECSPR sets minimum standards for project owners. Project owners must not have a criminal record or be established in a non-cooperative jurisdiction. Thus, it could be said that the project owners are somewhat well-intentioned. Generally, there are no education requirements for project owners. The only reference to an education requirement is as part of the assessment for loan pricing. However, it is one of many factors that feed into the loan price assessment. As a result, its impact on the loan price assessment is diluted by the other factors. Furthermore, it cannot be said whether project owners will be well or ill-informed.

For investors, the opposite is true. The ECSPR does not have requirements that mean investors will be well or ill-intentioned. Although it can be said that non-

90 See further a) Authorisation.
91 ECSPR article 12(3).
93 ECSPR article 5.
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sophisticated investors and natural sophisticated investors will have some level of knowledge. Thus, natural sophisticated investors might be well-informed, but it is difficult to categorise non-sophisticated investors in Baldwin’s framework. The knowledge test\(^95\) only means that non-sophisticated investors are sufficiently informed to engage with the risky investment that is crowdlending. No judgment can be made based on the ECSPR as to whether sophisticated investors that are legal persons will be well or ill-informed.

The analysis of investors and project owners using Baldwin’s framework means that a range of harmonised enforcement mechanisms will be necessary to address possible infringements committed by investors or project owners. An investor could breach the ECSPR because the investor is ill-intentioned. A project owner might breach the ECSPR because they are ill-informed. Each type of infringement necessitates a different response. A breach because of ill intent might necessitate higher penalties. A breach because the project owner is ill-informed might call for more education efforts and evaluating whether knowledge requirements are necessary rather than penalties.

\textit{(c) Enforcement Mechanisms and Roles in the ECSPR}

The ECSPR uses a mix of enforcement mechanisms. From penalties\(^96\) and withdrawal of authorisation\(^97\) to on-site inspections\(^98\) and complaints processes\(^99\) to reviews\(^100\). The ECSPR also employs a mix of enforcement roles.

\(^{95}\) See further (b) Knowledge Test and Risk Warning.
\(^{96}\) ECSPR article 39.
\(^{97}\) ECSPR article 17.
\(^{98}\) ECSPR article 15.
\(^{99}\) ECSPR articles 7, 38.
\(^{100}\) ECSPR article 15(2).
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Therefore, adequately equipping the ECSPR to respond to the range of infringements that could be committed by the market actors explored above. Part (i) explores the ECSPR’s enforcement roles by setting out the kinds of actors that have enforcement responsibilities in the ECSPR. Part (ii) scrutinises the ECSPR’s enforcement mechanisms. Part (iii) studies the ECSPR’s enforcement sanctions.

(i) Enforcement Roles
Both public and private actors have enforcement roles under the ECSPR. As explored in chapter 2, public actors are not the perfect enforcer, tend to be equipped with strong enforcement powers and have significant resource demands. Private actors were also explored in chapter 2 which have variable resources and degrees of motivation.

Using Shavell’s conception of public actors, NCAs are public actors under the ECSPR. ESMA’s role focuses more on the coordination of enforcement and investigations rather than direct enforcement. For example, ESMA acts to assist with enforcement collaboration between NCAs where one NCA’s requests for collaboration have gone unanswered by another NCA.

There are multiple private actors with enforcement roles under the ECSPR: CSPs, consumer associations, investors, project owners and the public in

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101 See further (a) CSPs and (b) Project Owners and Investors.
102 Public actors are ‘anyone who devotes the major faction of his work effort to enforcement and who is paid by the state – whether in the form of rewards or in a salary – is a public enforcement agent’ Steven Shavell, ‘The Optimal Structure of Law Enforcement’ (1993) 36 Journal of Law and Economics 255, 259; See further chapter 2.
103 See for example ECSPR articles 32(4), 43.
104 ECSPR article 31(5).
105 Private actors for the purposes of this analysis are those who fall outside Shavell’s conception of a public actor. Public actors are ‘anyone who devotes the major faction of his work effort
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general. NCAs’ enforcement role relates solely to CSPs to which they have
granted authorisation. The private actors have a variety of enforcement
roles. CSPs are tasked with a gatekeeper enforcement role of ensuring
project owners and investors engage with crowdlending by the processes and
procedures established under the ECSPR. For example, the CSP is responsible
for the knowledge tests, investor classification, pre-contractual reflection
period, bulletin board measures, conflict of interest measures, and asset
safekeeping service and payment services measures. The CSPs’ role as
enforcers enables more complete compliance with the ECSPR through the
business conduct requirements mechanism.

The public at large including consumer organisations, investors and project
owners can complain to NCAs where there is an infringement of the ECSPR.
Investors and project owners can complain to CSPs. This further outsourcing
of enforcement roles to many private actors may increase the likelihood of
compliance with the ECSPR. It may also be the case that small, repeated
infringements might never be reported. Private actors would need to make an
active choice to make a complaint. Some private actors may not be sufficiently

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106 ECSPR article 15(1).
107 For the other aspects of CSPs gatekeeper role see (2) Gatekeeper.
108 ECSPR article 21; See further (b) Knowledge Test and Risk Warning, (a) Investor
Classification.
109 ECSPR article 21.
110 ECSPR article 22; See further (b) Anti-Impulse Measures.
111 ECSPR article 25; See further b) Secondary Market.
112 ECSPR article 8.
113 ECSPR article 10.
114 ECSPR article 38.
115 ECSPR article 7.
motivated to make the complaint particularly if the complaints process is difficult and onerous.

(ii) Enforcement Mechanisms

Enforcement mechanisms’ can be prevention-based, act-based, or harm-based.\textsuperscript{116} The ECSPR uses a mix of prevention-based and act-based enforcement mechanisms. The business conduct requirements in the ECSPR such as the business continuity plan,\textsuperscript{117} the prudential requirements,\textsuperscript{118} and the NCA review and investigation mechanism\textsuperscript{119} are prevention-based enforcement mechanisms which seek to mitigate an act or harm from occurring. Not keeping records under article 26 of the ECSPR is an act-based mechanism because if the CSP does not keep the required records sanctions can be imposed. The business continuity plan mechanism requires CSPs to have plans in place in the event of CSP failure\textsuperscript{120} and ensures outstanding loans are serviced until maturation. It is a prevention-based mechanism.

The prudential obligations\textsuperscript{121} under the ECSPR are an example of an act and prevention mechanism. The prudential obligations\textsuperscript{122} require CSPs to set aside an amount ‘of at least the higher of’ €25,000.00 ‘and’ a quarter of the preceding year’s fixed overheads.\textsuperscript{123} These funds may constitute a CSPs’ own funds, an insurance policy specifically for prudential safeguards or a

\begin{footnotesize}
\textsuperscript{116} Shavell (n 104) 257-258.  
\textsuperscript{117} ECSPR article 12(2)(j).  
\textsuperscript{118} ECSPR article 11.  
\textsuperscript{119} ECSPR article 15(2).  
\textsuperscript{120} See further c) CSP Failure.  
\textsuperscript{121} See further g) Systemic Risk.  
\textsuperscript{122} Ibid.  
\textsuperscript{123} ECSPR article 11(1).  
\end{footnotesize}
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combination of both.\textsuperscript{124} If CSPs do not comply with the prudential requirements,\textsuperscript{125} the very act of not having the funds set aside will constitute a breach of the ECSPR. However, the prudential requirements are also a prevention-based mechanism as the measures are put in place to address future systemic risks\textsuperscript{126} to which the CSPs might be exposed. The prudential requirements\textsuperscript{127} demonstrate a high level of precaution from the EU. The prudential requirements\textsuperscript{128} also link with the EU’s reform of prudential requirements for investment firms.\textsuperscript{129} Although Macchiavello and Sciarrone question the decision to place prudential requirements on CSPs which do not operate in the traditional financial sector.\textsuperscript{130}

NCAs are equipped with powers to assess CSP compliance under the ECSPR.\textsuperscript{131} While the assessment could be used where a harm or act has occurred, it is also a preventative measure as the assessment can be used to ensure continued compliance. The mere threat of a possible assessment may be sufficient to ensure continued compliance with the ECSPR. As each NCA determines the

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\textsuperscript{124} ECSPR article 11(2).
\textsuperscript{125} See further g) Systemic Risk.
\textsuperscript{126} ibid.
\textsuperscript{127} ibid.
\textsuperscript{128} ibid.
\textsuperscript{130} Macchiavello and Sciarrone Alibrandi (n 131) 75 Macchiavello.
\textsuperscript{131} ECSPR article 15(1).
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frequency and depth of the assessment,\textsuperscript{132} the assessment’s efficacy will in large part depend on how an individual NCA deploys it. Leaving the frequency and depth of the assessment to the discretion of NCAs allows for enforcement to be tailored to the circumstances in each Member State. Nevertheless, the NCA’s discretion also allows for market fragmentation and jurisdiction shopping by CSPs. CSPs could establish in Member States where the NCA is lenient and does not conduct frequent and in-depth assessments. However, other NCAs may overuse their assessment powers to the extent where CSPs are deterred from establishing in that Member State. All three measures intervene before the act or harm has occurred. The ECSPR is overall quite prescriptive in how CSPs conduct their business.\textsuperscript{133} The detailed\textsuperscript{134} business conduct rules also mean that the ECSPR is trying to be very clear on what compliance with the ECSPR would look like.

(iii) Enforcement Sanctions
The ECSPR uses a mix of sanctions such as monetary fines,\textsuperscript{135} disclosures,\textsuperscript{136} commands such as a cease-and-desist order,\textsuperscript{137} or contractual-based sanctions such as withdrawal of authorisation.\textsuperscript{138} Provision is made to consider the harm caused in determining the ‘type and level’ of sanction.\textsuperscript{139}

\textsuperscript{132} ibid.
\textsuperscript{133} Macchiavello and Sciarro Alibrandi (n 131) 78 Macchiavello.
\textsuperscript{134} See further a) Theory of Legal Certainty.
\textsuperscript{135} ECSPR article 39(2)(d)-(f).
\textsuperscript{136} See for example ECSPR article 39(2)(a).
\textsuperscript{137} ECSPR article 39(2)(b).
\textsuperscript{138} ECSPR article 17.
\textsuperscript{139} ECSPR article 40(1)(e), (h).
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There are two types of monetary fines set out in the ECSPR: (1) a maximum fine of at least double the benefit derived from the infringement,\textsuperscript{140} and (2) a maximum fine of at least \( €500,000.00 \).\textsuperscript{141} The double-derived-benefit fine can go beyond the maximum limits set under the ECSPR. Linking the fine amount to the benefit derived from the infringement directly addresses offenders that conduct a cost-benefit analysis to decide whether they will comply. Some businesses consider a fine as a business expense that may never eventuate. A double-derived-benefit fine minimises the potential financial incentive for non-compliance. However, it is still possible that a CSP may take the ‘gamble’ that enforcement action might never be brought at all. It is also possible that non-compliance is a result of disengagement from regulatory culture\textsuperscript{142} or human failures and errors. These types of non-compliance are not addressed by having a double-derived-benefit fine. These types of non-compliance can be addressed with the maximum fine option set out under the ECSPR.

Obvious sanctions\textsuperscript{143} such as penalties\textsuperscript{144} are focused upon CSPs. The ECSPR also indirectly focuses its sanctions against CSPs, project owners and investors. The sanctions against project owners and investors are not always explicitly referred to in the ECSPR and are contractual sanctions. In theory, where a project owner or investor does not comply with the ECSPR, they simply do not

\textsuperscript{140} ECSPR article 39(2)(d).
\textsuperscript{141} ECSPR article 39(2)(e), (f).
\textsuperscript{142} See further Toni Makkai and John Braithwaite, ‘The Limits of the Economic Analysis of Regulation: An Empirical Case and a Case for Empiricism’ (1993) 15 Law and Policy 271
\textsuperscript{143} See for analysis on the market fragmentation and uncertainty caused because of the ECSPR’s position on sanctions b). Legal Uncertainties with the ECSPR.
\textsuperscript{144} ECSPR article 39.
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receive access or access is withdrawn to crowdlending provided by that CSP.\textsuperscript{145} For example, an investor might not complete the mandate specifying the parameters for individual portfolio management.\textsuperscript{146} The CSP would then need to refuse that investor access to their individual portfolio management services.\textsuperscript{147} Similarly, if a project owner does not rectify information in the KII\textsuperscript{148} that was inaccurate the offer might be cancelled.\textsuperscript{149} The project owner does not gain access to crowdlending.

\textbf{(d) Cross-Border Infringements}

The ECSPR responds to the possibility of cross-border infringements between Member States by giving ESMA a supervisory, reporting and coordinating role. For example, an NCA may request that ESMA co-ordinates the inspection or investigation into a cross-border CSP.\textsuperscript{150} The ECSPR also places a cooperation obligation on NCAs.\textsuperscript{151} The cooperation obligation outlines exceptional circumstances where a competent authority may refuse another competent authority’s request for information or cooperation, the actions that may be taken upon a request by an NCA for assistance\textsuperscript{152} with recourse available to ESMA where the request for assistance has been rejected or not acted upon\textsuperscript{153}, and collaborate on best practices and interpretation.\textsuperscript{154} Fines are recorded in a

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\textsuperscript{145} See also European Securities and Markets Authority, ‘Questions and Answers: On the European Crowdfunding Service Providers for Business Regulation’ (n 29) Questions 5.10-5.12.
\textsuperscript{146} ECSPR article 6(1); See further (c) Individual Loan Portfolio Management.
\textsuperscript{147} See further (c) Individual Loan Portfolio Management.
\textsuperscript{148} See further (a) KII\textsuperscript{S}.
\textsuperscript{149} ECSPR article 23(8), (12).
\textsuperscript{150} ECSPR article 32(2).
\textsuperscript{151} ECSPR article 31.
\textsuperscript{152} ECSPR article 31(4).
\textsuperscript{153} ECSPR article 31(5).
\textsuperscript{154} ECSPR article 31(6).
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centralised database run by ESMA; only ESMA, EBA and competent authorities can access the database.\(^\text{155}\) Although ESMA publishes data on criminal penalties imposed by competent authorities in an annual report.\(^\text{156}\)

(e) Harmonisation Challenges

The detail of the enforcement measures and the enforcement itself has been left to NCAs.\(^\text{157}\) The ECSPR sets the floor for the enforcement mechanisms and NCAs may gold plate if they wish. By setting the floor for enforcement mechanisms in the ECSPR, the EU signals that it will not tolerate Member States being too lenient on CSPs.

Member States may increase the level of the sanctions generally and or change them into criminal sanctions.\(^\text{158}\) This latitude given to the Member States is contrary to the harmonisation efforts at the core of the competition regulatory goal and the harmonisation efforts at the heart of the ECSPR. The latitude allows the possibility that Member States who wish to disincentivise the establishment of CSPs in their jurisdictions can have disproportionately grave sanctions. Although it will not prevent CSPs who have established in another Member State from providing services in a ‘grave sanctions Member State’ as it is the NCA who authorised the CSP who imposes sanctions upon the CSP.\(^\text{159}\) The latitude somewhat allows for Member State shopping by the CSPs. CSPs may choose to establish in a Member State where the NCA has only implemented the minimum standards as set out in the ECSPR. On the other hand, the latitude

\(^{155}\) ECSPR article 43(3).
\(^{156}\) ECSPR article 43(1).
\(^{157}\) ECSPR article 39.
\(^{158}\) ECSPR article 39(1).
\(^{159}\) ECSPR articles 15(1), 31(7).
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given to Member States is a conditional nod to their sovereignty. Each Member State can calibrate their enforcement sanctions as they see fit provided that the Member State complies with the minimum standards.

It could then be more favourable for CSPs to establish themselves in jurisdictions with more lenient enforcement measures and an NCA with a reputation for being lenient enforcers.160 This theoretical eventuality is limited by article 37 of the ECSPR in the cross-border context. Article 37 of the ECSPR sets out where the infringement continues to occur in one jurisdiction despite measures having been taken by the authorising NCA. Under article 37 of the ECSPR, the NCA in the jurisdiction where the infringement is occurring is permitted to take matters into their own hands or if there is a disagreement with measures taken by the authorising NCA for recourse to ESMA. Theoretically then it is possible for a Member State with active and quick enforcement from a marginally more lenient competent authority to create a favourable environment for CSPs to establish their headquarters. Therefore, jurisdiction shopping by CSPs according to each competent authority’s enforcement mechanisms and attitude to enforcement is a possible eventuality. Thus, providing an opportunity for regulatory arbitrage.161 However, the extent that competent authorities will make their jurisdictions attractive to CSPs according to their enforcement mechanisms is limited by the combination of the floor set

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for enforcement mechanisms in the ECSPR and the possible recourse to ESMA in the cross-border context.

(f) Conclusion
The themes of market fragmentation and respecting Member States’ sovereignty are dominant in enforcement measures under the ECSPR. The combination of the minimum standard penalties and the latitude given to NCAs regarding assessments means that Member States can choose to attract or deter CSPs from establishing in their jurisdiction. Thus, creating a possible competitive space between Member States.

(2) Marketing Communications Requirements
Under the ECSPR marketing communication requirements are not fully harmonised. The ECSPR uses a general duty that requires that marketing communications are clearly identifiable, not disproportionately targeting projects, fair, clear and not misleading and consistent with the KIIS.162 However, Member States set their own marketing communications requirements in national law.163 Summaries of these national requirements are published in a report on ESMA’s website.164 Some summaries merely refer to the penalties laid down in the national regulatory framework such as Austria.165 Other summaries confirm that the laws regarding marketing have been

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162 ECSPR article 27(1); See further (a) KIIS.
163 ECSPR article 28.
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published such as Belgium.166 Spain outlines that it has requirements that focus on matters such as the content, format features used, and target audience combined with a general principle that the market communications must be fair, clear, balanced and not misleading.167 On the other hand, Croatia took a different approach and focused on what would be taken into account - such as characteristics of the service, the price, nature, attributes and rights of the advertiser - to evaluate whether an advertisement was misleading.168 Other Member States did not provide any summary such as Bulgaria, Cyprus, Czech Republic and Germany.169 This evidences some market fragmentation within the ECSPR as the marketing requirements will differ from one Member State to another. Although, ESMA’s efforts in reporting the summaries of the marketing requirements do assist CSPs in navigating the various marketing regulatory requirements. The report is a key communications piece that educates CSPs on how clients should be communicated with through advertising. The adequacy of the reporting mechanism is reduced because some jurisdictions do not provide summaries or summarise incorrect information. This inconsistency is ironic given that ESMA is trying to communicate what the communication

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requirements are for CSPs. It remains to be seen whether the EU will further harmonise marketing communications.\textsuperscript{170}

c) Conclusion

To conclude, the ECSPR has a mix of enforcement measures targeted at the mix of potential people who could infringe the ECSPR. Thus, the enforcement element of the ECSPR theoretically achieves the competition regulatory goal. One weakness in the ECSPR’s enforcement is the latitude given to Member States in their implementation of the administrative and contractual sanctions in article 39 of the ECSPR. The latitude given to Member States gives rise to the potential for regulatory arbitrage. The ECSPR also does not achieve full harmonisation in relation to marketing communications requirements.

The ECSPR’s competition goal is process-oriented focusing on harmonisation. The ECSPR must take Member State sovereignty into account and a minimum standards approach to enforcement largely attains the ECSPR’s competition goal. The same cannot be said for the marketing communications requirement which could be fully harmonised. The less prescriptive principles-based approach in the ECSPR does not adequately address its overall focus on SMEs and start-ups.\textsuperscript{171} If misleading or inaccurate information is advertised about crowdlending services the reputational damage could negatively impact the CSP and the project owners. Therefore, limiting their capacity to participate in market competition. Furthermore, there could be reputational damage to the


\textsuperscript{171} See further chapter 2.
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entire industry. Thus, negatively impacting the crowdlending market’s capacity to allocate credit to SMEs and start-ups.

2. Market Efficiency

It is challenging to analyse the ECSPR’s allocative efficiency in enabling SMEs to access capital markets. It was outlined in chapter 2 that allocative efficiency is part of the ECSPR’s primary goal (allocative efficiency and competition). The challenge is that there are three important secondary goals (legal certainty, investor protection and other users, and a risk-based regulatory model) that feed into the attainment of the primary goals. Thus, there are many measures analysed under the other goals in this chapter that feed into the ECSPR’s allocative efficiency. For example, the analysis in Investor Protection and Other Users is vitally important to this section. The protection of investors in particular considerably impacts the ECSPR’s potential to achieve its aim for allocative efficiency. The protection of investors provides them with a safer environment to invest in and hopefully induces investment.

In light of this challenge, three areas of the ECSPR are now examined in light of allocative market efficiency: 1. Authorisation, 2. Secondary markets and 3. The €5 million limit.

a) Authorisation

The ECSPR has made a positive impact on market efficiency by providing authorisation and a passporting regime. Intricately linked to the

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172 ECSPR articles 3(1), 12, 13, 17.
173 ECSPR articles 18, 12(12); See further a) Passporting.
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classification regime\textsuperscript{174} are the cooperation requirements between individual competent authorities and competent authorities and ESMA.\textsuperscript{175} The classification regime\textsuperscript{176} would not work without cooperation between all these bodies.

Authorisation and classification\textsuperscript{177} are powerful trust indicators from a regulator to the market, investors, and project owners. Classification\textsuperscript{178} and authorisation signal certain standards have been met. Investors and project owners should without conducting their due diligence be able to trust that CSP will at a minimum comply with the ECSPR. Thus, hopefully streamlining the process of deciding whether to trust CSPs and adding to market efficiency.

The authorisation process\textsuperscript{179} requires that certain minimum standards are met by using prescriptive detailed\textsuperscript{180} business conduct requirements\textsuperscript{181} and general principles requirements that CSPs must possess sufficient knowledge, skills, and experience.\textsuperscript{182} The business conduct requirements are wide-ranging. For example, CSPs must demonstrate how their governance arrangements and internal control mechanisms ensure compliance with the ECSPR,\textsuperscript{183} CSPs must also demonstrate how the CSP complies with the prudential requirements in article 11 of the ECSPR\textsuperscript{184} and describe their outsourcing procedures.\textsuperscript{185} As a

\textsuperscript{174} See further a) Classification.
\textsuperscript{175} ECSPR articles 31, 32.
\textsuperscript{176} See further a) Classification.
\textsuperscript{177} ibid.
\textsuperscript{178} ibid.
\textsuperscript{179} Academic commentary has noticed the parallels between the ECSPR and MiFID II’s authorisation processes. Marije Louise and Adam Pasaribu, ‘Authorisation and Supervision of CSPs’ in Marije Louise and Pietro Ortolani (eds), Crowddfunding and the Law (Oxford University Press 2021) 161.
\textsuperscript{180} See further a) Theory of Legal Certainty.
\textsuperscript{181} ECSPR article 12(2); Delegated Regulation [2022] OJ L287/5 (n 37).
\textsuperscript{182} ECSPR article 12(3)(b).
\textsuperscript{183} ECSPR article 12(2)(e).
\textsuperscript{184} ECSPR article 12(2)(h), (l).
\textsuperscript{185} ECSPR article 12(2)(n).
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result, investors and project owners can be assured that CSPs when they apply for authorisation meet the requirements in the ECSPR. There is a periodic review mechanism to ensure continued compliance with the authorisation and the ECSPR.\textsuperscript{186} However, the NCA determines the frequency and depth of the review.\textsuperscript{187} This means there is a possibility for market fragmentation and unfair competition as a Member State with infrequent reviews may in a way encourage its CSPs to become lazy with their efforts to comply with the authorisation requirements. Thus, it creates the possibility of market fragmentation and unfair competition between CSPs in Member States where the NCAs frequently review their CSPs and those who do not as their regulatory compliance costs could be lower.

\textbf{b) Secondary Market}

As explored in chapter 1, some CSPs provide a space where investors can sell their investments and exit the investment early. This space can positively impact the allocative efficiency in crowdlending as it allows the utility of the resource, in this case, the investment, to be maximised.\textsuperscript{188} The impact secondary markets will have on market efficiency will depend on how adequately the CSP communicate the fact that advertisements only are allowed on the bulletin board and how the website itself is established. Thus, the efficiency will in part rely on the CSPs.

\textsuperscript{186} ECSPR article 15(2).
\textsuperscript{187} ECSPR article 15(2).
\textsuperscript{188} See further chapter 2.
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Under the ECSPR, this space is called a bulletin board. The bulletin board is a key feature of crowdlending. The ECSPR takes the position that bulletin boards do not constitute multilateral trading facilities (‘MTFs’) under MiFID II.

To stay in line with the same-activity-same-rules principle, the ECSPR set out that bulletin boards only allow clients to advertise. Any negotiations must take place outside of the platform. The CSP has minimal involvement in the transaction and only suggests a reference price. This in turn may negatively impact investor liquidity and market efficiency. While the way bulletin boards are set up is understandable given the context of MTFs under MiFID II, it results in a mechanism that relies on free market considerations.

The ECSPR is not endorsing or promoting any particular value other than a free market to encourage allocative market efficiency on bulletin boards. The ECSPR only requires the provision of the KIIS and warnings if appropriate by the investor who is selling. It is unclear whether the provision of this information must be included on the bulletin board itself, whether the CSP is responsible for enforcing the provision of this information and whether there are consequences if the information is not provided by the prospective seller. Yet

189 ECSPR article 25.
190 ibid.
191 ECSPR article 25(2); although it has been noted that there is little distinguishing them. Anne Hakvoort, ‘Secondary Trading of Crowdfunding Investments’ in Marije Louise and Pietro Ortolani (eds), The EU Crowdfunding Regulation (Oxford University Press 2021).
192 ibid.
193 ibid.
194 ECSPR article 25(5); See further f) Pricing, Credit Risk Assessment, and Credit Scoring. See further a) Liquidity Risk.
195 Macchiavello and Sciarrone Alibrandi (n 131) 29 Sciarrone.
196 See further (a) KIIS.
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it is thought that the bulletin board would operate more efficiently if the CSP was permitted to take a more active role.

In summary, the ECSPR has employed authorisation and passporting tools to help remedy crowdlending’s market efficiency issues. The ECSPR struggles with the market efficiency concerns presented by the challenging bulletin boards. Bulletin boards are challenging because the CSP cannot match investors on bulletin boards which would improve the allocative efficiency of the bulletin boards. Thus, market efficiency is improved but the ECSPR has created some barriers.

c) The €5 Million Limit

As explored in chapter 2, the ECSPR’s allocative market efficiency goal is to enable SME access to capital markets. However, the ECSPR puts an upper limit on how much capital a project owner can raise within 12 months using CSPs. As outlined in the scope section in this chapter, the €5 million limit was an EU policy decision owing to the differing Member State limits for prospectus requirements. It further indicates a view that other financial products are more suitable for SMEs that are seeking capital in amounts of more than €5 million. This upper limit directly impacts the ECSPR’s capacity to fulfil its allocative market efficiency goal. The €5 million limit has already been subject to critique by EU CSPs as it limits their capacity to attract big projects.

198 See further a) Passporting.
199 ECSPR article 1(2)(c).
200 See further C. Scope.
201 European Securities and Markets Authority, ‘Final Report: ESMA’s Technical Advice to the Commission on the Possibility to Extend the Transitional Period Pursuant to Article 48(3) of Regulation (EU) 2020/1503’ (ESMA35-42-1445 European Securities and Markets Authority 2022)
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3. Investor Protection and Other Users
The ECSPR protects using business conduct requirements, nudges, mandatory and default measures. The protection measures focus on investors and clients.
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Crowdlending clients including investors can be exposed to liquidity risk, default risk, CSP failure, information asymmetry, inexperience, fraud.

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209 Financial Conduct Authority, CP13/13 (n 33) 14; The Board of the International Organization of Securities Commissions (n 227) iv; Milne and Parboteeah (n 228) 23; Financial Conduct Authority CP18/20 (n 227) 22; Zetzsche and Preiner (n 227) 222; See further c) CSP Failure.

210 Kirby and Worner (n 227) 26-27; The Board of the International Organization of Securities Commissions (n 227) v; Paul Belleflamme and others, ‘The Economics of Crowdfunding Platforms’ (2015) 33 Information Economics and Policy 11, 46; Zetzsche and Preiner (n 227) 222; See further d) Information Asymmetry and Inexperience.

211 Financial Conduct Authority, CP13/13 (n 33) 13; Kirby and Worner (n 227) 27; The Board of the International Organization of Securities Commissions (n 227) v; Milne and Parboteeah (n 228) 22; Jørgensen (n 63), 259; See further d) Information Asymmetry and Inexperience.
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risk and pricing risk. While this analysis touches on some of these risks, each of these risks are examined in turn under the risk-based regulatory model analysis. This section focuses on the measures used to protect investors and clients and analyse whether they are adequate in protecting investors and clients. The analysis in the risk-based regulatory model section will examine whether the measures are adequate in responding to each individual risk.

a) Investors

There are seven tools used by the ECSPR to protect investors: investor classification, a knowledge test, a simulation of loss, an investment threshold warning, a pre-contractual reflection period or anti-impulse measure, disclosures and business conduct requirements. The business conduct requirements include governance arrangements for disclosures to investors which ensure that the information disclosed is easy to read and disclosed in a way that facilitates understanding ‘in particular by non-

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212 See also Commission, ‘Consultation Document - Crowdfunding in the EU - Exploring the Added Value of Potential EU Action’ (n 228) 7; Financial Conduct Authority CP13/13 (n 228) 14; Kirby and Worner (n 227) 26; Commission, Responses to the Public Consultation on Crowdfunding in the EU’ (n 228) 8; European Banking Authority, ‘Opinion of the European Banking Authority on Lending-Based Crowdfunding’ (n 227) 14; Milne and Parboteeah (n 228) 23; ‘Report on Crowdfunding in the EU Capital Markets Union’ (Staff Working Document) SWD (2016) 154 final; Zetzsche and Preiner (n 227) 223; See further e) Fraud Risk.


214 See 1. Risk-Based Regulatory Model.

215 ECSPR article 21.

216 ECSPR article 21(2).

217 ECSPR article 21(5).

218 ECSPR article 21(7).

219 ECSPR article 22.

220 ECSPR articles 23, 24.

221 See analysis in b) Clients.
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sophisticated investors’. The governance arrangements must be approved by the CSP’s management body. The disclosure policy must include how frequently information is updated, the internal functions responsible for preparing the information, how price-sensitive information is treated and how information is validated.

At the outset, this seems like a fairly robust investor protection package. Nevertheless, these investor protections are predicated upon an investor classification system where it is possible to apply for sophisticated investor status. Investor protections rely on nudges and disclosures that can be ignored. It is unclear in some circumstances what the consequence is of ignoring the nudge. Does the investor continue as a sophisticated, or non-sophisticated? Does it matter? Can the CSP refuse to provide their services to an investor that ignores the nudges? Thus, the analysis splits the examination into the mandatory investor protection mechanisms, nudges and default investor protection mechanisms. The KIIS, anti-impulse measures and the protections that flow from individual portfolio management are examined under the mandatory heading because they are mechanisms that are mandatory.

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223 ibid.
224 ibid.
226 ECSPR article 23(1).
227 ECSPR article 22.
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in their application and do not seek to indicate that a different decision might
be more appropriate. On the other hand, the simulation of loss test,\textsuperscript{229}
knowledge test,\textsuperscript{230} investment threshold\textsuperscript{231} and the risk warnings\textsuperscript{232} are nudges
where if for example the threshold or result of the knowledge test indicates
that perhaps the investment is not suitable the investor is not prevented from
investing. Finally, the investor classification mechanism is examined under a
default heading as non-sophisticated investors if they wish to change their
status, they must take active steps and apply for the change in classification.

\textbf{(1) Mandatory}
This section explores the investor protection measures that are mandatory in
their application.

\textit{(a) KIIS}
There are many disclosures required by the ECSPR; some are aimed at clients,\textsuperscript{233}
and some are aimed at investors.\textsuperscript{234} The KIIS disclosures under the ECSPR are a
mandatory protection measure and the only one that applies to all investors.\textsuperscript{235}
The KIIS is the most significant disclosure.\textsuperscript{236} There is no requirement for the
KIIS to be approved by the NCA.\textsuperscript{237} The project owner is responsible for the
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veracity of the information in the KIIS. The CSP must have ‘adequate procedures in place to verify [the] completeness, correctness and clarity of the information contained in the KIIS for the duration of the crowdfunding offer’. As a result, if there is an omission in the KIIS that is a direct result of the CSP’s inadequate procedures, the CSP ‘could be partially or fully responsible’. Where the CSP manages a portfolio on behalf of the investor, the CSP is responsible for the information in the KIIS. It will be very important for CSPs to carefully design their procedures for verifying the KIIS where portfolio management services are not offered.

The structure of the KIIS with its length and presentation requirements relies on research that seeks to simplify disclosures and make them more adequate. It is a marked shift from the traditional disclosure paradigm where the focus

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238 ECSPR article 23(11); European Securities and Markets Authority, ‘Questions and Answers: On the European Crowdfunding Service Providers for Business Regulation’ (n 29) Questions 5.2, 5.9.
239 A question asked by ESMA and answered by the European Commission. European Securities and Markets Authority, ‘Questions and Answers: On the European Crowdfunding Service Providers for Business Regulation’ (n 29) Questions 5.2.
240 ECSPR article 24(2); See further (c) Individual Loan Portfolio Management.
241 ECSPR article 23(6), (16), annex I.
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was to ensure the information was disclosed to the market and not on its packaging and whether it was comprehensible. The KIIS is examined from two linked perspectives in this chapter. The first perspective is how the KIIS protects investors and the second perspective comes later in this chapter under the heading of information asymmetry and inexperience.244

There are two types of KIIS set out in the ECSPR: one for where the investor selects the project245 and a second one for where the CSP manages a loan portfolio for the investor.246 In the first type where investors select the project, the project owners provide the information in the KIIS247 and the CSP ensures the KIIS is ‘clear, correct and complete’.248 The information in this KIIS covers basic information such as the name and contact details,249 the principal activity of the project owner,250 a description of the crowdfunding project,251 and the deadline for reaching the funding target.252 The project owner will need to strike a careful balance here between disclosing enough information to capture an investor’s interest without disclosing trade secrets and precious intellectual

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244 See further d) Information Asymmetry and Inexperience.
245 ECSPR article 23(1).
246 ECSPR article 24.
247 ‘because the project owners are in the best position to provide the information required to be included’ ECSPR recital 51.
248 ECSPR article 23(2).
249 ECSPR annex I part A(a).
250 ECSPR annex I part A(c).
251 ECSPR annex I part A(f).
252 ECSPR annex I part B(b).
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property. Details are provided about key financials and the amount of own funds committed by the project owner. More detailed disclosures are made available by links such as the project owner’s most recent financial statements. Disclosures are also made about the ‘existence and conditions of the pre-contractual reflection period for non-sophisticated investors’, and the risk mitigation measures including collateral and guarantees.

Where investors select the loan, they are responsible to evaluate the projects according to criteria of their choosing whether and how much to invest. The benefit of this approach is that an investor has an opportunity perhaps to see the potential impact of their investment on the project and possibly feel more “connected” to the investment. It also leaves open the possibility that an investor could choose to invest because of an apparent shared interest or socioeconomic background rather than based on objective criteria.

The second type of KIIS where the CSP manages a portfolio for the investor is an extended version of the first and includes all the information in the first KIIS with some additions. This second type of KIIS provides more information concerning risk diversification strategies and details concerning the

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224 ECSPR annex I part A(e).
225 ECSPR annex I part B(e).
226 See further a) Theory of Legal Certainty.
227 ECSPR annex I part A(d).
228 ECSPR annex I part B(g); See further (b) Anti-Impulse Measures.
229 ECSPR annex I part G(c).
231 ECSPR article 24.
232 ECSPR annex I part I(g), (j).
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investment parameters\textsuperscript{263} for example the minimum and maximum maturity date.\textsuperscript{264}

In the ECSPR there is a direct relationship between the increased level of service provided by the CSP to investors and the increased business conduct prescriptiveness of the ECSPR. It is seen in the increased information requirements when the standard KIIS\textsuperscript{265} is compared with the KIIS provided in individual portfolio management.\textsuperscript{266} The extended KIIS for individual portfolio management is longer and provides additional information to the standard KIIS. The standard KIIS details the risk factors,\textsuperscript{267} information about the project owner and the project,\textsuperscript{268} the main features of the crowdfunding process,\textsuperscript{269} and disclosures relating to loans.\textsuperscript{270} Whereas the KIIS for individual portfolio management provides the standard KIIS information and more. The additional requirements range from a prescribed methodology for default rates\textsuperscript{271} to disclosure of the credit risk assessment methodology\textsuperscript{272} and disclosing the risk diversification strategies\textsuperscript{273}.

The direct relationship is also seen when the regulatory requirements for loan pricing\textsuperscript{274} are compared with the fact that there are no loan pricing regulatory requirements when the CSP leaves loan pricing to market mechanisms. Where

\textsuperscript{263} ECSPR annex I part I(b), (c), (d), (f), (k).
\textsuperscript{264} ECSPR annex I part I(c).
\textsuperscript{265} ECSPR annex I parts A-C, G-I.
\textsuperscript{266} ECSPR annex I parts A-C, G, H.
\textsuperscript{267} ECSPR annex I part C.
\textsuperscript{268} ECSPR annex I part A.
\textsuperscript{269} ECSPR annex I part B.
\textsuperscript{270} ECSPR Annex I Part G.
\textsuperscript{271} Delegated Regulation [2022] OJ L287/33 (n 248).
\textsuperscript{272} ECSPR annex I part I(e); See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
\textsuperscript{273} ECSPR annex I part I(j).
\textsuperscript{274} ECSPR article 4(4); See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
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a CSP prices loans, the CSP is obliged to undertake a reasonable assessment and base the assessment on set criteria such as audited accounts for the past two years.\textsuperscript{275} EBA’s draft regulatory technical standards provide further granular detail\textsuperscript{276} for loan pricing setting out which accounting standards to use\textsuperscript{277} or the factors to take into consideration for the valuation such as the maturity of the loan, payment schedule and probability of default.\textsuperscript{278}

The only protective measures for sophisticated investors are the mandatory disclosures. If these measures are examined from the point of view of the needs of investors, it indicates the needs of experienced investors. This finds support in the data showing the increasing numbers of institutional investors\textsuperscript{279} which has been noted by the Commission as early as 2016.\textsuperscript{280}

Institutional investors will have more leverage than non-sophisticated investors and will be able to influence changes that non-sophisticated investors could not. Anecdotal evidence suggests the involvement of institutional investors

\textsuperscript{275} ECSPR article 4(4)(a), (b).
\textsuperscript{276} See further a) Theory of Legal Certainty.
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brings rigorous due diligence procedures on the part of the CSP.281 Thus, requiring CSPs to adjust their practices and business to pass these investigations. There is also the potential of ‘institutional investors’ ability to reduce information asymmetry’.282

Nevertheless, there are disadvantages to non-sophisticated investors. Institutional investors may cherry-pick the available investments leaving non-sophisticated investors with the remainder of less desirable investments.283 Another disadvantage for non-sophisticated investors is that crowdlending in other jurisdictions has moved away from non-sophisticated investors completely with the advent of institutional investor involvement284 and some related regulatory factors which are explored in chapter 4. It is difficult however to apply this institutionalisation shift across the board. There is anecdotal evidence of a desire to keep non-sophisticated investors’ involvement to maintain a diversified investment portfolio.285

(b) Anti-Impulse Measures

The ECSPR has a pre-contractual reflection period which puts a stay on the offer to invest or expression of interest until four calendar days elapse.286 In the

282 Macchiavello and Sciarrone Alibrandi (n 131) 50 Macchiavello; See further d) Information Asymmetry and Inexperience.
283 Macchiavello and Sciarrone Alibrandi (n 131) 50 Macchiavello.
284 For example, LendingClub in the US has retired its ‘individual investor’ services and now provides a service to pre-existing ‘individual investors’ that is analogous to a savings account. Its crowdlending services are only available to ‘institutions’. LendingClub, ‘Investing with LendingClub for Individual Investors’ (LendingClub) <www.lendingclub.com/investing/peer-to-peer> accessed 7 March 2023; LendingClub, ‘Institutional Investors Purchasing LendingClub Loans’ (LendingClub) <www.lendingclub.com/investing/institutional/overview> accessed 7 March 2023.
285 Carter and others (n 301).
286 ECSPR article 22(3).
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context of individual portfolio management, the stay applies ‘only to the initial investment mandate’.\textsuperscript{287}

Pre-contractual reflection periods operate similarly to the cooling-off period\textsuperscript{288} found in consumer law: both combat impulse buying.\textsuperscript{289} Research suggests that consumers desire tools that postpone impulse purchases.\textsuperscript{290} Pre-contractual reflection periods are a significant regulatory tool. Although, pre-contractual reflection periods do not only act to the advantage of non-sophisticated investors. The pre-contractual reflection period could act in favour of the CSPs and project owners. The pre-contractual reflection period may persuade investors to invest where otherwise no investment would be made. It would be particularly adequate for those investors who might simply forget about the option to rescind their offer until it is too late. Although this impact is ameliorated by the possibility of an investor exiting the investment early by using the bulletin board.\textsuperscript{291} The pre-contractual reflection period could also negatively impact the project owner’s reputation if it is seen that an investor withdraws their investment (particularly if it is a large amount).\textsuperscript{292}

\textsuperscript{287} ECSPR article 22(7).
\textsuperscript{291} See further b) Secondary Market.
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Not all persons will be sufficiently incentivised to take active steps to rescind the offer even if it is in their interest. Article 22(5) of the ECSPR makes some effort to address the possible inertia of non-sophisticated investors by requiring CSPs to include ‘at least the same modalities’ in expressing an interest to invest to revoke it. This means that it should be as easy to revoke an offer as it is to make an offer or express an interest.

(c) Individual Loan Portfolio Management

Individual portfolio management is where a ‘pre-determined amount of funds’ is allocated ‘in accordance with a specific mandate’ by the CSP ‘to one or multiple crowdfunding projects’.293 The mandate includes the ‘minimum and maximum interest rate payable’, the ‘minimum and maximum maturity date’, and the ‘range and distribution’ of the risk categories.294 In essence, the investor gives the CSP their funds and the CSP decides into which projects the funds are invested.

The ECSPR places an increased level of requirements on CSPs where the CSP manages a portfolio of loans for an investor. This increased level of requirements is linked to the investor’s increased reliance on the CSP’s due diligence in managing and selecting a portfolio of loans. The ECSPR is more detailed295 with its information disclosure requirements and business conduct requirements.
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requirements than in contexts where the investor selects the loan. It is seen in
the increased information requirements when the standard KIIS\textsuperscript{296} is compared
with the KIIS provided in individual portfolio management.\textsuperscript{297} The extended KIIS
for individual portfolio management is longer and provides additional
information to the standard KIIS. The standard KIIS details the risk factors,\textsuperscript{298}
information about the project owner and the project,\textsuperscript{299} the main features of
the crowdfunding process,\textsuperscript{300} and disclosures relating to loans.\textsuperscript{301} Although the
KIIS for individual portfolio management provides the standard KIIS information
and more.\textsuperscript{302} The additional requirements range from a prescribed methodology
for default rates\textsuperscript{303} to disclosure of the credit risk assessment methodology\textsuperscript{304}
and disclosing the risk diversification strategies\textsuperscript{305}. This demonstrates a
graduated increase in the degree of paternalism where the CSP provides
increasing levels of service to the investor.

(2) Nudges
This section explores the investor protection measures which might nudge the
investors to make certain decisions but ultimately can be ignored by the
investor.

\textsuperscript{296} ECSPR annex I parts A-C, G-I; See also (a) KIIS.
\textsuperscript{297} ECSPR annex I parts A-C, G, H; See also (a) KIIS.
\textsuperscript{298} ECSPR annex I part C.
\textsuperscript{299} ECSPR annex I part A.
\textsuperscript{300} ECSPR annex I part B.
\textsuperscript{301} ECSPR Annex I Part G.
\textsuperscript{302} See also (a) KIIS.
\textsuperscript{303} Delegated Regulation [2022] OJ L287/33 (n 248).
\textsuperscript{304} ECSPR annex I part I(e); See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
\textsuperscript{305} ECSPR annex I part II(j).
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(a) Simulation of Loss Test

As part of the assessment of whether crowdlending is suitable for prospective non-sophisticated investors, prospective non-sophisticated investors must simulate their ability to bear the loss.\(^{306}\) The simulation of loss test is calculated as 10% of the prospective non-sophisticated investor’s net worth. The calculation is based on (1) their regular and total income and ‘whether the income is earned on a permanent or temporary basis’, (2) assets and (3) financial commitments.\(^{307}\) CSPs must make the simulation of the ability to bear losses available on their website as an online calculation tool.\(^{308}\)

The use of simulation of loss tools is supported by research and the Securities and Markets Stakeholder Group as an investor protection tool.\(^{309}\) The advantage of the simulation of loss test tool is that loss-sustaining capacity is not an abstract idea,\(^ {310}\) while disclosures in terms of risk, like in the KIIS,\(^ {311}\) are a very abstract concept.\(^ {312}\)

The simulation of the ability to bear loss is a key nudge to prospective non-sophisticated investors as to whether or not it would be advisable to invest. While it imposes a once-off establishment cost on CSPs,\(^ {313}\) it is thought that the

\(^{306}\) ECSPR article 21(5); Delegated Regulation [2022] OJ L287/29 (n 249) articles 5-12.

\(^{307}\) ECSPR article 21(5).


\(^{310}\) ibid.

\(^{311}\) See also (a) KIIS.

\(^{312}\) Securities and Markets Stakeholder Group, ‘Advice to ESMA: Guidelines on Certain Aspects of the MiFID Suitability Requirements’ (n 329); Baisch and Weber (n 329) 184.

\(^{313}\) European Securities and Markets Authority, ‘Final Report Draft Technical Standards under the European Crowdfunding Service Providers for Business Regulation’ (ESMA35-42-1183,
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benefits of the nudges given to prospective non-sophisticated investors outweigh these cost considerations.

(b) Knowledge Test and Risk Warning
In the ECSPR, prospective non-sophisticated investors must undertake a knowledge test. If the non-sophisticated investor does not achieve the desired outcome in the test the non-sophisticated investor will receive a risk warning. Prospective non-sophisticated investors’ knowledge are assessed on their:

- experience,
- investment objectives,
- financial situation,
- ‘basic understanding of risks in general’ and in crowdlending,
- past investments,
- understanding of crowdlending, and
- professional experience in crowdlending.

A problem with the knowledge test requirement is that it does not specify the risks that need to be assessed. The risks are not listed in the draft Delegated Regulations. If the non-sophisticated investor does not provide the information

European Securities and Markets Authority 2021)

314 ECSPR article 21(2); See further Delegated Regulation [2022] OJ L287/29 (n 249) article 2.
315 ECSPR article 21(4); Delegated Regulation [2022] OJ L287/29 (n 249) article 4; Research shows that consumers ‘may misunderstand the relative riskiness between high-risk products’ and generally, changing the content of risk warnings ‘can have a measurable impact on consumer comprehension of investment risk’. Feddersen and others (n 66) 6.
316 ECSPR article 21(2); See further Delegated Regulation [2022] OJ L287/29 (n 249) article 2.
or in the opinion of the CSP lacks the experience, they are provided with a risk warning\textsuperscript{318} which must be acknowledged by the non-sophisticated investor.\textsuperscript{319} The risk warning must contain the below words:

\begin{quote}
An investment in a crowdfunding project includes the risk of losing the entirety of the money invested.\textsuperscript{320}
\end{quote}

The risk warning is a nudge that must remain visible on the website until the prospective non-sophisticated investor has acknowledged receipt and that they have understood the warning.\textsuperscript{321}

The above risk warning is adequate because it is short, to the point and in simple language. However, behavioural insights do not give reason to assume that risk warnings have ‘any influence on the way’ (prospective) non-sophisticated investors make decisions.\textsuperscript{322} So the risk warning may in effect be little more than an annoyance that a (prospective) non-sophisticated investor must click away.

It is unclear whether the investor proceeds as a sophisticated or a non-sophisticated investor if the risk warning is ignored or acknowledged and understood. The latest version of ESMA’s Q&A document\textsuperscript{323} states that the

\begin{flushright}
\textsuperscript{318} Research shows that consumers ‘may misunderstand the relative riskiness between high-risk products’ and generally, changing the content of risk warnings ‘can have a measurable impact on consumer comprehension of investment risk’. Feddersen and others (n 66) 6.
\textsuperscript{319} ECSPR article 21(4).
\textsuperscript{320} Delegated Regulation [2022] OJ L287/29 (n 249) article 4.
\textsuperscript{321} Delegated Regulation [2022] OJ L287/29 (n 249) article 2.
\textsuperscript{323} European Securities and Markets Authority, ‘Questions and Answers: On the European Crowdfunding Service Providers for Business Regulation’ (n 29) Question 5.1.
\end{flushright}
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requirement in article 21(6) of the ECSPR ‘prospective non-sophisticated investors and non-sophisticated investors shall not be prevented from investing’ in crowdlending applies to the outcome of the tests conducted under article 21(1) of the ECSPR. The knowledge test is one of the tests conducted under article 21(1) of the ECSPR. Thus, the outcome of the knowledge test does not prevent (prospective) non-sophisticated investors from investing. It does not however clear whether the investment is made as a non-sophisticated investor or a sophisticated investor.

(c) Investment Threshold and Risk Warning

Non-sophisticated investors are not subject to an investment limit under the ECSPR. Non-sophisticated investors are subject to an investment threshold. When the investment amount exceeds €1,000.00 or 5% of the investor’s net worth, the CSP must ensure that the non-sophisticated investor receives: 1 a risk warning, 2 the investor must provide the CSP with explicit consent to continue as a non-retail investor, and 3 the investor must prove their understanding of the investment and the risks to the CSP. The investor’s understanding may be evidenced by the results of the knowledge assessment in article 21 of the ECPSR. Nevertheless, the non-sophisticated investor is not prevented from making the investment and shedding the non-sophisticated investor protections.

The risk warning is a nudge intended to ‘not encourage’ the non-sophisticated investor to make an investment that crosses the investment threshold. The

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324 ECSPR article 21(7).
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risk warning could be interpreted as nudging the non-sophisticated investor to consider the possibility that the entire investment could be lost.\textsuperscript{326} This inference is not explicit. Perhaps the risk warning ought to suggest diversifying the investment in the risk warning. It should be made clear that investment diversification might reduce the risk of losing the entire investment, but it does not guarantee the investment. The non-sophisticated investor might continue to ignore the risk warning even with the diversification nudge. The non-sophisticated investor might also choose to take heed of the nudge and diversify their investment. It will be informative to see what the other jurisdictions’ measures are once the investment threshold is crossed.

As a result, the protection measures for non-sophisticated investors rely more on a ‘self-responsibility’ principle\textsuperscript{327} and informing the non-sophisticated investors of risks rather than strictly paternalistic measures. The classification as a non-sophisticated investor can be changed and the investment threshold warning can be ignored.\textsuperscript{328} The only mandatory measures for non-sophisticated investors are the pre-contractual reflection period\textsuperscript{329} and the KIIS.\textsuperscript{330} The ECSPR relies on nudges rather than shoves\textsuperscript{331} to indicate that the non-sophisticated investor should be aware of certain risks.

\begin{footnotesize}
\begin{enumerate}
\item ibid.
\item Macchiavello, ‘The European Crowdfunding Service Providers Regulation and the Future of Marketplace Lending and Investing in Europe: The “Crowdfunding Nature” Dilemma’ (n 26).
\item See further (a) Investor Classification.
\item See further (b) Anti-Impulse Measures.
\item See further (a) KIIS.
\item Kahan (n 245); Willis (n 225); Richard H Thaler and Cass R Sunstein, \textit{Nudge: Improving Decisions about Health, Wealth and Happiness} (n 223).
\end{enumerate}
\end{footnotesize}
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(3) Default
This section explores the default investor protection measures under the ECSPR.

(a) Investor Classification
Non-sophisticated investor classification under the ECSPR is based on the results of the knowledge test and the simulation of loss. The classification of investors as sophisticated or non-sophisticated investors largely reflects the professional-retail client distinction in MiFID II. An investor is classified as a sophisticated investor if they meet the fiscal and experience criteria set out in Annex II(I) of the ECSPR. All investors receive disclosures from the CSP, but the investment threshold warning and pre-contractual reflection period only apply to non-sophisticated investors.

The classification as a non-sophisticated investor is not set in stone. Non-sophisticated investors may request to be treated as a sophisticated investors if certain conditions are met. The request to be treated as a sophisticated investor must be in a prescribed template which includes an attestation setting out either the fiscal or experience criteria they meet from Annex II(I) of the ECSPR, state that they are aware of the consequences of losing the non-sophisticated investor protection, and state that they will remain liable for the

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ECSPR article 21, annex II; See also (i) Investors.
See further (b) Knowledge Test and Risk Warning.
ECSPR articles 2(1)(j), (k), 21; See further (a) Simulation of Loss Test.
Serdaris (n 19) 453 citing MiFID II articles 4(1)(10), (11).
See further (i) Investors.
ECSPR articles 3(4), 6(4) - (6), 8(2), (4) - (6), 19(2) 20, 23, 24, 25(5).
ECSPR article 21(7).
ECSPR article 22; See further (b) Anti-Impulse Measures.
See also (i) Investors.
ECSPR annex II part I(I).
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veracity of the information provided.\textsuperscript{342} In other words, non-sophisticated investors can apply to opt-out of their classification.

\textit{b) Clients}

There are few explicit client protection measures in the ECSPR. One such requirement is a general principle requirement for CSPs to be neutral and not receive a financial benefit for directing investors to a particular offer.\textsuperscript{343} Another is a duty placed on the CSP to ‘act honestly, fairly, and professionally in accordance with the best interests of their clients’.\textsuperscript{344} This duty is similar to the best interests duty found in MiFID II.\textsuperscript{345} The best interest duty ‘has its roots’ in common law countries and ‘can fill regulatory gaps or complement detailed\textsuperscript{346} conduct of business rules’.\textsuperscript{347} The best interest duty means that the CSP must balance the potentially competing interests of its clients.\textsuperscript{348} This also means that there is no guarantee that the CSP will always act in interests of for example investors as the CSP will have to act in project owners’ interests also.\textsuperscript{349}

\begin{itemize}
\item \textsuperscript{342} ECSPR annex II(II).
\item \textsuperscript{343} ECSPR article 3(3), recital 19.
\item \textsuperscript{344} ECSPR article 3(2).
\item \textsuperscript{345} Kitty Lieverse and Wendy Pronk, ‘Organisational and Operational Requirements for Crowdfunding Service Providers’ in Pietro Ortolani and Marije Louisse (eds), \textit{Crowdfunding and the Law} (Oxford University Press 2021) 169 citing MiFID II articles 24, 25.
\item \textsuperscript{346} See further a) Theory of Legal Certainty.
\item \textsuperscript{347} Luca Enriques and Matteo Gargantini, ‘The Overarching Duty to Act in the Best Interest of the Client in MiFID II’ in Danny Busch and Guido Ferrarini (eds), \textit{Regulation of the EU Financial Markets: MiFID II and MiFIR} (Oxford University Press 2017) 86, 95.
\item \textsuperscript{348} Lieverse and Pronk, ‘Organisational and Operational Requirements for Crowdfunding Service Providers’ (n 365) 169 citing MiFID II articles 24, 25.
\item \textsuperscript{349} Lieverse and Pronk, ‘Organisational and Operational Requirements for Crowdfunding Service Providers’ (n 365) 169 citing MiFID II articles 24, 25.
\end{itemize}
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In a few instances, CSPs are required to make disclosures to clients.\textsuperscript{350} One such instance is informing clients about the nature of bulletin boards.\textsuperscript{351} In the main, the ECSPR protects clients by placing business conduct requirements\textsuperscript{352} on the CSP. Client protections are the only protection measures that cater for project owners. This approach is in line with recommendations made by scholars such as Pekmezovic and Walker, and Milne and Parboteeah before the ECSPR was finalised.\textsuperscript{353} This regulatory style places responsibilities upon the businesses at the centre of the regulation, rather than merely envisaging businesses as only receiving regulatory sanctions.\textsuperscript{354} It is an indirect method of client protection.\textsuperscript{355}

The business conduct requirements are a mix of daily conduct\textsuperscript{356} such as outsourcing\textsuperscript{357} complaints\textsuperscript{358} and marketing communications requirements,\textsuperscript{359} and general conduct requirements\textsuperscript{360} placed on CSPs through mechanisms such as the authorisation regime.\textsuperscript{361}

\begin{itemize}
\item \textsuperscript{350} ECSPR articles 10(1), 19(2), (3), 25(5).
\item \textsuperscript{351} ECSPR article 25(3)(a); See further b) Secondary Market.
\item \textsuperscript{352} Cary Coglianese, ‘Management-based Regulation: Implications for Public Policy’ in Risk and Regulatory Policy: Improving the Governance of Risk (n 222).
\item \textsuperscript{353} Alma Pekmezovic and Gordon Walker, ‘The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital’ (2016) 7 William and Mary Business Law Review 347; Milne and Parboteeah (n 228).
\item \textsuperscript{355} Eugene Bardach and Robert Kagan, Going by the Book: The Problem of Regulatory Unreasonableness (Routledge 2017) 224-225.
\item \textsuperscript{356} ECSPR articles 4, 5, 7, 8, 9, 10, 19, 25, 26, 27, 28 recital 26, 57.
\item \textsuperscript{357} ECSPR article 9.
\item \textsuperscript{358} ECSPR article 7.
\item \textsuperscript{359} ECSPR article 27; See further (2) Marketing Communications Requirements.
\item \textsuperscript{360} ECSPR articles 12, 19, 20.
\item \textsuperscript{361} ECSPR article 19; See further a) Authorisation.
\end{itemize}
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One of the general conduct requirements that indirectly protects clients is the ex-ante controls the authorisation regime places ex-ante controls on the access of natural persons to the management of the CSP. Natural persons must disclose:

- whether the natural person was refused an authorisation or licence or whether an authorisation or licence was withdrawn from them,
- whether the natural person was dismissed from employment,
- their CV which should include their education and positions held for the past 10 years including details of the nature and duration of functions performed and reasons for departure, and
- details about the minimum amount of time that will be spent on the performance of their functions.

The self-responsibility principle can also be seen in client protection. For example, the ECSPR does not place an outright ban on conflicts of interest between (1) the CSP, their shareholders, managers, employees, or any natural or legal person linked to them as per article 4(1)(35)(b) of MiFID II and (2) clients. Nor are conflicts of interest between one client and another client banned. A CSP is only required to take ‘appropriate steps to prevent,
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identify, manage and disclose conflicts of interest’. Allowing persons involved in the CSP to potentially make investments in the projects listed on the platform could increase herding and cherry-picking of investments. Some investors may only invest in certain projects purely because they know an employee of the CSP has invested in that project.

Business conduct regulation takes advantage of the CSP’s understanding of the market. However, a regulation that emphasises business management systems will only work when the culture and practice of going beyond compliance are encouraged. In the context of crowdlending, it is unclear whether there will be a culture and practice where going beyond compliance is encouraged. It raises questions as to buy-in for the market into the ECSPR and minimum compliance. This matter will need to be examined once the ECSPR has had full legal effect for some time. The Irish NCA has issued guidance documentation on its website which is a positive step towards a culture and practice where going beyond compliance is encouraged. The EU will have to

\[\text{Coglianese and Lazer (n 222) 725-726.}\]
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review in time whether increased protections are necessary for project owners to possibly increase allocative efficiency, however, the ECSPR’s client protections are a positive step forward.

c) Conclusion

When considering the degree of paternalism imposed by the investor protection measures in the ECSPR, the ECSPR measures are at the milder end of the paternalistic spectrum. This is reflected in the default protection provided by the investor classification system. The entry knowledge test and simulation of the ability to bear a loss are an example of the mild but slightly more paternalistic measures taken by the ECSPR. If a non-sophisticated investor fails either of the tests, the non-sophisticated investor receives a warning but is not prevented from investing.

Thus, while the ECSPR does rely on the ‘self-responsibility’ principle for investor protection the ECSPR also relies on business conduct requirements and behavioural science-informed measures to protect investors. Taking a combined ‘self-responsibility’, behavioural science-informed and business conduct approach means that the market will require continuous monitoring by NCAs and ESMA to evaluate these protection mechanisms once the ECSPR reaches full


375 See also Jonneke van Poelgeest and Marije Louise, ‘The Regulatory Position and Obligations of Project Owners’ in Marije Louise and Pietro Ortolani (eds), The EU Crowdfunding Regulation (Oxford University Press 2021) 203.

376 See further (a) Investor Classification.

377 See further (b) Knowledge Test and Risk Warning.

378 See further (a) Simulation of Loss Test.


380 ibid.
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legal effect. The monitoring will need to evaluate whether more paternalistic measures are necessary or whether less intervention is necessary. The measures may need to transition into mandatory protections if it is found that non-sophisticated investors are continually making unwise investment decisions that result in mass losses. Equally the opposite effect may occur. Non-sophisticated investors may prove that as a group they have the capacity to make appropriate investment decisions in crowdlending. These possibilities would need to be measured in empirical research once the ECSPR has had full legal effect for some time.

E. Financial Regulatory Model
This section provides the financial regulatory model analysis that focuses on the risk-based regulatory model using the risks identified in this chapter namely: liquidity risk, default risk, CSP failure, information asymmetry, inexperience, fraud risk, pricing, credit risk assessment and credit scoring, and systemic risk.

1. Risk-Based Regulatory Model
a) Liquidity Risk
In crowdlending investors and project owners can be exposed to liquidity risk.\(^{381}\)
The ECSPR has two direct measures for liquidity risk (1) disclosures\(^ {382}\) and (2) measures to regulate the bulletin board.\(^ {383}\) As a result, this analysis overlaps with the analysis of secondary markets under the Market Efficiency heading.

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\(^{381}\) See chapter 2 for definition of liquidity risk.
\(^{382}\) ECSPR article 25(3), (5); Delegated Regulation [2022] OJ L287/63 (n 85) annex part C type 6; See also (a) KIIS.
\(^{383}\) ECSPR article 25(4).
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One of the risks the KIIS discloses is the risk that investors cannot sell their investments. CSPs have minimal involvement in the transactions on bulletin boards and only suggest a reference price. CSPs must:

1. disclose the nature of bulletin boards to their clients,
2. require their clients to make the KIIS available,
3. provide clients with information about the performance of the loans, and
4. ensure those qualifying as non-sophisticated investors receive the disclosure that crowdlending is not covered by the deposit guarantee scheme and receive the risk warning that the entire investment could be lost.

The presence of a bulletin board may mislead investors to believe that their investment is easily liquidated. The reality of bulletin boards is that they allow for the advertisement of an interest to sell. CSPs cannot match buying and selling interests which this could improve the bulletin board’s adequacy. The current status quo is a sub-optimal arrangement in terms of adequacy. On the other hand, creating an explicit exemption for bulletin boards from MTF requirements under MiFID II and allowing CSP to take a more active role would go against the efforts made by MiFID II to level the playing field and the same

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384 Delegated Regulation [2022] OJ L287/63 (n 85) annex part C type 6; See also (a) KIIS.
385 ECSPR article 25(5); See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
386 ECSPR article 25(3)(a).
387 ECSPR article 25(3)(b).
388 ECSPR article 25(3)(c).
389 ECSPR article 25(3)(d).
390 Article 25(3)(a) of the ECSPR stipulates CSPs must inform clients about the nature of the bulletin board. This may help alleviate the unfairness concern.
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activity same rules principle. A CSP’s intermediation role is not only limited on bulletin boards but actively discouraged because of the potential overlap with MTFs. A CSP is limited to fulfilling various disclosure requirements (nature of the bulletin board, availability of the KIIS, loan performance information, no deposit guarantee and article 21(4) of the ECSPR risk warning). A CSP may also choose to suggest a reference price in line with the methodology requirements in article 19(6) of the ECSPR. However, a CSP is not allowed to match an investor seeking to sell with an investor seeking to purchase. The ECSPR should specify the timing of the disclosure about the operation of the bulletin board. This information should be delivered upfront and early in the process as it is key that investors do not misconstrue the bulletin board as eliminating liquidity risk. Delivering information upfront and early in the process is key to enable in particular non-sophisticated investors to make wise decisions.

b) Default Risk

The ECSPR’s main response to default risk is through disclosures. The ECSPR mandates three types of disclosures: 1 a disclosure in the KIIS, 2 risk

391 See also (a) KIIS.
392 See further (b) Knowledge Test and Risk Warning.
393 ECSPR article 25(3).
394 See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
396 See chapter 2 for a definition of default risk.
397 ECSPR annex I part G(e).
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warning,\textsuperscript{398} a default rate report published on the CSP’s website,\textsuperscript{399} and 4 methodology and governance requirements.\textsuperscript{400}

First, the KIIS disclosure requires the project owner to disclose any default on a credit agreement in the past five years.\textsuperscript{401} There are, however, definitional problems with this disclosure requirement. This is the only reference to the term credit agreements in the ECSPR. A definition is needed because in the EU credit agreements are understood as agreements where (1) a creditor grants the credit and (2) the creditor is understood as someone who grants credit in the course of their trade, business or profession.\textsuperscript{402} As explored in 2. Consumer Credit, investors and CSPs do not fulfil the criteria for credit agreements or creditors in EU regulation. This makes it difficult to judge whether credit agreements are traditional bank loans which fall within the standard EU definition of credit agreements. Or do crowdlending loans come within the scope? ESMA and EBA have taken different approaches to the term credit agreements. EBA has provided a definition that only applies where individual portfolio management services are provided.\textsuperscript{403} Yet ESMA has not provided a definition\textsuperscript{404} and ESMA’s position applies when an individual portfolio

\textsuperscript{398} Delegated Regulation [2022] OJ L287/29 (n 249) article 2; See further (b) Knowledge Test and Risk Warning.

\textsuperscript{399} ECSPR article 20.

\textsuperscript{400} Commission Delegated Regulation (EU) 2022/2118 of 13 July 2022 supplementing Regulation (EU) 2020/1503 of the European Parliament and of the Council with regard to regulatory technical standards on individual portfolio management of loans by crowdfunding service providers, specifying the elements of the method to assess credit risk, the information on each individual portfolio to be disclosed to investors, and the policies and procedures required in relation to contingency funds C/2022/4841 [2022] OJ L287/50 (‘Delegated Regulation [2022] OJ L287/50’) chapter IV.

\textsuperscript{401} ECSPR annex I part G(e); See further (a) Credit Agreement.

\textsuperscript{402} See further 2. Consumer Credit; Consumer Credit Directive article 3(b), (c).

\textsuperscript{403} ibid; See also (c) Individual Loan Portfolio Management.

\textsuperscript{404} ibid.
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management service is not provided. This matter is fully explored under the heading of information asymmetry and inexperience.405

Second, a risk warning is a set piece of text prescribed by the legislator which is displayed prominently on the CSP’s website until the non-sophisticated investor acknowledges the risk warning. There are questions as to the efficacy of risk warnings. Risk warnings can act as nudges that relay information. However, the evidence demonstrating risk warning’s efficacy in the financial sector is varied.406 Some research finds that risk warnings have no impact407 and other research finds changing the content of risk warnings has a positive impact on consumer choices.

Third, under the ECSPR a CSP must disclose in a prominent place on its website two types of reports on default rates.408 One is an annual report of the default rates over the past 36 months. The other is an annual outcome statement that must be published within four months of the end of the financial year.

Fourth, the draft Delegated Regulations set out policy and organisational requirements for contingency funds delineating methodology requirements.409 These disclosures and risk warnings are only required where the CSP is providing a portfolio management service.410

405 See further d) Information Asymmetry and Inexperience; See also (c) Individual Loan Portfolio Management.
406 Feddersen and others (n 66) 9.
408 ECSPR article 20.
409 Delegated Regulation [2022] OJ L287/50 (n 422) chapter IV.
410 See further (c) Individual Loan Portfolio Management.
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It is possible that all or part of the investment will not be returned to the investor because the project owner defaulted. It may be that the investor has availed of the individual loan portfolio management services[^11] and one or many of the project owners in the portfolio has defaulted. In practice, contingency funds are used where an investment fails. It is a CSP’s way to respond to default risk. Contingency funds at the outset appear as a show of good faith on the CSP’s behalf[^12]. There are, however, significant fairness and investor protection concerns linked with the use of contingency funds. If communicated poorly, contingency funds have the potential to give the impression that the loan is guaranteed. This is misleading. Payments from contingency funds are discretionary[^13] and the full investment amount might not be returned.

There is no regulatory response to contingency funds where the investor selects the loan. The regulatory requirements for contingency funds only apply where the CSP manages a portfolio on behalf of the investor[^14]. The ECSPR addresses contingency funds by requiring CSPs to provide set warnings, and certain information disclosures to investors[^15] and every quarter make disclosures to the public about the performance of the fund[^16]. It is unclear[^17] why the contingency fund requirements only apply where portfolio management

[^11]: See further (c) Individual Loan Portfolio Management.
[^12]: With parallels to the signalling of voluntary cooling off periods analysed in Sparks and others, (n 308).
[^14]: ECPSR article 6(5), (6).
[^15]: ECPSR article 6(5).
[^16]: ECPSR article 6(6).
[^17]: See also b) Legal Uncertainties within the ECSPR.
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services are provided. It places investors who choose their investment and are offered a payment from a contingency fund at a disadvantage. This position is against the same activity same rules principle in the EU. The same requirements should apply to contingency funds regardless of whether the investor or the CSP selects the loan.

As explored in chapter 2, another response to default risk by CSPs is a buy-back obligation. It is unclear whether the buy-back obligation would constitute a contingency fund or a credit protection arrangement under the ECSPR. A credit protection arrangement under the ECSPR is where a loan is secured by either collateral or guarantees. A buy-back obligation is not a guarantee. Nor is it collateral which is liquid and has a traded market. The buy-back obligation likely will not constitute a contingency fund either because it is a mechanism operated by a “fourth”-party loan company, not by the CSP. This leaves investors exposed to an obligation which is potentially unregulated. It is unclear if the obligation is a contract only between the “fourth”-party loan company and the investor. If this is the case, it possibly would fall outside the scope of the ECSPR as there may not be a matching role conducted by the

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418 See further (c) Individual Loan Portfolio Management.
421 ibid.
423 Fourth party because crowdlending already constitutes three parties: project owner, investor and CSP.
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CSP. Should the buy-back obligation become popular the EU will need to consider how to intervene.

c) CSP Failure
CSP failure is a significant risk in crowdlending. As explored in chapter 2, CSP failure has potential impacts on the investor and project owner. The investor may lose the entirety of their investment. The project owner may become entangled in the CSP failure, particularly if it is a start-up.

The ECSPR has addressed CSP failure with (1) a business continuity plan requirement and (2) a disclosure requirement in the KIIS. Business continuity plans are a feature of risk-based regulation. CSPs are required as part of the authorisation process to have a business continuity plan.

The draft Delegated Regulations elaborate on the business continuity plan requirement. The plan must account for scenarios where the CSP fails and where there is a significant business interruption. The requirements set out the minimum content, which critical services must be continued, and what should be included in the plan regarding the continuity of servicing loans.

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424 ECSPR article 2(1)(a).
425 Zetzsche and Preiner (n 227) 227.
426 ECSPR article 12(2)(j).
429 See further a) Authorisation.
430 ECSPR article 12(2)(j).
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A business continuity plan must at least include information about (A) the critical services for existing investments and (B) the sound administration of (i) agreements between the CSP and clients and (ii) critical business data. This information must be adapted to the CSP’s business model and:

- include the contact details of the persons in charge in the event of failure,
- identify the three most likely failures and describe the measures taken to mitigate those failures,
- information about access to client information and ‘where relevant, client assets’
- identify operational and financial risks and the measures taken to reduce them,
- identify ‘critical business systems and contingency measures’,
- identify ‘critical business relationships, including outsourced functions’, and
- procedures to ensure communication between the CSP, clients, ‘business partners, employees’ and NCAs.

Critical services must be continued despite CSP failure or the failure of the third party to which services were outsourced. The business continuity plan must be adapted to the CSP’s business model and include arrangements for

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outsourcing critical services.\textsuperscript{437} The business continuity plan must include provisions for:

- a client failure notification,
- access to client investment information,
- ‘where applicable, the continued servicing of outstanding loans’,
- ‘where applicable, payment services continuation’ as per article 10(5) of the ECSPR, and
- ‘where applicable, the handover of asset safekeeping services’ as per article 10(5) of the ECSPR.\textsuperscript{438}

The business continuity plan must take into account the CSP’s ‘nature, scale and complexity’ and ‘set out detailed measures’ that will ‘ensure the sound administration’\textsuperscript{439} of (1) agreements between the CSP and clients, (2) knowledge test\textsuperscript{440} results and (3) ‘information and agreements’ to enable the tracing of ‘payments made by project owners and investors’.\textsuperscript{441}

The business continuity plan is one of the documents assessed in the authorisation application.\textsuperscript{442} While the CSP must review the business continuity plan every two years,\textsuperscript{443} NCAs are left to decide the frequency and depth of their compliance assessments.\textsuperscript{444} A CSP’s business model or size could develop significantly after their authorisation.\textsuperscript{445} As a result, there is a risk for

\begin{footnotesize}
\begin{enumerate}
\item Delegated Regulation [2022] OJ L287/38 (n 453) article 3(2), (3).
\item ibid.
\item ibid.
\item See further (b) Knowledge Test and Risk Warning.
\item Delegated Regulation [2022] OJ L287/38 (n 453) article 3(2), (3).
\item ECSPR article 12(2)(j); See further a) Authorisation.
\item ECSPR article 4(3).
\item ECSPR article 15(2).
\item See further a) Authorisation.
\end{enumerate}
\end{footnotesize}
regulatory arbitrage because a lenient NCA might mean that a CSP might not update its business continuity plans as it grows and develops. If the business continuity plan is no longer fit for purpose, it reduces the plan’s adequacy in protecting investors and other users should the CSP fail. An outdated and irrelevant business continuity plan could also impact the CSP’s financial stability because the CSP might not have the necessary safeguards ready if a failure event occurs. It might be the case that to ensure continuous compliance with the business continuity plan requirements NCAs might be required to conduct a compliance assessment every for example three years. Another possible option is to set an ‘expiry’ date on the authorisation.\textsuperscript{446} However, each of these options would increase regulatory compliance costs for CSPs.

Thus, the ECSPR’s response to CSP failure is twofold. The ECSPR seeks to ensure that the investor is informed about the risk of CSP failure while also ensuring that the CSP meets certain business management standards. This is an appropriate response to CSP failure. The response balances the need to protect investors without taking draconian measures that make it impossible for crowdlending and adequately ban crowdlending from the EU market. However, time will tell if a more frequent review mechanism would be necessary.

\textit{d) Information Asymmetry and Inexperience}
There is an overlap between the analysis conducted under the heading of investor protection, information asymmetry and inexperience. It was decided

\textsuperscript{446} ibid.
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to amalgamate the analysis on information asymmetry and inexperience to reduce repetition.

As discussed in chapter 2, information asymmetry can lead to a market for lemons. The project owner and CSP will likely be knowledgeable about their respective activities. However, non-sophisticated investors are likely to have the least amount of information about crowdlending and the project owner’s business. CSPs will likely have less information about the project owner’s business than the project owner. Similarly, the project owner will likely have less information about crowdlending.

Also discussed in chapter 2, inexperience can lead to insufficient risk awareness of the investment. Evidence shows inexperienced investors are likely to take on inappropriate risks for their needs, suffer more so from information asymmetry, struggle to decipher the nuance of information when provided and have a lesser capacity to bear loss.

The ECSPR relies on a mix of measures to address information asymmetry and inexperience ranging from disclosure tools to knowledge tests, simulations, and risk warning nudges. In this section, the most significant disclosure tool is analysed the standardised disclosure document and the CSP’s role in putting the measures in place is examined.

448 Zetzsche and Preiner (n 227) 10.
449 See further (b) Knowledge Test and Risk Warning.
450 See further (a) Simulation of Loss Test.
451 See further (b) Knowledge Test and Risk Warning.
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(1) Standardised Disclosure Document
The standardised disclosure document in the ECSPR is the KIIS.\(^\text{452}\) The KIIS is the most significant disclosure tool used in the ECSPR. The KIIS is quite comprehensive and targeted with the information it delivers. At times, the KIIS provides links to where further information can be found.\(^\text{453}\) In general, the KIIS has specific presentation requirements using tables and examples of what the fees and taxes would look like.\(^\text{454}\)

The KIIS contains basic information such as name and contact details.\(^\text{455}\) The KIIS discloses information about the borrower’s activities, services, products, financial figures, and description of the business.\(^\text{456}\) The KIIS has paternalistic disclosures about investor rights\(^\text{457}\) and fees.\(^\text{458}\) KIIS also requires targeted information about for example the minimum target capital\(^\text{459}\) and maximum offer amount.\(^\text{460}\) Furthermore, the draft Delegated Regulation specifically outlines a non-exhaustive list of risks that must be described.\(^\text{461}\) For example default risk,\(^\text{462}\) CSP failure,\(^\text{463}\) and liquidity risk.\(^\text{464}\) Thus the EU’s standardised disclosure document targets many of the risks examined in this thesis.

One of the risks that arise from the crowdlending business model is rooted in how CSPs make their money. There is no set formula for CSPs to generate

\(^{452}\) ECSPR article 23.
\(^{454}\) Ibid.
\(^{455}\) ECSPR annex I part A(a).
\(^{456}\) ECSPR annex I part A(c)-(f).
\(^{457}\) ECSPR annex I part F.
\(^{458}\) ECSPR annex I part H.
\(^{459}\) ECSPR annex I part B(a).
\(^{460}\) ECPSR annex I part B(d).
\(^{461}\) Delegated Regulation [2022] OJ L287/63 (n 85) annex part C.
\(^{462}\) See also b) Default Risk.
\(^{463}\) See further c) CSP Failure.
\(^{464}\) Ibid; See also a) Liquidity Risk.
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income. In the main, CSPs generate income in the form of fees imposed on investors and project owners which vary from origination fees to repayment fees to late payment fees. The ECSPR uses disclosure mechanisms to tackle CSP’s income-generating mechanisms. In the draft Delegated Regulation, the KIIS requires information about one-off, ongoing and incidental fees. This requirement to disclose information about one-off, ongoing and incidental fees aligns closely with the Commission’s recommendations in its 2015 study on possible new formats for disclosures to non-sophisticated investors in the context of PRIIPs. The information about the fees must be presented in a table format and includes all direct and indirect fees, commissions, costs, and charges about the investment and exit. Where the CSP manages a portfolio of loans for an investor, the ECSPR is required to continually provide the investors with a ‘fair description’ of the expected return taking into account the fees and default rates. The figures provided in the table also account for a range of costs such as stamp duty.

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466 Delegated Regulation [2022] OJ L287/63 (n 85) annex part H.
467 Commission, Consumer Testing Study of the Possible New Format and Content for Retail Disclosures of Packaged Retail and Insurance-Based Investment Products (n 262) xv.
469 Delegated Regulation [2022] OJ L287/63 (n 85) annex part H.
470 See further (c) Individual Loan Portfolio Management.
471 ECSPR article 6(4)(h)(iv). For more see f) Pricing, Credit Risk Assessments, and Credit Scoring.
472 ECSPR article 6(4)(h)(iv).
The ECSPR is quite prescriptive in informing all types of investors about CSPs’ fees. By relying on disclosure mechanisms, the ECSPR has not taken restrictive steps. For example, the ECSPR has not mandated a fee maximum. The ECSPR’s KIIS uses a set format to deliver information that eases comparison and communicates key information about fees and charges by using examples that demonstrate what the fees might practically mean for the investor. Thus, the KIIS supports the conclusion that it is informed by behavioural science about human decision-making.473 The KIIS is by no means perfect. There are questions raised regarding the information delivered in the KIIS.

(a) Credit Agreement
The first concern relates to where the KIIS requires the project owner to disclose any default on credit agreements by the project owner within the past five years.474 The problem is that the ECSPR does not define credit agreements. The type of agreements that are defined and facilitated under the ECSPR are loans.475 Loans are defined under the ECSPR as:

an agreement whereby an investor makes available to a project owner an agreed amount of money for an agreed period and whereby the project owner assumes an unconditional obligation to repay that amount to the investor, together with the accrued interest, in accordance with the instalment payment schedule;476

473 Serdaris (n 19) 462.
475 ECSPR article 2(1)(b).
476 ECSPR article 2(1)(b).
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Credit agreements in EU regulation are generally understood to be agreements where a creditor grants credit and a creditor is understood as someone who grants credit during their trade, business or profession. As examined in 2. Consumer Credit, it was found that investors and CSPs would not fulfil the criteria for credit agreements or creditor in EU regulation. As crowdlending does not fall within the common understanding of credit agreements in EU regulation this caused problems for the disclosure of a project owner’s defaults on credit agreements in the past five years. Would credit agreements in this instance be traditional bank loans which would fall within the EU’s broader understanding of credit agreements? Or would crowdlending loans come within the scope?

The lack of clarity of what constitutes a credit agreement was put to ESMA by stakeholders. ESMA did not elaborate further on the point other than to say that ESMA did not agree that the term credit agreement is not clear. In contrast, EBA acknowledged the lack of a credit agreement definition in the ECSPR. EBA made the policy decision to ‘define credit agreements for the purpose of’ chapter III of the EBA’s draft regulatory technical standards. Here EBA made an interesting policy decision. EBA defined credit agreements as loans facilitated by crowdfunding platforms. The impact of solely focusing on

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477 See further 2. Consumer Credit; Consumer Credit Directive article 3(b), (c).
478 See further 2. Consumer Credit.
480 ibid.
482 ibid.
483 ibid.
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loans facilitated by crowdfunding platforms when disclosing any defaults by the project owner in the past five years is that the project owner will not have to disclose defaults on any other forms of credit in the KIIS. EBA states that CSPs may find it difficult to access credit history from ‘national credit systems’. On the other hand, the narrow definition of credit agreements reduces the range and quality of the information provided to investors. To address this impact, EBA has set out a separate requirement for the project owners to disclose information concerning ‘the days past due and the amount of arrears in credit obligations’ outside of crowdlending.

While this clarity and additional concept of days past due and credit arrears from EBA are welcome, it likely only applies in the context of a KIIS for the individual portfolio management of loans. The clarification provided by EBA on credit agreements and the further requirement regarding days past due and credit arrears was given by the EBA in its draft regulatory technical standards required under article 6(7) of the ECSPR. Article 6(7) of the ECSPR only applies to individual portfolio management of loans. This means that the EBA’s clarification may not apply where the disclosure requirement regarding a project owner’s defaults on credit agreements in the past five years in the standard KIIS.

484 ibid.
486 See further (c) Individual Loan Portfolio Management.
487 ibid.
488 ECSPR annex I part G(e).
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Interestingly for this analysis, ESMA’s definition of default also uses the concept of days past due.489 However, ESMA combines days past due with whether the CSP considers the project owner to be unlikely to pay in full or otherwise fulfil their credit obligations.490 The link between EBA’s additional disclosure requirement concerning days past due and amount in arrears and ESMA’s default definition is interesting. EBA uses ESMA’s default definition in the same draft regulatory technical standards where EBA provides a definition for credit agreements and the additional disclosure requirement.491 This circularity means that it is likely similar information will be used in the KIIS for portfolio management492 and the standard KIIS.

The dichotomy in approaches from ESMA and EBA results in reduced regulatory clarity and certainty. The lack of a joint clear response from ESMA and EBA would be less concerning if CSPs’ project owner due diligence requirements were more stringent or if the CSP conducted a credit risk assessment493 in all instances.

The ECSPR sets out minimum due diligence requirements solely related to the presence of a criminal record or whether the project owner is based in a non-cooperative jurisdiction or high-risk third country under article 9(2) of AMLD V.494 The Commission has not yet taken the leadership necessary and did not

489 European Securities and Markets Authority, ‘Final Report Draft Technical Standards under the European Crowdfunding Service Providers for Business Regulation’ (n 268) 117.
490 ibid.
492 See further (c) Individual Loan Portfolio Management.
493 See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
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address the dichotomy when the Level 2 measures were reviewed and amended by the Commission.\(^{495}\) As such the dichotomy continues.

While the credit risk assessment is only required where the CSP prices\(^{496}\) the loans for the investors\(^{497}\) or where the CSP provides portfolio management.\(^{498}\) The CSP is obliged to provide a reasonable assessment according to a non-exhaustive list of prescribed factors.\(^{499}\) The factors are audited accounts of the past two years, information the CSP is aware of at the time of the assessment, information obtained from the project owner and information that enables the CSP to carry out a reasonable credit risk assessment.\(^{500}\)

The dichotomy results in more concrete protections for investors electing the portfolio management option. The dichotomy further results in increased potential information asymmetry for investors who do not avail of the option of portfolio management.

\(\text{(b) Conclusion}\)

Overall, the ECSPR’s KIIS provides targeted information over a broad range of areas, indicates where further information can be found and provides key information on fees and costs in an easy-to-read standardised format that

\(^{495}\) Delegated Regulation \([2022]\) OJ L287/50 (n 422); Delegated Regulation \([2022]\) OJ L287/63 (n 85).
\(^{496}\) See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
\(^{497}\) ECSPR article 4(4).
\(^{498}\) ECSPR article 6(2); European Banking Authority, ‘Final Report Draft Regulatory Technical Standards on Individual Portfolio Management of Loans Offered by Crowdfunding Service Providers under Article 6(7) Regulation (EU) 2020/1503’ (n 313) 13-17; See further (c) Individual Loan Portfolio Management.
\(^{499}\) ECSPR article 4(4).
\(^{500}\) ibid; See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
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utilises examples. Standardising key information about financial products in an engaging presentation format is key to improving the ability to select the correct financial product. The next chapter will examine whether the ECSPR has been adequate in addressing information asymmetry in comparison to the other jurisdictions. Independent of this examination, at this point it can be said that the KIIS has flaws. The credit agreement definition is a flaw that undermines the KIIS’ adequacy in addressing information asymmetry and inexperience.

(2) Gatekeeper
The ECSPR is designed so that a gatekeeper role is given to the EU regulators, NCAs and CSPs. Each body fulfils a slightly different gatekeeping role. The NCAs gatekeeping role is concerned with market access and the EU regulators are focused on information exchange and collaboration. The market access aspect is achieved through authorisation and passporting. The information aspect is achieved through information sharing between the regulators and information disclosure by regulators.

Important for this analysis from the perspective of information asymmetry and inexperience is the CSP’s gatekeeping role. The CSPs’ gatekeeping role is concerned with who or what gains access to crowdlending and protection measures. The access element is explored in investor classification in terms of

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501 Commission, ‘Behavioural Study on the Digitalisation of the Marketing and Distance Selling of Retail Financial Services Final Report’ (n 415) 129-130.
502 ECSPR articles 12, 13, 17; See further a) Authorisation.
503 ECSPR article 18; See further a) Passporting.
504 ECSPR articles 31, 32.
505 ECSPR articles 28, 45.
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the type of access investors have to crowdlending and in fraud risk regarding
the CSP’s due diligence obligations for project owners. Admittedly this access
element of the gatekeeping role is quite mild. Only in very specific
circumstances can access to crowdlending be blocked such as where project
owners have a criminal record. The protection measures are for example,
knowledge tests, investor classification, pre-contractual reflection
period, bulletin board measures, conflict of interest measures and asset
safekeeping service and payment services measures. This results in CSPs
having roles analogous to traditional investment firms. There are aspects of
the CSP gatekeeping responsibilities that are unclear (CSP’s role in verifying the
KIIS, the civil liability of CSP, the extent of CSP’s diligent selection of
projects, and the CSP’s role in bulletin boards). These ambiguous areas
have largely been left to the market or national responses. However, the
analysis of pricing, credit risk assessment, and credit scoring shows the
extent of the CSP’s responsibilities when pricing loans.

506 See further (a) Investor Classification, e) Fraud Risk. There is also some relevant discussion
in (b) Project Owners and Investors.
507 ECSPR article 21; See further (b) Knowledge Test and Risk Warning.
508 Ibid; See further (a) Investor Classification.
509 ECSPR article 22; See further (b) Anti-Impulse Measures.
510 ECSPR article 25; See further b) Secondary Market.
511 ECSPR article 8.
512 ECSPR article 10.
513 Macchiavello and Sciarrone Alibrandi (n 131) 80 Macchiavello.
514 ECSPR article 23(11).
515 ECSPR article 23(10).
516 ECSPR article 3(4).
517 ECSPR article 25.
518 Macchiavello and Sciarrone Alibrandi (n 131) 81.
519 Ibid.
520 See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
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Thus, the ECSPR links with the practice of placing public duties on regulated firms themselves.521 These firms are at the regulatory focus of the regulatory action and are not merely at the receiving end of regulatory penalties and sanctions522 but are incorporated into the ethos of what the ECSPR is attempting to achieve.

ev) Fraud Risk

Many different types of fraud could be perpetrated through crowdlending. The ECSPR addresses fraud in a few ways.

First, a CSP must undertake a minimum level of due diligence523 to ensure the project owners have no criminal record and the project owner is not established in a non-cooperative jurisdiction or high-risk third country under article 9(2) of AMLD V. In the KIIS for portfolio management,524 CSPs must disclose the procedures, methodologies and criteria of the selection of the projects to investors.525

Second, the ECSPR uses specialist pre-existing regulatory frameworks. For cyber-risk and the risk of money laundering, the ECSPR relies on PSD II and its response to cyber-risk526 and PSD II’s connections to AMLD V. However, the Digital Operational Resilience for the Financial Sector Regulation specifically

521 Van Loo (n 374).
522 See further (iii) Enforcement Sanctions.
523 ECSPR article 5.
524 See further (c) Individual Loan Portfolio Management.
525 ECSPR annex I part I(g).
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targets cyber-risk which includes CSPs in its scope and will apply from 17 January 2025.\textsuperscript{527}

Third, there is potential for fraud where the CSP manages a portfolio on behalf of investors.\textsuperscript{528} When compared with the other issues the ECSPR has addressed, the requirements are slightly more prescriptive. Investments in individual portfolio management of loans must stay within the investor’s mandate,\textsuperscript{529} investors must give specified parameters,\textsuperscript{530} and the CSP must have ‘adequate systems and controls for the management of risk and financial modelling’.\textsuperscript{531}

Fourth, as explored in the examination of client protection measures under 3. Investor Protection and Other Users, the ECSPR uses ex-ante controls on natural persons’ access to CSP management. The combination of experience and whether the person has an undesirable history means that the persons managing the CSP should have sufficient competency to conduct their role.\textsuperscript{532} The requirement to disclose whether a person has been dismissed, refused or had a licence withdrawn is likely to eliminate persons who have possibly demonstrated a history of fraud.\textsuperscript{533} Sufficiently competent persons are less likely to commit a fraud. It is however no guarantee. It does not eliminate those with a penchant for creative compliance or tactical fraud. Complete

\begin{footnotesize}
\begin{itemize}
  \item See also (c) Individual Loan Portfolio Management.
  \item ECSPR article 3(4); See further (c) Individual Loan Portfolio Management.
  \item Concerning the minimum and maximum interest rate, minimum and maximum maturity date, range, and distribution of risk categories, and if there is annual target return rate the likelihood it will be achieved. ECSPR article 6(1); See further (c) Individual Loan Portfolio Management.
  \item ECSPR articles 4(2), 6(2); See further (c) Individual Loan Portfolio Management.
  \item ECSPR article 12(1)(k), (l); Delegated Regulation [2022] OJ L287/5 (n 37) Annex 13.
  \item ECSPR article 12(1)(k), (l); Delegated Regulation [2022] OJ L287/5 (n 37) Annex 13.
\end{itemize}
\end{footnotesize}
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elimination of fraud would nevertheless require the perfect solution which of course does not exist.

It seems that the ECSPR is a well-rounded response to the potential for fraud in crowdlending. The EU has leveraged pre-existing regulatory responses that specialise in key areas of fraud which bolsters the ECSPR. The use of pre-existing regulatory frameworks that specialise in certain types of fraud risk indicates a market facilitatory approach. It also demonstrates the measured application of the same activity same rules principle despite the ‘new’ context of crowdlending. The potential for fraud that comes with automated models receives a crowdlending-tailored regulatory response.

f) Pricing, Credit Risk Assessment, and Credit Scoring

There are three points in crowdlending where pricing is relevant: 1 at the time of investment,\(^{534}\) 2 early exits from the investment or the bulletin board,\(^{535}\) and 3 where there is a risk of or has been a default.\(^{536}\) There are many different loan-pricing practices in the market.\(^{537}\) In some instances, the market is left to price the loans in an auction-style setting.\(^{538}\) In other instances, the CSP will recommend a price.

The ECSPR has not mandated a particular approach as being the “right one”. The ECSPR has, however, set out numerous requirements where CSPs are

\(^{534}\) ECSPR articles 4(4), 19(6).
\(^{535}\) ECSPR article 25.
\(^{536}\) ECSPR article 4(4)(e); See further b) Secondary Market, b) Default Risk.
\(^{537}\) For an examination of the pricing practices see Zaiyan Wei and Mingfeng Lin, ‘Market Mechanisms in Online Peer-To-Peer Lending’ (2017) 63 Management Science 4236.
\(^{538}\) Macchiavello and Sciarrone Alibrandi (n 131) 46 Macchiavello.
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involved in loan pricing\(^{539}\) which are a mix of information disclosures\(^{540}\) and mandates that certain factors should be considered.\(^{541}\) The EBA’s draft regulatory technical standards further elaborate on these requirements with an intricate system of requirements addressing a variety of matters concerning credit scoring, pricing and credit risk assessments.\(^{542}\) The requirements range from methodology requirements\(^{543}\) to disclosures on credit protection,\(^{544}\) to governance policies,\(^{545}\) to differing pricing methodologies depending on whether the loan is or has been originated.\(^{546}\)

Some CSPs may price their loans using automated models. Automated models can be very useful, speeding up transactions but they can also perpetuate fraud and bias among other things if not carefully constructed.\(^{547}\) In the recitals, the

\(^{539}\) ECSPR articles 4(4), 19(6).
\(^{540}\) ECSPR article 19(6).
\(^{541}\) ECSPR article 4(4).
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ECSPR envisages auto-investing tools as part of individual portfolio management of loan services.\(^{548}\) In EBA’s draft regulatory technical standards, a precautionary approach is evidenced towards the use of automated models for credit scoring or in suggesting pricing,\(^{549}\) and credit risk assessments in individual loan portfolio management.\(^{550}\) EBA’s draft regulatory technical standards set out a mix of disclosures and business conduct requirements. These requirements vary from requiring the ‘relevant function’ and the CSP’s management to have a good understanding of certain key areas of the automated model’s function,\(^{551}\) to policy and procedures requirements on the use of automated models,\(^{552}\) to disclosures to clients on when the automated model is used,\(^{553}\) to disclosures to investors in individual portfolio management on when and how automation is used.\(^{554}\)

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\(^{548}\) ECSPR recital 20; The AI technology to interpret complex documentation based on businesses values and preferences is already provided by businesses specialising in AI services such as Fluence. Fluence, ‘Fluence’ <https://fluence.world/> accessed 7 March 2023; See further (c) Individual Loan Portfolio Management.

\(^{549}\) ECSPR article 19(6).

\(^{550}\) ECSPR article 6(2); See further (c) Individual Loan Portfolio Management.


\(^{552}\) ibid.


\(^{554}\) Delegated Regulation [2022] OJ L287/50 (n 422) article 6(2); See further (c) Individual Loan Portfolio Management.
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Overall, the ECSPR does not have overarching governance requirements for CSPs. The ECSPR does have governance requirements where the CSP is involved in loan pricing, credit scoring, credit risk and automated models.\textsuperscript{555} The pricing, credit scoring and automated models’ governance arrangements focus on the design such as the nature of the information used, factors considered and outputs.\textsuperscript{556} The governance arrangements for the credit risk framework are different as it requires the framework to set out:

- the functions that must be established for performing the creditworthiness assessment for:
  - credit scoring,
  - ‘assigning loans to appropriate risk categories’,
  - designing credit risk monitoring and reporting processes, and
  - defining processes for when the project owner ‘is not able to fulfil its obligations or is in default’\textsuperscript{557}
- and document and define processes for allocating investors’ funds in portfolio management.\textsuperscript{558}


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The credit risk framework must also ensure that loan risk categories reflect the risk levels in the projects as per the credit scoring models and specific loan factors including the interest rate, loan maturity and payment frequency.\textsuperscript{559} Furthermore, the credit risk framework must include the review and re-assignment of risk categories and that the risk categories are ‘associated with a probability of default’.\textsuperscript{560} There is also a focus on the training and expertise of staff to whom responsibilities are delegated.\textsuperscript{561}

The ECSPR again relies on investor self-responsibility\textsuperscript{562} rather than strict paternalistic measures where there is no pricing, credit risk assessment or credit scoring. However, significant regulatory requirements apply once the CSP prices the loans. This is another instance of an increase in business conduct paternalism where the CSP provides more services. Where there is an increased reliance on the CSP’s competency the ECSPR uses governance requirements to protect clients.\textsuperscript{563} While the ECSPR addresses the risks associated with pricing, credit risk assessments and credit scoring, it remains to be seen whether the ECSPR’s response is adequate.

g) Systemic Risk

Even though systemic risk is not a major concern at this point,\textsuperscript{564} the ECSPR nevertheless placed prudential requirements on CSPs. The more obvious and

\begin{footnotesize}
\begin{enumerate}
\item ibid.
\item ibid.
\item Macchiavello, ‘The European Crowdfunding Service Providers Regulation and the Future of Marketplace Lending and Investing in Europe: The “Crowdfunding Nature” Dilemma’ (n 26).
\item See also b) Clients.
\end{enumerate}
\end{footnotesize}
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direct prudential requirements placed on CSPs are contained in article 11 of the ECSPR. CSPs must set aside an amount ‘of at least the higher of’ €25,000.00 ‘and’ a quarter of the preceding year’s fixed overheads.\textsuperscript{565} It appears perhaps there was a drafting error in this requirement as the language ‘at least the higher of’ indicates that there is a choice between the two amounts. Yet, the ‘and’ indicates that both amounts are necessary.

These funds may constitute a CSPs’ own funds, an insurance policy specifically for prudential safeguards or a combination of both.\textsuperscript{566} The current market evidence indicates that there are insufficient numbers of insurance providers offering the necessary insurance coverage in the market.\textsuperscript{567} The insurance market may respond and provide the necessary insurance coverage to CSPs for their prudential requirement needs. Another possibility is that the EU may have to rethink its prudential requirements under the ECSPR.

The ECSPR also places other prudential requirements on CSPs such as contingency fund policy disclosure,\textsuperscript{568} credit risk assessment methodology

\textsuperscript{565}ECSPR article 11(1).
\textsuperscript{566}ECSPR article 11(2).
\textsuperscript{568}ECSPR article 6(5), (6).
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requirements\textsuperscript{569} and credit risk assessment disclosures.\textsuperscript{570} EBA in particular considers these less obvious requirements to be prudential.\textsuperscript{571}

The ECSPR has prudential requirements for a market where systemic risk is seen to be low. The ECSPR’s position indicates that the EU legislature is erring on the side of caution with the business crowdlending market. It also indicates that even though systemic risk is low now it is worthwhile taking precautions in certain areas of a CSP’s business model. These certain areas are prudential safeguards in the form of capital requirements, credit risk assessments\textsuperscript{572} and contingency fund plans.

\textbf{F. Regulatory Goals}

This section provides the regulatory theory analysis of legal certainty.

\textbf{1. Legal Certainty}

The ECSPR has hugely impacted the legal uncertainties in the EU market. In large part, the ECSPR could arguably be viewed as having delivered on its regulatory goal of providing legal certainty. The ECSPR has enabled the provision of cross-border services in the EU. However, there are legal


\textsuperscript{570} ECSPR annex I part I(e); European Banking Authority, ‘Final Report Draft Regulatory Technical Standards on Credit Scoring and Pricing Disclosure, Credit Risk Assessment and Risk Management Requirements for Crowdfunding Service Providers under Article 19(7) Regulation (EU) 2020/1503’ (n 85) 22-26; See further f) Pricing, Credit Risk Assessment, and Credit Scoring.


\textsuperscript{572} See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
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uncertainties within the ECSPR itself and uncertainties that remain in the crowdlending market because of the scope of the ECSPR.

a) Theory of Legal Certainty
In chapter 2, it was found that when Braithwaite’s theory of legal certainty is applied to crowdlending, it follows that for the ECSPR to achieve its goal of legal certainty the ECSPR will need to be specific as it is the first time crowdlending has been regulated in the EU.573 In the first instance, the ECSPR is clear from its title and its scope that business crowdlending is within its scope.574 Next, the analysis over the course of this chapter has frequently returned to the point that the ECSPR is detail oriented such as the granular detail for loan pricing575 which sets out which accounting standards to use576 or the factors to take into consideration for the valuation such as the maturity of the loan, payment schedule and probability of default.577 Even in comparison to other EU financial legislation, the ECSPR is more detailed. For example, the ECSPR’s contingency fund requirements578 are more detailed than EMIR’s default fund requirements.579 EMIR requires that the default fund must have an

574 See further analysis on C. Scope.
575 See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
578 ECPSR article 6(5), (6); Delegated Regulation [2022] OJ L287/50 (n 422) chapter IV.
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internal policy framework which includes a statement on how extreme but plausible market conditions are defined and that it should be discussed by the risk committee and approved by the board.\textsuperscript{580} On the other hand, the ECSPR is more detailed with the requirement for a governance policy for the contingency fund requiring that the governance policy includes matters such as the legal and operational structure if the contingency fund is operated by a third party the governance policy must include a description of the management board’s composition, responsibilities and duties.\textsuperscript{581} This demonstrates that the EU is taking a detailed approach to crowdlending in the EU and aligns with Braithwaite’s theory of legal certainty.\textsuperscript{582} However, a concern with a detail-oriented regulatory approach is that it weaves a web of details so dense that it is challenging to navigate the regulatory framework. It could mean that the EU’s efforts for legal certainty achieve confusion instead. This remains to be seen.

\textit{b) Legal Uncertainties within the ECSPR}

There are five areas where the ECSPR is not clear and is adding to legal uncertainty and potentially fragmenting the market. First, it is unclear whether the risk awareness requirement for sophisticated investors means that there is an implied knowledge test requirement.\textsuperscript{583} It seems likely that there is no

\begin{flushright}
\textsuperscript{581} Delegated Regulation [2022] OJ L287/50 (n 422) article 17.
\textsuperscript{582} Braithwaite, ‘Rules and Principles: A Theory of Legal Certainty’ (n 595) 47.
\textsuperscript{583} ECSPR annex II(l); See the analysis of (l) Investors.
\end{flushright}
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requirement for a formal knowledge test but the risk awareness requirement implies that some form of informal knowledge assessment must be conducted.

Second, there is significant legal uncertainty surrounding the definition of credit agreements in the KIIS. The disagreement between ESMA and EBA over whether credit agreements merit a definition was explored in the information asymmetry and inexperience analysis of the KIIS. This legal uncertainty negatively impacts the quality of the information communicated in the KIIS to investors. It will impact both sophisticated and non-sophisticated investors alike as the KIIS is provided to both types of investors.

Third, there is a lack of clarity surrounding the applicable regulatory requirements for contingency funds that are operated where an investor does not avail of portfolio management services. The contingency fund requirements are contingent on the contingency fund being operated by the CSP in relation to the individual portfolio management of loans. This appears to mean that contingency funds are only regulated where they operate in relation to individual portfolio management by CSPs. However, it is possible that a CSP would operate a contingency fund in isolation of individual portfolio management services.

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585 See further d) Information Asymmetry and Inexperience.
586 See further b) Default Risk.
587 See further (c) Individual Loan Portfolio Management.
588 ECSPR article 6(5); See further (c) Individual Loan Portfolio Management.
589 See further (c) Individual Loan Portfolio Management.
590 ibid.
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Fourth, it is unclear what the sanctions are across the EU for breach of the ECSPR. As explored in the enforcement sanctions analysis, the ECSPR sets minimum standards for sanctions and allows Member States to set additional or criminal sanctions for infringements of the ECSPR.

One such area is civil liability. Member States are to apply their laws on civil liability to the persons responsible for the information in the KIIS. Market fragmentation is also possible because article 39 of the ECSPR sets out the minimum standards for penalties, permits Member States to provide additional penalties and Member States may also decide to keep their current criminal penalties for certain infringements under the ECSPR. France for example imposes criminal sanctions where there is a breach of the CSP’s authorisation imposing a possible 5-year imprisonment and a fine of €375,000,000. Poland has also included possible criminal sanctions for breach of the ECSPR. If false information is provided in the KIIS, a fine of zł5,000,000 or imprisonment for between 6 months to 5 years or both, while other jurisdictions have copied the minimum standards from the ECSPR such as

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591 See the analysis of Enforcement Sanctions under b) Enforcement.
592 ECSPR article 39(2).
593 ECSPR article 39(3).
594 ECSPR article 39(1).
595 ECSPR articles 23(10), 24(5) Detailed analysis is outside the scope of this thesis.
596 ECSPR article 39(2).
597 ECSPR article 39(3).
598 ECSPR article 39(1).
599 See further a) Authorisation.
600 France - Code Monétaire et Financier article L573.12.
601 See further (a) KIIS.
602 Poland - Ustawa z dnia 7 lipca 2022 r.o finansowaniu społecznościowym dla przedsięwzięć gospodarczych i pomocy kredytobiorcom Dz. U. 2022 poz. 1488 article 39.
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Latvia. Others such as Sweden or Luxembourg have largely copied the minimum standards in the ECSPR with a few variations. For example, in Sweden, if the NCA revokes a CSP’s authorisation the NCA may decide how the CSP is wound down. Some jurisdictions have maintained their existing regulatory framework including their increased financial penalties such as Portugal.

This market fragmentation can increase competition and reduce harmonisation between Member States. For example, the jurisdictions which have decided against having criminal sanctions for CSPs such as Sweden could be more attractive for CSPs to seek authorisation because it is the authorising NCA who is responsible for supervision. Sanctions are an area where the EU is respecting Member State sovereignty at the cost of a fully harmonised EU market. The fact that MiFID II also has minimum sanctions and leaves it to Member States to decide to criminalise sanctions makes it less likely that there will be harmonisation for the ECSPR on this point.

Member States are obliged to report their sanctions under the ECSPR to ESMA. However, the information collated by ESMA is not publicly available.

603 Latvia - Kolektīvās finansēšanas pakalpojumu likumam 2022/76.2 article 13.
604 Sweden - Lag (2021899) med kompletterande bestämmelser till EUs förordning om grärotsfinansiering chapter 3.
606 See further a) Authorisation.
607 Sweden - Lag (2021899) med kompletterande bestämmelser till EUs förordning om grärotsfinansiering s 4.
608 Portugal - Lei n. 3/2018, de 9 de fevereiro chapter 2.
609 Sweden - Lag (2021899) med kompletterande bestämmelser till EUs förordning om grärotsfinansiering chapter 3.
610 See further a) Authorisation.
611 ECSPR articles 15(1), 31(7).
612 MiFID II article 70(6); See further Christos V Gortsos, ‘Public Enforcement of MiFID II’ in Danny Busch and Guido Ferrarini (eds), Regulation of the EU Financial Markets: MiFID II and MiFIR (Oxford University Press 2017).
613 Email from ESMA to author (27 September 2022).
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reduces legal certainty and adds to market fragmentation, but it may also guard against jurisdiction shopping. If ESMA had shared the collated information about sanctions publicly it would make it easier to ascertain which jurisdictions are ‘friendlier’ with only the minimum sanctions.

Fifth, as explored in Section D under the heading of Competition, Member States set their own marketing communications requirements. Summaries of these national requirements are published in a report on ESMA’s website which varies in detail, and relevance. Some Member States have not provided information to ESMA yet. However, the summaries evidence differing approaches to marketing communications requirements which adds to market fragmentation and legal uncertainty across this new pan-EU market. The approach to marketing communication requirements contrasts with the approach taken to penalties. The ECSPR required ESMA to publish the information on marketing communications but not on penalties. This reduces legal certainty in the market as it is less clear what the penalties are in the pan-EU market.

ECSPR article 28; See further (2) Marketing Communications Requirements.
See further (2) Marketing Communications Requirements.
See further b) Clients.
See further (2) Marketing Communications Requirements.
See further (iii) Enforcement Sanctions.
See further (2) Marketing Communications Requirements.
See further (iii) Enforcement Sanctions.
ibid.
c) Legal Uncertainties Remaining in the EU Crowdlending Market
The ECSPR’s title and scope signal that business crowdlending for amounts under €5 million is within the scope of the ECSPR. This clarity about business crowdlending acts as a double-edged sword. While the ECSPR means that there is now a pan-EU regulatory framework for business crowdlending, there is no pan-EU regulatory framework for consumer crowdlending.

Once the ECSPR’s transitional period has ended and the Level 2 measures have all been finalised, the ECSPR’s impact in terms of figures and crowdlending volumes can be measured. But what can be said now about the ECSPR’s impact on legal uncertainty?

The ECSPR - for crowdlending that is within the ECSPR’s scope - has replaced a patchwork of Member State crowdlending regulation. Where once significant hours of research and legal advice were necessary to ascertain the regulatory

623 See also C. Scope.

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framework in another Member State, passporting is now available. With a simple notification, CSPs can now provide their services without the need to physically establish themselves in the new Member State.

In the region of Europe, excluding the UK, the combination of business and consumer crowdlending volumes in 2018 was $3,886.2 million (USD). Consumer crowdlending makes up the majority of that figure at $2,889.4 m (USD) with business crowdlending coming in behind at $996.8 m (USD). There were challenges in classifying consumer crowdlending ‘as some consumer loans involve personal lending by entrepreneurs for business-related spending’.

Personal loans for example are frequent informal financial support in early-stage businesses. By limiting its scope to business funding only, the ECSPR does not deliver a completely harmonised EU market for early-stage business funding and increases market fragmentation in the EU. This avenue will only be available to businesses within their Member States’ regulatory framework. Some Member States have regulated crowdlending for consumer borrowers such as some consumer loans involve personal lending by entrepreneurs for business-related spending’.

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626 See further a) Passporting.
627 ECSPR article 18(1)(a)-(d).
628 ECSPR article 12(12).
630 Ibid.
632 See further for example Reynolds (n 16); Fourati and Affes (n 16); See also 2. Consumer Credit.
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as the Netherlands,\(^{633}\) and France.\(^{634}\) As a result consumer crowdlending will be an avenue businesses can explore in their embryonic stages of development. While others such as Ireland continue to wait for an EU response for consumer crowdlending.\(^{635}\) It also means that consumer crowdlending continues to fall between multiple stools with limited reasoning to support the exclusion and limited protections available.\(^{636}\)

Overall, the biggest mismatch between the ECSPR and the EU data is the ECSPR’s exclusionary focus on business crowdlending.\(^{637}\) This has led to academic commentators calling for the ECSPR to be expanded to include consumer loans and Consumer Credit Directive type protections.\(^{638}\)

The EU had begun to address the issue. The Proposal for a Consumer Credits Directive addressed consumer crowdlending issues.\(^{639}\) However, the rapporteur tasked with shepherding the Proposal for a Consumer Credits Directive stated that consumer crowdlending merits a ‘special focus’ and that the Commission’s

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635 Department of Finance (n 47); Dáil Deb (n 47).


637 See also Ebers and Quarch (n 660).


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proposal did not ‘sufficiently address’ the issue of consumer crowdlending.\textsuperscript{640} The rapporteur proposed that the Commission ‘comprehensively’ revise the Proposal for a Consumer Credits Directive in 2024 ‘with a special focus’ on consumer crowdlending.\textsuperscript{641} The Council of the European Union ultimately amended the scope of the Proposal of a Consumer Credits Directive to solely include consumer crowdlending where the CSP itself is the credit provider.\textsuperscript{642} Therefore, consumer crowdlending where the investors are deemed to grant the credit is outside the scope of the Proposal for a Consumer Credits Directive.\textsuperscript{643} The combination of the proposal, the indication that a consumer crowdlending regulatory response could be delayed until 2024 and the ECSPR does not bode well for consumer crowdlending.

As a result, the reality is a piecemeal regulatory approach from the EU to crowdlending’s issues. If the EU at some point in the future commences drafting a Directive on consumer crowdlending, the CSPs will have to navigate layers of Member State transposition. Each Member State could have different tools and requirements. Although this would be an improvement on the current situation


\textsuperscript{641} ibid.


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where there is no EU regulatory response to consumer crowdlending where the investor is deemed to grant the credit.

However even if a Directive on consumer crowdlending is delivered, transposed, and becomes law issues remain. Catering for business project owners in a Regulation and crowdlending for consumer borrowers in a Directive is challenging. One of the main goals of the ECSPR is that it will allow passporting\(^{644}\) across the EU which is explored in 1 Competition. If a Directive on consumer crowdlending is used this could have various impacts.

One potential impact is that the difference could slow the development of CSPs that provide their services to both business and crowdlending for consumer borrowers across the EU.\(^{645}\) These dual-purposed CSPs would have increased hoops to jump through that would vary in each Member State. Another impact is that CSPs across the EU may choose to provide business-only or consumer-only lending. Therefore, dividing CSP throughout the EU. A third impact is that competition between CSPs for crowdlending for consumer borrowers could be localised within Member States only. Then linked to this impact is that EU-wide competition between CSPs for crowdlending for consumer borrowers is reduced. A fourth impact is that CSP for crowdlending for consumer borrowers will only provide the services in the individual Member States with limited expansion across the EU.

\(^{644}\) See further a) Passporting.

\(^{645}\) Although this position has been queried as having no empirical evidence in Qi Zhou, ‘Harmonisation of European Contract Law: Default and Mandatory Rules’ in Larry A Di Matteo and others (eds) Commercial Contract Law: Transatlantic Perspective (Cambridge University Press 2013).
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Nevertheless, the use of a Directive for consumer protection in this context allows for law to be framed in national terminology, and national discretion, and leaves room for Member State diversity of legal culture.646 This is one of the instances where the EU must walk a tightrope. The balancing act here is harmonisation against Member State sovereignty. Harmonisation increases market efficiency whereas increased Member State sovereignty decreases market efficiency. Recent research has shown that ‘regulatory clarity appears to be extremely significant in explaining the level of crowdfunding volume’.647

Another aspect of the ECSPR’s scope is article 1(2)(b) of the ECSPR which states ‘other services related to those defined in point (a) of Article 2(1) and that is provided in accordance with national law’. The wording of article 1(2)(b) of the ECSPR is not clear. It seems that read in light of the draft Delegated Regulation’s general usage of the phrase ‘other services’ in the draft regulatory technical standards,648 it might be taken to mean the services that might be provided in conjunction with crowdlending that are regulated by national law. If this interpretation is correct, it raises the question of what if the other services are not regulated by national law. This question is not addressed by the ECSPR.

A point where the ECSPR is relatively clear is related to the definition of loans under the ECSPR. Loans are defined as accruing interest under the ECSPR.649

649 ECSPR article 2(1)(b).
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The definition of loans likely means that social lending is outside the scope of the ECSPR. Kiva is an example of a platform that conducts social crowdlending. In social crowdlending, it is common for no interest to accrue on the money given. It may not have been justifiable to include social crowdlending within the scope of the ECSPR as no financial return is offered.

It is furthermore unclear whether national law can cater for the services that fall outside the scope of the ECSPR and whether national regimes can remain in existence under certain conditions. It can be inferred that national law can cater for services outside the scope and that national laws remain in existence under certain conditions because the ECSPR is a maximum harmonisation instrument. This is even though there are certain aspects of the ECSPR for example the limits of the KIIS correctness check, civil liability rules, and the need for diligent selection of borrowers that ‘appear to be left to national solutions, which implies a fragmented approach’. The scope of the ECSPR is problematic and leads to legal uncertainties.

To conclude, the ECSPR has achieved legal certainty for parts of the EU crowdlending market namely business crowdlending. Legal uncertainty remains for consumer crowdlending as it falls outside of the scope. There are, however, legal uncertainties rooted in ambiguities in the scope of the ECSPR.

G. Comments
This section explores comments and thoughts on (1) classification challenges, (2) competition, (3) investor protection, (4) market impact and (5) regulatory

650 Macchiavello and Sciarrone Alibrandi (n 131) 60 Macchiavello.
651 Macchiavello and Sciarrone Alibrandi (n 131) 85 Macchiavello.
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In terms of an overarching comment for the ECSPR, the ECSPR applies a MiFID II like approach to regulate crowdlending. The ECSPR’s authorisation requirements, general duty of care, investor classification, knowledge test, and marketing communications requirements have significant similarities with the equivalent MiFID II requirements. This MiFID like approach is a rather inventive aspect of the ECSPR.

1. Classification Challenges

From economic and legal perspectives there are significant similarities and differences between the services provided by CSPs on one hand, and other investment services and asset classes on the other. Crowdlending further highlights the classification and taxonomy challenges within the sphere of financial regulation.

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654 ECSPR article 3(2); Lieverse and Pronk, ‘Organisational and Operational Requirements for Crowdfunding Service Providers’ (n 365) 169 citing MiFID II articles 24, 25, van Poelgeest and Louisse, ‘The Regulatory Position and Obligations of Project Owners’ (n 395) 188; See also b) Clients.

655 ECSPR article 21, annex II; Serdaris (n 19) 453 citing MiFID II articles 4(1)(10), (11); Lee, ‘Investor Protection on Crowdfunding Platforms’ (n 312) 247; See also (a) Investor Classification.

656 ECSPR article 21(2); Delegated Regulation [2022] OJ L287/29 (n 249) article 2; Lee, ‘Investor Protection on Crowdfunding Platforms’ (n 312) 247.

657 ECSPR articles 19, 27; Goanta and others, (n 190) 289 citing MiFID II article 24(3).
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The regulatory treatment of crowdlending across the jurisdictions examined in this thesis has varied. The EU created a *sui-generis* category, a loan, for crowdlending which is defined in crowdlending-specific terms. The UK has ascertained that crowdlending deals with credit. Then Australia under its managed investment scheme regulatory framework classified crowdlending as an interest or rights to benefits in a scheme. Contrastingly both the US and New Zealand have both classified crowdlending as dealing with securities. There is no single consensus as to the classification of the financial product at the heart of crowdlending.

2. Competition

Under the competition regulatory goal, the ECSPR’s harmonisation efforts were considered. The ECSPR has made a significant impact in harmonising the EU business crowdlending market. Nevertheless, market fragmentation has not been eliminated in the EU business crowdlending market. Market fragmentation is evident in the sanctions prescribed in article 39 of the ECSPR and the marketing communications requirements. Here the ECSPR attempts to balance Member States’ sovereignty with the ECSPR’s harmonisation efforts. In

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658 See further chapter 1.
659 ECSPR article 2(1)(b); See also 1. Crowdlending Definition.
664 See further chapter 1.
665 These questions merit further research which some may wish to explore. It is however outside the scope of this thesis.
666 ECSPR article 28; See further (2) Marketing Communications Requirements.
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	his instance, the balance leans ever so slightly in favour of Member States’ sovereignty. Member States have the latitude to decide whether to increase the administrative and contractual sanctions to criminal sanctions or increase the severity of the administrative and contractual sanctions generally\(^{667}\) and to set their own marketing communications requirements.\(^{668}\)

The combination of the marketing communications requirements,\(^{669}\) minimum penalties\(^{670}\) and the latitude given to NCAs regarding assessments\(^{671}\) mean that Member States can choose to attract or deter CSPs from establishing in their jurisdiction creating a possible competitive space between Member States. Furthermore, with the interaction between the passporting\(^{672}\) aspect of the ECSPR and the responsibility placed on authorising NCAs for supervision,\(^{673}\) could mean that CSPs can still provide their services in Member States where NCAs wish to deter their establishment. Article 18 of the ECSPR states that authorising NCAs must inform the relevant NCAs and ESMA of the CSP’s intent to provide their services in other Member States. Once the authorising NCA confirms to the CSP that the information has been sent to the relevant NCAs and ESMA or 15 days have passed a CSP can provide its services in the other Member States.\(^{674}\) Importantly, the CSP does not need the permission of other

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\(^{667}\) ECSPR article 39(1).

\(^{668}\) ECSPR article 28; See further (2) Marketing Communications Requirements.

\(^{669}\) ibid.

\(^{670}\) ECSPR article 39(1); See further (iii) Enforcement Sanctions.

\(^{671}\) ECSPR article 15(1); See further (2) Marketing Communications Requirements.

\(^{672}\) See further a) Passporting.

\(^{673}\) ECSPR articles 15(1), 31(7).

\(^{674}\) ECSPR article 18.
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NCAs and as such cannot be blocked under the ECSPR from providing its services in the other Member States.

3. Investor Protection
The analysis in this chapter found that in the main the ECSPR’s investor protection is optional and relies on the self-responsibility principle informed by behavioural science. One interpretation of the largely default and nudge-based stance of investor protection is that the ECSPR is not underpinned by paternalistic leanings but is more motivated to improve market confidence. The market confidence motivation aligns with the current stage of development of the EU business crowdlending market. Before the ECSPR, crowdlending operated in a regulatory grey area across the EU. Unless crowdlending was regulated by a Member State, crowdlending was in a largely nebulous position.

The degree to which this approach to investor protection will be appropriate will depend on the degree of appropriate risk taken by non-sophisticated investors and whether non-sophisticated investors continue participating in crowdlending. The data currently shows growth in institutional investor participation in crowdlending. The ‘self-responsibility’ principle will likely suit the needs of institutional investors given their expertise and knowledge in investing and finance. Nevertheless, if non-sophisticated investors take on inappropriate risks a different regulatory response will be required. Another

676 See further Commission, ‘Behavioural Study on the Digitalisation of the Marketing and Distance Selling of Retail Financial Services Final Report’ (n 415).
677 ibid.
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possible motivation for a more paternalistic approach would be a crowdlending scandal which exposes investors to significant harm.

4. Market Impact
As will be explored in chapter 6, at this point, it is ‘not possible’ to gauge the ECSPR’s impact on the market as the ECSPR is not properly in effect. On paper, the ECSPR came into force on 10 November 2021. However, the ECSPR is still operating within a transitional period and thirteen articles of the ECSPR were until recently in limbo. The Commission following advice from ESMA extended the transitional period to 10 November 2023. All thirteen articles relied on the Commission endorsing the draft regulatory technical standards as delegated acts. It was only when the draft regulatory technical standards become delegated acts that the thirteen articles will be complete. The thirteen articles cover critical areas such as the KIIS, the authorisation process, and the knowledge test and simulation of the ability to bear the loss. While the draft regulatory technical standards are publicly available on ESMA or EBA’s website, the Commission may amend the draft regulatory technical standards as delegated acts.

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678 See further chapter 6 B. The ECSPR’s Current Position. Delegated Regulation [2022] OJ L273/3 (n 648); See also Financement Participatif France, ‘Communiqué de Presse FPF & Bundesverband Crowdfunding’ (n 648); Alois, ‘Neither Germany nor France is Prepared for Pan-European Crowdfunding Regulation’ CrowdFund Insider (n 648); Financement Participatif France, ‘PSFP: Prolongation de la Période Transitoire’ (n 648); Alois, ‘ECSPR: European Commission Extends Transition Period for Pan-European Crowdfunding Rules’ (n 648).
679 ECSPR article 51.
681 ECSPR articles 6, 7, 8, 12, 16, 19, 20, 21, 23, 28, 31, 32.
683 ECSPR article 23.
684 ECSPR article 12; See further a) Authorisation.
685 See further (b) Knowledge Test and Risk Warning.
686 ECSPR article 21; See further (a) Simulation of Loss Test.
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technical standards. For CSPs, this meant that while it was possible to structure their business relying on the draft regulatory technical standards, this structuring could have been subject to change if the Commission chose to amend the draft regulatory technical standards.

The delay in the ECSPR having full implementation is in part because the draft regulatory technical standards were published on 10 November 2021. These Level 2 measures were not expected to come into force before the end of 2022. The ECSPR was designed so that some of the draft regulatory technical standards would be submitted by ESMA and EBA to the Commission on 10 November 2021 and the remainder on 10 May 2022. Both of these dates occur during the ECSPR original 10 November 2022 transitional period. As explored throughout this chapter, the Level 2 measures contain important requirements that detail measures such as the credit risk assessment, simulation of loss test, authorisation, and business continuity plan. Therefore, CSPs would have been forced to seek authorisation and comply with a regulatory framework that had not been completely finalised or close their business.

The delayed full effect of the ECSPR has been linked to negatively impacting the number of CSP authorisations. Recently ESMA revealed some insights in

688 Sheehy and others (n 649).
689 ECSPR articles 6, 7, 8, 12, 20, 21.
690 ECSPR articles 19, 23, 31.
691 Delegated Regulation [2022] OJ L287/5 (n 37); See further f) Pricing, Credit Risk Assessment, and Credit Scoring.
692 Delegated Regulation [2022] OJ L287/29 (n 249); See further (a) Simulation of Loss Test.
693 Delegated Regulation [2022] OJ L287/5 (n 37); See further a) Authorisation.
695 See further a) Authorisation.
696 ibid.
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its technical advice to the Commission on the extension of the transitional period under article 48(3) of the ECSPR.697 ESMA reported, in the Member States that participated in their informal survey of the ECSPR, 94.5% have not applied for authorisation as of 22 March 2022.698 As of 27 September 2022, four CSPs have been authorised under the ECSPR.699 A mix of reasons for the delay was identified in the report ranging from the impact of COVID to the fact that CSPs were still adjusting to the increased operational costs resulting from the ECSPR.700 Interestingly one of the other reasons was that several CSPs are waiting for the draft regulatory technical standards to be endorsed by the Commission.701 It would be too expensive for the CSPs to change the structure of their business if the Commission amends the draft regulatory technical standards before endorsing them.702

5. Regulatory Model
One of the ECSPR’s goals is to reduce risk. Therefore, by implication one of the ECSPR’s goals is to have a risk-based regulatory model so that it can respond to risks in the market and reduce them. Yet the analysis throughout this chapter has repeatedly returned to business conduct requirements. For example, the analysis of investor protection and other users shows that the ECSPR relies on

697 European Securities and Markets Authority, ‘Final Report: ESMA’s Technical Advice to the Commission on the Possibility to Extend the Transitional Period Pursuant to Article 48(3) of Regulation (EU) 2020/1503’ (n 221).
698 European Securities and Markets Authority, ‘Final Report: ESMA’s Technical Advice to the Commission on the Possibility to Extend the Transitional Period Pursuant to Article 48(3) of Regulation (EU) 2020/1503’ (n 221) 6.
699 European Securities and Markets Authority, ‘Register of Crowdfunding Services Providers’ (n 48).
700 European Securities and Markets Authority, ‘Final Report: ESMA’s Technical Advice to the Commission on the Possibility to Extend the Transitional Period Pursuant to Article 48(3) of Regulation (EU) 2020/1503’ (n 221) 7.
701 ibid.
702 ibid.
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business conduct regulation to protect its investors, clients, and the market. Additionally in the risk-based model analysis, the risks were targeted with business conduct measures such as default risk, CSP failure, fraud risk, and pricing, credit risk assessment, and credit scoring. Business conduct regulation places regulatory responsibilities upon the businesses at the regulatory centre rather than merely envisaging businesses as only receiving regulatory sanctions. The business conduct regulation approach is in line with recommendations made before the ECSPR by scholars such as Pekmezovic and Walker, Ferrarini, and Milne and Parboteeah.

So, while the ECSPR’s goal is to reduce risk and provide a risk-based regulatory model, the ECSPR has delivered a model that is mixed between risk and business conduct-based regulatory model. There are even elements of principles-based regulation with broad sweeping duties for example placed upon CSPs to ‘act honestly, fairly, and professionally in accordance with the best interests of their clients’. Thus the ECSPR delivers a mixed methods regulatory model albeit one that leans heavily towards a risk-based regulatory model.

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703 See further 3. Investor Protection and Other Users.
704 See further b) Default Risk.
705 See c) CSP Failure.
706 See the analysis of ex-ante controls on management e) Fraud Risk.
707 See f) Pricing, Credit Risk Assessment, and Credit Scoring.
708 Van Loo (n 374).
709 Pekmezovic and Walker (n 373).
710 Guido Ferrarini, ‘Regulating FinTech: Crowdfunding and Beyond’ (2017) 2 European Economy 121.
711 Milne and Parboteeah (n 228).
712 ECSPR article 3(2). See further b) Clients.
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**H. Conclusion**

This chapter explored how the ECSPR addresses its goals. The analysis found that all the goals are addressed. This examination will form the basis of the comparative analysis in chapter 4 which examines whether, by comparison, the ECSPR is adequate in addressing its regulatory goals for crowdlending against the approach in Australia, New Zealand, the UK, and the US in achieving goals that are similar to the ECSPR’s goals.

The ECSPR is still operating within a transitional period.\(^{713}\) Nonetheless, the ECSPR delivers a mixed methods regulatory model albeit one that leans heavily towards a risk-based regulatory model. The ECSPR has hugely impacted the legal uncertainties in the EU market.\(^{714}\) However, there are legal uncertainties within the ECSPR itself and uncertainties that remain in the crowdlending market because of the scope of the ECSPR. The ECSPR has made a positive impact on market efficiency by providing authorisation\(^{715}\) and a passporting regime.\(^{716}\) This chapter has also highlighted harmonisation challenges posed by the penalties\(^{717}\) and marketing communications requirements.\(^{718}\) It was found that investor protection under the ECSPR is optional and relies on the self-responsibility principle\(^ {719}\) informed by behavioural science.\(^ {720}\)

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\(^{713}\) Delegated Regulation [2022] OJ L273/3 (n 648).

\(^{714}\) See further 1. Legal Certainty.

\(^{715}\) ECSPR articles 3(1), 12, 13, 17l See further a) Authorisation.

\(^{716}\) ECSPR articles 18, 12(12); See further a) Passporting.

\(^{717}\) ECSPR article 39; See further (iii) Enforcement Sanctions.

\(^{718}\) ECSPR article 28; See further (Z) Marketing Communications Requirements.


\(^{720}\) See further Commission, ‘Behavioural Study on the Digitalisation of the Marketing and Distance Selling of Retail Financial Services Final Report’ (n 415).