



European Securities and
Markets Authority

Opinion

Investment-based crowdfunding



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1 Executive summary

1. Crowdfunding is a means of raising finance for projects from ‘the crowd’ often by means of an internet-based platform through which project owners ‘pitch’ their idea to potential backers, who are typically not professional investors. It takes many forms, not all of which involve the potential for a financial return. ESMA’s focus is on crowdfunding which involves investment, as distinct from donation, non-monetary reward or loan agreement.
2. Crowdfunding is relatively young and business models are evolving. EU financial services rules were not designed with the industry in mind. Within investment-based crowdfunding a range of different operational structures are used so it is not straightforward to map crowdfunding platforms’ activities to those regulated under EU legislation. Member States and NCAs have been working out how to treat crowdfunding, with some dealing with issues case-by-case, some seeking to clarify how crowdfunding fits into existing rules and others introducing specific requirements.
3. To assist NCAs and market participants, and to promote regulatory and supervisory convergence, ESMA has assessed typical investment-based crowdfunding business models and how they could evolve, risks typically involved for project owners, investors and the platforms themselves and the likely components of an appropriate regulatory regime. ESMA then prepared a detailed analysis of how the typical business models map across to the existing EU legislation, set out in this document.
4. ESMA also identified issues for consideration by policymakers in relation to the regulatory framework for crowdfunding at EU level. These are set out in separate Advice to the EU Institutions.
5. Many of the key risks in investment-based crowdfunding arise because the majority of projects invested in are smaller companies with a high failure rate and the securities are typically unlisted, hence a significant potential of capital loss, risk of dilution, limited possibilities for liquidating an investment and limited information available on which to base a decision. However, some risks relate to the platforms’ business model, such as the potential for conflicts of interest, the impact of platform failure particularly where they hold or administer client assets and the risk that investors over-estimate the due diligence carried out. Because crowdfunding has the potential to improve access to finance for the real economy and to widen the investment opportunities available to non-institutional investors, there is also an opportunity cost if the development of the industry is unduly restricted.
6. When considering how existing EU legislation would apply to crowdfunding platforms, ESMA found that there was uncertainty as to which MiFID services/activities platforms were typically carrying out and hence which capital requirements applied. This opinion therefore clarifies that the fundamental MiFID service/activity in the ‘typical’ investment-based crowdfunding platform is reception and transmission of orders and so the most likely capital requirement applicable under MiFID is €50,000 or an appropriate equivalent

in terms of professional indemnity insurance. It notes that where Member States/NCAs have developed regimes using the Article 3 optional exemption which allows for lower capital requirements, platforms could incur costs which they would not otherwise and do not have access to a passport. It clarifies that collecting “expressions of interest” is likely, in ESMA’s view, to involve reception and transmission of orders unless there is a substantive difference between the two stages and sets out non-exhaustive criteria for determining whether that is the case.

7. Many platforms seem to be structuring business models so as to avoid MiFID requirements. Where platforms are operating outside MiFID there are significant risks to investors that are not addressed at EU level. The lack of a passport could also make it harder for platforms to achieve the scalability they need. While risks to investors could be mitigated by action at national level, such action will not address the scalability issues. Similarly, where business models are structured to avoid the PD requirements, in addition to potential risks for investors, moves to limit the size of offers and/or investor base could limit the potential for crowdfunding to raise finance. ESMA therefore advises that the impact of the PD thresholds on crowdfunding should be considered in the wider PD review.
8. ESMA considers that the use of collective investment schemes in crowdfunding could become more widespread and so the relevance of AIFMD, EuVECA and EuSEF legislation could increase. The opinion sets out ESMA’s view of when and how AIFMD would apply, including in relation to structures where each vehicle invests in only a single project, and advises the EU institutions to consider whether this was the intention behind the AIFMD.

2 Legal basis

9. Article 29 of Regulation (EU) No. 1095/2010 requires ESMA to “play an active role in building a common supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union”. Article 29(1)(a) of that Regulation provides that, in order to do so, ESMA may issue opinions to competent authorities.
10. Given the recent emergence of crowdfunding and the fact that the existing EU legislation was not designed with these businesses in mind, ESMA considered that there was a clear risk of divergent interpretations of the existing legislation. Because of the wide range of business models, and their novelty, there was also scope for a lack of clarity about which EU legislation was applicable, or potentially applicable, and how the legislation should be applied.
11. It is therefore appropriate for ESMA to build a common understanding of the main business models and the related risks and issues for consideration by supervisors, and to clarify which EU legislation is applicable to the typical business models and under which conditions to provide a basis for consistent supervision. ESMA is therefore issuing an

Opinion addressed to national competent authorities in accordance with Article 29(1) of Regulation (EU) No. 1095/2010.

12. The Opinion is based on the legislation which has been applied as at 17 December 2014. They do not attempt to address legislation which will become applicable in future.

3 Background

13. ESMA and EBA jointly prepared an assessment of the development and regulation of crowdfunding, drawing on a survey of national competent authorities, as an input to the Commission's consultation on the subject.¹ In the light of that work it became clear that a number of misunderstandings were in circulation in the market about the nature and impact of the applicable EU legislation, and that these might lead at least some platforms to seek to remain outside the regulatory framework, despite thereby forgoing access to the internal market. It also became clear that there were challenges for national competent authorities faced with a variety of new business models in interpreting those requirements in a consistent way and that there was an appetite among stakeholders for a clearer articulation of how the current rules applied to the different business models seen to date. That is what this document aims to provide in relation to investment-based platforms. ESMA hopes that NCAs will be able to use this document as a basis for discussion with existing platforms and those who may be considering establishing a platform about the nature, impact and potential benefits, as well as costs, of regulation.

4 Actors and business models

14. Crowdfunding refers to a call for funds for a specific project, usually through the internet. The people providing funds may do so as a donation, in return for a reward (generally non-monetary), in the form of a loan, in return for a right to participate in a share of the revenues or profits of the project, or through the purchase of a debt, equity or other security. ESMA's interest is in the last of these, called here 'investment-based crowdfunding'. However, we are aware that in practice platforms may offer more than one of these types of crowdfunding.
15. Investment-based crowdfunding involves at least three parties: the project owner seeking finance, the platform which acts as intermediary between the project and the investor, and the investor who forms part of the 'crowd' funding the project.² At least one party must also issue an instrument, often but not always a security. Often this will be the project owner seeking the finance. In this case, investors invest directly in the project, either by buying the security or by acquiring the beneficial rights in the security which is

¹ http://ec.europa.eu/internal_market/consultation/2013/crowdfunding/index_en.htm

² There may be instances where the platform and the project owner are one single entity. However, this paper is not intended to cover such cases.

held by the platform in a nominee account. In other cases a company, special purpose vehicle (SPV) or collective investment scheme (CIS) established by the platform or a third party will issue a security which is bought by the investor, such that the investor is indirectly exposed to the project. The company, SPV or CIS will in turn either hold securities in the project or have some other interest in the project. So far, each company, SPV and CIS structure has typically invested in a single project, reflecting the fact that individual investors choose to invest in individual projects. This means that a platform is likely to be administering multiple investment vehicles. Other structures are possible and may become more prominent in future.³ Sometimes the platform itself co-invests with the 'crowd'. In all of the above cases, the investor is investing in a primary market, although this could change in future. It is worth noting that both the issuer of the securities and the platform, in its capacity as an intermediary, are potentially subject to regulation.

16. To date, project owners raising finance are typically unlisted, smaller businesses and may be start-ups, innovative or otherwise. Project sizes are therefore typically relatively small, meaning that the main alternative source of financing (if available) would be investment by business angels or bank loans rather than traditional venture capital or IPO.⁴ So far, most platforms are themselves also relatively small businesses.
17. The securities to which investors acquire rights may or may not be transferable. Even where they are transferable, there is likely to be a very limited secondary market. For debt instruments interest may be payable, but there may be a high risk of failure of the project before the bond matures. Given that the investments are typically, directly or indirectly, in SMEs in an early phase, there are unlikely to be dividend payments on equity instruments. The profitable route to exit is therefore likely to be through sale of the project.
18. The essential service/activity undertaken by crowdfunding platforms is to provide a mechanism for projects to find investors and investors to find projects. In many respects this is a traditional intermediation activity, but the ability to display information to 'pitch' and to connect investors and projects online has made it feasible to reach a greater number of investors, including in many cases retail investors, at a potentially lower cost. In addition, it has made it possible for investors to invest smaller amounts than would be expected from a traditional 'business angel', although evidence suggest that invested amounts may in fact be substantial.

³ For example, one platform which also enables direct investment in equities/mini-bonds also hosts a venture capital fund managed by a third party which invests in certain projects that where the crowd has committed at least a third of the target amount. Another says that it will, on occasion, offer funds investing in a group of projects.

⁴ For example, NESTA's analysis of data on UK platforms between 2011 to first quarter of 2014 found that the average amount raised was £199,095 through equity crowdfunding, and £730,000 for debt-based securities. (Understanding Alternative Finance, Peter Baeck, Liam Collins, Bryan Zhang, November 2014). A research report analysing international data for the years 2009-2011 based on an international sample of platforms found that 26% of funds raised through equity-based crowdfunding platforms were for projects raising \$50,000-\$100,000, with 21% of funds for projects raising \$100,001-250,000 and for those raising \$250,001 or more, and 16% going to projects between \$25,001-50,000 and to those under \$25,000. (2012CF, The Crowdfunding Industry Report, Massolution.)

19. Crowdfunding platforms have really emerged since internet technology evolved in such a way as to allow two-way communication, which enables interaction between the members of the 'crowd' of investors, as well as between the 'crowd' and the project owners pitching. However, the extent to which this is used and the format varies across platforms and the role of the e-community in screening the projects should not be overstated, in particular because opinions may be biased.⁵ Typically, a project owner wishing to raise finance through an investment-based crowdfunding platform prepares a 'pitch' displayed on the website, which is a narrative about the project, sometimes in the form of a film, accompanied by information. The pitch specifies a target amount of funding to be reached, generally within a specified time-period which may be extendable. For mini-bonds the interest rate payable will be specified, while for equity investment the proportion of equity the target amount would constitute is specified. Typically, the funds raised are only made available to the project owner if the whole of the target amount is committed.
20. Potential investors often have to register with the website before seeing the full 'pitch' information available. However, while some platforms have criteria that investors need to satisfy before registering, having access to information or investing, this seems to be driven by regulatory requirements rather than because any form of investor selection is intrinsic to the business model.⁶
21. When an investor decides to invest in a particular project, the investor generally communicates the decision to the platform, which in turn communicates to the project and/or issuer, where the issuer is not the project owner, e.g., when a company, SPV or CIS is used.
22. Once the target investment amount is reached, the funds will be transferred to the project owner and/or the issuer, where the issuer is not the project owner, in return for the ownership of the security or, in some cases, beneficial ownership of rights in the security. Many but not all platforms are involved in this stage of the process, typically using a third party to process payments although some do hold client money.
23. In relation to projects, the main service provided by platforms is to provide access to a pool of potential investors and commitments from those who decide to invest, or express interest in doing so. Some may offer additional services, which could be specifically remunerated, such as help in preparing a pitch, legal/compliance assistance with, for

⁵ For example, on some platform there is discussion between potential investors about the reasonableness of proposed valuations of the equity share and prospects for the project. On others the crowd holds an e-vote of potential projects which determines whether they move to the stage of having a fundraising campaign on the platform. In many cases websites will give information about the number and sometimes the profiles of others who have committed to investing or expressed interest.

⁶ For example, some platforms are restricting investment opportunities only to professional investors and/or to less than 150 non-professional investors, apparently to ensure that the issuer does not have to prepare a prospectus in accordance with the Prospectus Directive. In Italy Law Decree No. 179/2012 and CONSOB Regulation No. 18592 require 5% co-investment by professional investors for platforms

example, the preparation of the securities issue, or acting as registrar for the project and/or the issuer as to the ownership of securities. Typically, platforms charge a percentage of the amount raised where a campaign is successfully funded. There may be additional administrative charges to the project.

24. In relation to investors, the main service provided by platforms is access to information about potential investment opportunities and the transmission of decisions to invest or expressions of interest in investing to those projects. Most platforms carry out some form of due diligence on projects which seek to be offered on the platform, but the scope of this varies, as does the degree of reliance which platforms indicate should be placed on that due diligence.⁷ Acceptance rates also vary. In general, platforms do not market themselves as providing personalised recommendations on investments, although some are required by their regulator to provide investment advice. Some platforms make no comment on the website on the merits or otherwise of the project, while others set out reasons why the project could be a good choice. Some platforms provide facilities which enable investors to track progress of the project after investing, sometimes following regulatory encouragement to do so. Some platforms charge fees to investors as well as to projects seeking finance, although there are a number which are only remunerated by the projects. Where fees are charged to investors, these are in some cases a proportion of the amount invested; in others the fees are a proportion of any profit made by the investor (i.e., a form of success fee). We have seen examples of platforms charging the investor 5% of the amount invested in addition to the 5% of amount raised charged to projects.
25. There are other differences in how platforms operate that are not necessarily significant differences in business model but are significant in terms of the applicable regulation. For example, many platforms do not themselves hold client money and instead use third parties to collect funds for onward transmission to the issuer. Some, though this seems to be less common, establish client accounts in which funds are held pending investment and may also hold client securities.
26. There has been a rapid expansion in the number of crowdfunding platforms in the last few years, as well as in the amounts being raised through this means, although starting from a low base and with varying levels of growth by country.⁸ It is not clear at this stage whether there is a sufficient pipeline of project owners seeking funding, or of investors, to sustain this number of platforms. In particular, while there are clearly examples already of

⁷ For example, one large platform states that it verifies whether claims made in pitches are “fair clear and not misleading” and that all projects raising funds on the platform are “vetted by [its] analysts” but did not disclose how this is done. Its terms and conditions state that “The material displayed on this Site is provided without any guarantees, conditions or warranties as to its accuracy.” Another large platform includes on each project page good reasons to invest in the project, and explains that its due diligence can involve meetings with the project team and the use of information from third parties such as clients, lawyers or accountants.

⁸ NESTA found that the market for equity crowdfunding in the UK had grown by 410% per annum on average from 2012 to 2014 to a total estimated market size of £84m. For debt-based securities, the growth was 117% per annum on average between 2012 and 2014, to an estimated total market size of £4.4m.

project owners using platforms for more than a single round of capital-raising, it is unclear to what extent platforms will benefit from such “repeat business”. It therefore seems likely that there will be consolidation in the sector over the next few years, with platforms failing and/or merging, and the remaining platforms being either those benefitting from economies of scale, or specialised in a particular sector. One response to the search for economies of scale by platforms has been to develop cross-border participation.⁹

27. Another market development which may emerge is an organised secondary market for securities in crowdfunding projects, either through the platform through which the funds were originally raised or a third party. At the moment this service typically is not provided systematically, though we understand that some platforms offer a bulletin board where those looking to sell or buy can indicate interest or indicate that they might try to help someone wishing to liquidate their investment to find a buyer. However, we are aware of at least one third party which does not itself operate a crowdfunding platform which has indicated it wants to establish a secondary market for securities related to crowdfunded projects.
28. Anecdotal evidence suggests that at least some platforms are keen to be within an appropriate regulatory/supervisory framework in order to increase confidence among potential users of the platform and to enable pan-European crowdfunding within a clear regulatory framework. However, some platforms seem to be carefully structuring their businesses so as to be outside the current scope of regulation as far as possible. It seems to us that such restructuring may increase the risks to investors. There also seem to be a number of platforms, or people considering launching platforms, who have little awareness of the regulatory regime applicable and in some cases may overestimate the impact of complying with financial regulation.

5 Risks and issues for consideration by regulators

29. Regulators need to consider the issues in relation to both the issuance of securities and their distribution. This means that it is not only the platform itself that may be subject to regulation: consideration should also be given to the issuer of the securities, which may be the project or another party.
30. In relation to the securities themselves, the issues arising are not in essence different from issues relating to the same types of securities issued by the same types of companies distributed through other means. Where the securities are not transferable securities in listed companies, key issues include whether investors are making investments appropriate to their needs, given:

⁹ For example, a platform created in Sweden in March 2011 claims on its website ‘to have a major focus on cross-border investments’ and states that ‘Anyone living outside of the United States can invest in an equity campaign on our platform’. Another UK-based platform started offering cross-border investment in November 2013 and states that since then 35% of new investors have come from outside the UK. It has now launched client accounts in euro as well as sterling and plans to add more currencies soon.

- the significant potential for loss of some or all of their capital;
- the significant risk of dilution of equity holdings through further rounds of capital raising;
- the very limited possibility of liquidating an investment;
- the fact that more limited information may be available about the project than would be the case for investment in a listed firm.

31. There are then other issues which may relate more to the role of the platform as an intermediary. For example,

- the potential for investors to over-estimate the amount of due diligence undertaken by platforms in relation to the viability the project;
- the potential for conflicts of interest to harm the interests of investors, in particular where the platform is remunerated by issuers, and/or projects;
- the relatively high operational risks and probability of failure of the platform itself and risk of discontinuity in the services offered that it would entail; the implications of this could be particularly significant where the platform holds client money or assets or is involved in some other way with the post-sale administration of the investment;
- the potential for platforms and/or investors to exploit privileged access to the project's intellectual property.

32. The relative anonymity of investing through a crowdfunding platform when compared, for example, with investing as a 'business angel' following physical networking events, may increase the potential for fraud to be carried out through such platforms. If perpetrated, such fraud could bring significant reputational risk to platforms, potentially so great as to threaten the platform's viability. The risk of money laundering through platforms would also need to be considered.

33. At this stage, given the small scale of the market and its nature, we have not identified significant potential for risks to financial stability arising from crowdfunding.

34. There are also potential opportunity costs to both projects and investors if they are not able to raise capital through or invest in projects through crowdfunding. For projects, alternative sources of finance may not be available. Investors may not find other similar investment opportunities without incurring significant search costs. ESMA concludes that the key components of an appropriate regulatory regime for crowdfunding activities are therefore likely to include:

- Proportionate capital requirements or similar mechanisms for safeguarding operational continuity. These requirements could be relatively low where platforms are not holding client assets;
- A mechanism to ensure that the investment opportunities reach investors for whom they are likely to be appropriate, given the particular characteristics of securities which are not readily realisable;
- A means of ensuring that those investors who do invest are aware of the risks before doing so;
- A means of ensuring appropriate safeguarding/segregation of the client assets (NB, this does not imply protecting investors against investment risk, but rather ensuring that client assets can be distinguished from those of the platform in case of insolvency);
- Proportionate regulation of the platform's organisational arrangements and conduct of business, in particular in relation to conflicts of interest and continuity of services where relevant;
- Certainty and clarity about the nature and extent of the platform's responsibilities towards clients.

6 Potentially applicable EU-level regulatory regime

35. As will be clear from the above, there are a range of possible approaches to investment-based crowdfunding, and the precise model chosen will have an impact on which legislation is applicable, and in which way. Some requirements discussed below will apply to the platform, others to the issuer. Some requirements will be applicable only to certain platforms, depending on their precise business model.

36. This paper necessarily summarises a wide range of legal provisions potentially applicable to crowdfunding. It has not been formulated for any other purpose and should not be relied on in any case to provide a complete statement of the requirements arising under the legislation discussed.¹⁰

37. This analysis only covers legislation for which the application deadline has already passed. However, it should be borne in mind that a number of new pieces of legislation

¹⁰ ESMA's analysis has focused on the legislation listed in Article 1(2) of the ESMA Regulation EU No. 1095/2010. A range of other legislation has been identified which could also be relevant in risk mitigation and is briefly considered in Appendix 3. Article 3(3) of the Consumer Rights Directive [2011/83/EU] excludes financial services from its scope, defined in Art 2(12) as "any service of a banking, credit, insurance, personal pension, investment or payment nature". We have therefore assumed that it would not apply to investment-based crowdfunding platforms. The Services Directive 2006/123/EC was not considered because it excludes financial services.

will be applied within the next few years, such as MiFID 2, and others where proposals are currently under consideration by the co-legislator.¹¹

38. The analysis does not include national measures which have been taken in areas not harmonised at EU level.

6.1 Prospectus Directive [2003/71/EC as amended]

39. The Prospectus Directive (PD) requires publication of a prospectus before the offer of securities to the public or the admission to trading of such securities on a regulated market, unless certain exclusions or exemptions apply. The PD does not directly specify who should draw up the prospectus but requires that the party responsible for the information (being at least the issuer/offer or/party seeking admission to trading/guarantor) is specified in the prospectus. The prospectus cannot be published until it has been approved by the NCA. [See in particular Arts 1, 3, 4, 5, 6, 13]

40. In theory therefore the PD would be applicable to securities offered to secure investment in projects funded through crowdfunding platforms. However:

- a) PD applies only where instruments are transferable securities, as defined in MiFID [Arts 1(1), 2(1)(a)]. If the instrument used were not a transferable security but nevertheless was a MiFID financial instrument, MiFID disclosure requirements would apply. However, where the instrument is not a MiFID financial instrument, any disclosure requirements would depend on national law as MiFID would not be applicable. It should be noted that provided the instruments are transferable securities, the PD would apply to the issue, provided that the size of the offer and/or investor base triggers the application of the PD, even if it were deemed that MiFID did not apply to platforms for other reasons.
- b) The size of the offer may not trigger the application of the PD, because
 - i. Offers with a total 'annual' consideration below €5m are outside the scope of the Directive [Art 1(2)(h)]
 - ii. Offers with a total 'annual' consideration below €100k are excluded from the obligation to publish a prospectus [Article 3(2)(e)]; however, Member States have discretion to apply national requirements to offers between €100k and €5m and practices in this regard vary

¹¹ These include Regulation (EU) No 600/2014 and Directive 2014/65/EU (MiFID 2), Regulation (EU) No. 596/2014 and Directive 2014/57/EU (Market Abuse) which, with certain exceptions, are due to be applied from 3 July 2016 (Market Abuse) and 3 January 2017 (MiFID 2), and the Commission's proposals for a revised Payment Services Directive (COM (2013) 247 final), Investor Compensation Schemes Directive (COM (2010)371 final), European Long Term Investment Funds (COM(2013)462).

- c) Offers are also exempt from the obligation to publish a prospectus if the offer is addressed only to 'qualified investors', which are essentially professional clients under MiFID [Article 3(2)(a), Art 2(1)(e)]
 - d) Offers are also exempt from the obligation to publish a prospectus if the offer is addressed to fewer than 150 natural or legal persons per Member State other than 'qualified investors' [Art 3(2)(b)]
41. Even where there is no obligation to publish a prospectus under PD, where MiFID applies there would still be disclosure requirements under MiFID in relation to financial instruments. These obligations would apply to the platform as the authorised investment firm, rather than directly to the issuer of the securities.

6.2 Markets in Financial Instruments Directive [2004/39/EC]

42. Where applicable, MiFID would impose duties on the crowdfunding platform in its capacity as investment intermediary. To be within MiFID scope, a firm needs to be carrying on MiFID services/activities in relation to MiFID financial instruments, and not exempt. The benefit to a platform of being within the scope of MiFID is that it has a passport to carry on the services/activities for which it is authorised throughout the EU without any additional authorization being required, in accordance with a single set of rules. This is at the 'cost' of complying with capital and other requirements.
43. The capital requirements, organizational requirements and conduct of business would apply as for other investment firms depending in some cases on the services provided (such as whether or not investment advice is provided). A very high overview of such requirements is set out at Appendix 1 and illustrates how they may mitigate risks related to crowdfunding. The initial capital requirements are summarised at Appendix 2. This paper will focus on key areas where there could be a question about how the requirements apply.

6.2.1 Which financial instruments?

44. MiFID applies in relation to the list of 'financial instruments' set out at Section C of Annex 1 to the Directive. The financial instruments most likely to be used in crowdfunding are transferable securities e.g. equities or 'mini-bonds', though others such as units in collective investment undertakings would be possible.
45. Many Member States, including Austria, Belgium, Germany and Sweden, have had experience of investment-based crowdfunding using forms of participation which are not considered to be transferable securities or to otherwise qualify as MiFID financial instruments, meaning that the platforms do not have to be authorised under MiFID to intermediate in relation to those securities.
46. Under 2004/39/EC Art 19(6), for services other than investment advice or portfolio management the appropriateness has to be assessed except in certain specified cases,

which include that the services relate to certain specified financial instruments or other “non-complex financial instruments” and that certain other conditions are met. In relation to crowdfunding the question therefore arises of whether the appropriateness test could be dis-applied. Of the instruments specified in Art 19(6), “shares admitted to trading on a regulated market” would not be relevant in most cases, as the shares in question are generally not admitted to trading on a regulated market. Of the other instruments specified in the list, bonds or other securitized debt, excluding those containing a derivative, could be relevant in the context of crowdfunding and therefore a platform would not need to carry out an appropriateness assessment where the other conditions of Article 19(6) are met. Directive 2006/73/EC Art 38 further specifies the criteria for instruments not specifically listed to be “non-complex”. It specifies that derivatives and instruments involving leverage are always complex. Other instruments shall be considered non-complex if there are frequent opportunities to dispose of/realize the instrument at publicly available market prices and adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood so as to enable the average retail client to make an informed judgement about whether to transact. Given that the equity and hybrid instruments through which crowdfunding investment typically takes place typically have no secondary market and limited other opportunities to dispose of or realize the investment, we do not consider that such instruments could be considered as non-complex. Consequently, in ESMA’s view, a platform offering investment through such instruments would have to carry out an appropriateness assessment.

6.2.2 Which MiFID services/activities?

47. Where a platform is carrying out MiFID services/activities in relation to MiFID financial instruments and does not meet conditions to be exempt, it would need to be authorised as an investment firm and comply with the relevant MiFID requirements. Some of the requirements vary according to which service/activities are being carried out. In particular, there are variations in:

- a) The level of initial capital required, which varies from €50k or an appropriate professional indemnity insurance cover, to €730k;¹²
- b) Whether a firm is eligible to benefit from any optional exemption which may be available under Article 3 of MiFID, where a Member State has exercised its option to use such an exemption;
- c) Which conduct of business requirements apply.

48. Where financial instruments are involved, the question arises which services/activities a platform is carrying out. This needs to be assessed case-by-case as business models

¹² See Appendix 2 for an overview of the capital requirements relating to different services/activities.

can vary and the definitions were not designed with these business models in mind. However, the activity most likely to be carried out by mainstream crowdfunding platforms in the absence of regulatory constraints is the reception and transmission of orders: the platform receives orders from investors and transmits them to the issuer or another third party intermediary.¹³

49. Some platforms have expressed the view that what they communicate to issuers are only expressions of interest and not orders. If this were the case, it might be possible to operate a platform through which investors had access to financial instruments without being in MiFID scope. Our reaction is that the way the platform describes the arrangement is not conclusive. While the notion of ‘order’ is not defined in MiFID, the way the term is used in description of the service of ‘execution of orders’ demonstrates, in ESMA’s opinion, that it is to be interpreted widely.¹⁴ As a result, to operate outside MiFID on the basis that the service offered does not involve the reception and transmission of orders but only the collection and transmission of expressions of interest, there would have to be a real, substantive distinction between the expression of interest and something which could be considered as an order. Non-exhaustive examples of factors that could be relevant in determining whether such a substantive distinction existed include:

- a) Whether there is a difference between the list of those expressing interest and those eventually investing which is sufficiently significant to constitute more than a proportion of ‘cancelled orders’;
- b) The extent to which the terms of the offer are known to investors before they communicate expressions of interest and the extent to which changes in those terms happen after the expression of interest;
- c) The nature and extent of the additional communication with the investor needed before a decision to invest was communicated;
- d) The nature and extent of the platform’s role in the subsequent execution of orders.

50. In addition, in determining which service/activity the platform was carrying out, the platform’s business model, marketing to projects and investors of the services it offers and structure of its revenue generation would have to be consistent with this characterization of the service it provided.

51. The service/activity of execution of orders on behalf of clients is explained in the MiFID definition as meaning “acting to conclude agreements to buy or sell one or more financial

¹³ Article 4(1)5 of Directive 2014/65/EU [MiFID 2] clarifies that the concept of ‘order’ is relevant in primary as well as secondary markets.

¹⁴ The definition of “execution of orders on behalf of clients” at Article 4(5) refers to “acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients”.

instruments on behalf of clients”[2004/39, Art 4(4)]. In many cases the agreement could be effectively concluded by the platform on behalf of the investor, and in this case the platform would be carrying out execution of orders on behalf of clients. However, there could also potentially be models where the deal was concluded elsewhere without involvement from the platform. A platform that itself carries out the service/activity of execution of orders on behalf of clients would not be eligible to benefit from the optional exemption under Article 3¹⁵.

52. As noted above, the service/activity of investment advice is generally not a part of platforms’ business models. However, it was noted that depending on how platforms presented projects they might in fact make such recommendations, inadvertently or otherwise, and would then need to comply with the relevant rules. It was also possible that investors might consider that they had received ‘advice’ when technically there had been no personalised recommendation. While this risk could arise in many situations, the issue is pertinent in relation to crowdfunding platforms because of the reliance investors may place in the platform’s ‘due diligence’ and where investors have to fulfil certain criteria in order to register in or invest through the platform. One NCA has developed a regime based on the optional exemption in Article 3 of MiFID which requires platforms wishing to benefit from that optional exemption to provide investment advice.
53. ESMA considers that underwriting/placing on a firm commitment basis is not a mainstream activity of crowdfunding platforms but it is possible that a particular platform would undertake to find a specified level of investment or, failing that, to take that stake itself. Any platform that did so would, in ESMA’s opinion, be subject to the full €730k MiFID/CRR capital requirements.
54. The question has arisen as to whether platforms that undertake to market offers for project owners are thereby carrying out the MiFID service/activity of placing without a firm commitment basis in regard to project owners. The service of ‘placing without a firm commitment basis’ is not further described in MiFID. Like many other MiFID services/activities, this is one which takes place in a wide range of contexts, some very far removed from crowdfunding. It is therefore important to consider the wider implications of any interpretation of this service/activity. While, as noted above, MiFID may apply to investment services/activities related to the issuance of securities in primary markets, MiFID does not regulate the public offer of securities in the primary market as such. That is done by the Prospectus Directive. The question is therefore what role the platform is playing in relation to the offer. In CESR’s advice to the Commission for its review of MiFID, it differentiated between an “open offer” of securities on the one hand and “placing” on the other.¹⁶ However, this was in an example illustrating both underwriting and placing, and drawn from a particular market context; the advice made

¹⁵ Insert cross-reference

¹⁶ CESR’s Responses to Questions 15-18 and 20-25 of the European Commission Request for Additional Information in Relation to the Review of MiFID, CESR/10-860, 29 July 2010, p10.

clear that other situations were possible.¹⁷ The advice noted that conflicts of interest could arise where an intermediary had a relationship with both issuers and investors and that some NCAs had identified particular risks where firms carrying out placing were also involved in distribution of financial instruments to retail clients.¹⁸ In the case of crowdfunding, it appears that the same activity could potentially be considered as reception and transmission of orders or as placing without a firm commitment basis. In the absence of further specification within MiFID or the implementing measures, any further specification is beyond the scope of this opinion. The consequences for platforms of the choice of applicable service/activity are as follows:

- a) Firms which carry out placing cannot be exempted under the Article 3 optional exemption.
- b) Firms which carry out placing are not within the scope of Article 31 of CRDIV. Article 31 CRDIV allows firms within its scope to hold specified levels of professional indemnity insurance instead of initial capital.

55. ESMA has also examined whether crowdfunding platforms are operating MTFs. To date, most crowdfunding platforms are operating in primary markets only. As such there is typically only one seller per financial instrument, though there may be multiple buyers. A characteristic of MTFs is that they bring together multiple buyers and sellers of a financial instrument. ESMA therefore concludes that in general crowdfunding platforms are not operating MTFs. However, it is clear that there is interest in developing secondary markets for these financial instruments. Where such a secondary market brought together multiple buying and selling interests in a system with non-discretionary rules in a way that resulted in a contract, it would in ESMA's opinion be operating an MTF. [Art 4(1(15))] Recital 6 clarifies that the 'system' refers to the set of rules rather than the technical means of execution, and that rules are 'non-discretionary' where the MTF operator has no discretion as to how interests may interact. Arrangements based on bulletin boards which merely list potential buyers and sellers without any other facilitation would be unlikely to constitute an MTF. Investment firms operating MTFs are subject to the full €730k capital requirements plus other responsibilities in relation to the MTF. Where the instruments traded on the MTF are shares admitted to trading on a regulated market, these requirements include pre- and post-trade transparency requirements. [Arts 29-30]¹⁹

¹⁷ Ibid, p10.

¹⁸ Ibid, p14ff.

¹⁹ As indicated above, this analysis is limited to MiFID 1. However, MiFID 2 will introduce a new category of trading venue called the OTF, organised trading facility. The implications of MiFID 2 changes have not been considered here.

6.2.3 Are there relevant exemptions?

56. ESMA has not identified any relevant exemptions in Article 2. Article 3 provides the option for Member States to exempt firms, where the firms meet certain conditions. Such firms do not benefit from a passport, but are also not subject to MiFID capital or other requirements. The conditions are that such firms:

- a) Do not hold of client money or securities;
- b) Provide only the investment services of reception and transmission of orders and/or investment advice;
- c) Transmit orders only to authorised firms:
- d) Are regulated at national level.

57. Two Member States/NCAs have designed regimes for the regulation of crowdfunding platforms within the optional exemption provided by Article 3. ESMA has considered whether it is possible for platforms to operate within the scope of the exemption and has concluded that it is possible, but that the requirement to transmit orders only to authorised firms, which is a pre-condition under Article 3 for any firm transmitting orders to benefit from the optional exemption, is likely to mean involving an additional party for which the business model would not otherwise have a need, while the requirement introduced by national law in one jurisdiction to provide advice makes it mandatory to provide a service that is otherwise often not part of platforms' business models. We understand that the intention behind this is to ensure investor protection. However, this could also raise costs for platforms and hence potentially investors.

6.2.4 How would a platform operate within MiFID?

58. Where a platform is carrying out business within MiFID scope and there is no applicable exemption, the platform could either be directly authorised as an investment firm, be operated by an investment firm or credit institution that has an existing MiFID authorization, or act as the tied agent of an investment firm or credit institution. It is an option for Member States to choose whether to allow the use of tied agents. Where it is allowed, the tied agent can be in another Member State. Where a platform operated as the tied agent of authorized firm rather than being directly authorized:

- a) This would require a link with an authorised firm which would take responsibility for platform's actions: this has generally not been the business model to date;
- b) The platform would be limited to soliciting business, reception and transmission of orders, placing and providing advice;
- c) The authorised firm would be responsible for ensuring compliance with MiFID requirements;

d) The platform itself would not be subject to capital requirements.

59. In either case, a range of organizational and conduct of business requirements would apply, with the aim of ensuring that client's assets are protected, that conflicts of interests are avoided, and that the investment firm acts in the interests of the clients. Amongst other things, this would mean that platforms remunerated by both projects and investors would need to ensure that this dual remuneration structure did not interfere with their ability to act in the best interests of clients.

6.3 Directive on investor-compensation schemes [97/9/EC]

60. This Directive provides access to compensation up to a specified amount for investors where the investment firm is no longer financially able to meet its obligations and requires all authorised investment firms to belong to such a scheme. It applies to MiFID firms in relation to MiFID financial instruments. Where firms are exempted from MiFID under the optional exemption 2004/39/EC Article 3 the ICSD does not apply, although Member States may require such firms to be members of an investor compensation scheme.

6.4 Market Abuse Directive [2003/6/EC]

61. The Directive prohibits insider dealing and market manipulation in relation to financial instruments which have been admitted to trading on at least one regulated market or for which a request for such admission has been made. [Arts 2-5,9]. It therefore seems likely that most of the instruments currently offered through crowdfunding platforms would be outside the scope of the Directive.

62. Where the directive applies, the insider dealing prohibition applies, among others, to the owners and managers of the issuer and to those who have access to the inside information through their professional activity, whether knowingly or not, which could include the platform where separate from the issuer. It imposes obligations on issuers of financial instruments to disclose inside information as soon as possible [Art 6] and on managers of firms issuing financial instruments to inform competent authorities of transactions on their own account relating to shares of the said firms, or to derivatives or other financial instruments linked to them.

6.5 Alternative Investment Fund Managers Directive [2011/61/EU]

63. At this stage, platforms which operate models based on indirect investment in the project are typically using vehicles that are specific to the project in order to allow investors to choose individual projects in which to invest. So far, these were typically SPVs or companies. One platform had previously used a collective investment scheme structure with each scheme investing in a single project, but had since moved away from that approach.

64. The AIFMD could be applicable to a platform where it manages a non-UCITS collective investment undertaking which raises capital from a number of investors with a view to investing it in accordance with a “defined investment policy”. In this case, the investment vehicle could be an AIF.
65. ESMA has issued guidelines on the definition of an AIF [ESMA/2013/611] which clarify what constitutes a ‘collective investment undertaking’ [para 12]: these are that the undertaking does not have a general commercial or industrial purpose; that it pools capital from investors with a view to generating a pooled return from assets; and that the unitholders/shareholders have no “day to day discretion or control” over operational matters. In general, these conditions would appear to be met by the vehicles NCAs have seen so far.
66. The guidelines also set out factors that would, singly or cumulatively, tend to indicate the existence of a ‘defined investment policy’ [para 20]. These factors are:
- a) The investment policy is determined and fixed, at the latest by the time that investors’ commitments to the undertaking become binding on them;
 - b) The investment policy is set out in a document which becomes part of or is referenced in the rules or instruments of incorporation of the undertaking;
 - c) The undertaking or the legal person managing the undertaking has an obligation (however arising) to investors, which is legally enforceable by them, to follow the investment policy, including all changes to it;
 - d) The investment policy specifies investment guidelines, with reference to criteria including any or all of the following:
 - iii. To invest in certain categories of assets, or conform to restrictions on asset allocation;
 - iv. To pursue certain strategies;
 - v. To invest in particular geographical regions;
 - vi. To conform to restrictions on leverage;
 - vii. To conform to minimum holding periods; or
 - viii. To conform to other restrictions designed to provide risk diversification.
67. So far, the operating model seems to have been that the decision to invest in a project is taken by the end investors and the vehicle is established to achieve this. The extent of the freedom exercised by the vehicle would be in relation to any decision to sell the investment and/or liquidate the company and potentially how to exercise any rights arising from the holding of securities in the project. In such a case, the first three of the

factors set out in the previous paragraph are likely to be satisfied. ESMA also examined whether the lack of discretion given to the vehicle prevented it from having a defined investment policy. However, in relation to the fourth factor above a possible interpretation would be that the vehicle had a defined investment policy, but that the scope of the policy was very restrictive. In ESMA's opinion, while the facts of a particular case might warrant a different conclusion, such a vehicle could in principle constitute an AIF.

68. However, AIFM contains various exclusions from scope which need to be considered. In particular it excludes:

- a) "holding companies" [Article 2(3)(a)] defined as "a company with shareholdings in one or more other companies, the commercial purpose of which is to carry out a business strategy or strategies through its subsidiaries, associated companies or participants in order to contribute to their long-term value, and which is either a company:
 - i. Operating on its own account and whose shares are admitted to trading on a regulated market in the Union; or
 - ii. Not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies, as evidenced in its annual report or other official documents" [Article 4(1)(o)];
- b) Securitisation special purpose entities [Article 2(3)(g)] defined as "entities whose sole purpose is to carry on a securitisation ... and other activities which are appropriate to accomplish that purpose", where securitisation is defined as "a transaction or scheme whereby an asset or pool of assets is transferred to an entity that is separate from the originator and is created for or serves the purpose of the securitisation and/or the credit risk of an asset or pool of assets, or part thereof, is transferred to the investors in the securities, securitisation fund units, other debt instruments and/or financial derivatives issued by an entity that is separate from the originator and is created for or serves the purpose of the securitisation, and: (a) in case of transfer of credit risk, the transfer is achieved by: the economic transfer of the assets being securitised to an entity separate from the originator created for or serving the purpose of the securitisation. This is accomplished by the transfer of ownership of the securitised assets from the originator or through sub-participation, or the use of credit derivatives, guarantees or any similar mechanism; and (b) where such securities, securitisation fund units, debt instruments and/or financial derivatives are issued, they do not represent the originator's payment obligations" [Article 4(1)(an)]

69. It seems that the holding companies established by platforms for the purpose of grouping together investors' holdings in a company would indeed be established for the purpose of generating returns from eventual divestment of the holding in the project. As such, the holding companies established by platforms to date typically would not fall within the scope of the Article 2(3)(a) exemption and could be considered as AIFs.

70. It seems that some SPVs established by crowdfunding platforms could qualify as securitisation special purpose entities under the meaning of the Article 2(3)(g) exemption. As a result such SPVs would not be considered as AIFs.
71. A further exemption is set out in Article 3(2) AIFMD: AIFMs which manage AIFs with total Asset Under Management (AUM) under a specified level and are at least subject to registration by the home MS NCA and provide to the NCA information on the AIFs they operate and their investment strategies and exposures are exempted from the rest of the Directive. Such AIFMs can opt into the rest of the Directive, but unless they do so do not benefit from a passport. The levels of AUM are €100m where there is leverage, and €500m where there is no leverage and no redemption rights are exercisable for 5 years after the initial investment [Article 3(1)-(4)]. Reaching these thresholds would imply a significant growth relative to the typical scale of assets invested through most crowdfunding platforms. Where this exemption applies, an AIFM is not subject to the restrictions on which other activities it can carry out which would otherwise apply under Article 6, though it would become subject to those restrictions if it chose to opt into the Directive in accordance with Article 3(4).²⁰

6.5.1 What requirements apply where a platform is within the scope of AIFMD

72. Where it applies, the Directive prevents AIFMs from carrying out activities other than investment management, administration and marketing of an AIF and certain related activities. There is no provision for authorised AIFMs to carry out MiFID services/activities where the AIF is internally managed. Where the authorised AIFM is a legal person external to the AIF itself, these additional services/activities can include the management of investment portfolios in accordance with mandates given by investors on a discretionary client-by-client basis, and as non-core services the provision of investment advice, safekeeping/administration of shares or units of CISs and reception and transmission of orders in relation to financial instruments. [Article 6, Annex 1, Article 5]. In relation to those activities, it would be subject to the initial capital, organisational and conduct of business requirements under MiFID. [Article 6(6)] In particular, this means that an authorised AIFM may not also be authorised under MiFID.
73. If AIFMD were applicable, requirements would include the appointment of a manager for the AIF (which could be the AIF itself) which would need to be authorised, and hence subject to organizational and capital requirements. Where the AIFM is also the AIF, the initial capital required is €300,000. In other cases it is €125,000 [Arts 6-9] Other requirements include rules to address conflicts of interest, ensure action in the best interest of investors, remuneration practices, risk management, valuation of assets, and

²⁰ See Commission Q&A on Single Market Legislation, question number 1165 on AIFMD, available at <http://ec.europa.eu/yqol/index.cfm?fuseaction=question.show&questionId=1165>

management of liquidity of the AIF. [Arts 12-16, 19] There is also a requirement to appoint a depository which is an authorised credit institution, investment firm or other eligible firm but may not be the AIF itself. [Art 21] There are also requirements for disclosure to investors. [Art 23]

74. Marketing of AIFs is in principle restricted to professional investors (i.e. professional clients under MiFID) [Articles 31, 32, 4(1)(ag)]. However, Member States may choose to allow marketing of AIFs to retail investors.

6.5.2 Would a platform authorised only as an AIFM be able to operate a typical crowdfunding platform business model?

75. The question as to whether a crowdfunding platform which offered investors indirect investment through an AIF could operate only with an AIFM authorisation depends on the assessment of which MiFID services/activities it would need to provide and how that relates to what is permitted under AIFMD. Authorised AIFMs are permitted to carry out a range of activities listed in the Annex to the Directive, including “marketing” AIFs they manage, that is they can make a “direct or indirect offering or placement” of the shares or units in such an AIF. If, in addition to the activities listed in the Annex, the platform were the AIFM and were deemed to be providing only the MiFID services/activities of reception and transmission of orders and/or investment advice (as defined in MiFID) it would seem to be possible where the manager is external to the AIF itself, because Member States may permit these activities under Article 6(4) of AIFMD. If it were determined that platforms intrinsically offer execution of orders this possibility would not be open to them, because these services/activities cannot be undertaken by virtue of authorisation as an AIFM as such and are not listed in Article 6(4) (cf Arts 5-6, Annex 1).

76. Where a platform is the AIFM and is external to the AIF, this would mean initial capital requirements on the platform of €125,000 and ongoing capital requirements depending on the level of overheads and total assets under management in the AIFs.

77. If such a platform only carried out the MiFID service of reception or transmission of orders, with or without provision of investment advice, it would seem feasible that it could operate a crowdfunding business model based on the establishment of a separate AIF for each project invested in. However, given that the initial capital required is significantly higher than under MiFID, it is not clear that a platform would choose the form of an authorised AIFM. It therefore seems more likely to be relevant for a platform that structured a single vehicle with multiple sub-funds, each investing in a single project, or potentially ‘clusters’ of investment opportunities in a single fund.

78. Where the AIFM manages AIFs with AUM under the thresholds specified in Article 3(2), the AIFM would be able to carry out additional MiFID services and to be authorised under MiFID, if not exempted, unless the Member State imposed additional restrictions which prevented this. However, such registration would not give rise to a passport for the marketing of the AIF unless the AIFM opted in to the whole Directive, which would in turn imply that it loses the right to be authorized under MiFID.

6.6 European Venture Capital Funds Regulation [EU No 345/2013]

79. The Regulation lays down conditions which managers have to meet if they want to use the designation “EuVECA” in marketing material relating to qualifying funds, which are established in a Member State and which intend to invest at least 70% of assets in small firms that do not issue listed securities and meet certain other conditions. [Arts 1-3] Such funds may not be leveraged [Art 5] and they may only be marketed to certain types of investors: those who are or choose to be treated as professional clients under MiFID, or who commit to investing at least €100k, or who state in writing in a separate document from the investment contract that they are aware of the risks of the commitment envisaged. [Article 6] Once registered as having met the conditions, AIFMs can market qualifying funds throughout the EU, using the designation EuVECA.
80. Managers of such funds must act honestly, fairly and with due skill, care and diligence; take steps to prevent malpractices that could harm the interests of investors or entities invested in; promote the best interests of the funds, their investors and market integrity; apply a high level of diligence in the selection and ongoing monitoring of investments in qualifying portfolio undertakings; adequately know/understand the entities they invest in; ensure no investor obtains preferential treatment unless that is disclosed in the fund’s rules/instrument of incorporation. [Article 7] There are also rules on the avoidance, management and disclosure of conflicts of interest [Article 9,] on the valuation of assets [Article 11] and on the disclosure of information to investors [Article 13]. There is no requirement to appoint a depositary.
81. In terms of prudential requirements, managers are required to ensure that they have sufficient own resources to manage the funds and ensure operational continuity and to disclose to investors the amount and why it is adequate. No amount of own resources or methodology for calculating them is mandated [Article 13]
82. In principle, it would seem attractive for a platform using an AIF as a vehicle for indirect investment in projects to seek to do so within the parameters of an EuVECA because the capital requirements are likely to be much lower than for an AIFM authorised under AIFMD and potentially lower than those applicable if a different structure were used requiring authorization under MiFID, and the qualification would bring with it a passport which is not available to registered AIFs.

6.7 European Social Entrepreneurship Funds Regulation [EU (No. 346/2013)]

83. The Regulation follows the approach of the Venture Capital Regulation in relation to managers of funds investing in social enterprises, which where the requirements are met may be marketed as “EuSEF”s and benefit from a passport. The same restrictions on the clients to whom the funds may be marketed apply as in the Venture Capital Funds Regulation. [Art. 6]

6.8 Distance Marketing of Financial Services Directive [2002/65/EC]

84. The Directive applies where there is a contract between a supplier (anyone acting in a commercial/professional capacity who in that capacity provides contractual services where the contract is concluded without the simultaneous presence of the supplier and consumer) and a consumer (any individual not acting in such a capacity) which is concluded without the two parties being physically in the same place. As such, it would be likely to apply in principle to the investment contract and to any separate contract with the platform, because the investor's counterparty would be a supplier. [Arts 1, 2]
85. Where it applies, the Directive requires information disclosures about the supplier and the financial service, whether there is a right of withdrawal and any applicable out-of-court redress/complaints/compensation mechanisms. [Art 3]
86. The Directive also provides for a 14 day right of withdrawal (longer for life insurance and pensions) but states that this right shall not apply to financial services "whose price depends on fluctuations in the financial market outside the supplier's control, which may occur during the withdrawal period". This exclusion from the obligation to provide for a right of withdrawal explicitly covers transferable securities and units in collective investment undertakings. [Art 6(1),(2)] Where the securities in question are not transferable securities, consideration would need to be given as to whether the price of the particular security was capable of fluctuating within the withdrawal period before determining whether the right of withdrawal should be disapplied.

6.9 Third Anti-Money Laundering Directive [2005/60/EC]

87. The third AMLD prohibits money laundering and terrorist financing. [Art 1] It applies to firms including credit institutions and financial institutions, the latter including MiFID investment firms, collective investment undertakings and firms providing certain services offered by credit institutions without being one (including lending, money transmission, participation in securities issues and related services [Arts 2, 3] Member States are also required to extend it in full or in part to other categories of institution which engage in activities "particularly likely to be used for money laundering or terrorist financing purposes", and to notify the Commission when they use this power. [Art 4]
88. The Directive requires firms to carry out due diligence on customers, which may be enhanced or simplified partially in certain circumstances, [Arts 6-13] and to have in place appropriate record-keeping and other internal procedures [Arts 30-33] This can be done by third parties under certain conditions [Articles 14-17]. Firms have an obligation to report any suspicious activity, to co-operate with any investigations by relevant public authorities, and not to disclose the report or any investigation. [Arts 20-24, 26, 28] Member States may impose stricter requirements. [Art 5]
89. As many platforms are currently operating outside the scope of MiFID they would not be automatically captured by the 3AMLD. However, the definition of 'financial institution'



also includes those carrying out money transmission, participation in securities issues and the provision of services related to such issues, and safekeeping and administration of securities. Depending on the business model, this could capture some platforms.

Appendix 1: MiFID requirements and risk outcomes

Please see charts below

Legend

| | |
|---|------------------------------|
|  | Good risk mitigant |
|  | Limited risk mitigant |
|  | Not applicable |
|  | Risk contributor |

Investor perspective

| | | | Conditions and procedures for authorisation | | | Organisational requirements | | | Conduct of business obligations | | | Passport | |
|--|---|--|---|--------------|---------------------------|-----------------------------|---------------------|-----------------------------|---------------------------------|-------------------------|-------------------------|----------------------|--|
| | | | Persons who direct the business | Shareholders | Initial capital endowment | Conflicts of interest | Client assets rules | Record-keeping requirements | Information requirements | Appropri. test | Suitability test | Reporting to clients | |
| Money laundering | Money laundering | Confiscation of assets | | | | | | | | | | | |
| Counterparty (or credit) risk | Project owner (or securities issuer if different) fails | Capital invested is lost (partly or as a whole) | | | | | | | | | | | |
| Counterparty risk | Platforms fails | Capital invested is lost (partly or as a whole) or cannot be reclaimed | | | | | | | | | | | |
| Market risk | Value of investment (equities and bonds) is dependent on market | Investment loses value | | | | | | | | | | | |
| Risk of fraud | Fraud | Capital invested is lost (partly or as a whole) or cannot be reclaimed | | | | | | | | | | | |
| Operational risk | Delay or mistake in the information flow, processing, safekeeping or administration (e.g., computer breakdown, mistake) | Capital invested is lost (partly or as a whole) or cannot be reclaimed or investment loses value because of delay or mistake | | | | | | | | | | | |
| Liquidity risk | Lack of secondary market | Investment cannot be sold | | | | | | | | | | | |
| Legal risk | Terms & conditions hardly understandable, unfair and/or providing no legal guarantee | Property rights cannot be enforced | | | | | | | | | | | |
| Legal risk | No complaints handling mechanism | Property rights cannot be enforced | | | | | | | | | | | |
| Lack of transparency / misleading information | Risk/return profile of investment not properly disclosed | Investment is more risky than expected by investor | | | | | | | | where applicable | where applicable | | |
| Lack of transparency / misleading information | Costs (direct and indirect) not properly disclosed | Investment is more costly than expected by investor | | | | | | | | | | | |
| Systemic risk | Systemic risk | Crowdfunding endangers financial stability (maturity and liquidity transformation, leverage) | | | | | | | | | | | |
| Opportunity risk | Crowdfunding cannot take place | Investors miss a valuable investment opportunity | | | | practicality? | practicality? | | | need for customisation? | need for customisation? | | |

Project owner perspective

| | | | Conditions and procedures for authorisation | | | Organisational requirements | | | Conduct of business obligations | | | Passport | |
|--|---|--|---|--------------|---------------------------|-----------------------------|---------------------|-----------------------------|---------------------------------|-------------------------|-------------------------|----------------------|--|
| | | | Persons who direct the business | Shareholders | Initial capital endowment | Conflicts of interest | Client assets rules | Record-keeping requirements | Information requirements | Appropri. test | Suitability test | Reporting to clients | |
| Money laundering | Money laundering | Confiscation of assets | | | | | | | | | | | |
| Counterparty (or credit) risk | Project owner (or securities issuer if different) fails | N/A | | | | | | | | | | | |
| Counterparty risk | Platforms fails | Project owner is unable to repay dues | | | | | | | | | | | |
| Market risk | Value of investment (equities and bonds) is dependent on market | N/A | | | | | | | | | | | |
| Risk of fraud | Fraud | Project cannot be funded | | | | | | | | | | | |
| Operational risk | Delay or mistake in the information flow, processing, safekeeping or administration (e.g., computer breakdown, mistake) | Project cannot be funded or not in a proper manner, project owner is unable to repay dues | | | | | | | | | | | |
| Liquidity risk | Lack of secondary market | N/A | | | | | | | | | | | |
| Legal risk | Terms & conditions hardly understandable, unfair and/or providing no legal guarantee | Intellectual proprietary rights are violated | | | | | | | | | | | |
| Legal risk | No complaints handling mechanism | N/A | | | | | | | | | | | |
| Lack of transparency / misleading information | Risk/return profile of investment not properly disclosed | N/A | | | | | | | | | | | |
| Lack of transparency / misleading information | Costs (direct and indirect) not properly disclosed | Funding is more costly than expected by project owner | | | | | | | | | | | |
| Systemic risk | Systemic risk | Crowdfunding endangers financial stability (maturity and liquidity transformation, leverage) | | | | | | | | | | | |
| Opportunity risk | Crowdfunding cannot take place | Project cannot materialise | | | | practicality? | practicality? | | | need for customisation? | need for customisation? | | |

Platform perspective

| | | | Conditions and procedures for authorisation | | | Organisational requirements | | | Conduct of business obligations | | | Passport | |
|--|---|--|---|--------------|---------------------------|-----------------------------|---------------------|-----------------------------|---------------------------------|-------------------------|-------------------------|----------------------|--|
| | | | Persons who direct the business | Shareholders | Initial capital endowment | Conflicts of interest | Client assets rules | Record-keeping requirements | Information requirements | Appropri. test | Suitability test | Reporting to clients | |
| Money laundering | Money laundering | Reputational risk, loss of revenues | | | | | | | | | | | |
| Counterparty (or credit) risk | Project owner (or securities issuer if different) fails | Reputational risk, loss of revenues | | | | | | | | | | | |
| Counterparty risk | Platforms fails | N/A | | | | | | | | | | | |
| Market risk | Value of investment (equities and bonds) is dependent on market | N/A | | | | | | | | | | | |
| Risk of fraud | Fraud | Reputational risk, loss of revenues | | | | | | | | | | | |
| Operational risk | Delay or mistake in the information flow, processing, safekeeping or administration (e.g., computer breakdown, mistake) | Reputational risk, loss of revenues | | | | | | | | | | | |
| Liquidity risk | Lack of secondary market | N/A | | | | | | | | | | | |
| Legal risk | Terms & conditions hardly understandable, unfair and/or providing no legal guarantee | Reputational risk | | | | | | | | | | | |
| Legal risk | No complaints handling mechanism | Reputational risk | | | | | | | | | | | |
| Lack of transparency / misleading information | Risk/return profile of investment not properly disclosed | Reputational risk | | | | | | | | where applicable | where applicable | | |
| Lack of transparency / misleading information | Costs (direct and indirect) not properly disclosed | Reputational risk | | | | | | | | | | | |
| Systemic risk | Systemic risk | Crowdfunding endangers financial stability (maturity and liquidity transformation, leverage) | | | | | | | | | | | |
| Opportunity risk | Crowdfunding cannot take place | Platform is not viable or profitable enough | | | | practicality? | practicality? | | | need for customisation? | need for customisation? | | |

Appendix 2: overview of initial capital requirements under MiFID/CRD/CRR

All investment firms carrying on MiFID services/activities are to hold initial capital of €730,000 [2013/36/EU, Article 28(2)] unless they meet the conditions for lower initial capital or an exemption:²¹

- 1) €125,000: firms which receive and transmit orders and/or execute orders and/or manage portfolios and which hold client money but do not deal on own account, underwrite/place issues on a firm commitment basis, operate an MTF, or operate a UCITS/AIFM. [2013/36/EU, Art 29(1)]
- 2) €50,000: where firms meets the conditions to be a €125,000 firm except that they are not authorized to hold client money, Member States may reduce the initial capital requirement to €50,000. [2013/36/EU, Art 29(3)]
- 3) Article 31 firms:²² firms which are not authorized to provide safekeeping services or to hold client money or securities and which provide only one or more of the services of reception and transmission of orders, execution of orders, portfolio management and investment advice have to hold *either* initial capital of €50,000, *or* professional indemnity insurance (PII) against liability from professional negligence or a comparable guarantee of at least €1m for each claim and €1.5m for all claims, *or* a combination of the two.²³ [Directive 2013/36/EU, Art 29(3)]

²¹ Note: there are also ongoing capital requirements which are not addressed here

²² Firms which are not authorized to provide safekeeping services or to hold client money or securities and which provide only one or more of the services of reception and transmission of orders, execution of orders, portfolio management and investment advice are excluded from the definition of investment firms in point 2(c) of Article 4(1) of CRR [Regulation (EU) No. 575/2013] and hence are only subject to Article 31 of CRD [Directive 2013/36/EU]

²³ Amounts are reduced by Art 31(2) where the firm is also an insurance intermediary authorised under Directive 2002/92/EC

Table 1: cases where MiFID/CRD/CRR provide for initial capital of less than standard €730,000

Key: Y = firm must offer one or more of these services to be eligible for the stated capital requirement
 N= service that must not be offered to be eligible for the stated capital requirement
 X= service that may be offered without affecting the initial capital requirement

| Activity/service carried out | | Initial capital required | | |
|------------------------------|--|--------------------------|-----------------------------------|-------|
| | | €50k <u>or</u> PII * | €50k (MS option, otherwise €125k) | €125k |
| A | Hold client money | N | N | Y |
| B | Reception and transmission of orders | Y | Y | Y |
| C | Execution of client orders | Y | Y | Y |
| D | Dealing on own account | N | N | N |
| e | Portfolio management | Y | Y | Y |
| f | Investment advice | Y | X | X |
| g | Underwriting and/or placing on firm commitment basis | N | N | N |
| h | Placing without firm commitment basis | N | X | X |
| i | Operation of MTF | N | N | N |

*Less if firm is also authorised insurance intermediary ** Provided firm does not manage a UCITS/AIFM

Appendix 3: Other potentially applicable legislation

91. ESMA's analysis has focused on the legislation within the scope of Article 1(2) of Regulation 1095/2010. However, there is a range of other EU legislation which is potentially applicable. While not intended to be exhaustive, ESMA has therefore considered the relevance of certain other EU legislation which, where applicable, could mitigate some of the risks identified or could affect the application of the legislation within the scope of Article 1(2). The analysis on the applicability of the Payment Services Directive was made in collaboration with EBA.

Payment Services Directive [2007/64/EC]

92. Among other things, the PSD lays down rules for distinguishing six different categories of payment service provider (PSP) and rules governing the provision of payment services by those entities. In particular it requires the authorization of 'payment institutions', which are those PSPs which are not already authorised as credit institutions or e-money institutions, or are otherwise excluded from the authorisation requirements. (Arts 1(1), 10(1)), We have been examining the flow of payments involved in the provision of investment-based crowdfunding services and which parties typically play which role in order to assess to what extent platforms themselves may be carrying out payment services or the alternatives where they are not.

93. Once again, a range of models are evident. Some platforms are not directly involved in the acceptance of payments or transmission of funds between parties. For example, one platform which facilitates direct investment in securities refers projects to a third party payment service provider which facilitates the collection of funds from investors through processing of direct debit mandates. Another platform which facilitates indirect investment accepts payment by bank transfer or cheque into a pooled account from which is used to finance a holding company that in turn invests in securities issued by the project. Another platform which facilitates direct investment but through a nominee structure establishes individual client accounts in which potential investors deposit funds, which are then used to purchase the securities. It should be noted that where a platform is an authorised investment firm under MiFID, the mechanism for the transfer of funds may constitute the holding of client money within the meaning of that Directive, and indeed the platform in the third example above is regulated in this way.

94. Nevertheless, the applicability of the PSD needs to be considered. The PSD defines a payment institution as a legal person that has been granted authorisation in accordance with Article 10 to provide and execute payment services throughout the Community. Payment services

are defined as any business activity listed in the Annex. Article 3 sets out the “negative scope” of the Directive; for example, the PSD does not apply to payment transactions based on paper-cheques identified under letter (g),

95. Under Article 1(2) the PSD lays down rules concerning transparency of conditions and information requirements for payment services, and the respective rights and obligations of payment services users and payment service providers in relation to the provision of payment services as a regular occupation or business activity. Reasoning on this provision, depending on the nature of the business undertaken by a platform, it is possible that the provision of payment services would not be its regular occupation. Also, while not in itself conclusive, an authorization as an investment firm under MiFID might be one indicator that the provision of payment services was not the main activity of the platform.
96. Where payment services are deemed to be a firm’s main activity there are other exemptions which could be potentially applicable. These could, depending on the nature of the business, include exemptions for:
- a) Commercial agents (Art 3(b));
 - b) Technical service providers which do not themselves enter into possession of the funds (Art 3(j)).
97. It should also be noted that payment transactions related to securities asset servicing are outside the scope of PSD, which would be relevant where platforms are holding securities on behalf of clients. (Art (3)(i)).
98. Not all payment instruments are covered by the PSD: for example, cheques are excluded. However, given that most crowdfunding platforms would be operating online and, if involved in taking payments would be using electronic means, it is likely that in-scope payment instruments would be used.
99. The list of payment services in the Annex to the Directive includes the following which are most likely to be relevant to investment through crowdfunding platforms according to the current understanding of their underlying activities:
- a) Services enabling cash to be placed on or withdrawn from a payment account, as well as all the operations required for operating a payment account; [points 1, 2]

- b) Execution of payment transactions; [point 3]
- c) Issuing of payment instruments and/or acquiring of payment transactions; [point 5]
- d) Money remittance. [point 6].

100. ESMA's understanding of how platforms' activities relate to the payment services listed above is that:

- a) where a platform accepted payments in a way that required a record attributing the payment to a particular client, it could be operating a payment account, regardless of whether, for example, the payment was held in a separate bank account or not;
- b) where an investor makes a payment on a one-off basis through the platform for immediate onward transmission to the issuer, it is possible that the payment service could be money remittance. Bearing in mind the definition of money remittance in Art 4(13) such a payment would need to be made for the sole purpose of transferring funds to the payee or a PSP acting on behalf of the payee or received on behalf of and made available to the payee, all without the creation of a payment account in the name of either payer or payee;
- c) Where a platform held funds in an account from which it released funds on receipt of further instructions from clients, it could also be executing payment transactions;
- d) It is also possible in some cases that the platform could be acquiring payment transactions.

101. If the crowdfunding platform were authorised as a payment institution it would be subject, among other requirements, to initial and ongoing capital requirements. Where only the service of money remittance is offered, the initial capital requirement is €20,000. Where operating a payment account, execution of payment transactions and/or acquisition of a payment transaction is undertaken these initial capital requirements are €125k. [Article 6, point (c)] There are also additional ongoing capital requirements, to be determined in accordance with one of the methodologies set out in Article 8, which reflect the size and, in some cases, the nature of the business undertaken. If crowdfunding platforms authorised under MiFID were to also be authorised as payment institutions the interaction between the two sets of capital requirements would need to be considered. In particular, Article 7 PSD requires Member States to take the necessary measures to

prevent firms from double-counting the same assets when determining capital requirements within a group or where payment institutions also carry out other activities. However, as noted above, while not conclusive, authorization under MiFID may provide an indicator that the provision of payment services was not the main activity of the platform, meaning that the potentially much higher capital requirements under PSD would not apply.

102. Where it applies, the PSD requires the safeguarding of payments, but gives Member States or competent authorities the possibility to waive these requirements for payments of under €600.

103. In addition, Member States may waive or allow their NCAs to waive all or part of the above requirements where the PSP meets certain conditions, in particular where the average monthly transactions in the preceding year have been under €3m per month and none of the management have been convicted of money laundering/terrorist financing. [Article 26] However, the transparency and information requirements in Title III and rules on rights and obligations on the provision and use of payment services in Title IV would apply in such cases, unless any of the conditions set out in those Titles are met (see e.g. Article 34 on low value payments).

Unfair Commercial Practices Directive: [2005/29/EC]

104. This Directive regulates business to consumer commercial communications/practices pre- and post-sale, in particular those which are misleading or aggressive. It applies to all sectors including financial services and so ESMA's understanding is that it would apply even, for example, where non-transferable securities are used and could be relied on to determine that advertising/marketing was misleading (including through omission of material risks, misleading impression of the service the crowdfunding platform was offering including e.g. in relation to due diligence), aggressive or otherwise unfair.

Misleading and Comparative Advertising Directive [2006/114/EC]

105. The Directive regulates business-to-business advertising in particular by requiring Member States to provide means to combat misleading advertising [Articles 1, 2(b), 3, 5] and lays down rules in relation to how comparisons are made, which apply to both business-to-business and business-to-consumer advertising [Arts 1, 4].

Unfair Terms in Consumer Contracts Directive [93/13/EEC]

106. The Directive provides that where the terms of a contract between a seller or supplier and a consumer that has not been individually negotiated are unfair, those terms shall not be binding on the consumer but the rest of the contract will continue to bind the parties if that is possible without the continuing existence of the unfair terms. [Articles 1-3, 6] It also provides that all written contract terms should be in plain, intelligible language. [Art 5]

107. A term is regarded as unfair if it causes a significant imbalance in the rights and obligations of the parties under the contract, to the detriment of the consumer. The assessment shall not related to the definition of the main subject matter of the contract and to the adequacy of price and remuneration, provided those terms are in plain, intelligible language. [Articles 2, 4(2)] A non-exhaustive list of unfair terms is annexed to the Directive, with some of those explicitly dis-applied to transferable securities [Annex(2)(c)]

Consumer Alternative Dispute Resolution (ADR) Directive [2013/11/EU]

108. Many pieces of EU financial services legislation contain provisions on access to redress out of court. However, the ADR Directive applies to disputes between a consumer and a trader in relation to 'service contracts' (among others) which could cover the contract between a platform and a consumer. [Arts 1, 2, 4]Where it applies, the provisions of this Directive take precedence over other EU legislation in case of conflict, except in relation to information from the trader about ADR entities. [Art 3]

Consumer Credit Directive and Mortgage Credit Directive [2014/17/EU]

109. At the moment the typical business model of investment-based platforms does not involve lending funds to investors for them to invest. However, we wanted to understand the situation if this business model were to emerge, and to understand to what extent CCD and MCD could be applicable to platforms carrying out both lending and investment-based crowdfunding.

110. CCD does not apply where an investment firm or credit institution lends fund to a consumer for the purposes of investing in a MiFID financial instrument, where the firm providing the credit would be involved in that transaction. [Art 2(2)(h)] So, if a platform were authorised

under MiFID and provided credit to investors to provide funds for them to invest in projects offered on that platform, the CCD would not apply.

111. Furthermore, our understanding is that because CCD applies, with certain exclusions, to ‘credit agreements’, defined as contracts between a consumer and a lender who is granting credit in the course of business (a ‘creditor’) [Arts 1-3], the directive would not apply to loans made on peer-to-peer lending platforms by a consumer providing credit to another party. If the platform itself were providing credit to consumers, or if it were lending funds to consumers for them in turn to lend on to other consumers, or if it were enabling consumers to borrow from creditors, the directive would apply.

112. Similarly, the Mortgage Credit Directive regulates, with certain exceptions, loans between professional lenders and consumers which are secured on residential immovable property or secured by a right related to residential immovable property and loans which are for the purpose of acquiring or maintaining rights in residential immovable property, including land and projected buildings as well as existing buildings, whether secured or not. [Arts 1, 3] It would not apply to consumers who lend to other consumers, or to a consumer who lends money to a business [Arts 3(1), 4(1), (2), (3).]

E-commerce directive [2000/31/EC]

113. The Directive regulates the provision of ‘information society services’. It provides that such services are subject to the rules of the Member State where the service provider is established [Arts 1-3] This rule does not apply to specified areas; the specified areas include certain aspects related to financial services but not those most likely to be relevant to crowdfunding. [Art 3(3), Annex]. The Directive does not cover rules applicable to services not provided by electronic means. An ‘information society service’ is, with certain exceptions, any service ‘normally provided for remuneration, at a distance, by electronic means and at the individual request of a recipient of services’. [Art 2(a)] The provision of information society services as such may not be made subject to prior authorisation. However, this does not apply to authorisation schemes not “specifically and exclusively targeted” at such services. [Art 4]

114. Member States cannot restrict the provision of ‘information society services’ from another Member State unless it is necessary and proportionate to meet certain specified policy objectives. The specified policy objectives include the prevention/investigation/detection/prosecution of crime and the protection of consumers, including investors [Art 3(3)-(6), recital 27].



115. Where applicable, the Directive requires, among other things, that the service provider makes available certain information and confirms orders received from consumers [Arts 5, 6, 10, 11]