

Regulatory Arbitrage in a FinTech World:

Devising an Optimal EU Regulatory Response to Crowdfunding

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Introduction

Loan-based crowdfunding (“crowdfunding”) has carved out a competitive place in the market for both borrowing and investment. While the future evolution and sustainability of crowdfunding in the European Union remains to be seen, it certainly has the potential to mobilise capital within the aims of the capital markets union. Crowdfunding burgeoned after the financial crisis as an alternative finance model for individuals and small business as the traditional banking sector became more risk averse in their lending outlook.¹ The crowdfunding phenomenon fits within the emergent FinTech industry specialising in the innovative use of financial technology to provide financial services.² It also fits into a wider story of the emergence of shadow banking in the 21st century whereby market players other than banks have entered the finance market. Crowdfunding involves disruptive innovation which brings competition into retail lending and investment markets. Crowdfunding is part of a wider trend towards ‘democratising’ finance by removing traditional middlemen in the form of financial institutions and providing easy to access web platforms. It is redefining customer

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¹ A. Pekmezovic and G. Walker, “The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital” (2016) 5 William & Mary Business Law Review 347.

² European Banking Authority, *EBA Consumer Trends Report 2016* (London: EBA, 2016), para.61; D.W. Arner, J. Barberis and R.P. Buckley, “The Evolution of FinTech: A New Post-Crisis Paradigm?” [2016] 47 Georgetown Journal of International Law 1271.

relationships, providing the means for the average person to engage in investment activities through extending credit.

Globally crowdlending has evolved at different rates; it remains at early fledgling stage in many countries. The most established market in Europe for crowdlending exists in the UK where the first P2P lending site in the world, Zopa, was established in 2005.³ From the perspective of third party investors who supply the capital for crowdlending, transparency, fairness and various forms of financial risk present as major concerns.⁴ This raises the role that regulation can play in safeguarding against risk or its consequences. Yet, as is often the case when societal shifts occur, there is a noticeable lag in the legal and regulatory landscape which creates uncertainty as compared with industry sectors where a regulatory framework is bedded down. As matters stand, with little consideration at Member State level and a passive EU response, there is a legal and regulatory minefield to be navigated by crowdlending platform operators and their legal advisors in the EU.

The literature on crowdlending (as opposed to crowdfunding more generally) is relatively small. With a few notable exceptions, there is a lack of EU-focused scholarship concerning the regulation of crowdlending.⁵ In addressing this gap the outlook presented here is largely from an investor perspective while focusing platform operators navigating an often uncertain regulatory

³ The latest available study valued the UK alternative finance market at £4.58 billion (€5.16 billion) in 2016: Centre for Alternative Finance, University of Cambridge, *Entrenching Innovation: The 4th UK Alternative Finance Industry Report* (Cambridge: University of Cambridge, 2017), p.6.

⁴ The article is largely concerned with financial risk to investors. Indirect risks of fraud such as identity theft, money-laundering, financing of terrorism are outside the scope of this article.

⁵ Notable exceptions include E. Macchiavello, "Peer-to-Peer Lending and the 'Democratisation' of Credit Markets: Another Financial Innovation Puzzling Regulators" (2015) 21(3) *Columbia Journal of European Law* 521; A. Pekmezovic and G. Walker, "The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital" (2016) 7(2) *William & Mary Business Law Review* 1; W.S. Warren, "The Frontiers of Peer-to-Peer Lending: Thinking About a New Regulatory Approach" (2016) 14 *Duke L. & Tech. Rev.* 298.

landscape.⁶ The article begins by contributing to conceptual clarity by addressing central definitional and taxonomical issues for crowdlending. It then moves to outline key financial risks for a crowdlending investor. The article goes on to consider the regulatory tension between facilitating growth of the crowdlending industry as against the need for regulatory intervention in the market to ensure adequate investor protection. The relevance of existing EU instruments to crowdlending is considered and the EU's regulatory response to date is then evaluated. It is contended that the absence of a clear and harmonised regulatory framework within the European Union allows regulatory arbitrage to flourish unchecked and is likely to inhibit market integration rather than facilitating stable market development in the crowdlending sector on an equitable basis. The remainder of the article argues in favour of the desirability of EU regulatory intervention and envisages key elements of an optimal EU regulatory response. This contribution to scholarship and regulatory debate on crowdlending is timely as the EU begins to consider what regulatory steps to take in the area.

Providing Definitional Clarity

Given the emerging rather than established nature of alternative finance, and the absence of well-established legal and regulatory frameworks, it is not surprising that some definitional clarity is lacking when it comes to crowdlending. Therefore a basic typological framework is for understanding crowdlending is offered through probing its definitional and operational parameters.

The first definitional categorisation involves recognising that crowdlending is part of the broader genus of crowdfunding. Crowdfunding is strongly premised upon the sharing economy's replacement of reliance on experts with reliance on and trust in peers. The European Commission captured the essence of crowdfunding as involving web-based matching in its definition of it as:

⁶ Issues of responsible lending and consumer protection from a borrower perspective are outside the scope of this article.

“an emerging alternative form of financing that connects directly those who can give, lend or invest money with those who need financing for a specific project ... using the internet to directly connect with funders....”⁷

Financial return crowdfunding covers investment/equity crowdfunding and crowdlending which is in essence debt-based crowdfunding. Crowdlending may encompass business or consumer borrowers.⁸ The legal wilderness in which crowdlending largely operates runs in hand in hand with a lack of consensus in relation to nomenclature. Crowdlending is known by various other names including peer-to-peer (or ‘P2P’) lending in relation to consumer lending and peer to business (P2B) lending or marketplace lending for business loan models. These alternate names have value as they allow for the taxonomical possibility of readily distinguishing between the relevant categories of loans based on the status of the borrower. Furthermore, these sub-categorisations suitably reflect that quite different investment propositions underlie P2P and P2B models. Indeed, as institutional investors and banks increasingly come on board as investors, the more generic taxonomy of marketplace lending more suitably covers the reality that the market has evolved and moved on from its peer-focused origins. In other words the peer to peer lending label is less apt than it once was. While not without limitations, ‘crowdlending’ nonetheless has broader taxonomical appeal as an operative umbrella term in the current state of market evolution.

In a regulatory vacuum an attempt to formulate a definition of crowdlending can assist in adding clarity to the regulatory debate. In the simplest of terms crowdlending involves the provision of capital in return for an expected return of capital plus interest over time. A platform operator

⁷ European Commission, *Crowdfunding in the EU – Exploring the Added Value of Potential EU Action* Consultation Paper (2013) http://ec.europa.eu/finance/consultations/2013/crowdfunding/docs/consultation-document_en.pdf [Accessed 3 January 2018].

⁸ For a good chart of current and former platform operators in the UK see <http://www.p2pmoney.co.uk/companies.htm> [Accessed 3 January 2018].

operates an electronic system to facilitate that lending. As noted above, although commonly referred to as peer-to-peer lending as a convenient identifier, crowdlending as a concept covers both peer-to-peer and peer-to-business lending. Consequently the involvement of a peer lender is not decisive; arguably the use of an online platform to match lenders and borrowers seems to be the crucial identifying criterion for crowdlending. New Zealand's pioneering regulatory framework provides a definition of "peer-to-peer lending services" in terms of:

"a person (A) provides a peer-to-peer lending service if—

- (i) A provides a facility by means of which offers of debt securities are made; and
- (ii) the principal purpose of the facility is to facilitate the matching of lenders with borrowers who are seeking loans for personal, charitable, or small business purposes."⁹

This is a useful and succinct plain English definition and gives recognition to the pivotal intermediary role of the platform operator although it does not specifically refer to the web-based context.

It is worth unpacking the roles of the parties involved in crowdlending. In loan-based crowdfunding "the borrower" is the recipient of monies. In classic P2P lending, the borrower will be a consumer. In P2B lending, the borrower will be an SME business, starting up or in expansion. Depending on the platform, the interest rate payable may be determined by the platform operator or in whole or in part on the basis of bidding rates in an online auction in respect of the relevant loan.

In terms of providing appropriate taxonomy to describe the provider of the capital, the use of the noun "lender" does not always sit well. Although used by some policy-influencers including

⁹ Financial Markets Conduct Regulations, 2014 LI 2014/326, Reg.185(1)(b) (New Zealand).

the European Banking Authority,¹⁰ the word “lender” seems best avoided as it connotes a direct lender-borrower relationship which may not exist where there is the interpolation of a platform operator or a third party credit institution as a loan originator. The platform operator frequently operates as an intermediary to whom the capital is first advanced by the retail investor and who then disburses it (and who often more properly represents a lender). Accordingly, consumers who provide money through peer-to-peer lending vehicles are often described by the operators of these vehicles as “investors”. This accords with the fact that they may have no contract-based or other legal right to directly enforce repayment of sums advanced. Investors are a non-homogenous group ranging from small-time retail investors through to institutional investors investing significant volumes. Investors rely on either manual selection of investments within the platform or an automated bid function or a combination of both to select suitable loans to invest their capital in based on factors such as interest rate, risk appetite and length of loan.

Within crowdlending, the intermediary/promoter is commonly described as the platform operator. The platform operator fulfils the role of online market-maker, matching borrowers and investors for the supply and demand sides of capital in accordance with agreed criteria using sophisticated algorithms and providing the mechanism for the transfer of funds between the two. Given this role, an analogy with a stockbroker has been drawn in relation to the role of the platform operator.¹¹ Platform operators generally generate revenue from fees including interest charged to borrowers. Transaction/participation fees are sometimes charged to investors.

Key Financial Risks to Investors

¹⁰ European Banking Authority, *Opinion of the EBA on Lending-based Crowdfunding* EBA/Op/2015/03 (2015) [https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+\(EBA+Opinion+on+lending+based+Crowdfunding\).pdf](https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf) [Accessed 3 January 2018].

¹¹ K. Davis and J. Murphy, “Peer-to-Peer Lending: Structures, Risks and Regulation” (2016) 3 *The Finisia Journal of Applied Finance* 37, 38.

Financial risk concerning crowdlending, which is debt-based, is generally considered less than equity-based crowdfunding as it does not involve the issue of shares or securities. However, free market autonomy permitting extension of credit to poor quality borrowers when combined with a lack of transparency by platform operators is not a recipe for strong investor protection. Indeed, it is well understood that there is a relationship between the success enjoyed by platform operators and the laxity of the regulatory environment.¹² Key financial risks to the investor are outlined below.

Poor Investment Performance: Credit Risk

The platform operator is responsible for vetting and assigning credit ratings to borrowers. In part the credit risk is determined by the appetite for risk that the platform has, and in part the risk behaviour exhibited by the investor. The platform operator may assume poor credit risks that a bank would not by charging exorbitantly high interest rates to compensate for that risk. This increases moral hazard. There is a common perception with the crowdlending sector that loans are often made available to individuals and businesses whose risk-profile makes them unattractive to bricks and mortar banks. Indeed, the collapse of UK-based Quakle in 2014 was attributed to a profile of low quality borrowers.¹³ Some P2P platforms provide high risk short-term month to month lending, named ‘pay day loans’, where interest rates can be punitive, particularly if maturity transformation is offered giving the borrower an option to extend the loan term.¹⁴ This may increase interest return for investors but it in turn exponentially increases the repayment risk for investors.

¹² T. Bonneau, “FinTech and the Definition of Banks and Investment Firms” <http://www.ebi-europa.eu/wp-content/uploads/2016/12/20161028-Th-Bonneau-Fintech.pdf> [Accessed 3 January 2018]; D.A. Zetzche and C. Preiner, “Cross-Border Crowdfunding: Towards a Single Crowdfunding Market for Europe” European Banking Institute Working Paper Series No.8/2017 (2017), p.14.

¹³ “Quakle collapse serves as a warning to peer-to-peer investors” *The Guardian* 15 February 2014.

¹⁴ In a UK context see the warnings of the FCA, *Information Sheet No.4 High Cost Short-Term Loans* <https://www.fca.org.uk/publication/information-sheets/high-cost-short-term-loans-p2p.pdf> [Accessed August 3 January 2018].

Unlike bank deposits which are guaranteed,¹⁵ crowdlending brings the risk of loss not just of the interest but also the capital invested. Where a borrower defaults on a loan, the investor will have to bear the loss (unless a buyback guarantee is offered by the platform in the event of borrower default, usually in return for a lower interest rate). Investors may seek to minimise the extent of their losses by selling under-performing loans on a secondary market provided by the platform, generally at a discount with platform fees being payable. This, however, depends on an active secondary market being put in place, a matter that will affect the liquidity of the investment. In practice, one of the best ways for crowd-lending investors to protect themselves is by spreading the risk through maintaining a diversified loan portfolio (and broader savings and investment portfolio) rather than putting all their eggs in one basket. However, this relies on individual investors to be savvy enough to observe this cardinal principle of sound investment practice. There may be little incentive for platform operators to pursue small borrowers who default.¹⁶ Some platform operators address this by guaranteeing repayment of the principal and interest. Such guarantees can only be as good as the financial strength and liquidity of the platform operator. Other operators such as Zopa and RateSetter in the UK have set up a guarantee fund to address bad debts caused by borrower default. In 2017 it emerged that RateSetter had not disclosed that it had directly intervened to ensure that large-scale losses in excess of its guarantee fund were not borne by investors.¹⁷

Due Diligence Deficit and Risk

One of the virtues of crowdlending is the speed with which borrowers are approved. That can, however, be a double-edged sword as there is no legal obligation on platforms operators to carry

¹⁵ Pursuant to Directive 2014/49/EU on the European Deposit Guarantee Scheme.

¹⁶ Warren, "The Frontiers of Peer-to-Peer Lending: Thinking About a New Regulatory Approach" (2016) 14 Duke Law & Technology Review 298, 313.

¹⁷ "P2P Lender RateSetter Steps in to Protect Investors from Losses" *The Financial Times* 19 July 2017 <https://www.ft.com/content/48c041d8-6c7d-11e7-b9c7-15af748b60d0> [Accessed 3 January 2018].

out due diligence on behalf of putative investors. The absence of regulation can contribute to acute asymmetries of information which operate against the interest of investors and contribute to poor understanding of the risk being assumed. Paradoxically, although absence of pricing information is the norm in an unregulated crowdlending market, apathetic ignorance reigns among investors lured by herd behaviour and the promise of high returns.¹⁸ This highlights the vulnerability of retail investors who are unable to make an informed judgment call on whether or not to invest. Crowdlending platforms often provide little or no financials which would permit would-be investors to make their own informed judgment call upon the credit-worthiness of a consumer borrower or an SME borrower in the early stages. In the absence of clear regulatory parameters focusing on prescribing mandatory information disclosure, the nature and findings of the platform operator's credit assessment check on borrowers is often not transparent to potential investors.¹⁹ Typically crowd-lending platforms do not disclose details of their own due diligence and credit assessment reports. This contrasts with the information disclosures required of traditional financial services providers and investment intermediaries. Clearly this increases the risks to the investor. Some platforms such as Funding Circle in the UK simply provide a short-hand rating eg A, B, C based on a credit assessment carried out. Others will provide a limited amount of information upon which to make a risk assessment. The problem is exacerbated in the P2B SME sector where start-ups are involved who present as an unknown quantity and where an auction-based system can increase herding behaviour and mispricing of underlying risk.

Financial Risk Concerning the Platform Operator

¹⁸ This harks back to Akerlof's classic lemons theory concerning the effect of information asymmetries on a market: G.A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism" (1970) 84 *The Quarterly Journal of Economics* 488.

¹⁹ Macchiavello, "Peer-to-Peer Lending and the 'Democratisation' of Credit Markets: Another Financial Innovation Puzzling Regulators" (2015) 21(3) *Columbia Journal of European Law* 521, 540.

Investors are impeded not just by an inability to carry out their own due diligence on borrowers, but also by a lack of transparency concerning the structure and finances of the platform operator itself. The ultimate financial risk for investors is the risk of provider collapse since this potentially risks loss of the some or all of the outstanding capital remitted to the platform as opposed to more limited losses which result from selected borrower default. Platform collapse may be the result of poor trading combined with poor financial management. However, a significant risk concerns conflicts of interest and malpractice. Platform collapse due to malpractice is perceived by the crowdlending industry as one of the most substantial risks facing the industry.²⁰ This is no doubt influenced by scandals which have already emerged. In 2015 questionable practices were engaged in by Swedish-based TrustBuddy's management who used investors' available unpledged capital in their accounts without their permission to lend to non-legitimate borrowers, resulting in a £3.5m deficit in capital available to repay them.²¹ In 2016 Ezubo, China's largest P2P lender collapsed in Ponzi scheme-style. Also in 2016, US-based LendingClub was the victim of employee fraud and its CEO resigned amid conflict of interest allegations. Appropriate prudential regulation is needed to help to guard against these risks.

The Inadequacy of Existing EU Regulatory Instruments

Having illuminated the considerable financial risks for crowdlending investors, the need for regulation to ensure investor protection is clear. A case for the need for European regulation of the crowdlending industry in the interests of investors can be solidly built from the conclusion that existing EU financial services frameworks are not sufficiently malleable to suit the context of crowdlending. This leaves an unfortunate regulatory vacuum in the EU as regards crowdlending where regulatory arbitrage for platform operators largely holds sway in relation to how they conduct

²⁰ Cambridge Centre for Alternative Finance, *Sustaining Momentum: The 2nd European Alternative Finance Industry Report* (2016), p.47.

²¹ "New 12pc peer-to-peer firm freezes investors' cash" *The Telegraph* 15 October 2015.

business. The reality is that if crowdlending platform operators have been well-advised, their operations will have been structured so as to avoid the applicability of relevant instruments such as the Market in Financial Instruments (MiFID) regime.²² Crowdlending platform operators can avoid the most onerous regulation where they are organised in such a way as not to qualify as a credit institution and not to provide investment services or payment services.²³ However, this is a fiendishly complex area and, in the absence of supra-national direction, there is a real possibility of divergent Member State approaches being taken to important issues of legal characterisation in interpreting and applying European legal instruments and implementing legislation.

In assessing the relevance of existing EU regulatory instruments, the crux is that crowdlending platforms do not usually qualify as credit institutions requiring authorisation from a national financial supervisory authority and as such escape financial supervision.²⁴ Credit institutions are defined in Article 4(1) of the Capital Requirements Regulation²⁵ in terms of being undertakings whose business is the taking of deposits and granting of credits. Article 2(1) of that Directive defines deposit as “a credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution is required to repay” The definition of deposit here is expressly tied to carrying on the business of banking in such a way as to

²² MiFID Directive 2004/39/EC. From 3 January 2018 MiFID II applies: Directive 2014/65/EU on Markets in Financial Instruments repealing Directive 2004/39/EC and MiFIR: the Markets in Financial Instruments Regulation 600/2014/EU.

²³ They may, however, require authorisation under national law as a credit intermediary if they are in the business of arranging credit for consumers.

²⁴ European Banking Authority, *Opinion of the EBA on Lending-based Crowdfunding* EBA/Op/2015/03 (2015) (2015) [https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+\(EBA+Opinion+on+lending+based+Crowdfunding\).pdf](https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf) [Accessed 3 January 2018]., Appendix, para. 33.

²⁵ Regulation (EU) No.575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

make it less readily applicable outside the traditional banking sector.²⁶ A potential exception would be where a platform operator is a balance sheet lender and is essentially underwriting its own loan-book through the platform. The practice of wholesale lending has been commented upon by the UK Financial Conduct Authority (“FCA”). It has said of that if a crowdlending platform operator borrows through a P2P platform and lends that money to others, it may be treated as “accepting deposits”.²⁷ However, in the absence of guidance, the boundaries of what will tip a crowdlending operation into the status of credit institution are not transparent. Notably the fourth Capital Requirements Directive (“CRDIV”)²⁸ with its useful guidance on matters such as corporate governance, supervision, data protection and prudential matters will not apply if a crowdlending platform is not regarded as falling within the definition of a credit institution or investment firm.

That said, even if a crowdlending platform manages to avoid being treated as a credit institution or regulated as an investment intermediary within MiFID, MiFID II²⁹ and MiFIR,³⁰ there are other hurdles to negotiate in the absence of a bespoke regulatory framework. Any direct role in relation to money remittance services by a platform operator may fall within the internal control mechanisms of Payment Services Directive 2.³¹ Some uncertainty surrounds the application of the E-

²⁶ A potential exception would be where a platform operator is a balance sheet lender and is essentially underwriting its own loan-book through the platform.

²⁷ <http://www.p2pfinancenews.co.uk/2017/02/28/fca-wholesale-lending> [Accessed 3 January 2018].

²⁸ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

²⁹ The Markets in Financial Instruments Directive (MiFID) Directive 2004/39/EC; MiFID II: Directive 2014/65/EU applies from 3 January 2018.

³⁰ The Markets in Financial Instruments (MiFIR) Regulation (EU) No. 600/2014.

³¹ Directive 2015/2366/EU of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC.

money Directive³² including concerning whether crowdfunding investor contributions constitute “payment transactions”.³³ This inconclusiveness highlights the regulatory compliance challenges facing intending platform operators in the EU when faced with legally untested interpretations of the application of EU regulatory instruments not specifically designed for the sector.

As EU financial services measures were not written with crowdlending in mind, there are differing views across Member States as to how they apply to that sector leading to unfortunate disharmony which stymies ease of cross-border expansion. Furthermore, unlike traditional banks, there is no bespoke regime which would allow for cross-border expansion for crowdlending operators by means of an EU passporting framework based on an authorisation regime. Evident regulatory gaps and uncertainties lend weight to the case for EU harmonisation to emerge. Practically speaking, failure by the EU to directly address crowdfunding including crowdlending has resulted in a legal quagmire coupled with fragmented and disparate regulatory responses at national level to this industry. As discussed below, some Member States have chosen to add their own national refinements for crowdlending on which they are unwilling to budge in the absence of an unequivocal EU stance on crowdlending and passporting. Problematic cross-border regulatory friction has thus ensued. There is a real case for bespoke EU-wide regulation in order to provide for sufficient investor protection, legal clarity and passporting possibilities thus enabling ease of cross-border expansion.³⁴

³² Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions.

³³ European Banking Authority, *Opinion of the EBA on Lending-based Crowdfunding* EBA/Op/2015/03 (2015) [https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+\(EBA+Opinion+on+lending+based+Crowdfunding\).pdf](https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf) [Accessed 3 January 2018], Appendix, para.112.

³⁴ Zetzche and Preiner, “Cross-Border Crowdfunding: Towards a Single Crowdfunding Market for Europe” European Banking Institute Working Paper Series No.8/2017 (2017), p.19-20; FG Lawyers, Amsterdam, “Most Important Regulatory Obstacles to Cross Border Crowdfunding” (2017 Briefing) <http://www.fglawyersamsterdam.com/wp->

Evaluating the Lack of a Bespoke EU Regulatory Response to Crowdlending

Given the inadequacy of existing EU instruments to tackle crowdlending, the EU's absence of a tailored response deserves scrutiny. To date the European Union has shied away from creating a harmonised regulatory regime in respect of crowdfunding including crowdlending. It has been trapped in a classic regulatory dilemma in its approach to crowdfunding. In line with its vision to promote an ever-closer capital markets union ("CMU") between Member States, a great impetus exists for creating regulatory synchrony among member states in relation to capital markets.³⁵ At the same time, a substantial concern exists that onerous regulation will smother the growing industry in the proverbial crib. Thus in 2016 the Commission characterised crowdfunding as "still relatively small" and concluded that it "needs space to innovate and develop."³⁶ Consequently in a single market context the crowdlending industry operates in a glaring regulatory vacuum as no EU instruments have been adopted which expressly regulate it. While the argument that the crowdlending industry is still developing and that regulation should stand back is often made,³⁷ FinTech is developing at an exponential rate and there are known risks for investors (and borrowers) when regulation is either absent or of uncertain application.

A hands-off regulatory stance ignores the important role of the EU in facilitating the opening up of markets and in particular facilitating free movement of capital through creating a level playing

[content/uploads/2017/01/2017JAN-Most-important-regulatory-obstacles-to-cross-border-crowdfunding.pdf](https://ec.europa.eu/info/publications/crowdfunding-eu-capital-markets-union_en) [Accessed 3 January 2018].

³⁵ Action Plan on Building a Capital Markets Union, COM(2015) 468 final. On crowdfunding see Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *Unleashing the Potential of Crowdfunding in the European Union* COM/2014/0172 final.

³⁶ Commission Staff Working Document, *Crowdfunding in the EU Capital Markets Union* Brussels 3.5.2016 SWD (2016) 154 final https://ec.europa.eu/info/publications/crowdfunding-eu-capital-markets-union_en [Accessed 3 January 2018], p.31.

³⁷ The European Parliament has taken the position that it is interested in facilitating market entry and allowing the market to develop before stepping in to regulate: European Parliament resolution of 9 July 2015 on Building a Capital Markets Union (2015/2634(RSP)).

field in the form of a harmonised regulatory framework. Thus a conclusion that regulation is not warranted is open to interrogation. Online crowdlending platforms provide considerable potential for cross-border activity yet actual and potential cross-border activity in the sector seems to have been underestimated by the Commission.³⁸ Furthermore, the goal of regulatory harmonisation in the European Union is worthwhile in order to foster the crowdlending industry and address the hurdles for businesses in having to negotiate a patchwork of national regulatory hurdles in establishing and expanding through the Union. In the absence of a harmonised approach across the EU, the uncertain application of existing EU instruments as understood at national level when combined with national legal frameworks make for a time-consuming and costly Gordian knot for would-be market entrants, such that lawyers are real beneficiaries of the regulatory vacuum. To take some examples, in Belgium, the practice of direct loan-based crowdfunding is prohibited although adaptive work-arounds have been found by market players including through the use of loan-notes. A proportionate licensing model providing a useful blueprint is seen in the UK in the approach of the FCA. Similarly, in Norway, the approach taken was to require platform operators to obtain a licence to provide financial services before setting up operations.³⁹ A limited bespoke regulatory response is seen in France, Portugal and Spain, designed with investor protection in mind by setting caps on investments per investor and per individual loan.

The creation of a proportionate EU regulatory framework for crowdlending would certainly create compliance costs but these would be reduced by the provision of a clear, navigable

³⁸ The Commission acknowledged that it did not have a true picture of the extent of cross-border crowd-funding activity as its data did not cover situations where the borrower and the platform were in different countries, only those where the borrower was: Commission Staff Working Document, *Crowdfunding in the EU Capital Markets Union* Brussels 3.5.2016 SWD (2016) 154 final https://ec.europa.eu/info/publications/crowdfunding-eu-capital-markets-union_en [Accessed 3 January 2018], p.11.

³⁹ Cambridge Centre for Alternative Finance and Judge Business School, *Moving Mainstream: The European Alternative Finance Benchmarking Report* (2015), p.34.

framework. The absence of a clearly navigated bespoke regulatory framework creates additional financial and time costs unique to each Member State as lawyers endeavour to negotiate the uncertainties on a Member State by Member State basis. Leaving aside new market entrants who are subject to the compliance challenges of an unclear regulatory framework, costly regulatory obfuscation caused by the lack of a harmonised EU regime also hinders established crowdlending operators from third countries such as the United States establishing a presence within the EU.

Most fundamentally, the status quo where there is no EU regulatory framework for crowdlending means that regulatory arbitrage rules ok as crowdlending operators freely cherry pick among Member States (which either regulate the industry differently or not at all) in choosing where to set up operations. Consequently a 'wait and see' approach at EU level to crowdlending should not be mistakenly characterised in unabashed positive terms as enabling the growth of the FinTech industry; the commercial reality is that it facilitates an unfettered and entirely legal race to the bottom by operators. The absence of a single market regime facilitates EU platform operators to play regulatory roulette to escape the imposition of meaningful minimum capital requirements, credit assessment, money handling and disclosure requirements. A truly enabling regulatory approach to facilitate the appropriate development of the crowdlending industry in the EU would consist of the adoption of well-crafted proportionate pan-European regulatory framework which sets clear base-line standards for market participation.

Notably the mid-term review of CMU in 2017⁴⁰ yielded some evidence of a shift in terms of willingness by the Commission to consider a pan-European authorisation model. The Commission committed to assessing the case for providing a licensing and passporting framework for equity-

⁴⁰ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on *The Mid-Term Review of the Capital Markets Union Action Plan* COM(2017) 292 final, 8.6.2017 https://ec.europa.eu/info/publications/mid-term-review-capital-markets-union-action-plan_en [Accessed 3 January 2017].

based crowdfunding and debt-based crowdfunding viz. crowdlending.⁴¹ The Inception Impact Assessment⁴² which followed in 2017 acknowledged both the risks of weak governance and the commercial challenges in terms of scaling up in the context of divergent national approaches in the absence of an EU framework. The four regulatory alternatives put on the table for crowdfunding and crowdlending were:

- (i) Maintain stakeholder dialogue without a European framework;
- (ii) Issue EU best practice guidelines to underpin a self-regulatory approach;
- (iii) Build an EU framework around adapting existing passporting frameworks from financial services;
- (iv) Adopt a stand-alone EU instrument to deal with cross-border crowd-funding applicable on an opt-in basis for platform operators who do not operate solely in a domestic context.⁴³

A number of points can be made concerning this menu of options presented for consultation. The first option of simply maintaining stakeholder dialogue approximates to a 'do nothing, wait and see' holding pattern while maintaining links with stakeholders. Interestingly, wariness of allowing uninformed consumers to lose money and regulators getting the blame has been held up as

⁴¹ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on *The Mid-Term Review of the Capital Markets Union Action Plan* COM(2017) 292 final, 8.6.2017 https://ec.europa.eu/info/publications/mid-term-review-capital-markets-union-action-plan_en [Accessed 3 January 2017], p.13.

⁴² European Commission, *Inception Impact Assessment – Legislative Proposal for an EU Framework on Crowd and Peer to Peer Finance* (2017) http://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-5288649_en [Accessed 3 January 2018].

⁴³ European Commission, *Inception Impact Assessment – Legislative Proposal for an EU Framework on Crowd and Peer to Peer Finance* (2017) http://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-5288649_en [Accessed 3 January 2018], p.3.

responsible for regulators dragging their feet in relation to crowdfunding.⁴⁴ This would be an unjustified stance to back given the inadequacies of existing EU regulation in this sphere and the need to create a proportionate EU regulatory response to address investor protection and level the EU playing field. The second option of formulating non-binding EU guidelines to underpin a self-regulatory approach lacks teeth and suffers from all the classic downsides of leaving matters to self-regulation, particularly as regards market player buy-in and enforcement. Self-regulatory bodies have a role to play in encouraging voluntary adoption of best practice in the industry. The UK's Peer-to-Peer Finance Association (P2PFA) representing 75% of UK platforms, has called for the regulator to set out common standards for declaring bad debts, and strict guidelines concerning how loans are marketed.⁴⁵ The P2PFA has also called for a ban on the common practice of "maturity transformation", where companies lend money out for a longer period of time that it was originally borrowed for. This usually increases the return for the platform operator but in casualising the practice of rolling over loan terms, the risk of default is exponentially increased. Furthermore, it can cause a mismatch between the investors' signalled preferred loan term (and thus the liquidity of their investment) and the reality. The European Crowdfunding Network has published a Code of Conduct for its members.⁴⁶ Such codes have value for those who want to maintain high standards. However, the Achilles heel of self-regulation is its largely voluntary nature. Market players may be insufficiently incentivised to fully act in the public interest rather in their own private interest.

As regards the options presented by the Commission which would involve active EU hard law intervention, placing regulation on the agenda for consideration is certainly welcome. However, the nature of such regulation needs to be correctly calibrated. As a preliminary matter, the conflation in the Impact Assessment of crowdlending with other forms of investment-based crowdfunding by the

⁴⁴ "Regulators will get the Blame for the Stupidity of Crowds" *Financial Times* 25 March 2014 <https://www.ft.com/content/8b2d68b2-b348-11e3-b09d-00144feabdc0> [last accessed August 21, 2017].

⁴⁵ "We need tougher regulation says peer-to-peer lenders" *Financial Times* 11 October 2016.

⁴⁶ European Crowdfunding Network, *Code of Conduct* <http://eurocrowd.org/about-us/code-of-conduct-2> [Accessed 3 January 2018].

Commission in presenting potential regulatory solutions risks ignoring the reality that the debt-based nature of crowdlending differentiates it from other forms of crowdfunding and means that crowdlending warrants individual treatment. Furthermore, the problem with an opt-in framework for cross-border operators is that it would be likely to contribute to regulatory arbitrage rather than providing an across the board set of operating principles for platforms. While regulatory arbitrage is impossible to eliminate completely unless a maximum harmonisation approach is adopted, it would be ironic if EU intervention in this area actively encouraged regulatory arbitrage by providing an opt-in rather than mandatory framework for market players. What is sorely needed by way of balanced regulatory response is a directive setting out a bespoke minimum harmonisation set of rules for all crowdlending operators in the EU, not an à la carte, opt-in framework which applies solely in a cross-border context. A directive could certainly be based on modelling existing authorisation and passporting frameworks as suggested by the relevant option succinctly presented by the Commission in the Impact Assessment. This makes eminent sense. However, some bespoke treatment is undoubtedly called for to take account of the unique characteristics of crowdlending.

The Impact Assessment provides an important opportunity for dialogue before a call is made on how to proceed but as stakeholder engagement goes it is poorer for being very sparsely sketched, thus making a real determination on regulatory impact difficult to estimate. One hopes that some maturation of perspectives will occur as the Commission moves to determine its next move, having considered responses received from stakeholders to the Impact Assessment. In doing so, there is a need to remain level-headed in relation to industry responses which are aimed at light touch as opposed to proportionate regulation.

In observing how the EU ultimately chooses to proceed on the basis of having set out a somewhat limited menu stall of regulatory options, it is not without significance that the European Banking Authority ('EBA') in its 2015 Opinion issued to the European Commission and Parliament had an altogether more categorical view. The EBA noted that crowdlending was outside its

regulatory remit and identified the importance of regulatory convergence on crowdlending in order to avoid the risks of regulatory arbitrage.⁴⁷ Unlike the Commission, it did not mention an opt-in halfway house as a solution but rather it hinted strongly at the desirability of providing a European legislative regulatory framework. Consistent with this both practitioners⁴⁸ and academics⁴⁹ have questioned the hands-off stance of the EU. These views lend weight to EU legislative intervention being the appropriate next step. An EU minimum harmonisation directive (not an opt-in framework) could set agreed policy markers across the board within the Union while representing a proportionate regulatory response. This would potentially encourage new market entrants as the absence of a clear regulatory framework may inhibit new market entrants who are concerned with the consequences of sunk costs and future potential regulatory costs when acting without a basic guiding regulatory pathway in making jurisdictional and legal choices. Furthermore, as the OECD notes, regulation can provide the necessary trust to enable product and market expansion.⁵⁰

Towards A Regulatory Model

It is important to find the right regulatory balance. Uncertainty concerning future regulation and its potential nature makes it difficult for platform operators to plan and adapt their business model. This creates competitive risk as well as regulatory risk. Therefore a responsive rather than a reactive

⁴⁷ European Banking Authority, *Opinion of the EBA on Lending-based Crowdfunding* EBA/Op/2015/03 (2015) EBA/Op/2015/03 [https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+\(EBA+Opinion+on+lending+based+Crowdfunding\).pdf](https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf) [Accessed 3 January 2018], para.8.

⁴⁸ FG Lawyers, Amsterdam, “Most Important Regulatory Obstacles to Cross Border Crowdfunding” (2017 Briefing) <http://www.fglawyersamsterdam.com/wp-content/uploads/2017/01/2017JAN-Most-important-regulatory-obstacles-to-cross-border-crowdfunding.pdf> [Accessed 3 January 2018].

⁴⁹ Zetzche and Preiner, “Cross-Border Crowdfunding: Towards a Single Crowdfunding Market for Europe” European Banking Institute Working Paper Series No.8/2017 (2017).

⁵⁰ OECD, *Refining Regulation to Enable Major Innovations in Financial Markets* Issues Paper DAF/COMP/WP2 (2015) [https://one.oecd.org/document/DAF/COMP/WP2\(2015\)9/en/pdf](https://one.oecd.org/document/DAF/COMP/WP2(2015)9/en/pdf) [Accessed 3 January 2018], p.9.

approach to regulating crowdlending is needed. Top-down regulation may misfire for being insufficiently attuned with business realities. Given the evolving nature of industry which is more established in some countries than others, a relatively cautious rather than highly prescriptive all-embracing regulatory approach is called for. When formulating either a national or an EU regulatory response, the regulatory model should not be rigid but flexible given the need for it to be able to apply to a range of different business models, both existing and future.⁵¹ An awareness of these tensions is present in a salient OECD Issues paper concerning innovations in the financial sector.⁵² Regulation must be flexible enough to easily accommodate market innovation. A 'one size fits all' approach is therefore inappropriate. Rather, a suitably proportionate regulatory response is required. What is called for is responsive regulation which is collaboratively arrived at and reflects organic development of relevant markets and market players on the supply and demand side. Therefore including stakeholders when developing regulatory models is key. In tune with that, the Commission is committed to maintaining dialogue with the European Supervisory Authorities, Member States and the crowdfunding sector with a view to promoting best practice and reviewing developments.⁵³ A stakeholder-centred approach fits within a new governance regulatory approach which takes account of the role of regulated actors in shaping accepted norms rather than simply as the subject of regulation.⁵⁴ Stakeholder dialogue also fits within the reflexive law model of including non-State actors in the development of regulatory practice. This was evident at national level in France where the crowdfunding industry associations' dialogue with regulatory authorities

⁵¹ Warren, "The Frontiers of Peer-to-Peer Lending: Thinking About a New Regulatory Approach" (2016) at 311.

⁵² OECD, *Refining Regulation to Enable Major Innovations in Financial Markets* Issues Paper DAF/COMP/WP2 (2015) [https://one.oecd.org/document/DAF/COMP/WP2\(2015\)9/en/pdf](https://one.oecd.org/document/DAF/COMP/WP2(2015)9/en/pdf) [Accessed 3 January 2018], p.9.

⁵³ Commission Staff Working Document, *Crowdfunding in the EU Capital Markets Union* Brussels 3.5.2016 SWD (2016) 154 final https://ec.europa.eu/info/publications/crowdfunding-eu-capital-markets-union_en [Accessed 3 January 2018], p.31.

⁵⁴ On new governance see N. Walker and G. de Burca, 'Reconceiving Law and New Governance' (2007) 13 *Columbia Journal of European Law* 519; D. Trubek and L. Trubek, 'New Governance and Legal Regulation: Complementarity, Rivalry and Transformation' (2007) *Columbia Journal of European Law* 539.

influenced the design of specific regulation for crowdfunding in 2014. While there would inevitably be costs associated with regulatory compliance with an EU-wide framework, at the same time crowdlending platform operators do benefit enormously from being able to provide competitive market offerings precisely because the disintermediated nature of crowdlending permits considerable cost savings. Some key regulatory elements which an EU crowdlending directive could enshrine are elaborated upon below.

Licensing and Passporting

Licensing and passporting would facilitate synergistic cross-border market expansion. Zetzche and Preiner rightly contend that cross-sectoral consistency with the banking and financial services sectors insofar as possible is important and would reflect a well-established EU policy goal in this regard.⁵⁵ Taking this approach, an obvious linchpin of a regulatory regime for crowdlending would involve placing an authorisation regime at its helm. This would require platform operators to apply for authorisation from a national regulatory authority based on meeting agreed criteria, and after authorisation to comply with certain rules, for example, in relation to information disclosure. The underlying conditions of such a licence require careful consideration and are discussed further below. A licensing regime would provide for the potential for that licence to be withdrawn in appropriate circumstances of misconduct or failure to meet the requirements of prudential rules. Allied to authorisation in one EEA Member State could be the inclusion of an associated all-important ability to use this as a passport to establish in any other EEA Member State without additional separate authorisation requirements. This would be a key enabler of cross-border trade by reducing regulatory barriers. Providing for passporting in an EU instrument would be a major advantage that could not be achieved by national regulators alone and thus requires the EU to come on board.

⁵⁵ Zetzche and Preiner, “Cross-Border Crowdfunding: Towards a Single Crowdfunding Market for Europe” European Banking Institute Working Paper Series No.8/2017 (2017), p.29.

Inspiration could be taken from MiFID,⁵⁶ MiFID II⁵⁷ and MiFIR⁵⁸ to design a simplified licensing and passporting regime for crowdlending within the EEA while ensuring that regulation is not disproportionate. Both practitioners⁵⁹ and academics⁶⁰ have pointed up the benefits of creating a tailor-made ‘MiFID-lite’ framework for crowdfunding to facilitate cross-border trade. While the existing financial services rulebook could in many respects be easily adapted for this purpose, an element of bespoke regulatory handling would also be called for to recognise the nature of crowdlending, the unique nature of the platform-based intermediation involved, and to avoid risks created by regulatory gaps.⁶¹ In order to create a level playing field, it would be beneficial to expressly rule out the possibility of gold-plating by Member States in the form of imposition of unjustified additional regulatory burdens at national level which would reduce the passport effect.

The Role of National Regulatory Authorities

Within any potential European regulatory framework for crowdlending, national regulatory authorities would have an important role in working in conjunction with national parliaments to implement any EU legislative act and in considering the need for additional hard law and soft law regulatory refinements at national level. Therefore, within an evolving regulatory framework, it would be crucial for national regulatory authorities to engage in mutual regulatory dialogue with existing and potential market players in order to facilitate the growth of the crowdlending industry

⁵⁶ MiFID Directive 2004/39/EC.

⁵⁷ The Markets in Financial Instruments Directive (MiFID) Directive 2004/39/EC; MiFID II, Directive 2014/65/EU came into force on 3 January 2018.

⁵⁸ The Markets in Financial Instruments (MiFIR) Regulation (EU) No. 600/2014.

⁵⁹ FG Lawyers, Amsterdam, “Most Important Regulatory Obstacles to Cross Border Crowdfunding” (2017 Briefing) <http://www.fglawyersamsterdam.com/wp-content/uploads/2017/01/2017JAN-Most-important-regulatory-obstacles-to-cross-border-crowdfunding.pdf> [Accessed 3 January 2018].

⁶⁰ Zetzche and Preiner, “Cross-Border Crowdfunding: Towards a Single Crowdfunding Market for Europe” European Banking Institute Working Paper Series No.8/2017 (2017).

⁶¹ R. Lenz, “Peer-to-Peer Lending – Opportunities and Risks” (2016) 7 European Journal of Risk and Regulation 688.

and new market entrants. Some national regulators have been astute to nurture the industry and attract inward investment. This ensures that innovation is given a leg up and not stifled. Much of value can be learned from countries which have actively set out to encourage FinTech start-ups by facilitating informal dialogue to guide them in doing business in the jurisdiction. In the UK, the FCA has been exemplary in championing a much-lauded regulatory sandbox approach to encourage market participation.⁶² An enabling approach of this kind would be best facilitated within a regulatory framework which is carefully calibrated to err on the right side of investor protection while providing a transparent framework which enables businesses to get off the ground.

A crowdlending directive should also allocate to national regulatory authorities a compliance and enforcement role. They could be required to provide an independent complaints and dispute resolution mechanism. Looking to alternative dispute resolution, it may, however, be feasible to extend the voluntary FIN-NET alternative dispute resolution mechanism to cover the crowdlending sector if it becomes regulated.⁶³

Prudential Regulation

While regulation needs to be sensitive so as not to stifle innovation and economic growth, there is also a clear need to protect investors against financial risks. An important role of regulation for the crowdlending sector would be to set and oversee liquidity and capital standards. An authorisation regime provided by a crowdlending directive should be centred around a harmonised framework of prudential rules for crowdlending. Prudential regulation can assist with ensuring economic stability and investor protection through providing capital and liquidity rules.

⁶² See eg the FCA's Project Innovate in 2014.

⁶³ FIN-NET is an EEA financial dispute resolution network: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/consumer-finance-and-payments/consumer-financial-services/finantsvaidluste-lahendamise-vorgustik-fin-net/vorgustik-fin-net/fin-neti-tutvustus_en [Accessed 3 January 2018].

Investors are ill-equipped to monitor and assess risks accurately in crowdlending. Therefore the loss-absorbing function of capital is heightened. A specific framework of prudential rules for crowdlending covering matters such as capital and liquidity, rules concerning client assets and conduct of business rules could broadly mirror the framework applicable to authorised investment firms and banks while being adapted for smaller scale crowdlending. Liquidity risk is obviously one of the biggest concerns even for short-term investors who have considerable sums invested in loans or in a platform awaiting investment in appropriate loans. Providing for minimum capital requirements would provide a degree of protection for lenders in the event of the insolvency of the platform operator. It would have the further benefit of assisting with operational continuity for lenders and borrowers in such an event. Initial minimum capitalisation rules are set out in MiFID II gauged at €730,000⁶⁴ but at €125,000 where a firm does not deal on its own account.⁶⁵ While being conscious of investor protection, capital requirements for crowdlending platform operators need to be appropriately pegged so as not to unfairly exclude start-ups and smaller operators. This could be dealt with by utilising a nuanced regulatory approach which would vary capital requirements depending on the size of the relevant undertaking and its crowdlending business. Minimum capital requirements should be proportionally linked to market exposure in terms of amounts invested. The EU could be inspired by the UK's specification of capital requirements for P2P platform lenders which operate on a sliding scale calibrated based on a percentage of the aggregate value of outstanding loans subject to a £50,000 minimum.⁶⁶

⁶⁴ Directive 2013/36/EU, Art.28(2).

⁶⁵ Directive 2013/36/EU, Art.29(1).

⁶⁶ Financial Conduct Authority, *The FCA's Regulatory Approach to Crowdfunding Over the Internet, and the Promotion of Non-Readily Realisable Securities by Other Media* (London: FCA, 2014).

As discussed earlier, crowdlending investors are unlikely to benefit from the EU Deposit Guarantee Schemes Directive which only extends to depositors with credit institutions.⁶⁷ Currently there is no current requirement for crowdlending platform operators to put in place a compensation scheme or provide insurance against default. By contrast, credit institutions covered by the Deposit Guarantee Scheme are obliged to make annual contributions to a fund with contributions calibrated according to deposits and degree of risk. Crowdlending is inherently far more risky than regular bank depositing. As it is, some, but not all, platforms require investors to contribute a percentage to a pooled fund to protect investors against bad debts. It would seem more appropriate that it is the platform operators who must make the relevant contributions rather than investors. Therefore it would make sense for EU legislation to require the establishment in each Member State of a dedicated ring-fenced fund to which crowdlending platform operators would contribute to protect crowdlending investors.⁶⁸ Another investor protection solution would be to require appropriate indemnity insurance to mitigate the risk to the investor in the event of default.⁶⁹

It would be prudent for any EU legislative framework to address continuity in the context of the platform operator's insolvency. This could draw inspiration from the FCA requirement in the UK that platforms have a resolution plan in place to address how repayments will be managed if the platform operator goes out of business so as to minimise detriment to investors in relation to outstanding principal and interest payments due to them. Thus if the platform operator collapses,

⁶⁷ Directive 2014/49/EU. See further: European Banking Authority, *Opinion of the EBA on Lending-based Crowdfunding* EBA/Op/2015/03 (2015) [https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+\(EBA+Opinion+on+lending+based+Crowdfunding\).pdf](https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf) [Accessed 3 January 2018], para.13.

⁶⁸ In the UK the FCA decided on balance against this for crowdlending on the basis that it would be a disproportionate regulatory response: Financial Conduct Authority, *The FCA's Regulatory Approach to Crowdfunding Over the Internet, and the Promotion of Non-Readily Realisable Securities by Other Media* (London: FCA, 2014), p.18.

⁶⁹ This solution is adopted in Finland.

there would be a plan for continued administration of loan repayments. This would help to build investor confidence.

Systemic Risk

As crowdlending industry grows, there is also a need to regulate to protect the economy as a whole against systemic shock or major collapse or disruption. Liquidity and financial stability are concerns as the EU crowdlending market grows and these have been examined by the Financial Stability Board based on applying the same principles that applying to the regulated banking sector.⁷⁰ In the UK, Lord Adair, former chairman of the Financial Services Authority, memorably observed that the P2P sector could be subject to losses that would “make the worst bankers look like absolute lending geniuses”.⁷¹ Certain business models particularly give rise to potentially systemic concerns, for instance where platforms operate in the shadow banking sphere providing loans and then essentially seeking to underwrite these through a P2P platform. This gives risk to the risk that the collapse of a significant player in the shadow banking sphere could have considerable economic reverberations.⁷² It is also cautionary that in the United States parallels have been drawn between crowdlending and the sub-prime market at the centre of the financial crisis with P2P lending being regarded as essentially securitising high risk consumer debt on a high risk-high gain basis.⁷³

As such, in approaching the regulation of crowdlending the concern of the EU should not simply be the protection of individual investors and borrowers, but also with issues of broader economic stability in particular to deal with the scenario where a platform operator becomes big

⁷⁰ Financial Stability Board, *FinTech Credit: Market Structure, Business Models and Financial Stability* (Basel: FSB, 2017) <http://www.fsb.org/wp-content/uploads/CGFS-FSB-Report-on-FinTech-Credit.pdf> [Accessed 3 January 2018].

⁷¹ “We need tougher regulation says peer-to-peer lenders” *Financial Times* 11 October 2016.

⁷² Warren, “The Frontiers of Peer-to-Peer Lending: Thinking About a New Regulatory Approach” (2016) 14 Duke L. & Tech. Rev. 298, 314.

⁷³ “US peer-to-peer lending model has parallels with subprime crisis” *Financial Times* 30 May 2016.

enough to systemically matter. Without regulation to take account of systemic risk, market players protected by limited liability may not voluntarily choose to factor this into their business model and make assume a high risk-high gain business model with scant regard for the broader economic implications of insolvency.

Investor Status Protections

When looking at investor protection in the crowdlending industry, it is relevant that neither crowdlending models nor investors are homogeneous. Investors range from savvy to unsophisticated consumers. As suggested by the Commission, familiar 'know your customer' rules could be adapted specifically for the sector to ensure that the would-be investor is a suitable candidate for the platform.⁷⁴ A regulatory approach adopted in a number of countries and also voluntarily by platforms involves creating a status of experienced or accredited investor and restricting the participation of non-accredited investors. For example, the ThinCats platform operator in the UK, which specialises in secured lending to businesses, restricts investor participation to experienced investors.

A number of Member States have set maximum investment limits with a view to protecting investors through diffusing risk.⁷⁵ These can be calibrated in different ways such as based on categorisation of the investor in terms of their level of sophistication or based on personal income or assets. The limit imposed may be per individual investment or in the aggregate for a given year such as the annual €5,000 cap in Austria for unsophisticated retail investors. Some may consider this regulatory overly paternalistic, but one way of reducing risk is to limit the maximum investment of an investor within a 12 month period. Of course this does not prevent them investing elsewhere but it would serve to enforce a dispersion of their investment risk if they are not savvy enough to do so

⁷⁴ Commission Staff Working Document, *Crowdfunding in the EU Capital Markets Union* Brussels 3.5.2016 SWD (2016) 154 final https://ec.europa.eu/info/publications/crowdfunding-eu-capital-markets-union_en [Accessed 3 January 2018], p.21-22.

⁷⁵ For example Austria, Germany, Spain and the UK.

on their account. In the UK retail investors other than high net worth individuals are restricted to investing 10% of their investible assets. Rather than calibrating investor thresholds, it may be more effective to concentrate on requiring suitable warnings to be made to would-be investors in relation to the risks involved.

Credit Assessment

An EU-wide regulatory framework could plug a major investor protection gap in requiring appropriate due diligence to be carried out in relation to individuals and businesses seeking loans and for transparency. The OECD has noted that the absence of “a credible, detailed, effective and accessible regime of credit scoring” in a country inhibits the development of peer-to-peer lending.⁷⁶ An equally valid perspective is that the absence of credit assessment rules in a territory will encourage certain market players to act in an unchecked manner to take advantage of this regulatory gap to exploit investors who lack the ability to weigh up the risk involved for financial gain. As such, classic regulatory arbitrage behaviour by market players presents. That said, finding a means to regulate on a pan-European level in relation to credit assessment presents some challenges which will require careful negotiation. Credit ratings for crowdlending in the United States are carried out in a highly speedy and efficient manner through data sharing. This has increased the accessibility of crowdlending for both borrowers and investors. The US approach of data sharing in relation to credit scoring is not one, however, that transplants readily to an EU context given the radically more restrictive approach to data protection under EU law. Within the EU the General Data Protection Regulation⁷⁷ prevents the use of data collected from customers for purposes other than that for which they were originally collected. This inhibits ease of access and transfer of relevant credit information. Some national regulators are already responding to this

⁷⁶ OECD, *Refining Regulation to Enable Major Innovations in Financial Markets* Issues Paper DAF/COMP/WP2 (2015) [https://one.oecd.org/document/DAF/COMP/WP2\(2015\)9/en/pdf](https://one.oecd.org/document/DAF/COMP/WP2(2015)9/en/pdf) [Accessed 3 January 2018], para.30.

⁷⁷ Regulation (EU) 2016/679.

challenge on behalf of the industry. Thus in the UK the FCA has carried out a collaborative evaluation of the quality of platform operators' creditworthiness assessments and is considering adopting prescriptive rules on this for consumer lending.⁷⁸ As regards devising a potential EU strategy along similar lines based on giving powers to national regulatory authorities, it is also pertinent that in the area of consumer lending more generally, in 2017 the Commission committed to introducing common creditworthiness assessment standards.⁷⁹ This gives the potential for joined up thinking as regards pan-European standards for crowdlending.

Disclosure Rules

A lack of transparency is a concern both in relation to prospective investors and those who have signed up with a crowdlending platform. It may not be unclear how a platform operator is owned. The web platform may provide little information other than basic contractual terms. It may not be clear how interest is calculated and what mutual rights and obligations are owed. The procedure for handling complaints may not be clear. Information (which may in any event be limited) may only be available after a prospective investor or borrower has registered on the platform. There may be misleading commercial practices in operation which are shielded from investors. Tailored disclosure standards could help to create a level of consistency concerning transparency in relation to matters such as expected return on investment, default rate information, loan risk assessments and corporate governance information. The practice of permitting maturity transformation should also be disclosed. This would facilitate more informed decision-making and risk assessment.

⁷⁸ Financial Conduct Authority, *Assessing Creditworthiness in Consumer Credit: Proposed Changes to Our Rules and Guidance* CP17/27 (2017) <https://www.fca.org.uk/publication/consultation/cp17-27.pdf>.

⁷⁹ European Commission, *Consumer Financial Services Action Plan: Better Products, More Choice* COM(2017)139 final, Brussels, 23.3.2017 <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52017DC0139> [Accessed 3 January 2018], at 3.2.

Information disclosure is well-handled in the UK where the information which the FCA requires to be disclosed includes anticipated and actual default rates, a description of how loan risk is assessed, and details of any assessment of credit-worthiness undertaken. The consumer must be given information on how the platform handles late loan repayments and borrowers in default. Information must also be provided in relation to how a lender may access their money before the end of the relevant P2P lending agreement and what would occur if the platform was to become insolvent.

A Fair and Equitable Intermediation Process

The need for the Commission to separate out crowdlending from equity-based crowdfunding when casting the regulatory net is exemplified when it comes to the distinctive matching processes for assigning investors to loans. The integrity of the matching process is crucial to investor confidence and risk-assumption. There are particular fairness concerns in relation to how equitably an auto-invest setting works as between individual investors and classes of classes of investor. Lenz correctly emphasises the importance of maintaining the “honest broker” role of the platform operator.⁸⁰ Ideally any EU licensing scheme for crowdlending should ensure that platform operators adhere to a fair and equitable mediation process. This would help to guard against unfair preference of some investors over others in allocating investors’ funds to projects. This would likely qualify as the most bespoke aspect in the design of a regulatory framework for crowdlending. As Lenz notes,

“[t]he core element of platform regulation is not the platform itself, but rather the process in which capital is mediated between borrowers and lenders. The legal framework should safeguard a fair and transparent mediation process....”⁸¹

⁸⁰ Lenz, “Peer-to-Peer Lending – Opportunities and Risks” (2016) 7 European Journal of Risk and Regulation 688, 698.

⁸¹ Lenz, “Peer-to-Peer Lending – Opportunities and Risks” (2016) 7 European Journal of Risk and Regulation 688, 698.

In the UK the FCA subjects crowdfunding platforms to the principle of treating customers fairly.⁸² This will not eliminate cash drag where there is a supply problem with an imbalance between investors with available funds to invest and a lack of supply unmatched borrowers. The problem of cash drag is well known to investors who are awaiting their funds to be automatically assigned by the platform to matching projects using an autobid function. This is, however, an area where it is difficult to regulate prescriptively and may be more suited to a self-regulatory, principle-based framework.

Conflict of Interest Rules

An EU framework would not be complete without reference to the key conflicts of interest concern. It would be sensible to require platform operators to disclose whether they have 'skin in the game' and whether they are acting as borrowers or investors. More stringently, platform operators could be prohibited from using investors' capital for investment or borrowing. However, the EU may wish to adopt a more general approach of sketching broad principles when devising a harmonised framework. If so, a directive could specify that crowdlending platform operators must have a policy on conflicts of interest and require disclosure of it. This is the approach taken in Spain where platform operators are required to publish their policy on conflicts of interest. Adopting this more generic minimum approach would not prevent national regulatory authorities from prescribing more detailed rules on what amounts to a conflict of interest.

Client Money Rules

Enshrining best practice rules in relation to the holding and transmitting of investor funds designed with investor protection in mind should be a priority in any EU legislative initiative. Client asset rules dealing with matters such as segregation of client assets from that of the crowdlending firm should

⁸² Financial Conduct Authority, *The Principles for Businesses* <https://www.handbook.fca.org.uk/handbook/PRIN.pdf>

(Release January 2018) [Accessed 3 January 2018], Principle 6.

be developed and should be binding. There is already a strong well in the financial services domain from which to develop such ring-fencing rules. The framework of the Payment Services Directive II,⁸³ which is hailed as FinTech-friendly, could potentially be adapted to crowdlending platforms in order to require appropriate segregation of investors' and borrowers' monies from that of the platform operator.⁸⁴ It is equally important to ensure that platform operators cannot escape the regulatory net through use of third parties to funnel payments. In this regard the EBA has sensibly suggested that the PSD framework could be applied to third party providers used by platform operators in relation to remittances in order to require these to be registered and authorised.⁸⁵ Thus there is no need to completely reinvent the wheel when designing client money rules for the crowdlending sector provided that the scope is broad enough to cover both own account and third party money handling. Some more bespoke regulatory treatment will, however, be required when moving beyond lodgement and withdrawal money transmission so as to fashion rules to cover the unique client money aspects of crowdlending relating to the holding of uninvested capital, capital repayments and interest payments on behalf of investors. Given the complexities involved and the need to factor in national law, within a European framework for crowdlending, detailed client money rules should realistically remain a matter for national regulatory authorities in an appropriate exercise of subsidiarity.

⁸³ Directive 2015/2366/EU.

⁸⁴ This form of regulatory adaptation is supported by the EBA: European Banking Authority, *Opinion of the EBA on Lending-based Crowdfunding* (2015) EBA/Op/2015/03 [https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+\(EBA+Opinion+on+lending+based+Crowdfunding\).pdf](https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf) [Accessed 3 January 2018], Appendix, para.79.

⁸⁵ European Banking Authority, *Opinion of the EBA on Lending-based Crowdfunding* EBA/Op/2015/03 (2015) [https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+\(EBA+Opinion+on+lending+based+Crowdfunding\).pdf](https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-03+(EBA+Opinion+on+lending+based+Crowdfunding).pdf) [Accessed 3 January 2018], Appendix, para.79.

Conclusion

As the Commission is poised to take a stand on regulation of crowdfunding including crowdlending, this article has contended that there is a need for the EU to play its part in developing a single market for crowdlending and has championed the case for a proportionate framework European directive in order to guard against unhealthy commercial opportunism to the detriment of borrowers and investors. By now crowdlending has assumed a distinct place within the evolving lucrative alternative finance investment market. Yet regulatory lag means that in an EU context there are considerable challenges and risks for existing and putative market entrants as well as investors at both a national level and at a cross-border level given disparate national regulatory responses and the uncertainties surrounding the application of existing EU regulatory instruments not written with FinTech in mind.

Although it represents one of the current regulatory cards placed on the table by the European Commission, a continuing hands-off regulatory response by the European Union would quite simply be unjustified. All regulatory options are not created equal. The time for 'wait and see' and simple stakeholder dialogue as the industry found its feet has passed. Reduction of the potential for commercial opportunism founded upon regulatory arbitrage in a fragmented European landscape through setting minimum investor protection standards presents a remarkably cogent rationale for meaningful yet proportionate EU intervention which would extend robustly beyond the stakeholder dialogue and opt-in solutions which the Commission has chosen to consult on as possible alternatives. A core MiFID-lite licensing and passporting regime based on a common framework would enable cross-border trade within the objectives of the capital markets union.

An apt regulatory framework for crowdlending would nonetheless require careful tailoring as crowdlending raises not only standard investor protection issues, but also considerable risks presented by conflicts of interest and platform collapse. Regulation also needs to take account of unique financial risks not usually present in other forms of crowdfunding concerning credit risks and

lending practices such as maturity transformation. Systemic risks also potentially rear their head. Consequently a challenge for the European Union is to afford crowdlending sufficiently bespoke treatment to sensitively regulate the distinctive aspects of the crowdlending model and attendant risks to investors.

While regulatory arbitrage cannot be completely eradicated, an appropriately calibrated directive of the type propounded here would make a positive contribution to national and cross-border crowdlending capital markets in the Union by creating a level playing field founded upon minimum harmonisation on key issues. Furthermore, it could also provide a suitable springboard for nationally tailored detailed intervention that would dramatically reduce the worst excesses of legitimate commercial opportunism by crowdlending platform operators which potentially arise in the absence of appropriate regulation.