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New Crowdfunding regulation 2020/1503 and current financial regulation – Know Your Client in crowdfunding

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ABSTRACT

Digitalisation and new technological innovations have provided a new environment for investors to access to financial markets. Besides traditional securities and financial institutions, new service providers has entered into the market with new investment methods and technologies. Crowdfunding has became popular alternative financing method for small and medium enterprises and investors to find new potential lucrative investments from these start ups and scale ups finding financing. Last financial crisis made banks to tighten up their loan services for these companies and then came social media and smartphones that provides access to internet straight from a users pocket. Companies were able to market their project straight to social media users in different platforms such as forums. Some companies made success stories out of crowdfunding and interest among public increased. Crowd was also able to see how the assets were used from social media.

Crowdfunding is now very well known financing method for SMEs and investors are interested about new projects for social reasons and for decentralising their invested assets. Some traditional tradeble securities are not that "hyped" as crowdfunding is. Social aspect in crowdfunding is for example taking part into financing a local business that needs a new machine or facilities. But who really has access to this market and which money they are investing? How crowdfunding works in real life? This thesis examines AML regulation in crowdfunding and infrastructure behind the operations.

When establishing a new innovation into financial market, it must be regulated for many reasons. Financial sector is heavily regulated for preventing financial crises and financial crime, and also providing safety to ordinary people using banking services or saving for a retirement or next summer holiday. Fintech and new innovations are here, and we need applicable regulation to keep the financial market functioning.

Keywords: Crowdfunding, Fintech, Financial regulation, Know Your Client, Anti- Money Laundering, Digital Finance

LIST OF ABBREVIATIONS

AIFMD	Directive 2011/61/EU
AML	Anti-money laundering
AML4	Directive (EU) 2015/849
AML5	Directive (EU) 2018/843
AUM	Assets Under Management
CDD	Customer Due Diligence
CMU	Capital Market Union
DFS	Digital Financial Service
EBA	European Banking Authority
EC	European Commission
ESMA	European Securities and Markets Authority
EU	European Union
FI	Financial Institution
FinTech	Financial technology
FIU	Financial Intelligence Unit
ICO	Initial Coin Offering
IPO	Initial Public Offering
KIIS	Key Investor Information Sheet
KYC	Know Your Client
MiFID II	Directive 2014/65/EU
MS	Member State
PSD2	Directive (EU) 2015/2366
SME	Small and medium enterprises
VC	Venture Capital

INTRODUCTION

In this paper I will review crowdfunding in European Union Economic area and regulation within EU. I will focus to equity based crowdfunding as an alternative form of investment product. My interests to conclude this examination lies in FinTech and rising amount of regulation, what an alternative investment form requires to acquire a solid position in investment markets. Finance sector is very heavily regulated field and due the new technical possibilities, new forms of investment products has arrived to the markets besides the traditional securities and other already known regulated investment products. These new ways of investment products need a comprehensive regulation to secure clients position as a investor and for these providing companies to determine the boundaries to act in these markets. Also, regulation needs to be followed and complied. This new directive relies a lot to existing financial regulation for some parts. For example how to know investing clients and determine their risk is already. Still, existing regulation is not suitable for new Fintech innovations or crowdfunding. Current EU legislation is made for traditional financial markets and do not suit the special need for new innovations, that operate most in electronical platforms. Almost all crowdfunding platforms I have seen offers customer service only on internet. This operating form keeps their company agile and costs low to customers.

Before this new regulation, crowdfunding was mostly regulated by national legislation and some EU level legislation was applied from suitable parts. From EU level was only recommendations and opinions by European Union Authorities such as ESMA and EBA related to crowdfunding. For establishing a solid single market for crowdfunding, harmonisation is needed. As financial sector from products to operations is very well regulated and supervised, new innovations cannot be overlooked. We still live an era of digitalisation and fast innovations, so it is understandable that important framework is already existing an can be applied partially, but exact legislation that suits the characteristics of crowdfunding is highly requested to maintain that advisable level or coherent legislation. Digital and online services has also opened possibilities to financial crime and money laundering. Therefore the parties and source for invested money must be known and traceable. Financial institutions has established operation that is know simply as Know Your

Customer which is usually in retail banking and investing services a survey that a client fulfills and then the institution monitors the financial actions of the client. This is also used for define clients apetite and tolerance for risk when suggesting investment products. To know clients financial behaviour, we can prevent financial crime and market abuse. This is important part to establish in crowdfunding for enabling this new innovative solution to reach its full market potential.

As EU has an ambitius plan to become financial innovation hub, legislation must serve this purpose too. With this regulation EC will make more coherent financial stabily Union for all investors and projects to find financing from alternative markets. Crowdfunding is also a new tool for allocating investors risk to different sized companies. This regulation makes investing more safe and gives a compherensive framework for companies and other projects to follow inside EEA.
Harmonized regulation will promote European Unions single market aims and make investing into European SME companies more attractive. In long run, this will increase innovation and efficient financing for different projects, also working financial markets will increase available jobs and promote entrepreneurship.

I will introduce crowdfunding as a investment method and as an fintech innovation, after that I will examine more legislation and financial markets, then operational infrastructure of crowdfunding plaforms and financial institutions reflecting Know Your Client- regulation into examined topic. As the operational infrastructure is partially same but applying some new technological innovation into the operations, I will go through how the KYC process is intergrated into action and how legislation in EU level is followed. Is there differences and how the new Crowdfunding regulation 2020/1503 changes the interpretation of current financial regulation. Compliance has an important role on financial regulation, which has secured both investors and the operators in the market. Hypothesis is establishing a alternative investment method into financial markets and adapting new innovations. Research questions are how crowdfund investor is known by the crowdfunding platform? KYC processess in crowdfunding? How the investor is recognized and which legislation a crowdfunding platform must follow when establishing a KYC process? How the new regulation interprets the KYC aspect? My research method is qualitative and I refer to existing research papers and other EU publications such as press releases and plan documentation.

1. Crowdfunding

1.1. Background

Crowdfunding is an alternative financing form, which can also be considered as investing form. Usually SME or a private person seeks for funding, when they cannot access to traditional bank loan or going public with their company to collect financing.[1] Funds are collected from crowd, the people who are willing to contribute the cause and usually sums per person are quite small. Statue of Liberty in New York was financed by a crowdfunding model in 1885 and the project might be the oldest know project that fits the modern concept of crowdfunding.[2]

Crowdinvesting fulfils the financing gap between companies that are not ready to go public to seek finance from stock markets and if the company do not qualify for a bank loan or private loan. Collected funds must be usually currently under 5 000 000,00[3] euros and amounts above that are not classified crowdfunding.[4] Quite often crowdfunding is used to finance different creative projects such as visual art or music.[5] Usually the projects has some target sum to collect and offers information how the funds are going to be used. Funds are collected from the crowd, which are people willing to invest or donate to the project. Projects can seek funding for a certain amount of money and if the sum is reached, collected assets will be transferred to the project. Project must offer a KIIS[6] for the potential investor to acknowledge themselves with the project, longevity and other aspects such as potential revenue and when it can be expected. Investment based crowdfunding offers revenue in form of interest, dividend or capital growth, smaller artist projects

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[1] Vignone, M., 2016. Inside equity-based crowdfunding: Online financing alternatives for small businesses. Chi.-Kent L. Rev., 91, p.803.

[2] Sadzius, L. and Sadzius, T., 2017. Existing Legal Issues for Crowdfunding Regulation in European Union Member States. *International Journal of Business, Humanities and Technology*, *7*(3), pp.52-62.

[3] Art. 1 para 2(c) Regulation (EU) 2020/1503 of the European Parliament and of the Council of 7 October 2020 on European crowdfunding service providers for business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937

[4] Hobza, M. and Vondráčková, A., 2020. The New Financial Crowdfunding Regulation and Its Implications for Investment Services under MiFID II. *Charles University in Prague Faculty of Law Research Paper No*.

[5] Röthler, D. and Wenzlaff, K., 2011. Crowdfunding schemes in Europe. EENC report, 9, p.2011.

[6] Key Investor Information Sheet

can offer revenue or reimbursement as a physical items such as art or access to a show. Quite often the invested amounts are small per investor, but amounts can become higher if the investor is for example a company instead of a private person.

1.2. Crowdfunding platforms in Europe

There are several different platforms to find suitable investment target, which can be a start-up, SME or a project. Most of the platforms are national and cover mostly one country, but some platforms have subsidiaries in few European countries. Crowdfunding platforms can be private company based, but there are also companies that have gone public. For example, American platform Lending Club[7] is now a listed company. Just to name a few well-established platforms in Europe are for example, CrowdCube[8] in United Kingdom, FundedByMe[9] in Sweden, My Microinvest[10] in Belgium, Symbid[11] in Netherlands, Invesdor[12] in Finland and Companisto[13] in Germany.

Platforms can themselves define which crowdfunding type they are going to specialise. Some of the platforms let investor to choose the project they want to invest in, but there can also be an option to invest to a pool of different projects, and the platform allocates the invested sum into these projects.[14] This allocation can happen through premade pools of projects or it can be made by a person or artificial intelligence. Process of allocating the invested funds reminds somewhat traditional securities investing by understanding the risk ability of the investor or other targets for the investment. Premade crowdfunding project allocation can remind a traditional investment fund, which is usually managed by a person, but some crowdfunding platforms use artificial intelligence and algorithm when allocating the funds.[15]

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[7] Lending Club. Retrieved from https://ir.lendingclub.com/home/default.aspx 12 April 2021
[8] CrowdCube. Retrieved from https://www.crowdcube.com 10 April 2021
[9] FundedByMe. Retrieved from https://www.fundedbyme.com/en/ 10 April 2021
[10] Spreds. Retrieved from https://www.spreds.com/en/compartments/95-mymicroinvest 10 April 2021
[11] Symbid. Retrieved from https://www.symbid.com 10 April 2021
[12] Invesdor. Retrieved from https://www.invesdor.com/en-gb/ 10 April 2021
[13] Companisto. Retrieved from https://www.companisto.com/en 10 April 2021
[14] Gabison, G.A., 2014. Equity crowdfunding: All regulated but not equal. DePaul Bus. & Comm. LJ, 13, p.359.
[15] Kruse, L., Wunderlich, N. and Beck, R., 2019, January. Artificial intelligence for the financial services industry: What challenges organizations to succeed. In *Proceedings of the 52nd Hawaii International Conference on System Sciences*.

Platforms can also guide the projects that seeks for funding how they should arrange the funding round and which stake they could give in the exchange for funding. There is no limit that one platform must allow all the investment forms to happen through their platform. National legislation usually requires registration and licensing, if the platform handles the money or collects it. Banking license is rarely needed, but a license to operate in financial markets is required. For a project to succeed and reach the goal sum, platform might have an effect on that. There is a lot differencies between the platforms, specialisation and technical solutions that can make a difference for the project. All platforms are independent actors, so all their solutions for the investor and the projects differs.[16]

1.3. Crowdfunding methods

Crowdfunding is divided roughly to four categories. Sometimes division is made into a three categories, as the first and second from upcoming list is referred as financial crowdfunding or crowdinvesting.[17] These terms can be divided further to subcategories, but in this thesis I will focus to the four main methods;[18]

1. Loan based

   Peer- to- peer – lending. Donator lends money for the company or the projects and espects to get loan back or with interest or other reimbursement. They can negotiate about the loan terms or accept a premade package through the platform. The platform is an intermediaire in the loan process. Investor can decide the amount to invest and it will be added into the total sum, which usually has a goal. No bank is used in the process, but possibly other payment deliver company.

2. Equity based

   This form is closes to traditional investment when someone purchases shares of a company expecting revenue in future or company's value to rise in future. Investor becomes usually a shareholder with different rules than the original owners, who usually manages and

[16] Cumming, D.J., Johan, S.A. and Zhang, Y., 2019. The role of due diligence in crowdfunding platforms. *Journal of Banking & Finance*, *108*, p.105661.

[17] Hobza, M. and Vondráčková, A., 2020. The New Financial Crowdfunding Regulation and Its Implications for Investment Services under MiFID II. *Charles University in Prague Faculty of Law Research Paper No*.

[18] Gabison, G.A., 2014. Equity crowdfunding: All regulated but not equal. DePaul Bus. & Comm. LJ, 13, p.359.

operates the company. Investor must be informed clearly what their investment equals for them. Crowdfunding is still used for SMEs, so the investors might not have the similar rights as in normal public companies. Their voting rights might be limited, and the value of shares can be changed. [19]

3. Donation based

   This type do not give any reimbursement back for the contributor. [20] Used mostly for rather unusual situations or when someone has faced personal difficulties and lacks own funds or bank has declined a loan to for example cover legal costs or medical procedure. Collected amounts might be quite small but still remarkable for an individual. Very similar financing form compared to a traditional fundraising for a charity or another similar cause.[21]

4. Reward based

   This method is sometimes called also pre-selling and usually gives something in change for the donator.[22] Can be called also patronage donating or crowd sponsoring. This is mostly used to finance artist and similar project where the investor gets something in exchange for donated money. It can be for example a ticket to a show or early access to produced music which is funded by crowdfunding. This is quite commonly used for example in US for financing podcasts or other digital content, that lacks sponsors or do not want to use sponsors. Donators can have access to extra material or earlier access to new episodes. Amount per donator tend to be small and target for fundraising is to cover the costs of the project. [23]

Significant is to understand that in loan based and crowd sponsoring gives something back to the donor, as term investor in this context might be misleading. To collect the funds, an intermediary is used, which is usually a website also known as crowdfunding platform.[24]

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[19] Hornuf, L. and Schwienbacher, A., 2017. Should securities regulation promote equity crowdfunding?. Small Business Economics, 49(3), pp.579-593.
[20] Gabison, G.A., 2014. Equity crowdfunding: All regulated but not equal. DePaul Bus. & Comm. LJ, 13, p.359.
[21] Chervyakov, D. and Rocholl, J., 2019. How to make crowdfunding work in Europe (No. 2019/6). Bruegel Policy Contribution.
[22] Ashari, F., Catonsukmoro, T., Bad, W.M. and Wang, G., 2020. Smart contract and blockchain for crowdfunding platform. *International Journal of Advanced Trends in Computer Science and Engineering*, *9*(3).
[23] Patreon. Retrieved from https://www.patreon.com/about 2 April 2021
[24] Gabison, G.A., 2014. *Supra nota* p.359

Crowdfunding has usually this all of nothing- ideology behind when fundrising the targeted amount. If the project do not fullfil this pre set goal, assets will be divided back to the crowd and no one loses or winns anything.[25] Still, the platforms has to decide how they will set the target amounts and if the target is not reached, are they still going to finance the project or not, but his information must be given to the crowd before any financial decisions.

1.4. Alternative investment markets

Crowdfunding is so called alternative investment method and due this alternative nature, investor protection and regulation is composed in different way. When traditional investment markets are heavily regulated, alternative investment methods rise partially from the excessive regulation as giving options for other ways to invest. Alternative investment methods have arisen in popularity in 2010 century due to internet and wider accessibility. Technological factors have enabled new ways for investing and making it faster than ever before. Even with more traditional investment markets, one is able to do transactions or other movements in financial market just by using a phone or a computer. Also, financial crisis in the past have given people interest to alternative investing for allocating their funds or just finding more suitable investment products.[26] Companies that seek for public funding, must follow very heavy compliance regulation, which can be too expensive for smaller companies that are in first growth phase. Alternative investing is not only about finding new ways to fill gaps between more traditional markets, but also offer other financial products than just securities. Some investment funds can be considered as alternative due their investing period or companies the funds are targeting.

1.5. Do we need regulation for crowdfunding?

Crowdfunding has risen in popularity and as other financial products and the markets are regulated, the alternativity of crowdfunding seems quite extreme as the investors are still normal people with their life savings and other forms of savings. All financial service providers must know their clients and ask the source of the invested money, to prevent money laundering and financing illegal

[25] Sadzius, L. and Sadzius, T., 2017. Existing Legal Issues for Crowdfunding Regulation in European Union Member States. *International Journal of Business, Humanities and Technology*, *7*(3), pp.52-62.
[26] Borello, G., De Crescenzo, V. and Pichler, F., 2019. Factors for success in European crowdinvesting. Journal of Economics and Business, 106, p.105845.

activities such as terrorism, crowdfunding currently lacks this aspect totally. Whenever a client makes any money transactions in bank or financial institution, they must recognize the customer and before the transaction can be fulfilled, the origin of the funds must be known. Investor protection is part of larger scale, where financial protection is provided for the institution and for the investor.[27]

When establishing a new innovation to financial markets, it must give a trustworthy image to the markets. Financial markets has a huge impact into many operations in every day life and to protect other actors in the field. As in traditional FIs must know the investor and their financial background, crowdfunding platforms did not have a clear guideline to this before. To protect all parties the platforms, projects and investors for possible financial crime or other abusive behaviour in financial markets, they must comply with Anti-Money Laundering regulation which have developed in EU very well in last decade.[28] Investor must be recognised from an official identification method and so called customer due diligence (CDD) must be conducted. For the project seeking for funding the same CDD must be completed, before any funding can be collected. As almost all financial services are now available also online, the possibility to financial crime has increased. It can be simply just abusing the market or influencing traders into certain behaviour for gaining own benefit, or it can be money laudering from source that seems to be legitimate. Same time as the services has become digital, monitoring customers cashflow and consuming has become easier for the FIUs to follow.

[27] Ingram, C., Teigland, R. and Vaast, E., 2014, January. Solving the puzzle of crowdfunding: Where technology affordances and institutional entrepreneurship collide. In *2014 47th Hawaii international conference on system sciences* (pp. 4556-4567). IEEE.

[28] Hornuf, L. and Schwienbacher, A., 2017. Should securities regulation promote equity crowdfunding?. *Small Business Economics*, *49*(3), pp.579-593.

2. Financial technology

2.1. What is FinTech?

Financial technology is a umbrella term that includes all kind of innovations that includes finance and technology.[29] It is abreviated as FinTech quite commonly and can mean everything from payment solutions for consumers to technological reformation in a company.[30] Different softwares such as FA Solutions[31] for asset management, payment solutions such as Klarna[32] and mobile payment applications such as MobilePay[33] are quite well established fintech solutions. Some of the new fintech innovations do not require new regulation, but some does.[34] For example a software that a company uses to combine customers data and market data, for a better functionality in banking services, applies already existing data and might just decrease need for multiple sotfware in a company. Other hand, fintech can mean a totally new way of investing money or connecting supply and demand in investment markets to each other.[35] Some way it can be considered just service design like legal design. Some digital banking services have taken over countries, where traditional banking services such as having a bank account have not succeeded, as the country do not have existing banking infrastructure, digital services are easily adapted as citizens still have smartphones which gives them access to internet and therefore alternative digital banking services.[36]

Fintech is said to revolutionize banking and finance world by offering more adaptable services and products with lower costs and accessibility we have not experienced before. Still, fintech and traditional banking services are used parallel.[37] Crowdfunding is considered to be a part of this fintech revolution and give alternative ways to finance SME's and find investors outside the traditional pool. Fintech can use algorithms, artificial intelligence, big data or machine learning

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[29] Schueffel, P., 2016. Taming the beast: A scientific definition of fintech. *Journal of Innovation Management*, *4*(4), pp.32-54.
[30] Lacasse, R.M., Lambert, B.A., Roy, N., Sylvain, J. and Nadeau, F., 2016, April. A digital tsunami: FinTech and crowdfunding. In *International Scientific Conference on Digital Intelligence* (pp. 1-5).
[31] FA Solutions. Retrieved from https://fasolutions.com 2 May 2021.
[32] Klarna. Retrieved from https://www.klarna.com/international/about-us/ 2 May 2021.
[33] MobilePay. Retrieved from https://mobilepay.fi/ 2 May 2021.
[34] Vučinić, M., 2020. Fintech and Financial Stability Potential Influence of FinTech on Financial Stability, Risks and Benefits. *Journal of Central Banking Theory and Practice*, *9*(2), pp.43-66.
[35] Lukonga, M.I., 2018. Fintech, Inclusive Growth and Cyber Risks: Focus on the MENAP and CCA Regions.
[36] Lacasse, R.M., Lambert, B.A., Roy, N., Sylvain, J. and Nadeau, F., 2016, April. A digital tsunami: FinTech and crowdfunding. In *International Scientific Conference on Digital Intelligence* (pp. 1-5).
[37] Meklin, H., The Emergence Of Fintech–The AML Vulnerabilities In the Eu Regulatory Framework., 2020.

when composing new services.[38] Traditionally lending money has been an exclusive business model for banks and access to this business area is hard to enter, as the business requires a lot of funds, assets and collaterals to establish a healthy venture. Interest are tailor made for every customer and an business secret, as banks are making their profits from the interest and customers could change service provider if interest were more transparent.[39]

Fintech tries to keep the end user experience easy and accessible.[40] That is easy to achieve by offering services online or through an newly designed platform or an application, when before financial services required human interaction, fintech is making a change here in the process.[41] This is also the main reason why fintech is also called market disrupter; ways we used to manage our finances are changing rapidly. Due the rapid change, there is also threats also. Legislation around these new innovations are coming behind and this makes fintech innovations fragile for criminal behaviour, such as terrorism funding, money laundering and other illegal financial sources.[42] For example KYC process in all financial institutions can be enhanced with blockchain run process that can lower the compliance and other operational costs regarding to customer relations and information.[43]

These earlier mentioned new technologies can make buying transferable securities easier in online platforms, not only crowdfunding. When purchasing any shares, bonds or equity crowdfunding these online platforms can benefit from smart contracts between the buyier and seller. Crowsdfunding platforms tend to adapt new technologies into their operations quite well and smart contracts are already in use in some platforms.

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[38] Ferretti, F., 2018. Consumer access to capital in the age of FinTech and big data: The limits of EU law. Maastricht Journal of European and Comparative Law, 25(4), pp.476-499.
[39] Peter Gomber, Robert J. Kauffman, Chris Parker & Bruce W. Weber (2018) Special Issue: Financial Information Systems and the Fintech Revolution, Journal of Management Information Systems, 35:1, 12-18
[40] Schwartz, A.A., 2018. The Gatekeepers of Crowdfunding
[41] Johnson, K., Pasquale, F. and Chapman, J., 2019. Artificial intelligence, machine learning, and bias in finance: toward responsible innovation. *Fordham L. Rev.*, *88*, p.499.
[42] Lacasse, R.M., Lambert, B.A., Roy, N., Sylvain, J. and Nadeau, F., 2016, April. A digital tsunami: FinTech and crowdfunding. In *International Scientific Conference on Digital Intelligence* (pp. 1-5).
[43] Parra-Moyano, J., Thoroddsen, T. and Ross, O., 2019. Optimised and dynamic KYC system based on blockchain technology. *International Journal of Blockchains and Cryptocurrencies*, *1*(1), pp.85-106.

"Fintech promises to increase efficiency in delivering financial services, widen their range, increase competition and promote financial inclusion. On the other hand, policymakers must address a set of risks that could merit public intervention."[44]

2.2. Fintech action plan

European Union has made an action plan regarding Fintech and the opportunities new financial methods has to offer for European Citizens and businesses in EU. Main thought behind this action plan is to make EU a global hub for Fintech innovations and offer framework for the businesses to thrive.[45] Fintech action plan includes also adapting new technologies such as blockchain and artificial intelligence into Capital Market Union. Aim for the action plan is establish a position for crowdfunding in financial markets and make it better regulated for providing the needed framework for the pioneers and new actors in the EU. Investor protection and enabling businesses working with these new technologies to have a fair legal framework in EU is the underlying power for creating the fintech action plan. The legislative framework includes also cryptocurrencies and other forms of digital currencies and payment solutions.[46] Fintech action plan includes also digital services related to fintech and EC has also a plan for digital single market in EU. Digital services such as Fintech has other aspects to integrate into the framework, such as adapting General Data Protection Directive into use, as digital services and smart devices can collect different delicate data. New innovations bring new aspects to take into consideration.

Blockchain is also one very much discussed topic under Fintech action plan as mostly well known application for such a technology is crypto-assets. Blockchain itself provides a lot of different application possibilities besides use in virtual currency.[47] Blockchain is visioned to be used in financial field much more, which is also discussed in Fintech action plan. Enabling this technology

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[44] Restoy, F., 2019. Regulating fintech: what is going on, and where are the challenges? speech at the ASBA-BID-FELABAN XVI Banking public-private sector regional policy dialogue "Challenges and opportunities in the new financial ecosystem", Washington DC,

[45] FinTech: Commission takes action for a more competitive and innovative financial market. Press release retrieved from https://ec.europa.eu/commission/presscorner/detail/en/IP_18_1403 25 March 2021

[46] Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions On A Digital Finance Strategy For The EU. Retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC05912 May 2021

[47] Norvill, R., Steichen, M., Shbair, W.M. and State, R., 2019, May. Blockchain for the Simplification and Automation of KYC Result Sharing. In *2019 IEEE International Conference on Blockchain and Cryptocurrency (ICBC)* (pp. 9-10). IEEE.

into financial infrastructure, compliance operations could be enhanced.[48] For further discussion related to blockchain innovations, EC has established a Blockchain Observatory and Forum.[49]

2.3. Capital market union (CMU)

Capital Market Union is latest European Commissions project to ensure free movement of capital in EU and make financial stability to invest and start business for all Member States.[50] Creating a solid single market also for capital markets Commission tries to integrate all freedoms of movement and create competitive framework for Citizen in the Union by harmonizing legislation and taking down any existing barriers.[51] By creating financial stability in all Member States, businesses and projects can expand more easily to other Member States to growth their business or attract new employees. For crowdfunding this would mean that an operating platform can seek investors from another Member State and companies can find more capital to growth their business. Part of the Capital Market Union and single market is to make Europe a global hub for FinTech.[52]

Capital Market Union is also intended to increase investing among Europeans. Many citizens prefer bank deposits over investing their savings, which makes European investment markets quite small an unefficient.[53] CMU includes retail financial services, which are bank accounts, payment cards, consumer and mortgage credits, insurance and long-term saving products, which are mostly for retirement. [54] For creating an efficient Single Market Union for finance, there must be a harmonized legislation for the market too. As equity based crowdfunding is establishing very well among investors in Europe, current regulation must be updated and tailored to suit new ways of

[48] Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions On A Digital Finance Strategy For The EU. Retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC05912 8 May 2021
[49] European Commission launches the EU Blockchain Observatory and Forum. Press release, European Commission February 2018. Retrieved from https://ec.europa.eu/commission/presscorner/detail/en/IP_18_521 8 May 2021
[50] Abascal, M., Alonso, T. and Pacheco, L., 2015. First step towards a Capital Market Union. Regulation Flash, 19.
[51] Bhatia, A.V., Mitra, S., Weber, A., Aiyar, S., de Almeida, L.A., Cuervo, C., Santos, A.O., Gudmundsson, T., Bergthaler, W. and Garrido, J., 2019. A Capital Market Union for Europe. IMF Staff Discussion Notes, (19/07).
[52] Communication from The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions On A Digital Finance Strategy For The EU. Retrieved from https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC05912 8 April 2021
[53] Bhatia, A.V., Mitra, S., Weber, A., Aiyar, S., de Almeida, L.A., Cuervo, C., Santos, A.O., Gudmundsson, T., Bergthaler, W. and Garrido, J., 2019. A Capital Market Union for Europe. IMF Staff Discussion Notes, (19/07).
[54] Communication from The Commission to The European Parliament, The Council, The European Central Bank, The European Economic and Social Committee and The Committee of The Regions. Brussels, 23.3.2017 COM(2017)

investing. Capital market union and fintech action plan for investor protection and for ensuring the legitimacy of investing into crowdfunding. Investor protection is not only for the investor, the other part of the trade also benefits for the regulation as it gives better framework to establish operations.[55]

2.4. Equity based crowdfunding

Equity based crowdfunding is like buying a stock of a company. Investor invest his or her own money and bears the risk of losses or profits limited to invested equity.[56] When an investor makes an equity-based investment to a company, the investor becomes an owner of company and most characteristic difference between equity based crowdfunding and the other forms is that in equity based the finance seeking instance is most likely a company, when in other forms there is a private person seeking the funding. In the fact sheet of offering is usually declared how much one investment makes in equity and what are the other terms for the investment. As crowdfunding is made by an intermediate through a web platform, which is different for every company seeking for funding, the after market are different when comparing with traditional stock markets. Investment is not as liquidate as traditional stock purchase or another traditionally tradeable security. Equity based crowdfunding can also have similarities with traditional bonds, even though peer- to- peer lending and loan-based crowdfunding differs from equity based. Traditional securities pay investor interest, dividend or the invested equity grows in value.[57] With crowd investing, an investor might need to wait for any revenue much longer or never receive any. Volatility with companies collecting financing through crowdfunding is much higher than with traditional securities.[58]

2.5. Infrastructure for crowdfunding

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[55] Kang, M., Gao, Y., Wang, T. and Zheng, H., 2016. Understanding the determinants of funders' investment intentions on crowdfunding platforms. *Industrial Management & Data Systems*.
[56] Cicchiello, A.F., 2019. Harmonizing the crowdfunding regulation in Europe: need, challenges, and risks. *Journal of Small Business & Entrepreneurship*, pp.1-22.
[57] Roth, J., Schär, F. and Schöpfer, A., 2019. The Tokenization of assets: using blockchains for equity crowdfunding. *Available at SSRN 3443382*.
[58] Klöhn, L., 2018. The Regulation of Crowdfunding in Europe. In the Economics of Crowdfunding (pp. 219-253). Palgrave Macmillan, Cham

As crowdfunding is considered as financial innovation, it has benefitted from technological development and internet accessibility. Crowdfunding platforms are usually fully digital websites and sometimes the platform operates totally in a mobile application. Digitality has lowered the costs for projects seeking for funding and also helped marketing the project. Most investors are familiar with digital banking and other services. [59] Operating fully digital has opened technological possibilites when concluding contracts with investors and projects that are seeking for funding.

Main difference between these crowdfunding platforms and banks is, that the first one is usually rather small company which just operates for crowdfunding projects, which means that these companies do not have as massive infrastructure for clients nor projects finding financing, such as compliance, after sales or legal department. When some of fintech companies delivers services to banks and other financial institutions, crowdfunding platforms are usually independent actors in their own pool.[60] I will shortly discuss about infrastucture, that is used with tradable securities. This operations can be used also in crowdfunding and some operations are a good example how well financial institutions have been established and what lacks from the crowdfunding markets. This lacks can lead to less investor protection, if the platforms cannot guide the investors or offer same operations as financial institutions.

2.5.1. Collecting funding for projects

Platforms act as a third party and offers a channel for the supply and demand to meet. Crowdfunding platform is an intermediare in the process.[61] When accepting new projects to their platform, project will be listed on their website and offer an information sheet about the content and form of the investment. Key Investor Information Sheet should declare how much the platform will collect commission and is the sum going to be deducted from the final invested sum or added on top of the invested sum. Platorms usually collect the funds for the company and take a commission for themselves to finance their own operations, so the other costs must be declared also. Quite often the investment is a security, but it can also be another beneficial right in a security.

[59] Koch, J.A. and Siering, M., 2015. Crowdfunding success factors: The characteristics of successfully funded projects on crowdfunding platforms.
[60] Balčiūnas, L., 2019. Collaboration between fintech firms and banks: An opportunity or a challenge for the EU bank recovery and resolution legal framework key objective?[interaktyvus]. In *Law 2.0: New Methods, New Laws: 7th International Conference of PhD Students and Young Researchers: Conference Papers* (pp. 28-40).
[61] Rossi, A. and Vismara, S., 2018. What do crowdfunding platforms do? A comparison between investment-based platforms in Europe. *Eurasian Business Review*, *8*(1), pp.93-118

Platforms are required to complete a due diligence investigation of their part when accepting new projects to their platform to seek funding.[62]

2.5.2. Custodian

Traditionally bank or other financial institution holds securities or other financial instruments for the client. Use of custodian is a normal part of purchasing any financial products, but in crowdfunding the custodian can be the crowdfunding platform or the investor itself, if the investment is physical paper or other certificate. Safekeeping of a physical certificate isoutsourced for the investor, if the platform do not offer custodian services. In traditional banking custodians are also regulated, and there is certain limitation for holding a custodian title. Crowdfunding do not need as excessive settlement process, than other tradeble securities, so use of custodian also differs. Investor makes the purchase on a platform, that holds that certain crowdfunding campaign so there is no need for a settlement process as the trade settles as the same moment. Still, some of the crowdfunding platforms do not act as custodian so the investor must protect the physical certificate themselves.[63]

2.5.3. Asset transfer

Crowdfunding platforms can use third party for transferring the collected assets or do it themselves, every platform can define their own rules for transferring assets. As financial institutions and banks have again well established regulation around payments and handling consumer payments, crowdfunding platforms have more freedom how to organise the asset transfer and collecting the assets from the crowd. Payment Service Directive is instructed to follow by as ESMA guided to apply the directive, but there was room for interpretations before the new regulation. FIs are required to run their clients against so called sanctions list regularly to find possible ML suspects or other information that FI must inform local authorities about. Assets cannot be transferred if client is not recodnised or the KYC data is outdated. This is a critical part of conducting a investment and crowdfunding platforms has to take this into consideration if they

[62] ESMA, 2014-1378 opinion on investment-based crowdfunding

[63] Commission Delegated Regulation (EU) 2018/1618 of 12 July 2018 amending Delegated Regulation (EU) No 231/2013 as regards safe-keeping duties of depositaries (Text with EEA relevance.) C/2018/4377 *OJ L 271, 30.10.2018*

are handling investors money and also, how to organise the infrastructure for crowdfunding from AML point of view.[64]

2.5.4. Exit strategy for crowdfunding

As crowdfunded projects are not traded as traditional securities, it will be harder or even impossible to liquidate the investment if needed. This is something that an investor must understand before making any actions.

Platforms must provide the investor clear information how long it might take to liquidate the invested amount and if there are any restrictions for liquidating the investment. So-called Hedge Funds or alternative investment funds, which operates under traditional securities regulation or AIFMD, must provide an exit strategy for investors who want to liquidate their investment fully or partially. It is important for the investor to acknowledge, that not all investment is able to liquidate or otherwise transferable.[65] Also, the platform might not take any responsibility about after sales and all investments through their platform are final, as the investments are made directly into the project. Some platforms have established an own after market for investors to sell their holdings on the same platform they made the investment. This is more like a bulletin board where the aftermarket sales can happen in quite unformal manner. Some investment into a company can be limited to certain function, and therefore once invested sum is already used for example into a machine and the company lacks assets to reimburse the amount an investor is requesting. After all, the companies are usually quite small, and the financing is usually collected for a certain reason and for example for an earlier decided acquisition.[66]

2.5.5 Risk assessment regarding the infrastructure

Equity based crowdfunding reminds a lot of acquiring other traditional transferable securities, but the infrastructure is different. There is risks for both parties -- the investor and for the crowdfunding platform. Liquidity of the assets can be hard for the investor and also for the platform, if there is no aftermarket established for the project the platform has enabled to collect

[64] AML5 directive
[65] Martinazzi, S., 2017. The age of fintech: providing a liquid and efficient secondary market for security based crowdfunding with distributed ledger technologies.
[66] Hong, Y., Hu, Y. and Burtch, G., 2018. Embeddedness, pro-sociality, and social influence: Evidence from online crowdfunding. *MIS Quarterly, Forthcoming*.

funding. Understanding the process and infrastructure behind investing money has different risks which might not be visible for the end user, which is here investor. Crowdfunding platforms are also quite small businesses, so it is possible that the platform can be laid down or the platform was established at first place for criminal use. Competent authorities exist and some countries require the platforms to register and have a license to operate, but everything is still possible.

2.6. Analysis of FinTech

Evaluating this part, crowdfunding has appeared to fullfil a gap in financial markets and offers a good alternative investment form for investors. Same time, traditional financial services has established a good infrastucture for processing investments and financial markets. All steps are very well though and builded for the purpose. Same time, crowdfunding lacks this infrastructure even tough, some steps used in traditional banking has become unnecessary.[67] When having small platforms collecting funding for projects, the infrastructure becomes more visible for both sides. How the custody process is established? What if the company is later sold and the shares must be collected from investors or if the financed business is able to go public? When applying MiFIR/MiFID into crowdfunding, the infrastructure remains national which can lead in future for distorting the crowdfunding opportunities and markets, as the platforms remains operating in national perspective. Now most of the platforms are independent, but what if FIs start to operate their own platforms? This could mitigate possibilities for ML or terrorist financing but also create even bigger financial conglomerates, which will increase the need of regulation which can slow down the CMU and fintech action plan operations. After all, crowdfunding has become a popular alternative financing method or an alternative investing method for a reason; filling the gap in financial markets for supply and demand.

From AML aspect it is reasonable question how well crowdfunding platforms knows their clients and their typical actions and how well they have establised customer due diligence for the investor and for the company seeking funding. Both parties here are the clients of the platform and the project seeking for funding must be gone through due diligence, but has the whole entity gone

[67] He, M.D., Leckow, M.R.B., Haksar, M.V., Griffoli, M.T.M., Jenkinson, N., Kashima, M.M., Khiaonarong, T., Rochon, M.C. and Tourpe, H., 2017. *Fintech and financial services: initial considerations*. International Monetary Fund.

through the same process? DD becomes important for the investor and the platform. As earlier it was upto national legislation if the platform kept a record of their investors or projects seeking fo funding

Money laundering is not the only risk in crowdfunding. It is also possible that projects seeking funding are using the platform for their malicious use for example rising funding for a product and the final result is not what investors were expecting. It is possible that the project no dot come out with any final product or result after all and the investors are left with nothing. This outcome is a reasonable threat mostly in other forms of crowdfunding than in financial crowdfunding.

When establishing a functioning crowdfunding platform, the question how to set up the infrastructure is very important to evaluate from the AML point of view and also how to communicate to investors their part in the process such as custodian or payment transfer. If platform do not offer custodian services, they can collaborate with another service provider or let this part for the investor to solve. Same with the asset transfer, this opens discussion for the responsie part for conclude the KYC process and CDD, if the platform do not handle any money.

3. Legal framework for crowdfunding in European Union

3.1. Background

Before the proposal of this directive, crowdfunding was regulated by almost all existing financial regulation picking an article here and there, which was not tailored for crowdfunding. Some parts of the crowdfunding do not fit to the traditional framework of financial regulation and national authorities had to make sure there is national framework or even updated legislation. This proposed directive still relies for most part on existing regulation and in next sections, I will examine this topic more in depth.

Investment platforms must follow existing EU level regulation and usually must apply for national license to operate such activities, because the platforms might collect money or make money transfers possible. Supporting new financial products and ensuring coherent legislation for investors and the platform benefits everyone.[68] For example, loan based crowdfunding was partially applicable with Consumer Credit Directive and Mortgage Credit Directive, when the platforms offering crowdfunding services applied MiFID II, Payment Service Directive and Alternative Investment Fund Manageres Directive. On top of directives, there was ESMA proposal and guide to Member States to instruct financial service providers how to find applicable law. Financial regulation is very much multilateral in EU level and one source do not offer exhaustive answer, as there is a lot of cross referencing which also means that the financial regulation professionals has a extensive substancial knowledge of the topic.[69] Directives and regulations were applied on those parts, that were applicable or a national authority guided to use them. Some Member States also had own crowdfunding legislation, as European Union lacked a harmonized version.[70] All financial instutitions or service providers must comply Anti Money Laundering

[68] Chervyakov, D. and Rocholl, J., 2019. How to make crowdfunding work in Europe (No. 2019/6). Bruegel Policy Contribution.
[69] Harkonen, E., 2018. Regulating Equity Crowdfunding Service Providers-An Innovation-Oriented Approach to Alternative Financing. *NJCL*, p.201.
[70] ESMA, 2014-1378 opinion on investment-based crowdfunding

regulation, which is divided to several directives. In this thesis we will focus to AML4 and AML5 directives and those relation with the new crowdfunding regulation.

European Union has long history with freedom of movement, which applies also to financial markets. However, investing into another EU Member State have not been as tempting to investors as keeping their assets in home country. Due different legislation, investor protection and local practices EU is innovating new ways to increase coherent financial markets in all MS. There is different projects with an aim for harmonizing legislation for financial innovations in European Union and making EU more attractive for investor, which I will write more in their own chapter.[71]

3.2. Anti-Money Laundering

3.2.1. Know Your Client

As a part of financial crime prevention all investors must be recognised and the source of their invested assets must be known. Clients go through a process when establishing customer relationship with the FI before they can make any investments or transfer their assets to new account or custodian. KYC data includes clients personal identification data such as address and full name and it is verified from passport or other official identification card. Customers incomes, assets and loans have to be clarified and the real beneficiary.[72] FI must also know if the client has political relations, because it might affect their financial traffic and rise the need for supervision. Data is collected for ensuring the so called normal use to give a framework for the FI which actions might rise alarm about suspicious activities, which are monitored to prevent financial crime and terrorist financing.[73] KYC data must be updated regularly.[74]

3.2.2. Customer Due Diligence

[71] Cicchiello, A.F., 2019. Harmonizing the crowdfunding regulation in Europe: need, challenges, and risks. *Journal of Small Business & Entrepreneurship*, pp.1-22.
[72] Thompson, J.R., Feng, L., Reesor, R.M. and Grace, C., 2021. Know Your Clients' behaviours: a cluster analysis of financial transactions. *Journal of Risk and Financial Management*, *14*(2), p.50.
[73] Robock, Z., 2014. The Risk of Money Laundering Through Crowdfunding: A Funding Portal's Guide to Compliance and Crime Fighting. *Mich. Bus. & Entrepreneurial L. Rev.*, *4*, p.113.
[74] Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC (Text with EEA relevance)

When establishing a new client into a financial institution, a customer due diligence (CDD) in conducted. Important knowledge is simply indentify the client and make a risk profile as an investor, identify normal financial information such as incomes, loans and assets. Political ties must be identified and possible beneficiary behind the assets must be known. This process is faster to conclude with natural persons, as with legal persons it can take longer depending on how large legal entity there is to verify. Every FI must conclude their CDD and KYC on their own, but there has been discussion about EU wide solution for the KYC and CDD process, which could be run by blockchain technology.[75] This solution could ease many smaller FI such as crowdfunding platforms, which tend to be smaller than traditional financial institutions and might not have the same resources. Possible EU wide KYC database is under discussion and research regarding EU's aim for Capital Market Union.[76] Project like this were regulation meets technology is called RegTech[77]. This would also prevent natural persons to distort their information in different FIs for seeking benefit for their own project or prevent running into unbearable debt.

3.3. How to know your client for crowdfunding platforms?

As the customers of the crowdfunding platforms are natural persons and legal entities, they are obliged to run due diligence for both. Projects seeking for funding must be know and the real beneficiaries behind the company must be verified. As the platforms tend to be small when comparing to other financial institutions,[78] the customer acquisition is important part of the platforms business. If the project is interesting and crowdfunding round succeed, it can lead in future more profitable projects. This also makes the platforms vulnerable for malicious use such as money laundering.[79] When FI's can have longer relationship with some company with possibility to track their finances in bank account, the crowdfunding platform do not have the same possibility. KYC compliant platforms can also seem more reliable and trustworth for the investor and it is important to understand that financial services are also a trust business where a reputation

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[75] Ostern, N.K. and Riedel, J., 2020. Know-Your-Customer (KYC) Requirements for Initial Coin Offerings. *Business & Information Systems Engineering*, pp.1-17.
[76] Zetzsche, D. and Preiner, C., 2018. Cross-border crowdfunding: Towards a single crowdlending and crowdinvesting market for Europe. *European Business Organization Law Review*, *19*(2), pp.217-251.
[77] Arner, D.W., Barberis, J. and Buckey, R.P., 2016. FinTech, RegTech, and the reconceptualization of financial regulation. *Nw. J. Int'l L. & Bus.*, *37*, p.371.
[78] Zetzsche, D. and Preiner, C., 2018 *Supra nota., p. 219*
[79] Pandey, S., Goel, S., Bansla, S. and Pandey, D., 2019, March. Crowdfunding Fraud Prevention using Blockchain. In *2019 6th International Conference on Computing for Sustainable Global Development (INDIACom)* (pp. 1028-1034). IEEE.

has a huge impact as the invested money can be investors life savings earned by themselves. Crowdfunding itself is can be considered more emotional investment method as the platforms are small and so are the projects, investor can feel like having a closer relationship with the project which creates more commitment from the investor side.[80]

3.4. Applicable legislation for crowdfunding

Crowdfunding has been regulated by more traditional financial regulation before this new tailor made regulation. As crowdfunding has own characteristics that differs from traditional financial services, there has been some flaws in current legislation that has left loopholes for the investor and the provider to solve themselves. Regulation have not been comprehensive and exhaustive.
As crowdfunding projects are not offered in traditional banks, but most of the regulation is made for banking and other financial services, the need for comprehensive regulation was very urgent. [81]Also, as there has been only national guides, ESMA's guide to crowdfunding and EBA's opinion to gatherthe applicaple legislation, the amount of loopholes has been severe. As having a comprehensive regulation that clearly states which other regulation or directive must be interpreted in certain case, has been a much needed improvement for harmonised crowdfunding market in EU.

3.5. European Securities and Markets Authority opinion on crowdfunding

On 2015 ESMA collected data amongst the MS about their crowdfunding guidance and national legislation. This paper is not exhaustive, but gives an idea how crowdfunding was organised and which kind of EU level legislation was followed and how it was interpreted.[82]
In collected data there was 46 crowdfunding entities, whereas 18 f them operated under MiFID and one was registered under AIFMD. Some of the remaining companies were considered as investment firm and one was excluded from MiFID scope and operated under national law.[83]

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[80] Simon, M., Stanton, S.J., Townsend, J.D. and Kim, J., 2019. A multi-method study of social ties and crowdfunding success: Opening the black box to get the cash inside. *Journal of Business Research*, *104*, pp.206-214.
[81] Härkönen, E., 2017. Crowdfunding and the Small Offering Exemption in European and US Prospectus Regulation: Striking a Balance Between Investor Protection and Access to Capital? *European Company and Financial Law Review*, *14*(1), pp.121-148.
[82] Investment- based crowdfunding, Insights from regulators in the EU. ESMA 2015.
[83] *Supra Nota p. 2*

Before this survey ESMA announced on 2014 an opinion on investment based crowdfunding which gave legal framework for crowdfunding platforms to operate in EU. As the survey in 2015 show, the results of interpreting the Opinion was wide. In the opinion was listed several existing financial directives and regulations and how some parts of the current legislation could be applied into crowdfunding. By the time of publishing this opinion, AML4 and AML5 directives were not enforced nor published yet, which means that the opinion do not give comprehensive overview to customer recognition or possible KYC data. ESMA's opinion applies AMLD3 which still requires to platforms to do a CDD to their customers, but the applicability is in the directive defined to concern FIs which takes part into securities issue, which is the closest definition of equity based crowdfunding.

3.6. Financial crises and the effect on regulation

Past financial crises has a major role of alternative investment products and growth of these markets. As some functions tightened and access to loan or other financial benefits for new companies, alternative ways of financing started to bloom. Earlier small companies and start ups had more access to bank loans, which enabled accelerated growth for the companies.[84] Because of new credit standards, small and just started companies had hard time for accessing loans. Need for alternative financing methods were born, as public financing intend initial public offering, which is usually not an option for a start up or a SME.[85]

Because of past financial crisis, financial regulation has tightened up which limits new and small investment companies or products entering the market as the need for skilled compliance personnel is real, but the smaller companies might not have the resources to have enough personnel to operate compliance.[86] This have opened alternative markets for investors and alternative products. When traditional securities markets are regulated in many ways, such as who can enter to the market and where the invested money came from and market monitoring, these alternative investment products might not have any regulation who can purchase such a product and with which money.[87]

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[84] Schwartz, A.A., 2012. Crowdfunding securities.
[85] Sadzius, L. and Sadzius, T., 2017. Existing legal issues for crowdfunding regulation in European Union member states. *International Journal of Business, Humanities and Technology*, *7*(3), pp.52-62.
[86] Ferretti, F., 2018. Consumer access to capital in the age of FinTech and big data: The limits of EU law. Maastricht Journal of European and Comparative Law, 25(4), pp.476-499.
[87] Navaretti, G.B., Calzolari, G., Mansilla-Fernandez, J.M. and Pozzolo, A.F., 2018. Fintech and Banking. Friends or Foes?. *Friends or Foes*.

FinTech solutions such as crowdfunding platforms could benefit from being able to buy compliance services from a third party, or other forms of outsourcing some of the operations.

3.7. Current regulation analyses

The affect of financial crisis is present when crowdfunding was rising in popularity. Access to loans become more challenging for some companies and the alternative nature without heavy regulation was tempting – for the investor and the company seeking for funding. When enabling these innovations and adopting them into our financial markets it is balancing between financial stability and good legal framework that keeps the innovation alive without modifying the initial idea behind it.[88] For establishing a new investment method, legislation and legal framework becomes quite quickly into valuable position as if the method will keep a position in market, it must adapt to regulation too. Otherwise, it will be just another infamous financial attempt which can seem more like a ponzi scheme.

Afterall, crowdfunding is not that far away from already known investment methods such as purchasing securities from stock market. Equity based crowdfunding reminds a lot of smaller scale stock purchase, so there is already applicaple legal framework in national and EU level. Important is to understand the similarities and the differences when approaching the innovation with new regulation.[89] As the platforms that offer crowdfunding are relatively small when comparing to traditional FIs, it becomes quite apparent that the compliance and back office systems are much heavier in FIs and includes operations, that are excess in crowdfunding.

When applying current regulation from here and there, it will cause a concern of applicability and interpretation. As ESMA guided to apply for example MiFID, AIFMD and EuVECA among others and when EU financial regulation relies a lot on exemptions that are used in national legislation, this is a confusing factor for a new investment method to establish itself into market. This also makes the regulation bit weak, as it is not tailored to suit crowdfunding and national legislation

[88] Macchiavello, E., 2017. Financial-return crowdfunding and regulatory approaches in the shadow banking, fintech and collaborative finance era. *European Company and Financial Law Review*, *14*(4), pp.662-722.
[89] Macchiavello, E., 2017. *Supra nota p. 665*

can fulfill some gaps between the EU level and national level. KYC regulation is not applied, which makes crowdfunding regulation weak when thinking about AML and other financial crime prevention practices. ESMAs opinion is well composed from other directives from applicable parts, but still lacks the characteristic of crowdfunding.

The aim here is after all giving access to the capital for the companies but ensuring enough compliance for investor protection and financial market protection against possible money laundering. New innovations bring new challenges. As mentioned, crowdfunding will fill in a gap for certain needs in financial markets, but this gap can also be very vulnerable for fraudulent use.[90]

4. Crowdfunding regulation 2020/1503

4.1. Crowdfunding platforms

This new regulation defines platforms role in crowdfunding process, as before they were just intermediare and propably producing the whole campaing for the projects as a one time event. Now the regulation gives a clear framework for the platforms to act as neutral intermediare and have responsibility over the project they have had. This also includes arraging a after market for the campaigns the platform has had previously. Platforms are not permitted to route investors to another platform and earning a commission from this.

New regulation provides the opportunity for cross-border action by a cross-border provision.[91] This can benefit the projects as the platform can advertise the project in other MS too and the legal framework is more tempting to the investor, as there is an EU level regulation for cross-border crowdfunding. Operating in national level has seem to be most chosen form of the platforms, this can also derive from the certain fact that the projects can be small and local, so the project might not be so interesting internationally, but for CMU purposes this will help crowdfunding to establish

[90] Hornuf, L. and Schwienbacher, A., 2017. Should securities regulation promote equity crowdfunding?. *Small Business Economics*, *49*(3), pp.579-593.
[91] Crowdfunding Regulation 2020/1503 Art. 18

a solid position in alternative finance markets. When the platform want to offer a project in other MS too, they must contact local supervising authority and provide information regarding the project. Article 18 paragraph 1 lists the needed information, which includes the countries, identity both the platform and person responsible for the project, starting date

4.2 Framework for infrastructure

Art. 4 of the regulation states that the platform shall establish a management body, that oversee operations of the platform. Later in the directive is stated that platform shall have a process for handling complaints.[92] Article 4 do not specify the operations under the management, but after reading the regulation further, it might operate in a similar manner than FIs back office and compliance operations. Quite often back-office operations manage also reporting to authorities, custodian services, settlements and organise the manual part of IPOs, which is in this relation the crowdfunding.

Custodian services are allowed, and applicable legislation is defined. Platform can also use a third party for safekeeping the assets. Assets or transferable securities can be physically delivered to custodian which can be a third party, as the platforms can operate fully digitally without having a suitable physical office with a safekeep for the assets. In Art. 10, where the safekeeping is introduced, also mentions applicable law in paragraph 1. (a) which can be interpret for providing framework for international application if the platform operates in other MS too and paragraph 1. (b) provides right to use a third party also for custodian or safekeeping the assets. This could help the platforms establishing a one custodian service in one MS, if they have operations in multiple MS or just buying the custodian service from some other service provider for example in all the countries they operate.

Crowdfunding platforms are eligible custodians, if they are a registered custodian by MiFID II and Capital Requirements Directive 2013/36/EU. Platforms can also comply with PSD2 if they are collecting the assets from crowd themselves and delivering to project, for this process a third-party service provider can also be used. Outsourcing is defined it Art. 9 of regulation, which also states that the platform is responsible for ensuring that the third-party provider is fully compliant with the outsourced activities.

[92] Art. 7 Crowdfunding regulation 2020/1503

4.3. Crowdfunding portfolios – investment funds or securities portfolio?

Some platforms enables a investor to invest multiple crowdfunding projects simultaneusly and therefore an investor can collect a portfolio through a platform. This process can be enabled by AI run algorithm that allocates the invested sum into different projects or there can be recommendations for the investor to choose the projects virtually by algorithm and no human interaction is needed.[93] This is called auto-investing and by the regulation it is now considered as individual portfolio management of loans.[94] Article 6 is dedicated to define these actions and how the platform must organise this service. It id divided into two categories; an individual portfolio management of loans and contingecy fund, which could be very similar with a investment fund, but this is just for crowdfunding projects and it is run by the platform, and the idea of this contingency fund is not to be an investment fund rather than a safety measure for the clients under individual portfolio management. The fund is established as a fallback and there is no certainty that there will be any pay outs for the investors. This contingency fund can be used when allocating investors funds into different crowdfunding loans or just ensuring a risk allocation for the investors. Making a payment into the fund is optional for the investors. Regulation do not offer any technical solutions for that and ESMA will publish a more detail technical solution paper about organising and operating the fund.

As the name of the individual portfolio of loans suggest, this version is made for a single investor even though some other investor can have the same portfolio. Credit risk must be assessed with every loan chosen to the portfolio and maturity information related to the loans must be given. Service provider must offer up to date information related to investors portfolio including a list of loans with weighted average annual interest on loans, allocation data and repayment schedule with interest payment schedule.

4.4. Investors – Sophisticated or not?

Equity based investment platforms must recognize their customers and rate them if they are sophisticated investor or non- sophisticated. Latter is considered not to be a professional and needs more information about the investment they are about to make and if they understand the risks and

[93] Lin, T.C., 2019. Artificial Intelligence, Finance, and the Law. *Fordham L. Rev.*, *88*, p.531.
[94] Recital 20 on Regulation (EU) 2020/1503

other aspects when doing an alternative investment, which is not traditional investment fund or a security. As MiFID II requires FIs to categorise their clients as retail clients or professional clients, crowdfunding uses terms sophisticated investor and non-sophisticated investor.[95] As recital 42. establish, MiFID II is still applied to distinct investors nature and it will be assessed every two years. By defining this in the regulation, platforms have responsibility to identify the investors as sophisticated or not, which means that they also must tell more about their possible investment history. Annex II defines the criteria even more and for example a natural person can be defined as a sophisticated investor if he or she works in a professional position in financial sector or has income of 60 000 eur in a fiscal year or has a portfolio that exceeds in euros 100 000.

4.5. Investor protection

Chapter IV is dedicated to investor protection which defines for example KIIS very in detail for enhancing the communication between the platform and investor. Notable is that platforms are now held accountable for possible misinformation or lack of information in the KIIS and not complying the regulation with lacked information related to the project, can lead to cancelling the project totally. Platforms are guided to inform the investors promptly and the project shall be suspended until the KIIS is updated, if this do not happen during 30 calendar days after the error was found, the project will be cancelled.[96] This article also points out the responsibility of the platform – KIIS must be provided for every project and in language, that is used in the MS where the project shall be held.[97] Investor has a right to request it in another language, but if it not possible for the platform, they must guide the investor to refrain from this certain project.[98] Content of KIIS is clarified more in Annex I and for example there must be information regarding the target capital, what if the target capital is not reached and what an investor gets for the invested amount, for example how many shares of the company etc.

Same investor can also participate other projects through another platforms, so this is taken into consideration by guiding the investors not to invest over 10% of their assets to crowdfunding due the risk nature. This guide text will be in KIIS:

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[95] Recital 44 in Crowdfunding Regulation 2020/1503
[96] Art. 23, para 12
[97] Art. 23, para 2
[98] Art. 23, para 12

"Investment in this crowdfunding project entails risks, including the risk of partial or entire loss of the money invested. Your investment is not covered by the deposit guarantee schemes established in accordance with Directive 2014/49/EU of the European Parliament and of the Council. Nor is your investment covered by the investor compensation schemes established in accordance with Directive 97/9/EC of the European Parliament and of the Council.

You may not receive any return on your investment.

This is not a savings product and we advise you not to invest more than 10 % of your net worth in crowdfunding projects.

You may not be able to sell the investment instruments when you wish. If you are able to sell them, you may nonetheless incur losses."[99]

4.6. Know Your Client and Client Due Diligence

Whilst recitals of the regulation are not applicable legislation itself, recitals will provide information how to interpret some parts of the regulation. Regulation text do not itself include a clear Article about AML or other measures to prevent money laundering or financial risk. Most importantly there is provisions about liabilities and supervision of the platforms, which is one version of AML procedure to define liabilities and competent authorities' scope and exercise or supervisory powers. Recital 32 contains most relative information regarding KYC and the clause states that AML4 and national legislation must be followed. From KYC point of view, the regulation does not bring anything new into consideration. After all, KYC is not a one single directive rather than a line of regulations and directives in financial regulation that has been shaped in operations the KYC process we now know.

Crowdfunding regulation amends from AML4[100] for CDD for project owners, but in this regulation it means that all crowdfunding campaigns must undergo at least a minimum level of DD process before accepting their project, which is established in the regulation. Project owners with criminal record will have hard time finding a suitable platform, as the regulation indicates that part of the CDD process is to clarify that the project owner does not have criminal records relating to financial law and commercial law. Minimum level of DD is defined to obtaining information related to

[99] Art. 23 para 6.(c) Crowdfunding Regulation 2020/1503
[100] Recital 32 Crowdfunding Regulation 2020/1503

project owners possible criminal past This article does not fully exclude convicted criminals to establish a crowdfunding project.[101]

4.7. How well the regulation fills the needs?

Content in this regulation is very straight forward, as the regulation reflects a lot of the earlier ESMAs opinion in content and applicability. Most importantly crowdfunding platforms obligations and liabilities are now more clear, but AML and KYC aspect is not enhanced a lot more than before. This can be explained by the nature of financial regulation, which tends to be multilateral and formed through many regulations and directives. There is not a one directive that could explain it all and like in this regulation, there is a lot of cross referencing between different legal writings which is important to remember. Even though this regulation is composed to suit crowdfunding and includes the parts that was earlier missing, for example about liabilities of the platform, existing financial regulation is still applicable from those parts it is needed.

This regulation gives a clear framework for crowdfunding platforms to operate and establish their business in EU, which fulfils also the ideology of CMU and Fintech Action Plan.

[101] Art. 5 Crowdfunding Regulation 2020/1503

CONCLUSION

Most of the topics around crowdfunding revolves around need for comprehensive and suitable regulation, accessibility, fintech and how to make this palette work in a way, that investing is safe for all parties and how to achieve a established position in financial markets as a new investing method. Infrastructure for crowdfunding is different when comparing with traditional FIs so the harmonised EU wide regulation has a good effect when establishing crowdfunding projects that are open for investors in all EU member states.

Progress of regulating crowdfunding has been steadily going forward for a decade and new regulation has very well answered for those parts which lacked regulation before, most of the loopholes has been fullfilled which is in line with CMU and FinTech action plan. This will make EU more attractive for investors and SMEs to seek funding through current platforms. Also, the aim for EU wide KYC database with blockchain seems to have a good support at least from FinTech side of the market.[102] Current aims with harmonized legislation and CMU along with technology could make it work very well. EU has proposed new regulation for using artificial intelligence and it might have affection to blockchain run database too, but the idea sounds good for all the actors in the field. Now KYC and other client data is handled entirely inside the company that uses the data, so this rises new questions how the infrastructure will be provided and by who? Will the current data ne transferred at some point for EU wide use or not? EU wide KYC database would benefit a lot when recognising politically exposed persons in transnational investments.

As the new regulation answers very well all those lingering questions had in previous parts of this thesis. It is very well composed to answer to those questions that have been open or there has been room for different interpretations. As KYC is left to rely on the AML4 and other existing regulation, crowdfunding can in future apply possible EU wide KYC database better if it will be established. By combining Whistleblower directive and Prospectus regulation into this, it is comprehensive and has the same impact as MiFID II has – making the market more transparent and offering a clear framework for crowdfunding to reach its full potential.

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[102] Norvill, R., Steichen, M., Shbair, W.M. and State, R., 2019, May. Blockchain for the Simplification and Automation of KYC Result Sharing. In *2019 IEEE International Conference on Blockchain and Cryptocurrency (ICBC)* (pp. 9-10). IEEE.

I read a lot of different research articles about crowdfunding and there was a clear void about the infrastructure, for example custodian processes. When the custodian part was issued in the regulation, defining the process for the platforms itself will help in future the investors with their investment in equity based crowdfunding. When other tradeable securities has this operation very well integrated in all FIs, for smaller and newer platforms this is a aspect that might cause physical challenges if the platform operates fully online. In real life it can mean that they must acquire a physical safe where to keep their clients securities, so mentioning the third-party possibility and even pointing it out that the platform might need to guide the investors for safekeeping, is a great thing for investor protection and for the investors to understand the process. I see a risk here when someone enter first time into crowdfunding investment platform and is so used to the existing infrastructure of FIs that the reality with finding a suitable custodian makes the equity based crowdfunding method too heavy for a single investor to organise so the crowdfunsing market can lack of investors due that.

New regulation derives from already existing legislation and do not offer anything new related to KYC regulation, but defines the minimal CDD process for the platforms. This will harmonise corwdfunding platforms operations and give to investors a minimul level of CDD and also therefore create possibilities to platforms to conduct even further CDD processes. After all, in financial regulation the FIs and other operationers in the field tend to enhance the processes itself which leads so called self-regulation and in some situations in future to well suiting legislation. Good legislation is cooperation between the service providers and legislators, and this is just the start for crowdfunding regulation. As in the Regulation is stated, that during the first two years ESMA shall collect information about KIIS and investors and their investment for futher knowledge. This period will tell us more about how the regulation has worked and how to delevop it further. Discussion between the platforms and authorities is important when enabling new regulation. Financial regulation develops in very fast pace and in last decade the development has been very fast due the technological development and adopting new ways of offering financial services. People are more connected than ever before and information is available around the day, which means also that active traders and investors can access to world wide markets more efficiently than ever before just with a smartphone.

Ater all crowdfunding is part of the so called FinTech revolution and the applicability of new technologicla innovations might be applicable easily in the crowdfunding field, as it operates almost fully digital , the regulation answers well to the lack of certain regulation but leaves room for apply for example EU wide Regtech in future.

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