

PRESS RELEASE

CySEC finalises the investment-based crowdfunding rules

NICOSIA, 15 January 2020 - The Cyprus Securities and Exchange Commission ("**CySEC**") has issued a Policy Statement to outline its finalised rules for investment-based crowdfunding.

Crowdfunding can serve as an alternative method to bank financing, through which small and medium enterprises ("**SMEs**") can access financing inter alia through the issuance of transferable securities (typically shares or debt instruments). Investors can access these investment opportunities through an internet-based electronic information system, or a platform, whereby the crowdfunding service provider matches SMEs seeking financing with the interests of those funding investors. In return for financing a business interest, a potential economic return is generated.

CySEC issued a Consultation Paper on 15 November 2019 that proposed the introduction of a set of complementary rules, carving Investment Based Crowdfunding into the Investment Services and Activities and Regulated Markets Law, transposing MiFID II (**the "Law"**).

Based on the feedback received, CySEC has finalised the aforesaid rules, which will be issued by means of a Directive (**the "Crowdfunding Directive"**). The Crowdfunding Directive is due to be published in full in the Cyprus government gazette.

CySEC's Crowdfunding Directive relates solely to investment-based crowdfunding through transferable securities and excludes loan-based, reward-based and donation-based crowdfunding.

The Crowdfunding Directive comprises a set of secondary rules for investment-based crowdfunding under the Law. The Crowdfunding Directive prescribed under the Law is therefore complementary to MiFID II's obligations, including but not limited to: conduct of business rules; management of conflict of interests; holding clients' money and financial instruments and product governance.

In offering cross-border transferable securities via investment-based crowdfunding, crowdfunding service providers and their platforms will be subject to prospectus thresholds governing the marketing, sale and distribution of securities across the European Union.

The Cyprus Investment Firms ("**CIFs**") acting as Crowdfunding Service providers will be subject to additional provisions aiming at ensuring investor protection.

These provisions include:

- **Conflicts of interest:** (i) CIFs will be subject to neutral intermediation¹ through licensing and activities restrictions, thereby ensuring, amongst other things, that the fees paid by the project owner to the CIF are not linked to order routing; (ii) CIFs will not be allowed to receive order routing benefits in respect of crowdfunding projects in general, i.e. both on its own or other platforms; and, (iii) CIFs will not be allowed to acquire (equity or debt as the case may be) participation in crowdfunding projects on a platform or allow certain categories of persons (**defined herein as “involved persons”**) to act as project owners;
- **Customer due diligence:** Additional customer and financial due diligence in respect of both the crowdfunding project (including credit risk) as well as the project owner, must be implemented before a project can be listed on a platform. Identity verification and anti-money laundering checks must be performed on both the end-investor and project owner;
- **Transparency obligations:** Project owners must produce a standardised pre-contractual document (under the responsibility of the project owner), including the natural persons effectively conducting the project owner’s business. This must be detailed in a Key Investment Information Sheet (**“KIIS”**). Certain procedures are in place to ensure that the content of KIIS is up to date and for rectifying errors or omissions. CIFs acting as Crowdfunding Service Providers must ensure that the content of KIIS is clear, complete and accurate before accepting a project on their platform. Marketing communications must be clear, accurate and not misleading, and consistent with the content of marketing communications and the KIIS.
- **Safeguarding clients’ funds and financial instruments:** All monies raised via the crowdfunding platform must be transferred by the CIF to the project owner only after the successful closing of the relevant offer (i.e. only if it meets or exceeds the funding goal). Financial instruments (i.e. transferable securities). This is subject to safekeeping, and must be divided into custodial and non-custodial transferable securities. CIFs acting as Crowdfunding Service Providers shall release the funds to the Project Owner only where the TS have been physically delivered or where sufficient evidence is provided by the Project Owner to the CIF that the ownership of the TSs has been transferred to the respective investors, in line with their contributions.
- **Exit opportunities:** CIFs which are Crowdfunding Service Providers may operate a bulletin board through which crowdfunding clients of the CIF may advertise their interest to buy or sell (as the case may be) transferable securities that had been made available through the CIF’s platform, thus providing exit opportunities for the end-investor.

The bulletin board may be designed to allow investors to contact with each other, with a view to transact, but it should not be designed in a way that renders it a trading system.

¹ This means the CIF classified as a Crowdfunding Service Provider does not become party to the transaction and does not participate in the execution of an order on behalf of an investor, but they are merely arranging the relevant transaction by bringing together the investor and project owner who is seeking funding – in a fair, transparent and not misleading manner.

The bulletin board should be understood as a place where investors are allowed to merely exchange information about buying and selling interests. It should not facilitate matching of orders and/or concluding of contracts. For clarity, a bulletin board allowing the publication of binding prices on it effectively operates as a trading venue, rather than merely as a point of information exchange about buying and selling interests. Only a CIF that has been properly authorised for the operation of a Trading Venue can operate in this fashion.

As a key pillar of the European Union's Capital Markets Union, the European Commission's proposal for an EU Bespoke Crowdfunding Framework (**the 'Framework'**) is currently subject to an ongoing legislative process. CySEC's Crowdfunding Directive has taken into consideration the content of the proposal should it come into force at a later date, without prejudice to the overall investor protection offered by the MiFID II regime. This is designed to facilitate a smooth legislative transition at the appropriate time.

CySEC expects its initiative to alleviate some, but not all, of the risks involved in investment-based crowdfunding. The aim is to create a regulatory framework that improves and enhances investor protection. To this end, investors should understand the high risks entailed before proceeding with any investment-based crowdfunding investment, even where bespoke rules are in force. In the interest of transparency, CySEC perceives these risks to inter alia include:

- The high likelihood of investors losing their entire invested amount, primarily because the means of alternative financing is most common in support for start-up businesses where the risk of corporate failure is high;
- Dividend or coupon payments are not only subject to a successful trajectory of the project in question, but also to a decision to pay such dividends, by the project owner;
- Startups may proceed with several rounds of share issuance, which in effect may result in diluting the value of the initial investment;
- The exit opportunities (i.e. cashing in) might be severely constrained as a result;
- The possibility of fraud cannot be ruled out.

CySEC's ongoing review:

CySEC will commence to evaluate applications from existing or prospective CIFs in relation to Crowdfunding services from February 2020. In line with its policy-making process, CySEC will analyse the market practices and will assess the effectiveness of existing rules and, where necessary, may issue guidance for the compliance of supervised entities with the regulatory framework and/or amendment of the existing rules accordingly. This is designed to provide an effective, proportionate and evolving framework that captures the industry's pace of change and ensures investor protection is not compromised.

ENDS.