

Legal Background of Debt-based Crowdfunding, Special Aspects of Client Information and Contracts

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CAPSTONE PROJECT SUMMARY

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1. Introduction – shortcomings in the regulatory background of crowdfunding

Technological innovation companies, start-ups and other non-listed SMEs have more limited or expensive or cumbersome funding opportunities and are much more vulnerable to the economic downturn (caused by coronavirus pandemic) than other market players.

The importance of the internet-based crowdfunding has increased significantly in the last 15 years and thus can be a viable option for these companies. The legal background of crowdfunding has been settled in the European Union by the Regulation (EU) 2020/1503 of the European Parliament and the Council of 7 October 2020 on European crowdfunding service providers for business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937 (ESCPR), but until now no specific regulation on crowdfunding has been developed in the Hungarian legal system.

2. The objectives and results of the project

a. Overview of the legal background

The ESCPR Regulation shall be binding in its entirety and directly applicable in all Member States of the European Union. At the same time, the different types of crowdfunding are very similar to the current nationally regulated financial activities. Debt-based crowdfunding involves the financing (lending and borrowing) of natural and legal persons and the transfer of money, which correspond to a variety of activities regulated by the Hungarian legal framework and can only be carried out with the permission of the central bank of Hungary (MNB) or on the basis of its notifications.

One of the objectives of the project is to highlight the Hungarian regulations that are relevant for debt-based crowdfunding activities vis-à-vis the ESCPR regulation. To analyze the relevant legal background first, we must define the possible structure and the related infrastructure through which the lending and borrowing activity can be organized.

The practice and solutions of international (US based and European) crowdfunding companies are also examined in the framework of the project. For loan placement the examined companies use an intermediate organization that is a commercial bank (as an issuing bank of the loans) or a payment service provider. Loans are invested through different channels: interpersonal lending; public offering of securitized, company member payment dependent notes; private placements to accredited investors and qualified purchasers of certificates; limited partnership interests in debt investment funds managed by an asset management company (Certificate program transactions and asset-backed securitization transactions); or loan sales to unrelated third-party institutions.

Depending on the lending and investment solutions and the connected activities, based on the resolutions of MNB, the debt-based crowdfunding activities are regulated by the CIA¹, CMA², IFA³ and CITA⁴.

b. Special aspects of client information

The other objective of the project was to identify what information the crowdfunding company must provide for investors and in which phase of financing. ESCPR imposes information obligation in several areas and in case of the ‘Key investment information sheet’ it defines certain specific obligatory sample texts. However, the Hungarian national regulation – especially the CIA –also defines several obligations regarding the content and scope of investor information. Besides that, I examined the guidelines of the European Securities and Markets Authority on marketing communications connected to other regulations.

¹ Act CCXXXVII of 2013 on Credit Institutions and Financial Enterprises

² Act CXX of 2001 on the Capital Market

³ Act CXXXVIII of 2007 on Investment Firms and Commodity Dealers, and on the Regulation Governing their Activities

⁴ Act XVI of 2014 on Collective Investment Trust and Their Managers, and on the Amendment of Financial Regulations

c. Special aspects of contracts

The third objective of the project was to outline the structure of the contracts signed by the project owners and the investors. To accomplish this task, I relied on the contracting practices of international companies.

3. Benefits to the client

The client is planning to implement a debt-based crowdfunding product on the market in the near future. In this context they want to identify those legal pitfalls that they need to pay particular attention in connection with the authorization of their debt-based crowdfunding activity, launching of their campaign, informing their investors, and contracting with their clients.

4. Key outcomes

To fulfil the first objective, I have examined in detail which elements of the Hungarian legal regulation must be considered when designing debt-based crowdfunding activities. Those activities and topics were highlighted when the ESCPR regulation must be applied in parallel with the Hungarian legislation.

For the second objective I listed those activities, incidences and themes about which the clients – especially the lenders – should be informed during a debt-based crowdfunding campaign, also highlighting the differences to an equity-based crowdfunding campaign.

For the third objective I compiled the framework of the client contracts, indicating the necessary content of the provisions for each topic.

5. Learning experience and lessons learnt

Crowdfunding as a financing opportunity – compared to the “classical financing” provided by banks – was an unknown topic to me previously. Beyond gaining insight into the subject, the most significant lesson for me was to realize how flexible and simple financial and investment services can be made through innovation and careful reconsideration of processes.