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Regulation of Crowdlending: The Case of Switzerland

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The increasing interdependence of firms and individuals throughout the world facilitates the development of the crowdlending market. Crowdlending is an emerging source of financing involving open calls to the public, generally via internet, to finance with loans individuals or companies (Meyer, 2007). The major role of crowdlending activities has been to bring new energy to a global economy that is unable to catch its breath following the recent financial crises (Berger, 2009).
North America leads the world in crowdlending volumes, representing 58% of the world's market. But the global strong growth is due, in part, to the rise of Asia as a major crowdlending player with 21% of the world's market, putting the region slightly ahead of Europe (Pignon. 2015).
As of today, Switzerland has not adopted specific regulation governing the practice of crowdlending, but the regulator has issued a fact sheet on this topic, informing the stakeholders of the crowdlending industry that some of their activities may be subject to banking regulation (Dietrich, 2015).
In this context, this article get a general overview of the regulations adopted abroad, in particular in the USA and in the European Union, where countries such as the UK or France chose to adopt a more detailed regulation, some with financial limits applicable to crowdlending campaigns or with specific requirements regarding who would be authorized to invest in crowdlending campaigns or soft regulation in the form of Best Practices.

INTRODUCTION

Crowdlending is not a new phenomenon in Switzerland. The first crowdlending platform based in Switzerland appeared as early as 2008, but recent numbers tend to show that this alternative finance solution gained importance mainly in the past three years (Pignon, 2015). As the practice of crowdlending developed in Switzerland and more and more platforms emerged, the question of the regulatory framework applicable to this new source of financing drew the attention of politicians and supervisory authorities (Derder, 2014). Following the path of other countries that adopted in the past years tailor-made regulations to address the specificities of crowdlending, Switzerland contemplates adopting certain statutory provisions applicable to crowdlending, in the course of a complete overhaul of the Swiss financial regulations.

Crowdlending can be defined as a form of community financing made in the form of loans from the lenders: the platform operator connects companies or individuals wishing to borrow funds to third parties, which are neither banks, nor financial intermediaries (Schneuwly, 2014). In this kind of crowdfunding campaigns, the borrower is often willing to raise funds quickly, and without having to first provide heavy warranties that would likely be requested by a bank, and the lenders will usually be rewarded by a reimbursement of their investment plus applicable interests.

From a contractual viewpoint, the relationship between the borrower and the lender can be considered as a loan agreement. In some circumstances however, such contractual relationship can further be characterized as consumer credit. Such characterization may trigger regulatory obligations for the lender.

Furthermore, the platform often plays an active role, managing the loan and its reimbursement and thus handling funds on behalf of the other parties (Pignon, 2015) which may trigger the application of financial regulations.

Before analysing the current regulatory framework and the scope of the contemplated new regulation, we will start by giving a brief overview of the notion of crowdlending and of the regulation issues. We will then proceed to a short comparative review of the regulations that have already been adopted in other countries on that matter. We will conclude with some thoughts on other possible future evolutions of the Swiss regulation framework of crowdlending.

REGULATION OF CROWDLENDING IN SWITZERLAND

The current Swiss regulatory framework for financial activities does not contain any specific rules regarding crowdlending activities. The regulatory status of the platform operator, the borrower and the lender, must therefore be assessed under the ordinary rules governing the provision of financial services in Switzerland (Essebier, 2015). As will be shown below, comparatively small changes to a crowdfunding scheme can trigger major implications from a regulatory perspective.

Firstly, crowdlending platforms that offer lenders the possibility to allocate funds directly to borrowers are not subject to licensing requirements under Swiss rules. Under this set-up, the funds are made available by the lender directly to the borrower, without such funds being channeled through the platform. The same conclusion also applies when the funds are channeled through a third party who is independent of the borrowers, platform operator or lenders (Essebier, 2015).

The regulatory situation is different when the funds made available by the lenders are booked on the accounts of the platform operator, before being made available to the borrowers. From a Swiss banking regulatory perspective, the key is to determine whether these funds are to be characterized as deposits from the public, which may only be taken on by entities benefiting from a banking license. If the platform operator accepts the funds from the lenders and immediately transfers the same to the borrowers, the acceptance of the funds cannot be characterized as a deposit, as the funds are not held by the platform, but being passed on to the borrower. In turn, the longer the holding period at the platform, the higher the likelihood that the funds are characterized as deposits. According to FINMA's current practice, a holding period in excess of three days may trigger a requirement to apply for a banking licence (Essebier, 2015). The requirements to obtain a bank license are high, in particular in terms of capital adequacy and internal organization. It is unlikely that platform operators can obtain such a license whilst still maintaining sustainable business activities. Accordingly, it is critical to structure the platform operator in such a way that it does not fall within the ambit of banking regulations. The possibility of *pooling* the contributions at the level of the platform before the funds are passed on to the borrowers is significantly restricted by this *short-holding-period* rule. As an alternative, platform operators may obtain funding commitments from the lenders, which are only drawn upon once a certain level of committed funding is reached or cooperate with a regulated bank.

In addition, each time the platform operator has the power to allocate the funds made available to it by the lenders, the platform operator is likely to be characterized as a financial intermediary within the meaning of the Swiss Anti-Money Laundering Act. Such legal characterization means that the relevant entity must register with, and is subject to, the supervision of a self-regulated body recognized by FINMA. Where a financial intermediary is not affiliated to any self-regulated recognized body, it will be directly supervised by the FINMA. The duties imposed on the financial intermediary are essentially Know Your Customer (KYC) rules and procedures, as well as certain organizational requirements. In addition to these KYC rules and procedures, financial intermediaries must also comply with the duties to report and to block assets in the event they have knowledge or suspicion of criminal activity. The reporting duty presupposes that the financial intermediary is aware of or has reasonable suspicion as regards the criminal origin of the assets involved. A financial intermediary may incur a criminal liability should it fail to comply with these duties.

Current regulatory status of the borrowers

Borrowers may also fall within the ambit of the Swiss Banking Act. Indeed, the receipt of deposits from the public on a professional basis is characterized as a banking activity in Switzerland. Conversely, the Swiss regulatory framework for banking activities is not triggered, at the level of the borrower, if one of these two cumulative requirements is not met:

- *Not a deposit from the public*: As far as crowdlending is concerned, one of the relevant exceptions is set forth in Article 5 (3) (b) of the Swiss Banking Ordinance, pursuant to which standardized notes in respect of which a prospectus meeting the requirements of Article 1156 SCO has been issued are not characterized as *deposits* under banking regulations. The issuance of a prospectus is therefore an avenue to avoid being subject to the Swiss banking legislation. The preparation of such prospectus, however, triggers significant costs. In addition, every person involved in the preparation of the prospectus is subject to a prospectus liability.
- *Not performed on a professional basis*: Another exception available in the context of crowdlending is set forth in Article 6 of the Swiss Banking Ordinance. Pursuant to this provision, an activity is deemed made on a *professional* basis, and thus subject to the regulatory requirements only if it involves the acceptance of more than 20 deposits. As a result, certain borrowers have elected to restrict the number of lenders to a figure which is below 20, so as to attempt to fall within the ambit of this regulatory safe harbor. This however negates the purpose of a crowdlending scheme, which is aimed at a large number of investors (Essebier, 2015). Furthermore, any public solicitation for deposits is considered to be a banking activity.

To the extent crowdlending platforms, by their nature, aim at a large public, a limitation to 20 lenders is only an imperfect response to this regulatory risk.

Current regulatory status of the lenders

The lenders act as mere investors. They should therefore not be subject to regulatory constraints in Switzerland in their capacity as investors.

That being said, the loans granted to borrowers in the context of a crowdlending platform could possibly be characterized as consumer loans within the meaning of the Swiss Consumer Credit Act (Essebier, 2015). This applies only in instances where the loans sourced through a crowdlending platform are used by the debtors for private purposes. The grant of consumer credits (Essebier, 2015) on a professional basis is subject to an authorization requirement (Essebier, 2015). The characterization of the investor as a creditor of a consumer loan will generally hinge upon the question as to whether or not the creditor is acting in a professional capacity. Acting in a professional capacity is not defined in Swiss law. It is however accepted that a part-time activity can be made in a professional capacity (Essebier, 2015). To the extent the cantonal authorities are in charge of the enforcement of the Swiss Consumer Credit Act, there is a risk that a person, whoextends funds on a regular basis on crowdlending platforms, falls within the framework of the Swiss Consumer Credit Act. This risk is however only of relevance if, as indicated above, the financed project is of a private nature.

WHAT WILL CHANGE FOR CROWDLENDING IN SWITZERLAND?

On November 4, 2015, the Swiss Government published the draft Swiss Federal Financial Services Act (the "*Draft FinSA*") and the Swiss Federal Financial Institutions Act (the "*Draft FinIA*"). One of the aims of the Draft FinSA is to facilitate the emergence of crowdfunding activities in Switzerland. The Draft FinSA proposes to deal with this topic from the perspective of the prospectus requirement. Indeed, the preparation of a prospectus constitutes a prerequisite to benefit from the carve-out as regards the regulatory definition of banking activities.

The prospectus requirement, which is currently in force in Switzerland has a limited scope. Under the new regulatory regime proposed in the draft Draft FinSA, one would have to distinguish between the prospectus and the basic information sheet. The proposed new rules can be summarized as follows:

- *Prospectus*: A prospectus requirement applies for all securities offered in or from Switzerland. The term securities comprises in particular standardized certificates which are suitable for mass trading, rights not represented by a certificate but with similar functions and derivative instruments. The proposed prospectus requirement is substantially in line with the EU Prospectus Directive (2003/71/CE). An alleviated prospectus requirement would apply to small and medium enterprises.
- *Basic information sheet*: The requirement to prepare a basic information sheet applies to all financial instruments offered in or from Switzerland to private clients. The term financial instruments comprises in particular equity and debt instruments, units in collective investment schemes, derivative instruments and structured products. The basic information sheet is to be presented in a uniform manner irrespective of the type of financial instrument and is to set out the key information on the financial product: the type and characteristics of the financial instrument, as well as its risk profile, its expected return and its costs. The purpose of the basic information sheet is to allow clients to compare various financial instruments.

Notes issued in the context of a crowdlending scheme would fall within the definition of securities and of financial instruments (Article 3 (c) Draft FinSA). That being said, the Draft FinSA provides exemptions from the prospectus requirement, for example when the financing does not exceed CHF 100'000 over a 12-month period (Article 38 (1) (e) Draft FinSA) or when the issuance of securities is made for a non-commercial purpose (Article 39 (i) Draft FinSA). In turn, a basic information sheet would need to be prepared in every event.

The preparation of a prospectus or a basic information sheet would have an impact on the characterization of the relevant set-up under the Swiss Banking Act.

As long as a prospectus or a basic information sheet is provided, the relevant financial instrument would not be deemed a deposit within the meaning of the Swiss Banking Act.

Accordingly, the borrower who prepares a basic information sheet would fall outside of the scope of the Swiss banking regulations, even if the exemptions from the prospectus requirement apply. Likewise, the platform operator should also benefit from increased flexibility as regards the holding of the funds contributed by the lenders, to the extent the entire process no longer involves deposits from the public.

In short, the alleviation of the regulatory requirements set forth in the Draft FinSA/FinIA hinges upon the requirement to prepare a basic information sheet, which, in turn, mitigates the risk that the crowdlending contributions be characterized as deposits from the public. The proposed new rules thus create the somewhat paradoxical situation in which a new regulatory requirement leads to an alleviation of another one.

Regulatory frameworks implemented outside of Switzerland

Certain jurisdictions outside of Switzerland have implemented a regulatory framework dedicated specifically to crowdfunding (Brüntje, 2015).

United States

In the U.S., the Crowdfunding Act entered into force in 2012, as a subcomponent of the JOBS Act, whose purpose is to facilitate the access of enterprises to the capital markets (Burkett, 2011). This act aims at facilitating the establishment of crowdfunding platforms and to provide for safety mechanisms for lenders. Pursuant to the Crowdfunding Act, platforms must register with the U.S. Securities and Exchange Commission as a broker or a funding platform. borrowers are subject to a financial limit of USD 1 million per year. No limits were put in place in relation to lenders. The limits do not apply once investors are able to demonstrate that they are experienced (Stemler, 2013).

United Kingdom

In the EU, the Commission has launched a study in 2015, "Crowdfunding: Mapping EU markets and events study" to gather and analyze data on crowdfunding markets across the EU as well as to analyze market trends. The latest version of this study has been published in November 2015. This study also sheds light on the attempts made in three EU member states to regulate crowdlending (De Buysere, 2012). Regulations on the European level, however, heavily limit mechanisms to promote offers and campaigns to a wide range of potential investors. In addition, company laws and banking and securities regulations hinder the emergence of an ecosystem with platforms that can offer the infrastructure for internet-based campaigns (Hooghiemstra, 2016).

The UK adopted in 2014, a new regulatory framework for crowdlending (regulation PS14/4). In becoming regulated, platforms have to comply with both the specific regulation and also broader considerations of becoming a firm regulated by the Financial Conduct Authority. The UK regulations have also implemented certain restrictions on investors entering into crowdlending transactions. For investors into securities, specific limits were put in place in relation to retail investors. These are only applicable until an investor has become experienced at making crowdfunding investments.

France

France adopted in 2014 a new crowdlending regulation (Blemus, 2015). Two new, optional, regulatory statuses were created, *conseiller en Investissement Participatif "CIP" and Intermédiaire en Financement Participatif "IFP"*.

Registration as a CIP requires platforms to satisfy a number of requirements. This includes adherence to a code of conduct and a restriction to focus on the issuance of ordinary shares and fixed rate bonds. The staged access rules require potential investors to first confirm their understanding of risks, and also tests them on their understanding of the risk profile of specific investments before they are made. While CIPs may provide some ancillary services, they may not receive funds from investors, nor receive securities from issuing companies.

Registration as an IFP also requires platforms to satisfy a range of criteria including good repute and professional skills. IFPs are able to crowdfund loans to both incorporated entities and individuals; however, for interest-bearing loans, only individuals are able to act as lenders. If IFPs wish to implement transfers of funds between lenders and borrowers, they also need to hold a license as a payment institution, under a simplified regime. Loans are restricted to a size of EUR 1 million.

CONCLUSIONS

As many anticipated, Switzerland followed the path of the United States and of European countries and is now considering taking the opportunity of a complete overhaul of its financial regulations to adopt specific rules aiming at crowdlending platforms. The adoption of a clear regulatory framework was indeed called for by many crowdlending professionals in Switzerland (Pignon, 2015), who deplored the lack of certainty of the current regime and lobbied in favour of a clear framework as a necessity to favour the development of crowdlending in Switzerland. Some authors however warn that overregulating or adopting regulation that does not take into account the specificities of crowdlending could backfire and result in stopping the current growth of crowdlending in Switzerland (Dietrich, 2015).

In its current form, the proposed regulation appears to mainly address the risk of uncertainty of application of the banking regulation, and to provide for a light regulatory framework while ensuring a minimum protection of the lenders by setting forth an obligation to provide minimum information on the loan (Lee, 2012). Contrary to some of its neighbours, Switzerland thus did not choose to adopt a detailed regulation, limiting access to confirmed professionals or setting financial thresholds to protect both borrowers and lenders.

Although these measures proposed to clarify the current regime and to provide for a light regulation can be saluted as a first step to find balance between the necessary flexibility of crowdlending and the protection of the interests of the borrowers and financers, one cannot help but note that the regulatory framework may not be the only hurdle, preventing crowdlending to develop in Switzerland.

So far, the Federal Council has rejected the possibility to adopt specific e-governance provisions in relation to crowdlending, and so, to address this lack of digital-friendly regulation, one measure that could be contemplated to facilitate such process could be for the concerned stakeholders to discuss and adopt some *Best Practices* on that matter to which the crowdlending platforms could adhere: it could provide for mandatory appointment of a representative for shareholders subscribing through crowdlending, mandatory provisions in the articles of association to allow for communication via email, or mandatory formation or explanations from the platform to ensure that the borrowers become familiar with the current legal environment. This would be a form of self-regulation which has a long and relatively successful tradition in the Swiss financial regulatory environment.

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