TWIST AND TURNS OF CROWDFUNDING REGULATION

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Abstract: *Crowdfunding has suddenly caught the attention of financial regulators in many jurisdictions. It appears the mark crowd funding is making in the financial services industry within many jurisdictions can no longer be ignored by regulators. Regulators role is to ensure that financial markets in their jurisdictions are fair, efficient and transparent. But most importantly the regulators must protect clients and investors against unscrupulous practices. The hype around crowd funding has really made many regulators to start digging deep into this financial product or services to see exactly what lies underneath. This paper zooms in on measures put in place by some jurisdictions to try and regulate crowd funding activities.*

INTRODUCTION

Crowdfunding has become a catchphrase for small and medium sized enterprises (SMEs) when it comes to raising capital for their businesses (Curry, 2015). Like any new financial products introduced into the market it is inevitable that some will be skeptical about it and some will see it as a holy grail for financing their business ventures (Young, 2013).

It is every regulator's apprehension that if a new product or service is introduced into the market to ensure that the interests of the clients and investors are well protected at all times (Cunningham, 2016). The questions that linger in the minds of many regulators in as far as crowd funding in concerned are, for example, how crowd funding should be regulated to protect the interests of investors, what systemic risks are being introduced by the product or service into the market, and how the risks can be mitigated, and so forth (Verdonik, 2016). All in all regulators try their best to be alive to all sorts of risks associated with the introduction of new financial products or services into their markets (Marboe, 2016).

Currently there is more than enough literature out there about the benefits and challenges of crowd funding available but not enough on how it should be regulated.

DEFINING CROWDFUNDING

Crowdfunding is simply defined as the use of small amounts of capital from a large number of individuals to finance a new business venture (Szycher, 2016).

The International Organisation of Securities Commissions (IOSCO)'s *Issues Report on Risks and Benefits of Financial Return Crowd funding,* defines 'crowd funding' as an umbrella term describing the use of small amounts of money, obtained from a large number of individuals or organizations, to fund a project, a business or personal loan, and other needs through an online web-based platform (IOSCO Issues Report on Risks and Benefits of Financial Return Crowdfunding, 2015).

Crowdfunding has its origins in the concept of crowdsourcing, which is the wider concept of individual realising a goal by receiving and leveraging small contributions from many parties (Szycher, 2016). Many communities have always engaged in crowdfunding activities even though they did not actually call it crowdfunding. In rural areas, for example, communities would donate some money to build a small bridge connecting villages, school, church or whatever the case may be is another form of crowdfunding. Who can ever forget the story about the crowdfunding of the Statute of Liberty by the American Committee of the Statute of Liberty for the shortfall of funds due to the fact the then Governor could not use city funds to bankroll the project (Djamchid, 2015). This is of course one of the well-known crowdfunded projects.

As mentioned before every society or community has in one way or the other being exposed to crowdfunding. It can therefore be argued that crowdfunding has been there since time immemorial and arguable will be there for a while whether regulated or not. Crowdfunding has evolved over time now with the advent of new technology and social media it has taken a different form (Vass, 2014). Those who are now engaging in crowdfunding activities routinely use well-known social media sites such as Facebook, Twitter, LinkedIn and others to raise capital for a particular course or business venture (Turban, 2015).

RISKS AND BENEFITS OF CROWDFUNDING

Crowdfunding today makes use of the easy accessibility of vast networks of friends, family and colleagues through social media websites like Facebook, Twitter and LinkedIn to get the word out about a new business and attract investors (Gunning, 2014). Crowd funding apparently has the potential to increase entrepreneurship by expanding the pool of investors from whom funds can be raised beyond the traditional circle of owners, relatives and venture capitalists (Community Leader, What is Crowdfunding, 2015).

The proponents of crowdfunding model also claim that its portals or platforms assist entrepreneurs to assess the market demand of their product, project or business venture (Adams, 2013). Some authors also argue that crowdfunding provides entrepreneurs with an opportunity to acquire funding for realising their new business ideas (Kemper, 2015).

Many of the crowdfunding platforms operate beyond their jurisdiction and thereby introducing cross border complexities (Weiner, 2014). These cross border complexities are not only limited to cross border enforcement but also broader legal implications. Some authors have singled out costs of capital as one of the challenges associated with crowdfunding model. For example, it is claimed that in Europe on average portals or platforms charge 10% from the capital raised and over and above this they also frequently charge for additional fees for due diligence of projects or insurance reducing uncertainty (Bruntje, 2015).

Data protection and technical problems associated with crowdfunding portals or platforms have also been identified as concerns rose by users or potential users (Damas, 2014).

TYPES OF CROWDFUNDING

Crowdfunding is an assorted group of schemes geared towards fundraising in an innovative way by entrepreneurs or perhaps even charities (Bruntjie, 2015). There are many types of crowdfunding and different jurisdictions choose to recognise certain types of crowdfunding. For example, in the United Kingdom (UK), the UK Crowdfunding Association officially recognizes donation, debt and equity crowdfunding types (Williams, 2014). The common types of crowdfunding that exists today include the following:

3.1 Equity Crowdfunding

Equity crowdfunding typically comes into play where crowd invests in a venture or project and in return it gets equity (Freedman et al., 2015). For many entrepreneurs, financing their business venture or project through the banks can be frustrating as banks will send them from pillar to post and even after then they will still not be guaranteed the necessary finance (New Approaches to SME and Entrepreneurship Financing Broadening the Range of Instruments: Broadening the Range of Instruments", OECD Publishing, 2015). Equity crowdfunding becomes the only best option for bankrolling their projects and investors are then rewarded with equity for placing their moneys into the project (Laemmermann, 2012). If the project succeeds the investors succeed too and the reverse is true too.

3.2 Debt Crowdfunding

Debt crowdfunding or peer-to-peer lending can come into play where, for example, an investor funds a project and when such a project succeeds he or she gets his or her money back with interest (Stephany, 2005). This kind of funding is highly preferred or sought by inventors and entrepreneurs who more often than not do not have the necessary securities, collaterals or guarantees that banks normally require before they can grant them a loan (Shi, 2015).

3.3 Donation Crowdfunding

Donation crowdfunding sometimes referred to as 'charity crowdfunding' normally comes into effect when members of the community fund a particular project that may have some significance to the community or society at large (Dresner, 2014). Donation crowdfunding can include courses such as paying for medical costs of a child whose parents cannot afford to pay for chemotherapy, building a monument to honor local heroes or even buying books or computers for a library, etc.

Donors, for example, do not expect any return but it makes them feel good that they have contributed to something significant in the community. In some jurisdictions they may use the fact that they donated something to the community for their tax deductions for tax return purposes (Howell, 2014).

REGULATION OF CROWDFUNDING IN DIFFERENT JURISDICTIONS

United States

According to report the large majority of crowdfunding platforms are found in the United States of America US and they include equity crowdfunding platforms (Lipman, 2016). Crowdfunding has received the attention from policymakers in the US with direct mention in the Jumpstart Our Business Startups (JOBS) Act; which was signed by President Obama into law on 05 April 2012. JOBS Act allows for a wider pool of small investors with fewer restrictions (Ennico, 2016). The US regulations have been set to combat the risks associated with crowdfunding and promote investor protection. Initially when JOBS Act was introduced the fear mongers were misinforming the public that the government was trying to stick its fingers in the crowdfunding pie. However, as we have learnt under JOBS Act anyone who wishes to start or grow a business is allowed to use the online equity crowdfunding platform to raise up to $1000, 000, 00 by selling stock in the company (Wales, 2014).

It has also been reported recently that in the US, for example, the Securities and Exchange Commission (SEC) has on 30 October 2015 adopted rules to allow companies to offer and sell securities through crowdfunding (The Securities and Exchange Commission adopts final rules on crowdfunding, 2015). According to SEC those rules would allow individuals to invest in securities based on crowdfunding transactions subject to certain limits (The Securities and Exchange Commission adopts final rules on crowdfunding, 2015). This is a step towards the right direction in that it provides clarity and certainty.

The New York Stock Exchange has gone so far as to list a few of the crowdfunding platforms on their exchange and by doing this creating a secondary market. The crowdfunding companies listed can also trade (Freedman, 2015).

Europe

Europe also has many crowdfunding platforms, but there is currently no European regulation in force aimed at crowdfunding at a European Union (EU) level yet (Boitan, 2016). Currently the regulators through the European Commission (EC) are looking into ways of regulating crowdfunding. It appears the key issues that the EC would be focusing on with regard to equity crowdfunding include anti-money laundering, advertising, consumer protection and where relevant intellectual property protection (Lloyd, 2017) .

It is, however, noteworthy that individual investments are required to be concluded in full compliance with anti-money laundering laws and the EU Markets in Financial Instruments Directive (MiFID) (Danmayr, 2013). This in a way dictates that platforms must ask the potential investor to provide information regarding their knowledge and experience in the investment field relevant to the specific type of service or product, and check if the investment profile matches the risk proclivity to risk investments, eventually warning the client in case of mismatch (Bottiglia, 2016).

As pointed out currently there is not EU regulation but just some patchwork of national legal frameworks. For example, in Italy the concept of equity crowdfunding is taken much more serious and if any platform wants to facilitate equity crowdfunding activities it has to apply for a licence and only once it has been awarded a licence can such platform become operational (Siclari, 2016). The Italian regulators also have very strict requirements that the platforms will have to adhere to before granting licenses. The licensed equity crowdfunding platforms are considered financial intermediaries. There is a set limit on amount of capital that can be raised by issuers per year through the crowdfunding platforms. The maximum amount that an issuer can raise through equity crowdfunding platforms is €5 million; however, there is no limit in the number of investors (Micic, 2015).

Singapore

Singapore, through its authorities the Monetary Authority of Singapore (MAS) has proposed measures to regulate equity crowdfunding also known as securities based crowdfunding (SFC)(Li, 2017). Currently in Singapore, any offer of securities is required to be made in or accompanied by a prospectus unless it qualifies for an exemption under (Part XIII of) the Securities and Futures Act (SFA) (Hu, 2016). Intermediaries that deal in securities, including an intermediary operating an SCF platform which facilitates offers of securities, are required to hold a Capital Markets Services (CMS) license under the SFA, unless exempted (Ying, 2015).

MAS have been studying how to facilitate SCF as it can potentially offer an alternative source of financing for start-ups and SMEs (Nicoletti, 2017). MAS is of the view that there are significant risks associated with SCF investments, which tend to have a high probability of capital loss and are more illiquid compared to traditional securities investment instruments (Djamchid, 2015). As a start, MAS will facilitate SCF offers to accredited investors and institutional investors through the following initiatives (Lin, 2017):

- MAS proposes to ease the current financial requirements for intermediaries that deal in securities, so long as they do not handle or hold customer monies, assets or positions and do not act as principal in transactions with investors. This will allow potential SCF platform operators with lower financial resources to apply for a license to offer SCF investments.
- MAS clarifies that the advertising restriction for restricted offers made to accredited investors (that are exempted from the prospectus requirement) does not prohibit SCF platform operators from advertising their platforms, so long as reference is not made to any specific SCF offer listed on their platforms. This clarification will provide certainty to potential SCF platform operators on the manner in which they can publicize their business.

Malaysia

The Malaysia Securities Commission introduced a guideline containing new requirements for the registration of equity crowdfunding platforms (Abdullah, 2016). The guideline provides for among other things that the equity crowdfunding platform operators' board of directors must be fit and proper and have the ability to operate an orderly, fair and transparent market.

As the operator plays a critical role in ensuring confidence in the equity crowdfunding platform, the guidelines entrust the operator with obligations to ensure issuers' compliance with platform rules (Lo, 2016). The operator may deny an issuer access to its platform if it is of the view that the issuer or the proposed offering is not suitable to be hosted on the platform. The operator is also required to ensure that funds obtained from investors are safeguarded in a trust account until the funding goal is met. Under this framework, an eligible issuer may raise up to Malaysian Ringgit, RM3 million within a 12-month period (Bulow, 2016). Issuers will be able to attract investments from retail, sophisticated as well as seed investors, subject to the investment limits as provided in the guideline (Bulow, 2016).

Equity crowdfunding investors are given a 6-day cooling off period, within which they may withdraw the full amount of their investment. In addition, if there is any material adverse change relating to an issuer, the investors must be notified of such change. The investors will be given the option to withdraw their investment if they choose to do so within 14 days after the said notification (Bulow, 2016).

CONCLUSIONS

IOSCO is an important organization that brings together international securities regulators who work together to set international standards for the securities sector. The organisation, *inter alia*, develops implements and promotes adherence to internationally recognized standards for securities regulation (IOSCO, 2015). One of IOSCO's recent report notes the benefits that might be enjoyed from crowdfunding but at the same time also notes the risks associated with the product. The report states that the greatest challenge when it comes to crowdfunding around the world for regulators is to strike a balance between encouraging crowdfunding and mitigating the risks associated with its growth, while protecting investor interests. IOSCO like many other international organizations is still grappling with the issues relating to crowdfunding.

The Financial Stability Board (FSB)'s mandate is to promote international financial stability. The FSB does this by coordinating national financial authorities and international standard-setting bodies such as IOSCO work toward developing strong regulatory, supervisory and other financial sector policies. FSB fosters a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions.

The FSB works through its members, seeks to strengthen financial systems and increase the stability of international financial markets. The policies developed in the pursuit of this agenda are implemented by jurisdictions and national authorities.

According to the FSB Report titled "*Financial Stability Board Regional Consultative Group for Asia – Report on Promoting Long-term Investment in Asia*" it appears many regulators in different regions are currently working tirelessly to promote the use of equity Crowdfunding by drafting or revising relevant legislation to assist emerging and growing companies to find investors via the internet.

The biggest challenge that many regulators have to face is to try the balancing act between ensuring sound regulatory framework and ensuring that the regulatory framework does not stifle the economy. With the recent financial downturn or recession around the world regulators have become even more careful and not to let anything slips through their fingers.

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