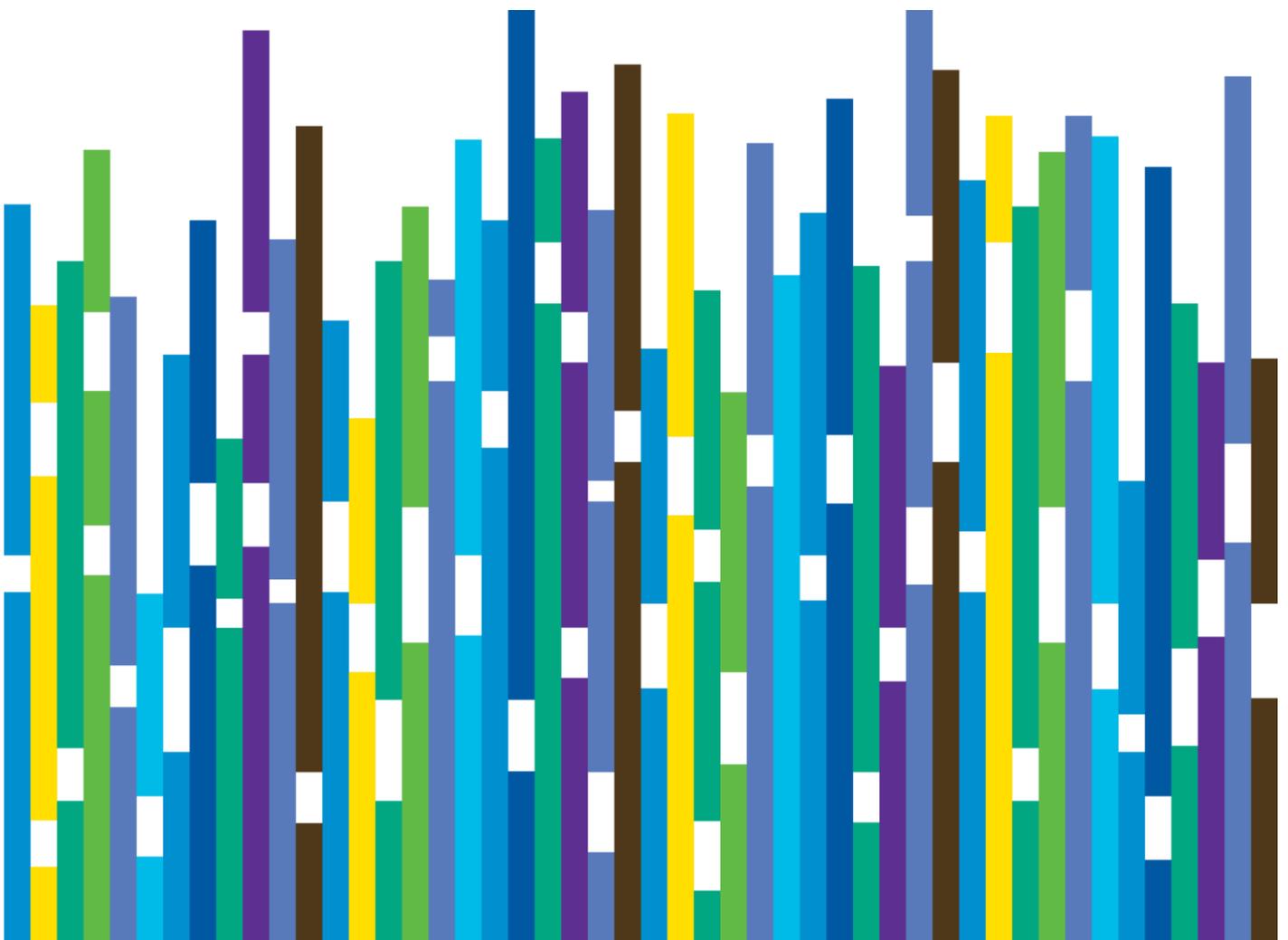


ISSUE BRIEF: INVESTMENT-GEARED CROWDFUNDING

Sourcing Equity and Debt Funding from the Crowd:
Developing a Regulatory Framework



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What Is Crowdfunding?

The term “crowdfunding” refers to a wide variety of financing, which has the use of an online platform to present projects and collect funds as a common base. Entrepreneurs (project owners or issuers) use these platforms to present social or business ventures and gather funding, while citizens (funders or investors) visit them to finance ideas pro-bono or to seek rewards or returns.

The many different models of crowdfunding can be grouped into four broad categories: donation-based, rewards-based, loan-based, and securities-based. This issue brief concentrates on the latter two — so-called investment-gearred crowdfunding (IGCF) — because it channels funding to businesses and returns to investors.

IGCF is a young industry in which most funded projects have not yet matured. It is gaining traction in many jurisdictions under different innovative formulas. Its future hangs on the quality of the investment projects featured by platforms and the associated returns for investors. Yet, it also needs a clear regulatory and supervisory framework that affords sufficient safeguards to investors.

For loans, default rates appear to be moderate with some platforms reporting rates of 1%, although given exponential growth few loans have matured.¹ For equity, it is estimated that investors could lose the entire principal in 50–70% of ventures.² In addition to fraud and the risks specific to each project, key risks in equity-based campaigns arise from the illiquidity of the instruments and the potential for dilution of rights.

What Is Its Potential?

By channelling finance to projects that would typically not receive attention from more traditional funding sources, IGCF may contribute to solving the funding gap affecting small and medium-sized enterprises (SMEs) and entrepreneurs, notably at the early stages of business development. It also broadens investor access to such projects and can facilitate collaboration between professional and retail investors.

Platforms benefit from high scalability, relatively low costs, and a potential to reach very large audiences. They may become part of popular capitalism, where small investors search for projects and distribute very small amounts of their savings across several of them. Yet, they may also gather larger sums from high-net-worth individuals and professional or institutional investors³ — the main funders of equity-based projects today.

There is not yet a clear view as to the size of the market. The International Organization of Securities Commissions (IOSCO) staff estimates that loan-based crowdfunding exceeds US\$6.2 billion globally, equivalent to 0.01% of the bank-originated credit to the real economy. However, it is growing fast, up 145% from 2012. No reliable estimate exists on securities-based operations as they have been forbidden or severely constrained in most jurisdictions until recently.⁴

In Europe, estimates range from a few hundred million to more than a billion euros raised by all forms of IGCF in 2013. In the United Kingdom (the most developed market to date), IGCF accounted for more

¹ IOSCO (2014).

² Financial Conduct Authority (2013). IOSCO Staff Working Paper (2014).

³ Professional or institutional investors refer in this paper to non-retail investors. Precise definitions vary across jurisdictions.

⁴ European Crowdfunding Network (2012). Nesta (2013). Massolutions (2012). Crowdsourcing.org (2013). Datamonitor (2013).

than £490 million in 2013, including £28 million in equity. This is equivalent to 1.8% of unsecured personal loans and 1.1% of assets under management.⁵ ICGF, therefore, already has a significant size in key markets, albeit limited.

In the Americas, the largest market is the United States, where loan-based ICGF exceeded US\$3.3 billion in 2013, pending the introduction of rules enabling securities-based campaigns. In Asia Pacific, the largest market is China, with more than US\$1.8 billion, making it the second-biggest market for ICGF worldwide.⁶

Developing a Regulatory Framework

To develop its potential for the economy and investors, investment-gearred crowdfunding (ICGF) needs a comprehensive regulatory framework that should address the following aspects:

1. Integrity of platforms operations
2. Transparency by issuers and platforms
3. Investor access and appropriateness
4. Due diligence and safeguards
5. SME access and focus
6. Corporate governance protections

1. Integrity of Platform Operations

- **Regulatory guidance or specific framework for platforms.** Guidance on the application of general securities regulation to crowdfunding increases legal certainty and facilitates market entry. However, a specific framework for ICGF appears the best solution, as existing frameworks of securities rules do not account adequately for the unique features of crowdfunding.
- **Operational aspects under proportionality.** Regulation should address the holding of client money, regulatory capital, business continuity, and recordkeeping. Under proportionality, rules should ensure safety for clients while avoiding unnecessary costs for platforms.
- **Internal complaints and alternative dispute resolution.** Platforms should have internal processes to handle client complaints. They should also join an out-of-court mechanism for dispute resolution because the typically small size of investments makes judicial remedies uneconomical.
- **Effective supervision and reporting mechanisms.** Securities supervisors may share the oversight of platforms with self-regulatory organisations. Reporting mechanisms should contribute to transparency and the growth of a reputational market.
- **Continuing to promote innovation.** Ongoing innovation should be fostered. To facilitate the responsiveness of the regulatory framework, regulators and supervisors should be given a prominent role in reviewing and updating the rules.
- **Professional competence.** Intermediaries should be competent to assess offers, to the extent required by the scope of their services (due diligence). Economic and financial expertise should be required, while technical knowledge on the given business field may be a plus.
- **Social networking functionalities.** The exchange of comments among investors and issuers is an integral part of ICGF. Portals should establish guidelines and moderate social media commentary. Comments from issuers and related parties should clearly be identified as such.

2. Transparency by Issuers and Platforms

- **Pre-subscription disclosure by issuers.** To the extent that nonprofessional investors are awarded access to ICGF, issuers should provide adequate disclosure. In most jurisdictions, prospectus rules apply to issuances well above the average size of crowdfunding campaigns.⁷

⁵ Financial Conduct Authority (2013). EFAMA (2013). Nesta (2013).

⁶ IOSCO (2014). World Bank (2013).

⁷ In the EU, the prospectus directive (2003/71/EC) applies only to issuances in excess of €5 million in 12 months. Member States apply different requirements for issuances under this threshold. Under €100 thousand, Member States are precluded from setting any requirement.

Simplified requirements are therefore needed for SME issuances through crowdfunding platforms.

- **Key items for disclosure.** Disclosure by issuers should include business plan and use of proceeds, project-specific risks, instrument-related risks, financial interest of related parties or professional investors, investor rights (including restrictions), valuation, liquidity (including shareholder agreements), business backlogs (including material contracts), conflicts of interests, and financial information.
- **Information from platforms.** Platforms should disclose their due-diligence approach, key risks, fees and costs, right of withdrawal, and aggregate data on past deals and outcomes in comparable format.
- **Headline warnings.** Standardised messages should warn about the level of risk, the lack of review of the offer by a securities supervisor, the potential to lose the entire investment and the absence of any guarantee, and the difficulty to exit the investment, where applicable.
- **Growing a reputational market.** Platforms should publish aggregate data on past offers and their outcomes in a comparable format. Regulation and supervision should steer this process.
- **Ongoing disclosure.** Issuers should publish periodic reports, making them available online and sending them to investors electronically, where the identity of the investors is known.

3. Investor Access and Appropriateness

- **Limiting access to platforms for retail investors.** Non-professional investors should be granted limited access to crowdfunding platforms, with attention given to their level of sophistication, ability to bear risk and withstand losses, and the type of instruments and projects on offer.
- **Providing education prior to investing.** Platforms should provide relevant educational materials that allow investors to gain an appropriate understanding. Self-certification of sufficient understanding by an investor alone should not be enough to gain access.
- **Maximum investment and diversification standards.** Unsophisticated investors should be effectively deterred from concentrating their portfolio in IGCF. Regulation and platforms should set maximum investment limits per project and platform. Investors should be encouraged to diversify.
- **Limits to financial promotion and personal recommendations.** Rankings of projects by platforms should not amount to the promotion of specific projects and therefore should be based on objective criteria (e.g., activities, location, deadlines). Platforms should not provide personal recommendations without complying with the standards applicable to regulated investment advice.
- **Guidelines and safe harbours.** Existing reviews of advertising by platforms have revealed frequent malpractice.⁸ Guidelines on permissible practices or safe harbours could help to correct this problem.

4. Due Diligence and Safeguards

- **Minimum requirements for due diligence by platforms.** Platforms should conduct adequate due-diligence on each project, at least to mitigate the potential incidence of fraud. Background checks of records on relevant parties should be part of this process.
- **Transparency on due-diligence approach.** Disclosing the process and checks applied by platforms would help raise awareness among investors as well as standards of practice in the market.
- **Consider co-investments by professional investors.** Where regulation or market practice leads to co-investment by retail clients with professional investors, retail clients should be cautioned about the need to still conduct their own due diligence.
- **Mitigate and disclose conflicts of interest.** Platforms should avoid any conflicts of interest, notably with project owners, related parties, and investors. If they cannot be avoided, relevant conflicts should be mitigated, and their nature and potential consequences disclosed to investors.
- **Right to cancel subscriptions.** Retail investors should have the right to cancel subscriptions within a reasonable timeframe before the deadline to subscribe shares expires. First-time

⁸ Financial Conduct Authority (2013).

investors should not be allowed to access offers for which the deadline expires before the cancellation period.

- **Limitation of channels.** The only subscription channel for securities issued through a crowdfunding portal should be the given portal. A “quiet period” should restrict other offerings from the same issuer.

5. SME Access and Focus

- **Delimit the scope of the crowdfunding exceptions.** Crowdfunding has been typically understood as a tool to finance business ideas at an early stage. If the concept is over-stretched, it could confuse investors. Access to IGCF should, therefore, be limited to small businesses. Established channels, offering a higher level of protection to investors, are preferable for larger undertakings.

6. Corporate Governance Protections

- **Protection for retail investors.** Platforms should perform background checks on significant stakeholders during due diligence, and all shareholder agreements should be disclosed. Protections could include a “tag-along right” whereby, if the majority shareholder sells its stake, minority shareholders can join the transaction.

Related Content

CFA Institute Comment Letter to FINRA on the Jumpstart Our Business Startups (JOBS) Act—Proposed Funding Portals (3 February 2014).

[http://www.cfainstitute.org/Comment Letters/20140203-2.pdf](http://www.cfainstitute.org/Comment%20Letters/20140203-2.pdf)

CFA Institute Comment Letter to the SEC on Crowdfunding (3 February 2014).

<http://www.cfainstitute.org/Comment%20Letters/20140203.pdf>

European Crowd-funding Network, “A Framework for European Crowdfunding” (2012).

<http://www.crowdfundingframework.eu/>

Financial Conduct Authority (UK), “The FCA’s regulatory approach to crowdfunding (and similar activities)” CP13/13 (October 2013).

<http://www.fca.org.uk/news/cp13-13-regulatory-approach-to-crowdfunding>

International Organisation of Securities Commissions (IOSCO), “Crowd-funding: An Infant Industry Growing Fast” (2014).

<http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>

NESTA, “The venture crowd: crowdfunding equity investment into business” (July 2012).

<http://www.nesta.org.uk/publications/venture-crowd>

Annex: Overview of Investment-Geared Crowdfunding (IGCF) Legislation in Key Jurisdictions

	France ¹	Germany ²	Italy ³	United Kingdom ⁴	USA ⁵	Spain ⁶	New Zealand ⁷
	specific rules	NO specific rules	specific rules	specific rules	specific rules	specific rules	specific rules
	equity or debt	equity or debt	equity	equity ^[E] // debt ^[D]	equity	equity and debt	equity and debt
1. INTEGRITY OF PLATFORM OPERATIONS							
• Platform and intermediary regulation	<ul style="list-style-type: none"> - registered "crowdfunding adviser" (CIP) - regulatory guidance for platforms 	<ul style="list-style-type: none"> - informal guidance for platforms - no licensing if pure brokerage of newly issued products and no holding of client money 	registered "equity crowdfunding portals"	<ul style="list-style-type: none"> - "operating and electronic system in relation to lending" ^[D] - regulatory guidance for platforms ^[D] 	<ul style="list-style-type: none"> - broker or "funding portal" - registered with SEC and FINRA - holds insurance ("fidelity bond") 	"registered platforms" (details of proposed framework still to be disclosed)	<ul style="list-style-type: none"> - licensed "crowdfunding service" - professional indemnity insurance - net tangible assets and liquidity - oversight body
• Operational aspects	<ul style="list-style-type: none"> - CIP: no holding of client money / no regulatory capital exemptions from payments directive (own funds, controls) 	n/a	<ul style="list-style-type: none"> - backup plans - record-keeping 	<ul style="list-style-type: none"> - regulatory capital (% loans, min. £50k) ^[D] - resolution plans ^[D] - minor adjustments to client money rules ^[D] 	<ul style="list-style-type: none"> - record-keeping (not particular method) - funding portal cannot hold client money 		<ul style="list-style-type: none"> - money handling rules applicable to brokers - record-keeping - IT business continuity - resolution plans
• Complaints and redress	internal complaint procedures	n/a	info on out-of-court dispute resolution	<ul style="list-style-type: none"> - internal resolution of disputes ^[D] - Financial Ombudsman Service ^[D] 			<ul style="list-style-type: none"> - internal resolution of disputes - be member of dispute resolution scheme
• Supervision and reporting	<ul style="list-style-type: none"> - securities supervisor (AMF) - approved sector associations 	n/a	<ul style="list-style-type: none"> - securities supervisor (CONSOB) - reporting requirements 	<ul style="list-style-type: none"> - securities supervisor (FCA) - reporting requirements ^[D] 	<ul style="list-style-type: none"> - platform register of securities holders - FINRA 		
• Professional competence	<ul style="list-style-type: none"> - general rules AMF - ongoing training 	n/a	able to assess offers from economic and financial perspective				appropriate skills, expertise and training
• Social networking functionalities					<ul style="list-style-type: none"> - platform guidelines, moderation, records, cannot comment - viewing public / posting private - disclose if owner or employee of issuer 		

¹ "Un nouveau cadre pour faciliter le développement du financement participatif", ACPR, AMF, Ministère de l'Economie, 30/09/2013. "Faire de la France le pays pionnier du financement participatif", Ministère de l'Economie, 14/02/2014.

² "Crowdfunding and supervisory laws", Jörg Begner, BAFIN, 12/09/2012.

³ "Legge di ulteriori misure urgenti per la crescita del Paese", Republic of Italy, 17/12/2013. "Regolamento sulla raccolta di capitali di rischio da parte di start-up innovative tramite portali on-line", CONSOB, 26/06/2013.

⁴ "The FCA's regulatory approach to crowdfunding (and similar activities)", CP13/13, FCA 10/2013. "The FCA's regulatory approach to crowdfunding over the internet", PS14/4, FCA 03/2014. Other applicable FCA rules not referenced in table.

⁵ "SEC Proposals on Crowdfunding", Release Nos. 33-9470, Securities and Exchange Commission, 23/10/2013.

⁶ "Anteproyecto de Ley (APL) para el Fomento de la Financiación Empresarial", 28/02/2014.

⁷ Shaping the future of our markets – Consultation: Licensing crowd-funding, Financial Markets Authority of New Zealand, 13/11/2013.

	France	Germany	Italy	United Kingdom	USA	Spain	New Zealand
2. TRANSPARENCY BY ISSUERS AND PLATFORMS							
<ul style="list-style-type: none"> • Pre-subscription disclosure by issuers <p>(exemptions to default prospectus rules)</p>	<ul style="list-style-type: none"> - business plans - financial statements - management interest in issuance - investor rights - securities' liquidity (including shareholder agreements) - specific project risks 	obligation to produce prospectus and KID for offers >€100k (no exemption to default rules)	<ul style="list-style-type: none"> - business plan - CV of directors - participation of professional investors - conflicts of interest - shareholder agreements 		<ul style="list-style-type: none"> - certified financial statements (GAAP) - business plans - use of proceeds - target funding - pricing methods - ownership and capital structures - identity of holders of >20% equity - material risk factors 		<ul style="list-style-type: none"> - issuers exempted from prospectus and investment statement requirements - no other requirements announced to date
<ul style="list-style-type: none"> • Promotion by issuer 		n/a		rules on financial promotions apply	restricted to notice with link to platform		
<ul style="list-style-type: none"> • Ongoing disclosure by issuers 		n/a			<ul style="list-style-type: none"> - annual reports on issuer website 		
<ul style="list-style-type: none"> • Disclosure of information by platforms 	<ul style="list-style-type: none"> - modalities of subscription - costs and fees - project risks (loss of principal, illiquidity and valuation) 	n/a	<ul style="list-style-type: none"> - key risks (loss of principal, illiquidity) - prohibition to distribute profits - tax treatment - right of withdrawal - fees and costs - aggregate data on deals and outcomes 	^[D] <ul style="list-style-type: none"> - key risks (default) - grade of risk for particular loan - due diligence approach - rates after charges / expected default - if loan secured - tax obligations - definition of late payment and default - exit before maturity - platform failure 	<ul style="list-style-type: none"> - securities and risks (including dilution) - maximum amounts - subscription process - information required from issuer in annual reports - need for investor to consider whether security appropriate - cancellation rights 		<ul style="list-style-type: none"> - issuer-prepared information - facility for questions and answers - funding currently pledged - information based on due diligence and any other assessment - due diligence carried and not carried out - eligibility criteria for issuers
<ul style="list-style-type: none"> • Headline warnings 		n/a	<ul style="list-style-type: none"> - illiquidity and very high risk - offer not reviewed by CONSOB 	<ul style="list-style-type: none"> - tailored warnings - 'must not downplay important information' 	<ul style="list-style-type: none"> - potential to lose entire investment - offer not reviewed by SEC 		warning statement, for investors to confirm understanding
3. INVESTOR ACCESS AND APPROPRIATENESS							
<ul style="list-style-type: none"> • Investor access 	<ul style="list-style-type: none"> - registration required to access project info - suitability-like test at registration - website to show only "suitable" projects 	n/a	<ul style="list-style-type: none"> - review educational materials - respond correctly to questionnaire (fully understand risks) - claim to be able to support full loss 	^[E] <ul style="list-style-type: none"> retail clients who: - receive investment advice/management - certify not investing >10% of portfolio - certify sophisticated - are certified high net worth (HNW) 	<ul style="list-style-type: none"> - review educational materials - acknowledge risk of loss and able to bear - respond correctly to questions, before each investment (understand risks) 		

	France	Germany	Italy	United Kingdom	USA	Spain	New Zealand
• Role for professional investors		n/a	> 5% invested by professional investors, banks or start-up incubators				
• Maximum investments and diversification	<ul style="list-style-type: none"> - €1k per debt issue - no diversification limit for equity - no overall limits 			<10% of portfolio for retail clients where no investment advice / management and not sophisticated / HNW	<ul style="list-style-type: none"> - \$2k or 5% of annual income or net-worth, if both <\$100k - 10%, maximum \$100k, if both >\$100k 	<ul style="list-style-type: none"> - €3k per issuance - €6k per platform 	investment limits were considered initially but have been discarded for the moment
• Appropriateness	<ul style="list-style-type: none"> - suitability-like test if no information, no recommendation - pre-contractual info about advice 	n/a		<ul style="list-style-type: none"> - appropriateness for any non-advised client before allowing access to platform ^[E] - cannot advise clients unless authorised ^[E] 	portals cannot make recommendations or manage investments		procedure for investors to affirm the risks of the investment, as set out in a warning statement
• Promotion by platforms	<ul style="list-style-type: none"> - cannot actively seek subscribers for a specific issuance - have to present multiple projects 	n/a		<ul style="list-style-type: none"> - guidance on good and bad practices ^[D] - rules on financial promotions apply ^[D] 	"safe-harbours for certain activities" (i.e., permissible to highlight issuances on objective criteria)	financial promotions are prohibited	
• Ongoing services	<ul style="list-style-type: none"> - CIP can provide ongoing services 	n/a					

4. DUE DILIGENCE AND SAFEGUARDS

• Due diligence by platforms	disclose due diligence criteria	n/a	disclose measures to reduce fraud	extent and outcome of due diligence must be disclosed ^[E]	<ul style="list-style-type: none"> - checks directors and holders of >20% - discretion to deny access to platform 		
• Conflict of interests	<ul style="list-style-type: none"> - management policy - MiFID-like rules on inducements 	n/a	management policy		<ul style="list-style-type: none"> - platform cannot hold interest in issuer - disclose issuer compensation 	platforms would not be able to charge issuers in line with financial promotion	<ul style="list-style-type: none"> - no discrimination of issuers or investors - disclose compensation - disclose interests
• Right to cancel subscription		n/a	right to cancel subscriptions within 7 days (retail clients)	right to cancel within 14 days, applies only to registration and not to subscriptions ^[D]	<ul style="list-style-type: none"> - up to 48 hours before deadline - offers live > 21 days 		
• Material changes to offer by issuer		n/a			investors must reconfirm		
• Control of issuer information		n/a			<ul style="list-style-type: none"> - >\$100k: financial statements certified by executive officers - \$100k-\$500k: public accountant-certified - >\$500k: audited 		

	France	Germany	Italy	United Kingdom	USA	Spain	New Zealand
• Offers in >1 portal		n/a	permitted (disclose)		not permitted		
• Contracting channel	online only	n/a	online only	- online only ^[D] - any channel ^[E]	online only		
5. SME ACCESS AND FOCUS							
• Scope of crowdfunding exceptions	<€1m in 12 months per issuer	<€100k in 12 months per issuer for equity (or more for 'profit sharing loans')	<€5m in 12 months per issuer innovative start-up: - <2 years / no merger - >51% owned by natural persons - turnover <€5m - not distribute profits - high-tech outputs ⁸	<€5m in 12 months per issuer (general exemption in prospectus Directive)	- <\$1m in 12 months per issuer - 1 year limitation on transfer of securities	- <\$1m in 12 months per issuer - open to only non-quoted companies	- >NZD 2m in 12 months per issuer
6. CORPORATE GOVERNANCE PROTECTIONS							
• Protections for retail investors		n/a	tag-along right (if majority shareholder sells stake, then minority has right to join transaction)		- disclose ownership and capital structure - identity of holders of >20% equity - risks of corporate actions, related-party transactions		

⁸ Fulfils one of these three conditions: (a) R&D expending >30% of costs/revenue, (b) >33% of employees hold Ph.D., (c) holds at least one industrial patent in industrial biotechnology, semiconductor product or plant variety.