Publication 11. 2020

Equity Crowdfunding Regulations

In the previous publication, we discussed the risks and rewards of equity-based crowdfunding. As this crowdfunding method deals with investments, it is necessary to talk about regulation. In this publication, we will briefly address or review equity-based crowdfunding regulations.

In general, for crowdfunding platforms, the "regulation for the stock market", is the usual benchmark for the relevant regulation for equity activities. The regulation will typically be focused on investor protection, market fairness, integrity, and systemic risks.

Investor Protection

Investors must have enough information to understand the risks involved in investing in a particular equity, when they are investing through a crowdfunding platform. The projects or listings on the platform are usually open to most investors, hence are perceived as having been screened and potentially even endorsed by such a platform. While legally such perception is not correct, the platform cannot dismiss the perception. This suggests that clear rules and regulations regarding the listing application process must be in place. Having complied with clearly defined listing requirements by the regulator and the platform itself, will expose the investment risks to potential investors in a transparent and honest way.

Disclosure to investors about each project/listing is of course by nature a gray area. For instance, a clear disadvantage of providing a proposal for early seed money, is that there is no clear or comparable data on the company yet. So, projections that will be provided have to be weighed very carefully by the investor on their probability of actually happening. This is not necessarily bad, but the adequacy of the disclosure should be commensurate to the specific facts and circumstances for the equity offering.

Another important issue is the “applicable law”. In the case of cross-border investing, for instance, it is often not totally clear which jurisdiction's laws should apply. Ideally, the platform would be required to be as clear as possible about which laws apply, where and how they would normally be interpreted. This applies both the regulations of the platform itself, but also with respect to the entity/project that is listed.

Market Fairness and Integrity

Platform owners, i.e. the operators of the crowdfunding platforms, must ensure that they understand the backgrounds and business of those projects or ideas posted on their platform. This is different than the investment or business risk faced by the investors or the entrepreneur on the investment itself, but it could affect, especially the investors. In addition to making sure there cannot be fraud committed by the platform owners themselves, there could be fraudulent investments on the platform. Since the actors/investors can be somewhat anonymous, if the users/investors of/through the platform are not checked properly, laundered money could be invested, or on the other hand, some of the actual investments could be phony and invested funds “go up in smoke”. This kind of activity would harm the reputation of the platform and cause investors to look elsewhere, even if most of the other investments are legal and real.

Systemic Risks and Reputation

Since equity crowdfunding is still a small segment of the financial sector as a whole, financial stability risks associated with it are often considered too minor to worry about. However, we must accept that if a large enough platform were to fail, it could still have knock-on effects (or systemic impact) if confidence in this “fintech” activity is undermined.

A certain oversight by a securities regulator may help detect phony investments, but it may be difficult without additional information and some clear “rules to play by”.

A large platform collapse could lead to others questioning the use of this alternative funding method, hence the idea of crowdfunding itself; and thus, potentially harming the ability of these small companies to get funding. For instance, if many investors are using multiple platforms, the spread of a rumor on one may cause other investors to decide not to supply their money to others. Or, if all platforms use some type of

Website: dcsx.cw Email: info@dcsx.cw

common technology or electronic storage location, if that were to fail, it could disable several platforms simultaneously; again, with potentially negative effects on usage.

Regulations in Practice

If we look at one of the most active and largest markets where equity crowdfunding happens -the USA- in 2015, the U.S. SEC ratified final rules that gave investors more investment choices, and also, facilitated access to capital for small/medium enterprises and companies. These rules are known as Regulation A+ and authorized by Title IV of the JOBS Act. These rules are articulated to promote crowd-equity. Moreover, on May 16, 2016, Regulation Crowdfunding was enacted, allowing non-accredited investors that were previously banned to participate in all kinds of public startup ventures, to participate in the financing of these public capital seeking projects. This has streamlined the way for small investors as well.

Non-accredited investors could now take part in crowd equity transactions in a limited way, depending on their yearly income in the USA. The limit of investments (both compared to their net yearly income and the total amount per investment) that a non-accredited investor can make, is defined. For the entity seeking finance: financial disclosure is a must for all startups. One must clearly describe the amount of money to be raised, how it will be spent, the price of every share, financial statements, audit reports requirements, major stakeholders and shareholders' information.

In emerging markets such as Africa and Asia, Equity Crowd Funding ("ECF") platforms have been the fastest-growing "fintech" areas, given their ability and need to reach SMEs. The regulatory environments vary widely. In some jurisdictions, there are no tailored regulatory frameworks, and platforms are obliged to comply with the same regulations as those for non-fintech equity issuance and trading platforms. In others, specific crowdfunding regulations apply such as the case of Malaysia. In 2015, it introduced a specific regulatory ECF framework whereby platform operations are regulated as recognized market operators, and the frameworks are built to adapt to new products and structures. In Kenya, crowdfunding platforms can operate, as long as they raise funds for domestic SMEs through sources outside the jurisdiction.

Cross-border initiatives are also underway in Asia, such as the ASEAN Collective Investment Scheme ("CIS") Framework and the Asian Regional Funds Passport ("ARFP"). They appear to be driving online ECF growth, although hard evidence is difficult to find. Asia's dynamism and its openness to technology are likely to become drivers for crowdfunding platforms there.

Final Thoughts

The bottom line is that regulations of equity-based crowdfunding impact investors and startups equally. It is true that these new regulations have paved the way for basically everyone worldwide to invest. But it is also evident that there are severe risks that can damage the investment of the inexperienced investors. These inexperienced investors can lose a high amount of money if the due diligence steps are skipped or done by inexperienced persons or platforms. The inexperienced investor must be protected.

Startups, small and medium-sized enterprises can now raise funds from almost everyone, but this should be bound in by a set of rules and regulations to protect the investor and the company's reputation. And these regulations must be known to everyone, as it will help in acknowledging rights and limitations for the investor and the startup business. For understanding all the aspects and proceedings with respect to those rules and regulations, and the thereto related chance of litigation, it is recommended to hire an expert lawyer that is able to provide required insights to the business owners before they embark on a crowdfunding activity.

Sources:

Douglas, D. and Overly, S. 2020. As regulators set rules for equity-based crowdfunding, investors prepare for its impact. May 20, 2012. https://www.washingtonpost.com/as-regulators-set-rules-for-equity-based-crowdfunding-investors-prepare-for-its-impact/2012/05/18/gIQAFwmVdU_story.html

IOSCO. 2017. IOSCO research report on financial technologies (Fintech). IOSCO. Last accessed https://www.iosco.org/library/pubdocs/pdf/IOSCOPD554.pdf

Hofmann, C., 2018. An Easy Start for Start-ups: Crowdfunding Regulation in Singapore. Berkeley Bus. Law Journal, 15, p.219.

Schroter, W. 2014. "Crowdfunding around the World." Retrieved July 2019 https://www.forbes.com/sites/wilschroter/2014/07/09/crowdfunding-around-the-world/#6e2938672448

This publication is presented to you by the Dutch Caribbean Securities Exchange

Dutch Caribbean Securities Exchange