Debt-Based Crowdfunding Regulations

Debt-based crowdfunding has become a popular way for businesses and start-ups to raise money.

And as millions are raised each year through this channel, both investors and businesses can be and are exposed to possible unethical practices and/or “financial pitfalls”.

Hence the need for regulations.

The introduction of regulations to crowdfunding is an effort by governments and lawmakers to provide better access to alternative financing sources for SMEs and start-ups.

It is also aimed at providing better protection for investors against fraudulent investment schemes.

Over the years, financial authorities and lawmakers have come up with regulations to govern crowdfunding practices. But with the presence of many different crowdfunding options, it has become hard to come up with the perfect regulatory framework for debt-based crowdfunding.

What types of regulations are there for debt-based crowdfunding?

In recent times, different Securities and Exchange Commissions (SECs) all over the world have introduced regulations for debt crowdfunding, which are intended to streamline it to the often already existing regulatory framework for equity crowdfunding.

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These regulations cover all aspects of crowdfunding, from how much a business can raise, to investor limits and qualifications requirements.

Here are some key areas covered:

- Introduction of precise requirements for new and inexperienced investors' assessment.
- Qualifications of a crowdfunding platform.
- Investor caps on how much they can invest (if they are not professional investors).
- Fundraiser eligibility and investment limits.

All these regulations have been put in place to minimize the risks posed to the investors. Accepting the reality of the internet as a platform for crowdfunding activities, financial authorities around the world have been forced to make changes in their rules to, as much as possible, protect investors against "too good to be true" financing offers.

Let's have a look at 3 interesting cases of countries that have actively reviewed and amended their regulations:

The United Kingdom

In the UK, the Financial Conduct Authority (FCA), has implemented the following "high level" crowdfunding regulations:

- The investors must portray adequate knowledge in their investment and how crowdfunding works.
- Investors must prove that they can afford their investment by either, showing their net worth, classifying as a sophisticated investor, or coming by recommendation from someone approved and regulated by the FCA.
- Investors must prove that they are not investing their entire available assets.

These regulations aim at ensuring that the investors invest only what they can afford. Additionally, in 2019, the FCA introduced new rules, which included placing new restrictions for new investors.

Under these new regulations, investors that are new in a sector are restricted to 10% of all their investable assets. However, if the investor has received adequate regulated financial advice, then, this limitation won't apply. The restriction will limit the risk of over-exposure for investors.

The new rules also cover requirements for P2P lending platforms governance and control, market restrictions on the platforms, investor assessments in knowledge and experience, and even the application for the Mortgage and Home Finance Conduct of Business Sourcebook.

The Republic of Thailand

In Thailand, the local SEC's new rules for P2P lending covers the following key elements:

- The Fundraiser must be a Thai based company with an outlined business plan to be eligible.
- The crowdfunding process must be conducted on an approved platform for purposes of application screening and compliance oversight.
- All fundraising companies should report their offering results to the SEC.

When it comes to financing limits, the SEC is very clear for both retail investors and SMEs or start-ups. SME's and start-ups can raise up to THB20 million (+/- US$ 640 K) from retail investors during the first year from debt-based crowdfunding, and THB40 million (+/- US$ 1280 K) with debt and equity crowdfunding combined.

There is no investment cap for non-retail investors.

For investors, retail investors are limited to only THB100,000 (US$ 3.2 K) for both equity and debt crowdfunding. Non-retail investors have no investment limits.

Furthermore, the SEC has a rigorous application process for persons seeking approval for funding portals. Eligibility requires one to possess a system for assessing the creditworthiness, and debt risks of the fundraisers.

The United States of America

In the U.S., an approach towards general crowdfunding regulations were rolled out via the Jumpstart Our Business Startups Act (JOBS Act), in 2012. And since its introduction, U.S. SEC reports that due to the many exemptions introduced or expanded, the entire exempt rules offering required reviews. Regulation Crowdfunding went into effect on May 16, 2016. For the first time in 80 years, start-ups and small businesses could raise up to $1M from their friends, family, and customers via online websites registered with the Securities and Exchange Commission. In June of 2019, the SEC came out with a Report on Crowdfunding activities in the US. At this stage crowdfunding -as a whole- raised about US$ 17 billion a year in the U.S.

The new regulations released covered the following key elements:

- Relevant SEC rules and regulations governing exemptions from regulations.
- Restrictions imposed on the existing exemptions.
- Protection measures for the investors regarding the exemptions.
- The status of the Accredited investors as outlined in Rule 501(a) of regulation D58.
- The private placement exemption rule of Rule 506 of regulations A and D.

- Gaps in the existing exempt offering framework.

These aren't, however, the only countries implementing crowdfunding. Countries like Singapore, Indonesia, Norway, Switzerland, and Russia are slowly embracing debt-based crowdfunding regulations, to expand their sources of alternative capital.

Impact of debt-based crowdfunding regulations

Changes in the crowdfunding regulations are evident in many countries around the world, and this is just the beginning. With the internet creating new opportunities for digital platforms, the financial sector is slowly opening up to debt-based crowdfunding. By the end of 2018, worldwide P2P lending (which is basically carried out through crowdfunding platforms, in one or the other form) had surpassed US$ 310 Billion.

The introduction of regulations to this model provides opportunities for start-ups to access capital much easier for growth and expansion. It ensures that all businesses have greater access to capital, which is good for the economic development of the countries. It also increases the competitive environment of the nation's pillar industries as it promotes the growth of start-ups and SMEs.

Regulations also help attract investors to the country as it minimizes the risk levels for all investments. They create a friendly environment that assures them of credible and approved fundraisers, which increases their chances of making good investments.

For middle-income countries, regulations also help increase their potential to grow their economy and attract more international investors. This new funding model will give their emerging sectors the capital they need to challenge the developed economies.

Challenges of debt-based crowdfunding regulations

Regulations in P2P lending, despite trying to simplify the fundraising process, often still don't offer adequate education to investors. This opens the market to inexperienced investors who don't understand the risks of debt-based crowdfunding.

Moreover, crowdfunding is still a new technology from the Fintech industry, and so many factors keep changing. As a result, it is becoming difficult for lawmakers to cover up all emerging gaps in the existing regulations. So, it will take some time until the financial authorities come up with a stable regulatory framework for debt-based crowdfunding.

Final thoughts

The introduction of debt-based crowdfunding regulations is an indication that this "funding" channel can provide financial solutions for SMEs and start-ups. However, it is still far from perfect, and new challenges and obstacles are bound to come up along the way.

So, even though it will take some time, maybe years, before developing a streamlined regulatory framework for most countries, the future for debt-based crowdfunding regulations seems very promising.

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