

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

**FEEDBACK STATEMENT
TO
MFSA CONSULTATION DOCUMENT
ON
INVESTMENT-BASED
CROWDFUNDING**

MFSA REF: 13-2016

1. INTRODUCTION

On 3rd November 2016, the MFSA issued a Discussion Paper on investment-based crowdfunding.

The deadline for the submission of comments was 15th March 2017 and the Authority received nine responses. A summary of the main comments received and the Authority's position in relation thereto, is provided in Section 2.

The Authority took cognisance of the wide array of issues which were raised in response to this consultation exercise. The Authority's position has been determined after a careful and thorough consideration of the feedback received.

2. SUMMARY OF THE FEEDBACK RECEIVED

*The typical activity of an investment-based crowdfunding platform –
Licensing Requirements*

In the Discussion Paper the Authority identified the investment service most likely to be provided by investment-based crowdfunding platforms as the reception and transmission of orders. The crowdfunding platform receives orders from investors to subscribe for instruments and transmits them to the issuer or another third party intermediary for execution. Respondents were asked whether they viewed reception and transmission of orders as the typical activity of an investment-based crowdfunding platform, and whether there are other investment services which they deem relevant to crowdfunding such as; placing of financial instruments, investment advice or execution of orders on behalf of clients. Participants were also asked to comment on how investment-based crowdfunding platforms handle investors' funds.

Industry comments:

1. Type of investment service

The majority of industry respondents confirmed that a good number of investment-based crowdfunding platforms may operate simply on the basis of reception and transmission of orders however there is no single model in the market. Thus the Industry requested flexibility as to what a crowdfunding platform can do with different requirements applying to those platforms wishing to go beyond the mere reception and transmission of orders.

They confirmed that the typical investment-based crowdfunding platform would perform reception and transmission of orders on behalf of investors, to invest in the chosen or designated project. Nevertheless, there may be ancillary activities which a platform might carry on in order to achieve the said typical activity in view of processes and procedures intrinsic to the operation of a crowdfunding platform. One such ancillary activity is controlling clients' money.

Industry respondents were concerned that the activity of controlling clients' money could imply a change in licence Category which would increase the regulatory burden by, *inter alia* increasing the applicable capital requirements under MiFID from €50 000 to €125 000.

2. *Holding or Controlling clients funds*

Most industry respondents commented that the handling of investors' funds will be an essential part of the business model for investment-based crowdfunding platforms.

It was explained that every project submitted to an investment-based crowdfunding platform to raise funds will have its goal in terms of funds [targeted amount] to be raised. A typical investment-based crowdfunding campaign would be set up in such a way that funds are only made available to the promoter (issuer) once the goal targeted by the project in terms of funds is reached. Hence in case the goal is not reached the funds are returned to the respective investor. Thus it is an intrinsic part of investment-based crowdfunding that the platform acts in a role 'akin to that of a trustee' in relation to the funds received from investors until the goal is reached or the time allocated for the goal to be reached has expired.

One Respondent put the following specific points forward for consideration:

- The funds are kept in custody under very specific terms dictated by individual contracts between the investors and the platform. Investors are made aware of the precise time period and terms under which their pledge would be transferred to the issuer.
- The platform may make use of payment institutions offering the facility of an escrow wallet. However, the instruction to either return the funds to the investor or pass them on to the issuer originates from the platform itself, and is not automatically linked to achieving the target goal.
- Additionally some platforms only carry out initial due diligence at the beginning and then do a complete review of the project credentials after the campaign threshold is successfully reached. This means that they would need to have time to carry out these further checks before passing on the money. If these checks fail, the money would be returned to the investors. This split due diligence is done in this way in order to be more sustainable and reduce time and costs of doing the full due diligence process on campaigns that fail.
- Within the local dimensions, the time span and amounts concerned per individual project are very small.

One Respondent considers that the possibility of a crowdfunding platform holding funds collected in a clients' account can present both advantages and disadvantages. Having conducted due diligence on its customers and, where applicable, the project for which financing is sought, puts the platform operator in a position to carry out more focused on-going monitoring and detect possible instances of money laundering checks prior to any other subject person that may be involved in the transaction. On the other hand it is recognised that the risk of money laundering or terrorist financing can be mitigated by having investor funds flowing directly to an

account held by the issuer rather than through a pooled account held by the crowdfunding platform as it would be easier to follow the flow of funds and traceability would be enhanced.

MFSA's Position:

Following a thorough review of the model explained in the industry feedback the Authority has concluded that in a typical investment-based crowdfunding model where the platform intermediates between the investors and the issuer directly, the platform will be controlling clients' money without taking ownership of the funds. Therefore it appears that the licence applicable would at least have to be Category 2 Investment Services licence in terms of the Investment Services Act.

The MFSA recognises the point made by the Industry that the amount per investor and the time span for which the amounts are held will be small, however the platform may still be controlling a considerable amount of funds overall. The use of a payment services provider in these circumstances is required to process payments however the platform would still be retaining control over the funds as it would be the one initiating payment and exercising discretion as to whether the funds are transferred to the issuer or back to the investors. The more robust capital requirement under a Category 2 licence would also mitigate towards the additional risk exposure incurred by the platform during the period in which it would be effectively holding and controlling client money.

The MiFID Passport

The Discussion Paper presented an approach based on the application of the general securities regulatory framework, with the addition of certain *ad hoc* investment protection measures. The platform operator would need to acquire an investment services licence in terms of the Investment Services Act and have both its head office and registered office in Malta. The platform operator would fall within the scope of MiFID with the benefit of a passport to carry on the services/activities for which it is authorised throughout the EU without any additional authorisation being required. The Discussion paper posed a question as to whether the passport is essential for investment crowdfunding platform operators in Malta.

Industry comments: The majority of industry Respondents replied that they consider the MiFID passport as beneficial to crowdfunding platforms in Malta as this would give such platforms access to a wider EU market. The viability of platforms hinges upon the ability to attract a constant and growing flow of Issuers, coupled with the ability to attract a multiplicity and variety of investors. Access to the EU-wide market is thus crucial towards achieving this economic viability.

One industry Respondent opined that it is actually more onerous on the platform operator to attempt to comply with the un-harmonised national regulatory regimes on marketing, advertising and promotion, than attempting to comply with the requirements under the MiFID Passport regime. Obtaining a MiFID Passport would provide comfort to the platform operator that its activities are lawful and would not run the risk of being caught under such fragmented regulation, which could carry significant risks, including the risk of suspension or cessation of operations, reputational damage and pecuniary liability.

A number of Respondents however further requested the MFSa to consider a lighter touch regime to be made available to start-up crowdfunding platforms which could run in parallel with the existing MiFID regime, particularly for those start-up investment crowdfunding platforms with no access to the EUR50,000/EUR125,000 capital requirement. A ‘softer’ regime based on the optional exemption in Article 3 of MiFID would assist such start-ups to grow their business and be in a position to then obtain a MiFID licence.

MFSa’s Position: In Article 3 MiFID provides Member States with an option to exempt firms from the provisions of the Directive under certain conditions. Such firms do not benefit from a passport, but are also not subject to MiFID capital or other requirements. One should underline however that even if this exempt framework were to be considered, these firms would still only be able to provide the investment services of reception and transmission of orders to particular entities and/or investment advice, and still not be able to hold client money or securities, while orders can only be transmitted to authorised firms.

The Authority has also taken note of ESMA’s comments on this issue. In its 2014 Report ESMA noted that where Member States have developed regimes using the Article 3 optional exemption which allows for lower capital requirements, platforms have incurred additional costs because the requirement to transmit orders only to authorised firms is likely to mean involving an additional party for which the business model would not otherwise have a need. It also considered that the lack of a passport can make it harder for platforms to achieve the scalability they need. Given these restrictions and the industry feedback received, the Authority considers that, having an exempt framework would not improve the feasibility of certain investment crowdfunding models. If anything the fact that such models would in any case not be able to hold or control client funds and would have no passporting rights would further detract from their feasibility.

The view presented in *the Discussion Paper* was that investment-based crowdfunding should be available to both public and private companies. The Discussion Paper explained the nature of Private Companies as set out in Article 209 of the Companies Act with a specific reference to the limitation on the number of shareholders to 50.

Industry comments: All Respondents agreed that in view of the requisite minimum initial share capital for the incorporation of a public liability company most issuers on Investment-based Crowdfunding Platforms will be private companies. One Respondent pointed out that a typical crowdfunding financing round is characterised by an average of 150-300 crowd-investors.

One Respondent proposed a derogation from Article 127 of the Companies Act or the setting up of a new type of limited liability company similar to the *société par action simplifiée* ("SAS") in France. Another Respondent suggested the use of a nominee in order to have access to further than 50 shareholders.

MFSA's Position: In terms of Article 127(2) of the Companies Act, for the purposes of determining the status of a company as being a private or public company it is the actual beneficial owners of the shares in the company that are taken into consideration, and any nominee or trust relationship is disregarded. This means that the nominee or trust relationship must, in terms of law, be looked through for the purposes of determining the number of members of a company.

The Authority has taken a holistic view of the funding cycle and options of private companies. Even within the current legal framework private companies can still benefit from an investment-based crowdfunding regime. Investment-based crowdfunding can provide private companies with a springboard to other sources of funding. Once the Issuer has progressed in its business life cycle (in great part owing to the funding obtained through investment-based crowdfunding), it is more likely that the Issuer will be in a position to attract and access other sources of finance (whether through the granting of banking facilities, listing on the primary market or an MTF or attracting business angels, venture capital or private equity investments).

Caps on Investable amounts per investor and per project

The Discussion Paper proposed the following safeguards over and above the authorisation and conduct of business requirements applicable to investment service providers:

- i. a cap on maximum investable amount per individual investor;
- ii. a cap on maximum project size.

Industry comments: All Industry Respondents agreed that due to the high risk element in crowdfunding, it would be appropriate for caps to be in place regarding the amount allowable to be invested by an individual per offering. Other investment protection measures suggested were a cap on the number of projects an individual may invest during one calendar year, as well as a cap on the percentage investment per individual dependent on income of the investor, in such way that an individual may only dispose of a limited percentage of his annual income in crowdfunding investments. As to a maximum project size most suggested €5 000 000 which amount currently triggers the application of the Prospectus Directive. One Respondent suggested the use of the UK investment-based Crowdfunding Framework as a model with respect to caps on investable amounts.

As to the amounts, a number of respondents cautioned that any extreme measures in limiting the size of offers and/or investor base could limit the potential for crowdfunding to raise finance and thus for such industry to flourish in Malta.

MFSA's Position: Following consideration of the caps on Investable amounts per investor and per project currently in place across Europe¹, the Authority is considering to apply:

- a) an investor cannot invest more than € 5 000 over a period of 12 months in **one issuer** listed on an investment-based crowdfunding platform;
- b) of an offer of securities made on an investment-based crowdfunding platform cannot exceed the value of € 5 000 000 over a period of 12 months;
- c) an investor cannot invest more than 20% of his net annual income through **an investment-based crowdfunding platform** over a period of 12 months;
- d) Measures a) and c) above shall not apply to professional clients under MiFID.

¹ European Commission Report on Crowdfunding in the EU Capital Markets Union dated 3rd May 2016.

Location of the Issuer – due diligence on Issuer and business plan

The Discussion Paper presented a local framework for the regulation of investment-based crowdfunding, where both the corporate issuers and platform operators need to be limited liability companies formed and registered in Malta in accordance with the Companies Act. Respondents were asked whether they desired to see any restrictions on the location of the issuers on investment crowdfunding platforms. Furthermore the Discussion Paper proposed that platforms should be required to conduct minimum due diligence tests on the projects/project owners [issuer] and take measures to reduce the risk of fraud.

Industry Comments: Most respondents expressed themselves against restricting Issuers listed on Maltese Investment-based Crowdfunding Platforms to Maltese Companies.

One Respondent observed that the wider the geographical catchment would allow the platform to work more efficiently. Allowing free movement of capital much needed for local SMEs. In addition, when viewed upon from the point of view of the platform operator, in ensuring its commercial viability, a platform is greatly dependent on its ability to attract a significant volume of issuers.

A Respondent suggested the inclusion of conditions for admissibility to listing on Crowdfunding Platforms and the model adopted under the Listing Rules with respect to the location of prospective issuers could be similarly adopted to crowdfunding platforms.

MFSA's Position: The MFSA has considered the ample feedback received and the current legal landscape in Europe and is of the view that:

1. Issuers on investment-based crowdfunding platforms should not be restricted to Maltese Companies. Listing on Maltese investment-based crowdfunding platforms will initially be open to Maltese and EU registered, although the Authority may eventually consider whether third country registered issuers could also be allowed to list provided they are not incorporated in countries blacklisted by the Financial Action Task Force's [FATF];
2. The platform will need to apply certain reasonable due diligence measures on the project proposal and the project owners' ability to deliver on the proposal. The Platform will have to ensure that prospective issuers admitted to listing on

a Maltese investment-based Crowdfunding Platform satisfy the following conditions:

- i. the applicant is duly incorporated or otherwise validly established according to the relevant laws of its place of incorporation or establishment;
- ii. the applicant is operating in conformity with its memorandum and articles of association or equivalent constitutional documents; and
- iii. the shares of the application are issued in conformity with the law of the applicant's place of incorporation and duly authorised according to the requirements of the applicants memorandum and articles of association or equivalent constitutional document.
- iv. the applicant has presented a feasible business plan which includes clear funds targets, information on how the funds collected will be applied as well as a summary of the sustainability of the company as a going concern.

Prospectus Requirement – Summary Information Document²

The Discussion Paper set out the prospectus requirement and applicable exemptions under the Companies Act. Furthermore the Discussion Paper proposed that investment-based crowdfunding platforms should be subject to specific disclosure requirements tailored to crowdfunding even where the offer would trigger application of an exemption to the general prospectus requirements. Respondents were asked to indicate what type of information they would deem essential to include in a summary information document for crowdfunding.

Industry Comments: The general view of the Respondents was that a summary information document should contain enough information so as to enable the investor to understand the service to be provided by the platform, the identity of the issuer and the nature of the instrument being offered. By providing the investor with such information the investor should then be in a position to take investment decisions on an informed basis. The objective is to provide investors with key information upon which to base their investment decisions. On the one hand there is the need to avoid replicating the onerous disclosure requirements applicable to non-exempt prospectuses under the Prospectus Directive by keeping disclosures down to a minimum. On the other hand, the information disclosed must be meaningful and sufficient enough to enable such decisions.

² The term 'Key Information Document' originally used in the Discussion Paper has been replaced by 'Summary Information Document' so as not to be confused with that found under the PRIPS framework.

Some respondents referred to the disclosure requirements under the (MSE) Prospects programme, as also suitable for application to investment-based crowdfunding with minor adjustments.

A Respondent opined that the summary information document on the issuer should disclose both project specific information as well as generic information on the implications of crowdfunding initiatives.

One respondent observed that platforms should explicitly state that although the information is reviewed by the service provider, this provides no guarantee, warranties or representations whatsoever as to the accuracy and truthfulness of the information. The disclaimer should also state that the information provided in this respect remains the sole responsibility of the Issuer and that investments are made at the risk of the investor on the basis of such information.

MFSA's Position:

In terms of the current applicable rules, the Licence Holder is required to provide appropriate information, in a comprehensible form to its clients or potential clients such that they are reasonably able to understand the nature and risks of the Investment Service to be provided by the Licence Holder and of the specific type of Instrument that is being offered, and consequently to take investment decisions on an informed basis. This information may be provided in standardized format and must include details about; 1) the identity of the Licence Holder and how it may be contacted; 2) its services and 3) the financial instruments being offered.

With respect to the above, the Authority is considering imposing supplementary requirements for a licence holder which qualifies as an Investment-based Crowdfunding Platform so as to ensure that essential and appropriately structured information will be provided to investors on crowdfunding platforms with a view to enabling them to understand the nature and the risks of a Company promoted on an investment-based crowdfunding platform. These supplementary conditions will be incorporated in the Conduct of Business Rulebook.

The Platform operator will accordingly be required to draw up a summary information document clearly structured into four sections: 1) general risk warnings; 2) a section with information obtained from the issuer relating to its activities, the project to be funded and the offer of securities; 3) a section on the services to be offered by the platform and 4) the total amount to be charged to the investor. The information must include the following elements:

1) general risk warnings:

The general risk warnings that would need to be included should be on the following lines:

- (a) it is a well known fact that start-ups and small businesses have a propensity to fail. Investing in these entities through crowdfunding involves a high degree of risk, and you should not invest in this offering unless you can afford to take the risk of lose your entire investment.
- (b) securities issued by start-ups and small businesses are difficult to sell.
- (c) the rights of purchasers of the securities under this offering may be diluted or negatively affected as a result of a number of factors, including the rights and characteristics of other securities already issued by the issuer, future issuances of securities by the issuer, and potential changes to the capital structure of the issuer.
- (d) this crowdfunding summary information document is not a prospectus and the MFSA has not reviewed its content for its truth and accuracy.

2) a section with information obtained from the Issuer relating to its activities:

- (e) the name and address of the issuer and his contact details as well as a short description of the nature of the operations currently carried out by the issuer and its main activities stating the main categories of products sold and /or services provided and identifying the main markets in which it operates;
- (f) hyperlinks to access a copy of the memorandum and articles of the issuer, the full prospectus or offering document (if any);
- (g) a short description of the main risk factors which according to the issuer, are specific to their activity and project (including risk associated with the issuer's financial situation and the financial situation of the market in which it operates);
- (h) general terms of the offer, including: the minimum subscription target; the type of securities being offered, the offering starting and ending dates, the number of securities being offered and the offering price per security; any rights and conditions attaching to the securities and how the new securities issue will change the current share capital of the company and the weight of the current shareholders of the issuer's capital;
- (i) if any shares issued carry voting rights, an explanation as to how the investors will be able to exercise their right;
- (j) reasons for the offer and use of proceeds;
- (k) summary details of the assets, liabilities and financial position and sustainability of the Company;
- (l) an indication as to whether or not the issuer other concurrent offerings or has already carried out other crowdfunding offerings. If yes, a summary as to the amount raised and a description of the project for which the money was raised;
- (m) a description of any conditions related to or limitations [lock-ins] to the subsequent transfer of securities offered for subscription;

3) a section with information on the platform and the services it offers:

- (n) the name and address of the platform operator and his contact details;
- (o) a statement of the fact that the platform operator is licensed by the MFSA, together with the address of the MFSA;

- (p) a short description of the procedures in place for collecting and sending the issuer the subscription forms as well as the rules applied in the case of over-subscription. An indication as to whether a subscription can be revoked before the closing of the offering.
- (q) Hyperlinks to access a copy of the documents to be filled by the investors such as the subscription document, shareholder agreement (if any) and the self-declaration form to be used for the appropriation test;
- (r) a short description of the nature, frequency and timing of reports to investors;
- (s) a summary description of the steps which it takes to ensure their protection, including summary details of any relevant investor compensation or deposit guarantee scheme which applicable;
- (t) a hyperlink to a communication channel for investors or potential investors between themselves before and after subscription; and
- (u) a hyperlink to a description of the procedures applicable for lodging a complaint with the platform.

4) the amount to be charged to the investor:

- (v) the amount to be charged to the investor broken down into the price of the offer and the fees charged for the service by the platform and any other service providers.

The Platform Operator is required to ensure that an investor confirms to have read the summary information document before subscribing to an offer.

With regard to the nature of the instruments allowed to be listed on the platform the MFSA is of the view that since crowdfunding platforms are open to retail investors, issuers should only be permitted to list non-complex instruments on these platforms.

Anti-Money Laundering

The Discussion Paper explained that investment services providers are automatically subject to rules designed to combat money laundering and terrorist financing. Maltese legislation on anti-money laundering comprises the Prevention of Money Laundering Act (PMLA), the Prevention of Money Laundering and Funding of Terrorism Regulations (PMLFTR), as well as Sub-Title IV A of the Criminal Code. Under the PMLA, a subject person is required to report transactions suspected to involve money laundering or funding of terrorism, to conduct due diligence tests on their clients and to take other measures to prevent fraud. Respondents were invited to express any concerns they may have on susceptibility if investment-based crowdfunding to money laundering.

Industry Respondents expressed no major concerns in respect of the above. The general view was that investment-based crowdfunding is no more or less susceptible to money

laundering than any other form of investment or transaction. One Respondent noted that the FIAU has just published the revised Implementing Procedures which improve the legislation insofar as it relates to the provision of online financial services activity. Reference was also made to the risk-based approach under the 4th Anti-money Laundering Directive which should guide platforms into balancing out their resources in relation to AML and CFT measures.

One submission maintained that a Platform Operator should be able to place reliance on a third-party payment service provider, and would thus be exempt from the onerous duties of, amongst others, keeping and maintaining the know-your-customer documentations, together with internal controls and procedures. As is ordinarily the case under the AML Regime, the ultimate responsibility at law would still fall upon the Platform Operator, but the actual compilation, updating and processing of information would be carried out by the third-party payment services provider, which is itself subject to such duties. Another respondent noted that a crowdfunding platform would normally make use of a payment institution which may undertake due diligence procedures in regards to investors. However, in such case the platform would retain the responsibility to perform due diligence with respect to promoters and their projects.

MFSA Position:

Investment Services Licence Holders are considered to carry on “relevant financial business” for the purposes of the Prevention of Money Laundering and Funding of Terrorism Regulations [L.N. 180 of 2008] as amended. Accordingly, besides adhering to the Prevention of Money Laundering Act, 1994, Licence Holders are required to adhere to the Regulations and any relevant Guidance Notes issued by the Financial Intelligence Analysis Unit,

Regulation 15 of the Legal Notice requires that an Investment Services Licence Holder appoints a Money Laundering Reporting Officer. The person assuming this role may or may not act as Compliance Officer.

The Money Laundering Reporting Officer must ensure that proper Know Your Customer procedures are in place and that the procedures set out in the Implementing Procedures relating to the identification and verification of natural or legal persons are complied with. Copies of identification documents are to be retained of all customers and these should invariably be authenticated.

The point made by the industry that the third party payment services provider has analogous duties has been noted and discussions on the possibility of having the platform operator’s and the payment services provider’s AML obligations streamlined will be taken up with the FIAU.

The Authority is also considering the possibility of issuing a Guidance Note on the Fitness and Propriety Standards a crowdfunding service provider would be expected to maintain with respect to Issuers listing on its platforms.

The Appropriateness Test

The Discussion Paper set out some of the main conduct of business requirements applicable to investment services licence holders qualifying as MiFID Firms. *Inter alia*, the platform operator would be required to assess the appropriateness of the instrument for the client [the appropriateness test]. Respondents were asked whether they envisaged any problems in applying the appropriateness test online.

Industry Respondents observed that the application of the appropriateness test online is not a reality which is particular to crowdfunding platforms. As more and more financial services are provided on an online basis, the same issues which impact the whole industry will likewise impact investment based crowdfunding platforms. They pointed out no particular difficulty in performing an appropriateness test online. One Respondent observed that the objective of crowdfunding is to enable the investors to make quick and easy micro investments and this should be reflected in the requirements. The Authority was asked whether an investment-based crowdfunding platform would be able to rely on self-declarations by investors in respect of the appropriateness test.

MFSA's Position:

Whilst the Authority has no objection to licence holders performing the appropriateness test online, the Authority will not allow a platform to rely on self-declarations by investors with respect to their knowledge and experience in view of the fact that the responsibility of the assessment of the client's knowledge and experience rests with the Licence Holder (in this case the platform) and cannot be shifted in any manner onto the client.

3. CONTACTS

Any comments or queries in relation to these Regulations or in relation to this feedback statement should be addressed to the Regulatory Development Unit, MFSA via: finreg@mfsa.com.mt .