

DISCUSSION PAPER

INVESTMENT-BASED CROWDFUNDING

[MFSA REF:13-2016]

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DISCUSSION PAPER ON INVESTMENT-BASED CROWDFUNDING

INTRODUCTION

Crowdfunding is an emerging alternative form of financing that connects directly those who can provide funds, for a financial return or otherwise, with those who need financing for a specific project. Crowdfunding is becoming more and more widespread since the financial crisis, as banks' lending activity has fallen and small businesses are finding it more difficult to access finance. Small businesses play a central role in the Maltese economy. In Europe they represent 95% of the business and provide 55% of the total jobs in the private sector. For the Maltese economy this is even larger. The Entrepreneurship 2020 Action Plan invites Member States to "*assess the need of amending current national financial legislation with the aim of facilitating new, alternative forms of financing for start-ups and SMEs¹ in general, in particular as regards platforms for crowd funding*".²

DEFINITION, RISKS AND OPPORTUNITIES

Crowdfunding refers to '*open calls to the wider public, typically through the internet, to finance a specific project. Crowdfunding campaigns typically collect small contributions coming from a large number of individuals*'³. On one side of a crowdfunding transaction there is a person with an idea for a project who sets up a crowdfunding campaign (project owner or campaigner), and on the other side many people who give money to realise this idea (contributors). The web-based crowdfunding platform intermediates in the crowdfunding transaction and assists in publishing campaigns, reaching contributors and the collection of funds.

¹ Small and Medium Sized Enterprises.

² Entrepreneurship 2020 Action Plan - Reigniting the entrepreneurial spirit in Europe [Brussels 09.01.2013, COM(2012) 795 final], as cited in Consultation Document "Crowdfunding in the EU - Exploring the added value of potential EU action".

³ European Commission Consultation Document, "Crowdfunding in the EU – Exploring the added value of potential EU Action", 3rd October 2013.

Under the umbrella term ‘crowdfunding’, there exist different models of crowdfunding depending on the instrument used to contribute the funds⁴. In investment-based crowdfunding, companies issue equity or debt instruments to crowd-investors through a platform. Investment-based crowdfunding has the potential to bring significant benefits to the Maltese economy in terms of jobs and growth, especially by providing an alternative funding source for start-ups, SMEs and unlisted companies. At the same time, there are also high risks associated with such investments and appropriate safeguards need to be in place.

Some of these key risks are highlighted below:

(a) Loss of Capital: investment-based crowdfunding will attract mainly start-ups and SMEs which may not have an established track record, and the failure rate is high. These pose high risks of capital loss to investors, particularly for those who may not be familiar with early stage investing.

(b) Lack of liquidity: in the absence of a secondary market for trading in the securities, investors face the risk of not being able to sell their securities or may only be able to sell them at a significant discount.

(c) Fraud: as fundraising is carried out through online platforms, investors will not have personal contact with the persons making the offers of securities. There may also be limited information on the projects being funded. Hence, there is a risk that the projects may not be genuine and that the rewards or returns promised to investors will not materialise.

(d) Platform closure or failure: in the event of a temporary or permanent shut down of a crowdfunding platform that handles customers’ money, investors may face losses unless safeguards are in place.

Q1. Do you think investment-based crowdfunding can have a positive effect on local SMEs?

Q2. What are your general concerns with regards to investment-based crowdfunding?

⁴ The scope of this paper is restricted to investment-based crowdfunding. Other forms of crowdfunding include donation, reward and lending-based crowdfunding.

REGULATION OF INVESTMENT-BASED CROWDFUNDING

The MFSA has been monitoring the developments at European Union [EU] level. In October 2013 the European Commission issued a Consultation Document⁵, and invited stakeholders to express their views on how European action can help unleash the full potential of crowdfunding in Europe. In March 2014, the European Commission adopted a package of measures to stimulate long-term financing and support sustainable growth in the EU⁶. Improving SME's access to financing through crowdfunding, is part of this work plan. The European Supervisory Authorities have also carried out work on crowdfunding, in their respective areas of responsibility. Most notably, in December 2014 the European Securities Markets Authority (ESMA) published advice⁷ and an opinion⁸ on investment-based crowdfunding. These ESMA Papers have provided national competent authorities with some clarity on how crowdfunding business models fit within the existing EU Rules.

ESMA is concerned that crowdfunding platforms in Europe are incentivised to operate in a way that they fall outside existing regulatory parameters, which is holding back their growth and increasing risks for investors. However, a recent Commission Working Document⁹, has ruled out any action at EU level in the near future. The working document demonstrates that crowdfunding remains relatively small in the EU, and given the predominantly local nature of crowdfunding, there is no strong case for EU wide policy intervention at this juncture. In view of this recent development, the Authority is considering 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. The approach chosen by the Authority is to apply the general securities regulatory framework, with the addition of some *ad hoc* investment protection measures. The platform operator would need to acquire an investment services licence in terms of the Investment Services Act as explained in further detail below, and have

⁵ European Commission Consultation Document, "Crowdfunding in the EU – Exploring the added value of potential EU Action", 3rd October 2013.

⁶ (MEMO/14/238).

⁷ ESMA/2014/1560.

⁸ ESMA/2014/1378.

⁹ Commission Staff Working Document on "Crowdfunding in the EU Capital Markets Union", issued on the 3rd May 2016.

both its head office and registered office in Malta. The platform operator would fall within the scope of MiFID¹⁰ 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.

Q3. Do you agree with the application of the securities regulatory framework to investment-based crowdfunding?

Q4. Would you like to see less restrictions on the location of the issuers on investment crowdfunding platforms?

LICENSING REQUIREMENT FOR PLATFORM OPERATORS

In investment-based crowdfunding contributors purchase financial instruments, and therefore the intermediary role played by the crowdfunding platform may be deemed to be an investment service (the reception and transmission of orders). The Investment Services Act, 1994 (“the Act”) provides a statutory basis for regulating the provision of investment services. A licensable activity takes place when an investment service listed in the First Schedule of the Act is offered in respect of an instrument listed in the Second Schedule. There are four categories of investment services licence and these vary, *inter alia*, in the nature of the service provided and the associated capital requirements¹¹. Some investment services listed in the First Schedule are more onerous than others and therefore attract higher capital requirements. The least onerous licence category is Category 1A, where the minimum initial capital requirement is of €50,000. With a Category 1A licence an investment service provider can provide the reception and transmission of orders, investment advice and also place instruments without a firm commitment.

The Authority has identified the investment service most likely to be provided by investment-based crowdfunding platforms as the reception and transmission of orders. The crowdfunding

¹⁰ Markets in Financial Instruments Directive (Directive 2004/39/EC).

¹¹ For the details of the criteria which the MFSA would apply in considering an application for a licence vide Part A of the Investment Services Rules for Investment Services Providers.

platform receives orders from investors to subscribe for instruments and transmits them to the issuer or another third party intermediary for execution. Some platforms undertake to market offers for project owners, thereby carrying out the service/activity of placing without a firm commitment.

The Authority is currently considering whether to restrict the category 1A licence when provided to investment-based crowdfunding platforms in order to restrict the platforms' activity to reception and transmission of orders and placing without a firm commitment only. In general, platforms do not market themselves as providing personalised recommendations on investments. Some platforms operating in the EU are required by their regulator to provide investment advice. The Authority is of the view that platforms should restrict their involvement in the investments to customer due diligence checks and the investors should be encouraged to make their own well informed investment choices.

Q5. Do you view the typical activity of an investment-based crowdfunding platform as the reception and transmission of orders?

Q6. Is there another investment service which you deem relevant to crowdfunding such as placing of financial instruments, investment advice or execution of orders on behalf of clients?

Q7. The MiFID passport comes with quite onerous capital requirements. How essential is the passport for investment crowdfunding platform operators in Malta?

THE ISSUER

The Authority is of the view that investment-based crowdfunding should be available to both public and private companies.

Article 89 of the Companies Act requires Maltese public companies, to issue a prospectus whenever they issue any form of application for their shares or debentures. Whenever there is an offer of transferable securities to the public in a European Member State, a harmonised EU prospectus must be published in accordance with the Prospectus Directive¹² unless one of the

¹² Directive 2003/71/EC.

exemptions or the limitation of scope within the Directive applies¹³. Some offers of securities are exempt from the prospectus requirement. These include:

- i. offers where the total consideration of the securities for the offer within the European Union and the EEA does not exceed five million (5,000,000) euro, which limit shall be calculated over a period of twelve months,
- ii. offers of securities made only to qualified investors; and
- iii. offers to less than 150 persons per Member State¹⁴.

Article 209 of the Companies Act provides that a private company is a company which, by its memorandum or articles -

- (a) restricts the right to transfer its shares; and
- (b) limits the number of its members to fifty; and
- (c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

The meaning of ‘invitation to the public’ within this provision should be construed in accordance with article 2(3) of the Companies Act which excludes certain offers from the definition of ‘offer to the public’, such as offers to qualified investors or offers to less than 150 persons.

Q8. Is investment-based crowdfunding a practical option for private companies within the current legislative framework?

Q9. Which exemptions from the prospectus requirement are most relevant to crowdfunded offers?

Q10. Do you agree with the interpretation that crowdfunded offers are likely to fall outside the scope of the Prospectus Directive?

¹³ On 30 November 2015, the European Commission published a proposal to replace the existing Prospectus Directive (Directive 2003/71/EC) with a Regulation which will be directly applicable.

¹⁴ Article 2(3)(b) of the Companies Act.

FINANCIAL INSTRUMENTS

The financial instruments most likely to be used in investment-based crowdfunding are shares and mini-bonds¹⁵. These securities are usually not listed on regulated stock markets, making them highly illiquid and hard-to-price. Most EU legislation on financial services, including MiFID and the Prospectus Directive only apply where the financial instruments are transferable securities. Many investment-based crowdfunding platforms operating within the EU have avoided EU regulation on this basis, and ESMA has encouraged Member States to take measures to avoid the use of securities that would not qualify as transferable securities.

The Authority however intends to interpret the term ‘transferable’ broadly and only in very limited circumstances will securities be deemed to be non-transferable. Shares, and bonds or other debt securities are listed under ‘transferable securities’ in the Second Schedule to the Investment Services Act. The fact that there is no, or only a limited secondary market for these securities when offered on online crowdfunding platforms does not alter their nature as transferable securities. Shares which are conditionally negotiable, such as shares of private companies are also still transferable securities notwithstanding that restrictions apply to their transferability. Investment-based crowdfunding platforms are therefore unlikely to avoid regulation on this basis.

Q11. Do you agree that equities and bonds are the most common instruments used for investment through crowdfunding platforms?

Q12. What measures can be taken by the platform or the issuer to increase exit options for investors?

¹⁵ A mini-bond is a type of debt security, typically issued by small businesses. Mini-bonds run for around three to five years, in general, and offer an interest rate of between 6% and 8% a year. They are becoming increasingly popular with investors, attracted by the interest rates on offer, however, they are illiquid and can be high risk, as the failure rate of small businesses is high.

CONDUCT OF BUSINESS REQUIREMENTS

Investment-based crowdfunding platforms would be subject to the licence conditions applicable to investment services licence holders qualifying as MiFID Firms [the Rules]. A range of conduct of business requirements apply. *Inter alia*, the platform operator would be 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 and of the specific type of instrument that is being offered, and consequently to take investment decisions on an informed basis. In addition, the appropriateness of the instrument for the client has to be assessed unless a number of conditions are satisfied. One such condition is that the investment service relates to non-complex financial instruments. Financial instruments specifically listed in the Rules as non-complex include “*shares admitted to trading on a regulated market, bonds and other securitized debt, excluding those containing a derivative.*” Bonds and other debt securities could be relevant in the context of crowdfunding and a platform would not need to carry out an appropriateness assessment where any other applicable conditions are met. However shares issued on a crowdfunding platform may not qualify as non-complex instruments since such shares are not normally quoted on a regulated market. This implies that the sale of shares on a crowdfunding platform would be subject to an appropriateness test.

Furthermore, the Rules further specify the criteria for instruments not specifically indicated therein as being “non-complex”. In this regard, derivatives and instruments involving leverage are always complex. Other instruments should be considered non-complex if:

- i. there are frequent opportunities to dispose of or realise the instrument at publicly available market prices: and
- ii. adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood so as to enable the average retail client to make an informed judgement about whether to transact¹⁶.

Given that the equity and hybrid instruments through which crowdfunding investment takes place typically have no secondary market and limited other opportunities to dispose of or

¹⁶ Investment Services Rules for Investment Services Providers Part BI, MiFID Firms; SLC 2.25.

realise the investment, such instruments should be considered as complex. Accordingly, potential investors on an investment-based crowdfunding platform should be subjected to an appropriateness test with a view to assess the potential investor's knowledge and experience.

The online nature of crowdfunding platforms' operations has made it feasible for them to offer their services to a great number of persons including individuals from different member states acting outside their business i.e. consumers. The online platform is providing its services for a fee and is acting in way of business. A platform may therefore need to abide to legislation related to consumer protection in the context of distance contracts. Distance Selling (Retail Financial Services) Regulations 2005 cover contracts for retail financial services (banking, insurance, payment and investment services, including pension funds) that are negotiated at a distance (e.g. by telephone, fax or over the Internet), i.e. by any means which do not require the simultaneous physical presence of the parties to the contract. The Regulations apply where there is a contract between a supplier (anyone acting in a commercial/professional capacity) and a consumer (any individual not acting in such capacity). Where they apply, the Regulations require information disclosures about the supplier and the financial service¹⁷.

Q13. What do you view as the largest obstacles to performing the appropriateness test online?

ANTI-MONEY LAUNDERING LEGISLATION

Investment-based crowdfunding platforms present a risk because there is a risk that they could be potentially used for money laundering or terrorist financing. Platforms that collect funds for subsequent onward transmission are particularly vulnerable to abuse for money laundering purposes, when money is held in individual client accounts from which funds are transferred to the issuer once an investment is decided upon.¹⁸

Maltese legislation on anti-money laundering comprises the Prevention of Money Laundering Act (PMLA), the Prevention of Money Laundering and Funding of Terrorism Regulations

¹⁷ The Distance Selling Regulations [S.L. 330.07] implement Directive 2002/65/EC.

¹⁸ In December 2014 ESMA published an Opinion to national competent authorities and Advice to the EU institutions, setting out the results of its analysis of the business models of investment-based crowdfunding platforms, their regulatory treatment under the current EU rules and the issues for consideration by policymakers.

(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. The PMLFT Regulations define a "subject person" as any legal or natural person carrying out either relevant "financial business" or "relevant activity". Relevant financial business includes investment services carried on by a person or institution licensed or required to be licensed under the provisions of the Investment Services Act, and any activity which is associated with them. The term relevant activity includes managing of client money, securities or other assets, unless the activity is undertaken under a licence issued under the provisions of the Investment Services Act. Investment services providers are therefore automatically subject to rules designed to combat money laundering and terrorist financing.

The imposition of a Category 1A investment service licence on the platforms would prevent them from controlling investors' funds, and mitigate the risks because this would not allow platforms to hold and control clients' money. In practice many platforms currently operating in the EU already use third party payment institutions for the transfer of funds.

Q14. Do you view investment-based crowdfunding activity as susceptible to money laundering?

Q15. Do you view the current legislation on money laundering as fit for application to online financial services activity?

Q16. What are your views on the handling of investors' funds?

OTHER INVESTMENT PROTECTION MEASURES

In light of the specific risks posed by investment-based crowdfunding, the Authority is minded to introduce 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;

- iii. requirements for platforms to conduct minimum due diligence tests on the projects/project owners and to take measures to reduce the risk of fraud;
- iv. specific disclosure requirements tailored to crowdfunding even where the offer would trigger application of an exemption to the general prospectus requirements. Such key information document would include prominent risk warnings.

Q17. Do you agree with the introduction of investment and project size caps? What other consumer protection measures would you suggest?

Q18. What information would you deem essential to include in a key information document for crowdfunding?

Q19. What are your general views on the regulatory approach outlined in this paper?

CONTACTS

The MFSA is seeking initial feedback from the industry before deciding whether to go forward with detailed proposals for a legal framework on investment-based crowdfunding. Responses should reach the MFSA by **31st January 2017**.

Please send your responses to the Regulatory Development Unit, MFSA (to the attention of Dr. Emaliese Lofaro, email: elofaro@mfsa.com.mt).

Communications Unit

Malta Financial Services Authority

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