Towards a Crowdfunding Regulatory Framework

Thursday, May 8, 2014

By Dr Charles Cassar

Weblink: *http://www.timesofmalta.com/articles/view/20140508/business-comment/Towards-a-crowdfunding-regulatory-framework.518160*

In 2009, Palmer Luckey was a sunny 16-year-old Californian boy with a thing for virtual reality headsets. He was a keen collector of these quirky, unfashionable gizmos, but never found one that quite matched his expectations. So he started making his own. In March 2014, Oculus VR, the company he set up to produce his virtual reality heads, the Oculus Rift, was sold to Facebook for $2 billion.

On the way to stardom, Luckey had two crucial helping hands. One was an old-fashioned celebrity endorsement: John Carmack, a game developer of near-mythical repute, took a keen interest in the project and of his own accord demonstrated the technology to the press at E3 2012, generating huge buzz around the product. The other was decidedly more 21st century: Oculus Rift raised $2.4 million through Kickstarter, an internet based 'crowdfunding' platform.

So what is crowdfunding, and how does it allow Californian lads to raise millions to develop sci-fi gadgets? Simply put, crowdfunding is the process of raising finance for the development of a product or the carrying out of an endeavour through a typically large group of small backers (the crowd), usually via a web platform (the crowdfunding platform) which permits entrepreneurs to promote their projects to the public.

Crowdfunding operations follow a number of different business models. Oculus Rift used Kickstarter, which employs rewards-based model, but there are four major recognised business models:

Donation based: people give money to activities or products they want to support;

Rewards based: people give money to receive a reward, service or product (e.g. a limited edition version of the video-game they are backing);

Loan based: people lend money to individuals or businesses in the expectation of a return in the form of interest and capital repayments Investment/equity based: people invest directly or indirectly in new or established businesses by acquiring shares or debt securities, or units in a collective investment scheme;

Crowdfunding can satisfy an important economic need – channelling finance towards small, innovative start-ups that may be perceived as too risky by financial institutions and may not have the maturity and infrastructure necessary to obtain finance via the IPO route. Facebook's acquisition of Oculus Rift has underlined the potential that the crowdfunding model has as a catalyst for entrepreneurship and technological innovation.

Closer to home, it encourages us to look closely at the steps that we should be taking as a jurisdiction to encourage the growth of this new and economically useful financial service, especially given ongoing efforts to develop Malta into an international hub for start-ups and innovation. In this context, the lack of a bespoke regulatory framework addressing the needs of the sector is probably the most immediate challenge.

One should not promote a high-risk product to an unsophisticated, retail investor

Theoretically, one would expect loan-based and investment-based crowdfunding operations to be regulated under the provisions of the Financial Institutions Act, 1994 and the Investment Services Act, 1994 respectively (we can set aside donation and rewards-based operations for the purposes of this discussion, since they pose lower regulatory risks). However, the existing legislative framework pre-dates the development of crowdfunding as a viable source of finance and therefore does not adequately address the specific concerns raised by the sector.

The issuing of a 'crowdfunding rulebook' would be an important first step towards opening Malta up for such business, and would almost certainly serve to encourage growth in the area.

TIMESOF MALTA.COM

Towards a Crowdfunding Regulatory Framework

Thursday, May 8, 2014

By Dr Charles Cassar

Weblink: http://www.timesofmalta.com/articles/view/20140508/business-comment/Towards-a-crowdfunding-regulatory-framework.518160

Which special challenges does crowdfunding pose that such a rulebook should seek to address? A recent paper by the UK FCA identified a number of risks including the lack of a secondary market, the possibility of platform failure and the potential for conflicts of interest. However, the key concerns are probably three:

Suitability and appropriateness: financial regulation requires operators to assess the suitability and appropriateness of financial products to the needs of investors. In simple terms, this means that one should not promote a high-risk product to an unsophisticated, retail investor. However, crowdfunding is almost by definition focused on high-risk/high-return opportunities. The rulebook will need to identify ways in which the market can remain accessible to retail investors that are the backbone of the service while protecting such investors from taking imprudent risks with their money. A limit on the portion of their net worth that inexperienced investors may invest via crowdfunding could be prudent in this context.

Public offer of securities: the offering of securities (such as shares and bonds) to the public is an activity which is subject to stringent regulation. While such regulation is healthy and necessary, it may not be proportionate to the circumstances of businesses seeking to raise finance through crowdfunding platforms. Our law already provides for a number of exemptions from the rules associated with a public offer of securities; any further flexibility would be welcome and helpful in this context. Investee due diligence: reputable crowdfunding operators already seek to carry out due diligence on investees that are promoted on their platform in order to protect their reputation. Sensible regulation should seek to formalise this market practice, but without raising the bar so high that crowdfunding becomes inaccessible to the technology start-up niche that is most in need of it.

Perhaps we can also take some comfort from the fact that we will not quite be trailblazers in the sector. The UK has published rules that came into force on April 1, providing us with a blueprint on how to implement a crowdfunding rulebook within the strictures of existing EU directives. The US has also been hard at work, with the Jobs act being designed to create certain exemptions in favour of crowdfunding.

This is not to say that we should slavishly follow other jurisdictions. The introduction of a new rulebook gives us the opportunity to create a market that is both safe as well as attractive, and there is no reason why we should not seek to be innovative as well. If the private sector, regulators and professionals can work together towards a sensible rulebook for crowdfunding, the next Palmer Luckey could very well be Maltese.