

## **KEEPING THE “CROWD” IN “CROWDFUNDING”**

### **ISLE OF MAN PROPOSALS FOR THE REGULATION OF CROWDFUNDING**

The Isle of Man and the Department of Economic Development (“DED”) are continuing to look at ways to bring quality new businesses to the island. The DED has made no secret of the fact that the island can offer some very real opportunities to the financial technology (“Fintech”) sector and the entrepreneurs and businesses in this arena. One such exciting possibility and source of new business for the island has been identified as crowdfunding.

Crowdfunding is a relatively new and ‘disruptive’ form of (a) investing (if you are a consumer); and (b) raising capital (if you are a company). There are many different types of crowd funding but for the purpose of this article we are going to look at two of the most popular types: equity crowdfunding and loan crowdfunding. Both forms take the same approach and are based upon the same premise: that is, that potential investors will use a designated online crowdfunding platform to enable them to provide capital to companies, either in return for the companies issuing fresh shares to investors, or by way of the companies taking the capital in the form of interest bearing debt.

Raising capital through crowdfunding has become increasingly popular over the past few years, and there are a number of contributory factors that we can point to in order to explain this. First, from the underlying companies’ point of view, more traditional sources of lender (e.g. the banks) are not lending as much as they did pre financial crisis and, when they do lend, the loans are not necessarily on terms that are to the liking of the companies seeking the capital. Secondly, from the consumers’ point of view, those consumers that might have some surplus or investment cash will not be seeing any decent return on that cash by keeping it in the bank, what with interest rates being where they are. Many consumers are therefore looking at alternative ways that they can invest their money and many companies are looking at alternative ways to raise finances. Crowdfunding offers one solution to both.

In the past twelve or so months a number of overseas territories have begun to consider what protections might be sensible or advisable in order to prevent, or at least mitigate, consumers from being burned by failed crowdfunding investments. “Solutions” offered may depend on whether the crowdfunding is by way of equity investment or loan and various proposals range from the UK limiting the types of person that may invest, to the U.S. imposing stringent high net worth tests, right through to New Zealand opting not to impose any restrictions on its lenders.

Having been undertaking a consultation process dating back to April 2015, the Isle of Man Financial Services Authority (the “Authority”) is proposing a new regulatory structure whereby crowdfunding will be a newly-created, stand-alone regulated activity which will require the company that runs the online platform to obtain a new “Class 6” licence. Equity crowdfunding already likely falls within the regulated activity of investment business by virtue of “arranging in deals”, and so creating this new Class 6 regulated activity will be no huge leap for equity crowdfunding. Regulating loan crowdfunding will be a considerable leap, however, given that this type of lending has not

historically been regulated (although aspects might have been caught by the Moneylenders Act 1991 and subject to oversight by the Office of Fair Trading).

The new Class 6 crowdfunding activities will have their own licence conditions, which in due course (once tested) will become part of the Financial Services Rule Book. Some of the rules that are applicable to crowdfunding are already in existence, such as audit requirements and risk management. Others, however, will be new conditions, and the remainder of this article looks briefly at some of those new proposed conditions and their potential impact on crowdfunding in the Isle of Man.

As the licence holders running the crowdfunding websites/platforms are not financial service advisers, there are some obviously sensible conditions that are proposed to be put in place, such as that licence holders are not able to recommend investments or advise potential lenders. This flows through into conditions that the crowdfunding websites must contain specific information warning about the risks inherent with crowdfunding, rate of failures of issuers generally, and the need to place minimum content on the websites such as investee company business details, directors, amount being raised, etc.. There is also a condition that there must be a "Crowdfunding Offering Document" that includes descriptions of the investment, rights attaching to the investment and so forth. These obligations do not, on the face of it, seem too onerous and resonate with many existing forms of security issuance.

The difficulty is that crowdfunding is not supposed to be like many other forms of security issue or capital raising. It is supposed to be a new, disruptive avenue that can perhaps offer cheaper capital to companies while enabling consumers to have a viable alternative to stagnant savings.

For the crowdfunding concept to work and be a successful initiative on the Island, it will need to work for investors and companies alike. We can start to get a picture from the above of how the consumer is, rightly, being protected. What, however, of those companies that are seeking a jurisdiction in which to either operate crowd funding platform companies or, importantly, in which jurisdiction the underlying investee companies are likely to have the most success in raising capital? These companies will be interested in the proposed limitations concerning who can and cannot invest in equity crowd funding. Some might question whether these limitations are too onerous and place an unnecessary barrier to entry; others may question whether the investment levels have been set too high. As proposed you will currently need to fit within one of the following categories:

- (1) Be a "Restricted Client" which means that you can invest no more than £1,500 per investment and an aggregate of £5,000 per crowdfunding platform; or
- (2) Be a "High Net Worth Client", which means having to have £100,000 net worth available for investing/lending (excluding pension, insurance arrangements and principal place of business) and consider yourself to have experience in illiquid investments/loans, in which case you can invest £10,000 per loan and a maximum of £50,000 per platform; or
- (3) Be an "Unlimited Client", which means having a minimum of £500,000 net worth available for investment (again not including principal place of business, etc.).

Again, it is clear that the Authority is taking a robust view on how best it can protect consumers who would like to invest in equity crowdfunding. A concern that some companies may have, however, is that these restrictions will limit the size of the available investment pool that is open to them within the Isle of Man. Capital raisings of any decent size are almost certainly likely to need the support of the “High net Worth” and “Unlimited Client” because the Island just may not have the critical mass to enable the willing and available Restricted Clients to satisfy company requirements, especially as platforms that allow Restricted Clients to invest will have to limit the amount that a company can raise to £1million a year. That may well be enough for some companies, but it might not be enough to attract the sort of business to the Isle of Man that the DED is targeting.

Investors may, of course, be happy to go through the process of entering into new agreements (including statements of risk acknowledgement and certifications) with the crowdfunding platforms every time that they want to make a small investment. It would probably become a formality much the same as with a stock broker or a retail initial public offering application form. With those investments, however, the investor has the ability to freely transfer their investment or loan portfolio onwards when it wishes to. With the new Class 6 regime as anticipated, investors will need to be aware that, although the re-sale of investments purchased through a crowdfunding platform is not prohibited, finding a market to facilitate this may well be an issue, as under the Class 6 licence conditions the licence holder (the crowdfunding portal) cannot facilitate any onward sales or secondary trading. This stretches to the extent that the website is even prohibited from providing channels of communication such as discussion boards on its website to help the investors and lenders that first invested or lent through them. Given these restrictions, crowdfunding investors and lenders must understand that there is an additional (regulatory-imposed) risk to the liquidity of their investment; the likelihood is a knock-on effect to the long term position that they may invariably therefore have to take.

The process is still in consultation, with a combined response to the second consultation having been issued in December 2015. It is clear from the consultation process that the Authority is taking its role seriously in seeking to protect consumers while at the same time ensuring that reputational risk to the Island is minimised. These values and protections should be applauded. However, the key will be to ensure that the area does not become so regulated or filled with obstacles that the local crowdfunding industry dissolves, lacking the necessary international competitiveness that is needed to ensure its success as an industry and as a source of alternative capital. If the authorities can get this right, by providing a level of safeguarding to consumers while not being inhospitable through excessive regulation or placing too high a barrier to entry to enable efficient alternative funding, then the Isle of Man can find itself in a dominant position within this exciting and fast-growing sector.

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