

7 May 2014

## **Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities**

The purpose of this notice is to remind parties engaging in crowd-funding activities of the potential application of relevant securities laws and regulations, and to remind the public of the potential risks involved in participating in crowd-funding activities, in view of the increase in such activities internationally and in Hong Kong.

### ***What is crowd-funding***

“Crowd-funding” typically refers to the use of small amounts of money, obtained from a large number of individuals or organisations, to fund a project, a business or personal loan, and other needs through an online web based platform (Note 1).

### ***Potential securities regulatory implications applicable to crowd-funding activities***

Crowd-funding may come in different forms. The more common types that have emerged are:

- (1) equity crowd-funding - under which investors invest in a project or a business, usually a start-up, and gain in return an interest in shares in or debt issued by a company or an interest in participating in the profits or income of a collective investment scheme (Note 2);
- (2) peer-to-peer lending (P2P lending) - under which online platforms match lenders (investors) with borrowers (issuers) to provide unsecured loans to individuals or projects;
- (3) donation crowd-funding – under which sums are raised for charitable causes; and
- (4) reward/ pre-sale crowd-funding – under which returns in the form of physical goods or services are provided in return for the sums provided by the payer.

Depending on the specific structure and features of the relevant arrangement, some types of crowd-funding activities, in particular equity crowd-funding and P2P lending, may be subject to the provisions of the Securities and Futures Ordinance (Cap.571) (“SFO”), and/or the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap.32) (“C(WUMP)O”).

#### **(i) Offers of investments**

Where the crowd-funding activity involves an offer to the public to purchase securities (for example shares, debt instruments or interests in collective investment schemes), there are restrictions under the SFO and the C(WUMP)O. Specifically:



- It is an offence under the SFO for a person to issue any advertisement, invitation or document which to his knowledge is or contains an invitation to the public to acquire securities or participate in a collective investment scheme, unless the issue has been authorized by the SFC or an exemption applies (Note 3).
- A document offering shares in or debentures of a company to the public is subject to prospectus registration requirements under the C(WUMP)O unless an exemption applies. It is an offence under the C(WUMP)O for the company and every person who is knowingly a party to the issue to issue a prospectus which does not comply with the relevant disclosure and registration requirements (Note 4).

(ii) Intermediaries licensing and conduct of business requirements

Crowd-funding platform operators should note that even where an exemption applies to an offer of investment (for example, where the offer is only made to professional investors), they may still be subject to licensing obligations if the crowd-funding activity and/or the business of the operators constitutes “regulated activity” as defined under the SFO (Note 5).

Depending on the nature of the business, crowd-funding platform operators may be required to be licensed to carry on one or more of the following types of regulated activities (Note 6):

- Type 1 (dealing in securities)
- Type 4 (advising on securities)
- Type 6 (advising on corporate finance)
- Type 7 (providing automated trading services)
- Type 9 (asset management)

Crowd-funding platform operators are also reminded that an intermediary which is required to be licensed by or registered with the SFC under the SFO would also be subject to conduct and other relevant requirements of the SFC, including the applicable codes and guidelines issued by the SFC from time to time.

(iii) Regulatory requirements applicable to automated trading services and/or recognized exchange companies

Depending on the nature of services provided and type of products offered, platform operators should be aware that there are certain requirements under Part III of the SFO relating to automated trading services and recognized exchange companies which may be applicable to their business activities (Note 7).

***Potential liability and ensuring compliance***

Parties which seek to engage in crowd-funding activities should be aware that a breach of the SFO and C(WUMP)O could lead to serious consequences including criminal liability resulting in a term of imprisonment and/or fines. Civil proceedings may also be brought on the basis of a breach of relevant provisions.



Apart from securities laws and regulations, parties engaging in crowd-funding activities should also check if there may be other Hong Kong laws and regulations which are applicable to their activities and/or their operators including for example those relating to money-lending.

Parties should seek professional advice if in doubt to ensure compliance with all applicable laws and regulations, which could vary depending on the specific features of the activities undertaken. Crowd-funding platform operators and/or any party who wishes to raise funds via crowd-funding activities should take note that the legal and regulatory obligations referred to above are not intended to be exhaustive and do not constitute legal advice from the SFC.

### ***Risks for investors participating in crowd-funding activities***

Crowd-funding activities may give rise to significant risks, including the following (Note 8):

- **Risk of default** – failure of the investment project or business, typically start-ups in the case of equity crowd-funding, or default in repayment of loans under P2P lending which are commonly unsecured, which may lead to a total loss for investors.
- **Risk of illiquidity and dilution of stock value** – investors may have difficulty to liquidate positions in their investment in crowd-funding as there may be little or no secondary market for the investments involved. The value of shares issued in the case of equity crowd-funding may be subject to dilution by further issuance.
- **Risk of platform failure/ insolvency** – a crowd-funding platform may temporarily or permanently shut down, may be hacked, and could become insolvent. This may lead to a total loss of investment, in addition to loss of information.
- **Risk of fraud** – due to the anonymity created by the online aspect of crowd-funding platforms, investments in crowd-funding activities could be subject to higher risks of fraud in which case the investor may lose his/her investment in entirety.
- **Platform operating outside Hong Kong** - if the crowd-funding platform is out of the jurisdiction, investors may not enjoy the same protection under applicable laws and regulations in Hong Kong.
- **Information asymmetry and lack of transparency** – full and accurate information on the investment or loan for the crowd-funding activity, including the project or company in which the investment is made or the borrower's profile, may not be readily available on or fully verified by the crowd-funding platforms. Certain platforms may also lack sufficient transparency, for example, as to the valuation of an investment, and by withholding information (for instance about historic default rates or costs). In addition, risks may not be fully disclosed even after an investor has actually made an investment or become a member of the crowd-funding platform.



- **Cyber security** – crowd-funding is vulnerable to the risk of cyber-attacks in view of the online nature of crowd-funding. Such cyber-attacks may come in varied forms, such as overloading a platform’s infrastructure, confusing accounts and/or identity theft.
- **Illegal activities** - platforms may be used to engage in illegal activities such as money laundering or illegal commerce that could lead to regulatory action including suspension by relevant law enforcement agencies. Depending on the particular crowd-funding activity in question, it may also be subject to other non-securities related laws and regulations.

Investors considering participation in crowd-funding activities and in doubt about the nature, risk profile and regulatory status of such activities should seek professional advice (Note 9).

### **General**

The SFC will keep in view the development of crowd-funding activities and may issue further guidance where appropriate. The SFC will also take appropriate regulatory action where non-compliance with relevant securities laws and regulations is detected.

### **Securities and Futures Commission**

Notes:

1. This definition is adopted in a staff working paper entitled “Crowd-funding: An Infant Industry Growing Fast” published by International Organization of Securities Commissions on 5 February 2014 (“IOSCO Paper”).
2. Equity crowd-funding could take many different forms. Depending on the particular structure of the crowd-funding activity, it could involve an investor obtaining an interest in the company via shares or debt instruments, or that an investor may be promised a share in the profits or income generated from the relevant crowd-funding arrangement managed by a third party.
3. Section 103 of the SFO.
4. In case of an issue by a company incorporated in Hong Kong, sections 38, 38B and 38D of the C(WUMP)O; in case of an issue by a company incorporated outside Hong Kong, sections 342 and 342C of the C(WUMP)O.
5. Sections 114 and 115 and Schedule 5 to the SFO.
6. In considering if licensing obligations under the SFO applies, parties should have regard to the definition of “securities” as set out in Schedule 1 to the SFO and the definition of different types of regulated activities as set out in Schedule 5 to the SFO.
7. Sections 19 and 95 of the SFO.
8. The IOSCO Paper raised broadly similar investor protection concerns regarding crowd-funding activities. In particular, it pointed out that for equity crowd-funding,



which usually invests in start-ups, there is a 50% chance of a start-up folding in the first 5 years of existence. It also noted that for peer-to-peer lending, the default rates for one of the major overseas peer-to-peer lending platforms reached a high of 30% in 2009.

9. The Investor Education Centre has also published information on its website outlining the key risks of participating in crowd-funding activities. Please access the information via the link: [www.hkiec.hk](http://www.hkiec.hk).