

Should Hong Kong legislate on crowdfunding?

If so, how?

1 Introduction

Crowdfunding has recently blossomed all over the world and experienced accelerated growth globally. Massolution's 2015 Crowdfunding Industry Report revealed that there were at least 1250 crowdfunding platforms worldwide and over \$34bn was raised last year.¹ Around one-fifth of all UK equity deals are now made via crowdfunding.² John Tsang Chun-wah, the Financial Secretary of Hong Kong, announced in the 2015-16 Budget Speech that a steering group would be established to study how to facilitate crowdfunding activities in Hong Kong so as to maintain its status as an international financial centre.³

This paper seeks to argue that there is a pressing need to legislate crowdfunding in Hong Kong. Part 2 of this article will first discuss the definition of crowdfunding. The legislative frameworks in Hong Kong and other jurisdictions will then be examined. It is found that Hong Kong is lagging far behind our counterparts in the relevant legal development. Part 3 will critically analyze the arguments against legislations. The counter-arguments will conclude that law reform is necessary and desirable in Hong Kong with due regard to its current commercial and economic environment. In Part 4, key recommendations that can strike a balance between facilitating crowdfunding and investor protection would be made. Approaches adopted by other jurisdictions will be critically analyzed. The conclusion will point out the cautionary steps prior to any reform and the limitations of this research paper.

¹ Massolution, '2015CF Crowdfunding Industry Report' (Massolution, March 2015)

² S. Appleton, 'Funding Crowds Move into the Finance Mainstream' [2015]69(5) IGI 16

³ Hon J.C. Tsang, 'The 2015-2016 Budget Speech' (*Budgetgovhk*, 2015)

<http://www.budget.gov.hk/2015/eng/pdf/e_budgetspeech2015-16.pdf> accessed 14 February 2016

2 Overview

2.1 Definition

Crowdfunding is a new form of finance option to companies and is commonly used to encourage the development of early-stage entrepreneurial businesses. According to the International Organization of Securities Commission (“IOSCO”), it refers to “the use of small amounts of money, obtained from a large number of individuals or organizations, to fund a project, a business or personal loan, and other needs through an online web based platform.”⁴ Being an ordinary member of the IOSCO, the Securities and Futures Commission (“SFC”) in Hong Kong has endorsed and cited this definition in its publication.⁵

There are four types of crowdfunding:⁶

- (a) **Donation Crowdfunding:** Payer donates money to fund a project or cause.
- (b) **Reward Crowdfunding:** Payer receives physical products or services in exchange for their contributions.
- (c) **Peer-to-Peer Crowdfunding:** Payer provides loan to the issuer, thereby receiving interests and repayment of the principal.
- (d) **Equity Crowdfunding:** Payer invests in the company shares and receives financial return in form of dividends and/or capital growth.

Donation and reward crowdfunding are not regulated by financial market laws as they are not considered as investments. However, peer-to-peer and equity crowdfunding are classed as “financial return crowdfunding” carrying significant investment risks. They fall within the ambit of securities law in various jurisdictions though there is no international harmonization of regulatory requirements.

⁴ E.Kirby, S.Worner, ‘Crowd-funding: An Infant Industry Growing Fast’ (Ioscoorg,2014)

⁵ SFC, ‘Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities’ (SFC, 7 May 2014)

⁶ *ibid.*

2.2 The Existing Legislative Framework in Hong Kong

Hong Kong has not introduced specific laws to regulate crowdfunding activities. However, upon close examination on its general securities regulatory framework, it is found that crowdfunding is unlikely to be accommodated under the current regime:

2.2.1 Prohibitions against Issue Without Prospectus

According to the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32), where public offers are made, a company must not issue any form of application for shares or debentures of the company unless it is issued with a prospectus.⁷ Prospectus refers to any written document containing an offer or invitation to take up shares or debentures.⁸ Although there are exemptions, it is unlikely that these exemptions could apply to crowdfunding, for examples:

2.2.1.1 Offers to Professional Investors

‘Professional investors’ includes persons of high net worth of not less than HK\$8m and experienced investors e.g. financial institutions or banks⁹

Since crowdfunding offers are made to the public, this exemption would not apply. Even if this exemption applies, it is quite futile to limit crowdfunding to professional investors only because most of them would probably opt for other investment products with higher return rate.

2.2.1.2 Large Investments

Offers with minimum consideration payable by any person for the shares or minimum principal amount of not less than HK\$500,000 are exempt.¹⁰ Since crowdfunding refers to raising aggregated small sums, this exemption is inapplicable.

⁷ Cap 32 s.38(1)

⁸ Cap 32 s.2

⁹ Cap 32 Sch.17 Pt.1, ss.1

¹⁰ Cap 32 Sch.17 Pt.1, ss.4

2.2.1.3 Small-Scale Offerings

Offers to not more than 50 persons or offers with total consideration payable for the shares or debentures not exceeding HK\$5m are exempt.¹¹

This exemption is unlikely to be applicable. Firstly, offers are made to numerous people in portals. Secondly, even though the total consideration payable is small, offerors must ensure that offerees have exercised caution and obtained independent professional advice.¹² This requirement is impractical for startup businesses to comply with.

Accordingly, issuers making public offers via crowdfunding portals would have to comply with the prospectus requirement so as not to be liable for fines.¹³ This hugely discourages financial return crowdfunding as the costs of preparing a prospectus and ensuring full and plain disclosure of all material facts relating to the securities issued or proposed to be distributed are disproportionately high.

2.2.2 Prohibition against Unauthorized Advertising

Even if one of the exemptions above applies, it is still an offence to advertise or invite acquisition of securities unless authorized by the SFC.¹⁴ Thus, anything inviting the public to acquire the equity or debt securities in crowdfunding portals will probably require SFC's authorization. But such an authorization is very rarely granted.

2.2.3 Prohibition against Unlicensed Regulated Activities

Securities and Futures Ordinance (Cap 571) stipulates that any person carrying on business in a regulated activity in Hong Kong must be licensed or registered with the SFC. Ten types of regulated activity are listed in Schedule 5.

¹¹ Cap 32 Sch.17 Pt.1, ss.2,3

¹² Cap 32 Sch.18 Pt. 3

¹³ Cap 32 s.38(3)

¹⁴ Cap 571 s.103(1)(10), s.105

Crowdfunding probably falls within the ambit of one of the regulated activities such as Type 1 “Dealing in Securities” which is broadly defined as “any person making or offering to make an agreement with another person, or inducing or attempting to induce another person to enter into or to offer to enter into an agreement for acquiring, disposing of, subscribing for, or underwriting securities.”¹⁵ It is a criminal offence to run a business in a regulated activity or hold oneself out as carrying on the business unless he is authorized or licensed.¹⁶

Licensing is not only costly, but also burdensome. Crowdfunding platforms will have to comply with all the requirements in the Code of Conduct e.g. ensuring that their clients have knowledge and obtained appropriate advice about the investment products, and that the product is suitable for the client.¹⁷ These personal checks are impractical and disproportionately cumbersome. Yet, any breach would result in sanctions such as revocation of license or court actions.

2.2.4 Prohibition against Unauthorized Money Lending Business

Money Lenders Ordinance (Cap 163) prohibits unlicensed person to carrying on business as money lenders.¹⁸ Money lenders refer to those whose business is that of making loans or who advertises or announces himself or holds himself out in any way as carrying on that business.¹⁹

It is arguable the exemption of providing “a loan made by a company, a firm or individual whose ordinary business does not primarily or mainly involve the lending of money, in the ordinary course of that business” could be applicable.²⁰ But it is believed that under such an arguable situation, the case will be determined by the court. One would be very unlikely to take the risk.

¹⁵ Cap 571 Sch.5

¹⁶ Cap 571 s.114

¹⁷ SFC, Code of Conduct for Persons Licensed by or Registered with the SFC, para.5.1A

¹⁸ Cap 163 Pt.2

¹⁹ Cap 163 s.2

²⁰ Cap 163 Pt.2(5)

If license has to be obtained, lenders must ensure that all the strict requirements under Cap 163 are complied with for the agreement to be enforceable. Since the compliance costs are disproportionately high, financial return crowdfunding are largely discouraged.

2.3 Latest Developments in Other Jurisdictions

Although some jurisdictions such as Brazil, Hungary and India are still using general securities regulatory regime to govern crowdfunding activities, lots of others have employed or proposed to use special tailored regime:

2.3.1 United States

The “Jumpstart Our Business Startups Act” (“JOBS Act”) was promulgated in 2012, amending the Securities Act 1933 and allowing issuers to raise funds not exceeding \$1m during any 12-month period.²¹

Also, state laws are preempted. Issuers raising funds via registered crowdfunding platforms are not required to obtain authorities’ approval provided that certain requirements relating to investor protection are met.²² Exemptions such as lifting restrictions on advertisements to accredited investors are also created.²³

The Act has received huge support. In October 2015, the Securities and Exchange Commission adopted the final rules to permit companies to offer and sell securities through crowdfunding.²⁴

2.3.2 United Kingdom

The Financial Conduct Authority (“FCA”) implemented rules in the Conduct of Business Sourcebook in April 2014 to govern financial return crowdfunding activities. Any retail client investing no more than 10% of

²¹ Securities Act §77d(a)(6)(A)

²² Jobs Act Title IV

²³ *ibid.* §506(c)

²⁴ SEC, ‘SEC Adopts Rules to Permit Crowdfunding’ (*Secgov*, 30 October

2015) <<https://www.sec.gov/news/pressrelease/2015-249.html>> accessed 14 February 2016

their net assets in a 12-month period into non-readily realizable securities can receive offers from the issuer directly in crowdfunding platforms.²⁵

In February 2016, the FCA published a consultation paper and proposed further rules regulating peer-to-peer crowdfunding. The proposed rules loosen the previous lending restrictions and emphasize providing investors with clear access to certain information so that interested investors can assess the investment risks and make informed decisions. These rules are ready to take effect on April 2016.²⁶

2.3.3 New Zealand and Australia

In New Zealand, the Financial Market Conduct Act 2013 allows issuers to raise up to \$2m in a 12-month period from retail investors through licensed crowdfunding platforms. It creates exemptions to the prospectus requirement.²⁷ The Government explained that the objective is to enable funds for SMEs and start-ups to be raised in this new forms of intermediated capital raising, which was potentially more efficiently than through traditional finance options.²⁸

Given the successful implementation, Australia is now considering adopting the New Zealand model to facilitate crowdfunding. The Corporations and Markets Advisory Committee published a discussion paper in 2013 and is still making recommendations to the Government.

2.3.4 Canada

There are different regimes in different provinces and territories across Canada. Securities regulators of a number of participating jurisdictions implemented registration and prospectus exemptions tailored for crowdfunding sites to facilitate start-ups and SMEs to raise capital in 2015.²⁹ It permits issuers to raise not exceeding \$250,000 per distribution

²⁵ FCA, Conduct of Business Sourcebook, para.4.7.8R

²⁶ FCA, 'Consultation Paper: FCA Handbook changes to reflect the introduction of the Innovative Finance ISA and the regulated activity of advising on peer-to-peer agreements' (FCA, February 2016)

²⁷ FMC Act Sch.4 cl.59.

²⁸ NZ Government, 'The Business Growth Agenda Progress Reports' (*mbie.govt.nz*, February 2013)

²⁹ CSA, 'Multilateral CSA Notice 45-316—Start-up Crowdfunding Registration and Prospectus

and only two distributions are allowed during any 12-month period.³⁰ Ontario experiencing significant hurdles in reforming its laws has also adopted the exemption in November 2015.

Since the reform is still at its infancy, there has been no rule regulating peer-to-peer crowdfunding in Canada yet. Canadian regulators thought that any reform had to be carefully studied as investing on unsecured personal loans involve higher risks.³¹

2.3.5 Mainland China

In 2014, the Securities Association of China issued draft regulations on equity crowdfunding. It set out clear special regulatory framework and sought to encourage the development of SMEs.³² Zhou Xiaochuan, the People's Bank of China's Governor, clearly stated that China would not ban internet finance and the existing regulations would be improved to cope with this new financial innovation.³³

2.4 Implications

The existing regime in Hong Kong is relatively conservative. Having so many legal hurdles, crowdfunding could hardly survive. More and more jurisdictions are now providing a special tailored regime to accommodate financial return crowdfunding to facilitate start-ups and SMEs to raise funds efficiently via the internet.

Exemption'(CSA, 14 May 2015)

³⁰ Multilateral Instrument 45-108 Crowdfunding

³¹ Theglobeandmail.com, 'Peer-to-peer lender Bondora' (*The Globe and Mail*, 7 October 2015) <<http://www.theglobeandmail.com/globe-investor/investment-ideas/european-peer-to-peer-lender-bondora-enters-canadian-market/article26709682/>>accessed 14 February 2016

³² Crowdfundinsider.com, 'Crowdfunding in China: Potentials, Challenges, Risks and Solutions' (*Crowdfund Insider*, 6 October 2015) <<http://www.crowdfundinsider.com/2015/10/75384-crowdfunding-in-china-potentials-challenges-risks-and-solutions/>>accessed 14 February 2016

³³ Chinadailycomcn, 'Cabinet backs self-regulation of online financial industry' (*Chinadailycomcn*, 4 April 2014) <http://usa.chinadaily.com.cn/business/2014-04/04/content_17408585.htm>accessed 14 February 2016

3 Views on Whether to Legislate on Crowdfunding

As financial return crowdfunding is almost legally impossible under the existing legislative framework, the question next is whether the laws should be reformed.

3.1 Arguments against Legislation

Since this topic is emerged very recently in Hong Kong and there has been no data or consultation relating to the law reform in Hong Kong, this paper will refer to studies conducted in other jurisdictions to suggest possible arguments against legislation.

3.1.1 Lack of Demand

It may be argued that there is a lack of demand from the start-ups and SMEs. Firstly, access to finance is not difficult for most firms.³⁴ Secondly, crowdfunding is not appealing to the public because people would probably have no direct interest in a start-up or SME. Thirdly, it is impractical for SMEs to attract sufficient quantity of peer-to-peer loans.³⁵

Similarly, Germany has decided not to adopt special regulatory regime. Kaiser-Stockmann, a Chair of the IBA Closely Held and Growing Business Enterprises Committee, commented that crowdfunding were not obviously appealing to the more sophisticated investors and the growth of dedicated investment funds had not been seen.³⁶

3.1.2 Crowdfunding is Simply a Fad

Some may argue that crowdfunding is just a sudden hit. It is skeptical whether people would still be enthusiastic about crowdfunding and whether professional services providers would consider crowdfunding intermediations as an attractive business proposition.³⁷

³⁴ Industry and Regional Development Branch 'Baseline Review of Angel Investment in New Zealand' (Ministry of Economic Development, November 2007)

³⁵ J.Barrett, 'Crowdfunding: Some Legal and Policy Considerations'[2012]18 NZBLQ 296

³⁶ S. Appleton, *supra* n2

³⁷ J.Barrett, *supra* n35

This may well be the situation in Denmark where the authorities preferred the existing securities law as they considered that this new financial technology required further observation and careful consideration to make workable reform.³⁸

3.1.3 Too Many Investment Risks are Involved

Another argument may be that legislation would expose investors to enormous investment risks. The SFC has issued a notice reminding the public of the potential risks of crowdfunding activities.³⁹

3.1.3.1 Issuer-Related Risks

3.1.3.1.1 Business Default: According to the IOSCO, there is a 50% default rate for start-ups in the first five years of its existence.⁴⁰ Also, peer-to-peer loans are usually unsecured. Unsophisticated investors may lose their contributions easily.

3.1.3.1.2 Illiquidity: Investors may not liquidate the investment easily since secondary markets may not even exist.

3.1.3.1.3 Information Asymmetry: Issuers know the business conditions a lot more than the investors. Misrepresentation or fraud can happen easily.

3.1.3.2 Investor-Related Risks

3.1.3.2.1 Low Financial Literacy: Ordinary investors may not be sophisticated enough to make informed decision.

3.1.3.2.2 Insufficient Shareholder Protection: Shares might be diluted unfairly and easily. Minority shareholders may not be able to affect the company's decisions to protect their interests. Costs of initiating unfair prejudice proceedings are disproportionately high.

³⁸ *ibid.*

³⁹ SFC, *supra* n5

⁴⁰ E.Kirby, S.Worner, *supra* n4

3.1.3.3 Platform-Related Risks

3.1.3.3.1 Operation Outside Jurisdiction: Transactions may be governed by foreign laws if the platform or issuer is incorporated outside Hong Kong.

3.1.3.3.2 Platform Failure: The platform may collapse, causing loss of information and investments.

3.1.3.3.3 Illegal Activities: There may be illegal fund raising, money laundering and fraud, e.g. Wangwang Dai claimed itself as “China’s biggest and safest platform” but disappeared suddenly in 2014, causing substantial loss to numerous investors.

In Poland, Ewa Butkiewicz, a Senior Vice-Chair of the IBA Banking Law Committee, said that although there had been calls for reform to accommodate crowdfunding, they had not seen a sufficiently certain commercial environment to encourage investors to enter the crowdfunding market.⁴¹ Similar arguments may be made by opponents in Hong Kong.

3.2 Why Legislation is Necessary?

The above arguments can be rebutted with due consideration to the current commercial and economic environment in Hong Kong.

3.2.1 Demand and Necessity

3.2.1.1 Access to Finance

Easy access to finance may be the case for New Zealand and Germany. But it is a huge barrier for start-ups and SMEs in Hong Kong.

Hong Kong scored 89.6 and ranked the first in the 2015 World Index of Economic Freedom⁴², showing that its legal protections, and labour force and skills are excellent. Yet, a study revealed that the level of entrepreneurship in Hong Kong was very low. Its entrepreneurial

⁴¹ S. Appleton, *supra* n2

⁴² Fraser Institute, ‘Economic Freedom of the World 2015 Annual Report’ (Fraser Institute, 2015)

prevalence rate was only 3.64 whereas U.K. got 5.74 and the U.S. got 7.96.⁴³

Difficult access to capital is probably the main culprit. According to a research conducted by the Hong Kong Federation of Youth Groups, 34.6% of the interviewees showed their interests in starting up a business but only 7.5% actually tried to do so. Among those who have not thought of starting up a business, 29.8% of them said the reason is due to the lack of capital. Case studies also showed that those who tried to start up their business had to give up due to the lack of capital to cover operating expenses.⁴⁴

Although the government has given support to start-ups and SMEs, the impact is minimal. There are insufficient funding schemes and each funding scheme has its own specific policy objectives, eligibility requirements and funding caps. For example, the SME Export Marketing Fund aims to encourage SME to engage in export promotion activities and expand markets outside Hong Kong. It requires applicants to have substantive business operations in Hong Kong and the maximum grant must not exceed \$200,000.⁴⁵ As a result, not all the worthy projects can be qualified.

Banks in Hong Kong are not showing great support to start-ups and SMEs. According to a survey, only 11.7% of the respondents would consider having bank loans as 41.5% worried about the high interest rates.⁴⁶ Also, most of the banks require clients to provide proofs showing that they have stable income and that their businesses are not risky. It is difficult for start-ups to apply for bank loans successfully.

Crowdfunding fills a gap left by the government and banks. It is a fairer and a more transparent means of funding them as public evaluation

⁴³ CUHK, 'Global Entrepreneurship Monitor HK & Shenzhen' (CUHK, 2009) 19

⁴⁴ HKFYG, 'Difficulties in Starting a Business: A Study on Youth Entrepreneurship' (HKFYG, 2011) 123-124

⁴⁵ Trade and Industry Department, 'SME Export Marketing Fund Guide to Application' (*Tidgovhk*, October 2015) <http://www.smefund.tid.gov.hk/english/emf/files/EMF_Guide_Eng.pdf> accessed 14 February 2016

⁴⁶ HKFYG, *supra* n44, 129

is involved. Legislating financial return crowdfunding provides an easier access of finance to start-ups and SMEs and boost entrepreneurship.

3.2.1.2 Government Policies and Objectives

Promoting crowdfunding is consistent with government policies and objectives.

According to the Basic Law, the Government shall provide an appropriate economic and legal environment to maintain Hong Kong's status as an international financial centre.⁴⁷ Recently, the government has also recognized the needs to improve the ecosystem for local start-ups and SMEs to enable local industries to diversify.⁴⁸

Crowdfunding enables creative projects to be carried out once it gets sufficient funds from the public even if developers cannot find appropriate sponsors. One example is the Pebble Watch. The developer was rejected by many firms but raised \$3.8m through crowdfunding.⁴⁹ Legislating crowdfunding enables the emergence of diversified products. Being an international city, it is incomprehensible why legal barriers to crowdfunding should still exist while more and more counterparts are relaxing their laws to accommodate crowdfunding. To maintain competitiveness and sustainability, it is advisable that Hong Kong should legislate on crowdfunding.

3.2.1.3 Public Support

The opponents' argument that consumers are not interested in financial return crowdfunding can be rebutted simply by the fact that the crowdfunding industries in other jurisdictions are extremely vibrant and billions of funds are raised over the years. Equity crowdfunding has seen global fundraising volumes up 182% in 2014 to \$1.1bn and peer-to-peer

⁴⁷ Basic Law Art.109

⁴⁸ Hon J.C.Tsang, *supra* n3, 14

⁴⁹ Theglobeandmail.com,'Venture capital rejection leads to funding record'(The Globe and Mail, 18 April2012) <<http://www.theglobeandmail.com/report-on-business/small-business/sb-money/venture-capital-rejection-leads-to-funding-record/article4170756/>>accessed 14 February 2016

crowdfunding has seen fundraising volumes up 223% to \$11.08bn.⁵⁰

There has not been a lack of talented inventors and designers in Hong Kong. There are some interesting projects in Hong Kong made possible through donation and reward crowdfunding. Visual artist Rachel Ip raised HK\$25,000 to create a photobook titled 100 Self-Portraits of Hongkongese. Designer Joe Kwan raised over HK\$292,000 to produce an innovative watch.⁵¹

Financial return crowdfunding has its appealing benefit of spreading risks by diversifying investors' investment portfolios. It is also cost-effective. Lenders can save their time in meeting the borrowers physically. With the sharpest traders and investors, financial return crowdfunding industry can certainly be vibrant in Hong Kong.

3.2.2 Economic Growth

Indeed, the opponents' doubt of whether crowdfunding was simply a fad was made when crowdfunding was still an infant. In these several years, crowdfunding experienced accelerated growth globally and the law reforms in other jurisdictions are working well. It is not too premature for Hong Kong to reform its laws. The successful reforms in other jurisdictions do provide valuable references to Hong Kong.

As what Premier of the PRC *Li Keqiang* said, financial innovation is one of the driving forces for people to start their own businesses and provide job opportunities, and people's demand for financial services can push forward reforms in the sector.⁵² If financial return crowdfunding can be facilitated in Hong Kong, entrepreneurship can be better supported and economy can be further boosted.

⁵⁰ Massolution,*supra* n1

⁵¹ Scmpcom,'Ten great Hong Kong projects made possible by crowdfunding' (*SCMP*,26 August, 2015)<<http://www.scmp.com/lifestyle/article/1852694/ten-great-crowdfunded-projects-hong-kong-connection>>accessed 14 February 2016

⁵² Chinadailycomcn,'Premier calls for financial innovation'(*Chinadailycomcn*,26 March 2014) <http://www.chinadaily.com.cn/china/2014-03/26/content_17381258.htm>accessed 14 February 2016

3.2.3 Risks can be Mitigated

It is undeniable that financial return crowdfunding is inextricably affiliated with risks. Yet, most of them can be mitigated by specific consumer protection measures. One should not be prevented from making investments as long as he is aware of those risks. How the risks can be mitigated will be discussed in Part 4.

4 Key Recommendations

There is a real necessity for Hong Kong to adopt a special regulatory framework to legislate and regulate financial return crowdfunding. Here are some suggestions on the primary aims and basic features of the reform:

4.1 Primary Aims

Firstly, financial return crowdfunding must be facilitated by relaxing the existing securities law. Secondly, an appropriate degree of consumer protections must be secured. Thirdly, an informed participation in a fair and transparent market must be promoted. To achieve these aims, the following specific measures are suggested:

4.2 Specific Measures

4.2.1.1 Disclosure Requirements

Since the prospectus requirement is too onerous for start-ups and SMEs, a new exemption should be created for crowdfunding. Yet, the exemption should not lift issuers' disclosure obligations. Key information e.g. financial statements, prices and rights of the securities offered, purposes of the funds should be disclosed fully and frankly. In Canada, issuers must complete and sign an offering document containing all material facts and declare it is free of misrepresentation. They also need to give notice when the business has fundamental changes.⁵³ In the U.S., issuers must disclose detailed information regarding its finances, use of proceeds, etc.⁵⁴ They provide a good guidance that the disclosure

⁵³ Multilateral Instrument 45-108 Crowdfunding.,at.18

⁵⁴ SEC Form S-1

obligation should only be lessened but not lifted to protect investors.

Licensed crowdfunding platform acting as an intermediary must be imposed with due diligence duties. In the U.S., the crowdfunding platform is required to undertake a background check on each issuer relying on the exemption to reduce the risk of fraud.⁵⁵ Such provisions are important so that the platforms can act as a gatekeeper to verify issuers' credibility, filter fraudulent businesses, and report any suspicious business.

4.2.1.2 Licensing Requirements and Removing Advertising Restrictions

New exemption to the advertising restrictions should be created for crowdfunding. Yet, all platforms should be licensed at SFC's discretion. Relevant considerations like whether the applicant is knowledgeable and reliable, whether it has skills to perform trusteeship and due diligence, and whether it is willing to stay in the market should be made. SFC should adopt a liberal and transparent approach in granting licenses.

Although not many jurisdictions have set out the responsibilities of peer-to-peer crowdfunding platforms, this is important to cope with risks like platform failure. For example, it must set resolutions plan in the event of platform collapses so that repayments will continue to be collected and that the lending money will not lose out. A special Code of Practice is published by the U.K. Crowdfunding Association. Similar code should also be published by the SFC for the platforms to follow.

4.2.1.3 Investment Cap

Investment cap is not available in every jurisdiction but it is suggested that such cap should be imposed in Hong Kong to cope with the risk of business default and illiquidity. Investors should only provide funds that are not needed for their daily cash flow.

There should be both issuer cap and investor cap. Issuers in the U.S. can only raise an aggregate amount of USD 1,000,000 in any 12-month

⁵⁵ Securities Act §4A(5).

period.⁵⁶ The investor cap is scaled, allowing aggregate investments in any 12-month period of up to either (i) 5% of an investor's annual income or net worth if it is less than USD 100,000 with a minimum cap of USD 2,000; or (ii) 10% of an investor's annual income or net worth if it is equal to or more than USD 100,000 with a maximum cap of USD 100,000.⁵⁷ In Canada, the cap imposed on the issuer is CAD 10,000 per year and that on each investor is CAD 2,500 per distribution.⁵⁸ It is suggested that Hong Kong should adopt flexible caps like the U.S rather than fixed cap in the Canadian model as this can cater for investors with different wealth.

4.2.1.4 Education and Warning Statements

To protect unsophisticated investors with low financial literacy, it is suggested that one could only invest after he has taken an online course equipping them with the essential knowledge and passed an official online test. Also, platforms must display warning statements reminding investors of the risks. In Canada, investors must sign a risk acknowledgment form confirming that they are aware of the risks and agree to go on.⁵⁹ This is a good way of protecting investors by alerting them to the illiquid and risky nature of the investment.

4.2.1.5 Liability

To tackle with the problem of information asymmetry, civil and/or criminal liability should be attached. For examples, issuer making misrepresentation or licensee breaching the duty of due diligence should be liable. Investors should receive appropriate remedies such as damages and/or withdrawal right.

Penalties for fraud and money laundering in the existing laws should not be lessened. The U.K. Financial Markets Conduct Act created an offence for fraudulent misrepresentation in a document required for the purposes of the Act. The maximum sentence is five years and a fine not

⁵⁶ Securities Act §77d(a)(6)(A).

⁵⁷ Securities Act §77d(a)(6)(B).

⁵⁸ Multilateral Instrument 45-108 Crowdfunding, at.5(1)

⁵⁹ OSC Form 45-108F2

exceeding \$200,000.⁶⁰ But the same act may also be caught by the Crimes Act with the maximum sentence being ten years.⁶¹ It is unclear as to whether new provision should prevail. It is argued that the criminal liability for crowdfunding should be lower because it was unreasonable to impose heavy fine when there were an investment cap and a lower disclosure standard.⁶² Yet, committing fraud on the internet should not be made different from fraud in an ordinary course. It is only the maximum penalty and it is always for the judge to consider the seriousness of the case to decide the appropriate sentencing options. Creating new offences with lesser penalty will only encourage crimes and cause confusions.

4.2.1.6 Mandatory Shareholder Protection Provisions

Issuers should explain the rights of the shareholders in the offering documents clearly. Although it is difficult to prevent the initial investors from being diluted by subsequent issues, minority shareholder should enjoy some mandatory rights such as voting right so that the minority shareholders as a group can have an opportunity to affect the company's decisions and protect their interests.

4.2.1.7 Restriction on Cross-Border Activities

Issuers should be incorporated locally. Some jurisdictions like France allow issuers seeking funds to be locals or foreigners. Yet, since the objective is to help fundraising for start-ups and SMEs in Hong Kong, it is suggested that only issuers incorporated in Hong Kong should be permitted. This also makes it explicit to unsophisticated investors that the transactions are governed by Hong Kong laws.

Given that running a platform would require manpower, technology and experience, no such platform may be developed locally. It is suggested that non-local service providers should be permitted. However, it must be authorized and registered with SFC and has a head office in

⁶⁰ FMC Act s.512

⁶¹ Crimes Act 1961 s.242.

⁶² H.W. Hillind,'Exploiting the Crowd: The New Zealand Response to Equity Crowd Funding' [2015]21 NZBLQ 46

Hong Kong.

5 Conclusion

Financial return crowdfunding can potentially be a vital economic pillar in Hong Kong. Deplorably, the existing regulatory framework in Hong Kong is lagging behind. As an international financial centre with talented inventors, designers and sharp investors, Hong Kong should legislate and regulate this practice as soon as possible. To better protect investors, careful consideration must be made to have a practical reform. The new regime should be drafted very carefully so as not to conflict with the existing ordinances.

In this paper, key recommendations are made by critically analyzing different approaches adopted in other jurisdictions. Yet, since crowdfunding is still developing, there may be unforeseeable risks that require special measures to cope with. Moreover, further details such as how much the investment cap should be would involve economic analysis on the net worth of Hong Kong people. This would fall outside the ambit of legal discussions. Interdisciplinary research is needed to carve out more workable and detailed recommendations. I hope this research will become a guidepost for further research on this topic in the future.

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