



SFC ISSUES NOTICE ON RISKS AND POTENTIAL REGULATORY ISSUES OF CROWD-FUNDING

Introduction

The Securities and Futures Commission (**SFC**) issued a notice on 7 May 2014 to remind parties carrying out crowd-funding activities of the potential securities regulatory implications and liabilities for breaches of relevant regulations. It also advises the public on the potential risks of investing in such activities.

What is “crowd-funding”?

Crowd-funding is the funding of projects, businesses or personal loans, and other needs by using small amounts of money gathered from a large number of individuals or organisations through an online web-based platform.¹

The most common types of crowd-funding are:

i. equity crowd-funding	under which investors invest in a project or 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;
ii. peer-to-peer lending (P2P lending)	under which lenders (investors) and borrowers (issuers) are matched via online platforms to provide unsecured loans to individuals or projects;
iii. donation crowd-funding	under which money is raised for charitable causes; and
iv. reward/pre-sale crowd-funding	under which returns in the form of physical goods or services are provided in exchange for the sums provided by the payer.

¹ Crowd-funding: An Infant Industry Growing Fast”, *International Organization of Securities Commissions staff working paper*

Potential application of relevant securities laws and regulations

Some types of crowd-funding activities, particularly equity crowd-funding and P2P lending, may be subject to the provisions of the Securities and Futures Ordinance (SFO) and/or the Companies (Winding Up and Miscellaneous Provisions) Ordinance (C(WUMP)O)². In practice, it will depend on the specific structure and features of the relevant arrangement.

(1) Offers of investments

Restrictions under the SFO and C(WUMP)O will apply to crowd-funding activities which involve offers to the public to purchase securities (e.g. shares, debt instruments or interests in collective investment schemes):

SFO

It is an offence under SFO s103 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*.

C(WUMP)O

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.

- Relevant sections for an issue by a company incorporated in Hong Kong: C(WUMP)O ss38, 38B and 38D.
- Relevant sections for an issue by a company incorporated outside Hong Kong: C(WUMP)O ss342 and 342C.

(2) Intermediaries licensing and conduct of business requirements

Licensing obligations

² 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 below are not intended to be exhaustive and do not constitute legal advice from the SFC.

Even where an exemption applies to certain offers of investment under the SFO or C(WUMP)O³, crowd-funding platform operators are reminded that they should be aware of licensing obligations if the crowd-funding activity and/or the business of the operators constitutes a “regulated activity” as defined under SFO ss114 and 115.

The following is a summary of the types of regulated activities⁴ for which crowd-funding platform operators may need to be licensed:

- 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

Codes and guidelines

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.

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

Platform operators should be aware of certain requirements under Part III of the SFO (s19 and 95) relating to automated trading services and recognized exchange companies which may be applicable to their business activities.

Potential liability and enforcement of a breach

Parties which seek to engage in crowd-funding activities are reminded that:

- breaches of the SFO and C(WUMP)O may have 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 the relevant provisions;

³ For example, one that is only made to professional investors.

⁴ The nature of the business will also have to be looked at.

- they should check if there may be other Hong Kong law and regulations which are applicable to their activities and/or their operators including for example those relating to money-lending; and
- professional advice should be sought if they are in doubt to ensure compliance with applicable laws and regulations, which could vary depending on the specific features of the activities undertaken.

Potential risks for investors participating in crowd-funding activities

The following are some of the risks that potential investors should consider before engaging in crowd-funding activities. When in doubt, investors should seek professional advice to minimise loss.

Risk of default	Failure of the investment project or business (which are usually start-ups in equity crowd-funding), or default in repayment of loans under P2P (which are commonly unsecured), 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 or insolvency	Crowd-funding platforms may be shut down or hacked, or even become insolvent, leading to a total loss of investment and information.
Risk of fraud	There is a higher risk of fraud due to the anonymity inherent in online crowd-funding platforms.
Platform operating outside Hong Kong	Investors in crowd-funding platforms operating outside Hong Kong may not enjoy the level of protection offered under Hong Kong's regulatory regime.
Information asymmetry and lack of transparency	Full and accurate background information on the investment or loan for the crowd-funding activity may not be readily available or fully verified by the crowd-funding platform. Some platforms may also lack transparency (e.g. in the valuation of an investment), or withhold valuable information (e.g. historic default rates or costs). Risks may not be fully disclosed even after an investor has made an investment or has become a member of the crowd-funding platform.
Cyber security	Cyber attacks are a potential concern as crowd-funding operates via the internet. Cyber attacks may come in different 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. This could lead to regulatory action including suspension by relevant law enforcement agencies.

CHARLTONS

Best Boutique Firm 2013

Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com