

Propositions of Crowdfunding Regime in Hong Kong - Part I

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Governmental Efforts

The Innovation and Technology Bureau of the Hong Kong government dished out the Innovation & Technology Venture Fund in July 2016. It is scheduled to be up and running next year, with an initial capital of HKD 2 billion.

The newly formed bureau's efforts are gearing up, as internet advocates commented that the government's response to the fast-changing technology sector could benefit from the examples of other places in optimizing policies and regulations.

thereafter the handover of Hong Kong to the mainland China in 1997.

One recent example is the implementation of Competition Ordinance (CO), which came into effect in December 2015, setting Hong Kong's considered framework for offering legal protection against anti-competitive practices.

For the time being, in terms of industries, CO is largely applied to the telecommunication sector. In the meantime, existing business practices of certain industries like shipping may follow the

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Hong Kong may re-live its robust economic boom over the 1970's and 1980's, when the city was known for its versatility, creativity and prompt reaction to changes. These qualities are still

trend to curb unfair competition, while some blatantly improper tendering practices have been ruled illegal by court.

Crowdfunding Regulations: Time to Evolve

Hong Kong is one of the few major financial centers yet to establish a specific crowdfunding legal frameworks. It is time to evolve.

Currently, donation and reward crowdfunding activities are not specifically regulated in Hong Kong. P2P lending and equity crowdfunding are potentially subject to certain regulatory provisions.

Hong Kong has been observing the experience of other places in regulating crowdfunding activities, especially those developed states like the U.S., UK, and Australia.

This is amidst broader policy planning, education system modification and promotion of healthy development of the property and stock markets, and within the government's blueprint of refashioning the IT sector.

Alternative Source of Finance and Investment

The rise of crowdfunding came as the limited access to equity finance for small-medium enterprises (SMEs) from traditional financial institutions like banks during the post-financial tsunami era. At the same time, there were individuals seeking to fund start-ups, betting on the potential of such companies, thus creating both supply and demand for crowdfunding channels.

Crowdfunding platforms (mostly running online)

avail direct transactions between investors and businesses, effectively bypass traditional institutions like banks or investment funds. With the application of technology, crowdfunding platforms offer higher degree of flexibility to investors, and reduce associated transaction costs.

Inherent Risks

Regulators' efforts of nurturing crowdfunding sector and recognizing inherent risks should go hand in hand.

As start-ups are at early stage of development, their immaturity could result in high likelihood of failure.

Existing Crowdfunding-related Provisions

- *Restrictions on share offers to the public under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (CWUMPO)*
- *Prohibiting unauthorized invitations to the public under Section 103(1) of the Securities and Futures Ordinance (SFO)*
- *Prohibiting regulated activities under the SFO without being licensed or registered to do so by the Securities and Futures Commission*
- *Prohibition of carrying on a money lending business without license under Section 7 of the Money Lender Ordinance*

Crowdfunding Regulations/Legislation Progress in other Jurisdictions

- *UK: The Financial Conduct Authority (FCA) regulates equity crowdfunding platforms by requiring all platforms that deal with transactions for the sale of securities to be authorized and licensed by the FCA. The licensing requirements are set forth in Sections 19 and 21 of the Financial Services and Markets Act (FSMA) of 2000.*
- *New Zealand: Introduced a tailored regulatory regime for equity crowd funding and peer-to-peer (P2P) lending under the Financial Markets Conduct Act 2013.*
- *Australia: Consultation period for discussion paper for crowdfunding regulation closed in 2015*
- *Singapore: Monetary Authority of Singapore (MAS) issued a consultation paper in in February 2015*

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On top of that, given the non-listed nature of the start-ups, there exists a lack of market for trading their shares, increasing difficulties for the investors to realize their returns. Internet-based crowdfunding platforms might also be prone to cyber-attacks.

Lessons from Overseas Counterparts

The Financial Services Development Council (FSDC), an advisory body of the government, issued a research paper earlier this year. It called on the government to take a page from the legal frameworks in western economies to regularize crowdfunding.

For example, the U.S. Securities and Exchanges Commission (SEC) adopted Title III of the Jumpstart Our Business Start-ups Act last year, permitting securities-based crowdfunding by private companies without registering the offering with the SEC. Larger crowdfunded businesses with more than 500 investors and more

than USD 25 million in assets still have to file reports like a public company.

Similar capital requirements are also imposed by the Financial Conduct Authority (FCA) of the UK.

Suggestions made by the FSDC included making amendments to Hong Kong's regulations, such as capping the number of investors and the monetary value of funds, leaving the current regime unchanged.

Prospectus Exemption

While the U.S. approach is a viable, FSDC proposed to amend the CWUMPO and the SFO to exempt crowdfunding fundraisers from the prospectus requirement for offerings made in an existing licensed regulated activity as defined by the SFO. Such activities could, for instance, be automated trading services (Type 7), dealing in securities (Type 1), or advising on corporate finance (Type 6).

These activities generally require paid-up share capital of HKD 5 million, and liquid capital of HKD 3 million, certain minimum number of staffers and record-keeping, monitoring and disclosure requirements, per Schedule 1 of Securities and Futures (Financial Resources) Rules, Cap 571N.

It is also proposed that the companies taking part in crowdfunding must be public companies limited in shares incorporated in Hong Kong, or

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companies incorporated overseas but registered in Hong Kong under Part 16 of the Companies Ordinance. Such companies have to fulfil a broad range of legal disclosure requirements.

Burdensome disclosure requirements might stoke up deterring effect. S. 38A of CWUMPO gives SFC the power to grant specific prospectus exemptions. FSDC suggested that certain exemptions should be extended to young crowdfunding platform companies. Firstly, the platform should be held to receive a declaration from each investor in connection with each crowdfunding that he or she understands the risks of the offering, has read the materials published by the issuer, and will not invest more than a certain amount. Second, the platform should be held to provide materials, and if possible, workshops on investor and financial education. A potential investor may be asked to

go through an online training program and pass a qualifying "test" before he or she is allowed to make an investment.

These measures are to make sure that the investors have thorough understanding about the be all and end all of the assets which they put money into, especially when it involves an emerging technology which is yet to be able to put into use.

Review the "Hybrid" System

Once crowdfunding becomes fully integrated in Hong Kong's financial system, not only would start-ups benefit from smoother fundraising procedures, there will also be more companies attracted to incorporate or register in Hong Kong, creating job opportunities and injecting new bloods for the financial sector.

Enormous advancement of neighboring Shenzhen's innovation and technology sector presents another opportunity to Hong Kong financiers.

Hong Kong can take its standing advantage as a banking and financial services hub to serve as the major fundraising hub for start-ups in Shenzhen.

Meanwhile, regulators and lawmakers should strike a careful balance between promoting alternative financial industry, luring foreign investments and protecting investors against potential dangers.

Other than fine-tuning relevant laws and regulations, it is also the high time the Hong Kong government review the “hybrid” regulating system.

As per S. 4 of SFO, the core mission of the SFC is to protect the interests of investors. The SFC enforces statutory provisions in this regard. On the other hand, the HKMA is governed by the Exchange Fund Ordinance and the Banking Ordinance, with an aim to maintain and develop the city’s financial infrastructure. For example, the HKMA has launched a Fintech Supervisory Sandbox to facilitate the pilot trials of Fintech and other technology initiatives of authorized institutions before they are launched on a fuller scale. To a certain extent, the statutory roles of the SFC and the HKMA are not in unison.

Many developed markets, including the U.S., have abandoned this split system. It is time for the

Hong Kong government and lawmakers to overhaul existing frameworks to facilitate cooperation between the duo, and establish a more effective regulatory system.

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