

## Introducing a Regulatory Framework for Equity Crowdfunding in Hong Kong



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## **EXECUTIVE SUMMARY**

1. Technology is fast changing the landscape of finance. As the Government's Steering Group on Financial Technologies points out in its recent report, "*The development of Fintech is underpinned by innovative start-ups that may have the potential of transforming traditional products and business processes*". This is happening at the institutional as well as retail levels. Regulation has to adapt to facilitate new possibilities and to meet fresh challenges in investor protection. Opportunities do come with risks. Neither should be a reason to ignore the other.
2. One possibility often raised is equity crowdfunding. Crowdfunding not only breaks new ground in financing, it is also an innovative kind of community participation. This paper proposes some options for a framework to promote, and also to regulate, this new activity.
3. Part I of the paper is an introduction. Part II examines the state of financing small and medium enterprises, in particular start-ups, in Hong Kong. As with all new things, it is difficult to predict how much benefit equity crowdfunding will bring. But considering the experience to date, and given that it is an often cited part of the Fintech ecology, Hong Kong should try to be near the front rather than the back of this development.
4. Part III of the paper turns to review of how the United States, the United Kingdom, Singapore, and Mainland China are approaching crowdfunding. They all appear to accept that the activity will happen whether one regulates it or not, and the best response is to facilitate development within some rules. But these jurisdictions do differ in their policy choices and regulatory techniques chosen.
5. The US has opted for specific legislative action, viz., the JOBS Act plus detailed SEC rules thereunder. The UK has embraced crowdfunding into the existing regulatory framework. The Financial Conduct Authority licenses platforms and imposes both prudential and conduct requirements on them.
6. In Mainland China, the People's Bank of China has announced that the respective authorities will issue specific regulations for various types of Fintech activities, including China Securities Regulatory Commission for equity crowdfunding. Singapore appears least enthusiastic among the jurisdictions surveyed. Its approach is mostly to treat crowdfunding like and under the same rules as for traditional fundraising activities.
7. Part IV surveys some early data on the economic impact of crowdfunding in the above jurisdictions. Part V of this paper looks at potential approaches for Hong Kong to

regulate equity crowdfunding. They range from full legislative actions, to maintaining the status quo, to a middle option through regulatory initiative. The middle option would involve: (i) conditional exemptions from the prospectus regime applicable to public offerings; (ii) licensing levers on the crowdfunding platforms; and (iii) limits on risk exposure by reference to how much an investor can invest, whether as a percentage of annual income or simply in terms of an absolute amount per issue or a variation cum combination of these two elements.

8. What option should be adopted in Hong Kong is a decision for the policy-makers. This will necessarily involve striking a balance between innovation and entrepreneurship on the one hand, investor protection on the other. In addition, prudent investor choices will remain important, as investors must bear the risk of their own decisions. Ultimately, Hong Kong should aim to be a leader in Fintech and its healthy development. In this light, we believe an appropriate avenue should be created to allow and to regulate equity crowdfunding.

*Note: This paper shares much of its content with the academic publication: D Donald, G Mok and A Fong, "A People's Market of Hong Kong: Facilitating Crowdfunding of SMEs," to be printed in Finance, Rule of Law and Development in Asia: Perspectives from Singapore, Hong Kong and Mainland China, eds. Hu, Vanhullebusch & Harding (Brill Academic Publishers, forthcoming).*

## I. INTRODUCTION

9. Markets thrive on network externalities, which is a synonym for liquidity. In the past, the only way that such network effects could be achieved was either to exploit existing connections between people (such as family or club ties) or to gather people together in a single place at an agreed upon time (such as on the floor of a stock exchange). Technology has changed this dramatically. At any moment any person can use freely available networks like Facebook or LinkedIn to communicate instantly with a vast number of other users. Today an ordinary college student could use such networks to invite people to a graduation party or sell an old laptop on eBay, and likely be able to contact more people than might belong to an official stock exchange in an average developing country. These same network tools can also be used by an entrepreneur to invite investors to participate in her inchoate business without the medium of a stock exchange. Technology has enabled changes in finance to an extent that we are only just beginning to grasp.
10. Hong Kong is a business centre. It was created purposely for international trade, and has carried on that activity for over a century and a half. After World War II, it became a manufacturing centre, and in the 1970s it began to develop as a financial centre. Currently, Hong Kong enjoys high international rankings for its financial centre,<sup>1</sup> the competitiveness of its economy,<sup>2</sup> the business-friendly aspect of its regulatory framework,<sup>3</sup> and the quality of its rule of law.<sup>4</sup> With respect to providing the necessary atmosphere to promote innovation, however, Hong Kong does not receive praise.<sup>5</sup> Although Hong Kong has for decades been famous for its *laissez-faire* approach to economic development, the government of Hong Kong has usually been well-disposed to provide the necessary law to allow business to develop. This is particularly true of the financial sector, where a regulatory framework whose content and operation meet international best standards has been built up over a brief period

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<sup>1</sup> Hong Kong has been ranked in the third or fourth position globally as an international financial centre since 2007. Long Finance, *The Global Financial Centres Index*, nos. 1-16, (2007- 2014). For example, on a scale of 800, since 2010 Hong Kong has been rated semi-annually as follows: 2010 - 739, 760; 2011 - 759, 770; 2012 - 754, 733; 2013 - 761, 759; 2014 - 761; 756. *The Global Financial Centres Index*, Numbers 7-16. See *Global Financial Centres Index* (2015).

<sup>2</sup> Hong Kong led the world in the World Economic Forum's "The Financial Development Report 2011" and "The Financial Development Report 2012." See World Economic Forum (2011/12).

<sup>3</sup> The Heritage Foundation ranked Hong Kong as the freest economy in the world for 20 consecutive years. See heritage.org (2015), *Index of Economic Freedom*.

<sup>4</sup> The World Justice Project in 2013 ranked Hong Kong above France, Belgium and the United States for access to civil justice. See World Justice Project (2013), *Rule of Law Index 2012-2013*.

<sup>5</sup> See *The World Economic Forum* (2015: 8).

of less than three decades.<sup>6</sup> During more than half of that time, Hong Kong has been a Special Administrative Region of the People's Republic of China (referred to as the HKSAR).

11. Given Hong Kong's character and history there is little doubt that the HKSAR will eventually provide an effective framework so that business can freely benefit from the technological advances in networking capacity for finance. A strong crowdfunding market will likewise stimulate innovation and improve employment prospects. It is the purpose of this paper to explain why and how this might be done. Part II examines the role of small and medium enterprises (SMEs) in the Hong Kong economy, and the currently available avenues of financing. It shows that the addition of crowdfunding is a next logical step in the development of Hong Kong's corporate finance infrastructure. Part III presents a survey of how crowdfunding has been regulated in select jurisdictions around the world. It focuses on regulation in the United States, the United Kingdom, Singapore and China. Part IV looks at the benefits that crowdfunding has brought and is expected to bring in these same jurisdictions.
12. Part V discusses possible ways forward in Hong Kong. One is to amend the Securities and Futures Ordinance (SFO) expressly to provide for crowdfunding. Another would be to take no action at all, and limit crowdfunding to the private offering scenarios currently permitted by law. A third would be to allow crowdfunding through a series of measures at the level of administrative regulation. This could be achieved by combining a class exemption from the prospectus requirement for offerings on a licensed crowdfunding platform with a decision to treat crowdfunding platforms as a type of regulated activity under Hong Kong law. A further protection would be to impose a cap on the amount that an investor can place on crowdfunding issues, either in a given year or per issue. Crowdfunding could operate safely and efficiently on such regulatory adjustments. Ultimately, as equity crowdfunding is a community activity, a type of public engagement in the economy falling outside of the paradigm of public offerings as regulated during the 20<sup>th</sup> century, it will bring the proverbial 'wisdom of crowds' to valuing innovation and entrepreneurship in Hong Kong.

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<sup>6</sup> The Securities and Futures Commission began operation in 1989 and the Hong Kong Monetary Authority was established in 1993. The Securities and Futures Ordinance came into effect in 2003. For a discussion of this history, see Donald (2014), p. 117-23. By contrast, the US Securities and Exchange Commission has existed for 80 years, and the US Federal Reserve Bank has existed for over 100 years.



## II. THE PLACE OF CROWDFUNDING IN HONG KONG SME FINANCE

### A. Innovation in the Hong Kong Economy

13. The Government's 2015 budget singled out SMEs for special support. This is well-placed. Since the 1950s, Hong Kong entrepreneurs have been a driving force of innovation in its economy, and where possible the HKSAR Government has done what it could to facilitate this activity. As will be discussed below, both the government and private associations have taken steps to stimulate business start-ups and to help them gain access to financing for their operations, research and development. Progress in information technology has dramatically changed the possibility of creating networks of investors and matching the needs of investors and entrepreneurs starting a new enterprise. These changes open opportunity for further facilitative action by the HKSAR government in the form of regulatory adjustment. This will work in tandem with the direct economic stimulus that has already been earmarked.<sup>7</sup>
14. Hong Kong is a leading hub for innovation and entrepreneurship, especially in the increasingly-important information and communications sector (ICT). As part of its Digital 21 Strategy, Hong Kong seeks to become one of the leading information and technology hubs in the world.<sup>8</sup> ICT employs around 78,000 people and constitutes roughly only 2% of the total labour force. However, it has an outsized impact on the economy and contributes around 6.1% of the GDP.<sup>9</sup> In particular, according to statistics by the Census and Statistics Department, the number of companies engaged in "information technology services," which encompasses areas such as computer software, mobile application development and online services, grew from 6,512 in 2012 to 7,139 in 2013, a year-on-year increase of nearly 10%.<sup>10</sup> The number of people employed by the industry subsector also grew by about the same percentage, from 37,139 in 2012 to 40,671 in 2013.<sup>11</sup> Fostering innovation and technology companies in Hong Kong has been one of the Government's primary focuses. In the 2014 Policy Address, the Government noted its recent efforts to create an "environment conducive to the development of innovation and technology, encourage investment in this area and enhance co-operation among the Government, industry, academia and research sectors."<sup>12</sup>

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<sup>7</sup> See HKSAR Financial Secretary, the Hon John C Tsang, Budget Speech 2015-16, paragraphs 38-48.

<sup>8</sup> See generally Digital 21 Strategy (2015).

<sup>9</sup> *Ibid.*

<sup>10</sup> Hong Kong Census and Statistics Department (2014), p. 35.

<sup>11</sup> *Ibid.*

<sup>12</sup> Policy Address (2014).

15. While the usual form of finance for a going concern is its revenues from operations, access to external capital is vital to the formation and growth of the new companies that advance technology and bring innovation. Corporate finance is therefore one of the most important areas of a young business's operations, ensuring it can employ the people and produce the products or offer the services that will allow future expansion. Corporate finance is particularly important for technology-based start-ups, as they need cash to finance the basic activities of R&D and marketing. A survey undertaken by the Hong Kong Trade Development Council ("HKTDC") in 2011 shows that 81.9% of would-be entrepreneurs did not proceed with their plans for starting a business due to a lack of start-up capital.<sup>13</sup> Likewise, another survey taken in 2014 found that obtaining capital was a challenge which start-ups ranked second only to discovering new business opportunities and customers.<sup>14</sup> It is a disheartening thought that in one of the world's leading financial centres the economy for young, innovative enterprises might be operating at only 20% of capacity because of lacking access to finance.
16. While government agencies and bodies have promoted Hong Kong as a centre for financing, much of the focus has been placed on Hong Kong's role financing large corporations at the Initial Public Offering (IPO) stage.<sup>15</sup> The IPO process is an extremely valuable tool to allow relatively established corporations to make the transition to global competitors, and it should be supported. However, focus on the finance of such companies does little for the enterprises that are still too small to participate in IPOs. Even the Growth Enterprise Market (GEM), which aims to promote innovative businesses, requires two years of business activity with a cash flow of at least HK\$20 million in aggregate for the two years preceding listing and a market capitalization of at least HK\$100 million at the time of listing.<sup>16</sup> Such prerequisites often shut out SMEs.
17. Recently, the Hon. Mr. Charles Mok, the Legislative Councillor for the Information Technology constituency, also suggested that the Hong Kong Government "consider formulating relevant financial policies and legislation to facilitate investments from angel investors, venture capitalist firms or crowdfunding in financing the start-ups at various stages, so as to build an effective and sustainable technology start-up

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<sup>13</sup> Hong Kong Trade Development Council (2011), p. 6.

<sup>14</sup> Hong Kong Trade Development Council (2014a), p. 35. The question posed was 'how difficult to overcome business management challenges'. On a scale of 1 to 5 with 1 being "very easy" and 5 being "very difficult", "seek loans/funds for business operation/development" was rated 3.49 only slightly below "find new business opportunities/customers" which was given a rating of 3.56.

<sup>15</sup> See for example Financial Services Development Council (2014).

<sup>16</sup> Stock Exchange of Hong Kong (2014) Growth Enterprise Market Listing Rules, Chapter 11.

ecosystem”.<sup>17</sup> In a like manner, Andrew Leung, of the Industrial Sector constituency, has stated in Legislative Council proceedings that:

*Young people of Hong Kong have bright ideas, only that they lack the experience and funds to start up a business. We therefore suggest the authorities to promote a new concept called “crowdfunding”. Crowdfunding seeks to make use of the internet platform to display and brief on publicity proposals, in the hope of bringing their products to mass production. People who are interested to render their support, take part in the production or purchase the products may help the young people realize their dreams by offering sponsorship. I think the Government may enact legislation on crowdfunding and provide legal support for people seeking funding.*<sup>18</sup>

18. Whether the investment is aimed at the technology sector or the restaurant next door, crowdfunding allows a community to support products and services it finds valuable and desirable. Investors who value a business are able to support it not just through the market for its products, but also by taking a partial ownership stake. Once proper investor safeguards are in place, crowdfunding presents many positive characteristics: community participation, job-generation, the possibility of a good return, and a feeling among young entrepreneurs that their efforts are understood and supported by the community which they seek to serve through their new business. While it would be possible to put off the creation of genuine crowdfunding indefinitely, relying on the financing methods listed below, this is far from the “can do” attitude which Hong Kong has succeeded with and would like to project to the world. Both innovative entrepreneurs and the communities that support their efforts and enjoy their products deserve a medium to come together in direct, common engagement. That medium can be crowdfunding, and Hong Kong should step up to the task and facilitate its development.

## **B. Existing Avenues for Financing Start-ups**

### **a. Introduction**

19. The current sources of finance for start-ups are limited. Although the Hong Kong market does present all traditional means of finance, and does so at a high level of professional quality, the current menu does not meet all needs. The HKTDC survey discussed above clearly shows that. In this section, we will present the types of financing currently available and highlight their strengths and weaknesses. The challenges faced by SMEs in receiving funding are different from those of large

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<sup>17</sup> Legislative Council of Hong Kong (2014), p. 22.

<sup>18</sup> Legislative Council of Hong Kong (2013), p. 348.

companies. Start-ups, especially, may not have an adequate credit history, security, or business plan to convince professional investors or loan officers to provide backing. According to the HKTDC survey, the capital requirements for most start-ups ranged from HK\$10,000 to HK\$200,000, with figures varying in relation to the business type (i.e. retail or wholesale companies needed to purchase inventory while online/mobile service providers mainly required funds for server and communication costs). The survey also listed the most common sources of finance for the start-ups as personal, family, or friendship-based finance. The entrepreneurs responding to the survey found the pressure from debt (an unwavering duty to repay principle and interest) created so much risk that they “would rather defer their plans in order refrain from borrowing as far as possible”.<sup>19</sup>

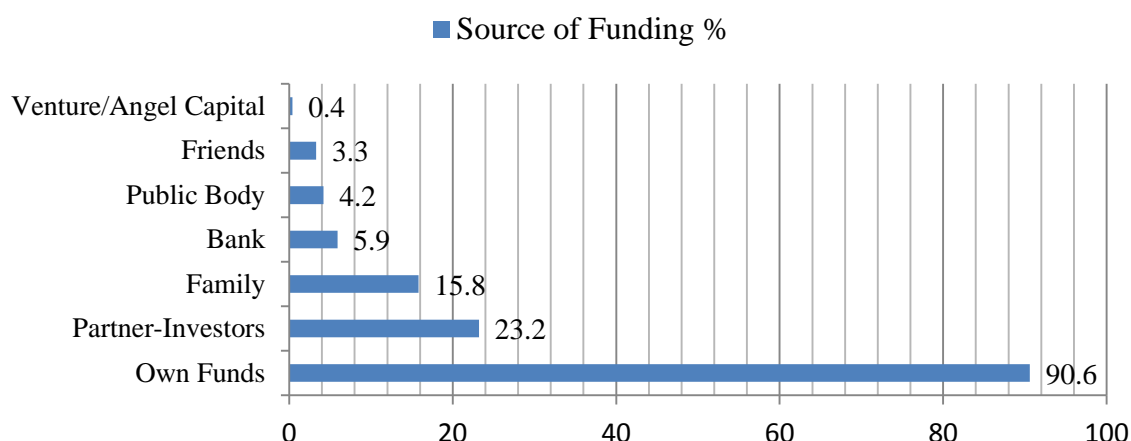
20. Currently, SMEs have access to three main forms of corporate finance: debt, grant, and equity financing. In a 2011 survey, new entrepreneurs indicated that they received their capital from the following sources shown in Figure 1.<sup>20</sup> Debt financing is provided mainly by commercial banks and entails the legal obligation to repay principal with interest, regardless of the fortunes of the business. Grant financing is bestowed on a business by government or private sources with liberal or no repayment obligation, but is both very limited in amount and tends to involve an extensive and long application process. Equity financing involves the investor or financier taking an equity position in the company in exchange for share of the company. Equity carries no repayment obligation and forces investors to share the risk of business failure. However, as discussed above, the means to facilitate equity funding beyond circles of friends and family investment focuses on well-established businesses.

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<sup>19</sup> Hong Kong Trade Development Council (2014), p. 28.

<sup>20</sup> Hong Kong Trade Development Council (2011), p. 12-13. See Hong Kong Trade Development Council (2014), p. 28, where another survey was done on new entrepreneurs which found that they received their start-up capital from the following sources: own or partners' funds (96%), family or friends (34%), financing from investors or investment institutions (12%), bank/finance company loans (11%), government/public organization finance schemes (8%).

Figure 1: Avenues for financing start-ups



Note: The content of this chart has been re-created from the data published in Hong Kong Trade Development Council (2011), p. 12-13.

**b. Debt financing**

21. Debt finance for companies will take the form of a loan or debentures. The main elements of debt finance are the requirement to repay the amount borrowed within a certain period with interest. The simplest form of debt financing is a loan, and at the lower end of the scale, start-up founders may seek to use existing sources of debt financing, such as credit card or personal bank loans to finance the company. SME financing from banks is common for companies with a steady cash flow that can be applied to loan repayment instalments. Loans from banks may also be security-linked loans, involving a charge over assets such as property, which again assumes that the entrepreneur beginning a project has assets at her disposal. However, such commitments are often impractical for start-ups, especially if they need significant time to develop their product before being able to repay a loan. As mentioned above, a founding entrepreneur may seek loans from family and friends to avoid either the lending requirements of a commercial bank for the potential consequences of default. In the 2014 HKTDC survey discussed above, it was found that approximately 10% of responding youth entrepreneurs and would-be entrepreneurs raised or borrowed funds from their relatives and friends.<sup>21</sup>
22. The Hong Kong Government has taken steps to address the lack of bank loans by introducing a SME Financing Guarantee Scheme, which assists SMEs in obtaining bank financing by guaranteeing a percentage of the loan to participating lenders.<sup>22</sup> According to the statistics published by the Hong Kong Mortgage Corporation, during

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<sup>21</sup> *Ibid.*, p. ii.

<sup>22</sup> Hong Kong Mortgage Corporation (2015a). However, as the average loan amount is HK\$4.5 million dollars, this is unlikely to assist start-up entrepreneurs.

the two years between the Scheme's launch in 2012 and 2015, a total of 9,717 out of 10,841 applications received were approved.<sup>23</sup> However, this guarantee scheme requires a minimum of one year of operation, and is thus unlikely to be given to assist a fresh start-up with a bright idea but in need of access to financing.

23. For smaller companies, the Hong Kong Mortgage Corporation has also established a "Micro Business Start-up Loan".<sup>24</sup> New businesses with an age of up to five years can apply for a start-up loan which requires a credit report, business plan and training stage, as well as a formal loan application and vetting interview. Between the program's launch in 2012 and 2014, 143 of 294 applications received were approved with the average loan size of HK\$260,000 and the average loan term of 4.5 years.<sup>25</sup> The interest rate per annum applied in the programme is not higher than either 8% with guarantor or 9% without.
24. Another programme is the Youth Business Hong Kong and Microfinance Scheme, which is targeted towards youths (18-35) who have a "viable business idea" that can start in one year or is already in operation for no more than three years.<sup>26</sup> The programme allows a maximum of HK\$100,000 to be provided interest-free for business start-ups following approval by a vetting committee.
25. Issuances of either corporate bonds or convertible notes are unlikely both for the reasons discussed above with regard to loans and because of the legal complexity and distribution problems they entail. As such, it is unlikely that SMEs can afford or would prefer to issue debt instruments.
26. Thus, debt finance, while useful for larger companies, does not sufficiently meet the needs of start-ups. The OECD's report on SME Financing notes that: "debt is generally considered not to be an appropriate form of financing for innovative SMEs, or other entities with projects characterised by higher risk-return profiles, at least not during the early stages when revenue generation and profitability are still at best uncertain and as debt servicing necessitates regular payments of interest and principal."<sup>27</sup> Among the significant risks the debt presents to entrepreneurs include having to pledge personal assets, risk credit damning credit ratings, and pay unreasonably high rates of interest. Moreover, even if a start-up wanted to avail itself of credit, banks "remain quite traditional [...] they almost always demand collateral to support a loan for business investment [...] lending based on just a sound business plan is almost

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<sup>23</sup> Hong Kong Mortgage Corporation (2015b).

<sup>24</sup> Hong Kong Mortgage Corporation (2015c).

<sup>25</sup> Hong Kong Mortgage Corporation (2015d).

<sup>26</sup> Hong Kong Federation of Youth Groups (2015).

<sup>27</sup> OECD (2006), p. 34.

unheard of”.<sup>28</sup> This corroborates two HKMA surveys on SME business financing undertaken in 1999 and 2000 which found that most SMEs found it difficult to borrow from banks to finance business development. The 2009 GEM Report concluded that financiers, bankers, and investors alike were sceptical of loan financing due to the lack of its availability to start-ups.<sup>29</sup> The remaining alternative is thus to raise capital through allotment of equity stakes.

**c. Equity finance**

27. For the reasons explained in the previous subsection, equity finance is the more popular financing option for start-ups. It is attractive from both sides of the relationship: the entrepreneur has no duty to repay a fixed sum and the investor acquires the possibility of participating in very significant value growth as the inchoate business concept progresses into a viable enterprise. The drawbacks are of course that the investor takes on very significant risk, and such risk is in most cases reduced by requiring a certain period of stable business operations before the investment is made.
28. The need for a stable business history can be circumvented by approaching investors, such as family, friends or neighbours, who have information about the company’s founder unrelated to the start-up and therefore have achieved a level of trust. The progress of an equity issuer from one source of financing to the next can be regarded as a movement up stages of a “chain”, whereby an issuer’s exhausting capital received from one source will encourage the founder to seek more capital higher up the chain.<sup>30</sup> As with debt financing, the first targeted investors for sales of equity stakes may be from the founder herself, co-founders, family and friends – i.e. a personal network. The Global Entrepreneurship Monitor Report 2009 found that the rate at which informal investors backed businesses in Hong Kong dropped dramatically after the 2008 recession, and more so than in other economies.<sup>31</sup>

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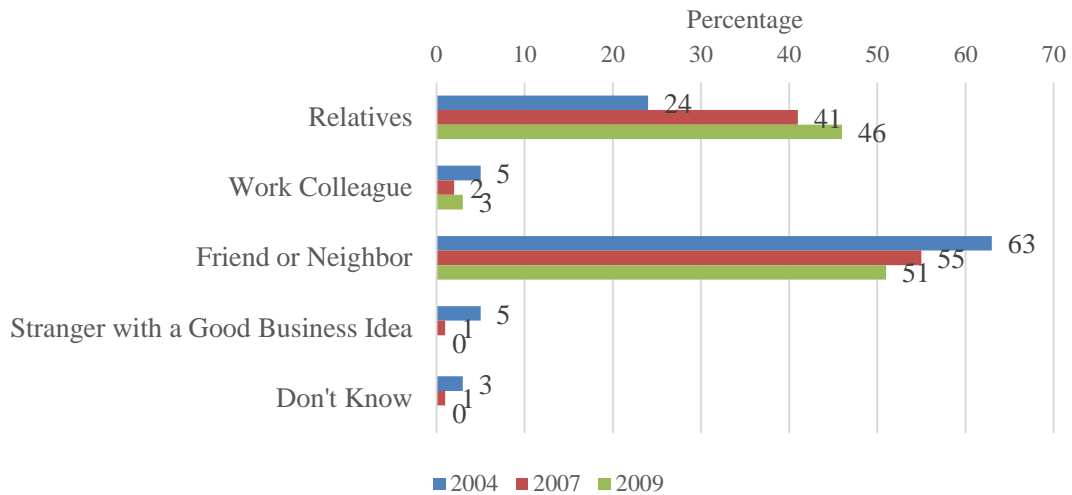
<sup>28</sup> Au & White (2014), p. 25.

<sup>29</sup> Center for Entrepreneurship (2009), p. 34.

<sup>30</sup> Au & White, *supra* note 28, p. 22.

<sup>31</sup> Center for Entrepreneurship (2009), p. 45.

Figure 2: Relationship between Informal Investors and their Investees (Hong Kong)



Note: This chart is recreated from the exact figures presented in Center for Entrepreneurship, *supra* note 32, p. 45 (Figure 24).

29. However, as can be seen from Figure 2 above, the percentage of investment provided to a “Stranger with a Good Business Idea” increased from 0% in 2004 to 5% in 2009. This increase may demonstrate a trend towards investor willingness to back founders with whom they have no previous affiliation. The trend could be a positive sign that Hong Kong investors would be willing to use a crowdfunding network to seek higher returns from their accumulated savings, even without the bonding that comes from the relationship of family or friendship.
30. While ordinary investors in Hong Kong may be more willing today to back a start-up enterprise, the wealthy have seen the advantages of such investments for decades, and earned angelic accolades for their efforts. Business angels are investors who can make equity investments (or sometimes convertible debt) at a company’s early stage of development, and this essential capital can yield high returns. Business angels may invest alone or as a syndicate, depending on the amount needed and the advisory skills which the business angels can offer. The Hong Kong Business Angel Network cited 22 successful local cases between 2011 and 2014.<sup>32</sup> While this is probably an underestimate, it suggests that the true figure is likely still far too little in an economy where over 100,000 new companies are incorporated each year.<sup>33</sup>
31. Venture capital firms also provide attractive terms of financing for start-up enterprises, but in order to reduce both risk and the period before a company can be flipped

<sup>32</sup> Hong Kong Business Angel Network (2015).

<sup>33</sup> See Hong Kong Companies Registry (2014).



through public offering, they usually invest in companies that are well established and have a detailed business plan. The Hong Kong Venture Capital and Private Equity Association (HKVCA) reports investment size ranges of US\$30,000 to US\$50 million in Hong Kong's venture capital market.<sup>34</sup>

32. Another, and growing, source of corporate finance is private equity, which has the favourable characteristic that investments tend to be longer term, but like venture capital, private equity tends to prefer investments in more established companies. A private equity firm would need to cash out of its investment, and this is often accomplished by selling their shares in connection with an IPO or the placement of a share packet with another private equity firm. In 2013, Hong Kong was "home to the second largest private equity centre in Asia", with 376 private equity firms holding approximately US\$98.5 billion of capital under management.<sup>35</sup> While this benefits larger companies in the final stages of development before going public, it does not offer significant support to local start-ups.
33. From the above, we can see that equity is useful not only because it is a source of capital that does not require repayment, but also because the equity investor takes a stake in the businesses' success and can bring talent to its leadership. The resulting participation, oversight and mentoring, as well as advertising through the investor's own networks, can be of great benefit to the company and significantly boost the venture's chances of success. However, the availability of such financing is much lower than needed, even in "the second largest private equity centre in Asia". Au and Smith find the general perception by entrepreneurs and the general public that venture capital will be able to provide funding needs of around US\$1 million to a firm between the seed and start-up stage to be mistaken and exaggerated.<sup>36</sup> The result is that start-ups are often in need of additional sources of funding to carry them through from the start-up phase to the point where they are ready to attract injections of capital from professionals. Au and Smith report that "many early-stage entrepreneurs cannot find funding to bridge the 'equity gap' between what they can gather from personal sources initially and what they could solicit from venture capital funds".<sup>37</sup> This gap in funding between the beginning, seed stage and the point where the start-up can begin to solicit venture capital based on a demonstrably viable business model with a proven track record can be deadly for the incipient business.<sup>38</sup>

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<sup>34</sup> See Hong Kong Venture Capital and Private Equity Association (2014).

<sup>35</sup> Hong Kong Trade Development Council (2014b).

<sup>36</sup> Au & White, *supra* note 28, p. 20.

<sup>37</sup> *Ibid.*

<sup>38</sup> The stages of equity investment are usually (1) founder and/or co-founders; (2) family and friends; (3) angel investors [a person with HK\$8,000,000 net worth or HK\$1,600,000 in annual income]; (4) venture

**d. Grant financing**

34. The government has also entered the field, replicating the advantages of angel investment to a certain degree. The Innovation and Technology Fund operated by the HKSAR's Innovation and Technology Commission supports the Small Entrepreneur Research Assistance Programme (SERAP). Under the programme, start-ups in the technology field can carry out research and development with funding support received on a dollar-for-dollar matching basis, with the funds recouped if revenue is generated or there is third-party investment.<sup>39</sup> Between the programme's launch in 2012 and November 2014, a total of 398 projects had been funded with total of HK\$ 480 million.<sup>40</sup> This programme is also supplemented by the Hong Kong Science and Technology Parks Corporation, which operates multiple incubation programmes.<sup>41</sup> The market has stepped forward in recent years to provide additional sources of financing for start-ups and entrepreneurs. Jack Ma, of the Alibaba Group, announced a HK\$1 billion foundation to encourage and boost entrepreneurship amongst youths in Hong Kong.<sup>42</sup>

**C. Government Measures to Facilitate Financing**

**a. A history of facilitating the market**

35. The continued strength of Hong Kong as a leading innovation and entrepreneurial hub is contingent on start-ups having multiple avenues of financing suited for their different stages of development. There are limitations associated with debt financing as loans are clearly not the preferred way for start-ups. We have seen that there is a gap in the equity financing that is available after the family, friends and neighbours of entrepreneurs have exhausted their disposable savings. The government programmes like the SME Financing Guarantee Scheme, the Micro Business Start-up Loan, the Youth Business Hong Kong and Microfinance Scheme, and the Innovation and Technology Fund are useful, but cannot fill the entire gap.
36. It is time for the government seriously to consider facilitating an alternative, market-driven source of start-up financing through adjustment of the regulatory framework. Crowdfunding offers a source of corporate finance that can potentially fill part of the gap between the initial support of friends and family and the institutional investment

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capitalists [investments usually starting around HK\$4,000,000]; (5) initial public offering and investment banks. See Fundersandfounders.com (2013).

<sup>39</sup> Innovation and Technology Fund (2015a).

<sup>40</sup> Innovation and Technology Fund (2015b).

<sup>41</sup> See Startmeup.hk (2015).

<sup>42</sup> Ng & Yu (2015). Many details still remain unclear at the date of writing.

that can precede an IPO. This source has been brought to the market through advances in communications technology, and is purely market-driven. Recourse to the market is not only highly complementary with Hong Kong's traditional philosophy of market-driven development, but it could also be more efficient than the existing funding programs, which require significant grant application lead time and where the decision to grant funding to a particular firm and deny it to another might be conceptually sound but in practice burdensome and ultimately erroneous. While the government's funding programs remain an essential component in the stimulation of innovative enterprises in Hong Kong, a solution from the market can therefore provide an excellent supplement. The introduction of financing platforms using new data transmission technology can also have latent benefits for Hong Kong's IT sector, and could become a source of expertise and knowhow in itself.<sup>43</sup>

**b. A natural next step – crowdfunding**

37. As noted in Part I, advances in the type of data transmission platforms made famous by social media firms like Facebook and LinkedIn now enable individual entrepreneurs starting or expanding a business to reach out directly to investors and solicit equity financing. These changes are altering the stages of corporate finance discussed above, creating a network of investors at the gap between the personal and the institutional networks that are currently used. The discussion in the preceding subsections shows that Hong Kong can use an additional avenue to source financing for start-up enterprises, and we believe that it should take advantage of the current opportunities technology offers to make the regulatory adjustments necessary to facilitate crowdfunding.
38. The International Organization of Securities Commissions (IOSCO) defines "crowdfunding" as "an umbrella term describing 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".<sup>44</sup> The financing network that a crowdfunding platform can bring to a start-up enterprise can effectively bridge the gap between a circle of personal acquaintances and the larger community of the international capital market, as represented on the stock exchange. The difficulty, as will be discussed in Parts III and IV, arises in regulating an activity that resembles an IPO without imposing the same, in this case prohibitive, regulatory costs of an IPO.

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<sup>43</sup> It is no accident that an economy in which a specific type of product is used avidly also becomes a manufacturer and exporter of that product. Examples are Italy which has cultural passions for food and fashion that have shaped its export industry, and Germany which hosts one of the only highway systems in the world allowing high-performance automobiles to be driven at very high speeds, rendering the country a de facto test-track for its automobile industry.

<sup>44</sup> IOSCO (2014), p. 8.

39. Although the concept of crowdfunding is still new to Hong Kong, the market's interest in it is growing. In May 2014, the Hong Kong Securities and Futures Commission (SFC) issued a notice warning persons engaging in activity like crowdfunding that absent proper licensing and compliance measures they may be running afoul of existing investor protection and market supervision provisions.<sup>45</sup> Investment through crowdfunding platforms both provides start-ups with sorely needed finance and, in the case of equity crowdfunding, gives ordinary savers an opportunity to benefit from the kind of high-return investment previously reserved for wealthy angel investors and sophisticated institutions. This return of course comes with increased risks, and our regulatory framework exists to protect investors from the unnecessary risks of fraud, misconduct and negligence. For this reason, it will be necessary to find a proper balance in the regulation between opening up to beneficial financial activity and shutting out abusive behaviour. The following Parts III and IV will discuss how a number of jurisdictions have taken regulatory action to introduce crowdfunding into their financial systems, and evaluate on the basis of available data the success they have had in attracting capital from many small investors.

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<sup>45</sup>

SFC (2014).

### III. A COMPARATIVE VIEW OF EXISTING CROWDFUNDING REGULATORY REGIMES

#### A. Introduction

40. As discussed above, the term “crowdfunding” is used to refer to a number of ways in which advances in communication technology allow investors to interact with persons in need of capital. The basic activities to be achieved in this way have long been present; what is new is the facility with which collective action problems can be overcome through technology. If we examine the four types of crowdfunding that IOSCO sees as relevant,<sup>46</sup> we find standard types of transactions framed in a more high tech context:

- *Donation crowd-funding*, which in the past was performed through informal networks, gatherings like dinners and balls, or even through televised appeals with a bank of phones to receive pledges;
- *Reward crowd-funding*, which in the past was also performed through informal networks, similarly to the gathering of donations;
- *Peer-to-peer lending*, which is essentially a disintermediated form of a classical cooperative arrangement where members seeking savings opportunities lend to other members in need of capital;
- *Equity crowd-funding*, which is essentially an offering of equity shares to a group of investors on analogy to an IPO, whether that be large enough to constitute a public offering or small enough to remain a private placement.

41. In Hong Kong, locally-based donation, reward, and peer-to-peer lending crowdfunding platforms exist as examples of market activity in this area, although full equity crowdfunding has not been embraced due to the regulatory challenges.<sup>47</sup> Examples of crowdfunding platforms include:

- FringeBacker: a Hong Kong-based, global crowdfunding platform (donation, reward, and peer-to-peer fundraising) which has had success in connecting projects with crowdfunding backers. Their most recent and prominent successes include the Hong Kong Free Press (more than HK\$580,000 raised), Hong Kong Martial Arts Living Archive (more than HK\$250,000 raised), and fundraising for Jacqueline Lai’s equestrian showjumping (more than HK\$480,000

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<sup>46</sup> IOSCO, *supra* note 46, p. 8-9.

<sup>47</sup> Hong Kong’s entrepreneurs also take recourse to foreign crowdfunding platforms, including Indiegogo and Kickstarter to crowdfund their projects.

raised). FringeBacker focuses on crowdfunding for “creative arts, innovative industries and charitable organisations”.<sup>48</sup>

- Nest: an incubation centre with operations in both Hong Kong and London that operates a company called “Investable” in Hong Kong. Investable is an equity crowdfunding platform that both takes stakes in start-up companies and acts as a mediator between professional investors and such companies.<sup>49</sup>
- WeLab: a Hong Kong-based company which operates WeLab, a Hong Kong peer-to-peer online lending platform,<sup>50</sup> and Wolaidai, “China’s first fully mobile peer-to-peer lending platform”.<sup>51</sup> As of 2 January 2014, WeLab reported receiving more than HK\$131 million in loan applications since its start in the summer of 2013.
- Music Bee: a Hong Kong-based platform where music artists can have their songs and albums crowdfunded.<sup>52</sup> Examples of successful projects backed include Chet Lam’s new album, which received almost HK\$400,000 after listing on the platform.<sup>53</sup>

42. Our review of the market has shown that a form of pre-sales crowdfunding, which could be characterized as reward crowdfunding, is popular among start-up companies. In this model, an entrepreneur offers consumers prototypes of products or services, for which the consumer makes payment prior to production. This essentially replaces the need for generic business capital because consumers provide the capital necessary to manufacture a given product.<sup>54</sup> Pre-sale, or reward, crowdfunding is not a financial

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<sup>48</sup> FringeBacker (2015).

<sup>49</sup> Nest (2015); Investable (2015) and Shu (2014).

<sup>50</sup> See Robertson (2014).

<sup>51</sup> WeLab (2015).

<sup>52</sup> Music Bee (2015).

<sup>53</sup> See Yu (2015).

<sup>54</sup> Pebble, an American start-up company focusing on smartwatch technology, used the American crowdfunding platform Kickstarter for multiple rounds of such pre-sale fundraising. Pebble’s first round of fundraising in 2012 raised around US\$10,250,000 (<https://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android/description>) while its second round of fundraising in 2015 raised more than US\$20,300,000 (<https://www.kickstarter.com/projects/597507018/pebble-time-awesome-smartwatch-no-compromises>). In each case, Pebble adopted a reward crowdfunding approach in the form of pre-order rewards, whereby the provider of funds received the eventual product as a “reward” for donating a certain sum. Pre-sale crowdfunding is feasible for companies operating in the mass-market technology sector if the sums collected for a given round of production are large enough to engage a team with adequate manufacturing facilities. However, it is unlikely that such just-in-time funding for production needs could ever replace the need for corporate capital. Equity crowdfunding can both provide such capital and bring the skills and perspectives of additional investors into the company. These investors also become “lifelong brand ambassadors” for the company which has been noted to “[add] value

activity that requires specific regulatory measures.<sup>55</sup> On the other hand, equity crowdfunding, which is the main focus of this paper, allows ad hoc networks of investors and entrepreneurs to be assembled in a manner that, in the past, required either the kind of networks that have long existed between financial institutions or an organization like an exchange trading floor. It therefore resembles the process of an IPO because it creates network externalities to allow aggregation of both funds and information to solve a collective action problem inherent in focusing small investments into a single enterprise. However, there are significant differences between the scale and purpose of an IPO and that of crowdfunding, and this leads to the regulatory choices that we discuss in this paper. Not only will the issuer not “list” its securities on the crowdfunding platform – so that there will be no secondary market for the shares – but neither the issuer nor the investor is prepared to bear the regulatory costs associated with a traditional public offering.

43. For the purposes of the initiatives advocated in this paper, the aspect of equity crowdfunding that must be appreciated is the necessary trade-off between the regulatory rigor traditionally applied to public offerings of securities and the associated costs. Crowdfunding brings a large collective of investors together to purchase securities offered by a small issuer that is unable to make a public offering requiring a full securities prospectus and perhaps the guidance of a regulated sponsor and a listing on a recognized stock exchange. Rephrased in an unflattering way, equity crowdfunding is a public offering of shares in a high-risk enterprise with less regulatory protections. There is a larger element of caveat emptor. Seen in a more positive manner, equity crowdfunding allows retail investors to benefit from holdings in potentially high growth enterprises while making small investments that together allow young companies to grow and thrive, concomitantly supporting the economy. While individual exposure may be small, social benefits are great. The latter characterization highlights both the democratic aspect of the funding model (in that

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that...persuades...entrepreneurs to sell equity rather than promise rewards. Investors ask for more, but give more in return” (www.crowdfundinsider.com/2015/01/60767-rewards-equity-and-a-crowd-in-between/).

The recent case of Oculus is illustrative in this regard. Oculus raised more than US\$2,400,000 from Kickstarter by promising to deliver a virtual reality headset to crowdfunders. However, the company founders then sold the company to Facebook for more than US\$2 billion dollars leading to tension from the original Kickstarter backers who had not profited from the sale of the company. Internet users expressed their opinion that they would have rather purchased stock in the company instead of a pre-sale of the product (see <http://www.crowdsourcing.org/editorial/tension-over-2b-oculus-acquisition-shows-that-the-time-for-equity-crowdfunding-is-now/31151>). Clearly, a sale of equity is significantly more flexible than entering into contracts *en masse* for the production and delivery of goods.

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Of course, problems could arise by way of false advertising or breach of contract, and on the other hand, government can get involved by facilitating networks to make such pre-sales. If Hong Kong were to decide not to proceed with improvement of its financial services framework to allow financial crowdfunding, a network for pre-sales of products and services from start-up companies could be an alternative as a first step to stimulate entrepreneurial activity in Hong Kong.

retail investors can benefit in ways often reserved to wealthy and sophisticated venture capital investors) and the likely limits on exposure (given the small shares that would arise from the participation of many investors in a small enterprise).

44. Although the IOSCO characterizes the first two types of crowdfunding as “community” oriented and the second two as entailing “financial return,” we think that equity crowdfunding can also be understood as a community exercise: investors support and “bet” on the fortunes of an entrepreneur not far removed financially from themselves. Surely such communal support of job-generating businesses has greater social relevance than, say, betting a like amount in a day at the horse races. It would be highly peculiar for such betting to be supported through substantial, legal infrastructure in any jurisdiction, while crowdfunding remains prohibited. Perhaps this is why leading markets are providing regulatory frameworks in which equity crowdfunding, which previously would have only been possible through contacts with a venture capital firm or a private network of investors, can begin and develop. Crowdfunding allows a community to take a stake in the businesses that serve it, adding solidarity and support to a hope for financial return.
45. Crowdfunding has three major components: the issuer entrepreneur, the platform through which the issuer seeks to raise funds, and the investors who provide funding through this platform. The comparative discussion presented in this Part III is thus organized by addressing the regulation of each of these aspects in relevant jurisdictions.

## **B. Regulation of Platforms**

46. Crowdfunding is enabled through online platforms, on which start-ups pitch their ideas to attract investment. Regulators should ensure that investors are only invited to invest through a platform that is trustworthy. Thus, mandating the safe and orderly operation of such platforms is extremely important to crowdfunding.

### **a. United States**

47. In 2012, the US enacted specific legislation to help young start-ups raise capital, and one of these capital formation measures includes regulating crowdfunding.<sup>56</sup> As its name and acronym suggest, the 2012 Jumpstart Our Business Startups (JOBS) Act was meant to change the regulatory framework to facilitate the access of start-up companies to corporate finance, thereby stimulating employment. As with all such laws, it is being implemented with detailed rules issued by the Securities and

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<sup>56</sup>

Gerber (2012).



Exchange Commission (SEC).<sup>57</sup> According to the SEC, the JOBS Act mainly intends to “reduce barriers to capital formation, particularly for smaller companies”.<sup>58</sup>

48. US securities laws require that before a company offers securities to the public, the securities must be registered with the SEC,<sup>59</sup> through a registration process that is generally deemed thorough, but complicated and expensive, especially for small start-ups.<sup>60</sup> The registration statement constitutes the bulk of a prospectus that is the primary document to be used in communicating with potential investors. Issuers can be exempted from registration if they do not use general solicitation to market the securities. Traditional routes to sell equity securities without the burden of registration have been private placements under Regulation D<sup>61</sup> and offerings to qualified institutional buyers (so-called QIBs) under Rule 144A under the Securities Act.<sup>62</sup>
49. Title III of the JOBS Act created a new category of exemption from the registration requirement for crowdfunding. It allows offerings to ordinary investors – regardless of income – without registration and a prospectus, provided that the offering takes place through a licensed broker or funding portal, the amount raised during a 12 month period does not exceed USD1 million, and no one person invests too large a portion of their annual income.<sup>63</sup> The SEC Rules provide for registration of both a broker-dealer acting as an intermediary in crowdfunding as a funding portal.<sup>64</sup> The requirements a portal must meet are lighter than those applied to broker-dealers.
50. Licensing of the platform will overlap with existing licensing of broker-dealers under the Securities Exchange Act of 1934. However, the Act contains specific requirements that portals educate investors regarding potential risks of the investment,<sup>65</sup> and the SEC Rules set forth an extensive body of requirements for the registration of a funding

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<sup>57</sup> SEC Release Nos. 33–9974; 34–76324, “Crowdfunding,” 80 *Federal Register* 71388 (16 November 2015) (SEC Crowdfunding Rules).

<sup>58</sup> Sec.gov (2013).

<sup>59</sup> See §5 US Securities Act of 1933. Under §5, all issuers of non-exempt securities must register their securities with the SEC, and issue a prospectus – which meets the requirements under §10 of the Securities Act – where necessary.

<sup>60</sup> Lynn & Pinedo (2012).

<sup>61</sup> See 17 CFR § 230.501 *et seq.* Title II of the JOBS Act allows “general solicitation or general advertising” to “accredited investors” under Reg D, §230.506(c). An “accredited investor” is an institution or a physical person with a net worth over US\$1 million or annual income exceeding US\$200,000.

<sup>62</sup> See 17 CFR § 230.144A.

<sup>63</sup> See JOBS Act, §302(a), codified at 15 USC § 77d. The restrictions on investment will be discussed in subsection III.C.a, below.

<sup>64</sup> SEC Crowdfunding Rules, codified at 17 CFR Part 227.

<sup>65</sup> See JOBS Act, §302(b), insertion of a new §4A into the Exchange Act and SEC Crowdfunding Rules, 17 CFR §227.302(b).

portal,<sup>66</sup> including prohibitions on offering investment advice or recommendations, directly or indirectly soliciting purchases or sales of the securities displayed on its portal, and managing or otherwise handling investor funds.<sup>67</sup> The portal would have to “determine whether and under what terms to allow an issuer to offer and sell securities” on the platform according to criteria that are “reasonably designed to highlight a broad selection of issuers offering securities ... applied consistently to all issuers and offerings and are clearly displayed on the funding portal’s platform.”<sup>68</sup>

51. Portals will also have to be a member of the Financial Industry Regulatory Authority (FINRA, formerly the National Association of Securities Dealers, which is a self-regulatory organization under the Exchange Act and issues further regulations for such portals.<sup>69</sup> These regulations would constitute part of the FINRA Funding Portal Rules, which regulate the licensing of portals, their conduct, and ongoing monitoring for compliance.<sup>70</sup> These rules will be separate from the current FINRA By-laws, but unless circumstances require otherwise, any funding portal members or people associated with funding portal members shall be subject to both the By-laws and the Funding Portal Rules.<sup>71</sup> The membership requirements for portals in the proposed rules are based on those for broker-dealers, but are “simplified to reflect the limited nature of their business”.<sup>72</sup> The conduct rules would require portals to behave in a manner reflecting “high standards of commercial honor and just and equitable principles of trade,” while refraining from engaging in activity constituting “any manipulative, deceptive or other fraudulent device”.<sup>73</sup> Each portal would then have to establish an internal monitoring system to supervise the activities of each associated person of the funding portal member, so that they comply with SEC regulations and with the Funding Portal Rules.<sup>74</sup>

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<sup>66</sup> SEC Crowdfunding Rules, 17 CFR §§227.400 - 404.

<sup>67</sup> 17 CFR § 227.402(a).

<sup>68</sup> 17 CFR § 227.402(b).

<sup>69</sup> In testimony delivered to the House Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services on 1 May 2015, FINRA CEO Richard G. Ketchum explained: “In order to fulfill our mandate under the JOBS Act crowdfunding provisions, we plan to file our proposed rule set applicable to crowdfunding portals immediately after the SEC adopts its Regulation Crowdfunding. FINRA has streamlined the already limited set of rules that would apply to funding portals. We intend for these rules to be in place by the time the SEC’s proposed Regulation Crowdfunding goes into effect.” FINRA (2015).

<sup>70</sup> FINRA (2013).

<sup>71</sup> *Ibid.*, Background & Discussion.

<sup>72</sup> *Ibid.*, also see proposed Funding Portal Rule 110 at Finra.org (2015).

<sup>73</sup> See proposed Funding Portal Rule 110, *Ibid.*

<sup>74</sup> See proposed Funding Portal Rule 300, *Ibid.*

**b. United Kingdom**

52. Equity crowdfunding platforms fall under the UK Conduct of Business Sourcebook (COBS), which requires that platforms meet requirements for “suitability” and “appropriateness”.<sup>75</sup> These standards have been achieved through collaboration between the UK Financial Conduct Authority (FCA) and the UK Crowdfunding Association (UKCFA), a private association. The UKCFA was founded by 14 UK crowdfunding businesses in 2012 and has published a binding Code of Practice designed to protect investors by increasing transparency and ensuring honesty.<sup>76</sup> However, membership in the UKCFA is not mandatory for crowdfunding platforms, even if most platforms do join the UKCFA to enhance their reputation by showing investors that they are part of an organization that aims to protect consumers and promote the growth of crowdfunding.<sup>77</sup>
53. The 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 (for platforms dealing with regulated activities) and 21 (for platforms dealing with “financial promotions”—essentially investment activities) of the Financial Services and Markets Act (FSMA) of 2000.<sup>78</sup> However, platforms engaging in both of the aforementioned activities may be qualified for exemptions from licensing under the FSMA (Financial Promotion) Order 2005 (FPO).<sup>79</sup> There are over 65 such exemptions, which include the scenario that the financial promotion is made to only one investor or a small group of investors and the promotion is tailored for these recipients,<sup>80</sup> as well as that in which all investors are certified high net worth individuals or sophisticated investors.<sup>81</sup> Many equity crowdfunding platforms were “structured using a combination of exclusions and exemptions from the regulated activities regime” because the FCA had not yet taken action on their regulation, but this has become increasingly unnecessary in the wake of the FCA recognizing crowdfunding as a legitimate way to raise capital and thus amending rules that specifically deal with this activity.<sup>82</sup> The general requirements of “suitability” and “appropriateness” are designed to be open-ended and flexible.

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<sup>75</sup> COBS 9 and 10, respectively.

<sup>76</sup> Ukcfa.org.uk (2014).

<sup>77</sup> *Ibid.*

<sup>78</sup> Fca.org.uk (2014a).

<sup>79</sup> Mutimer (2013).

<sup>80</sup> See Article 28 FPO legislation.gov.uk (2005).

<sup>81</sup> See Article 48 and 50 FPO at *ibid.*

<sup>82</sup> FCA (2013) and (2014); Osborneclarke.com (2014).

**c. Singapore**

54. In February 2015, the Monetary Authority of Singapore (MAS) published a consultation paper in which it expresses the opinion that crowdfunding would be an “offer of securities” regulated pursuant to the Securities and Futures Act (SFA).<sup>83</sup> Platforms that are deemed to be facilitating any securities offerings may be subject to licensing requirements under the SFA and would be monitored by the MAS.<sup>84</sup> The framework proposed in the consultation paper is that any platform on which crowdfunding takes place would have to be licensed for “facilitating offers of securities to investors,” and perhaps for other activities, depending on its business model.<sup>85</sup> In light of the differences in risk profiles between a platform and a broker-dealer, the MAS proposal would “lower the base capital requirement and remove the security deposit requirement for intermediaries.”<sup>86</sup> The MAS proposes to do this by lowering the minimum base capital requirement for such intermediary crowdfunding platforms from S\$250,000 to S\$50,000 and to remove the S\$100,000 lodgement normally posted to protect damaged investors.<sup>87</sup>
55. International crowdfunding platforms have set up branches in Singapore. An example is Swedish-based FundedByMe, which offers all forms of crowdfunding for the companies listed on its platform, depending on the company’s place of incorporation and operations.<sup>88</sup> Equity crowdfunding has been offered in Singapore only for European-based start-ups.<sup>89</sup> The fact that FundedByMe chose Singapore for its Asian hub indicates a certain optimism that the jurisdiction will soon facilitate crowdfunding through express regulation or derogating tolerance.

**d. China**

56. Shenzhen, whose GDP in 2017 is expected to overtake that of Hong Kong,<sup>90</sup> was in 2014 named China’s most competitive business environment by the Chinese Academy of Social Sciences, largely because of its climate of stimulating innovation through start-up companies.<sup>91</sup> China is in the process of adapting its legal and regulatory

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<sup>83</sup> Hawksford Singapore Pte Ltd (n.d.)

<sup>84</sup> Insightlegalasia.com (n.d.).

<sup>85</sup> MAS (2015), p. 7.

<sup>86</sup> *Ibid.*

<sup>87</sup> *Ibid.*, p. 8.

<sup>88</sup> Fundedby.me (2015).

<sup>89</sup> *Ibid.*

<sup>90</sup> Frank Chen (2014).

<sup>91</sup> Chang (2015).

framework to equity crowdfunding, and concrete measures can be expected.<sup>92</sup> Currently, Chinese equity crowdfunding platforms operate either as private placement to qualified investors or in the shadows of financial regulation. Popular crowdfunding platforms like DemoHour and Dreamore are mostly rewards-based, and equity crowdfunding platforms like SeedAsia are rare.<sup>93</sup>

57. With 600 million Internet users, China has the world's largest online population. When regulations catch up with the rising crowdfunding trend, start-up firms will be able to benefit from the potentially enormous dimensions of China's investment pool. If even 1% of these 600 million people were to invest in the Chinese economy through properly regulated equity crowdfunding platforms, they could inject hitherto unseen amounts of capital into innovative ventures that will aid China's technological competitiveness and labour market.

**e. Conclusions**

58. The jurisdictions compared above display four different states of regulatory treatment of equity crowdfunding platforms. Legislation in the US has created a clear regulatory framework for crowdfunding, with a 200 page implementing regulation that specifies exact requirements for licensing and operation of the platform, and a duty to submit to the regulation of a self-regulatory organization, FINRA. The UK has addressed crowdfunding with a typically lighter touch, using existing law, with regulatory monitoring and governance through codes of conduct. Singapore has proposed a model in which the platform will be licensed like a securities dealer and is relying on existing exemptions for sophisticated investors. China has mapped out the future jurisdiction over new financial techniques, and we can expect rules or guidelines in the future from the China Securities Regulatory Commission (CSRC).

**C. Regulation of Issuers**

59. The issuers of securities and in particular their public offerings of shares are at the centre of the traditional regulatory scheme for public offerings, which demands registration of the securities with the regulator or the creation and publication of a prospectus disclosing facts about the issuer and the issue, or both registration and publication. It is specifically this aspect of the regulatory framework that should be tailored in order to allow crowdfunding to serve start-ups. However, given the

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<sup>92</sup> In July 2015 the People's Bank of China issued guidelines assigning responsibility for a number of newer financing techniques to the various overseers of the financial sector. The China Securities Regulatory Commission will regulate equity crowdfunding. See Midori Yoshimura, "Just Released: China's New Guidelines For Online Finance Market," *Crowdfund Insider* (19 July 2015).

<sup>93</sup> Lin (2014).

heightened risk of failure in young enterprises, regulators must attempt to achieve a delicate balance between facilitating the crowdfunding activity and subjecting retail investors to the twin dangers of overly risky investments and securities fraud.

**a. United States**

60. The JOBS Act introduced an exemption to the registration requirement for public offerings,<sup>94</sup> so that crowdfunding issuers can offer securities through general solicitation without full SEC registration. Instead, issuers must – under the new regulations – file with the SEC and provide investors with information regarding the company, its management and business model, particular risks that the investment presents, the amount of the offering and the purpose for fundraising, and a description of the financial condition of the issuer, among other things.<sup>95</sup> In October 2013 FINRA proposed rules for funding portals with a view to effectively implement the JOBS Act, and these would also require equity crowdfunding platforms to pre-screen issuers for robust organization and a reasonable belief of the absence of fraud.<sup>96</sup> The Rules also make sure that such platforms implement anti-money laundering programs, and subject the platforms to investigations and sanctions by the FINRA.<sup>97</sup> These new rules thus ensure that it is in the interests of the platform to maintain its own integrity, and to ensure its business is conducted honestly. Through these proposals, issuers are regulated by the platforms, and not directly by FINRA. Thus it appears – at least on the basis of the regulatory proposal – that the US is willing to accept a somewhat lightened prospectus requirement partly in exchange for a reasonable degree of screening of issuers by the platform. Although the burden of screening seems to fall squarely on the platform, any issuer attempting to raise funds through a crowdfunding platform should try to provide all potential investors with the kind of information they would expect before making an investment decision, as doing so would enhance their reputation.

**b. United Kingdom**

61. The FCA has not introduced any exemptions to the prospectus and disclosure rules for equity crowdfunding, and expects full compliance from both offerors and platforms.<sup>98</sup>

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<sup>94</sup> JOBS Act, §302.

<sup>95</sup> 17 CFR § 227.201.

<sup>96</sup> See proposed Funding Portal Rule 300(b) at Finra.org, *supra* note 66. FINRA filed a notice of amendment and immediate effectiveness of this rule in October 2015. See SEC Release No. 34-76238: Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule To Establish Fees for Funding Portals, 80 *Federal Register* 66342 (28 October 2015).

<sup>97</sup> See proposed Funding Portal Rule 800(a), *Ibid.*

<sup>98</sup> FCA (2014), p. 40.

It does point out, however, that existing exemptions may be fully exploited in the context of crowdfunding, such as in the case where the total “offers fall below the €5 million limit, they may be exempt from the need for a prospectus under the Prospectus Directive”<sup>99</sup>

**c. Singapore**

62. In its 2015 Consultation Paper, the MAS points out that a prospectus would be necessary if a crowdfunding opportunity were offered to the public, and for this reason the MAS proposes that such offers beyond a limited circle of sophisticated investors be prohibited within the facilitated ambit of crowdfunding.<sup>100</sup> Beyond that, the MAS makes no special provision for issuers in its proposed rules.

**d. China**

63. As in other jurisdictions, China makes a distinction between an issuer’s offering of securities that is public and one that is non-public.<sup>101</sup> As such, it is conceivable that a crowdfunding offering structure like that proposed in Singapore, which is also available in the US as a private offering, would be possible in China.
64. A platform that has raised capital in China, SeedAsia, pre-screens issuers before they are then introduced to accredited investors. The start-ups that are featured “would have ideally gone through some sort of incubation program and would have shown promise”.<sup>102</sup> Because SeedAsia implements a filtering system for candidates of start-ups and investors who want to be featured on their platform, co-founder Tom Russell has said that SeedAsia is “kind of a hybrid between Kickstarter and private investment”.<sup>103</sup> The current situation in China thus resembles a private of QIB offering in the US.

**e. Conclusions**

65. In the US, issuers are pre-screened to some extent by the platform that decides to facilitate the purchase of that issuer’s shares. As things currently stand in the UK, Singapore and China, only the type or size of offering made by the issuer and the possibility of a private offering to qualified investors are expressly dealt with by law or proposed regulation to create prospectus free offerings in crowdfunding.

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<sup>99</sup> FCA (2014), p. 41, note 15 and FSMA s 85(5)(a) in connection with Schedule 11A, s 9.

<sup>100</sup> MAS, *supra* note 78, p. 9.

<sup>101</sup> Law of the People’s Republic of China on Securities (2005), Articles 10, 13.

<sup>102</sup> Ho (2013).

<sup>103</sup> *Ibid.*

## D. Regulation of Crowdfunding Investors

66. Securities laws sometimes regulate *investors* as opposed to issuers or intermediaries, but this is unusual and reverses the normal regulatory arrangement focusing on the person undertaking the regulated act (here an offering of securities) rather than the addressee of that act. This occurs, for example, when prospectus requirements are waived if securities are offered only to sophisticated investors, or when hedge funds are not subjected to full investment fund regulation because they only offer their products to wealthy individuals or institutions. In such circumstances, it is deemed that the investors can protect themselves, so that the government need not act on their behalf.
67. Crowdfunding presents a different situation. If a jurisdiction agrees to allow open-ended crowdfunding with light regulation of issuers and offerings, then it exposes ordinary investors (a group that might also be referred to as “consumers”) to financial risk. In other areas where consumers are given access to potentially dangerous products and services, such as the consumption of alcoholic beverages or participation in betting on sports, age requirements are introduced. In the financial services area, special warnings are also used, such as when derivative instruments are sold to ordinary investors in some jurisdictions. Similar protections can be introduced in a regulatory regime for crowdfunding so that ordinary investors can be allowed open access to crowdfunding investments while also receiving protection against serious financial risk.

### a. United States

68. The JOBS Act introduces tight controls on the permitted financial exposure of investors. It provides that:

the aggregate amount sold to any investor by an issuer during a given 12-month period may not exceed:

- (i) the greater of US\$2,000 or 5% of the investor’s annual income or net worth (for investors with income or the net worth less than US\$100,000), or
- (ii) 10% of the investor’s annual income or net worth, and in no case more than US\$100,000 (for investors with income or net worth exceeding US\$100,000).<sup>104</sup>

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<sup>104</sup>

JOBS Act §302, to be codified at 15 USC §77d.



69. The SEC appears to propose enforcing this requirement simply by passing the requirement of the law on to the intermediary, so that if the intermediary is found to have accepted investors who violate the limit, the crowdfunding would lose its exempted status,<sup>105</sup> triggering various violations of law for both the intermediary and the issuer.

**b. United Kingdom**

70. The FCA restricts offers of unlisted securities, the kind of securities that would be offered in crowdfunding, to investors who meet one of a number of criteria and tests. These are that the investor is a “professional client” or a retail client who confirms that he or she is investing with professional advice, is a venture capital or corporate finance professional, is a certified or self-certified “sophisticated investor” or “high net worth investor,” or certifies that he or she “will not invest more than 10% of their net investible financial assets” in the unlisted securities.<sup>106</sup>

71. The UKCFA rules focus on the sophisticated investor criterion, and allow anyone who sufficiently understands the risks of equity crowdfunding to engage in it. To enforce the requirement of investors understanding the risks, member platforms require a potential investor to complete a questionnaire that assesses whether she/he fully understands the risks of investing in start-ups.<sup>107</sup> Depending on the results of the questionnaire, the investor will be classified as sophisticated or ordinary on the platform. An ordinary investor would have to meet another of the FCA criteria listed above.

**c. Singapore**

72. The 2015 MAS consultation paper proposes that equity crowdfunding offers be made only to accredited investors and institutional investors,<sup>108</sup> that is, to those falling within private offering exemptions already contained in Part XIII of their Securities and Futures Act.

**d. China**

73. As explained above, we are now waiting for issue of the Chinese rules on crowdfunding, but its securities law does contain the possibility of a private offering exemption similar to that found in Singapore. In practice, platforms engaging in

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<sup>105</sup> Proposed 17 CFR § 227.100(a)(2).

<sup>106</sup> FCA (2014), pp. 35-36. Codified in UK Conduct of Business Sourcebook (COBS), 4.7.7.

<sup>107</sup> Seedrs.com (2014a); Fca.org.uk (2014b).

<sup>108</sup> MAS, *supra* note 78, p. 9-10.

crowdfunding without official endorsement have allowed only accredited investors to participate in equity crowdfunding. For example, potential investors through SeedAsia need to apply to the platform to be screened, establishing that they have the financial capability to adhere to SeedAsia's minimum investment of US\$ 2,000 per investor.<sup>109</sup> As is the case in the US, one simply needs to prove financial capability in order to be an equity investor through crowdfunding in China, and experience is not determinative.

e. **Conclusions**

74. Each jurisdiction examined limits investors' access to crowdfunding. Singapore uses the currently existing "professional investor" category to exclude investors without the required experience and financial standing. In this sense, it could be argued that Singapore does not actually allow crowdfunding. The UK also uses various investor screening mechanisms, including self-certifications of sophistication or professional skills, or a pledge that their total investment does not exceed 10% of their investible assets. The US approach overlaps with that used in the UK and resembles consumer protection used in other areas, such as protection against the consumption of certain substances or engaging in certain dangerous activities: under these rules, an investor's net worth together with a proportion of exposure will determine his or her ability to invest in a crowdfunded offer, and the size of such investment. It is likely that China's CSRC is watching each of these jurisdictions – and Hong Kong as well – in formulating its own investor restrictions for crowdfunding.

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<sup>109</sup>

Ho (2013).

## **IV. A COMPARATIVE VIEW OF CROWDFUNDING BENEFITS**

### **A. United States**

75. Examining the benefits of adopting equity crowdfunding is a large part of understanding why Hong Kong should take concrete steps to facilitate equity crowdfunding through reasonable regulation. In the US, evidence already exists that initial equity crowdfunding activity supports small businesses, boosts job creation, and encourages innovation.
76. Crowdfund Capital Advisors (CCA) released a report in January 2014 with findings that companies experienced a 351% quarter-to-quarter increase in positive cash flow from successful equity crowdfunding campaigns.<sup>110</sup> Additionally, 48% of the companies polled said they intended to use the crowdfunding proceeds to hire new staff, and 39% of the responders did hire an average of 2.2 new employees with the capital raised from crowdfunding.<sup>111</sup> These benefits were realized even before the full approval of equity crowdfunding—as mentioned previously, currently such fund raising is restricted to accredited investors (i.e., institutions and high net worth individuals). Once equity crowdfunding becomes an established part of the financial system, it could be expected to focus a significant amount of the society’s savings on innovative start-ups.

### **B. United Kingdom**

77. The true impact of early crowdfunding activity in the UK may be difficult to gauge because in April 2012 the UK government also launched the Seed Enterprise Investment Scheme (SEIS), offering up to 50% individual income tax relief, up to 28% capital gains tax relief, and capital gains tax re-investment relief to investors who provide capital to eligible start-up companies, most of which are offered through crowdfunding platforms.<sup>112</sup> This strong incentive to utilize the new platforms may have led to an early jump in platform use that could recede if the tax incentives are later removed. The Crowdfunding Centre has reported that crowdfunding injected over £9 million into UK start-up companies during the brief period between January and March 2014.<sup>113</sup> Breakdowns of this figure are that rewards-based crowdfunding raised £4.3 million, while equity-based crowdfunding raised more than £5 million during the same period.

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<sup>110</sup> Crowdfundcapitaladvisors.com (2014).

<sup>111</sup> *Ibid.*

<sup>112</sup> Seis.co.uk (2015); Crowdcube.com (2015b); Seedrs.com (2014b).

<sup>113</sup> Alois (2014).

## C. Singapore

78. The Singaporean government has begun to recognize the economic potential of equity crowdfunding. In a Budget Speech in February 2014, equity crowdfunding was described as “an alternative source of financing for start-ups and small companies”.<sup>114</sup> However, as crowdfunding has not yet been regularized in Singapore, it is understandable that there are no statistics on its impact. Despite having no formalized position under law, Singapore projects have reported successfully raising capital through US-based rewards crowdfunding platforms, such as:

- Project Silverline, which provides senior citizens with second-hand smartphones with healthcare and personal safety apps, and raised US\$54,000 on Indiegogo; and
- Bamboobee, a business venture to produce handcrafted bamboo-made bicycles, which raised a total of US\$63,879 on Kickstarter.

## D. China

79. As in Singapore, because China has not yet provided for regulation or supervision of crowdfunding, no studies or reports have to date measured the economic impact of the activity undertaken in the shadows, distinguishing growth from that funded through traditional venture capital channels. However, it has been reported that rewards-based crowdfunding platforms in China have already shown promise:<sup>115</sup>

- DemoHour, founded in 2011, has helped more than 2,000 projects raise funds from small contributors, with each contributor donating an average of 300 yuan; and
- Dreamore, founded in September 2011, has raised more than six million yuan for over 300 projects.

80. These crowdfunding platforms have also encouraged technological innovation by successfully funding projects that benefit that sector. DemoHour, for example, focuses on innovative household gadgets, and has supported an ecologically friendly blue-tooth sound box made from bamboo, an anti-pollution air control system for cars, and a sensor cup that records the user’s daily water intake.<sup>116</sup>

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<sup>114</sup> Singaporebudget.gov.sg (2014). See §C.38 of the Budget Speech.

<sup>115</sup> Sun (2014)

<sup>116</sup> Sun (2014).

81. This last project, referred to as “Cuptime”, has been one of the most successful projects on DemoHour, receiving 1.35 million yuan from over 2,600 contributors in a month.<sup>117</sup> Such projects highlight the potential of crowdfunding to boost China’s technological innovation and economic growth. A 2013 study commissioned by a World Bank project predicts that the Chinese market for crowdfunding investments could reach a staggering US\$50 billion annually by 2025.<sup>118</sup>

## **E. Similar Benefits for Hong Kong?**

82. Regulating equity crowdfunding is the only way the market can fully and safely reap its benefits. As we explained in Part I, a lack of funds is nearly as challenging to Hong Kong start-up companies as finding the central business concept on which to base the company. As such, there can be little doubt that additional sources of funding for start-up enterprises would bring significant benefit. Sound regulation will bring a level of safety and legal stability, encouraging more and more savers to join the “crowd”. A good regulatory framework would also be highly complementary to the aims of existing projects, like Cyberport and the Science and Technology Park. Equity crowdfunding can significantly broaden this ecosystem by bringing more investors to start-ups and more investment opportunities to savers, while serving to create companies that further utilize existing facilities and creating new jobs.
83. In this new field, if Hong Kong were to develop a regulatory framework of notably high quality, it could aspire to supplement its current status as a leading international financial centre with that of Asia’s hub for dynamic start-up capital, a title which it may have to wrest from Shenzhen.<sup>119</sup> If this framework were to incorporate the recommendation expressed in Part V, requiring start-ups to be formed under Hong Kong company law, crowdfunding could also serve to showcase the fact that the level of transparency achieved in its company law far exceeds international standards. Currently, Hong Kong could still snatch first-starter advantage from other Asian jurisdictions. This may allow Hong Kong both to set standards and dictate the terms of play in this new and dynamic sector.
84. In the course of our discussion with industry practitioners, an innovative idea also came up that the insurance industry might be interested in creating special insurance product for crowdfunding platforms to add to their own credibility and attractiveness. Indeed, facilitating crowdfunding could have positive knock-on effects for other sectors. And there may well be other benefits not presently anticipated.

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<sup>117</sup> *Ibid.*

<sup>118</sup> Information for Development Program/The World Bank (2013).

<sup>119</sup> See BloombergBusiness (2015) and Chang (2015).

85. In conclusion, there are many benefits to be gained from regulating equity crowdfunding in Hong Kong. These benefits have been seen and proven in the US and the UK. Equity crowdfunding, despite being a new phenomenon in Asia, has already been viewed favourably as an important new avenue to increase investment. In Part V, we propose adjustments to the Hong Kong regulatory framework to facilitate equity crowdfunding.

## V. POSSIBLE REGULATION OF CROWDFUNDING IN HONG KONG

### A. Legislative and Regulatory Alternatives

86. Hong Kong's existing legal and regulatory framework does not specifically address any form of crowdfunding. As mentioned in Part II, the SFC is monitoring the advance of this new form of financing, and in May 2014 issued a notice warning that absent proper licensing and compliance with possibly overlapping regulations, crowdfunding may run afoul of existing investor protection and market supervision provisions.<sup>120</sup> In light of the significant advantages crowdfunding can offer both the Hong Kong real and financial economies, we propose that Hong Kong regularize crowdfunding very soon. The adjustments to the Hong Kong regulatory framework presented in following range from legislative amendment to leaving the current regime unchanged. What would be appropriate probably falls in the golden mean between the two, and we suggest some relatively simpler adjustments to how the regulatory framework could be interpreted and applied in order to accommodate equity crowdfunding.

87. The SFC has pointed out that equity crowdfunding transactions could cause friction with the existing regulations in two respects: the offerings of securities do not attempt to comply with full protections required for offerings of shares to the public, and the platforms themselves do not attempt to achieve the status of registered exchanges.<sup>121</sup> Any adjustment of the regulatory framework must therefore address these two matters.

#### a. Legislative action

88. The core of equity crowdfunding is to facilitate offers to the public to purchase shares issued by a start-up company and investors' acceptance of such offers. This activity is managed through the crowdfunding platform or entity. Offers of securities to the public are subject to prospectus and registration requirements expressed in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (CWUMPO) and the Securities and Futures Ordinance (SFO). Dealing in securities, advising on such deals and facilitating the contracting behind such dealing are all regulated activities requiring licensing under the SFO. Legislative amendment would therefore focus on the CWUMPO and the SFO.

89. Pursuant to ss 2 and 38D CWUMPO any document used to offer shares of a company to the public is deemed a prospectus and must contain prescribed content and be registered with the SFC. Pursuant to s 103(1) SFO any offering of securities to the

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<sup>120</sup> SFC (2014a), p. 2.

<sup>121</sup> *Ibid.*

public must be approved by the SFC. (The interaction between the CWUMPO and SFO is not straightforward and will not be analysed here.) The content of the required prospectus is set forth in the third schedule of the CWUMPO. This base requirement is subject to a number of exemptions. A further, specifically dedicated exemption could be created expressly to address crowdfunding. This could be done by amending s 38B CWUMPO to insert an exception from the prospectus requirement for offerings made in a crowdfunding as defined by the SFO. A dedicated section of the SFO could then be inserted to define the regulated activity of crowdfunding. This section could define the activity, provide for the licensing of the crowdfunding platform – perhaps as a new form of regulated activity – specify the type of information to be made available to investors, and insert the kinds of restrictions on investment that would allow a balance between higher risk companies and lower disclosure (such as the percentage of income limit discussed in section B.d, below). This legislative provision would resemble Title III of the US JOBS Act, by regulating the platform, the disclosure of the offering and the exposure of an investor.

90. Such a legislative amendment would create high legal certainty and allow a custom-designed regulatory framework, but this approach – in light of the time required for past legislative initiatives in Hong Kong – would likely be time consuming. In addition, as we explain below, whilst some of the solutions included in the JOBS Act are ingenious, we think that the American style of powerful government regulatory intervention at the legislative level, which has been used for everything from specifying the techniques by which securities transactions must be cleared to preventing regulators from placing restrictions on the derivatives market,<sup>122</sup> may not be a good match for the regulatory style of the Hong Kong market.

**b. Limited activity on the basis of current exemptions**

91. We understand that a form of crowdfunding is currently performed by a few companies in Hong Kong under what the active parties understand as the range of current exceptions to the prospectus requirement. Sections 2(1) of CWUMPO and 103(2)(ga) SFO expressly exclude from the prospectus requirement certain types of exempted offerings provided for in the 17<sup>th</sup> schedule of CWUMPO. These include offerings to “professional investors,” which the SFO defines broadly to include banks, insurance companies, investment schemes and other financial intermediaries, including any class that the SFC names in specified regulations to this end.<sup>123</sup> A

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<sup>122</sup> With regard to the legislative order that central depositories hold all listed securities, see Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975), codified in relevant part at 15 U.S.C. § 78q-1(e). The (short-lived) prohibition on regulating the derivatives market was contained in The Commodity Futures Modernization Act of 2000, H. R. 5660, 106th Congress (December 14, 2000).

<sup>123</sup> See CWUMPO, s 2(1), in connection with CWUMPO Schedule 17, pt. 1, s 1, in connection with SFO Schedule 1, pt. 1, s 1, in connection with SFO, s 397.



physical person or a company may privately invest in the equity of a start-up company without any special permissions or license. If the same person or company were to inform professional investors about the availability of such shares, the start-up company's offering would enjoy the professional investor exemption from the prospectus requirement.

92. It would also be possible to conduct funding through an offering of company shares provided that the total consideration payable for the shares does not exceed HK\$5 million.<sup>124</sup> If an offering were to be made in this way, any document setting forth the offer would have to be accompanied by a declaration that it has not been reviewed by any regulatory authority in Hong Kong, and the potential buyer should "exercise caution in relation to the offer."<sup>125</sup>
93. If crowdfunding in Hong Kong were to remain confined to such a limited form or amounts, relying on such limited regulatory exemptions, its full economic benefits would likely not be realized. However, current information indicates Singapore is remaining at this level of crowdfunding activity, which may be seen by some as good argument for not taking extra measures to create an earmarked framework for crowdfunding in Hong Kong.

c. **A depository receipt option**

94. Another option for crowdfunding presents itself by stacking up two existing exemptions. The same type of exemption from the prospectus requirement provided under sections 2(1), 38B and 17<sup>th</sup> schedule CWUMPO for "professional investors" is also available for small offerings to persons not exceeding 50 in number, provided that the offer is accompanied by a warning that no regulatory authority has reviewed the offering document, advising caution in relation to the offer, and encouraging the offeree to seek independent professional advice.<sup>126</sup>
95. If these offerees were both to remain at 50 or below and were to be entities licensed to perform regulated activity types 1 (dealing in securities), 4 (advising on securities) or 6 (advising on corporate finance), they may well enjoy a second exemption

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<sup>124</sup> See CWUMPO, s 2(1), in connection with CWUMPO Schedule 17, pt. 1, s 3 and pt. 2, in connection with SFO Schedule 1, pt. 1, s 1.

<sup>125</sup> See CWUMPO, s 2(1), in connection with CWUMPO Schedule 17, pt. 1, s 3 and Schedule 18, pt. 3, in connection with SFO Schedule 1, pt. 1, s 1.

<sup>126</sup> See CWUMPO, s 2(1), in connection with CWUMPO Schedule 17, pt. 1, s. 2, in connection with CWUMPO Schedule 18, pt. 3. Other exemptions limiting the total proceeds raised and setting a floor for the minimum consideration collected from each investor are less well adapted to the needs of crowdfunding.

provided in s 103(2)(a)(ii) SFO.<sup>127</sup> Under the literal wording of this exemption, such a licensed entity might be able to issue unlisted securities depository receipts evidencing other securities without a prospectus.<sup>128</sup> In this way, such licensed entities might purchase the shares of a start-up facilitated privately by a crowdfunding company and then (arguably) claim to be able to offer depository receipts certifying rights in the shares held to the general public under an exemption<sup>129</sup> from the prospectus requirement.

96. While this structure would not demand regulatory change, it presents both uncertainty and complexity. The structure's primary strength may well be that it depends wholly on private sector initiative. However, even in this regard high costs create a private disincentive. It would require licensing a number of deposit-receipt-issuing entities for type 1, 4 or 6 activity, which would entail meeting both the substantial financial resources and organizational requirements applicable to each. From a policy perspective, the structure has the disadvantage that the investing public would not become shareholders in the start-up companies, divorcing them both from corporate governance and community participation in the finance of new companies in Hong Kong.

**d. Allowing crowdfunding within the scope of current regulated activities**

97. Another option, which this paper presents below in some detail, would be for the SFC to interpret crowdfunding activity within an existing regulated activity and issue a conditioned exemption from the prospectus requirement. The condition for this exemption could be that the issuer provides investors with disclosure equivalent to that required at the annual general meetings of public companies organized under the company law of Hong Kong. Such disclosure is both extensive and in any case required by all Hong Kong public companies. A further condition might be that the platform receives declarations from each investor that he or she will not invest more than a certain amount (see section B.d below). The SFC could issue both the class exemption and its interpretation of crowdfunding as a regulated activity in a single consultation with draft texts. No legislative activity would be necessary.

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<sup>127</sup> The prospectus requirement "does not apply to the issue, or the possession for the purposes of issue, of any advertisement, invitation or document- (a) made by or on behalf of an intermediary licensed or registered for Type 1, Type 4 or Type 6 regulated activity (whether acting as principal or agent) in respect of- ... (ii) unlisted securities (excluding unlisted securities that are structured products)."

<sup>128</sup> This exception excludes "structured products", but the definition of structured product provided in SFO, Schedule 1, pt. 1, expressly excludes depository receipts, which would cover the type of instrument being issued to the public regarding the shares held on deposit.

<sup>129</sup> This exemption has never been applied in this manner, and the opinion offered in this sentence is based on the plain meaning of SFO s 103(2)(a).

## **B. A New Regulatory Structure without Legislative Action**

### **a. The basic framework**

98. Key components of this option are all at the level of SFC action. The SFC could provide an official interpretation for the crowdfunding platform and make an exemption with respect to the prospectus requirement. These adjustments would of course have to be conditioned on sufficient protection for crowdfunding investors. Options exist with regard to both platform and conditions for the prospectus exemption, and are presented below as alternative routes. Of course any framework ultimately adopted would seek to allow crowdfunding to develop in an environment that provides a level of protection and supervision appropriate to the risk presented to investors.

### **b. The crowdfunding platform**

99. The platform through which equity crowdfunding activities would be conducted should be understood as falling within an existing regulated activity. The type of activity may vary depending on the business model of a crowdfunding platform, and such business models would of course adjust to any decision made by the SFC regarding the type of activity it understands as falling under an existing regulated activity license. To begin discussion, we offer three possible regulated activity types that may be seen as containing crowdfunding: providing automated trading services (Type 7), dealing in securities (Type 1), or advising on corporate finance (Type 6). Because in this early stage of the crowdfunding, platforms facilitate the forming of contracts for the transfer securities, invest in those same securities and often have revenue models resembling underwriters (earning a percentage of the capital amount placed), the SFC will have to decide which regulated activity or activities are best understood to include the service of the crowdfunding platform.

100. The type of requirements necessary for licensing generally derive from ss 114-116 SFO, as fleshed out by the applicable SFC rules and guidelines,<sup>130</sup> in particular if the ATS form is selected, the new rules on electronic trading systems<sup>131</sup> and alternative liquidity pools (ALPs).<sup>132</sup> Beyond specified financial resources and risk management policies, adequate operational facilities ensuring secure provision of the regulated service, the characteristic of being a “fit and proper” person, which is a general rule including both skill and moral standing, and applies to the entity and to its

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<sup>130</sup> Principal among this are the SFC (2006), SFC (2003), SFC (2014), and the Securities and Futures (Financial Resources ) Rules, CAP 571N.

<sup>131</sup> See SFC (2014), Paragraph 18 of the Code of Conduct.

<sup>132</sup> See SFC (2015), Paragraph 19 of the Code of Conduct.

management.<sup>133</sup> The licensing of each of these activities requires paid-up share capital of HK\$5 million and liquid capital of HK\$3 million,<sup>134</sup> adequacy of staff and organization, and ongoing reporting. Licensed entities must keep full records and audit trails of their activity, provide users with adequate transparency, and in the cases of ATS operations – participate in ongoing surveillance of operations in a manner consistent with Hong Kong and international market practices.<sup>135</sup> Existing SFC licensing requirements are clearly set out in standardised detail that should not present surprises to a crowdfunding platform, and for the various regulated activities, approximately 38,000 firms were licensed under them at the close of 2013.<sup>136</sup> No doubt the SFC would also particularize specific requirements applicable to crowdfunding platforms as a subcategory of existing requirements.<sup>137</sup>

101. Regardless of the regulated activity or activities type(s) under which crowdfunding platforms are eventually understood to fall, it appears useful in light of the evolutions of crowdfunding rules globally (discussed in Part III, above) that two requirements be added through supplementation or amendment of SFC guidelines. First, 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 (see section B.d below). Second, the platform should be held to provide materials, and if possible, workshops on investor and financial education.

**c. A general prospectus exemption for crowdfunding offerings**

102. In all modern capital markets, investors are protected in the context of securities offerings by disclosure. For crowdfunding, if full securities offering disclosure were to be demanded, the regulatory costs would be prohibitive. For this reason, it will be necessary that the SFC act in some way, perhaps under s 38A(2) CWUMPO, which gives the SFC power to create and publish general exemptions “for any class of prospectuses issued by companies”.<sup>138</sup> The SFC has already created general exemptions with respect to a number of types of contents within prospectuses, and of

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<sup>133</sup> See SFC (2003), s 11.

<sup>134</sup> Securities and Futures (Financial Resources) Rules, CAP 571N, Schedule 1.

<sup>135</sup> See SFC (2003), s 11.

<sup>136</sup> See SFC (2014b), p. 40.

<sup>137</sup> A possibility has been raised that an equity crowdfunding platform may be likened to a “stock market” and therefore would run into trouble with the statutory monopoly of the Stock Exchange of Hong Kong under s19 SFO. This would be an extraordinarily wide interpretation of s19 and the definition of “stock market” in Schedule 1 SFO, so wide that it could even catch entirely private investment activities involving unlisted securities.

<sup>138</sup> The SFC is expressly given power to determine the set of requirements from which it may create an exemption. See CWUMPO ss 38A(3), (4) and (5).

particular interest here is that one of these exemptions frees young companies listed on the Growth Enterprise Market (GEM) from reporting a multi-year economic track record and producing a number of otherwise required reports.<sup>139</sup> A like exemption could be formulated for crowdfunding. In order to preserve investor protection while reducing regulatory burden, the exemption should be subjected to conditions. For example, it could apply only to (i) offerings of companies formed under the Hong Kong Companies Ordinance that provide potential investors with all reports and statements they would have to provide members at an annual general meeting, or (ii) equivalent information for non-Hong Kong companies, and (iii) in each case make the offering only through a licensed crowdfunding platform. If an exemption formulated by the SFC under s 38A(2) CWUMPO is met, the offering would also be covered by the exemption provided in s 103(3) SFO.<sup>140</sup>

103. This design works because Hong Kong company law has already crafted a core of disclosure documents that are relatively complete and less burdensome.<sup>141</sup> In most jurisdictions, the switch from disclosure through formal prospectus to disclosure of the type provided by unlisted companies at an ordinary meeting would bring a dramatic decrease in transparency. This is not as much the case in Hong Kong, which requires that shareholders be provided, at every annual general meeting:

- Audited financial statements according to Hong Kong accounting standards;<sup>142</sup>
- A directors report setting forth<sup>143</sup>
  - The company’s principal activities during the financial year,
  - Principal risks and uncertainties facing the company,
  - Important events that have affected the company in the past year,

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<sup>139</sup> See Companies (Exemption of Companies and Prospectuses from Compliance with Provisions) Notice, CAP 32L, s 5.

<sup>140</sup> The exemption is that the prospectus requirement of s 103(1) “does not apply to the issue [...] of a prospectus which complies with or is exempt from compliance with Part II of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32)”. See SFO s 103(3)(a)(i).

<sup>141</sup> The bulk of required disclosure – particularly the directors’ report and complete financial statements – are not necessary for certain private companies limited by shares, but all such companies must place a restriction on the transfer of their shares and refrain from public offerings, which means that all companies participating in equity crowdfunding would be public companies limited by shares, and thus subject to Hong Kong’s wide-ranging disclosure requirements.

<sup>142</sup> See Companies Ordinance (CO), CAP 622, s 380, Schedule 4.

<sup>143</sup> These requirements are set out in CO ss 388, 390 and Schedule 5, as well as in the Companies (Directors’ Report) Regulation, CAP 622D.

- An indication of the company’s future development,
  - An analysis of the key performance indicators,
  - Key relationships with employees, customers and suppliers,
  - Information on arrangements enabling a director to acquire shares,
  - Directors’ direct and indirect interests under significant transactions entered into by the company,
  - Shares issued and equity-linked agreements entered into by the company,
  - Reasons for any resignation of a director, and
  - A permitted provision indemnifying a director.
- An auditor’s report, which is expressly subject to criminal sanction for knowing or reckless omission of required content.<sup>144</sup>

104. An exemption from issuing a prospectus in connection with a crowdfunded offering thus would not leave a vacuum without significant information made available to investors. It would take advantage of the disclosure requirements of Hong Kong company law, creating a simple avenue to crowdfunding with low transaction costs and low risk. Seen more broadly, a use of Hong Kong law may well encourage the crowdfunding of local companies, creating jobs in the real Hong Kong economy.

105. It might be argued that this design has the significant disadvantage of unnecessarily linking a financial industry service to activity in the real economy of Hong Kong – and thus limiting its potential – by creating an incentive for the use of Hong Kong company law. If disclosure equivalent to that required in Hong Kong were required, this probably would encourage start-ups to incorporate in Hong Kong, which might well mean basing operations in Hong Kong and employing staff from Hong Kong, as well as paying registration fees in Hong Kong and calling on Hong Kong legal and accounting expertise. Unlike other major jurisdictions, the use of local law is not ordinary for Hong Kong, where only about 15% of listed companies are not foreign (Bermuda and Cayman Island law constitute about 70%). Limiting the range of possible offerings to companies using Hong Kong law or equivalent disclosure could be understood as disadvantaging such round-trip structures. However, it is reasonable to use the Hong Kong law applicable to public companies as a benchmark because Hong Kong company law (substantially reworked in 2012) presents a relatively modern and

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See CO s 408.

investor friendly disclosure models available today. However, there is no special tangible benefit for Hong Kong in encouraging structures employing offshore jurisdictions and putting distance between the investors and the supposed legal place of the company in which they invest.

**d. Investor eligibility**

106. To allow crowdfunding to function effectively and safely, Hong Kong could condition its special regulatory treatment on limitations designed to protect crowdfunding *investors*. This unusual step can be understood as necessary because certain other protections available for public offerings and on a recognised stock exchange are being waived. While the UK model of giving investors an examination to test their sophistication and risk profile may be more attune with Hong Kong's laissez faire traditions, crowdfunding could subject ordinary retail investors to financial risk in a way that other forms of investment do not. As such, we think that the relatively stricter, American model would also be a worthy reference.
107. Under the US model, two numerical and percentage limits are set depending on whether the investor's income is more or less than US\$100,000 (about HK\$800,000). Further, the SEC appears to be drawing this legal limit as a bright line for eligibility of crowdfunding, and leaving it to the platforms to see it is observed. Along these lines, two alternatives are available in a number of dimensions: first, a single quantum percentage limit of, e.g., 10% of an investor's annual income, or of a standard measure including both annual income and net worth could be used for all new investments during the same period.<sup>145</sup> Second, numerical caps could be set on the amount that an investor could inject into any one company and any number of companies during a given period. These numerical caps could be scaled along income bands. The enforcement of these restrictions could be either laid at the door of the crowdfunding platform as a condition of licensing or be left to the personal responsibility of the investor to pledge ascertaining compliance, with the platform held to collect and archive a declaration on this fact from each investor as an ongoing condition of licensing. The choice of model, the setting of limits and the placement of responsibility for enforcement would be policy choices that should be decided following some form of quantitative analysis or public consultation.

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A question arises as to whether this 10% should be a limit applied to an investor's increase in exposure during a given period of time, such as a year, or for each investment. We tend to think that the first position is advisable. An argument to the contrary could be made that by investing in different companies the investor has diversified his portfolio with 10% in one business and various investments of 10% in other businesses. However, start-up companies all share very high risk profiles, which we think justifies such a limit to be applied for an entire annual period.

108. The primary weakness of leaving compliance to investors is that they could make false declarations or engage in multiple investments at different platforms, and go bankrupt – damaging themselves and the community. The threat of such damage to investors would likely encourage platforms to adequately vet the accuracy of investor declarations, such as by asking the investors to provide copies of their annual tax returns or monthly pay statements at the time of subscription. It would be highly problematic for the SFC to demand disclosure of such private data from ordinary investors, but if the platform needs this information in order for the investor to enter into a contact, the investor would both have an incentive to comply and be free to seek out an alternative platform, so that any disclosure of private data would be completely voluntary. If a higher margin of safety for retail investors is desired, lower limits on individual and total investment could be combined with placing a duty on every crowdfunding platform to see that such limits are in fact observed.
109. As discussion develops, a number of other variables along this line could also be considered. It would be possible – as an alternative approach or additional requirement – to place an absolute cap on the amount that any investor could invest in any one company or any one issue. And/or there can be a cap on the amount that any company could raise in total or per issue. It could also be decided to exempt from the numerical or percentage investment cap persons who are not professional investors but who have sufficient income and/or net worth.

### **C. Conclusions**

110. The options discussed above are not intended to be a definitive list of regulatory strategies, but they present possible frameworks for facilitating the development of a Hong Kong equity crowdfunding market. Economic data shows that corporate finance of the type provided by crowdfunding would be highly beneficial to small enterprises in the Hong Kong economy. Other major financial centres have introduced frameworks for crowdfunding. Singapore’s approach is minimal, with little distinction between crowdfunding and the existing exemption for offers to professional investors. China has not yet provided definite rules, but has declared a clear intention to act. With a simple interpretation of its current regulatory framework and some minimal requirements from platforms, issuers and investors, Hong Kong could gain an advantage in this very important new area of corporate finance with a robust regime for genuine crowdfunding activity while strengthening its own economy for start-up businesses.

### **D. Summary of the Regulatory Possibilities**

111. Crowdfunding could be offered under (i) its own custom-drafted section of the SFO, (ii) to a limited extent under the professional investor or small offering exceptions to the



prospectus obligation, or (iii) through a sophisticated attempt at stacking exceptions and issuing exempted depositary receipts. Each of these presents certain difficulties, as discussed above.

112. An option that may be more in tune with Hong Kong traditional regulatory style would be for the SFC to interpret the crowdfunding platform service within an existing regulated activity and issue a conditioned exemption from the prospectus requirement.
113. If the method in point 2, above, were used, crowdfunding could be considered to fall under automated trading services (Type 7), dealing in securities (Type 1), or advising on corporate finance (Type 6).
114. The SFC could condition licensing a crowdfunding platform on some type of investor protection, such as that the platform ascertain or receive declarations from each investor that he or she will not invest more than a specified amount or a specified percentage of annual personal income in the relevant equity offering, including any crowdfunding investments made in the preceding 12 months.
115. A condition for exempting crowdfunding from the prospectus obligation could be that the issuer provides investors with disclosure equivalent to that required at the annual general meetings of public companies organized under the company law of Hong Kong.
116. The SFC could issue both the class exemption and its interpretation of crowdfunding as a regulated activity in a single consultation with draft texts.

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## About the Financial Services Development Council, Hong Kong

Established in January 2013, the Financial Services Development Council (FSDC), Hong Kong is a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC will advise the Hong Kong SAR Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidate our competitiveness through leveraging the Mainland to become more global.

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