



ISLE OF MAN
FINANCIAL SERVICES AUTHORITY

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CONSULTATION RESPONSE CR19-02/T16

**CONSULTATION ON POSSIBLE
EXPANSION OF CLASS 6 REGULATED
ACTIVITY (CROWDFUNDING PLATFORMS)
TO INCLUDE LIMITED SECONDARY
TRADING FACILITIES**

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GLOSSARY

Term	Meaning in this document
Authority	Isle of Man Financial Services Authority
Class 6	The regulated activity of operating a crowdfunding platform (in the context of this paper being investment-based crowdfunding)
IOSCO	The International Organization of Securities Commissions
RAO	The Regulated Activities Order 2011
Standard Licence Conditions (or SLCs)	The Licence Conditions for Crowdfunding Platforms

1 BACKGROUND

This Consultation Response is issued by the Isle of Man Financial Services Authority ('the Authority') following Consultation Paper CP18-04/T16, which was open from 24 August to 5 October 2018.

The purpose of the consultation was to obtain information, views and evidence regarding a possible expansion of Class 6 regulated activity (crowdfunding platforms) that could permit a limited ability for investment-based crowdfunding platforms to facilitate secondary trading of investments, if those investments were originally crowdfunded using the same licensed Class 6 investment-based crowdfunding platform.

This response will be of particular interest to regulated entities, potential crowdfunding platforms, professional advisors as well as the general public, being potential consumers of investment-based crowdfunding platforms.

2 SUMMARY OF RESPONSES TO QUESTIONS RAISED

Responses were received from 8 parties, 7 of whom were broadly in favour of the proposals. The questions asked by the Authority along with a summary of the responses received and the Authority's response are shown in the following table:

Question 1	
<p>(a) Please provide any general comments on the proposed introduction of the ability to provide limited secondary trading facilities as part of a crowdfunding platform.</p> <p>(b) Please provide specific comments on:</p> <ul style="list-style-type: none">(i) the proposed changes to the Standard Licence Conditions, and(ii) whether they will provide sufficient protection to consumers of secondary trading facilities.	
Responses received (in summary)	Authority's response
All of the respondents supported the introduction of a secondary market for crowdfunding, with 7 of the 8 broadly supporting the Authority's proposed approach	The Authority is pleased to have this support.

<p>subject to their specific comments which have been addressed under section 3 below.</p>	
<p>Question 2</p>	
<p>What risks and opportunities for investors and users of a secondary trading facility do you envisage, if the secondary trading facilities are introduced in the manner set out in this Consultation Paper?</p>	
<p>Responses received (in summary)</p>	<p>Authority's response</p>
<ul style="list-style-type: none"> • Respondents stated that the main benefit of the crowdfunding regime is to give growing businesses an avenue to raise additional capital, typically before listing on an alternative or main market. While the Class 6 crowdfunding regime has been in place for some years, it is considered by many respondents that a secondary market will offer greater opportunity for investors to liquidate their investments at an appropriate time. • It is considered by 4 of the respondents that increased liquidity that could be offered by a secondary market would reduce the risks to investors of becoming involved in investments which would be difficult to sell without an established market. • While it is generally accepted that the expansion of the regime to include a secondary market will increase the liquidity of the shares sold on the platform, concerns were expressed about the importance of measures being in place to mitigate the risks of 	<p>The Authority notes the opportunity that secondary markets may bring, and that this should be beneficial to the consumer.</p> <p>The Authority also shares the view that there is a risk in overstating the ability to sell through a secondary market, and about the potential to mislead investors as to the ability to sell. It is for this reason that the proposed addition to SLC 5(e)(v) was included. SLC 5 relates to the need for a 'General Warning about Crowdfunding' to be prominently displayed on the platform's website, which consumers must confirm they have read and understood. The additional required text is shown in red below:</p> <p><i>“(v) There is no guarantee you will be able to sell your investment or call in your loan when you want to, or at all. Even where a secondary trading facility is provided on the platform, the ability to buy and sell depends on demand and you should not assume you will be able to trade because of the existence of a secondary trading facility.”</i></p>

<p>potentially misleading statements being included on a platform about the <i>extent</i> of the liquidity of shares posted for sale.</p> <p>Finally, it was noted by 4 of the respondents that the controls which are proposed through the SLCs appropriately mitigate many of the risks presented by a secondary market.</p>	
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Question 3

What are your views regarding the requirement for the licenceholder to have at least one senior staff member with appropriate investment experience and knowledge?

Should this person have to be of director level, or only have a direct reporting line to the Board?

Responses received (in summary)

- 3 respondents stated that the appointment of senior staff member with appropriate investment experience would not be required on the basis that crowdfunding is not investment business, does not include the provision of investment advice and the cost of such an appointment may be onerous.
- 2 respondents stated that they understand the need for the appointment of a senior staff member with appropriate investment experience and agree with the principle. 1 of those respondents expanded on this to suggest outsourcing the ability to appoint either a part time person

Authority's response

It is important to make clear that, but for the Authority making Class 6 (crowdfunding platforms) a separate regulated activity, and exempting investment-based crowdfunding from Class 2 (investment business) regulated activity, the activity of investment-based crowdfunding would amount to investment business. The definition of investment business is much wider than providing advice. It also includes being involved in the arrangement of a deal in investments, managing investments, administering investments etc.

Furthermore, the provision of a secondary market for equities is classed internationally (for example by IOSCO – an international standard setter) as investment business.

Therefore, the purpose of appointing a person with investment experience is not to

<p>or a contractor with direct access to the board.</p>	<p>provide investment advice. Such a person is also needed to ensure market fairness through making appropriate disclosures when listing equities for sale, as well as monitoring trading for unusual and suspicious activity among trades. A person with experience in investment business is considered very important to undertake these key roles.</p> <p>The Authority will continue to require a senior member of staff with appropriate investment experience, but that individual does not need to be full time. Any applicant would need to demonstrate as part of its application how it proposes to fulfil this requirement in a way that is proportionate and reasonable for the business it plans to undertake.</p>
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Question 4

Do you have any other feedback on matters set out in this paper?

Responses received (in summary)	Authority's response
<p>2 respondents requested information in respect of Initial Coin Offerings and blockchain business and particularly whether Class 6 activity would be extended to encompass this sector.</p>	<p>The Authority is currently considering its options in respect of Initial Coin Offerings and wider distributed ledger technology. Any proposals in respect of this sector and regulated activity will be the subject of a separate consultation in due course at the appropriate time.</p>

3 OTHER COMMENTS OR ENQUIRIES RAISED AND THE AUTHORITY'S RESPONSE

A. 3 respondents requested that Licence Condition 19A(c)(i) be removed. The condition states that “the identity of potential secondary traders must be anonymous and undiscoverable by each other at the time expressions of interest or bids are made”.

IOSCO Principle 36 (an international standard against which the Island is assessed) requires that “*Regulation should be designed to detect and deter manipulation and other unfair trading practices*”. The Authority seeks to ensure that the sellers of investments do not know the identity of potential purchasers when determining which (if any) bid to accept in order to limit the possibility of parties acting in concert and avoiding potential conflicts from arising.

B. 3 respondents requested that Licence Condition 19A(c)(iii) be amended to either raise the controlling percentage, raise the percentage of shares which may be sold at any one time, or both. The condition states that “where the potential seller holds, or has held 15 percent or more of the voting rights in the relevant body corporate at any time, the licenceholder must ensure offers for sale are limited to no more than 5 percent of the total voting rights in issue at any one time, with at least 20 business days elapsing between more than one such offer for sale”.

The purpose of this condition is to assist in preventing ‘pump and dump’ type frauds. It will also assist in the prevention of controllers or other persons closely related to the business (who clearly are likely to have more information on the business than a purchaser, no matter what level of disclosure is provided) from making too quick an exit by sale to the unwitting purchaser, and ensure that their trades are reported.

This condition applies only to shares sold via the platform’s secondary market, this limitation does not apply to the initial offering of equity by a company seeking to raise finance through the primary market. The comments from the 3 respondents were not averse to such a restriction in principle, however suggested that the thresholds be reviewed in line with proposals by the EU Parliament, and similar jurisdictions to the Island.

The Authority is minded to make an adjustment to the licence condition, so that where a potential seller holds or has held 15 percent or more of the voting rights, offers for sale are limited to a maximum of 8% of the voting rights at a time. In this way a controlling interest cannot be disposed of at one time.

C. 1 respondent requested that Licence Condition 19A(b) be amended which currently states: “investments may only be traded if they have been owned by the seller for a minimum period of 12 months”. The request was to be limited to 4 – 6 months on the

basis that a 12 month limitation will have an adverse impact on the liquidity of the shares listed.

The nature of crowdfunding as a concept is to allow retail investors to invest in a start-up business which they would like to support or to derive long term growth from rather than for short term return. If and when a business has developed to such a point that trades in its securities are very regular and a 12 month lock-in period becomes prohibitive, a crowdfunding platform's secondary market is no longer considered to be an appropriate venue and the business should consider listing on an alternative or full market.

D. 1 respondent requested that the investing limits for restricted clients and high net worth clients at SLC 11 be removed and replaced with a "percentage of investable assets".

The Authority understands that the circumstances of each customer will be different and so a more flexible approach to how much a restricted or high net worth client may invest could be more appropriate. However, while such an approach has merit on the face of it, an accurate determination of what a client's 'investable assets' are, and quantifying and monitoring those assets is a highly subjective assessment which is reliant on a number of factors that the platform operator, and even the customer themselves are unlikely to be able to measure accurately or reliably. A monetary limit on a platform within a rolling 12 month period is effective and can be monitored.

E. 1 respondent enquired whether crowdfunding platforms which do not offer loan or equity instruments require a Financial Services Licence.

Only crowdfunding platforms involved in the sale of investments and/or loan instruments require licensing. Platforms which are not investment or loan based (for example those seeking charitable contributions for good causes) do not require a Financial Services Licence.

4 OTHER MATTERS

Throughout the consultation process, the Authority has continued to research and develop the regulatory framework for an investment crowdfunding secondary market.

Based on this research the Authority will expand the SLCs to include one new condition and to clarify another existing SLC. The amendments do not represent a material change, rather they address part of the regulatory nuances of supervising a secondary market which are not currently addressed in the regulatory framework.

The Authority will expand standard licence condition 7 (monitoring of disclosures and materials) to encompass monitoring activity and trades. This will take the form of a new condition, SLC 7A, which has been developed based on the requirements of the IOSCO

Principles, specifically IOSCO Principle 36. The methodology behind Principle 36 requires that, *“the regulation of trading in secondary and other markets should prohibit: market manipulation (or attempts at manipulation); misleading conduct; insider trading; and other fraudulent or deceptive conduct.”*

The draft licence condition is as follows:

7A. Oversight of crowdfunding activities and secondary trading opportunities

- (1) A licenceholder must maintain effective methods of reviewing and monitoring crowdfunding postings and secondary trading opportunities to ensure that the following activity is prohibited:
 - (a) market or price manipulation (or attempts at market or price manipulation);
 - (b) insider trading;
 - (c) front running; and
 - (d) other fraudulent or deceptive conduct or market abuse.
- (2) If a licenceholder knows or suspects that prohibited activity under (1) has occurred, or been attempted, the licenceholder must make a report to the Authority within 1 business day of the knowledge or suspicion.
- (3) A report under (2), shall be in such form as is required by the Authority, together with such documents and information as it may reasonably require.
- (4) For the avoidance of doubt, the requirement to make a report under (2) does not limit or preclude any other reporting obligations of the licenceholder including reports required to be made to the Financial Intelligence Unit ('FIU').

The Authority will publish guidance in support of the SLCs in due course.

The provision of information to the regulator is seen as a key component to the effective supervision of a secondary market. SLC 20A was drafted to achieve this function, however following consideration by the Authority, the wording has been clarified in order to place further flexibility in the reporting obligations of licenceholders to the Authority which was absent in the version consulted on. SLC 20A will be amended to read as follows:

20A. Regulatory Reporting

In addition to any other reporting requirement, a licenceholder that offers secondary trading opportunities for investments on its platform, must report details of all

trades completed by such date and in such form as the Authority may reasonably require.

5 OUTCOME AND NEXT STEPS

Following the consultation, and because there were no material concerns raised about the proposed changes, the Authority intends to proceed with the proposed amendments, including the changes as set out in section 3 item B and section 4 above.

6 IMPLEMENTATION

Subject to the approval of Tynwald, amendments to the Regulated Activities Order will be considered by Tynwald in spring 2019, and is planned to come into effect before the end of Q2 2019.

In case of any query, please contact the undersigned —

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