

KEY POINTS

- The regulatory approach in both Israel and the UK is media and technology-neutral – such that regulated activity is regulated regardless of the media or technology used.
- The Israel Securities Authority has proposed that a platform operator will be required to register with and be regulated by it, creating a new category of regulated entity.
- In May 2016, the US Securities and Exchange Commission's new equity crowdfunding rules, Regulation CF, became effective.
- In July 2016 the UK's FCA announced a general call for input into a review of the regulation of equity crowdfunding and P2P lending; high on the agenda will be the ability of investors to self-certify that they fall within a restricted category with access to equity crowdfunding websites.

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Regulation of crowdfunding in the UK, US and Israel: a comparative review

Over the last few years, equity crowdfunding and peer to peer lending have taken ever more prominence in the financial markets as traditional sources of debt and equity finance for certain categories of companies have become harder to source. The functionality and general availability of the Internet has made crowd funding models far simpler to construct and to bring to the attention of the general public.

In this article, we will consider how three jurisdictions, the UK, US and Israel, have dealt with the regulatory aspects of the equity crowdfunding sector, comparing and contrasting the approaches taken by the regulators.

REGULATION OF A CROWDFUNDING ENTITY

UK

The Financial Conduct Authority (FCA) regards its rules as media- and technology-neutral. It should make no difference how one conducts the business: if it contains the elements of an activity that the FCA regulates under UK law, then it will be subject to the FCA's rules even if the medium or technology used did not exist when the rules were first framed.

Web-based equity crowdfunding has always been a regulated activity in the UK, and the operator of a crowdfunding website therefore requires permission from the FCA for the activity of "arranging deals in investments" (Art 25(1) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001). This regulated activity is equivalent to that for conventional corporate finance firms. The difference is therefore one of medium alone, and the FCA did not need to create any new basis for permission to run a crowdfunding website (although it has had to consider aspects of the conduct of website operators in relation to its more detailed obligation to regulate the way in which regulated services are provided).

UK crowdfunding has received a boost from the Enterprise Investment Scheme tax shelter, which has offered increasingly generous tax incentives to UK-resident individual taxpayers to invest in young companies in technology. In 2015, over £1.5bn was subscribed to EIS-qualified investments, a substantial chunk of which was sourced through crowdfunding media.

Israel

The Israel Securities Authority (ISA) earlier in 2016 proposed that a platform operator ("Offering Coordinator", to use ISA's terminology) will be required to register with and be regulated by the ISA. This will be a new category of regulated entity. Prior to this proposal, being a crowdfunding platform per se was not a regulated activity; regulation was only triggered upon the production of a prospectus. The threshold requirements for an Offering Coordinator will be based on the "fit and proper" tests beloved of regulators, and will include the need to demonstrate its officers' probity and adequate insurance. The Offering Coordinator will be responsible for ensuring that the share offers made through it meet the disclosure requirements applicable to equity crowdfunding offers and avoid any conflict of interest.

The ISA's most recent proposal on this was released on its website at the beginning of 2016¹ as a draft regulation, following the release of the original draft of the crowdfunding regulations in 2014.²

For the time being, and until the new regulations come into effect, it is not yet possible for entities to submit an application for approval by the ISA in this new category. However, it is known that several entities are exploring the possibility to do so once the regulations are approved. It is not yet clear whether the ISA will open a period for applications prior to the regulation taking effect.

US

In the US, rewards-based crowdfunding platforms such as Kickstarter began to appear prior to 2010. Equity-based platforms were historically limited because sales of securities over the internet were restricted by the regulations of the Securities and Exchange Commission (SEC) prohibiting what it considered to be "general solicitation and general advertising" of the offer and sale of securities not registered with the SEC for sale to the public. But in the age of the internet, certain platforms arose which offered and sold securities within password-protected websites in private placements solely to "accredited investors," ie, high net worth individuals with more than US\$1m in assets and annual income greater than \$200,000. Although as a matter of law these private placements could also be made to up to 35 persons who were not accredited investors, these private placement website platforms did not in general allow non-accredited investors to enter their sites for fear of violating the

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general solicitation/advertising rules. It is of course also true that if these platform operators were taking commissions on the sale of securities through their sites, they would have to be registered with the SEC as broker-dealers and become members of the self-regulatory organisation, the Financial Industry Regulatory Authority (FINRA).

In 2012, the US Congress passed the Jumpstart Our Business Startups Act (giving the acronym "JOBS Act"), directing the SEC to make new regulations to ease various securities restrictions to encourage funding of small business. Pursuant to this JOBS Act mandate, the SEC, in 2013, adopted Regulation 506(c) under the Securities Act of 1933 (Securities Act) to allow the use of general advertising and solicitation for private placements so long as sales were made only to accredited investors. This has had the intended effect of opening up private placement websites to non-accredited investors who can now review documentation and learn about securities offerings but not invest. Compliance with Regulation 506(c) has placed a burden on issuers of equity private placements to take reasonable steps, such as reviewing tax returns or bank and brokerage statements, to verify that investors are in fact all accredited. Although not decisive in the expansion of the US equity crowdfunding market, these developments were useful steps along the way.

In 2015, the SEC adopted amendments to Reg A (commonly referred to as "Reg A+") under the Securities Act and in May 2016, the SEC's new equity crowdfunding rules, Regulation CF, became effective.

Reg A+ provides, among other things, a "Tier 2" format for offerings of up to US \$50m, using short form "offering circular" disclosure filings with the SEC that are "qualified" rather than "registered," general solicitation and general advertising, and sales to an unlimited number of non-accredited investors, although such investors may purchase securities priced at no more than 10% of the greater of their net income and net worth. Upon implementation of Reg A+, sites began to offer both Regulation 506(c) private placements to accredited investors and Tier 2 offerings to *all* investors.

Companies operating Regulation CF platforms must, in all cases, be registered with the SEC as broker-dealers or "funding portals", a new category of registration. Online funding portals are subject to regulations less onerous than for broker-dealers but more restrictive in certain ways. Funding portals must take reasonable steps to prevent fraud and ensure that investors and issuers comply with the new regulations. Issuers with officers or directors who are "bad actors," for example, cannot offer their securities on funding portals. Portal operators cannot receive commissions or compensate others for the sale of securities through their sites, they cannot recommend investments in issuers on their portals and they cannot act in any way as investment advisors (another category requiring SEC registration). They can publish on their portals material about their issuers which under the old rules would have violated the prohibition on general solicitation and advertising, but they also must provide educational material about the risks of investing in securities and onsite chat rooms for "crowd" discussions with the issuers offering securities on their sites. Also, crowdfunding portal intermediaries cannot take a financial interest in the companies on their platforms unless such interest is compensation for their services, in the same class of securities being offered to the public.

Under Regulation CF, funding portals must also become members of FINRA. As of 27 September 2016, FINRA reported that 17 platform companies have registered as funding portals. This number does not include, however, those crowdfunding platforms that are registered separately as broker-dealers.

REGULATION OF THE OFFERING PROCESS

UK

Equity fundraising is presently subject to the EU Prospectus Directive. However there is an important exemption from the production and approval by the FCA of a prospectus (which is a standard requirement for a formal public offer) where the amount raised over a

12 month period is not more than €5m. At present, the vast majority of fund raisings done via crowdfunding websites are for companies seeking less than this amount because they are only in the relatively early stages of developing their business. This means that a straightforward "Information Memorandum" complying with the principle of being "clear, fair and not misleading" is sufficient. In fact, certain service providers have created their own templates for essential factual information for promotion on their websites (leaving the investor to consider whether he needs further information from the issuer and to seek this via direct due diligence enquiries).

The FCA, concerned about protecting investors, intervened with regulations in 2014, following consultation, which imposes an element of restriction on access to equity crowdfunding websites. First, access is now no longer open to the general public. Investors intending to register with an FCA-regulated crowdfunding service must fall into one of four "exempt" self-certification categories. Of these, the two most commonly relied upon are:

- the investor is a certified high net worth individual, who must be able to demonstrate in the preceding UK fiscal year gross income of at least £100,000 or net assets (excluding home, mortgage, pensions and life assurance) exceeding £250,000; and
- the investor is a certified restricted investor, who can confirm that in the preceding fiscal year he/she did not, and in this fiscal year he/she will not, hold more than 10% of net investments (ignoring home, mortgage, pensions and insurance) in private equity investments.

Clearly, the certified restricted investor category is open to some abuse, especially since this is based entirely on self-certification. In July 2016, the FCA announced a general call for input into a review of the regulation of equity crowdfunding and P2P lending, and this issue is going to be high on its agenda for review and reform.

The second area is regulation of the promotion itself. The FCA introduced generic

reform to the manner of retail financial promotion in 2014, whereby a “direct offer financial promotion” (a promotion with an application form or subscription proposal attached) could only be offered by an investment firm to a retail investor for whom the firm considered it to be suitable (given what the firm was obliged to determine about his/her circumstances). This has led to the development of generic suitability questionnaires for use in a range of retail product offerings (including, of course, crowdfunding websites). Once again, the FCA is looking into the efficacy of these procedures, where standards and approaches vary considerably around the retail financial services sector.

Israel

The approach taken by the Israeli legislature is different. Israel, too, is media- and technology-neutral, requiring any issue of securities to take place pursuant to a properly approved prospectus or to comply with one of the few exemptions that the Israeli Securities Law provides. One such exemption is for offers to fewer than 35 retail prospective investors during any 12-month period.

It is therefore possible for a crowdfunding business based in Israel to offer investment opportunities that are:

- targeted at non-Israelis (in compliance with whatever rules apply to those investors in their home jurisdictions); and/or
- within the range of exceptions from the 35-investor rule by reason of size or expertise.

Several such firms have developed successful businesses in this area. Challenges to the position that the ISA has taken over the application of the 35-investor rule and the scope of various exemptions from it have generally been unsuccessful, as exemplified in a recent such decision rendered by the Commercial Division of the Tel Aviv District Court in the matter of *Exit Valley*.³ In this case, Her Honour Judge Ruth Ronen sided with the ISA and commented that equity crowdfunding in Israel is forbidden until the legislative process to amend the current legal status is completed. As a result of this and

other similar cases, it is anticipated that other crowdfunders will refrain from developing and activating equity crowdfunding platforms aimed at soliciting retail investors before the regulations are finalised.

Interestingly, in the proposed reform of the system the ISA has taken what for Israel is an entirely novel approach to equity crowdfunding. Instead of protecting investors entirely or chiefly through the regulation of disclosure (as in the “conventional” prospectus requirement), investor protection is to be achieved by limiting the value of a crowdfunding offer and the amount any individual investor may invest. Pursuant to the proposed regulation currently promoted by the ISA, a company may raise up to ILS 1m (c. £200,000) within a 12 month period from an unlimited number of Israeli retail investors or contingent on the approval of either the Small Business Authority or the Chief Scientist, ILS 1m more, and these investors may invest up to ILS 10,000 (c. £2,000) each per offer subject to a personal ILS 20,000 (c. £4,000) total in all issues over 12-months.

Pursuant to the proposed regulations, the disclosure requirements in a crowdfunding equity offering will be substantially narrower compared to the “conventional” prospectus offer. In the former, offering documents will be required to include, *inter alia*, the details of the offeror, the designated purpose of the capital raised, incorporation documents and financial statements.

It seems that the ISA has looked to the US and the UK for inspiration in reaching its decision to limit the amount a person may invest over the course of a year, although the exact parameters of the test are different.

Even once these proposed changes become law, the amount that can be raised by Israeli start-ups in Israel through Israeli crowdfunding websites is in most cases not even 5% of the amount that companies raising money in the EU can access under EU Prospectus Directive exemptions. Some have therefore called into question the usefulness of the new proposals. However, it is hoped that this proposal is a first step, and that over time as the ISA becomes more confident with

this market, the amounts will rise to come into line with international norms.

US

In the US, where the crowdfunding focus is on the promotion of early stage businesses based in the US (foreign private issuers need not apply), funding portal investment limits have been set at a maximum of US \$1m in a 12-month period for any one issuer, from an unlimited number of investors. Investors do not have to be accredited but their investment amounts are limited over a 12-month period to:

- the greater of US \$2,000 or 5% of the lesser of annual income or net worth, for investors with net worth or annual income of less than US \$100,000; and
- 10% of the lesser of annual income or net worth, but not more than US \$100,000, if the investor’s annual income and net worth are both US \$100,000 or more.

The SEC has indicated that it will review these limits in 2018.

Unlike in private placement offerings to accredited investors where offering materials to prospective investors are not required, due to their assumed sophistication, crowdfunding issuers must provide prospectus like information to the crowd. Although not as detailed as a registration statement prospectus or a Reg A+ offering circular, funding portal Issuers must file a Form C with the SEC providing public disclosure of certain business, financial and offer information including, for example, the names of the issuer’s officers, directors and 20% owners, related party transactions, a description of the issuer’s business and planned use of proceeds, risk factors, a description of the financial condition of the company and financial statements which range from issuer-prepared financials for very small offerings to two-year audited financials for issuers proposing to raise the US \$1m maximum. Regulation CF also subject issuers filing the Form C to the anti-fraud provisions of US securities laws.

Securities sold through a funding portal offer are “restricted” securities under federal securities laws and must be held for one

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Biog box

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year before they can be freely resold into the market. Reg A+, Tier 2 securities, on the other hand, are not restricted and are freely tradeable once issued. The difference here has to do with the higher level of disclosure required in a Reg A+, Tier 2 offering. Although, disclosure is still important in Regulation CF, the burden of risk, as mandated by the JOBS Act, is now shifting to individual investment limits, allowing more people the potential for losing less!

CONCLUSION

Regulators seem to be wary of this new mode of investing, which makes less use of Prospectuses and does not impose rigid requirements on the information that companies provide and potential investors demand. Whilst the FCA was the first out of the blocks in regulating this field effectively, it is now having second thoughts, and seeking industry input, whilst all regulators in the UK, US and Israel seem to be taking the approach that if the investors are restricted in the amount that can be invested per annum, or per offer, or as a percentage of net worth, that this equates to satisfying the requirements of investor protection.

We can also see a divergence of regulatory culture, perhaps due partially to the respective maturity of the relevant domestic markets, between the UK and Israel. Whereas in the UK there are “interim permissions” and “transitional provisions” whenever the law or the FCA Handbook changes, this has not been an approach adopted by the Israel Securities Authority, (it was specifically considered and rejected in the recent *Exit Valley* case, in particular at paras 83 and 84 of the judgment); whilst Israeli authorities have not offered an industry wide set of transitional rules or permissions for those few entities in Israel engaged in crowdfunding-like activity prior to the new laws completing their path through the legislative process, they realise that such a regime is what smaller developing companies need in order to raise finance to build their business, and are moving forward with vigour to introduce the new crowdfunding regime, which it is hoped will be in place during 2017. ■

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- 1 http://www.isa.gov.il/%D7%97%D7%A7%D7%99%D7%A7%D7%94%20%D7%95%D7%90%D7%9B%D7%99%D7%A4%D7%94/Legislation/Proposed%20Legislation/2233/Documents/010216_2.pdf (in Hebrew).
- 2 <http://www.isa.gov.il/%D7%97%D7%A7%D7%99%D7%A7%D7%94%20%D7%95%D7%90%D7%9B%D7%99%D7%A4%D7%94/Legislation/Proposed%20Legislation/2233/Documents/23914.pdf> (in Hebrew).
- 3 Administrative Appeal 18700-04-16 *Exit Valley Ltd v Israel Securities Authority*, (Tel-Aviv District Court, 18.09.2016).

Further reading

- The future for peer-to-peer (P2P) lending: the proposed regulatory framework for lending platforms [2014] 1 JIBFL 37.
- Investing in non-bank originated debt investments: Ranger Direct Lending Fund plc's successful IPO [2015] 7 JIBFL 438.
- LexisNexis Loan Ranger blog: Crowdfunding for trade finance?