As fundraising methods continue to diversify, the DFSA provides a robust regulatory framework for equity and loan based crowdfunding in the DIFC

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What you should know

On 1 August 2017, the Dubai Financial Services Authority ("**DFSA**"), the regulator of financial services and securities in the Dubai International Financial Centre free zone ("**DIFC**"), introduced a regulatory framework for loan and investment based crowdfunding platforms, making the DIFC the first jurisdiction to introduce a regulatory regime for crowdfunding platforms in the GCC countries. In developing the framework, the DFSA had considered how the United Kingdom, Isle of Man, New Zealand, Singapore and the United States had each tackled the regulation of crowdfunding.

Why does this matter?

Everybody is talking about ICOs, blockchain and cryptocurrencies such that the previous hype around crowdfunding has almost become old fashioned. Despite a recent surge in ICOs, which saw an explosion of fundraising activity during the course of 2017, loan and equity based crowdfunding remain a popular method of raising capital for start-ups and small and medium-sized enterprises ("SMEs"). Equity crowdfunding platforms Seedrs and Crowdcube have together raised over US$ 1 billion in approximately 1,200 different offerings. By contrast, Kickstarter (where projects are not funded for equity or interest payments, but rather for rewards to backers such as early access to a project or limited edition giveaways) has raised over US$ 3.5 billion across 139,010 crowdfunded projects since 2009.

The crowdfunding space is certainly growing, and the World Bank has published a report which states that by 2025, the crowdfunding market potential in emerging markets alone is estimated to be up to US$ 90-95 billion per year.

The United Arab Emirates is a large hub for start-ups, particularly as: (i) there is strong encouragement from the UAE federal government to develop innovative and disruptive platforms and technologies; and (ii) the Gulf, as a region, is blessed with many willing investors. The DFSA's recent moves to formalise its approach to crowdfunding will be considered as a general acceptance of crowdfunding as a regulated fundraising method in the DIFC.

How does the DFSA's crowdfunding framework compare to other jurisdictions?

The DFSA's crowdfunding framework became effective through amendments made to seven of the modules to the DFSA Rulebook. However, rather than attempting to squeeze crowdfunding into an existing Regulated Activity set out in the DFSA regulations, the DFSA opted to create new Regulated Activities of "Operating a Loan-based Crowdfunding Platform" and "Operating an Investment-based Crowdfunding Platform", which includes the "operation of an electronic platform which facilitates the bringing together of persons to obtain funding for a business or venture (issuers) and persons who are willing to provide funding (investors)".

Unlike the Financial Conduct Authority in the United Kingdom ("**FCA**"), the DFSA expressly states that other defined financial services, such as "arranging deals in investments" and "operating an alternative trading system" will not be applicable to crowdfunding activities. Similarly, whilst share issuances must normally comply with the prospectus regime in the DFSA Markets Law and Rules, the DFSA has created a new category of exempt offers available to investment-based crowdfunding, provided that the shares issued are only accessible to investors on a crowdfunding platform.

The FCA is responsible for regulating loan-based and investment-based crowdfunding in the UK, as those activities are caught under the restrictions in The Financial Services and Markets Act 2000 ("**FSMA**") (Regulated Activities) Order 2001 ("**RAO**"). Loan-based crowdfunding platforms are covered by Article 36H RAO (operating an electronic system in relation to lending) and, generally speaking, operators must therefore be authorised by the FCA to operate crowdfunding platforms if they are not exempt persons. Similarly, investment-based platforms are caught by a number of other provisions including Article 25 RAO (Arranging deals in investments) and therefore the platform operator and security issuers must seek to ensure that their offerings fall within an existing FSMA exemption to the requirement to publish a prospectus, including limiting the number and type of investors which may participate in the offering. Additional activities by crowdfunding platform operators in the UK may be subject to further regulation. For example, if the operator of the platform receives, holds or processes investor/lender money, they will be subject to the FCA's Client Asset sourcebook which dictates how a firm can handle client money. Additionally, communications made to potential investors may constitute a financial promotion and must therefore comply with Chapter 4 of the FCA's Conduct of Business sourcebook.

The aim of the DFSA's framework is to promote financial technology innovation in the DIFC while providing certain protections for consumers. Those protections include:

- ensuring that investors are provided with enough information in relation to the risks that they face by crowdfunding SMEs, such as: (i) the relatively high risk of capital loss; (ii) the lack of an immediate return, given the long term nature of an early stage investment in SMEs; (iii) the lack of liquid markets in which the investor may dispose of their investments and therefore the lack of a clear exit route; and (iv) the potential for fraud, whereby an investor unwittingly funds a scam pitch;

- limiting the amounts that may be raised in loan-based crowdfunding such that only up to US$ 5,000 can be lent by any individual Retail Client lender to a particular borrower and an aggregate limit of US$ 50,000 may be lent by any individual Retail Client lender in any calendar year;
- ensuring that individual Retail Clients in investment-based crowdfunding may only invest up to US$ 50,000 in any calendar year and providing all investors with a minimum 48 hour cooling off period following an investment, during which they may withdraw their commitment without any penalty; and
- requiring Retail Clients to sign risk acknowledgement forms for each investment made through a crowdfunding platform.

By creating new categories of Regulated Activities, the DFSA has allowed crowdfunding activities to take place in the DIFC with less regulatory interference or cost to operators than they would have faced if they were required to navigate the full extent of the DFSA Rulebook. The DFSA has therefore stayed true to its aim of promoting financial technology whilst ensuring that retail investors have certain protections in place as set out above.

Andrew Tarbuck, capital markets partner at Hogan Lovells (Middle East) LLP, commented on the DFSA framework:

"The DFSA has provided a thorough framework for crowdfunding underpinned by a clear and separate definition as a regulated activity in the DIFC in its own right. This makes other DFSA regulation that may be applicable to crowdfunding easier to navigate. Regulatory developments that assist start-ups and SMEs to source capital more efficiently and effectively can only be beneficial."

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