

Public Consultation on

Facilitating Equity Crowdfunding in Sri Lanka

7 April 2022



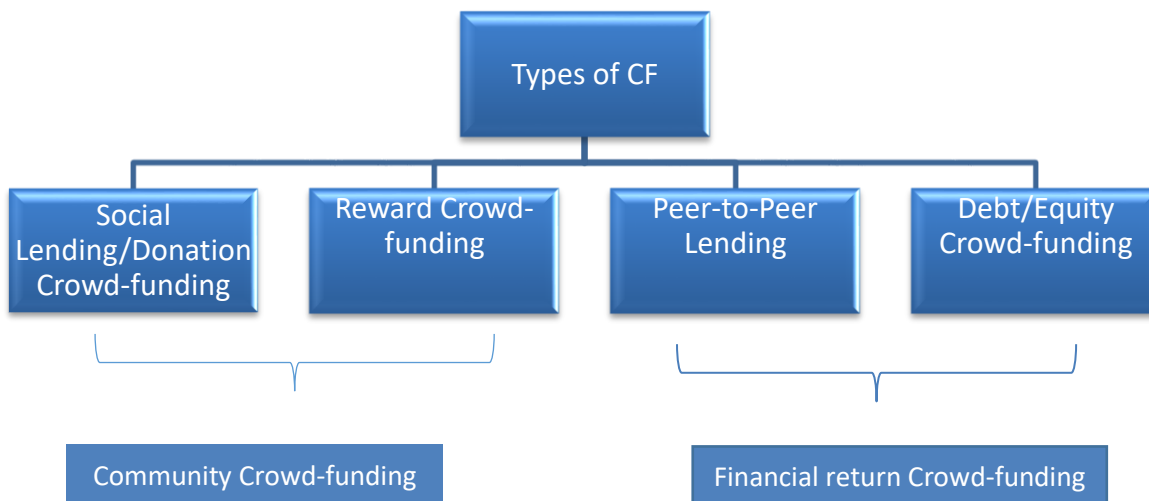
1.0 Foreword

This paper discusses the concept of Equity Crowdfunding and the practices adopted in other stock markets, and seeks public comment on the proposed policy and regulatory framework with respect to facilitating Equity Crowdfunding developed under the technical assistance provided by the Asian Development Bank (ADB). The Securities and Exchange Commission of Sri Lanka (SEC) would like to invite the public and other stakeholders to submit written comments on the questions posed in this consultation paper (refer Section 6.0 for further details), **on or before 23rd May 2022**, under the title "**Public Consultation on Equity Crowdfunding**". Comments received may be publicly available and will not be treated as confidential unless a special request is made in that respect.

2.0 Overview of Crowdfunding (CF)

CF is solicitation of funds (small amount) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause.

Types of CF are enumerated in figure 1.



Source: IOSCO Staff Working Paper - Crowdfunding: An Infant Industry Growing Fast

- i. **Social/Donation CF:** Social/Donation CF denotes solicitation of funds for social, artistic, philanthropic or other purpose, and not in exchange for anything of tangible value. Eg. Kickstarter, Indiegogo
- ii. **Reward CF:** Reward CF refers to solicitation of funds, wherein investors receive some existing or future tangible reward (such as an existing or future consumer product or a membership rewards scheme) as consideration. Eg. Kickstarter, RocketHub
- iii. **Peer-to-peer lending:** In Peer-to-Peer lending, an online platform matches lenders/investors with borrowers/issuers in order to provide unsecured loans and the interest rate is set by the platform. Some Peer-to-Peer platforms arrange loans between individuals, while other platforms pool funds which are then lent to small and medium-sized businesses. Eg. Lending Club, Prosper, Zopa, Funding Circle
- iv. **Debt/Equity CF:** Equity/Debt CF platform provides an online fund raising platform for start ups, small and medium companies, etc by issuing equity or debt securities. Businesses seeking to raise capital through this mode typically advertise online through a crowdfunding platform website, which serves as an intermediary between entities/persons who are in need of funds and investors/lenders. Eg. Syndicate Room, Crowd cube and Seeders.

3.0 Benefits and Risks of Equity Crowdfunding (ECF)

3.1. Benefits

- ECF provides a much needed new mode of financing for start-ups and SME sector and increases flows of credit to SMEs and other users in the real economy.
- Cost advantages: through ECF platforms entrepreneurs can raise equity financing without having to undergo the procedures and costs associated with initial public offering
- Lower cost of capital
- Can maintain control in companies by offering a small proportion of shares
- Provides a new investment avenue and a new product in relation to portfolio diversification by Investors
- Provides a low cost marketing tool (through social media,etc)
- Timing : relatively shorter than raising funds through other modes

3.2. Risks

- Substitution of Institutional Risk by Retail Risk:
 - Presently, the risk in financing Start-ups and SMEs is mainly borne by Venture Capital Funds (VCFs), Private Equity (PE) Investors etc.
 - In crowdfunding, these entities solicit investments in smaller sums from large number of investors. Hence, the risk taking by VCF/PE (informed investors) is substituted with retail investors, whose risk tolerance level may be relatively low.
- Risk of default:
 - There is no or less recourse to the investors against the issuer, in case of a default or fraud.
- Risk of Fraud :
 - There is possibility of genuine websites being used by fraudsters claiming to be promoters of projects or of false websites being established, simply to defraud the investors or to entice individuals to provide credit card details etc.
- Disclosure risks: ECF platforms may lack standardization and provide less detail than securities in the public markets

4.0 ECF, as an alternative fund raising avenue for SMEs in Sri Lanka

ECF platforms have facilitated alternative on-line fund raising mechanism for SMEs and provide a new investment avenue for investors. In many jurisdictions, ECF platforms are operating successfully. ECF platform can positively contribute for the country's economic development by providing a low cost alternative fund raising mechanism for start-ups, SMEs etc., generating much needed foreign inflows, offering diverse investment opportunities for both local and foreign investors. However, it is important to note that proper regulatory measures and risk management framework needs to be put in place to effectively manage potential risks associated with ECF platforms in line with the applicable International Organization for Securities Regulators (IOSCO) principles.

5.0 Experience from other jurisdictions

Salient feature	Malaysia	Thailand
Eligibility for the ECF operator	<ul style="list-style-type: none"> Registered under the Securities commission of Malaysia Must be a locally incorporated company 	<ul style="list-style-type: none"> Must be incorporated in Thailand Must have a minimum paid-up registered capital of THB 5 million, and their systems must be ready for use upon applying to the SEC for approval to operate
Limitation on capital Raised	<ul style="list-style-type: none"> An issuer can only raise up to RM3 million within a 12-month period, irrespective of the number of campaigns an issuer may seek funding for during the 12-month period; and An issuer can only utilise the ECF platform to raise a maximum amount of RM5 million, excluding the issuer's own capital contribution or any funding obtained through a private placement exercise 	
Eligible investors and investment limit	<ul style="list-style-type: none"> Sophisticated investors: No restrictions on investment amount Angel investors: A maximum of RM500,000 within a 12-month period; and Retail investors: A maximum of RM5,000 per issuer with a total amount of not more than RM50,000 within a 12-month period. 	<ul style="list-style-type: none"> Allowed for retail and non-retail investors including institutional investors, mutual fund companies and venture capital investors & angel investors Retail investor - must be not more than THB 100,000 to each
Obligations on the crowd funding platforms	<ul style="list-style-type: none"> Carry out a due diligence exercise on prospective issuers Ensure the issuer's disclosure document is verified for accuracy and made accessible to investors through the ECF platform; Inform investors of any material adverse change to the issuer's proposal ; Ensure that the fundraising limits imposed on the issuer are not breached; and Ensure that the investment limits imposed on the investor are not breached. Establish and maintain one or more trust accounts designated for the funds raised by an issuer hosted on its platform 	<ul style="list-style-type: none"> Screening issuers wishing to offer crowdfunding shares or debentures via the crowdfunding portal ECF platform operator must put in place the following but not limited to: <ul style="list-style-type: none"> a system to prevent access to information concerning the offering of shares through an ECF platform by anyone who is not a member A system that allows the ECF platform operator to identify investors and to verify their qualifications as retail or non-retail investors before investing through the ECF platform

Salient feature	Malaysia	Thailand
Permitted and non-permitted Issuers	<p><u>Permitted</u></p> <ul style="list-style-type: none"> ▪ Only locally incorporated private companies and limited liability partnerships (excluding exempt private companies) will be allowed to be hosted on the ECF platform. <p><u>Not Permitted</u></p> <ul style="list-style-type: none"> ▪ Commercially or financially complex structures (i.e. investment fund companies or financial institutions); ▪ Public-listed companies and their subsidiaries; ▪ Companies with no specific business plan or its business plan is to merge or acquire an unidentified entity (i.e. blind pool); ▪ Companies other than a micro fund that propose to use the funds raised to provide loans or make investment in other entities; ▪ Companies other than a micro fund with paid-up share capital exceeding RM5 million; and ▪ any other type of entity that is specified by the SC 	<p><u>Permitted</u></p> <ul style="list-style-type: none"> ▪ Must be a company incorporated under Thai law, and must intend to use the proceeds of newly-issued shares and debentures to fund the company's operations, or for refinancing <p><u>Not Permitted</u></p> <ul style="list-style-type: none"> ▪ Listed company on the Stock Exchange of Thailand
Key Disclosure requirements	<ul style="list-style-type: none"> a) Information that explains key characteristics of the company; b) Information that explains the purpose of the fund raising and the targeted offering amount; c) Information relating to the business plan of the company; and d) Financial information relating to the company– <ul style="list-style-type: none"> ▪ for offerings below RM500,000: <ul style="list-style-type: none"> - audited financial statements of the company, where applicable (e.g. where the issuer has been established for at least 12 months); and - where audited financial statements are unavailable (e.g. the issuer is newly established), certified financial statements or information by the issuer's management; or ▪ for offerings above RM500,000: audited financial statements of the company. 	

6.0 Proposed Regulatory Framework

6.1. General Requirements and Obligations of ECF Operators

- i) ECF Platform Operator Requirements and Registration
 - a) ECF platform operators shall be registered as market operators under Chapter 1 and 2 of Part IV of the SEC Act No. 19 of 2021 (the SEC Act).
 - b) Process for registering should be properly defined and time bound.
 - c) ECF operators should be a formally registered company or corporation.
 - d) ECF operators might consider selectively registering foreign ECF operators that have significant experience in other countries and can show a letter of introduction.
 - e) All registered ECF platform market operators shall be subject to the market misconduct provisions contained in Section 127(a) (iv) of Part V of the SEC Act and the regulations and oversight of the Commission under the provisions of the SEC Act.
- ii) ECF Platform Operators
 - a) Shall be subject to the provision under section 123 of Chapter 2 of Part IV of the SEC Act which empowers the Commission to review market operators in the interest of investors or the maintenance of an orderly and fair market.
 - b) Owners and key officers should be subject to “fit and proper” testing.
 - c) Shall demonstrate competence and capacity to analyse business and financial plans of start-ups and small enterprises.
 - d) Shall provide a detailed operating plan including fees, charges and other expenses that it may charge, impose on issuers or investors.
 - e) Shall complete contingency plans in the event the ECF operator is unable to carry out its operations or cessation of business.
 - f) Shall be responsible for delivering fair dealing outcomes to investors and to exercise effective oversight of their operations.
 - g) ECF operators are prohibited from providing financial assistance to Investors.
 - h) ECF operators should periodically review their policies and processes against the measures in this regulation and take actions to address any gaps arising from the review.
- iii) Responsibilities of the Board of Directors of the ECF Operator
 - a) ensure compliance with applicable rules,
 - b) ensure implementation of adequate internal controls,
 - c) regular assessment of risks,
 - d) Should the Board of Directors identify a breach of the rules in this regulation by those operating or managing the ECF platform, they must immediately notify the SEC.
- iv) An ECF Platform Operator shall comply with the minimum capital requirement imposed by the Commission from time to time.
- v) Due Diligence Requirements

- a) Maintain internally developed procedures clearly setting out evaluation criteria used in conducting due diligence on issuers.
 - b) Issue risk warning statements, including all risk factors that users may require in making a decision to participate on the platform.
- vi) Anti-Money Laundering (AML) / Know Your Client (KYC) Requirements
 - a) An ECF platform operator shall adhere to rules and regulations of the Financial Intelligence Unit (FIU) of the Central Bank of Sri Lanka (CBSL) including AML and KYC requirements.
- vii) Data protection / privacy / cybersecurity / IT systems
 - a) Shall demonstrate that they have proper IT systems in place and can manage normal IT-related risks (it is a fintech, so should have fintech capacity).
 - b) Shall demonstrate that they will be able to manage risks and can demonstrate the processes and contingency arrangements in place where they are unable to carry out operations.
 - c) Shall appoint at least one person to be responsible for the operation and financial management of the recognized market and to act as the main contact with the SEC Sri Lanka.
 - d) Shall be able to take appropriate action against a person in breach including directing the person in breach to take any necessary remedial measure.
 - e) Shall ensure proper regulation and supervision of its users, or any person utilizing or accessing its platform, including suspension and expulsion of such persons.
- viii) Safeguarding / Management of Investor Funds
 - a) Maintain accurate and up-to-date records of Investors' monies held and ensure that Investors' funds are not misappropriated.
 - b) Maintain separate bank accounts for funds raised for different Issuers.
 - c) Ensure that the ECF Operator has sufficient financial, human and other resources for the operation of the recognized market, at all times.
 - d) An ECF Operator shall establish and maintain in a licensed institution (either a commercial bank, central depository or clearing house), one or more trust accounts designated for the funds raised by an issuer hosted on its platform. This trust money may only be released by an operator to the issuer once a pre-set targeted amount has been reached, when there is no material adverse change made to the offer during the relevant offer period and when a cooling- off period of six days has expired.
- ix) Communication systems
 - a) ECF Platform shall operate a convenient communication channel to facilitate communication between issuers and investors.
- x) Dispute resolution mechanisms and avoiding conflicts of interest
 - a) Dispute mechanism must be in place, set out in writing, and made known to both issuers and investors.
 - b) To avoid conflicts of interest, operators should not be allowed to invest in issuers on its platform and provide full disclosure on fees and charges.
 - c) Further, operators must not provide financial advice to investors investing in an issuer hosted by the operator.
 - d) ECF Operators must provide information on how the platform facilitates the investor's investment including providing communication channels to permit discussions about issuers hosted on its platform.

- e) Include a general risk warning regarding participation in equity crowdfunding.
 - f) Provide information on the rights of investors relating to participation in equity crowdfunding.
 - g) Provide information on processes and contingency arrangements in the event the operator is unable to carry out its operations or ceases its business.
- xi) Financial education program
- a) Shall be in place, and available to support both issuers and investors. In the light of ECF, financial literacy involves educating investors about the basics of equity crowdfunding. All platforms should be required to submit a financial literacy action plan in their proposal to the SEC.
- xii) Reporting Requirements
- ECF Operators shall submit:
- a) Quarterly interim financial reports,
 - b) Quarterly compliance reports,
 - c) Audited annual financial statements.
- xiii) Management of ECF Platform Cessation
- a) ECF Platform Operators shall have a proper business cessation plan to manage a voluntary or involuntary cessation of the ECF platform operator.
 - b) Shall protect all transactions that have taken place if a registration is subsequently cancelled or revoked in accordance with section 123(6) of Chapter 2 of Part IV of the SEC Act
 - c) Cessation of operation plans should include any communication plans to investors including:
 - i. Public notices 30 days prior to the cessation of operations,
 - ii. How to inform them who they should contact following the operator's closure or whether there will be another party appointed to continue liaising with the investor; and
 - iii. The plan for handling investors' funds including the transfer of funds/operations to another ECF Operator.
- xiv) An ECF platform operator shall maintain records for a period of six (6) years
- xv) An ECF platform operator shall adhere to any other requirements imposed by the Commission from time to time
- xvi) Secondary Market for Shares
- a) Shares purchased under ECF cannot be resold for a period of one year.
 - b) It is suggested that the re-selling of shares under ECF be either restricted to the initial pool of investors in a ECF scheme or to the same restricted pool of high net-worth or sophisticated investors to avoid selling on a broader, more open secondary market. However, a company that initially raised funds via ECF can decide to go for a listing subsequently.

6.2. Requirements/ Restrictions for Investors

- i) Categories of investors/investment limits

Investors can be limited to sophisticated investors, high net worth individuals and investment funds (no more than 10% of the ECF offering) and if retail investors are considered, limits should be quite low).

 - a) ECF Operators shall ensure that the investment limits imposed on the investors are not breached.

- ii) Cooling off/right of cancellation
 - a) This is a standard clause allowing investors to change their minds; benchmark seems to be 2-5 business days.

6.3. Requirements/Restrictions for Investees (Issuers)

- i) General eligibility requirements are for local unlisted firms
- ii) Certain companies are not eligible to use equity crowdfunding. These include:
 - a) non-Sri Lankan companies;
 - b) companies that already listed on the Colombo Stock Exchange (CSE);
 - c) investment companies;
 - d) companies that have been disqualified by the SEC; and
 - e) companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.
- iii) Investee size limitation (possible size of an issue)
- iv) Information disclosure requirements
 - a) Platform operators should
 - carry out a due diligence exercise on prospective issuers planning to use its platform;
 - monitor and ensure compliance with its rules and disclosure requirements;
 - ensure the issuer's disclosure document lodged with the platform operator is verified for accuracy and made accessible to investors through the platform;
 - b) Issuers should provide information
 - that explains the key characteristics of the issuer;
 - that explains the purpose for raising the funds and the amount that the issuer seeks to raise;
 - relating to the issuer's business plan; and
 - financial information relating to the issuer, that includes:
 - A. for offerings below LKR 500,000:
 - I. audited financial statements where applicable (e.g. where the issuer has been established for at least 12 months); and where audited financial statements are unavailable (e.g. the issuer is newly established), certified financial statements or information by the issuer's management; and
 - B. for offerings above LKR 500,000: audited financial statements of the issuer.
 - C. Issuers are required to inform investors of any material adverse change to the issuer's proposal;
- v) Limitations on the value of shares issued under ECF
 - a) The following limits on the amount that an issuer may raise:
 - 1) up to LKR 75 million within a 12 month period, irrespective of the number of projects an issuer may seek funding for during the 12 month period; and
 - 2) up to LKR 100 million in total, excluding the issuer's own capital contribution or any funding obtained through private sources.

- b) Platform operators should ensure that the fundraising limits imposed on the issuer are not breached;
 - c) Issuers cannot raise funds simultaneously on multiple ECF platforms in relation to the same issue.
- vi) Other requirements/restrictions
- a) ECF share issuance should be “all or nothing” (AON), namely, there are a few jurisdictions have a “Keep-It-All” (KIA) model, In the KIA model, the entrepreneurial firm can keep the entire pledged amount, albeit at higher fees, as long as a set amount of capital is raised (in South Korea this is 80%). An issuer names an amount of equity they want to raise. If the target amount is not raised among ECF investors, the issuance does not proceed. This feature ensures discipline and finality: issues either fail or succeed, and there is no middle ground that might raise questions or trigger disputes.

7.0 How to Submit Comments

The Securities and Exchange Commission of Sri Lanka would like to invite the public and other stakeholders to submit written comments on the following questions posed:

- (A) A number of jurisdictions have introduced equity crowdfunding with proper safeguards, do you think Sri Lanka is ready for equity crowdfunding?
- (B) Considering the importance of ensuring the credibility of an ECF platform operator, do you think that the general requirements and obligations of ECF Operators provided in 6.1 are adequate? Specify changes, if any, along with the rationale.
- (C) Do you think that there should be a secondary market for ECF at the initial stage? Provide reasons/rationale for your answer.
- (D) Do you think that there should be investment limits for different investor categories (eg.retail investor, qualified investor etc.) considering risks associated with ECF and if yes, what are the possible threshold limits?
- (E) Should there be a limitation on the issue size and if yes, please specify such possible value limits.
- (F) Taking into consideration that the companies coming for crowdfunding lack any significant track record, are the conditions and requirements mentioned in 6.3 are adequate? Specify changes, if any, along with the rationale.
- (G) Any additional suggestions or views with regard to the proposed regulatory framework included under section 6.

Please submit your written comments on the above-mentioned questions, **on or before 23rd May 2022**, under the title **"Public Consultation on Equity Crowdfunding"**.

Written comments may be sent by any one of the following methods:

By Registered Post:

Mr.Prabash Wanigatunge
The Acting Director Capital Market Development
Securities and Exchange Commission of Sri Lanka
Level 28-29, East Tower
World Trade Centre
Echelon Square
Colombo 01
Sri Lanka

Your comments should be submitted in an envelope marked **"Public Consultation on Equity Crowdfunding"** on the top left-hand corner of the envelope.

E-mail : prabash@sec.gov.lk

If you wish to provide comments in the capacity of a representative of an organisation, you should provide details of the organisation whose views you represent.

Participants submitting comments should include their personal/company particulars as well as their correspondence address, contact phone number and email address on the cover page of their submissions.

The comments received would be subject to consideration by the Securities and Exchange Commission of Sri Lanka. Comments received may be publicly available and will not be treated as confidential unless a special request is made in that respect.