

## **CROWDFUNDING AS AN ALTERNATIVE FINANCING FOR SMEs AND START-UPS IN MALAYSIA: AN INTRODUCTORY NOTE FROM THE LEGAL PERSPECTIVE**

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### **ABSTRACT**

Small and Medium Enterprises (SMEs) and start-ups have consistently contributed to a country's tax revenue, technology advancement, and innovation, job creation as well as economic outputs. However, they are facing great challenges or setbacks in securing funding from external sources. To overcome the fundraising issues or financing lacuna, many entrepreneurs have resorted to crowdfunding as an alternative source of their equity or debt financing. Crowdfunding, being a significant aspect of the recent fintech innovation and digital disruption, has been put under the spotlight and received high expectations from all stakeholders to be an effective solution to SMEs and start-ups. This article would be focusing on crowdfunding with financial returns, namely, equity crowdfunding (ECF) and crowdlending/peer-to-peer lending (P2P). The research methodology employed by this article is primarily based on the literature review of various legislations, scholarly articles, research papers, government policies, books, and other publications concerning the ECF and P2P from different disciplines. At the end of this article, the author opined that crowdfunding could be a useful alternative financing method for SMEs and start-ups in Malaysia as it helps the capital formation and bridges the financing gaps for them. Countless benefits could also be offered to the society and economy at large with the proper crowdfunding regulations in place. Upon reviewing the Guidelines on Recognised Markets issued by the Securities Commission Malaysia (Guidelines), the author argues that the Guidelines is a carefully crafted and balanced regulation, albeit there is room for improvement.

**Keywords:** Small and medium enterprises, alternative financing, crowdfunding, securities law, Securities Commission Malaysia.

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## **PENGUMPULAN DANA MASYARAKAT SEBAGAI ALTERNATIF KEPADA PEMBIAYAAN PKS DAN SYARIKAT PEMULA NIAGA DI MALAYSIA: SATU NOTA Pengenalan dari Perspektif Perundangan**

### **ABSTRAK**

Perusahaan Kecil dan Sederhana (PKS) dan syarikat pemula niaga telah menyumbang secara konsisten kepada hasil negara, kemajuan teknologi, dan inovasi, penciptaan peluang pekerjaan dan juga pengeluaran ekonomi. Namun, mereka masih menghadapi cabaran atau halangan yang hebat dalam proses mendapatkan dana dari sumber luaran. Untuk mengatasi isu-isu pengumpulan dana atau kekurangan pembiayaan, ramai usahawan terpaksa menggunakan pendanaan ramai sebagai sumber alternatif bagi pembiayaan ekuiti atau hutang. Pendanaan ramai, menjadi salah satu aspek yang penting terhadap inovasi teknologi kewangan dan perubahan digital, telah menjadi tumpuan dan mendapat harapan yang tinggi daripada semua pihak berkepentingan untuk menjadi kaedah penyelesaian yang efektif bagi PKS dan syarikat pemula niaga. Makalah ini akan memfokuskan kepada pendanaan ramai dengan pulangan kewangan, iaitu pendanaan ekuiti (ECF) dan pembiayaan ramai/pembiayaan antara rakan setara (P2P). Metodologi penyelidikan yang digunakan dalam makalah ini utamanya berdasarkan pada ulasan literatur dari pelbagai perundangan, makalah ilmiah, kertas-kertas penyelidikan, dasar-dasar kerajaan, buku-buku dan penerbitan lain mengenai pendanaan ramai ekuiti dan pembiayaan rakan setara dari pelbagai disiplin ilmu. Di akhir makalah ini, penulis berpendapat bahawa pendanaan ramai boleh dijadikan sebagai satu kaedah pembiayaan alternatif yang bermanfaat bagi PKS dan syarikat pemula niaga di Malaysia kerana ia boleh menyumbang kepada pembentukan modal dan merapatkan jurang pembiayaan bagi PKS dan syarikat pemula niaga. Manfaat yang tidak terduga dapat disumbang kepada masyarakat dan ekonomi secara menyeluruh dengan peraturan pendanaan ramai yang betul. Setelah meneliti Garis Panduan Pasaran yang diiktiraf yang dikeluarkan oleh Suruhanjaya Sekuriti Malaysia, penulis berpendapat bahawa Garis Panduan ini adalah satu peraturan yang teliti dan seimbang, walaupun terdapatnya ruang untuk penambahbaikan.

**Kata kunci:** Perusahaan kecil dan sederhana, pembiayaan alternatif, pendanaan ramai, undang-undang sekuriti, Suruhanjaya Sekuriti Malaysia.

## INTRODUCTION

The economic significance of the Small and Medium Enterprises (SMEs) and start-ups are enormous, in both developed and developing countries. In general, they have constantly contributed to domestic tax revenue, technology advancement, and innovation,<sup>1</sup> job creation as well as economic outputs in the form of Gross domestic product (GDP).<sup>2</sup> According to the World Bank, SMEs appear to account for about 90% of businesses and more than 50% of employment across the globe. In addition, they are also believed to have contributed up to 40% of GDP in developing economies.<sup>3</sup> The importance of SMEs and start-ups to social and economic advancement is therefore conspicuous. Despite that, they are facing great challenges or setbacks in securing funding from external sources owing to some of their intrinsic characteristics.

Firstly, since SMEs and start-ups are generally incorporated as private companies, it seems to be harder for them to source capital and be noticed by investors as compared to those public listed companies.<sup>4</sup> With such informational inefficiency, SMEs and start-ups suffer from the mismatch between capital resources and investment opportunities.<sup>5</sup>

Moreover, the mainstream banking institutions may not have the risk appetite to finance the SMEs and start-ups because (i) they

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<sup>1</sup> Department for Business, Innovation & Skills, SMEs: enablers of success and economic rationale for government intervention §. Ref: BIS/13/1320 (2013), 9-13.

<sup>2</sup> Lerong Lu, "Promoting SME Finance in the Context of the Fintech Revolution: A Case Study of the UK's Practice and Regulation" *Banking and Finance Law Review* 33, no. 3 (2018): 318.

<sup>3</sup> The World Bank, "Small and Medium Enterprises (SMEs) Finance" The World Bank, accessed January 14, 2021, <https://www.worldbank.org/en/topic/sme/finance>.

<sup>4</sup> Devashis Mitra, "The Role of Crowdfunding in Entrepreneurial Finance," *Delhi Business Review* 13, no. 2 (2012): 70.

<sup>5</sup> Sebastiaan N. Hooghiemstra and Kristof de Buysere, "The Perfect Regulation of Crowdfunding: What Should the European Regulator Do?," ed. Dennis Brüntje and Oliver Gajda in *Crowdfunding in Europe: State of the Art in Theory and Practice* (Springer International Publishing Switzerland, 2016), 146-148.

may not have financial track records to prove their financial position to the bank; (ii) the lack of regular cash flow to ensure repayment of the loan;<sup>6</sup> (iii) the want of assets to be offered as collateral; and (iv) the nascent business ideas of the SMEs and start-ups with no clear evidence of success.<sup>7</sup> Meanwhile, the costs and requirements to raise capital from the securities markets are highly prohibitive and cumbersome to SMEs and start-ups.<sup>8</sup> Hence, going public is not viable for SMEs and start-ups that are at the earlier stage of their business cycle.

Although venture capitalists or angel investors could be the potential source of finance to SMEs and start-ups, they could be very selective in their investment.<sup>9</sup> Given that most of the venture capitalists or business angels would have a specific forte or preference, they may only invest in SMEs or start-ups that they could comprehend based on their respective expertise.<sup>10</sup> Further, to exercise effective control over the SMEs and start-ups and to mitigate any potential agency cost/moral hazard predicaments, the venture

<sup>6</sup> John Armour and Luca Enriques, "The Promise and Perils of Crowdfunding: Between Corporate Finance and Consumer Contracts," *The Modern Law Review* 81, no. 1 (2018): 54, <https://doi.org/https://doi.org/10.1111/1468-2230.12316>.

<sup>7</sup> Mokhtarrudin Bin Ahmad, Masurah, I. M. K, and Muhamad, S. C. R., "Crowdfunding as a Funding Opportunity for Youth Start-Ups in Malaysia" *Pertanika Journal of Social Sciences & Humanities* 25, no. S (2017): 145.

<sup>8</sup> Iota Kaousar Nassr and Gert Wehinger, "Unlocking SME Finance through Market-Based Debt: Securitisation, Private Placements and Bonds," *OECD Journal: Financial Market Trends* 2014, no. 2 (2015): 150-154; Patricia H Lee, "Crowdfunding Capital in the Age of Blockchain-Based Tokens," *St. John's Law Review* 92, no. 4 (2018): 838.

<sup>9</sup> Chris Harvey, "Why Are Venture Capitalists so Picky?" Chris Harvey, June 8, 2019, <https://medium.com/@ChrisHarveyEsq/why-are-venture-capitalists-so-picky-e83b4a5d43fc>.

<sup>10</sup> Rob Bueschen, "The Surprising Bias Of Venture Capital Decision-Making," *TechCrunch*, September 25, 2015, <https://techcrunch.com/2015/09/24/the-surprising-bias-of-venture-capital-decision-making/>. Dan Moskowitz, "Being a Venture Capitalist: A How-to Guide," *Investopedia* (Dotdash, August 22, 2019), <https://www.investopedia.com/articles/personal-finance/091415/howto-guide-being-venture-capitalist.asp>.

capitalists would opt to take up effective control rights over the subject SMEs and start-ups.<sup>11</sup> In this regard, proximity is pertinent to ensure their effective control. Hence, those SMEs and start-ups outside of the “convenience proximity” would not be able to catch the attention of the venture capitalists.<sup>12</sup>

To address the fundraising issues faced by SMEs and start-ups, many entrepreneurs have resorted to crowdfunding as an alternative source of equity or debt financing. Crowdfunding, being a significant aspect of the recent fintech innovation and digital disruption,<sup>13</sup> has been put under the spotlight and received high expectations from stakeholders to be an effective solution for SMEs and start-ups.

This article focuses on crowdfunding with a financial return, i.e., equity crowdfunding (ECF) and crowdlending /peer-to-peer lending (P2P). The research methodology employed by this article is primarily based on the literature review on various primary and secondary legislation, scholarly articles, research papers, government policies, books, and other publications concerning the ECF and P2P from different disciplines. Pursuant to the literature review, the author synthesises, analyses, comments and performs a qualitative assessment on the authoritative texts, concepts, debates, and reasoning, *inter alia* in: (a) explaining the definition and the concept of crowdfunding; (b) evaluating the benefits and risks of

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<sup>11</sup> Steven N Kaplan and Per Strömberg, “Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts,” *The Review of Economic Studies* 70, no. 2 (2003): 281–282 and 295–314, <https://doi.org/https://doi.org/10.1111/1467-937X.00245>; See also, Stefano Caselli and Giulia Negri, *Private Equity and Venture Capital in Europe: Markets, Techniques, and Deals* (London, United Kingdom: Academic Press, 2018) 202–212.

<sup>12</sup> Eva Lutz et al., “Importance of Spatial Proximity between Venture Capital Investors and Investees in Germany,” *Journal of Business Research* 66, no. 11 (2013): 2346–2347; Armour and Enriques, “The Promise and Perils of Crowdfunding”, 54–55.

<sup>13</sup> John Kong Shan Ho, “Regulating Equity Crowdfunding in Hong Kong: Appreciating Anglo-American Experiences and Recognizing Local Conditions,” *Common Law World Review* 45, no. 4 (2016): 331, <https://doi.org/https://doi.org/10.1177/1473779516671252>; KalleSetälä, “Crowdfunding in the Banking Industry: Adjusting to a Digital Era,” (Master diss., Jyväskylä University School of Business and Economics, 2017), 6–8.

crowdfunding; (c) examining some plausible directions of the crowdfunding regulation across the globe and studying the regulatory approach taken by the Malaysian financial regulator; (d) accessing the crowdfunding regulatory framework in Malaysia in details; and (e) offering some suggestions to improve the existing crowdfunding regulatory framework in Malaysia for the consideration of the financial market regulator and other interested parties.

## **THE CONCEPT AND DRIVING FACTORS OF CROWDFUNDING**

### **Concept of Crowdfunding**

Eleanor Kirby and Shane Worner of the International Organisation of Securities Commissions defined crowdfunding as follow:<sup>14</sup>

Crowd-funding is 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.

In a similar vein, Meredith B Cross of the United States Securities and Exchange Commission aptly put that crowdfunding is a term “used to describe a form of capital raising whereby groups of people pool money, typically comprised of very small individual contributions, to support an effort by others to accomplish a specific goal.”<sup>15</sup>

Premised on the above and other selected definitions of crowdfunding, the following characteristics can be observed:

- i. A form of financing or fundraising through small individual contributions from a large pool of investors;

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<sup>14</sup> Eleanor Kirby and Shane Worner, “Crowd-Funding: An Infant Industry Growing Fast,” Staff Working Paper of the IOSCO Research Department SWP3/2014 (2014): 8, <https://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>.

<sup>15</sup> “United States Securities and Exchange Commission,” United States Securities and Exchange Commission, September 15, 2011, <https://www.sec.gov/news/testimony/2011/ts091511mbc.htm>.

- ii. It is founded on an old practice of raising money and has its root in the concepts of ‘micro-finance’<sup>16</sup> and ‘crowdsourcing’<sup>17</sup> for which the crowd (namely a pool of investors) is used to substitute the conventional fund providers exemplified by the banks, investment institutions, governments, venture capitalists, or angel investors;<sup>18</sup>
- iii. Usually, it is aimed to support specific business or non-business goal; and
- iv. It happens through an online platform with the support of technology.

Within the broad concept of crowdfunding, there are generally four distinctive subsets of crowdfunding and they are (1) the donation model, (2) the reward-based model, (3) the ECF model, and (4) the P2P model.<sup>19</sup>

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<sup>16</sup> Jonathan Morduch, “The Microfinance Promise,” *Journal of Economic Literature* 37, no. 1 (1999): 1569-1573.

<sup>17</sup> Daren C Brabham, *Crowdsourcing* (Cambridge, Massachusetts: The MIT Press, 2013), 1-25; Jean-Fabrice Lebraty and Katia Lobre-Lebraty, *Crowdsourcing: One Step Beyond*, 1st ed. (London, United Kingdom: ISTE Ltd and John Wiley & Sons, 2013), 15-27; See also, Andrew A Schwartz, “Social Enterprise Crowdfunding in New Zealand,” in *The Cambridge Handbook of Social Enterprise Law*, ed. Benjamin Means and Joseph W Yockey (Cambridge, United Kingdom: Cambridge University Press, 2018), 209-210.

<sup>18</sup> Alexandra Horváthová, “Crowdfunding: Business and Regulatory Perspective,” in *The Oxford Handbook of IPOs*, ed. Douglas Cumming (New York, United States of America: Oxford University Press, 2018), 721-722.

<sup>19</sup> Yannis Pierrakis and Liam Collins, “Banking On Each Other Peer-to-Peer Lending to Business: Evidence from Funding Circle,” NESTA, 2013, 10-11, [https://media.nesta.org.uk/documents/banking\\_on\\_each\\_other.pdf](https://media.nesta.org.uk/documents/banking_on_each_other.pdf); Kirby and Worner, “Crowd-Funding: An Infant Industry Growing Fast”, 8-10.

## Driving factors

There are various potential driving factors behind the recent trend of crowdfunding activities.<sup>20</sup>

Firstly, given that the financial supports received by the SMEs and start-ups are disproportionately low in comparison with the big corporations, a huge financing gap therefore exists.<sup>21</sup> This financing gap is increasingly wider because banks or traditional financial institutions have become more risk-averse after the 2008 financial crisis. Financial institutions would avoid financing SMEs or start-ups because their credit risks are generally higher and business performance is more susceptible to the impact of undesirable events and challenges.<sup>22</sup> Consequently, this ‘uphill resistance in financing’ prevents SMEs and start-ups to access initial funds for a venture.<sup>23</sup> The funding *lacuna* and cash-flow drought are expected to be more alarming in light of the Covid-19 pandemic.<sup>24</sup>

<sup>20</sup> Jonas Schimdt, “Crowdfunding Statistics Worldwide: Market Development, Country Volumes, and Industry Trends,” *Entrepreneur Handbook*, May 16, 2020, <https://entrepreneurhandbook.co.uk/crowdfunding/>; “Malaysia’s Regulated Crowdfunding Markets Cross RM1 Billion Mark,” Securities Commission Malaysia, October 5, 2020, <https://www.sc.com.my/resources/media-releases-and-announcements/malaysias-regulated-crowdfunding-markets-cross-rm1-billion-mark>.

<sup>21</sup> Facundo Abraham and Sergio L Schmukler, “Addressing the SME Finance Problem,” *Research & Policy Briefs* No. 9, 2017, <http://documents1.worldbank.org/curated/en/809191507620842321/pdf/Addressing-the-SME-finance-problem.pdf>.

<sup>22</sup> JánDvorský et al., “Evaluation of Important Credit Risk Factors in the SME Segment,” *Journal of International Studies* 11, no. 3 (2018): 204-207.

<sup>23</sup> Lerong Lu, “Promoting SME Finance in the Context of the Fintech Revolution”, 331.

<sup>24</sup> Arjuna Chandran Shankar, “Covid-19: Malaysia SMEs See Zero Cash Inflow for at Least Three Months Due to MCO,” *The Edge Markets*, March 30, 2020, <https://www.theedgemarkets.com/article/covid19-malaysia-smes-see-zero-cash-inflow-least-three-months-due-mco>; International Labour Organization, “A Global Survey of Enterprises: Managing the Business Disruptions of COVID-19,” *Second Quarter 2020 Situational Analysis*, 2020, 2-3 and 21-31,



Also, the recent financial crisis has led to a drastic drop in the investor's confidence in conventional financial intermediaries and markets as well as the unprecedented level of risk aversion among the investors.<sup>25</sup> Against this backdrop, research indicates that investors are now more willing to move their investment to a new venue or instrument with a better financial return such as crowdfunding.<sup>26</sup>

Crowdfunding platform operators being a member of the alternative financiers has leveraged the cutting-edge information technology to reduce the communication cost between the fundraiser, funders, and the platform day-to-day operation costs substantially.<sup>27</sup> The use of technology allows crowdfunding platform to scale their business and eventually causes crowdfunding activities to thrive. Meanwhile, the increasing public confidence in internet security for banking and financial activities may have indirectly contributed to the growth of online crowdfunding activities.<sup>28</sup>

## BENEFITS AND RISKS OF CROWDFUNDING

Financial regulation is predominantly a risk-based regulation.<sup>29</sup> It means that financial market regulators will go through a series of

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[https://doi.org/https://www.ilo.org/wcmsp5/groups/public/---ed\\_dialogue/---act\\_emp/documents/publication/wcms\\_760306.pdf](https://doi.org/https://www.ilo.org/wcmsp5/groups/public/---ed_dialogue/---act_emp/documents/publication/wcms_760306.pdf).

<sup>25</sup> Luigi Guiso, "Trust and Risk Aversion in the Aftermath of the Great Recession," *European Business Organization Law Review* 13 (2012): 195-204, <https://doi.org/10.1017/S1566752912000146>.

<sup>26</sup> Lerong Lu, "Promoting SME Finance in the Context of the Fintech Revolution", 323.

<sup>27</sup> Iris H-Y Chiu, "Fintech and Disruptive Business Models in Financial Products, Intermediation and Markets — Policy Implications for Financial Regulators," *Journal of Technology Law and Policy* 21, no. 1 (2016): 77-78; Armour and Enriques, "The Promise and Perils of Crowdfunding," 56.

<sup>28</sup> Securities Industry Development Corporation, "Digital Disruption: Game Changer for the Capital Market Industry," *Engage@SIDC* 1, no. 2 (2015): 7.

<sup>29</sup> Iain MacNeil and Justin O'Brien, "Introduction: The Future of Financial Regulation," in *The Future of Financial Regulation*, ed. Iain MacNeil and Justin O'Brien (Portland, United States of America: Hart Publishing, 2010), 7-9; See also, Julia Black, "Regulatory Styles and Supervisory Strategies," in *The Oxford Handbook of Financial Regulation*, ed.

cost-benefit analysis to identify the potential risks of a certain financial activity especially the highest risk of such activity<sup>30</sup> before they could (i) determine the priority in allocating regulatory resources, (ii) ascertain the degree of the regulatory interventions for risk management, and (iii) eventually finalise the terms of the regulations.<sup>31</sup>

Although a typical cost-benefit assessment would be much more complex in nature and may involve rigorous qualitative and quantitative data analysis, it would still be useful to undertake some basic evaluations on the potential benefits and risks of the crowdfunding practices before discussing crowdfunding regulations.

## Benefits

The promotion of crowdfunding could help to bridge the financing gaps of SMEs and start-ups and ameliorate the cash flow problem.<sup>32</sup> To do so, this alternative financing provides accessible capital to SMEs and start-ups to fund business operation and expansion by reducing the search costs for capital with the help of the internet.<sup>33</sup>

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Niamh Moloney, Eilís Ferran and Jennifer Payne (New York, United States of America: Oxford University Press, 2015), 241-243; Greg Paoli and Anne Wiles, "Key Analytical Capabilities of a Best-in-Class Regulator," Research Paper Prepared for the Penn Program on Regulation's Best-in-Class Regulator Initiative, 2015, 2-10, <https://www.law.upenn.edu/live/files/4710-paoliwiles-ppr-researchpaper062015pdf>.

<sup>30</sup> Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation: Theory, Strategy, and Practice*, 2nd ed. (New York, United States of America: Oxford University Press, 2012), 282-295.

<sup>31</sup> Cary Coglianese, "What Does Risk-Based Regulation Mean?" *The Regulatory Review*, July 8, 2019, <https://www.theregreview.org/2019/07/08/coglianese-what-does-risk-based-regulation-mean/>.

<sup>32</sup> Derek Eldridge, Tahir M Nisa, and Mariateresa Torchia, "What Impact Does Equity Crowdfunding Have on SME Innovation and Growth? An Empirical Study," *Small Business Economics*, 2019, <https://doi.org/10.1007/s11187-019-00210-4>.

<sup>33</sup> Ajay Agrawal, Christian Catalini, and Avi Goldfarb, "Some Simple Economics of Crowdfunding," *Innovation Policy and the Economy* 14 (2014): 67-68, <https://doi.org/https://doi.org/10.1086/674021>.

If a business owner wishes to employ the ECF, he could raise funds without providing valuable assets as security or paying interest. In addition, through ECF, business owners have options such as (i) avoid giving away disproportionate control rights of the company (in the forms of voting rights, control over the management and operation as well as seats in the board of directors) to investors;<sup>34</sup> (ii) keep away from entering unfavourable fundraising terms as in the case of getting investment from venture capitalists or angel investors; (iii) have more liberty to dictate the fundraising commitment depending on the specific factors i.e., size of the company, liquidity and risk exposure. In light of the less stringent disclosure requirements under the crowdfunding regulations, which enable the company to set their business plan, the purposes of funding and the targeted amount to be raised with a greater degree of flexibility; and (iv) cultivate a higher spirit of entrepreneurship.<sup>35</sup>

In the case of P2P, SMEs and start-ups could obtain credit or loans from a large group of funders in a shorter period, with greater transparency and under more flexible terms, unlike loans from conventional banking.<sup>36</sup> In addition, the P2P method is arguably much more ‘user-friendly’ compared to borrowings from the traditional banks because, the terms of borrowing and repayment are more competitive; the process to obtain a loan is faster and simpler; and the platform is generally designed to be easy-to-use and backed with effective user interfaces, in the case of P2P.<sup>37</sup>

Besides raising capital, business owners may also utilise the crowdfunding platform as a medium to obtain some intangible gains such as: to market or draw public attention to their business plan and

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<sup>34</sup> Goncalo de Vasconcelos, “5 VC Clauses Entrepreneurs Should Never Ever Accept,” *Forbes*, May 31, 2017, <https://www.forbes.com/sites/goncalodevasconcelos/2017/05/31/5-vc-clauses-entrepreneurs-should-never-ever-accept/?sh=7a5190f671a1>.

<sup>35</sup> John Kong Shan Ho, “Regulating Equity Crowdfunding in Hong Kong”, 321.

<sup>36</sup> Robert Wardrop et al., “Moving Mainstream: The European Alternative Finance Benchmarking Report” (London, United Kingdom: Wardour Communications Limited, 2015), 18-19.

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

idea;<sup>38</sup> to establish closer business or partnership relationships with funders;<sup>39</sup> and to gather feedbacks or intelligence from the public.<sup>40</sup>

Crowdfunding provides investors with extra investment opportunities and allows them to diversify their investments.<sup>41</sup> In light of the decline of confidence in the traditional financial markets and intermediaries, crowdfunding platform becomes an investment tool that is highly sought after by investors in building up their asset class and taking up stakes in the growing company.<sup>42</sup> Participants in crowdfunding activities may easily rely on the collective knowledge, perspective, and information from the ‘crowd’ to evaluate the fundamentals of a target company before investing.<sup>43</sup>

Furthermore, crowdfunding platforms are also able to gain profits for hosting crowdfunding campaigns. In a nutshell, the three major actors of crowdfunding namely the fundraisers, investors, and the platform receive some benefits. Meanwhile, other related parties

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<sup>38</sup> Ethan Mollick, “The Dynamics of Crowdfunding: An Exploratory Study,” *Journal of Business Venturing* 29, no. 1 (2014): 1-3.

<sup>39</sup> Paul Belleflamme, Thomas Lambert, and Armin Schwiendach, “Crowdfunding: Tapping the Right Crowd,” *Journal of Business Venturing* 29, no. 5 (2014): 585-588; Matthew Hollow, “Crowdfunding and Civic Society in Europe: A Profitable Partnership?” *Open Citizenship* 4, no. 1 (2013): 69-71.

<sup>40</sup> Massolution.com, “2015CF The Crowdfunding Industry Report,” Crowdsourcing LLC, 2015, 17-18, <https://doi.org/https://www.smv.gob.pe/Biblioteca/temp/catalogacion/C8789.pdf>; Duoqi Xu and Mingyu Ge, “Equity-Based Crowdfunding in China: Beginning with the First Crowdfunding Financing Case,” *Asian Journal of Law and Society* 4 (2017): 84-85.

<sup>41</sup> Anita Anand, “Is Crowdfunding Bad for Investors,” *Canadian Business Law Journal* 55, no. 2 (2014): 215-217 and 220-224.

<sup>42</sup> Michael Blanding, “Crowdfunding a Poor Investment?” *Harvard Business School: Working Knowledge*, July 1, 2013, <https://hbswk.hbs.edu/item/crowdfunding-a-poor-investment>; Securities Industry Development Corporation, “Digital Disruption”, 6-8.

<sup>43</sup> Michael R Meadows, “The Evolution of Crowdfunding: Reconciling Regulation Crowdfunding with Initial Coin Offerings,” *Loyola Consumer Law Review* 30, no. 2 (2018): 274-275.

such as the information technology suppliers and advertisers will benefit as well.<sup>44</sup>

In a broader context, it is pertinent for governmental policies and regulations to promote crowdfunding because it could democratise and diversify the equity and debt financing options in the financial market.<sup>45</sup> A more diversified financial market will allow SMEs and start-ups to have more options in getting their fund with a lower cost of capital due to the escalated competition amongst the suppliers of the fund.<sup>46</sup> Besides that, promoting crowdfunding as alternative finance would also contribute to the diversity of a country's industrial sectors as emerging industries without a track record will have better access to funding.<sup>47</sup> Therefore, crowdfunding could foster innovations<sup>48</sup> and forge a mature economy with a diversified industrial base. It also provides a better ability to withstand economic uncertainties and changes.<sup>49</sup>

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<sup>44</sup> Janusz Cichy and Witold Gradoń, "Crowdfunding as a mechanism for financing small and medium-sized enterprises," *e-Finanse: Financial Internet Quarterly* 12, no. 3 (2016): 40-41.

<sup>45</sup> Javier Ramos and Bruno Gonza'lez, "Crowdfunding and Employment: An Analysis of the Employment Effects of Crowdfunding in Spain," ed. Dennis Brüntje and Oliver Gajda in *Crowdfunding in Europe: State of the Art in Theory and Practice* (Springer International Publishing Switzerland, 2016), 100; Carmen Estevan De Quesada, "Crowdfunding in Europe," in *European Contract Law in the Digital Age*, ed. Stefan Grundmann (Cambridge, United Kingdom: Intersentia, 2017), 103-105.

<sup>46</sup> Gregory Gaynor, Joel Morse and Mikhail Pevzner, "The Crowdfunding Effect," *Strategic Finance* (Institute of Management Accountants, Inc., October 1, 2015), <https://sfmagazine.com/post-entry/october-2015-the-crowdfunding-effect/>.

<sup>47</sup> John Kong Shan Ho, "Regulating Equity Crowdfunding in Hong Kong", 333.

<sup>48</sup> Arash Gholamzadeh Nasrabadi, "Equity Crowdfunding: Beyond Financial Innovation," ed. Dennis Brüntje and Oliver Gajda in *Crowdfunding in Europe: State of the Art in Theory and Practice* (Springer International Publishing Switzerland, 2016), 206-207; See also, David Groshoff, "Equity Crowdfunding as Economic Development," *Campbell Law Review* 38, no. 3 (2016): 330-334.

<sup>49</sup> John Kong Shan Ho, "Regulating Equity Crowdfunding in Hong Kong", 333.

## Risks and drawbacks

Although the promotion of crowdfunding is believed to have numerous benefits, the risks associated with crowdfunding cannot be dismissed. Crowdfunding combines the complexity of external equity or debt financing like initial public offerings (IPO) or the issuance of bonds with the systemic risks in venture capital funding.<sup>50</sup> This is because crowdfunding allows SMEs and start-ups to raise funds from a potentially large pool of retail investors. The investors may require an expert assessment to fully appreciate the risks and prospects of a business.<sup>51</sup> As opposed to institutional or sophisticated investors, some scholars argue that investment in crowdfunding could be very risky to retail investors because they are more vulnerable to (i) herd mentality, inclusive of irrationalities and collective biases;<sup>52</sup> (ii) fraud; (iii) information asymmetry that could lead to adverse selection;<sup>53</sup> (iv)

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<sup>50</sup> Arjya B Majumdar, "Regulatory Arbitrage in Cross-Border Crowdfunding," in *The Oxford Handbook of IPOs*, ed. Douglas Cumming (New York, United States of America: Oxford University Press, 2018), 747-748.

<sup>51</sup> Jeremy C Short, "Research on Crowdfunding: Reviewing the (Very Recent) Past and Celebrating the Present," *Entrepreneurship Theory and Practice* 41, no. 2 (2017): 149-150, <https://doi.org/https://doi.org/10.1111/etap.12270>; Charles Smith, "Crowdfunding Risks: An Argument Against Investing Through Equity Crowdfunding," *Financial Poise*, January 20, 2020, <https://www.financialpoise.com/crowdfunding-risks/>.

<sup>52</sup> Shreenivas Kunte, "The Herding Mentality: Behavioral Finance and Investor Biases," *Enterprising Investor*, August 6, 2015, <https://blogs.cfainstitute.org/investor/2015/08/06/the-herding-mentality-behavioral-finance-and-investor-biases/>; See also, Michelle Baddeley, "Herding, Social Influence and Economic Decision-Making: Socio-Psychological and Neuroscientific Analyses" *Philosophical Transactions of the Royal Society B: Biological Sciences* 365, no. Jan 27 (2010): 281-282, <https://doi.org/10.1098/rstb.2009.0169>, whereby herding is aptly defined by Michelle Baddeley as "the phenomenon of individuals deciding to follow others and imitating group behaviours rather than deciding independently and atomistically on the basis of their own, private information."

<sup>53</sup> Man Li, "A Signaling Game Analysis of Project Investment on Equity Crowdfunding Platform," *Open Journal of Social Sciences* 5 (2017): 276-278, <https://doi.org/10.4236/jss.2017.53026>.

uncertainty as to the prospect of the company;<sup>54</sup> and (v) the inherent agency cost<sup>55</sup> due to the short of legal or contractual protection and the lack of control on the subject company to deal with unwanted opportunism by the company's management.<sup>56</sup> Such risks may lead to potential market failure if they remain unregulated.<sup>57</sup>

Considering that most start-ups and SMEs are working on untried ideas and unexplored business in infant industries, it would not be surprising that the tendency of failure of the start-ups and SMEs is high.<sup>58</sup> The investors in crowdfunding namely P2P and ECF are therefore exposed to higher risks of default and greater risks of losing their entire investments. Furthermore, in a normal business cycle, a company will usually go into several rounds of public fundraising for expansion. In some fundraising exercises, new shares

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<sup>54</sup> Ronald J Gilson, "Locating Innovation: The Endogeneity of Technology, Organizational Structure, and Financial Contracting," *Columbia Law Review* 110, no. 3 (2010): 901.

<sup>55</sup> Shareholders, who do not participate in the day-to-day operation of a company (namely the principal), engage managers (namely the agents) to run the company on their behalf. Nonetheless, scholars have pointed out that there will be occasions where agents may not be acting in the best interest of principal if both are profit-maximisers for themselves. Hence, investors who participate in crowdfunding, are also susceptible to the agent costs as they are not involved in the daily decision-making of the company they invested. For more information on the agency theory, please see Michael C Jensen and William H Meckling "Theory of The Firm: Managerial Behavior, Agency Costs and Ownership Structure" *Journal of Financial Economics* 3 (1976): 308–310 and Anh Huu Nguyen, Duong Thuy Doan and Linh Ha Nguy. "Corporate Governance and Agency Cost: Empirical Evidence from Vietnam." *Journal of Risk and Financial Management* 13, no. 5 (2020): 103. <https://doi.org/https://doi.org/10.3390/jrfm13050103>.

<sup>56</sup> Armour and Enriques, "The Promise and Perils of Crowdfunding", 58.

<sup>57</sup> Lin Lin, "Private Equity Investor Protection: Conceptualizing the Duties of General Partners in China," *Berkeley Business Law Journal* 15 (2018): 59-60.

<sup>58</sup> Financial Conduct Authority, "A Review of the Regulatory Regime for Crowdfunding and the Promotion of Non-Readily Realisable Securities by Other Media," Financial Conduct Authority, 2015, 9, <https://doi.org/http://walescapital.com/wp-content/uploads/2015/02/FCA-crowdfunding-review.pdf>.

will be issued in exchange for capital. Hence, equity dilution occurs<sup>59</sup> and presents significant risk on an investor's financial return and share of the company's profit because many investors in crowdfunding do not have contractual protections or voting rights to prevent such dilution.<sup>60</sup> Although investors may rely on the legal protection for minority shareholders under the Companies Act 2016 (CA 2016),<sup>61</sup> most likely they will treat it as their last recourse as a legal proceeding could be costly and time-consuming and the outcome of a suit is unpredictable.

The research also reveals that numerous platforms were found to mislead investors about the risks of the fundraising campaign and overly optimistic financial returns.<sup>62</sup> It, therefore, raises serious doubt as to the due diligence being done on the fundraisers. Besides that, in crowdfunding, most investors are invested in companies that are at their early stage. It means that it may take years for the business to grow and for the return to materialise. Hence, the opportunity costs could be significant.<sup>63</sup>

Moreover, the lack of a mature and readily available secondary market for the dealings of the stake or securities acquired from the crowdfunding platform posts exponential liquidity risks on the

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<sup>59</sup> Murad Ahmed, "Critics Raise Concerns about Equity Crowdfunding Site Crowdcube," *Financial Times*, May 27, 2015, <https://www.ft.com/content/e9d998c2-ee93-11e4-88e3-00144feab7de>.

<sup>60</sup> John Kong Shan Ho, "Regulating Equity Crowdfunding in Hong Kong", 322.

<sup>61</sup> Companies Act 2016 ("CA 2016") s.346; See also, Companies Act 1965 (Revised 1975) (Repealed by CA 2016), s.181; Wong Kim Yoon V. Cheong Kim Hong & Ors [2019] 1 LNS 1004; ISM Sendirian Berhad V. Queensway Nominees (Asing) Sdn Bhd & Ors and Other Cases [2020] 1 LNS 322.

<sup>62</sup> Colin Mason, Annaleena Parhankangas, and Hans Landström, "Why Crowdfunding May Not Be the Great Democratising Force in Investment after All," *The Conversation*, September 12, 2019, <https://theconversation.com/why-crowdfunding-may-not-be-the-great-democratising-force-in-investment-after-all-123024>.

<sup>63</sup> Elvis Picardo, "Invest Through Equity Crowdfunding: Risks and Rewards," *Investopedia*, January 18, 2020, <https://www.investopedia.com/articles/investing/102015/invest-through-equity-crowdfunding-risks-and-rewards.asp>.



investors.<sup>64</sup> In other words, it means that it would be hard for investors to exit by selling the shares or other forms of interest acquired from the platform.

The shares or other forms of financial interests acquired through crowdfunding may suffer from defeated price formation and price informativeness.<sup>65</sup> This could be due to the exemptions granted to the fundraisers of crowdfunding campaigns from making the full-fledged mandatory and ongoing disclosure as required in the conventional securities market. Also, crowdfunding generally does not involve a proper book-building or auction process by investment banks or professional underwriters before fixing the opening price for a share as compared to the conventional securities markets. In certain situations, the opening price is based on the valuation of the fundraiser or the platform solely.<sup>66</sup> Thus, it raises serious concern about the accuracy of the price formation. Further, the price information of the subsequent market price of a share is also questionable due to the absence of a mature secondary market in crowdfunding.<sup>67</sup> Without an effective secondary market, it would be hard for a share price to reflect all the public information and trading activities.<sup>68</sup>

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<sup>64</sup> Corporate Finance Institute, "What Is Equity Crowdfunding?" CFI (CFI Education Inc.), accessed January 21, 2021, <https://corporatefinanceinstitute.com/resources/knowledge/finance/equity-crowdfunding/>.

<sup>65</sup> Eugene F Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work," *The Journal of Finance* 25, no. 2 (1970): 413-416; Christopher Paul Saari, "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry," *Stanford Law Review* 29, no. 5 (1977): 1031-1041; Anita Todea, "Financial Literacy And Stock Price Informativeness: A Cross-Country Study," *Studia Universitatis Babeş-Bolyai Oeconomica* 63, no. 1 (2018): 63-64, <https://doi.org/10.2478/subboec-2018-0004>.

<sup>66</sup> Armour and Enriques, "The Promise and Perils of Crowdfunding", 59.

<sup>67</sup> Armour and Enriques, "The Promise and Perils of Crowdfunding", 73-74.

<sup>68</sup> Qi Chen, Itay Goldstein, and Wei Jiang, "Price Informativeness and Investment Sensitivity to Stock Price," *Review of Financial Studies* 20, no. 3 (2007): 619-625.

Crowdfunding is also subject to internet security risks as the platform and the underlying transaction are on the internet. Therefore, it is susceptible to cyber-attack or other forms of internet crimes.<sup>69</sup>

After highlighting the risks posed to the investors and the platform, it is noteworthy that the disclosure requirements may also give rise to some concerns on fundraisers' trade secrets and intellectual property.<sup>70</sup> Fundraisers are required to reveal certain information about the "million-dollar idea" to the public.<sup>71</sup> If their unregistered intellectual properties have been disclosed and the same is eventually misappropriated, the potential litigations that follow suit such as passing-off claims could be emotionally draining and very costly to the fundraisers.<sup>72</sup>

Some of the abovementioned risks could lead to inefficiency in the funding mechanism and potential misallocation of resources whereby companies with better prospects are left uninvested or underinvested.<sup>73</sup> Therefore, the regulators must consider the benefits and risks of crowdfunding in designing the regulatory framework for crowdfunding practices.

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<sup>69</sup> UpGuard Team, "How Risky Is Crowdfunding?" UpGuard, August 5, 2020, <https://www.upguard.com/blog/just-how-risky-is-crowdfunding>.

<sup>70</sup> David Postolski, "Crowdfunding or Crowdfinancing and Its Intersection with IP," Financial Worldwide, February 2019, <https://www.financierworldwide.com/crowdfunding-or-crowdfinancing-and-its-intersection-with-ip#.YA2dwOgzY2w>.

<sup>71</sup> John Kong Shan Ho, "Regulating Equity Crowdfunding in Hong Kong", 322.

<sup>72</sup> Craig C Martin, "Avoiding the Inefficiency of Litigation," Pretrial Practice & Discovery 15, no. 3 (2007), [https://jenner.com/system/assets/publications/2105/original/PP\\_D\\_Martin\\_Spring07.pdf?1315481513](https://jenner.com/system/assets/publications/2105/original/PP_D_Martin_Spring07.pdf?1315481513); Anika Gill, et al., "Comparison of the Effects of Litigation and ADR in South-East Queensland," International Journal of Construction Management 15, no. 3 (2015): 254-255.

<sup>73</sup> Simon Gilchrist, Jae W Sim, and Egon Zakrajšek, "Misallocation and Financial Market Frictions: Some Direct Evidence from the Dispersion in Borrowing Costs" Review of Economic Dynamics 16, no. 1 (2013): 159-160, <https://doi.org/https://doi.org/10.1016/j.red.2012.11.001>; Alina Koutun, "Quality Signals in Equity-Based Crowdfunding." (Master of Science diss., KTH Royal Institute of Technology, 2016), 16-17.

## APPROACH AND DIRECTION OF CROWDFUNDING REGULATION

Although the crowdfunding mechanism has been criticised for its associated risks, it cannot be denied that its contributions to the financial industries and the economy at large are significant. The bottom line is that the crowdfunding regulations must be able to provide adequate infrastructure in promoting market development while containing the proliferation of adverse outcomes.<sup>74</sup> Upon balancing the risks and benefits of crowdfunding practices, the most optimal regulatory approach should allow businesses to raise funds efficiently on one hand. On the other hand, it should stimulate continuous economic growth and innovation whilst providing sufficient investor protection.<sup>75</sup>

To reduce the compliance costs for raising capital, P2P and ECF should be exempted from the full application of the existing securities laws. Such exemptions will then help to improve the efficiency of crowdfunding in raising funds for SMEs and start-ups. Considering that the growth of crowdfunding could help in driving innovation, technology advancement, and long-term economic growth, laws should be implemented to support crowdfunding in achieving such ambitions. Hence, it is reasonable for regulators to grant the regulatory exemptions because it is believed that such exemptions could facilitate the growth of the crowdfunding market and the economy.<sup>76</sup> Meanwhile, to secure financial stability in the long run, crowdfunding regulations must also have a sufficient

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<sup>74</sup> David Lascelles, "Financial Innovation: Good Thing, Bad Thing?" Centre for the Study of Financial Innovation, 2014, 6-13; See also, Justin Schardin, "Reviving the Reputation of Financial Innovation," Bipartisan Policy Center, February 6, 2014, <https://bipartisanpolicy.org/blog/revivin-reputation-financial-innovation/>.

<sup>75</sup> Nikki D Pope, "Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption," University of Pennsylvania Journal of Business Law 13, no. 4 (2011): 973, 982-985; James Dunn, "The New Crowdfunding Rules: How Will Investors Be Protected?" INTHEBLACK, August 25, 2017, <https://www.intheblack.com/articles/2017/08/25/crowdfunding-investor-protection>.

<sup>76</sup> Jakob Edler and Jan Fagerberg, "Innovation Policy: What, Why, and How," Oxford Review of Economic Policy 33, no. 1 (2017): 8-9.

investor protection framework to deal with systemic risks and to ensure that the crowdfunding market is fair, efficient, and transparent.<sup>77</sup> The crowdfunding regulations in Malaysia shall be assessed against the aforesaid requirements.

There are broadly three (3) regulatory approaches being employed by regulators across the globe:<sup>78</sup>

1. The first approach is one that maintains the existing corporate finance framework and prohibits all equity crowdfunding activities;
2. The second approach is one that brings crowdfunding within the ambit of the existing securities laws with certain exemptions in place so that crowdfunding practices are free from the full application of the existing laws; and
3. The third approach is one that creates bespoke or tailored legislation to promote equity crowdfunding.

A total ban under the first approach is not adopted in Malaysia because the Malaysian regulator seems to recognise the advantages of crowdfunding practices.<sup>79</sup> Instead, the crowdfunding regulations in Malaysia appear to take the second approach. These involve regulations and policies which stretch the existing securities laws that are crafted with other contexts in mind, that is to apply in the case of crowdfunding.<sup>80</sup> Such an approach is highly appropriate as an initial regulatory approach. A new regulatory framework or review of the existing securities laws merely to encapsulate the crowdfunding practices would be too slow as to obstruct the growth of such practices.<sup>81</sup> Considering that the crowdfunding practices change

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<sup>77</sup> International Organization of Securities Commissions, "Objectives and Principles of Securities Regulation," OICV-IOSCO, May 2003, 5-7.

<sup>78</sup> Arjya B Majumdar, "Regulatory Arbitrage in Cross-Border Crowdfunding," 747-748; See also, Eleanor Kirby and Shane Worner, "Crowd-Funding: An Infant Industry Growing Fast," 50.

<sup>79</sup> Securities Commission Malaysia, "Proposed Regulatory Framework for Equity Crowdfunding, Public Consultation Paper No.2/2014," 3-5.

<sup>80</sup> ASEAN Secretariat, "Facilitating Equity Crowdfunding in The Asean Region," Association of Southeast Asian Nations, 2017, 37-39, <https://doi.org/https://asean.org/storage/2017/09/Final-Facilitating-Equity-Crowdfunding-in-ASEAN.pdf>.

<sup>81</sup> John Kong Shan Ho, "Regulating Equity Crowdfunding in Hong Kong", 331.

rapidly, it is, therefore, reasonable to defer the adoption of the third regulatory approach as the time-consuming legislative processes may not be able to catch up with the development in crowdfunding practices.

As opposed to the third approach, the second approach only relies on the primary legislation to provide or delegate the necessary authority for the regulator to make the related secondary rules.<sup>82</sup> In Malaysia, the main regulation governing crowdfunding practices can be found in the Guidelines on Recognised Markets (SC-GL/6-2015(R6-2021)) (Guidelines). It is binding secondary legislation that is made by the Malaysian financial market regulator, Securities Commission Malaysia (SC)<sup>83</sup> pursuant to Section 377 of the Capital Markets and Services Act 2007 (CMSA 2007) read together with Subdivision 4, Division 2 of Part II CMSA 2007.<sup>84</sup> In doing so, it appears that SC has treated the crowdfunding platform as a ‘mini-stock market’ and therefore it decided to bring the crowdfunding platform operators into the existing registered electronic facility framework set out in Subdivision 4, Division 2 of Part II CMSA 2007.<sup>85</sup>

Since the Guidelines take the form of delegated or secondary legislation, it is, therefore quicker and administratively easier to change the crowdfunding regulations. This is for the regulation to reflect any up-to-date best practices and adapt faster to contemporary challenges.<sup>86</sup> Moreover, it is appropriate to allow crowdfunding

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<sup>82</sup> ASEAN Secretariat, “Facilitating Equity Crowdfunding In The Asean Region,” 96; See also, Stefan Loesch, *A Guide to Financial Regulation for Fintech Entrepreneurs* (West Sussex, United Kingdom: John Wiley & Sons Ltd, 2018) 35-36.

<sup>83</sup> International Monetary Fund, Malaysia: Publication of Financial Sector Assessment Program Documentation— Detailed Assessment of Implementation of IOSCO Objectives and Principles of Securities Regulation IMF Country Report No. 13/59 (Washington, D.C: International Monetary Fund, 2013) 6-7.

<sup>84</sup> Securities Commission Malaysia, “Guidelines on Recognized Markets,” (SC-GL/6-2015(R6-2021)) (2015) (“Guidelines”), para 1.01.

<sup>85</sup> Securities Commission Malaysia, “Proposed Regulatory Framework for Equity Crowdfunding, Public Consultation Paper No.2/2014,” 8.

<sup>86</sup> Herbert Smith Freehills, “Policy Making Through The Back Door – Spotting Issues And Challenging Brexit-Related SIS,” Herbert Smith Freehills, January 31, 2020,

regulation to assume the role of delegated or secondary legislation to fill in the details of technical matters while the primary legislation shall be reserved for matters concerning policy or other broader objectives.<sup>87</sup>

Crowdfunding regulation in Malaysia seems to take a permissive approach as sufficient exemptions from the existing laws have been given to the crowdfunding practices. Considering that crowdfunding is still a burgeoning phenomenon,<sup>88</sup> such a permissive or ‘light-touch’ approach is an effective way. This will foster the development of the crowdfunding market especially if such an approach is backed by a threat of stringent governmental intervention.<sup>89</sup>

As the markets increasingly mature and, regulators may consider imposing a more context-specific law and bespoke legal framework on crowdfunding. Such context-specific law or primary legislation is required if the government intends to provide more

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<https://www.herbertsmithfreehills.com/latest-thinking/policy-making-through-the-back-door-%E2%80%93-spotting-issues-and-challenging-brex-it-related>; Joe Marshall, “How Is Secondary Legislation Made?” Institute For Government, May 19, 2020, <https://www.instituteforgovernment.org.uk/explainers/how-secondary-legislation-made>.

<sup>87</sup> United Kingdom, Constitution Committee of the House of Lords, *The Legislative Process: The Delegation of Powers*, 16th Report of Session 2017–19 (London: House of Lords, 2018) accessed: January 29, 2021, 32–34,

<https://publications.parliament.uk/pa/ld201719/ldselect/ldconst/225/225.pdf>; See also, Nir Kosti, David Levi-Faur and Guy Mor, “Legislation and Regulation: Three Analytical Distinctions,” *The Theory and Practice of Legislation* 7, no. 3 (2019): 170–177.

<sup>88</sup> Michael M. Gierczak et al., “Crowdfunding: Outlining the New Era of Fundraising,” ed. Dennis Brüntje and Oliver Gajda *In Crowdfunding in Europe: State of the Art in Theory and Practice* (Springer International Publishing Switzerland, 2016), 8–10.

<sup>89</sup> Nathan Rose, “How the World Regulates Equity Crowdfunding,” *The Regulatory Review*, June 26, 2019, <https://www.theregview.org/2019/06/26/rose-how-world-regulates-equity-crowdfunding/>; Armour and Enriques, “The Promise and Perils of Crowdfunding”, 53–54 and 84.

certainty in crowdfunding practices and enhance public confidence in the market.<sup>90</sup>

Although there are resemblances between the business model (including risks) of crowdfunding and traditional financing, crowdfunding activities exhibited certain platform-specific risks and other new risks that were not envisaged by the existing securities laws.<sup>91</sup> Hence, applying the existing securities laws in Malaysia to the context of crowdfunding could bring about regulatory *lacuna*. With that in mind, some commentators also warn that the second approach may result in uncertainty and inconsistency in regulatory treatment.<sup>92</sup> Thus, the Malaysian government shall monitor the application of the Guidelines closely, and amend the crowdfunding regulation to deal with any potential *lacuna* and to mitigate such uncertainty and inconsistency promptly as and when required.

## REGULATORY FRAMEWORK FOR FINANCIAL RETURN CROWDFUNDING IN MALAYSIA

In Malaysia, the SC as the financial market regulator has wide power to regulate the capital markets<sup>93</sup> and it has brought ECF and P2P within the ambit of capital market regulations through the issuance of the Guidelines.<sup>94</sup> The Guidelines aim to regulate the main actors in the crowdfunding transactions, namely the platform operators, issuers, and investors.

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<sup>90</sup> John Kong Shan Ho, “Regulating Equity Crowdfunding in Hong Kong”, 330.

<sup>91</sup> Rainer Lenz, “Peer-to-Peer Lending: Opportunities and Risks,” European Journal of Risk and Regulation 7, no. 4 (2016): 697-698.

<sup>92</sup> Armour and Enriques, “The Promise and Perils of Crowdfunding”, 53.

<sup>93</sup> Securities Commission Malaysia Act 1993, s. 15.

<sup>94</sup> Capital Markets and Services Act 2007 (“CMSA 2007”), s. 377 and sub-div. 4, div. 2 of pt. II; Malaysia, Securities Commission Malaysia, Guidelines on Recognized Markets, SC-GL/6-2015(R6-2021) (Kuala Lumpur: Securities Commission Malaysia, 2015) accessed: January 15, 2021, <https://www.sc.com.my/api/documentms/download.ashx?id=73180796-2958-44d3-90a1-7dab13ec9839> (“Guidelines”), chs. 13 and 14.

## Platform Operators

### General Obligations as Recognised Market Operator (RMO)

Most processes in the ECF and P2P models take place on the crowdfunding platform. It is not surprising that the platform operator is the main target of the regulation. Broadly speaking, the Guidelines set out two major requirements on the platform operator under the heading of registration requirements and ongoing requirements.<sup>95</sup> Firstly, the ECF and the P2P operators must apply to the SC to be registered as a RMO after fulfilling the requirements in the Guidelines.<sup>96</sup> The detailed criteria for the registration are carefully expounded in Part B of the Guidelines. If the application is successful, the SC may register the ECF and the P2P operators as a RMO.<sup>97</sup> Upon appraisal, such registration requirements are generally revolving around the common theme of ‘investor protection,’ ‘management of systemic risks and the fair, orderly, and transparent market.’<sup>98</sup> This is essential to bring the crowdfunding regulation to be in line with the overriding objectives of the global securities regulations.<sup>99</sup>

This regulatory measure is a permissive approach because the level of regulations for recognised markets is relatively less cumbersome or stringent compared to ‘the approved market’ such as the approved stock exchange or derivatives exchange.<sup>100</sup> With such a permissive approach, the crowdfunding market is believed to have more prospects to grow.

Secondly, once the ECF and P2P platform operators have been registered as the RMO, they are then required to be subject to the general ongoing requirements provided in Part C of the Guidelines.

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<sup>95</sup> Steve Kourabas and Ian Ramsay, “Equity Crowdfunding in Malaysia,” *The Company Lawyer* 39, no. 6 (2018): 192-193.

<sup>96</sup> CMSA 2007, s. 35; Guidelines, para 1.02.

<sup>97</sup> CMSA 2007, s. 34.

<sup>98</sup> Guidelines, chs. 2-4.

<sup>99</sup> Antonio Marcacci, “IOSCO and the Spreading of a US-Like Regulatory Philosophy around the World,” *European Business Law Review* 25, no. 6 (2014): 774-781; Georges Ugeux, *International Finance Regulation: The Quest for Financial Stability* (New Jersey, United States of America: John Wiley & Sons Ltd, 2014) 1-8.

<sup>100</sup> Guidelines, paras 1.07-1.10.



Such ongoing requirements include the operational aspects of the platform, the oversight/self-regulation obligations of the operators (inclusive of the obligations to display the rights of the investor who uses their platform and the complaints and dispute resolution procedures),<sup>101</sup> the reporting requirement, and the corporate governance of the RMO.<sup>102</sup>

Generally, the platform operators are subject to all the regulatory requirements in the Guidelines unless otherwise waived by Parts 13 and 14 of the Guidelines.<sup>103</sup> The SC will have the authority to conduct periodic assessments of the operators' compliance and the platform operators need to provide full assistance to the SC.<sup>104</sup>

## **Context-Specific or Additional Requirements concerning Crowdfunding**

### **Incorporation**

Firstly, the ECF and P2P platform operators must be incorporated under Malaysian law.<sup>105</sup> Although the SC could register a foreign operator as a RMO if the foreign operator satisfies certain conditions as determined by the SC,<sup>106</sup> it cannot partake in running an ECF or P2P platform unless it has been incorporated locally. Requiring all platform operators to be locally incorporated entities could be a move to ensure the SC has the *locus standi* to supervise and bring enforcement actions on the operators. This removes the thorny problem of extraterritorial applicability.<sup>107</sup>

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<sup>101</sup> Guidelines, paras 6.01 (j)(ii) and (vi).

<sup>102</sup> ASEAN Secretariat, "Facilitating Equity Crowdfunding in The Asean Region," 99.

<sup>103</sup> *Ibid.*, 41.

<sup>104</sup> CMSA 2007, s. 36; Guidelines, para 5.04.

<sup>105</sup> Guidelines, paras 13.02 and 14.04.

<sup>106</sup> *Ibid.*, paras 3.02 and 3.03.

<sup>107</sup> A V Lowe, "The Problems of Extraterritorial Jurisdiction: Economic Sovereignty and the Search for a Solution," *International and Comparative Law Quarterly* 34, no. 4 (1985): 724-728 and 740-746, See also, Anthony J Colangelo, "What Is Extraterritorial Jurisdiction," *Cornell Law Review* 99, no. 6 (2014): 1312-1324.

In addition to ‘the local incorporation’ requirement, the P2P operators must also have at least RM5 million paid-up capital whilst this capital requirement is silent on ECP operators.<sup>108</sup> Also, in the context of the Guidelines, it is important to note that P2P financing refers to ‘the fund-raising activity (inclusive of invoice financing activity) via the sale and purchase of trade receivables or invoices which is evidenced by investment notes.’<sup>109</sup> Hence, a person who intends to operate a platform to host the invoice financing activities must be registered as the P2P operator.<sup>110</sup>

### **On-going Obligations of the Operators**

#### *Due Diligence*

In contrast to any public offering of shares on the securities exchanges, ECF only involves simplified due diligence on the potential issuer. These include ensuring the fit and properness of the issuer and its related parties, verification of issuer’s business plan; and ensuring that the information contained in the issuer’s disclosure document is accurate and accessible to investors.<sup>111</sup> Likewise, in P2P crowdfunding, the regulation only requires the platform to undertake a basic risk assessment/background check on the issuers of the investment notes.<sup>112</sup>

In both ECF and P2P, the extent of disclosure as required in the existing securities law is basically exempted.<sup>113</sup> The crowdfunding regulation in Malaysia only requires a simplified disclosure document

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<sup>108</sup> Guidelines, para 14.04.

<sup>109</sup> Ibid, para 14.01.

<sup>110</sup> Ibid, para 14.03.

<sup>111</sup> Guidelines, paras 13.04 (a)-(b) and 13.05; See also, Anja Hagedorn and Andreas Pinkwart, “The Financing Process of Equity-Based Crowdfunding: An Empirical Analysis,” ed. Dennis Brüntje and Oliver Gajda in *Crowdfunding in Europe: State of the Art in Theory and Practice* (Springer International Publishing Switzerland, 2016), 75; SuaShiang-Nian, “Equity Crowdfunding Retail Investor Protection In The UK: A Comparative Study With Malaysian Law And Practice,” *Legal Network Series 1*, no. A cxi (2019), pt. E.

<sup>112</sup> Guidelines, paras 14.05(b)-(c) and 14.06.

<sup>113</sup> Sua Shiang-Nian, “Equity Crowdfunding Retail Investor Protection in the UK”, pt. E.

of the issuers to be verified by the platform operators. This is to make sure that the self-declared statement of the issuers is accurate.<sup>114</sup> Given that the scope of the due diligence and risk assessment is quite limited, it is doubtful if such limited due diligence and risk assessment would be helpful to sniff out any potential fraud or other systemic abuse.<sup>115</sup> The scope of the due diligence and risk assessment in the Guidelines is wide without specific details.<sup>116</sup> Thus, it could give room for different interpretations that may lead to inconsistencies in application amongst platforms.

It is worrying that such widely drafted provisions might leave too much discretion on the operator to determine the sufficiency of the due diligence or the risk assessment requirements. It also means that such provisions rely heavily on market-driven incentives to compel platforms to conduct high-quality background checks and enforce effective disclosure.<sup>117</sup> However, researchers warn that instead of imposing strict regulations, platform operators tend to take a lax approach in enforcing the due diligence or risk assessment requirements to attract more issuers to raise funds via the platform.<sup>118</sup>

### *Disclosure Obligations*

The ECF and P2P operators are obliged to display the disclosure documents of the issuers on their platform and make sure that the documents are readily accessible to investors.<sup>119</sup> In addition, the operators must also disclose their method and procedure to the investors for their investment decisions.<sup>120</sup> For instance, the platforms may set up communication channels, discussion boards, or forums to

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<sup>114</sup> ASEAN Secretariat, "Facilitating Equity Crowdfunding in The Asean Region," 106.

<sup>115</sup> Ibid, 109.

<sup>116</sup> Guidelines, paras 13.05 and 14.06.

<sup>117</sup> Nathan Rose, "The 2016 International State of Play of Retail Equity Crowdfunding," Crowdfund Inside, February 21, 2016, <https://www.crowdfundinsider.com/2016/02/81584-the-2016-international-state-of-play-of-retail-equity-crowdfunding/>.

<sup>118</sup> ASEAN Secretariat, "Facilitating Equity Crowdfunding in The Asean Region," 109.

<sup>119</sup> Guidelines, paras 13.04(b), 13.23(a), 14.5 (c) and 14.31 (a).

<sup>120</sup> Ibid, paras 13.23 (b) and 14.31 (b).

allow investors to exchange opinions about the offerings. This could be ‘an important complementary information source’ for investors.<sup>121</sup> In addition, the P2P operators would need to disclose other context-specific information relevant to the investment notes namely the risk scoring mechanism of the investment notes, the defaulting criteria of the notes as well as the statistics on the issuer’s default rate.<sup>122</sup> Such disclosure requirement is paramount to ensure the transparency, investor protection, and monitoring of the crowdfunding markets.<sup>123</sup>

### *Monitoring & Oversight Duties*

The ECF and P2P operators are also required to put in place procedures or policies to constantly monitor the market and its compliance with the SC’s rules, directions, and guidelines.<sup>124</sup> Apart from that, the platform operators are obliged to conduct an investor education program and have appropriate infrastructures in place to satisfy the anti-money laundering/counter-terrorism financing requirement.<sup>125</sup>

Importantly, the Guidelines also demand the ECF operators perform certain oversight duties, such as the duty to inform investors if there are any material adverse changes to the issuer’s proposal; the duty to ensure the compliance of the fundraising limit of the issuer; and the duty to ensure the investment cap of the investors is not breached.<sup>126</sup> Similarly, the P2P operators also need to monitor the issuer’s proposal and inform investors if they notice any material adverse change on such a proposal.<sup>127</sup> Besides that, the P2P platform

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<sup>121</sup> Simon Kleinert and Christine Volkmann, “Equity Crowdfunding and the Role of Investor Discussion Boards,” *Venture Capital: An International Journal of Entrepreneurial Finance* 21, no. 4 (2019): 327-329 and 345.

<sup>122</sup> Guidelines, para 13.31.

<sup>123</sup> Mushera Ambaras Khan and Mohd Radhuan Arif bin Zakaria, “An Analysis on the Legal Framework for Disclosure in Prospectus and the Standard of Disclosure in Determining Takeovers and Mergers Activities Post IPO,” *International Journal of Business and Society* 21, no. S1 (2020): 20.

<sup>124</sup> Guidelines, ch. 6.

<sup>125</sup> *Ibid*, paras 6.01 (h) and (i).

<sup>126</sup> Guidelines, paras 13.04 (c) -(e).

<sup>127</sup> *Ibid*, para 14.05 (d).

operators are also required to assume certain monitoring roles and the need to maintain a risk scoring system for investment notes.<sup>128</sup> They must also put in place procedures and policies to deal with the issuer's default, and set interest rates on the investment notes pursuant to SC's direction.<sup>129</sup>

### *Trust Account*

Both the ECF and P2P operators are required to maintain records of the investors' funds that are being held by them.<sup>130</sup> On top of that, the ECF and P2P operators must also maintain at least one trust account with a licensed banking or financial institution to hold the investors' monies raised in relation to hosting at their platform,<sup>131</sup> and in the context of P2P, the operators also need to create at least one more separate trust account for the purposes of holding the funds received as repayment to investors.<sup>132</sup> Also, such trust accounts must be managed by an independent registered trustee<sup>133</sup> and the investors' fund shall only be released to issuers if some conditions precedent is fully satisfied.<sup>134</sup>

Since the investors' funds are placed in the trust account, the platform operators cannot simply deal with the fund except it is in accordance with the Guidelines and the agreements between the platform, issuers, and investors (Agreements). As long as the Guidelines and the conditions precedent set out in the Agreements are not fulfilled, the fund technically still belonged to the investors.<sup>135</sup>

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<sup>128</sup> Ibid, paras 14.24-14.26.

<sup>129</sup> Ibid, paras 14.05 (a), (e) and (f).

<sup>130</sup> Ibid, paras 13.06 and 14.07.

<sup>131</sup> Ibid, paras 13.08 (a) and 14.09 (a); See also, Meriem Arif, "Malaysia's Equity Crowdfunding: The 4 Players," *Ethis*, January 7, 2020, <https://blog.ethis.co/malaysia-equity-crowdfunding/>.

<sup>132</sup> Guidelines, para 14.14 (a).

<sup>133</sup> Ibid, paras 13.08(b), 14.09(b) and 14.14(b); See also, Graham Virgo, *The Principles of Equity & Trusts*, 4th ed. (Oxford, United Kingdom: Oxford University Press, 2020) 337-359, 363-397 and 398-426.

<sup>134</sup> Guidelines, paras 13.08(c), 14.10 and 14.15.

<sup>135</sup> Samantha J Hepburn, *Principles of Equity and Trusts*, 2nd (New South Wales, Australia: Cavendish Publishing (Australia) Pty Ltd, 2001) 263-264, 265, 271 and 335-358; Sarah Wilson, Todd & Wilson's Textbook

Such a mechanism is to safeguard investors as the platforms must return the fund if the conditions precedent cannot be fulfilled.<sup>136</sup>

The conditions precedent is not exhaustive. In other words, the platform operators may impose extra conditions in the investor's interest before releasing the funds.<sup>137</sup> Upon examination, the mandatory trust account requirements seem to be consistent with the ECF and P2P operators' overall regulatory mandate is to protect the funds from any conversion or misappropriation by the platforms' managers.<sup>138</sup>

### *Keeping the Fund Raised*

In the case of ECF platforms, the fund raised from a campaign can be released to the issuers only if the target amount has been successfully met.<sup>139</sup> The SC has imposed this condition precedent based on the all-or-nothing model (AON), rather than the keep-in-all model which allows issuers to keep whatever sum raised.<sup>140</sup> This is because the AON model provides better assurance that issuers will have a stronger financial position to begin and realise their plans.<sup>141</sup> Meanwhile, the SC also adopted a similar regulatory approach on P2P. The issuer only can receive the amount raised if it has hit at least 80 per centum of the target sum.<sup>142</sup>

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on Trusts & Equity, 12th ed. (Oxford, United Kingdom: Oxford University Press, 2015) 1-25 and 444 and 474.

<sup>136</sup> Securities Commission Malaysia, "SC Releases New Guidelines To Facilitate Equity Crowdfunding," press release, February 10, 2015 issued, <https://www.sc.com.my/resources/media-releases-and-announcements/sc-releases-new-guidelines-to-facilitate-equity-crowdfunding>.

<sup>137</sup> Guidelines, paras 13.10 and 14.13.

<sup>138</sup> Ibid, paras 13.07 and 14.08.

<sup>139</sup> Ibid, para 13.08 (c) (i).

<sup>140</sup> Douglas J. Cumming, Gaël Leboeuf, and Armin Schwienbacher, "Crowdfunding Models: Keep-It-All vs. All-Or-Nothing," *Financial Management* 49, no. 2 (2019): 331-335.

<sup>141</sup> Securities Commission Malaysia, "Proposed Regulatory Framework for Equity Crowdfunding, Public Consultation Paper No.2/2014," 12-13.

<sup>142</sup> Guidelines, para 14.27.

### *Conflicts Of Interest*

Conflicts of interest can arise if a financial service provider is serving multiple interests with similar objectives.<sup>143</sup> Such conflicts of interest may also encourage the misuse of information needed for the effective functioning of financial markets.<sup>144</sup> Hence, it is common that regulators would have a framework to deal with the risks of conflicts of interest.

In both ECF and P2P, the Guidelines have imposed obligations on the operators to manage conflict of interest and such obligations are extremely critical to ensure that ‘the platform operators, as a facilitator between the issuers and investors, would not compromise its impartiality in treating the issuers and the investors.’<sup>145</sup> The conflict management regulations may help to ameliorate unwanted risks from conflicts of interest, preserve the integrity of crowdfunding markets and foster public confidence in such markets. These benefits will then translate into the rapid development of the crowdfunding markets in the long run.

To address the risks of the conflict of interest, the SC has taken the step to ban the ECF and P2P operators from directly and indirectly providing any form of financial assistance to the investors.<sup>146</sup> This approach appears to be the regulator’s endeavour to ensure that the platform’s duties to safeguard the interest of the investors and self-regulation will not be clouded by other kinds of interests.<sup>147</sup>

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<sup>143</sup> Kelly-Ann McHugh, “Conflict of Interest: Examples in Financial Services and More,” MyComplianceOffice, July 30, 2020, <https://mco.mycomplianceoffice.com/blog/conflicts-of-interest>.

<sup>144</sup> Andrew Crockett et al., “Conflicts of Interest in the Financial Services Industry: What Should We Do About Them?” (Geneva, Switzerland: Centre for Economic Policy Research, 2004), 5-6.

<sup>145</sup> Securities Commission Malaysia, “Proposed Regulatory Framework for Equity Crowdfunding, Public Consultation Paper No.2/2014,” 16-17.

<sup>146</sup> Guidelines, paras 13.13 and 14.16.

<sup>147</sup> Themis Trading LLC, “Stock Exchange Conflicts of Interests,” Themis Trading LLC, February 10, 2017, <https://blog.themistrading.com/2017/02/stock-exchange-conflicts-of-interests/>; George S. Dallas, “Stock Exchanges and Shareholder Rights: A Race to the Top, Not the Bottom?” Harvard Law School Forum on Corporate Governance, December 28, 2018,

In contrast with some other jurisdictions, Malaysia's crowdfunding regulation permits the ECF platform operators to invest in the campaigns of the issuers subject to the conditions in the Guidelines.<sup>148</sup> It appears that the SC has taken cognisance of the nature of the ECF practices whereby the platform operators usually do not assume a totally impartial role because they may need to be more proactive. Therefore, like venture capitalists, they take some stake in the issuers to send some positive signals and boost the public confidence in the issuers. The ECF operators are therefore permitted to acquire shares of the issuers hosted at their platforms.<sup>149</sup> This creates a 'win-win' situation because most start-ups or SMEs issuers lack the cash flow to pay for the services of the platform.<sup>150</sup>

To avoid the risk of conflicts of interest, ECF operators and their directors or shareholders can only hold shares provided that it cannot be more than 30 per centum. This must be followed by public disclosure about their shareholding.<sup>151</sup> Moreover, ECF operators also need to disclose to the public if they have paid any referrer for introducing issuers to their platform or accepted any form of payment from the issuers operating on the platform.<sup>152</sup>

In the case of P2P operators, the SC has taken a slightly stringent approach to control conflicts of interest. It appears that the Malaysian regulator adopts the general position that the platform *per se* shall be neutral and impartial to instill public confidence in the P2P markets. Hence, the Guidelines prohibit the operators from investing in the issuers offering investment notes via their platform.<sup>153</sup> The 'green-light' is only given to the platform officers to invest in those issuers on the condition that the platforms must have an appropriate mechanism to manage conflict of interest.<sup>154</sup>

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<https://corpgov.law.harvard.edu/2018/12/28/stock-exchanges-and-shareholder-rights-a-race-to-the-top-not-the-bottom/>.

<sup>148</sup> Guidelines, paras 13.11 and 13.12.

<sup>149</sup> Securities Commission Malaysia, "Proposed Regulatory Framework for Equity Crowdfunding, Public Response Paper No. 2/2014" 10-12.

<sup>150</sup> *Ibid*, 16-17.

<sup>151</sup> Guidelines, paras 13.11 and 13.12; See also, ASEAN Secretariat, "Facilitating Equity Crowdfunding in The Asean Region," 119.

<sup>152</sup> Guidelines, para 13.11(b).

<sup>153</sup> *Ibid*, para 14.17.

<sup>154</sup> *Ibid*, para 14.18.



## Secondary Markets

There are concerns that the lack of secondary markets for financial assets or interests acquired from the crowdfunding platform will present liquidity risks to the investors.<sup>155</sup> Hence, the SC has recently decided to allow the ECF and P2P operators to operate a secondary market to enable the trading of the issuers' shares and investment notes provided that the operators have first obtained the SC's approval to run a secondary market.<sup>156</sup> Such secondary markets are most welcomed as it offers an avenue for investors to realise the value of the shares or investment notes easily.<sup>157</sup> However, there are some concerns that the secondary markets for these crowdfunding-related asset classes may be susceptible to the risks of systemic abuse, and speculations.<sup>158</sup>

Hence, the SC seeks to mitigate these risks by requiring ECF and P2P operators to comply with additional requirements for operating the secondary markets like their securities exchange counterparts. Such additional requirements, amongst other things, aim to ensure fair trading,<sup>159</sup> fair access to the secondary markets<sup>160</sup> disclosure of order types in the market structure<sup>161</sup> sufficient

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<sup>155</sup> Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy*, 2nd ed. (Oxford, United Kingdom: Hart Publishing Ltd, 2015) 519-521.

<sup>156</sup> Muhammed Ahmad Hamdan, "SC Lifts Equity Crowdfunding Fundraising Limit," *The Edge Markets*, April 16, 2020, <https://www.theedgemarkets.com/article/sc-lifts-equity-crowdfunding-fundraising-limit>.

<sup>157</sup> Chad Willbur, "Secondary Market Liquidity and Fair Market Value," *Carta*, December 17, 2020, <https://carta.com/blog/secondary-market-liquidity-and-fair-market-value/>; See also, Tan Zhai Yun, "Platforms: Secondary Market Can Increase Attractiveness of P2P Financing as an Asset Class," *The Edge Markets*, May 11, 2020, <https://www.theedgemarkets.com/article/platforms-secondary-market-can-increase-attractiveness-p2p-financing-asset-class>.

<sup>158</sup> Khairani Afifi Noordin, "Industry: Secondary Market to Help Grow ECF Participation," *The Edge Markets*, February 3, 2017, <https://www.theedgemarkets.com/article/industry-secondary-market-help-grow-ecf-participation>.

<sup>159</sup> Guidelines, paras 13.30(a) and 14.36 (a).

<sup>160</sup> *Ibid*, paras 13.30(b) and 14.36(b).

<sup>161</sup> *Ibid*, paras 13.30(c) and 14.36(c).

resources by operators have sufficient resources to operate in the secondary markets;<sup>162</sup> and the operators' arrangements for self-regulation and market oversight.<sup>163</sup> Further, there are more detailed requirements governing trading operations and market transparency of secondary markets.<sup>164</sup>

Specifically, the Guidelines require the ECF and P2P operators to put in place an 'orderly, clear and efficient clearing and settlement procedure'<sup>165</sup> to support the smooth operation of the secondary markets of crowdfunding securities. Besides, the crowdfunding regulation in Malaysia also demands the operators to make sure that the final settlement of every transaction must be by end of the value date, intra-day, or real-time.<sup>166</sup> Also, ECF and P2P operators who run a secondary market must set out effective risk-management frameworks to deal with operational risks.<sup>167</sup> Such risk management requirements are mainly to ensure 'the security and operational reliability of the system for secondary markets.'<sup>168</sup>

The regulatory frameworks to establish the secondary market shall be received with open arms as it can address the liquidity risks of the securities acquired from crowdfunding. It will also provide an effective avenue for the investors to exit the company and realise some gains.<sup>169</sup> Upon cursory appraisal, the combinations of requirements in the Guidelines are robust and cover many facets of the securities trading and the operation of the secondary market. It appears to be effective to prevent market abuse and ease the supervision and compliance of the operators.

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<sup>162</sup> Ibid, paras 13.30(e) and 14.36(f).

<sup>163</sup> Ibid, paras 13.30(f) and 14.36(g).

<sup>164</sup> Ibid, paras 13.32-13.33 and 14.38-14.39.

<sup>165</sup> Ibid, paras 13.34 and 14.40.

<sup>166</sup> Ibid, paras 13.35 and 14.41.

<sup>167</sup> Guidelines, paras 13.36-13.37 and 14.42-14.43.

<sup>168</sup> Ibid, paras 13.36 and 14.42.

<sup>169</sup> Oliver Christopher Gomez, "Investing: The ECF Growth Story," *The Edge Markets*, February 11, 2020, <https://www.theedgemarkets.com/article/investing-ecf-growth-story>; Iris H-Y Chiu, "Decoupling Tokens from Trading: Reaching beyond Investment Regulation for Regulatory Policy in Initial Coin Offerings," *International Business Law Journal* 2018, no. 3 (2018): 271-272.

## Issuers

The Malaysian crowdfunding regulations have imposed certain restrictions and requirements on issuers who intend to raise funds via the issuance of shares or investment notes. These are discussed below.

## Restrictions

### Eligibility of Issuers

The Guidelines only permit the locally incorporated entities to participate in the crowdfunding process. For ECF, only the private company and limited liability partnership (LLP) may avail themselves of this alternative financing method to raise funds from the public.<sup>170</sup> On the other hand, the SC allows more types of locally incorporated entities to utilise the P2P platform. They include sole proprietor, partnership, LLP, a private company, and an unlisted public company.<sup>171</sup> In a recent amendment to the Guidelines, a new power is vested on the SC to allow other types of permitted issuers to participate in the P2P activities.<sup>172</sup> It is uncertain whether the SC will use this new power to allow a foreign entity to use the crowdfunding platform.

It is interesting to note that the SC allows the ECF platform to host micro-fund provided that: the micro-fund is registered with the SC as a venture capital company, it has specified investment goal and only raise funds from sophisticated investors and angel investors.<sup>173</sup> This regulation should be accepted with applause because it allows the platform to serve another group of customers within the same facility, infrastructure, and system.

Furthermore, the SC has restricted certain entities from using the ECF platform. They are: companies with financially complex structures; public-listed companies including their subsidiaries; companies that have no specific business plan or operate blind pool; companies that propose to raise funds to invest in or offer loans to

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<sup>170</sup> Guidelines, para 13.14.

<sup>171</sup> Ibid, para 14.19 (a).

<sup>172</sup> Ibid, para 14.19 (b).

<sup>173</sup> Ibid, para 13.18.

other entities; companies with paid-up capital exceeding RM10 million; and other entities to be specified by the SC. Also, it is noteworthy that restrictions on paid-up capital exceeding RM10 million does not apply to micro-fund.<sup>174</sup> In the case of P2P, the categories of entities prohibited from offering on the P2P platform are highly similar to those in the ECF.<sup>175</sup>

Under the company laws, there are restrictions on private companies from the offering, transfer of shares,<sup>176</sup> or debentures to the public<sup>177</sup>. Similarly, private companies should not be allowed to use crowdfunding in the general context. Nevertheless, the issuance of the private company's shares or investment notes to the public through the ECF and P2P platform is permitted, by virtue of the exemption granted under the CA 2016.<sup>178</sup> Besides that, the CA 2016 also dictates that private limited companies cannot have more than 50 non-employee shareholders.<sup>179</sup> This restriction can be overcome by using the nominee structure without contravening the existing law.<sup>180</sup> The nominee structure is a viable solution because the existing company laws do not set a limit on the maximum number of nominees a shareholder may appoint. Meanwhile, it can be argued that the existing crowdfunding regulation is a 'safe harbour' to the full application of the CMSA 2007. The issuance of debt or equity in the crowdfunding platform does not need a prospectus and approval of the SC.<sup>181</sup>

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<sup>174</sup> Guidelines, para 13.15.

<sup>175</sup> Ibid, para 14.20.

<sup>176</sup> CA 2016, s. 42(2); See, Steve Kourabas and Ian Ramsay, "Equity Crowdfunding in Malaysia," 193.

<sup>177</sup> CA 2016, s. 43; See also, Kenneth Foo Poh Khean and Lee Shih, Companies Act 2016: The New Dynamics of Company Law in Malaysia (Selangor, Malaysia: The Malaysian Current Law Journal SdnBhd, 2018) 5-7.

<sup>178</sup> CA 2016, s. 43(3)(c).

<sup>179</sup> Ibid, ss. 42(1) and (3).

<sup>180</sup> Ying Hu, "Regulation of Equity Crowdfunding in Singapore," Singapore Journal of Legal Studies 46 (2015): 70-71.

<sup>181</sup> CMSA 2007, s. 212 and pt VI, div 3.

## Financing Limit and Rules on Multiple Listing

Under the previous regime, the SC has imposed a yearly limit of RM3 million and an overall limit of RM5 million for the amount of fund an issuer can raise from ECF.<sup>182</sup> As a result of further liberalisation, the yearly capital raising limit of RM3 million was lifted and the overall fundraising is now increased to RM10 million.<sup>183</sup> The imposition of the fundraising cap on the ECF is justified because this alternative financing method is mainly aimed to provide the ‘seed capital’ at the project onset or to allow the SMEs/start-ups to prove their idea.<sup>184</sup> The SMEs and start-ups would eventually need to rely on traditional financial institutions, venture capitalists, or angel investors to fund the next phase of their venture.<sup>185</sup> RM10 million is believed to be adequate to serve as the ‘seed monies’ for a business.

Conversely, it is noteworthy that the SC has taken a different approach in regulating the P2P markets for which the Guidelines generally do not impose any fundraising limit on the issuers hosted on the P2P platform. Furthermore, such a fundraising cap does not apply to micro-fund hosted in the ECF platform.<sup>186</sup> It appears reasonable to subject the micro-fund to no cap and allow it to operate as freely as possible. This is because micro-fund can only accept investment from sophisticated investors and angel investors who have more resources to evaluate and cope with risks, unlike retail investors. On the other hand, venture capitalists generally require large fund infusions. The fundraising cap may reduce their incentives to raise funding via the ECF platform and prevent the platform from realising its full potential as an effective medium to connect capital with opportunity.

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<sup>182</sup> Securities Commission Malaysia, “Guidelines on Recognized Markets,” (SC-GL/6-2015(R3-2019)) (2015) (“Previous Guidelines”), para 13.19.

<sup>183</sup> Guidelines, para 13.19.

<sup>184</sup> ASEAN Secretariat, “Facilitating Equity Crowdfunding in The Asean Region,” 133; See also, Blair Bowman, “A Comparative Analysis of Crowdfunding Regulation in the United States and Italy,” *Wisconsin International Law Journal* 33, no. 2 (2015): 342-343; Chang-hsien Tsai, “Legal Transplantation or Legal Innovation: Equity-Crowdfunding Regulation in Taiwan after Title III of the U.S. Jobs Act,” *Boston University International Law Journal* 34, no. 2 (2016): 277.

<sup>185</sup> Securities Industry Development Corporation, “Digital Disruption”, 8.

<sup>186</sup> Guidelines, para 13.20.

While the Guidelines are silent about oversubscription, the SC appears to permit issuers to keep any oversubscription, provided that the issuers have effectively disclosed the investment plan to the investors.<sup>187</sup> Conversely, the SC takes a different approach in regulating the P2P market in which the issuers will not be allowed to keep any oversubscriptions.<sup>188</sup>

It is also noteworthy that an issuer can only offer their shares or investment notes on one ECF platform and one P2P platform concurrently at a time subject to the disclosure requirements.<sup>189</sup> Multiple offering on the same kind of platform is prohibited if it is for the same purpose.<sup>190</sup>

### Requirements and Obligations

Although the prospectus requirements do not apply to crowdfunding, issuers would still be subject to certain disclosure obligations. In both context of the ECF and P2P, issuers must lodge a standardised disclosure document comprising of minimum information as set forth by the Guidelines. The information is mainly about the issuers and must include among other things: the characteristics of the company, the purposes and the targeted amount of the funding, the business plan of the company, and the financial information.<sup>191</sup> It is mandatory for the issuers to provide their audited financial statements if they have been incorporated for 12 months, or beyond 12 months if the targeted amount of offering is above RM500,000.00.<sup>192</sup> Nonetheless, the SC accepts financial statements duly certified by the management of the issuers in lieu of an audited account if the company is newly established and when the offering value is less than RM500,000.00.<sup>193</sup>

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<sup>187</sup> Securities Commission Malaysia, “Proposed Regulatory Framework for Equity Crowdfunding, Public Response Paper No. 2/2014” 20-21.

<sup>188</sup> Guidelines, para 14.28.

<sup>189</sup> Guidelines, paras 13.17 and 14.22.

<sup>190</sup> Ibid, paras 13.16 and 14.21.

<sup>191</sup> Ibid, paras 13.21 and 14.29.

<sup>192</sup> Ibid, paras 13.21(d) (i)(A) & (ii) and 14.29 (e)(i)(A) & (ii); See also, Loo Choo Hong, “Crowdfunding: Issues Pertaining to Financial Reporting and Assurance in Malaysia,” *Journal of Wealth Management & Financial Planning* 5, no. June (2018): 21.

<sup>193</sup> Guidelines, paras 13.21(d) (i)(B) and 14.29 (e)(i)(B).

In addition to the minimum requirements above, the platform operators may impose additional disclosure requirements if they think fit.<sup>194</sup>

Furthermore, the issuers hosted on the ECF platform are also subject to ongoing disclosure requirements. These include the need to provide regular, effective, and transparent updates to their shareholders pertaining to their business progress, financial position, or other types of communication as required by the Guidelines.<sup>195</sup> In contrast, the Guidelines is silent on the ongoing disclosure requirements applicable to the issuers who raise fund via the P2P platform. For this reason, it could be argued that the issuers who obtain their borrowings through the P2P platform are not subject to the corresponding ongoing disclosure requirements as compared to their ECF counterparts.

In the spirit of disclosure or transparency regulations, the Guidelines also demand issuers to make sure that all the information disclosed to the platform operators must be true, accurate and should not contain false or misleading statements or material omissions.<sup>196</sup> This requirement is particularly important to curb fraudulent offers<sup>197</sup> and ensure that investors can make informed judgments in relation to capital allocation and performance evaluation effectively.<sup>198</sup>

It may be argued that the disclosure requirements in the Guidelines are a simplified one as compared with the comprehensive prospectus requirements for securities offering on the exchange.<sup>199</sup> Such relaxed disclosure requirements appear to be a delicate arrived

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<sup>194</sup> Securities Commission Malaysia, "Proposed Regulatory Framework for Equity Crowdfunding, Public Response Paper No. 2/2014" 22-23.

<sup>195</sup> Guidelines, para 13.24.

<sup>196</sup> Guidelines, paras 13.22 and 14.30.

<sup>197</sup> Elif Härkönen, "Crowdfunding and the Small Offering Exemption in European and US Prospectus Regulation: Striking a Balance Between Investor Protection and Access to Capital?" *European Company and Financial Law Review* 14, no. 1 (2017): 144.

<sup>198</sup> Arnold S. Jacobs, "What Is a Misleading Statement or Omission Under Rule 10b-5?" *Fordham Law Review* 42, no. 2 (1973): 248-249.

<sup>199</sup> CMSA 2007, s. 235 and 236; See Securities Commission Malaysia, "Prospectus Guidelines," (SC-GL/PG-2012 (R9-2020)) (2012); Shanti Geoffrey, *Capital Market Laws of Malaysia*, 1st ed. (Selangor, Malaysia: LexisNexis, 2010) 319-329.

decision of the SC on balancing the need for investor protection and capital formation.<sup>200</sup> This approach is also highly pragmatic because the expenses of preparing a prospectus are disproportionate to the proceeds of an offer,<sup>201</sup> especially in the case of crowdfunding. From a broader perspective, such a simplified requirement is also consistent with the general permissive approach of the Malaysian crowdfunding regulations. It helps to reduce the overall compliance costs for raising capital for the SMEs and start-ups with just enough disclosure to ensure investor protection.<sup>202</sup>

However, without sufficient empirical data and market reports, it is too early to access if such simplified disclosure requirements justify the trade-offs between the capital need of the SMEs and start-ups on one hand and the investor protection or market stability on the other hand. Also, since the regulation only requires an abridged version of the prospectus.<sup>203</sup> There are concerns that investors may not have sufficient information to fully appraise the issuers or appreciate the risks involved. Therefore, their investment may continue to be beset with herding, information asymmetry, and higher agency cost.<sup>204</sup>

Premised on the above, the disclosure requirement may have taken a back-seat. This is understandable because a stringent disclosure requirement may hinder the development of crowdfunding

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<sup>200</sup> Sebastiaan N Hooghiemstra and Kristof de Buysere, "The Perfect Regulation of Crowdfunding", 146.

<sup>201</sup> Karel Lannoo, "More Union for the EU's IPO Market," ECMI Commentary No. 41/23, 2016.

<sup>202</sup> Christian Hofmann, "An Easy Start for Start-Ups: Crowdfunding Regulation in Singapore," *Berkeley Business Law Journal* 15, no. 1 (2018): 230.

<sup>203</sup> Joseph Hogan, "Like Oil and Water: Equity Crowdfunding and Securities Regulation," *Lewis & Clark Law Review* 18, no. 4 (2014): 1099.

<sup>204</sup> Gerald Spindler, "Behavioural Finance and Investor Protection Regulations," *Journal of Consumer Policy* 34 (2011): 324-325; Pinghsun Huang and Yan Zhang, "Does Enhanced Disclosure Really Reduce Agency Costs? Evidence from the Diversion of Corporate Resources," *The Accounting Review* 87, no. 1 (2012): p. 199-204 and 223-224; Puput Tri Komalasari, "Jurnal Akuntansi Dan Keuangan Indonesia," *Jurnal Akuntansi Dan Keuangan Indonesia* 13, no. 1 (2016): 71-75 and 83.



and increase the capital costs for SMEs and start-ups. At this juncture, the simplified disclosure requirements may be able to ensure the sufficient disclosure of material information to safeguard the investors' interest while enabling the capital to be raised effectively. Furthermore, these simplified disclosure requirements, if coupled with platform operators' due diligence and background checks, will provide an extra layer of assurance in terms of the relevancy and accuracy of the information.<sup>205</sup> Nevertheless, when the crowdfunding markets become more complex and bigger in size, more comprehensive disclosure requirements would be desirable. Given that the disclosure requirement is the cornerstone of financial regulation and the vanguard of investor protection,<sup>206</sup> it is worthy for regulators to monitor closely the efficiency of this simplified disclosure requirement.

## Investors

One of the key purposes of crowdfunding regulations is protecting the investors. Hence, the SC has decided to impose investment caps on both local and overseas investors on ECF and P2P markets.<sup>207</sup> As for ECF, the regulation has classified investors into 3 separate groups with 3 different types of investment limits.<sup>208</sup> Firstly, sophisticated investors comprised of mostly institutional investors such as banks,

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<sup>205</sup> Securities Commission Malaysia, "Proposed Regulatory Framework for Equity Crowdfunding, Public Response Paper No. 2/2014" 23.

<sup>206</sup> Emiliós Avgouleas, "What Future for Disclosure as a Regulatory Technique? Lessons from Behavioural Decision Theory and the Global Financial Crisis," in *The Future of Financial Regulation*, ed. Iain G Macneil and Justin O'Brien (Portland, United States of America: Hart Publishing, 2010), 209-210; Luca Enriques and Sergio Gilotta, "Disclosure and Financial Market Regulation," in *The Oxford Handbook of Financial Regulation*, ed. Niamh Moloney, Eilís Ferran, and Jennifer Payne, 1st ed. (Oxford, United Kingdom: Oxford University Press, 2015), 512-532.

<sup>207</sup> Alexandra Horváthová, "Crowdfunding: Business and Regulatory Perspective," 740-741.

<sup>208</sup> Wan Amir Azlan Wan Haniff, Asma Hakimah Ab Halim, and Rahmah Ismail, "The Regulation of Equity Crowdfunding in United Kingdom and Malaysia: A Comparative Study," *Academic Journal of Interdisciplinary Studies* 8, no. 3 (2019): 50-51.

financial institutions, insurance companies, venture capital company, and private equity corporations do not subject to any investment limit.<sup>209</sup> Secondly, angel investors are generally high-net-worth individuals and they are subject to a maximum limit of RM500,000 per year.<sup>210</sup> Thirdly, retail investors who are nothing like sophisticated investors and angel investors are subject to the most stringent restriction in which a maximum limit of RM5,000 per issuer with a total limit of RM50,000 per year.<sup>211</sup> Apart from that, retail investors on P2P markets are not encouraged to invest more than RM50,000 on any P2P platform at any time whereas sophisticated investors or angel investors are not subject to any investment restrictions.<sup>212</sup>

The purpose of investment limits is to manage the risk exposure of the investors by preventing (retail) investors from high risk.<sup>213</sup> By setting the maximum investment limit, and discouraging investors from putting too much of their funds on a single P2P platform, the regulator is ensuring diversification of investment.<sup>214</sup>

## COMMENTS & SUGGESTIONS

From the foregoing discussion, it can be seen that crowdfunding is an important alternative financing method especially in countries with less established networks of professional investors such as venture capitalists and angel investors. This is because SMEs and start-ups may not have many available options to seek capital.<sup>215</sup> Due to the

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<sup>209</sup> Guidelines, paras 1.17 and 13.25(a).

<sup>210</sup> Ibid, paras 13.01 and 13.25 (b).

<sup>211</sup> Guidelines, para 13.25 (c).

<sup>212</sup> Ibid, paras 14.32-14.33

<sup>213</sup> Armour and Enriques, "The Promise and Perils of Crowdfunding", 76.

<sup>214</sup> Janette Rutterford and Dimitris P. Sotiropoulos, "Putting All Their Eggs in One Basket? Portfolio Diversification 1870–1902," *Accounting History Review* 26, no. 3 (2016): 285-291; Cory S Fawcett, "Don't Put All Your Easter Eggs in One Basket: Diversify," *Prescription for Financial Success*, April 18, 2019, <https://financialsuccessmd.com/dont-put-all-your-easter-eggs-in-one-basket-diversify/>.

<sup>215</sup> Lars Hornuf and Armin Schwienbacher, "Should Securities Regulation Promote Equity Crowdfunding?" *Small Business Economics* 49, no. 3 (2017): 591.

relatively small pool of professional investors in Malaysia,<sup>216</sup> it is therefore justified for the SC to exempt the crowdfunding markets from the full application of the existing securities laws. This is to ensure that it would not stop the impetus of the crowdfunding markets to serve as effective alternative financing. Although the Malaysian regulator appears to take a permissive approach, it has installed an appropriate structure to ensure investor protection. Notwithstanding that, there are some notable recommendations that should be considered by the regulator in improving the regulation of crowdfunding.

Firstly, to improve the disclosure requirement, the SC may require the issuers to have a balanced and structured disclosure in which the information of the issuers must be presented in a ‘clear and readily comprehensive’ manner.<sup>217</sup> This is mainly to assist the retail or less sophisticated investors in reaching an informed decision.<sup>218</sup> Unlike professional investors, it also helps to reduce costs for retail investors who may lack the resources and skills to analyse complex details.<sup>219</sup> Also, the regulator should have measures to ensure that only strictly necessary information is revealed to avoid information overload that may likely prejudice investors’ interests.<sup>220</sup> Furthermore, the disclosure requirements must also be designed to

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<sup>216</sup> Eliza Nor, “Venture Capitalists in Malaysia: Challenges and Future Directions,” *Journal of Business and Management Sciences* 3, no. 4 (2015): 124 and 128-129.

<sup>217</sup> Armour and Enriques, “The Promise and Perils of Crowdfunding”, 74-75.

<sup>218</sup> Zachary J Griffin, “Crowdfunding: Fleecing The American Masses,” *Journal of Law, Technology & the Internet* 4, no. 2 (2013): 383

<sup>219</sup> United States of America, Staff of the Office of Investor Education and Advocacy of the U.S. Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors*, (U.S. Securities and Exchange Commission, 2012) accessed: January 11, 2021, <https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf>.

<sup>220</sup> Julie R. Agnew and Lisa R Szykman, “Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice, and Investor Experience,” *The Journal of Behavioral Finance* 6, no. 2 (2005): 57-59; See also, Thomas M J Mollers, “Investor Protection in the System of Capital Markets Law: Legal Foundations and Outlook,” *North Carolina Journal of International Law* 36, no. 1 (2010): 67.

minimise the impacts of behavioural biases.<sup>221</sup> For instance, investors are more prone to overestimate the immediate cost and benefit and underestimate those costs and benefit accrued in the future.<sup>222</sup> It would be useful to require issuers to provide their forecast about their business on top of information pertaining to their existing status.

Secondly, the SC should impose a policy to encourage partnerships between professional/sophisticated investors and the platform.<sup>223</sup> Given that the professional/sophisticated investors are well-equipped with the required expertise to perform the business proposal screening and due diligence,<sup>224</sup> the platform is encouraged to engage them to develop methodology in sieving out offerings that are not proper or risky. This is a way to improve the due diligence or risk management mechanism of the platform without changing or amending the existing regulations. Meanwhile, there is also a strong business case for leveraging such partnership because professional/sophisticated investors could directly or indirectly share their resources, connection,<sup>225</sup> and business intelligence to the platform. This may ultimately improve the success rate of the offerings and help the platform to scale. Furthermore, this partnership will also help to mitigate the concerns about price formation and price information by inviting such professional/sophisticated investors to

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<sup>221</sup> Kristine Erta et al., "Applying Behavioural Economics at the Financial Conduct Authority," *Financial Conduct Authority Occasional Paper No.1*, 2013, 4-10 and 14-20.

<sup>222</sup> Armour and Enriques, "The Promise and Perils of Crowdfunding", 72-73.

<sup>223</sup> Yexia Zhang and Zhi Chen, "The Future Development of Crowdfunding Industry in China," in *Financing from Masses: Crowdfunding in China*, ed. Jiazhao G Wang et al. (Gateway East, Singapore: Springer Nature Singapore Pte Ltd., 2018), 142.

<sup>224</sup> Musibau Akintunde Ajagbe and Kamariah Ismail, "Venture Capital in Malaysia: A Case Study of Malaysian Venture Capital Berhad (MAVCAP)," *Australian Journal of Basic and Applied Sciences* 7, no. 10 (2013): 369-370; See also, Darian M Ibrahim, "Equity Crowdfunding: A Market for Lemons," *Minnesota Law Review* 100, no. 2 (2015): 575-576.

<sup>225</sup> Silvio Vismara, "Equity Retention and Social Network Theory in Equity Crowdfunding," *Small Business Economics* 46, no. 4 (2016): 587-588.

take part in the price determination process of the share or investment notes before offering such securities to the public.<sup>226</sup>

Thirdly, the widely worded due diligence/risk management requirements may lack the necessary details to guide the platform operators and could lead to inconsistency in terms of implementation. The SC could overcome this issue by requiring platform operators to come out with a technical code of practice setting out the standardised criteria and procedure concerning the due diligence/risk management requirements. Such technical code can incorporate other best practices of the crowdfunding industry to serve as a standard to be observed by the ECF and P2P operators.<sup>227</sup> As a soft law, it could supplement the existing SC regulations.<sup>228</sup>

The fourth suggestion borders on investor protection. The Guidelines provide investor protection through a compulsory entry knowledge test to retail investors before they are permitted to open an account with the platform.<sup>229</sup> This is to ensure that retail investors can have a better understanding of the risks of crowdfunding investment. To improve the platforms' 'know-your-client' rules, the regulations shall also dictate all investors must provide sufficient information for the platform to categorise them. In particular, the sophisticated and angel investors need to furnish the necessary supporting documents to the platform for verification purposes.<sup>230</sup> Such an improved 'know-

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<sup>226</sup> Armour and Enriques, "The Promise and Perils of Crowdfunding", 82-84.

<sup>227</sup> Theresa Tan, "Crowdfunding Platforms to Have Code of Practice," *The Straits Times*, December 31, 2017, <https://www.straitstimes.com/singapore/crowdfunding-platforms-to-have-code-of-practice>; See also, John Kong Shan Ho, "Regulating Equity Crowdfunding in Hong Kong", 329.

<sup>228</sup> Tadeusz Gruchalla-Wesierski, "A Framework for Understanding 'Soft Law'," *McGill Law Journal* 30, no. 1 (1984): 39-59 and 86-88; Roberta S. Karmel and Claire R. Kelly, "The Hardening of Soft Law in Securities Regulation," *Brooklyn Journal of International Law* 34, no. 3 (2009): 884-886 and 927-930.

<sup>229</sup> Emma Radmore, Caroline Stevenson, and Amelia Green, "EU Crowdfunding Regulation – Investor Protection Aspects," *Womble Bond Dickinson*, May 27, 2020, <https://www.womblebond Dickinson.com/uk/insights/articles-and-briefings/eu-crowdfunding-regulation-investor-protection-aspects>.

<sup>230</sup> *Ibid.*

your-client' policy<sup>231</sup> may also allow the platform operators to perform their oversight duties more effectively as they can develop targeted supervisory frameworks based on the categories of the investors.

The fifth suggestion is on regulatory oversight. The crowdfunding regulations should strengthen the oversight and policing roles of the platform for a fair and orderly market.<sup>232</sup> Some researchers argue that ECF and P2P operators should be given the explicit duties to deny issuers to be hosted on their platform if the operators have 'reason to believe that the issuer has or is likely to abuse the system or deceptive conducts.'<sup>233</sup> In crowdfunding, investors generally have dispersed shareholding and lack of control rights on the companies as compared to the case of venture capitalists or angel investors.<sup>234</sup> To mitigate this concern, the platform may need to assume the advocacy role. This will help to improve the corporate governance of the issuers, *inter alia*, by encouraging the investors to negotiate for contractual protections such as pre-emption rights and the shareholders' awareness and education.<sup>235</sup>

Another suggestion affects tax incentives. Such incentives should be given to issuers who use the crowdfunding platform to raise funds so that they can enjoy tax deductions on corporate tax and

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<sup>231</sup> Rainer Lenz, "Peer-to-Peer Lending: Opportunities and Risks," *European Journal of Risk Regulation* 7, no. 4 (2016): 699, <https://doi.org/10.1017/S1867299X00010126>.

<sup>232</sup> Andrew A Schwartz, "The Gatekeepers of Crowdfunding," *Washington and Lee Law Review* 75, no. 2 (2018): 888, 890-891, 931-934 and 950.

<sup>233</sup> Alma Pekmezovic and Gordon Walker, "The Global Significance of Crowdfunding: Solving the SME Funding Problem and Democratizing Access to Capital," *William & Mary Business Law Review* 7, no. 2 (2016): 455.

<sup>234</sup> Jules, "A No-Holds-Barred Take on the Pros and Cons of Crowdfunding," *easyship*, April 10, 2020, <https://www.easyship.com/blog/pros-and-cons-of-crowdfunding>; Lars Hornuf, Tobias Schilling, and Armin Schwenbacher, "The Relevance of Investor Rights in Equity Crowdfunding 16 Apr 2020," *Oxford Business Law Blog*, April 16, 2020, <https://www.law.ox.ac.uk/business-law-blog/blog/2020/04/relevance-investor-rights-equity-crowdfunding>.

<sup>235</sup> Cody R Friesz, "Crowdfunding & Investor Education: Empowering Investors To Mitigate Risk & Prevent Fraud," *Suffolk University Law Review* 48, no. 1 (2015): 141-150.

capital gain tax.<sup>236</sup> Also, investors in crowdfunding should be able to enjoy tax relief to compensate them for taking higher risks in investing in the SMEs and start-ups.<sup>237</sup> Such tax relief could motivate investors. The government should also offer more financial supports to issuers if they manage to put forward a high-quality business proposal or partake in works that promote the industrial revolution 4.0,<sup>238</sup> through accelerator programmes.<sup>239</sup>

Lastly, crowdfunding markets are growing very rapidly. The SC should maintain a tight feedback loop with the industrial players,<sup>240</sup> take note of the latest development of the crowdfunding regulations across the globe and conduct periodic reviews on the existing crowdfunding framework. This is to ensure the effectiveness and relevancy of the regulations. The Malaysian regulator should also monitor closely and audit the compliance to the Guidelines by the platform operators. This can be achieved through the wider adoption of regulatory technologies (RegTech).<sup>241</sup> Proportionate sanctions shall be imposed to deter non-compliance and abuses of the system.<sup>242</sup>

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<sup>236</sup> Wan Amir Azlan Wan Haniff, Asma Hakimah Ab Halim, and Rahmah Ismail, "The Regulation of Equity Crowdfunding in United Kingdom and Malaysia," 51-52 and 54.

<sup>237</sup> Antonella Francesca Cicchiello, Francesca Battaglia and Stefano Monferrà, "Crowdfunding Tax Incentives in Europe: a Comparative Analysis," *The European Journal of Finance* 25, no. 18 (2019): 1862-1878.

<sup>238</sup> Simon Karl Hubert Backhaus and Devika Nadarajah, "Investigating the Relationship between Industry 4.0 and Productivity: A Conceptual Framework for Malaysian Manufacturing Firms," *Procedia Computer Science* 161 (2019): 697; Yong Man Ling, Nor Aziati binti Abdul Hamid and Lee TeChuan, "Is Malaysia Ready for Industry 4.0? Issues and Challenges in Manufacturing Industry," *The International Journal of Integrated Engineering* 12, no. 7 (2020): 134-137.

<sup>239</sup> Ben Lim, "Complete List of Top Startup Accelerators in Malaysia," Nexea, November 6, 2018, <https://www.nexea.co/complete-list-top-startup-accelerators-malaysia/>.

<sup>240</sup> Securities Industry Development Corporation, "Digital Disruption", 8.

<sup>241</sup> Douglas W Arner and Janos Barberis and Ross P Buckley, "The Evolution of FinTech: A New Post-Crisis Paradigm," *Georgetown Journal of International Law* 47, no. 4 (2016): 1306-1318; See also, Stefan Zeranski and Ibrahim E Sancak, "Digitalisation of Financial

## CONCLUSION

Crowdfunding is believed to be a useful alternative financing method for SMEs and start-ups as it helps the capital formation and bridges the financing gaps for them. However, its associated risks cannot be underestimated.<sup>243</sup> Therefore, crowdfunding regulations should aim to provide accessible and cost-effective finance for SMEs and start-ups. At the same time, the regulation should provide (retail) investors with appropriate protections and reduce systemic risks. Although some researchers propound that those stringent regulations may stifle the potential of crowdfunding, a lack of sufficient regulations could be more damaging as the crowdfunding markets could be more susceptible to abuse and fraudulent conduct. If such issues persist, investors will eventually lose their confidence in crowdfunding and take their investment elsewhere which could bring about the collapse of this alternative finance.<sup>244</sup> Hence, appropriate investor protections are always necessary for investors' participation and market growth.

The Malaysian regulator has attempted to balance among all the crucial regulatory goal accessible alternative finance, investor protection, and a fair and orderly market. The Guidelines of the regulator exhibit the carefully crafted and balanced regulations on crowdfunding. Despite that, there is room for improvement. Suggestions are therefore expounded above for the consideration of the regulators and all stakeholders. Countless benefits could be offered to the society and economy at large. On this note, multidisciplinary studies and constant research on the Malaysian

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Supervision with Supervisory Technology (SupTech)," *Journal of International Banking Law and Regulation* 35, no. 8 (2020): 310-314.

<sup>242</sup> Rüdiger Veil, "European Capital Markets Law," in *European Capital Markets Law*, ed. Rüdiger Veil, 2nd Edition (Oxford, United Kingdom: Hart Publishing, 2017), 170-179.

<sup>243</sup> Maya Puspa Rahman, Mohamed Asmy Mohd ThasThaker and JaritaDuasa, "Developing a Shari'ah-Compliant Equity-Based Crowdfunding Framework for Entrepreneurship Development in Malaysia," *ISRA International Journal of Islamic Finance* 12, no. 2 (2020): 242.

<sup>244</sup> Australia, Corporations and Markets Advisory Committee, *Crowd Sourced Equity Funding Report*, (Sydney: Corporations and Markets Advisory Committee, 2014) accessed: February 11, 2021, 5-7 and 18-20, <https://www.camac.gov.au/camac/camac.nsf/byheadline/reportsfinal+reports+home.html>.



crowdfunding markets are much needed to help to refine crowdfunding regulations.