



Equity Crowdfunding: A Funding Alternative for Pakistani Start-ups and MSMEs

1. The Concept of Crowdfunding: How Does it Work?

The term ‘crowdfunding’ corresponds to the idea of soliciting small amounts of funding from an expanded pool of eligible investors, often including the general public. This funding methodology involves greater use of technology — the project/idea that needs to be funded is publicised over a digital platform, tapping a wide and diverse range of qualifying internet users to gain financial support. Over the last decade, advances in technology and the concept of a ‘shared economy’ that emerged in the aftermath of the 2008 financial crisis have revolutionised the global financial landscape, largely to address difficulties faced by entrepreneurs, early-stage enterprises, and micro, small and medium enterprises (MSMEs) in raising growth capital.

Approximately 70% of all MSMEs in emerging markets lack access to credit¹. The situation is exacerbated by stringent collateral requirements, strict financing covenants, and extensive lending conditions and documentation requirements, hence restricting enterprises’ access to formal lending channels. Access to formal financial credit is even more difficult for start-ups with no previous history of sustained cashflows or integrity-related parameters, including reports from credit information bureaus. In this context, using digital infrastructure to channel funds from retail and institutional investors to provide liquidity and capital support to emerging entities, especially MSMEs and start-ups, can unlock significant economic advantages.

Crowdfunding campaigns can be further divided into three categories i) equity crowdfunding (ECF); ii) debt-based crowdfunding; iii) non-investment crowdfunding, i.e. donation-based and reward-based campaigns. The categorisation is broadly based on the type of return one can expect for one’s contribution to such campaigns. ECF refers to a campaign where the issuing entity raises funds for a specific project against the issuance of equity securities to accredited investors. Crowdfunder, AngellList, CircleUp, and PeerRealty are a few prominent crowdfunding platforms dealing with this type of funding.

Debt-based campaigns involve interest-based, peer-to-peer (P2P) consumer lending (individuals extending unsecured loans to a consumer borrower), peer-to-business (P2B) business lending (individuals extending unsecured loans to fundraising entrepreneurs or MSMEs), P2P property lending (individuals extending loans secured against property), business-to-business (B2B) lending and mini-bonds². The idea is very similar to traditional borrowing. However, this methodology allows the issuing entity access to a larger base of retail clients. One other emergent model within the debt-based category is revenue-based crowdfunding. This allows a more lenient approach to repayments and is linked to the borrowing entity’s performance, therefore, encompassing variable payments and investment horizons³. LendingClub, Prosper, and Upstart are prominent debt-based crowdfunding platforms. Platforms like Startwise and Localstake offer revenue-sharing crowdfunding as well.

Author

Hashim Sohail, CFA
Senior Analyst Knowledge
Management, Karandaaz
Pakistan

Edited by

Ali Shahruckh Pracha

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¹ Stein, P., Goland, T., and Schiff, R. 2010. Two trillion and counting. City: McKinsey and Company and Washington D.C.: International Finance Corporation. <http://documents1.worldbank.org/curated/en/386141468331458415/pdf/713150WP0Box370rillion0and0counting.pdf>

² Individuals or institutions purchase securities from companies in the form of unsecured bonds which are ‘mini’ because the issue size is much smaller than the minimum issue amount needed for bonds issued in institutional capital markets

³ In revenue-based models, the borrower offers to reimburse investors with a certain threshold (usually 1.5–2 times of their investment) by paying a set percentage (~2–10%) of annual revenues until the multiple is paid-off. Accordingly, the repayment time and effective interest rate are variable, depending on the firm’s revenues

Non-investment crowdfunding is more popular in the non-profit sector and can take the form of donation-based or reward-based campaigns. The former allows a participant to donate funds based on a philanthropic or civic motivation to support a social, environmental, political, or charitable cause against a non-monetary benefit, while the latter provides donors with a non-financial reward—a token of appreciation or pre-purchasing of a product or service being funded—as an acknowledgement of their contribution. Some examples of successful non-investment crowdfunding platforms are Kickstarter, Indiegogo, and FundRazr.

2. Estimating Global Crowdfunding Activity and Closing in on Asia Pacific (APAC)

There are numerous sources quoting different estimates of the size of the global crowdfunding market. However, one credible source is a report issued by the Cambridge Centre of Alternative Finance (CCAF) in the United Kingdom (UK) in 2020, which provides in-depth, region-wise analysis and sizing of the crowdfunding market. Its only limitation is that its dataset does not extend beyond 2018. Based on the latest available figures, global annual crowdfunding activity is estimated at USD 257 billion and is heavily tilted towards debt-based financing—a constant factor across all regions. Funds raised through debt-based crowdfunding constituted 98% of total global activity in 2018 — P2P consumer lending transactions are the most recurrent, having a 75% share. In absolute terms, equity-based funding during the year clocked in at USD 4.5 billion, followed by the non-investment category with USD 1.5 billion.

Exhibit 1: Crowdfunding investments by category and region

Crowdfunding categories	Crowdfunding products	2018 (value in USD million)						
		Global	Africa	APAC	Europe	North America	Middle East	Latin America and the Caribbean (LAC)
Debt-based crowdfunding	P2P/marketplace consumer lending	195,000	111	163,982	4,946	25,418	97	432
	P2B/marketplace business lending	50,000	18	44,513	3,539	2,084	47	127
	P2P/marketplace property lending	6,000	-	2,505	1,904	713	500	49
	Mini bonds	333	-	289	43	-	-	-
	Revenue sharing	398	5	10	106	275	-	1
	Sub-total		251,731	135	211,299	10,538	28,490	644
Equity-based crowdfunding	ECF (including real estate)	4,474	7	442	1,628	2,318	35	45
Non-investment crowdfunding	Donation-based	639	12	76	75	447	2	27
	Rewards-based	877	1	207	239	408	8	12
	Sub-total	1,516	13	283	314	885	11	39
Grand total		257,721	155	212,023	12,480	31,662	690	693
Share (%)		N/A	0.1%	82.5%	4.8%	12.2%	0.3%	0.3%

Source: Cambridge Centre of Alternative Finance. 2020. The global alternative finance market benchmarking report.

The majority of crowdfunding activity is concentrated in the APAC region, constituting 82.5% of global activity. China is the most active crowdfunding market within APAC. The country makes up to 98% (USD 207 billion) of the APAC region's crowdfunding activity and has an 80% share in the global market. The second-most popular market for crowdfunding is the North American region, attracting ~12% of global activity. Excluding China, global crowdfunding investments in 2018 amounted to USD 51 billion and still pose a significant opportunity to grow further. As per World Bank estimates, by 2025, the developing world alone will have the potential to deploy up to USD 96 billion annually in crowdfunding⁴.

The preference for different variants of crowdfunding varies across global markets. The APAC region has the highest volume for debt-based funding (84% of global debt crowdfunding activity), while equity-based crowdfunding is mostly concentrated in the North American and European regions, as the former captures more than 50% of global ECF activity while the latter contributes ~36%. Similarly, activity within the non-investment variant is most popular in North

⁴ InfoDev, Finance and Private Sector Development Department. 2013. Crowdfunding's potential for the developing world. Washington D.C.: World Bank. https://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf.

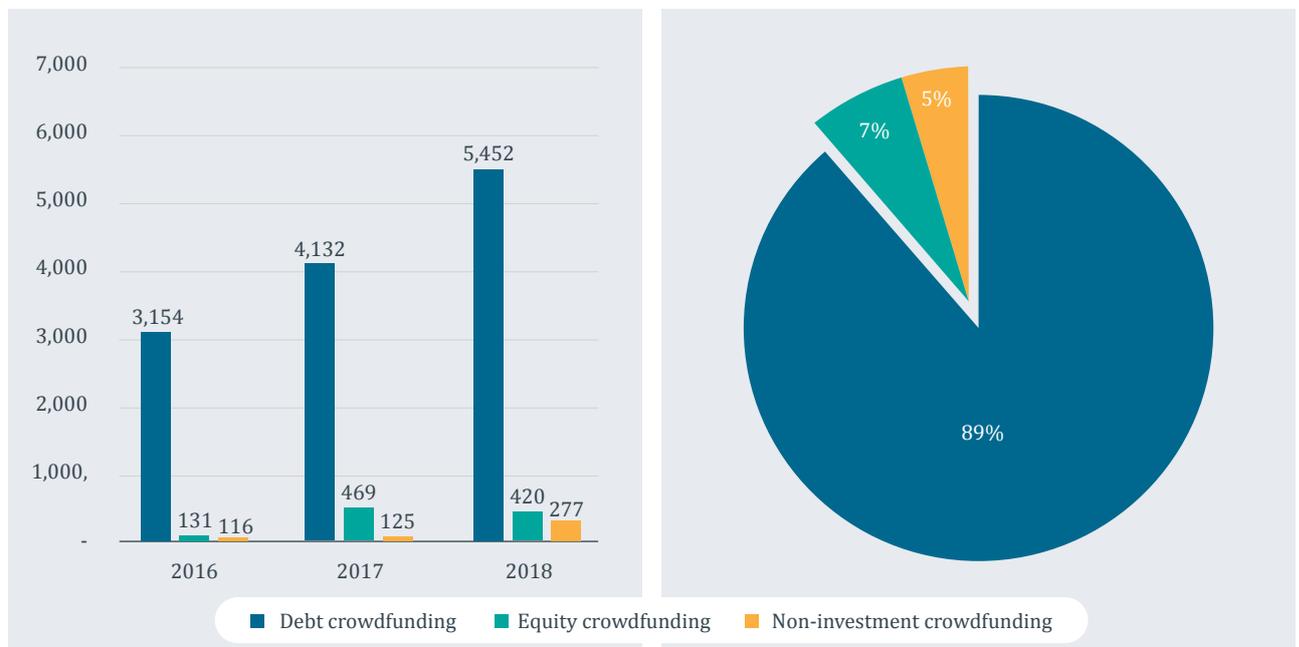
America, whereas Europe and the APAC region trail with an almost similar share in aggregated non-investment crowdfunding, i.e. 21% and 19%, respectively.

2.1 The APAC region (excluding China)

Excluding China, crowdfunding investments have registered a compounded annual growth rate (CAGR) of 34% in APAC since 2016. Of the total USD 6.2 billion in crowdfunding proceeds raised in 2018, the debt-based component was 89%, whereas the equity and non-investment variants had a share of 7% and 5%, respectively. In terms of annualised growth, debt-based investments grew slightly slower than the overall market (CAGR of 31% since 2016), while equity-based and non-investment crowdfunding compounded at a much higher rate of 79% and 55% annually.

While this can be attributed to the low base of these two components, their share in the overall mix has been increasing, both expanding their respective shares in the pie by two percentage points. Data shows that since 2016, there has been considerable traction in equity campaigns compared to donation/rewards-based crowdfunding. Both stood at a fairly similar level in 2016 — USD 131 million raised in equity and USD 116 million raised in donation/rewards campaigns. Investments in equity were 1.5 times the non-investment variant by 2018—USD 420 million raised in equity and USD 277 million raised in donation/rewards campaigns.

Exhibit 2: Crowdfunding investments in the APAC region (excluding China) by variant category



Source: Cambridge Centre of Alternative Finance. 2020. The global alternative finance market benchmarking report.

Note: Amounts are in USD million. The shares in the pie chart are as of 2018 and based on the value of investment raised under each variant.

3. Benefits of Equity Crowdfunding

ECF offers an alternative to traditional forms of raising finance and a wide range of benefits to issuing entities, including:

- **Access to capital from an expanded pool of investors:** Prime beneficiaries of ECF are early-stage entrepreneurs who usually deploy their own funds or gather monies from friends and family. ECF allows access to a much larger pool of investors, putting in small chunks of investment against equity shares to fund a particular venture. Since there are usually a number of small investors, there is little chance of an external investor holding a majority stake to influence business decisions. This allows the retention of control over a company/venture.
- **Validation of the idea:** The successful closure of an ECF campaign also serves as validation of ventures, products, or services for which funds are being raised. Going forward, this could give leverage to sponsors seeking larger ticket investments from angel investors or venture capitalists (VCs), as a successful ECF campaign would serve as proof of wider consumer/investor interest in the issuing entity's business prospects.

- **An opportunity for better marketing:** ECF campaigns can also help issuing entities gain traction among consumers for products and services. The use of digital media to market campaigns can enhance the visibility of the issuing entity's brand and offerings, allowing it to expand its reach beyond investors. Thus, a successful campaign can provide an opportunity to establish a dedicated and loyal customer base, mainly in the form of its initial investors, who see potential in the long-term operational existence of the business they are supporting. The firm can also pre-sell its product/services to these initial investors to gauge product acceptance. Referrals from existing investors can further enhance the visibility of the company's offerings.

- **An easier route for small-sized funding, compared to traditional modes of raising finance:** Many locally domiciled start-ups and MSMEs often complain that the loan application procedure at commercial banks is not borrower-friendly, and requirements for excessive documentation result in delayed loan processing. The situation is exacerbated due to the non-existent credit history of these early-stage start-ups and unserved MSMEs. As per the World Bank's enterprise survey, 13% of Pakistani respondent firms stated they had had loans rejected (global loan rejection ratio: 11%, South Asia: 14%)⁵. The application process for ECF is usually straightforward — eligible entities are required to register with a particular ECF platform and submit a proposal with details of their venture. In addition, there are some documentary relaxations extended to certain transactions/solicitations to keep operational costs low.

4. Potential Risks of Participating in Equity Crowdfunding

Crowdfunding investments are generally high-risk, and investor protection is an important focus for regulators. While ECF can prove to be a beneficial tool for emerging entities to raise finance and attract attention to their offerings, such investments are associated with certain risks that investors should take into account before participating.

- **Illiquid securities:** Potential investors should bear in mind that once they have invested in a private entity, their investment may be locked-in for years until the issuing entity has grown enough to realise its potential in the shape of an exit. Investors with a longer holding period may not see this as a matter of concern, but the ones seeking quick returns may find it difficult to take their investment out. In addition, the dearth of a secondary market for such securities also limits the options available to realise returns. Investors have to wait until the entity has grown enough to either go public or the business model is successful enough to attract attention for an exit opportunity, usually a potential acquisition.

- **Lack of control:** ECF corresponds to the idea of raising small chunks of investment from a wide array of investors. These investors do not usually have the right or power to influence the future direction of the business. Moreover, the issuing entity may conduct subsequent rounds of funding for additional capital (from angel investors/venture capitalists or private equity firms), which could dilute crowdfunding investors' stake in the entity, while one can argue that enhanced valuations may result in greater returns.

- **Less transparency:** Compared to publicly listed companies, entities opting for an ECF campaign to raise funds are granted more relaxed reporting requirements. Since these are early-stage, small-sized entities, regulators take a facilitative approach to keep compliance costs to a minimum. This might translate into less information being available to the public and to investors, which could give rise to unclear expectations, difficulties in gauging business performance, and speculations on future potential.

- **Risk for scams:** Crowdfunding investors are usually less sophisticated and lack proper investment advice and the ability to perform due diligence — there is always the risk of running into a potential scam. Low transparency in private markets provides a fertile ground for fraudsters to take advantage of information asymmetries. However, different jurisdictions across the world specify certain responsibilities for ECF platforms, which include due diligence of potential proposals prior to listing and thorough background checks on the sponsors and management of issuing entities. Scams are a major reputational risk for platforms as well. Therefore, with strict monitoring and adherence to risk management guidelines, platforms act as an intermediary, providing reasonable scrutiny of upcoming campaigns.

- **Cybersecurity breach:** Crowdfunding platforms handle sensitive personal and financial information that can be exposed to information security and privacy risks. Users' personal information e.g, name, ID, e-mail address, bank account number, phone number, is handled by numerous entities, including the platform and its employees and other third-parties that verify identities or store information. Therefore, if data is not adequately secured, any hack, whether to an investor's account or to the online server where personal data resides, will expose investors' data to a potential security breach. An attacker might gain access to sensitive information, which could be used to fraudulently withdraw funds or impersonate or run illicit campaigns. While many regulators specifically require crowdfunding platforms to ensure robust IT infrastructures and server security, different regions have specific data protection laws as well to ensure sensitive information is properly maintained and not disclosed without authorisation.

⁵ World Bank. Undated. Enterprise survey: Pakistan > Finance. <https://www.enterprisesurveys.org/en/data/exploreeconomies/2013/pakistan#finance> [accessed 6 October 2020].

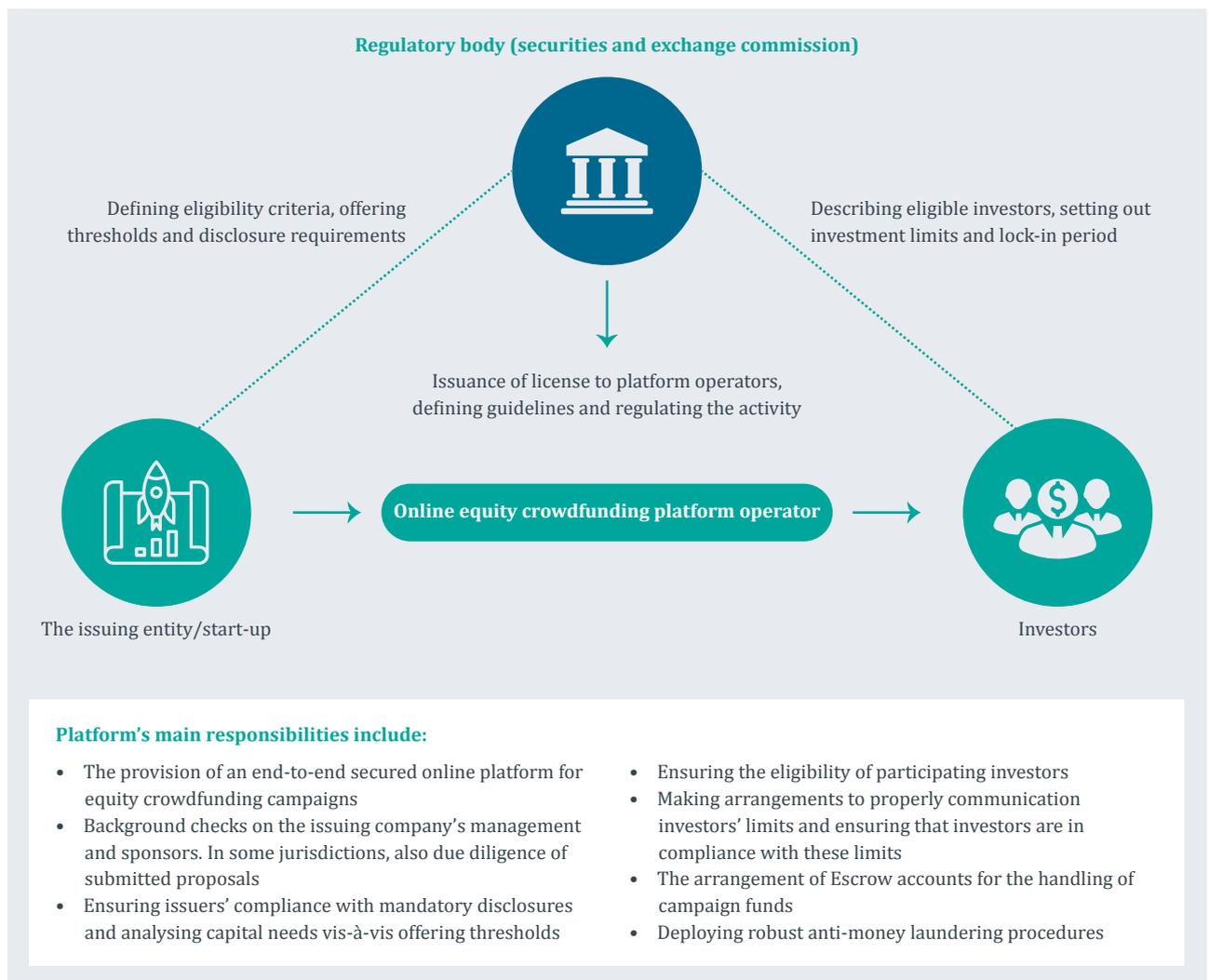
5. Regulatory Structures for Equity Crowdfunding: Takeaways from Four International Regimes

As crowdfunding is gaining traction as a possible tool to bridge the funding gap for scalable business models, different jurisdictions have tried to define comprehensive sets of rules and guidelines to formalise and propagate crowdfunding activity while effectively managing the risks involved. For the purposes of this research note, we have analysed four international regimes and regulatory structures from the perspective of governing ECF platforms, issuers and investors.

Online platforms offering ECF are generally required to be registered and licensed under specific laws⁶ by individual securities and exchange commissions or equivalent regulators. Such platforms are usually required to fulfil certain responsibilities, i.e. conduct due diligence of submitted proposals, analyse capital requirements, conduct background checks on the issuing company's management and sponsors, and deploy robust anti-money laundering procedures.

Similarly, regulations also specify the forms of companies that can issue ECF securities and the types of investors allowed to participate in such campaigns. Different regimes also put a cap on the absolute amount of funding that can be raised through ECF in a given year — some also define a threshold of cumulative funding that any issuer can raise through this method. Guidelines for investors vary by the level of their sophistication across regimes that were reviewed for this study. Accredited/sophisticated investors are usually defined based on their net worth or annual incomes, with specific limits on monies that these investors are allowed to park annually in an ECF offering. However, for financially sophisticated and wealthier investors, the limits are more relaxed than those of their retail counterparts.

Exhibit 3: Operating Structure of Equity Crowdfunding



⁶ In Switzerland, there is no specific framework governing the operations of such platforms, and each case is reviewed independently by the Swiss Financial Market Supervisory Authority.



5.1 Malaysia

The governing framework for ECF in Malaysia is the ‘Guidelines for Recognized Markets’⁷, first issued in 2015. They clearly bifurcate responsibilities and allowances in terms of operators/platforms and issuers and investors opting for ECF investments. As per the regulations, platform operators are required to register themselves as regulated market operators (RMOs) with the Securities Commission (SC) and should be locally incorporated. While there are general provisions applicable to all entities licensed as RMOs, there are some additional obligations imposed on ECF platform operators.

5.1.1 Guidelines for platform operators

Crowdfunding platform operators in Malaysia are required to carry out a detailed due diligence exercise on prospective issuers planning to use their platform. The regulations define due diligence as: i) background checks on the issuer to ensure that sponsors and directors meet the ‘fit and proper criteria’; ii) verification of the issuer’s business proposition. Similarly, these operators are also responsible for ensuring the accuracy of any disclosures made by the issuing entity in its proposal and should be able to communicate any material change⁸ relevant to a proposal in a timely fashion.

Operators are required to have one or more trust/escrow accounts specially designated to handle funds raised by any issuer hosted on their platform — the release of funds to the issuer is conditional on the successful completion of an ECF campaign, i.e. if the targeted amount sought to be raised has been met. Platform operators are also prohibited from offering any sort of financial assistance to investors, compelling them to invest in any of the campaigns running on their platforms.

Platform operators wishing to operate a secondary market for ECF securities are required to first seek and acquire approval from the SC to operate such a platform. However, a particular operator can only allow the trading of securities that have previously been hosted and issued via its own platform.

5.1.2 Guidelines for issuers

Similarly, the regulations set a clear criterion on permitted and non-permitted issuers. Only private firms incorporated in Malaysia and limited liability partnerships are permitted to raise funding through ECF offerings. The regulations also restrict issuers that prohibit them from concurrently running financing campaigns on multiple platforms. Entities classified as non-permitted issuers include:

- Companies (other than micro-funds) with a paid-up share capital exceeding MYR 10 million;
- Commercially or financially complex structures, i.e. investment fund companies or financial institutions;
- Public-listed companies and their subsidiaries;
- Companies with no specific business plan or where the business plan is to merge with or acquire an unidentified entity;
- Companies (other than micro-funds) that propose to use the funds raised to provide loans or make investments in other entities.

Operators also have the option to allow micro-funds to be hosted on their platforms to raise capital. The Guidelines for Recognized Markets define a micro-fund as an entity that: i) is registered as a venture capital company with the SC; ii) has a specified investment objective; iii) only raises capital through sophisticated investors and eligible investors.

Regulations place a limit on the overall funding that can be raised through ECF campaigns by any issuer (except micro-funds) throughout its operational period. This limit is set at MYR 10 million, equivalent to ~USD 2.5 million⁹. All issuers are required to submit a proposal to the operator that explains key company characteristics, states the issue size, and explains the purpose of the fundraising, alongside a business plan.

For issue sizes below MYR 500,000 (~USD 124,000), audited financials are only submitted where they are available. For example, certified financial statements issued by the issuer’s management will be adequate in the case of the issuer being a newly established entity that is unable to provide audited statements. Audited financial information is a mandatory requirement for issues exceeding MYR 500,000. Upon conclusion of a successful ECF campaign, issuers are

⁷ Securities Commission Malaysia. 2020. Guidelines for recognized markets (revised). <https://www.sc.com.my/api/documentms/download.ashx?id=0274f358-5adb-42b0-a4d3-39ef0f64b6f9>.

⁸ As per the guidelines, material adverse change may include i) the discovery of a false or misleading statement in any disclosures in relation to the offer; ii) the discovery of a material omission of information required to be disclosed in relation to the offer; iii) a material change or development in the circumstances relating to the offering or the issuer.

⁹ USD estimated are based on respective parities as of 22 January 2021.

required to provide regular updates on the progress of the business and the issuer's financial position via regular filings with the operator.

5.1.3 Guidelines for investors

From the investors' perspective, the regime takes a tiered approach to limit the annual investment in an ECF campaign for each type of investor. Investors are divided into three categories: i) sophisticated investors¹⁰ having no limitation on the amount of investment; ii) angel investors¹¹ who are allowed to invest a maximum of MYR 500,000 (~USD 124,000) during a 12-month period; iii) retail investors whose investment is capped at MYR 5,000 (USD 1,240) per issue and MYR 50,000 (USD 12,400) during a 12-month period. These limits are applicable to both local and foreign investors. The guidelines also limit the crowdfunding operator's shareholding to up to 30% in any issuing entity hosted on its platform in order to manage potential conflicts of interest.

Moreover, the regulations also prohibit the trading of shares during the first six months of their issuance (as a result of a successful ECF campaign). If the promoter of an issuer wishes to sell, transfer, or assign their shares, they are required to wait an additional six months from the date the shares began trading on the secondary market to initiate such a transaction.



5.2 The UK

ECF activity in the UK is regulated by a wide range of laws. They include the Financial Services Market Act (FSMA), 2000¹², Financial Conduct Authority (FCA) Handbook - Markets in Financial Instruments Directive and Conduct of Business Sourcebook (COBS)¹³, Prospectus and Markets in Financial Instruments Regulations, 2018¹⁴, and the Companies Act 2006¹⁵. The idea of investment-based crowdfunding — involving non-readily realisable securities — was already regulated in the UK as the regime follows a uniform approach to regulating investment transactions without differentiating between the medium used to solicit funds. Therefore, all such transactions are required to be authorised by the FCA, whether arranged online or offline. However, in 2014, the FCA introduced additional provisions to strengthen consumer protection rules for investors and issuers involved in such kinds of activity.

5.2.1 Guidelines for platform operators

ECF platforms come under the ambit of Article 25 of the FSMA (Regulated Activities) Order, 2001 as it governs the arrangement of deals for another party seeking to buy, sell, subscribe for, or underwrite a particular investment, and are required to submit certain documentation to complete FCA authorisation. The documentation requirements include: i) the submission of a suitable and detailed regulatory business plan setting out the planned activities (and related risks), budget, and resources; ii) a clear indication that the platform possesses adequate financial and non-financial resources (i.e. management with adequate skill and experience); iii) a website that is either up-and-running or at a suitably advanced stage; iv) an understanding of the requirements for FCA authorisation and the permission profile for which they wish to apply¹⁶.

One distinctive feature for UK-based platforms is that while they are required to conduct background checks on the sponsors, promoters, and management of the issuing entity, these platforms are not required to run detailed due diligence on the issuing entity's business prospects¹⁷.

¹⁰ Sophisticated investors include i) collective investment schemes (including pensions funds); ii) entity holding of Capital Markets Services (CMS) license and its directors or CEO; iii) banks; iv) insurance companies; v) VC management corporations; vi) private equity management corporations; vii) trusts with assets under management exceeding MYR 10 million; viii) corporates and partnerships with net assets exceeding MYR 10 million; ix) individuals with net personal assets exceeding MYR 3 million (excluding the value of the individual's primary residence) with a gross annual income exceeding MYR 300,000 in the preceding 12 months.

¹¹ Regulations define an angel investor as an individual who i) is a tax resident in Malaysia; ii) has total net personal assets in excess of MYR 3 million; iii) has a gross total annual income not less than MYR 180,000 in the preceding 12 months; iv) has a gross total annual income exceeding MYR 250,000 jointly with spouse.

¹² Financial Conduct Authority. Financial Services and Markets Act, 2000. <https://www.legislation.gov.uk/ukpga/2000/8/contents> [accessed 7 October 2020].

¹³ Financial Conduct Authority. FCA Handbook - Markets in financial instruments directive and conduct of business sourcebook (COBS). <https://www.handbook.fca.org.uk/handbook/COBS/1/> [accessed 7 October 2020].

¹⁴ Financial Conduct Authority. Financial Services and Markets Act, 2000 (Prospectus and Markets in Financial Instruments) Regulations, 2018. <https://www.legislation.gov.uk/uksi/2018/786/regulation/2/made> [accessed 7 October 2020].

¹⁵ Financial Conduct Authority. Companies Act, 2006. <https://www.legislation.gov.uk/ukpga/2006/46/contents> [accessed 7 October 2020].

¹⁶ Financial Conduct Authority. 2015. A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media. <https://www.fca.org.uk/publication/thematic-reviews/crowdfunding-review.pdf>.

¹⁷ Ramsay, L, and Kourabas, S. 2017. Facilitating equity crowdfunding in the ASEAN region. Arlington, VA.: Nathan Associates Inc. <https://www.nathaninc.com/wp-content/uploads/2018/05/Facilitating-Equity-Crowd-Funding-in-the-ASEAN-Region-ACTI-16D-049-2017.pdf>.

In its review of the regulatory regime for crowdfunding, FCA explicitly mentioned that there is usually a lack of balance in offers made through investment-based crowdfunding platforms¹⁸, as usually critical information on associated risk is not clearly mentioned in the proposal. This leads to a potentially misleading or unrealistically optimistic impression of the investment. Therefore, the FCA encourages platforms to deploy internal checks on the accuracy and sufficiency of information presented in any ECF campaign registered on a platform.

5.2.2 Guidelines for issuers

The Company's Act, 2006 prohibits private limited companies from offering securities to the public. Therefore, the ECF is only possible if the issuing entity is registered as a public limited company under the Act. For a company to be classified as public limited, it should not have a nominal value of allotted share capital that is below GBP 50,000 (~USD 68,000). Unlike other regimes, the FCA does not place any restriction on the amount of funds that an entity can raise via ECF. However, previously, there was a provision requiring a comprehensive prospectus to be issued for issues sizes exceeding EUR 5 million, which, since 2018, has been increased to EUR 8 million¹⁹. This change aims to reduce the compliance costs of small and medium enterprises (SMEs), allowing them to raise larger funding amounts via online platforms.

5.2.3 Guidelines for investors

The Conduct of Business Sourcebook (COBS), places restrictions on the promotion of non-readily realisable securities. Accordingly, such securities cannot be offered to the general public. Instead, the rules define four categories of investors that can be approached to invest in ECF securities. They must be certified as one of the following:

- High net worth investors
- Sophisticated investors
- Self-certified sophisticated investors
- Restricted investors

Rules define high net worth investors as individuals who are declared to have either: i) a net annual income of GBP 100,000 (~USD 137,000) or more through the immediately preceding financial year, excluding any withdrawals from pension savings; or ii) held net assets²⁰ worth of GBP 250,000 (USD 342,000) or more in the preceding financial year. Moreover, high net worth investors also need to undertake that they accept that the investment opportunities they are exposed to could pose the risk of them losing all resources invested, and that they are aware they can seek advice from authorised persons specialising in advice on such high-risk investments.

Sophisticated investors are individuals possessing a written certificate authorised within the last 36 months by a third-party firm confirming they have been assessed as sufficiently knowledgeable of the risks associated with engaging in investment activities of non-readily realisable securities.

A self-certified sophisticated investor is one who has signed a statement within the 12 months preceding the date of promotion (of an ECF campaign to such an investor), confirming that they may receive promotions from a person authorised by the FCA to invest in non-readily realisable securities, and they are aware of the resultant risk exposure. In addition, a self-certified investor must confirm one of the following criteria:

- They have been a member of a network or syndicate of business angels for at least the last six months prior to the date of the undertaking;
- They have made more than one investment in an unlisted company in the two years prior to the date of the undertaking;
- They are working, or have worked in a professional capacity in the private equity sector or in the provision of finance to SMEs in the last two years;
- They currently, or have in the last two years, been a director of a company with an annual turnover of at least GBP 1 million.

Similar to high net worth investors, sophisticated and self-certified sophisticated investors are also required to submit an undertaking regarding the acceptance of the risks involved and their consequences.

¹⁸ Financial Conduct Authority. 2015. A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media. <https://www.fca.org.uk/publication/thematic-reviews/crowdfunding-review.pdf>.

¹⁹ Financial Conduct Authority. 2018. Financial Services and Markets Act, 2000 (Prospectus and Markets in Financial Instruments) Regulations, 2018. <https://www.legislation.gov.uk/uksi/2018/786/regulation/2/made> [accessed 7 October 2020].

²⁰ Net assets for this purpose do not include property of primary residence or money raised through a loan secured on that property; any rights under a contract of insurance; any benefits payable on the termination of service or on death or retirement; any withdrawals from pension savings.

A restricted investor is an individual who has signed a statement confirming that in the previous 12 months from the date of receiving such promotion, they have not invested more than 10% of their net assets in non-readily realisable securities, and undertake that in the next 12 months, they do not intend to invest more than 10% of their net assets in such securities.

5.2.4 Other benefits for investors

To help smaller higher-risk trading companies raise finance, the government of the UK has designed two schemes, the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS)²¹. A range of tax incentives has been introduced for investors purchasing shares in companies qualifying under these two schemes. While investing in an EIS eligible company, investors are allowed to claim 30% of the value of their investment, capped at GBP 1 million per year as income tax relief. Moreover, if an investor holds the shares in such a company for a duration of three years, they are exempt from capital gains tax (CGT). There is also a possibility of deferring the CGT payment, given the gain is invested in the shares of an EIS qualifying company. If the shares are disposed of at a loss, the amount of loss after deducting the 30% income tax relief can be set against any income tax for the year in which they were disposed of, or on the income of the previous year.

SEIS benefits are very similar to those of EIS. However, investors can claim 50% of their investment value, capped at GBP 100,000 (~USD 137,000) per tax year as income tax relief. There is also an additional CGT benefit on reinvestment where if an investor chooses to reinvest gains from other non-SEIS eligible investments to a SEIS-qualifying company, they can claim 50% CGT relief on the original investments.



5.3 The United States of America (USA)

The regime for ECF activity in the USA is divided based on the type of investors eligible to participate in such transactions and the ultimate amounts that can be raised by the issuing entity. As per the Securities Act, 1933, the offer of securities in the USA needs to be registered with the Securities and Exchange Commission (SEC) unless a registration exemption is available. The Jumpstart Our Business Start-ups (JOBS) Act, 2012 introduced such exemptions that allow early-stage companies to solicit capital from a wider range of investors without getting their offerings registered with the SEC. Accordingly, Article II - "Access to Capital for Job Creators" (implemented through provision 506 of Regulations D), Article III - "Crowdfunding" (implemented through Regulations Crowdfunding), and Article IV - "Small Company Capital Formation" (implemented through Regulations A+) of the JOBS Act are the relevant blueprints that regulate crowdfunding activity in the USA.

Regulations Crowdfunding is the main set of regulations dealing with the concept behind crowdfunding²², i.e. allowing start-ups to raise small-sized investments from a vast pool of investors. Eligible companies under Regulations Crowdfunding are allowed to market their offerings to the general public as well; the investment is however capped, which is a function of investors' annual income and net worth. Companies seeking exemptions under Article II of the JOBS Act are allowed only to make solicitations from accredited investors²³, and in case of a private placement, from a restricted number of non-accredited investors. Regulations A+, on the other hand, is very similar to a small-sized initial public offering (IPO), allowing companies to raise higher amounts of capital, i.e. up to USD 75 million — the limit was recently revised; entities were previously allowed to raise a maximum of USD 50 million under these regulations. While certain issuers can opt to go public, it is not a general requirement for Regulations A+ offerings.

5.3.1 Guidelines for platform operators

Under regulations, crowdfunding issuers can only conduct ECF offerings through an intermediary, which the regulations define as broker-dealers and funding portals²⁴ that are registered with the SEC and are Financial Industry Regulatory Authority (FINRA) members as well²⁵. The regulations also prohibit issuers from running concurrent offerings on multiple platforms.

²¹ For an entity to be an EIS eligible entity, it has to have a maximum workforce of 250 and gross assets allowable under EIS of GBP 15 million. SEIS has lower limits of 50 staff and GBP 200,000 gross assets, and businesses must also be less than two years old. There are no age restrictions under EIS.

²² US Securities and Exchange Commission. 2017. Updated investor bulletin: Crowdfunding for investors. <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-11> [accessed 10 December 2020].

²³ To be an accredited investor, an individual must have a net worth of at least USD 1 million (excluding the value of a primary residence) or an annual income of at least USD 200,000 for the last two years. Companies with at least USD 5 million in assets and family offices with at least USD 5 million in assets under management are considered accredited investors.

²⁴ Funding portal means a broker acting as an intermediary that does not (i) offer investment advice or recommendations; ii) solicit purchases, sales or offers to buy the securities displayed on its platform; iii) compensate employees, agents, or other persons for such solicitation based on the sale of securities displayed on its platform; iv) hold, manage, possess, or otherwise handle investor funds or securities.

²⁵ US Securities and Exchange Commission. 2021. Regulations crowdfunding: Requirements for intermediaries. <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-11> [accessed 22 January 2021].

In order to make an investment, it is mandatory for the investor to open and maintain an account with the intermediary. The platforms are required to explicitly mention and communicate certain details to users, including i) the process for the offer, purchase, and issuance of securities and associated risks; ii) investor limits; iii) restrictions on the resale of securities; iv) limitations on an investor's right to cancel an investment commitment and the circumstances where the commitment might get cancelled by the issuer. It is the platform's responsibility to ensure that the investors are in compliance with the investment limitation requirements concerning the latter's annual income and net worth.

Similar to other regimes, these intermediaries are required to conduct a background check on each issuer whose securities are to be offered with added checks for each officer, director, or beneficial owner having 20% or more of the issuing entity's outstanding voting shares. The regulations follow a structure similar to that of Malaysia, where the intermediaries are required to direct investors to transmit funds directly to a designated third party, an escrow arrangement, whose job is to hold and handle funds raised during the campaign. Regulations define such third parties as registered brokers/dealers and banks or credit unions. The transmission of funds to the issuing entity is initiated when the aggregate amount of investment commitments from all investors is equal to or greater than the target amount of the offering. There is a provision within regulations that allows investors to cancel their investment commitments. This cancellation can only be made 48 hours prior to the stipulated deadline²⁶, whereby any cancellations within 48 hours are not processed unless there is a material change in the terms or information regarding a particular ECF campaign.

5.3.2 Guidelines for issuers

With respect to the issuing entities, Regulation Crowdfunding puts a cap on the total amount of capital that can be raised via crowdfunding during a year. Initially, the threshold was set at USD 1.07 million, which the SEC has recently increased (vide an amendment on 14 January 2021) to USD 5 million²⁷. There is also a basic criterion for issuers who are eligible to raise funding under these regulations. As per the criteria, the issuing entity:

- Should be incorporated in the USA;
- Should not be an investment company under the Investment Company Act, 1940;
- Is not subject to the requirements of detailed filing under the Exchange Act, 1934;
- Is not a disqualified issuer under Regulations Crowdfunding;
- Has previously sold securities under the regulations and has filed with the SEC and provided annual reports to investors during the two years immediately preceding the filing of the ECF offering application;
- Has a specific business plan and does not plan to engage in a merger or acquisition with an unidentified company.

The offering application needs to be submitted to the SEC and the selected intermediary for onward communication with the investors, and should include details of the issuing entity (including its legal status, address, website, number of employees, business model and anticipated plans, risks specific to the company or its business, ownership and capital structure, and the names of the directors, officers²⁸, and beneficial owners holding 20% or more of the voting equity shares). The application should clearly state the target offering amount and the corresponding deadline for completions. The issuer should explain whether it will accept investments in excess of the target offering amount and must provide a reasonably detailed description of any intended use of proceeds. The application should also state the issue price of the securities and the method used for determining the price. For issuers with no prior operating history, the discussion should focus on financial milestones and operational, liquidity, and other challenges. For issuers with an operating history, the discussion should focus on whether historical results and cash flows are representative of what investors should expect in the future. With respect to the financial history, regulations follow a tiered approach where disclosure requirements are tied to the amount of capital raised via ECF during the last 12 months. This includes the offering against which the application is being submitted.

Exhibit 4: Mandatory disclosure requirements for issuers

Capital raised during the last 12 months of application	Minimum disclosure requirements
USD 107,000 or less	The amounts of total income, taxable income, and total tax along with the issuer's financial statements, certified by the executive officer
> USD 107,000–535,000	The issuer's financial statements reviewed by an independent public accountant
> USD 535,000	In the case of first-time ECF issuers, financial statements need to be reviewed by an independent public accountant. Otherwise, the financial statements need to be audited by a public accountant

²⁶ While regulation crowdfunding does allow issuers some flexibility to change the deadline upon early completion of an offering, there is still a requirement for an equity crowdfunding campaign to stay open for at least 21 days. Any change needs to be communicated adequately by the ECF platform to the investors.

²⁷ US Securities and Exchange Commission (SEC). 2021. Regulations crowdfunding amendments: General rules and regulations. <https://www.ecfr.gov/cgi-bin/text-idx?SID=7a56efc9d7baf6f39c0e76fac40ca048&mc=true&node=20210114y1.78> [accessed 22 January 2021].

²⁸ The term 'officer' means a president, vice president, secretary, treasurer, or principal financial officer, comptroller or principal accounting officer, and any person routinely performing similar functions.

5.3.3 Guidelines for investors

While anyone can invest in ECF offerings under Regulation Crowdfunding, there is still a cap on the total investment that non-accredited investors can make in such offerings during a 12-month period. The regulations take a tiered approach, and the cap on aggregate investment is linked to a respective investor's annual income and net worth. Furthermore, there is a lock-in period of 12 months, restricting investors from offloading securities during the said period.

Tier 1: Investors having either an annual income or net worth less than USD 107,000 are allowed to invest up to the greater of USD 2,200 or 5% of the greater of annual income or net worth.

Tier 2: Investors whose annual income and net worth, both, are equal to or more than USD 107,000 can invest up to 10% of annual income or net worth, whichever is greater. However, their investment cannot surpass a hard threshold of USD 107,000.

Prior to the recent revisions announced in November 2020²⁹ (made effective in January 2021) by the SEC, there was no such distinction between accredited and non-accredited investors, as all investors were required to comply with the aforesaid limits. Furthermore, earlier provisions used to consider the 'lesser of' investors' annual income or net worth when calculating investment limits. This has now been relaxed.

5.3.4 Article II and Article IV of the JOBS Act

With the enactment of Article II of the JOBS Act (via provision 506(c) of Regulation D), the SEC has allowed early-stage entities to pursue general solicitation (such as advertising in the newspaper, on the internet, etc.), which previously was only allowed to entities that planned to go public and could afford the associated costs of listing on a stock exchange. Under Article II, private entities can now publicly advertise their investment campaigns, allowing them access to a wider pool of potential investors. This is particularly beneficial for start-ups and new ventures that do not have a pre-defined list of investors to take on private placements. However, where companies opt for general solicitation to raise capital, the offer of securities can only be made to accredited investors. While there is a restriction on who can invest, the regulations do not place any limitations on the amount of capital that can be raised or the number of investors.

Regulation A+ basically provides an exemption from the SEC's registration requirements for public offerings of up to USD 75 million, essentially allowing smaller companies a more cost-efficient approach to raising capital. For any entity to be eligible for this exemption, it needs to comply with a basic criterion. Exemptions under these regulations are only available to US and Canadian companies, whereby investment companies and blank check companies (i.e. ones that have no specific business plan, or plan to engage in a merger or acquisition with an unidentified company) are not eligible to raise funds under this exemption. The SEC has introduced two tiers with different requirements for eligible issuers under these regulations.

Under Tier 1, a company can raise up to USD 20 million in any 12-month period. Under Tier 2, companies can offer securities worth USD 75 million during a 12-month period. For both tiers, companies can only accept payment against the sale of securities once their respective offering materials have been reviewed and qualified by the SEC. The offerings are open to all investors, i.e. accredited and non-accredited, and there are generally no restrictions except for non-accredited investors opting to invest in a Tier 2 offering. In such a situation, individual investors are restricted to investing no more than 10% of the greater of their annual income or net worth — excluding the value of the primary residence.

Moreover, there are different disclosure requirements for each of the tiers. Under Tier 1, financial statements prepared and submitted for a potential offering are not required to be audited. In contrast, Tier 2 issuers are required to submit audited financial statements for the two preceding fiscal year ends or for the shorter period they have been in existence³⁰. For Tier 1 offerings, there is no such requirement of ongoing reporting to the SEC, and the companies only need to submit an exit report upon the completion of a particular offering. On the other hand, issuers under Tier 2 are obligated to file periodic reports with the SEC, including audited financial statements for the year, unaudited interim financial statements, and details about any fundamental change affecting the company's business³¹.

²⁹ US Securities and Exchange Commission. 2020. SEC harmonises and improves "patchwork" exempt offering framework. <https://www.sec.gov/news/press-release/2020-273> [accessed 10 December 2020] and <https://www.sec.gov/rules/final/2020/33-10884.pdf>.

³⁰ Knight, J.H., and Lay, W.N. 2018. FAQs about regulation A+ securities offerings. Bass Berry and Sims. <https://www.bassberrysecuritieslawexchange.com/wp-content/uploads/sites/201/2018/06/Regulation-A-FAQ.pdf>.

³¹ Ibid.



5.4 Singapore

Crowdfunding in Singapore is governed and regulated by the Monetary Authority of Singapore's (MAS) Securities and Futures Act. MAS initiated a consultation process in February 2015 to refine its regime to be more conducive and facilitative for securities-based crowdfunding, i.e. debt-based and equity-based crowdfunding. The authority issued a reference paper³² entailing proposals to reduce the regulatory and financial burden on online crowdfunding platforms, along with clarifications with respect to investors that can participate and any concessions allowed to the issuers with respect to the disclosure requirements.

5.4.1 Guidelines for platform operators

The capital market services (CMS) license covers a wide array of regulated capital market activities. Broker-dealers, fund managers, real estate investment trust (REIT) managers, corporate finance advisers, securities-based crowdfunding operators, and credit rating agencies are all required to be registered with MAS under the CMS license³³. However, there are different base capital requirements for each of these entities based on the activities in which they specialise. Accordingly, entities wishing to operate as crowdfunding platforms must be CMS license holders.

The issuance of a CMS license is generally based on the 'fit and proper test' of entities, shareholders, and directors, the five-year track record of the management and major shareholders, internal system and risk management policies, and ability to meet financial requirements as per the Securities and Futures Act³⁴. Post-finalising its consultations in 2016, MAS extended significant relaxation in the applicable financial requirements for security-based operators. The authority reduced the minimum base capital requirement for such platforms from SGD 250,000 (~USD 188,000) to SGD 50,000 (~USD 38,000). It also removed the requirement to maintain a security deposit of SGD 100,000³⁵.

Moreover, the requirements with respect to other aspects of conducting business are similar to other regimes³⁶. For example, in terms of the handling of funds, the regulations require platforms to take all necessary steps and deposit all funds received during a campaign in a separate trust on behalf of the beneficiaries. The platform should not commingle these funds with its day-to-day activities. The regulations also expressly state that any interest earned on these funds deposited in a trust account accrues to the investors, and a share is paid to or held for the benefit of the customer. In addition to securities-dealing services, platforms that are also engaged in the provision of financial advisory services to their costumers can do so under the CMS license, subject to compliance with other requirements under the license. Such platforms are exempted from holding a separate financial advisory license under the Financial Advisers Act. However, they are still required to adhere to the conduct requirements under the said Act.

5.4.2 Guidelines for issuers

The regulations in Singapore do not place any restrictions with respect to the overall capital that an issuer can raise via ECF or put a cap on investors' participation. There are some relaxations with respect to the offering mechanisms aimed to lower operational costs for SMEs. Issuers opting to raise capital via crowdfunding are generally required to issue a prospectus. However, this requirement is exempted if the offer falls into any of the following³⁷:

- Small offer exemptions, i.e. 'personal offers' for no more than SGD 5 million (USD 3.8 million) during a 12-month period;
- Private placement not exceeding 50 investors during a 12-month period;
- Offers to institutional and accredited investors³⁸.

³² Monetary Authority of Singapore. 2015. Facilitating securities-based crowdfunding. <https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Consultation-Papers/Facilitating-Securities-Based-Crowdfunding.pdf>.

³³ Monetary Authority of Singapore. 2020. Types of capital market entities in Singapore. <https://www.mas.gov.sg/regulation/capital-markets/types-of-capital-markets-entities-in-singapore> [accessed 7 January 2021].

³⁴ Monetary Authority of Singapore. 2018. Securities and Futures Act: Guidelines on criteria for the grant of a capital markets services license other than for fund management and real estate investment trust management. <https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Fund-Management/Regulations-Guidance-and-Licensing/Guidelines/SFA--SFA04G01--Guidelines-on-criteria-for-grant-of-CMSL-other-than-FMCs--8-Oct-2018.pdf>.

³⁵ Monetary Authority of Singapore. 2016. Responses to feedback received: Facilitating securities-based crowdfunding. <https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Consultation-Papers/Crowdfunding/Response-to-Feedback-Received--Facilitating-Securities-based-Crowdfunding.pdf>.

³⁶ Monetary Authority of Singapore. 2021. Securities and Futures (Licensing and Conduct of Business) Regulations, 2021. <https://sso.agc.gov.sg/SL/289-RG10?DocDate=20040229#pr22-> [accessed 22 January 2021].

³⁷ Monetary Authority of Singapore. 2020. Types of capital market entities in Singapore: Securities-based crowdfunding operators. <https://www.mas.gov.sg/regulation/capital-markets/types-of-capital-markets-entities-in-singapore> [accessed 7 January 2021].

³⁸ 'Accredited investor' refers to i) an individual whose net personal assets exceed SGD 2 million (excluding primary residence), financial assets (i.e., bank deposits and other investments) exceed SGD 1 million, net income not less than SGD 300,000 in the preceding 12 months; ii) corporations with net assets exceeding SGD 10 million.

Issuers can avail the small offers exemption to avoid the requirement of issuing a full-blown prospectus. However, there is a restriction on who can be approached to invest in such a campaign. Regulations define personal offers as those made to persons who have prior relationships and connections with the issuer or who have previously indicated to the issuer or a platform that they are interested in offers of that kind. Therefore, offers under this exemption are not advertised for mass solicitation³⁹.

The controlling shareholders, management, directors, business associates, and other persons whom the offeror reasonably believes to have sufficient knowledge of the issuer's business and financial performance are usually considered to be the ones that have a prior connection to the issuers. The regulations also allow the offering of securities to persons who have previously indicated investment interest to the issuer directly, or to a crowdfunding platform to facilitate other investors like venture capital firms and business angels who may not have had prior contact or connection with the issuer, but possess relevant knowledge of handling such investments. Platforms, however, are required to run some pre-qualification tests on such investors to ensure that i) the potential investors either have sufficient knowledge and experience to invest in crowdfunding securities; or (ii) such investments are suitable for them in light of their investment objectives and risk tolerance⁴⁰.

5.4.3 Guidelines for investors

The regulations specifically emphasise that any offers made under the aforementioned exemptions should not be publicised for mass solicitations. The platforms are also required to follow advertisement restrictions, i.e. allowing access only to qualifying investors and not the general public⁴¹. While general solicitation for ECF is not prohibited in Singapore under any law, issuers pursuing such offers need to be in compliance with prospectus requirements.

6. Equity Crowdfunding and its Relevance to Pakistan

The majority of Pakistani MSMEs lack access to formal credit for several reasons, including: i) their lack of documentation; ii) higher vulnerability to economic cycles; iii) restricted capacity to provide high-value collateral. So far, only 179,000 SMEs are catered to by commercial banks⁴² against an estimated SME population of over one million units in the country,⁴³ i.e. only 18% of SMEs are formally catered to. On the other hand, the average loan size of microfinance operators hovers at PKR 39,000, showing a major concentration of low-ticket loans to individuals rather than enterprise lending. Therefore, the flow of credit to these small-sized businesses is restricted. Based on a third-party study conducted for Karandaaz Pakistan, the estimated credit gap for small- and medium-sized entities in Pakistan is as much as PKR 2.5 trillion⁴⁴. The situation gets worse due to the non-availability of alternative financing avenues that can be leveraged to close this financing gap.

As per current statistics published by the State Bank of Pakistan (SBP), currency in circulation vis-à-vis banking deposits is currently at 42%,⁴⁵ which was 28% in 2014. This shows a contraction in banking deposits. Moreover, the investment-to-deposit ratio (IDR) of Pakistan's banking industry has now reached 66%⁴⁶, i.e. only a third of deposits are being rolled-out as advances. Based on September 2020 figures, 89% of banking investments were parked in government securities and bonds⁴⁷, highlighting the risk-averse behaviour of domestic banks and restricted flow of finance to the private sector, with an even more contracted pool available to SMEs — at 6.2% of private sector credit as per recently published data⁴⁸.

³⁹ Monetary Authority of Singapore. 2018. Securities and Futures Act: Guidelines on personal offers made pursuant to the exemption for small offers. https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Fund-Management/Regulations-Guidance-and-Licensing/Guidelines-on-Personal-Offers-made-pursuant-to-the-Exemption-for-Small-Offers-SFA-13G19_8-Oct-2018.pdf.

⁴⁰ Ibid.

⁴¹ Monetary Authority of Singapore. 2018. Securities and Futures Act. Guidelines on advertising restrictions in sections 272A, 272B and 275. https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Fund-Management/Regulations-Guidance-and-Licensing/Guidelines-on-Personal-Offers-made-pursuant-to-the-Exemption-for-Small-Offers-SFA-13G19_8-Oct-2018.pdf.

⁴² Karandaaz. Undated. Small and medium enterprise (SME) financing > SME borrowers. <https://portal.karandaaz.com.pk/dataset/sme-borrowers/1069> [accessed 22 January 2021].

⁴³ Estimation based on a third-party market analysis and feasibility study conducted by LFS Advisory for Karandaaz-Pakistan.

⁴⁴ Ibid.

⁴⁵ Reading as of September 2020.

⁴⁶ Karandaaz. Undated. Banking infrastructure and transactions. <https://portal.karandaaz.com.pk/category/banking-infrastructure-and-transactions/2002> [accessed 22 January 2021].

⁴⁷ State Bank of Pakistan. 2020. Banks and non-banks holdings of GoP marketable securities (outstanding stock basis - face value). <https://www.sbp.org.pk/ecodata/GoP/2020/08-Dec-2020.pdf>.

⁴⁸ Karandaaz. Undated. SME finance as % of private sector credit. <https://portal.karandaaz.com.pk/dataset/sme-finance-percentage-private-sector-credit/1071> [accessed 22 January 2021].

The Pakistan Stock Exchange (PSX) announced a dedicated SME board in 2017 to attract equity investments in small- and medium-sized entities. However, the board remains defunct. In late 2019, the Securities and Exchange Commission of Pakistan (SECP) reconsidered the listing requirements for this SME board and rebranded it as the growth enterprise market (GEM). Some key listing provisions have also been relaxed to accommodate issuing entities and enhance the pool of eligible investors in an effort to activate the board. The previous regulations defined eligible SMEs as entities with a 'post-issue' paid-up capital of PKR 25 million – 200 million, essentially placing a restriction on the amount of capital that can be raised via an SME board listing. As per the new GEM guidelines, the floor of having a post-issue paid-up capital of PKR 25 million has been retained, but the cap has now been removed. The requirement of having at least five qualified institutional buyers (QIBs) has also been abolished, and the new guidelines do not enforce a hard restriction with respect to the minimum number of mandatory institutional investors. Moreover, the private fund established under the SECP's Private Fund Regulations, 2015 and foreign companies have also been added to the list of eligible institutional investors, thereby expanding the overall pool of eligible investors.

In order to cater to non-institutional investors, the former SME board's listing regulations had a concept of high net worth individuals who were defined as investors placing a bid of PKR 1 million and above, essentially defining a threshold for their minimum bidding activity. This has now been changed, and the eligibility of individual investors is now linked to their financial capacity. Individual investors having net assets of at least PKR 15 million — excluding the value of personal residence — can now take part in GEM offerings. In terms of issuing methodologies, the regulations had always allowed both, i.e. fixed-price mechanism and book building. However, the latter was only allowed for SMEs that had a post-issue paid-up capital of PKR 100 million or more. This restriction has now been removed, thereby allowing small-cap companies to explore the opportunity of fair price discovery through the book-building methodology. With respect to the mandatory disclosure requirements, the issuers were previously required to submit audited financial statements for the last five years (in situations where an entity did not have an operational existence of five years and regulations allowed entities to cover a shorter period starting from their commencement of business). This requirement has been significantly reduced to dilute the compliance burden, and issuing entities are now only required to submit audited financial statements for the last two years or a shorter period if the operational existence of an entity has been less than two years. In this context, using digital infrastructure to channel funds from retail and institutional investors to provide liquidity and capital support to emerging entities, especially MSMEs and start-ups, can unlock significant economic advantages.

As crowdfunding gains momentum across the world, the SECP has also taken the initiative of formulating and introducing regulatory guidelines to launch the equity-based variant in Pakistan as a starting point. Karandaaz Pakistan provided technical assistance to the SECP in this regard, whereby draft ECF guidelines were developed. The SECP is currently testing these under its newly launched regulatory sandbox⁴⁹. As per news reports, the applications approved under the first cohort for six-month live testing include digital insurance, digital platforms for mutual funds, Rob advisory, and crowdfunding. Crowdfunding powered by extensive digital outreach can prove to be a significant contributor to addressing the financial woes of start-ups and MSMEs. With the launch of a comprehensive regulatory framework for ECF in Pakistan, the SECP not only aims to provide a larger pool of investors to local start-ups and MSMEs, but also envisions strengthening and further enhancing the depth of Pakistan's capital markets by giving digital-savvy investors an opportunity to invest in alternative financing channels.

Box 1: Key regulatory considerations for an equity crowdfunding framework in Pakistan

For platforms

With respect to the eligibility requirements and issuance of a license to undertake ECF, platform operators should be obliged to clearly state in their license application whether they have sufficient financial and non-financial resources to successfully run the platform, and should be able to demonstrate the availability of an independent online platform. The sponsors, directors, and key management should be able to comply with the 'fit and proper' guidelines. The threshold for the base capital requirement should be given due consideration so that it is not too restrictive for the operators, while at the same time, the defined threshold is reasonable against the operating risks involved. One such example can be the Singaporean regime where MAS received feedback for the reduction of the minimum capital requirement and security deposits, and accordingly, post-consultations, the authority revisited the thresholds and reduced the minimum base capital requirement for platforms from SGD 250,000 to SGD 50,000 (equivalent to PKR 6 million).

In order to manage any potential conflict of interest, the regulations should clearly define the investment thresholds that an ECF platform can invest in an ECF campaign publicised over its platform. Furthermore, platform operators should be required to have a trust account to handle campaign funds, which should only be

⁴⁹ The SECP had opened applications for its first cohort in February 2020.

transmitted to the issuers upon successful closure of an ECF campaign, as is the case in other regimes. The platform should also ensure that investors and issuers are in compliance with their respective investment/offering limits.

One key feature for such platforms across different regimes is the due diligence of campaign proposals. Across all regimes, platform operators should be required to conduct detailed background checks on the sponsors, directors, and management of the issuing entity. The platform should be obligated to have internal checks in place to ensure all relevant information on the proposed campaign is, including potential risk, clearly mentioned in the proposal and adequately communicated to investors.

The platforms should also ensure robust IT and operational infrastructure to control and manage trading activity. The Malaysian regime has specific clauses on the management of trading operations whereby platforms are required to ensure that adequate arrangements are in place to manage system failures and malfunctions. The platforms are also required to take measures to control excessive market volatility, which may include circuit breakers, price limits, and trading halts. Internal procedures should be able to identify manipulative activities on the platform and ensure the proper execution of trades to protect sensitive information. Policies to monitor anti-money laundering/counter-terrorism financing, along with reporting mechanisms, should be part of the internal operational framework of these platforms.

For issuers

While some regimes put a limit on the capital raised via ECF during a year, others do not specify a threshold as such. Rather, they ease reporting requirements (e.g., the issuance of a prospectus) for a certain offering amount, indirectly facilitating small-sized entities. Pakistan's equity market still lacks depth, and in order to manage systemic risks, it is favourable to specify offering limits on issuers. However, defining a threshold is not that straightforward. The GEM board primarily envisioned catering to the financial needs of mature SMEs can be studied as a reference point. As per GEM's updated listing guidelines, eligible entities are required to have a minimum post-issue paid-up capital of PKR 25 million, and the issuing entity is required to offer at least 10% of its paid-up capital in a particular public offering. However, there is no cap on the offering amount.

A tiered-wise approach can be considered for ECF issuers where annual offering limits for early-stage and small-cap start-ups can be more restrictive compared to their mature counterparts (in terms of their operational existence, paid-up capital, and level of profitability). The disclosure requirements should also be a function of the entity's maturity. A similar structure (as prevalent in the USA) can be adopted where minimum mandatory disclosure requirements can be pegged against the threshold of capital raised during a year, facilitating small-sized entities with fewer compliance requirements. Moreover, the framework should outline the possibility and mechanism of migration to the GEM, as this will provide i) a systematic up-gradation to eligible entities; ii) a possible listing pipeline for GEM; iii) clarity on the possible exit options to crowdfunding investors.

For investors

ECF campaigns, by their very nature, are riskier investments. A common factor across all examined regimes is the clear identification of eligible investors and restricted allowances for participation in such campaigns. The Malaysian structure has pre-defined annual investment thresholds for different types of investors based on their financial sophistication. In the USA, the investment limits are a function of investors' annual income and net assets, with more restrictive regimes for low-income/non-accredited tiers. In the UK, overall solicitation is restricted to a certain class of investors — whereby such securities cannot be offered to retail investors.

One general fact about the domestic market is that the idea of equity investment is not particularly popular among ordinary citizens. Therefore, it is recommended to have a similar tiered approach with clear instructions for non-institutional investors to adequately protect their interests. Again, taking GEM guidelines as a reference, in addition to institutional investors, the GEM offering is limited to individuals possessing net assets of PKR 15 million (excluding the value of their personal residence). However, there is no cap on the amount of investment an individual can make. Considering the riskier nature of ECF securities and their vast outreach, overall participation from non-sophisticated investors also needs to be restricted. However, instead of defining a hard threshold, this limit should essentially be a function of individuals' net worth, allowing investors to take on exposures based on their financial capability. The regulatory framework should also allow participation from overseas citizens to leverage the Pakistani diaspora, as that could direct further capital to domestic MSMEs and improve remittance inflows.

About Karandaaz

KARANDAAZ PAKISTAN is a Section 42 company established in August 2014 and focuses on fostering economic growth and creating jobs through financial inclusion of unbanked individuals and unserved enterprises, with a special focus on women and youth. The company has four verticals:

Karandaaz Capital

Provides wholesale structured credit and equity-linked direct capital investments to micro, small and mid-size enterprises (MSMEs) that demonstrate compelling prospects for sustainable business growth and employment generation in Pakistan.



Knowledge Management and Communications

Supports the company's core financial inclusion goal by developing and disseminating evidence based insights and solutions.



Karandaaz Digital

Focuses on expanding the poor's access to digital financial services in Pakistan by working across the ecosystem with all stakeholders.



Karandaaz Innovation

Manages the Innovation Challenge Fund and Women Entrepreneurship Challenge, providing risk capital and grants to partners with the aim to generate innovative solutions in areas of financial inclusion and entrepreneurship.

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GATES foundation



📍 1E, Mezzanine Floor, Ali Plaza,
Nazimuddin Road, F-6/4, 44000, Islamabad
☎ Tel: (051) 8449761
✉ Email: info@karandaaz.com.pk

🌐 karandaaz.com.pk
🐦 twitter.com/KarandaazPK
🌐 linkedin.com/company/karandaaz-pakistan
📘 facebook.com/KarandaazPK