



Crowd-funding: An Infant Industry Growing Fast

Staff Working Paper of the IOSCO Research Department

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About this Document

The IOSCO Research Department is conducting research and analysis around IOSCO Principles 6 (on systemic risk) and 7 (reviewing the perimeter of regulation). To support these efforts, the IOSCO Research Department is undertaking a number of information gathering exercises including extensive market intelligence in financial centres; risk roundtables with prominent members of industry and regulators; data gathering and analysis; the construction of quantitative risk indicators; a survey on emerging risks to regulators, academics and market participants; and review of the current literature on risks by experts.

This holistic approach to risk identification is important in order to capture those potential risks that may not be apparent in the available data (i.e. not necessarily quantifiable), or which may be currently seen as outside the perimeter of securities market regulation, but nonetheless significant.

Two potential areas of financial innovation that have seen strong growth in recent years are peer-to-peer lending and equity crowd-funding. These industries affect a number of key global initiatives outlined by IOSCO and the G20. These include the diversification and broadening of markets; mechanisms aiding in the long-term financing of the real economy; and the promotion of wider stability within the financial system.

As a first step towards engaging with this issue, the IOSCO Research Department, has undertaken a review of these practices and how they might relate to IOSCO, its members and their regulatory remit and the wider real economy. This IOSCO Staff Working Paper "*Crowd-funding: An Infant Industry Growing Fast*" presents a review of financial return crowd-funding, as well as key insights on the main implications for users. It is the first publication of its kind in tying together a global overview of the industry along with a mapping exercise of the global regulatory landscape.

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Executive Summary

Introduction

- 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.
- Crowd-funding has four subcategories: Donation crowd-funding, reward crowd-funding, peer-to-peer lending and equity crowd-funding. This document is a factual report analysing peer-to-peer lending and equity crowd-funding, being forms of market-based finance that are collectively referred to as “financial return crowd-funding” or “FR crowd-funding”.
- The online nature and the usually small size of investments of FR crowd-funding makes this industry different from private placement or other similar activities.

Nature of financial return crowd-funding

- FR crowd-funding globally has grown rapidly in the last 5 years, with data suggesting that the peer-to-peer lending market doubles each year. It accounts for approximately \$6.4 billion outstanding globally.
- FR crowd-funding market is worth over \$1 billion in the USA, the UK and China, and is taking off in many other jurisdictions across the world.
- FR crowd-funding has three main business models: the client segregated account model, the notary model and the equity crowd-funding model. The major difference between the two peer-to-peer lending models, the client segregated account model and the notary model, is that in the latter a bank originates the loan unlike the former where the platform originates the loan. The third model, equity crowd-funding, is different from peer-to-peer lending as it allocates stock equity to investors, with the financial return coming in the form of dividends and/or capital growth.

Key benefits

- The primary benefit of FR crowd-funding to entrepreneurs seeking to raise funds as a form of market-based finance is the ability to raise capital, in most cases without giving up large parcels of equity interest.
- FR crowd-funding spreads risk – the majority of investors are individuals (although some institutional investors are beginning to enter the market) with funding requests filled in much smaller incremental amounts.
- Another benefit is the lower cost of capital and higher returns to investors – crowd-funding provides a low cost alternative to channelling savings to the real economy, usually at rates lower than those attainable through traditional funding avenues. Additionally, venture and seed capital requests are difficult to access in the current economic environment. Crowd-funding alternatives provide an affordable and attainable option for raising capital.

- FR crowd-funding can help economic recovery by financing small and medium enterprises (SMEs) which are a key engine of economic growth. Helping those entities more efficiently access capital for their development and expansion can contribute to job creation and economic recovery.

Key risks

- Risk of default: In equity crowd-funding the risk of default/investment failure is estimated to be around 50%. In peer-to-peer lending there has been a concerted effort by the industry to reduce default rates, which reached a high of 30% in 2009. While there has been some success in reducing the default rate, the actual rate of default in many cases is unknown as many of the platforms have only opened in the last three years and the loans originated by them have only recently started to mature.
- Risk of platform closure/failure: Despite the short life of crowd-funding, there has already been a case of a peer-to-peer lending platform closing leaving no data on contracts behind and resulting in 100% investment loss. Investors bear a higher risk than in many other types of investments.
- Risk of fraud: This is compounded in both peer-to-peer lending and equity crowd-funding by the anonymity created by the online aspect of these industries. This is the case for both the lender/investor and borrower/issuer parties, whereby the opportunity to defraud is an ever present reality.
- Risk of illiquidity: Investors cannot sell their participations as there doesn't exist a secondary market. This lack of liquidity in FR crowd-funding could be a risk for investors if they are not aware of this.
- Risk of cyber-attack: The online nature of FR crowd-funding makes FR-crowd funding vulnerable to the risk of cyber-attacks.
- Lack of transparency and disclosure of risks: Risks tend not to be disclosed until a lender/investor becomes a member of the platform.

Regulatory regimes

- The regulatory regimes are dependent on jurisdictional choices in regulation.
- There currently is no cross-jurisdictional harmonisation in the regulation of these industries.

Peer-to-peer lending is regulated in five different ways. These are:

1. Exempt/ unregulated through lack of definition
2. Platforms regulated as an intermediary
3. Platforms regulated as a bank
4. The US model: there are two levels of regulation, Federal regulation through the Securities and Exchange Commission (SEC) and state level, where platforms have to apply on a state-by-state basis.
5. Prohibited

Equity crowd-funding is regulated under three main regimes. These are:

1. Regulation that prohibits equity crowd-funding completely.
 2. Equity crowd-funding is legal but the regulation of the industry creates high barriers to entry
 3. Regulation may allow the industry to exist, but with strict limits
- One approach to the regulation of FR crowd-funding by some jurisdictions looks to designate the markets as exempt or to lighten the regulations around the issuance of shares through equity crowd-funding in order to promote SME growth.

Analysis of potential systemic risks and investor protection concerns

- Drawing on the past work of the IOSCO Research Department peer-to-peer lending and equity crowd-funding is analysed to establish if they pose a systemic risk. The main conclusion at the time of writing is that the industries do not pose systemic risk yet. The following impact factors are relevant in this analysis.
- **Size:** The peer-to-peer lending market is very small, accounting for only a fraction of all credit provided to the real economy. However, it is an industry that is almost doubling each year in size. This means that even though the current market size is too small to cause systemic risk, it has the potential to grow to a sizeable market in a short amount of time.
- **Liquidity:** There is a lack of liquidity in peer-to-peer lending, with relatively few platforms providing a secondary market on which to sell loan portfolios. Equity crowd-funding has even less liquidity as there is no secondary market for shares in start-ups due to the inability to accurately judge the value of the equity shares. This is a problem for investors who want to liquidate positions.
- **Cross-border activities and implications:** A few platforms have chosen to open their business to other nationals, introducing cross border complexities. Questions are yet to be answered in regards to contract law enforcement across jurisdictions. Further in-depth work is required to understand the legal implications of cross-border operations. Therefore, cross border complexities could become a source of systemic risk in the future.
- **Interconnectedness through securitisation practices and bank involvement:** There have been recent examples of the securitisation of peer-to-peer unsecured loans. This opens the market to new investment, but also opens the rest of the financial market to exposure to packaged loans which are predominately unsecured in nature. Since this segment of the market is extremely small, it is not currently a source of systemic risk.

In conclusion, the FR crowd-funding market does not present systemic risk to the financial system at present. However, rapid future growth of the market could change this. There is also a concern for investor protection raised by these financial activities.

The application of the IOSCO Objectives and Principles

- IOSCO's *Objectives and Principles of Securities Regulation* provide a good regulatory foundation for peer-to-peer lending and equity crowd-funding.

Next Steps:

- Although no currently a systemic risk, these markets do pose problems for investor protection which need to be addressed.
- Further monitoring and research is required. There is a need for further research, inter alia, in developing indicators based on hard data.
- In order to exploit the benefits of FR crowd-funding while mitigating its risks a balanced regulatory approach will be required. The balance will need to be established by each regulator as it depends on political choices and the regulatory regime, which varies across the globe.
- At the same time there might be a need for the international harmonisation of regulatory requirements given the possible cross-border nature of the FR crowd-funding market. IOSCO is well positioned to examine the need for global principles or standards in this area.

Introduction

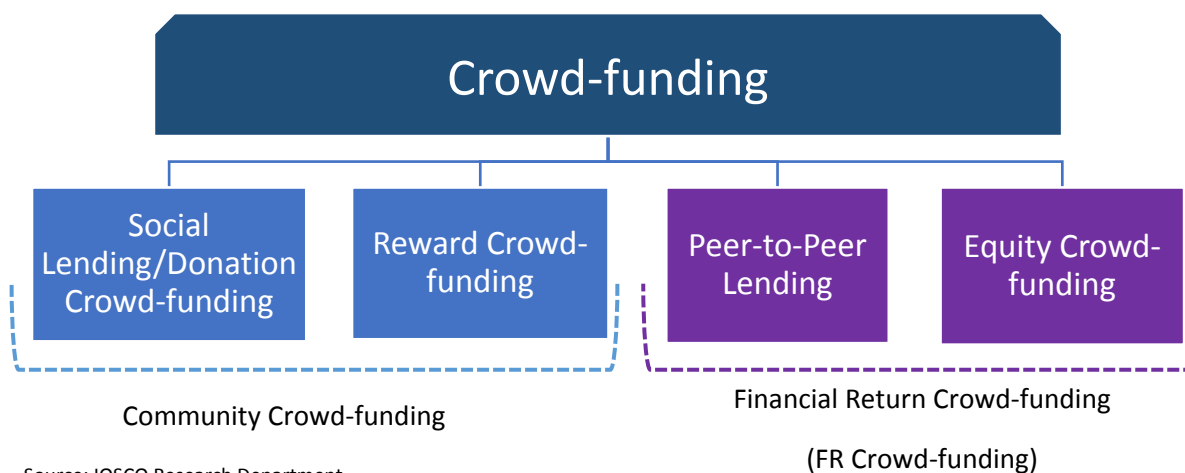
Crowd-funding is an umbrella term describing the use of small amounts of money, obtained from a large number of individuals or organisations, to fund a project, a business or personal loan, and other needs through an online web-based platform. Peer-to-peer lending is a form of crowd-funding used to fund loans which are paid back with interest. Equity crowd-funding is the raising of capital through the issuance of stock to a number of individual investors using the same method as crowd-funding.

Peer-to-peer lending and equity crowd-funding platforms are of particular interest to IOSCO and its members because they are growing rapidly and are accessible easily to both retail and sophisticated investors alike. Various IOSCO members have recently published or are in the process of publishing guidelines, policies or reviews on developments in their jurisdictions. Peer-to-peer lending and equity crowd-funding have also drawn the attention of governments who wish to encourage the growth of small and medium enterprises (SMEs), which has led some governments to actively seek to lend money through these platforms, or implement regulatory changes through the use of exemptions or regulation reviews of these markets.

Types of crowd-funding²

Crowd-funding can be divided into four categories: social lending/donation crowd-funding, reward crowd-funding, peer-to-peer lending and equity crowd-funding.³ This is shown in Figure 1.

Figure 1: The various forms of crowd-funding activities



Source: IOSCO Research Department

² Crowd-funding should not be confused with micro-financing (for example, such as the Grameen Bank style of micro-lending). Microfinancing is predominately a bank based exercise, whereby the bank is the sole provider of the loan, is the originator of the loan and bears the risk of the loan. As such, it does not draw on the principles of many investors funding small parts of a required capital need.

³ Pierrakis, Y and Collins, L (2013) *Nesta...Banking on Each Other: peer-to-peer lending to business: evidence from Funding Circle*, [pdf] Available at: <http://www.nesta.org.uk/library/documents/Peer-to-peer-lending-report.pdf>, p11

Social lending/donation crowd-funding and reward crowd-funding are a way of fundraising for charitable causes, for example through angel investors, or pre-paying for a product from a business, for example NakedWines.com.⁴ These two categories of crowd-funding can be collectively referred to as “community crowd-funding” (see Figure 1). The main difference between these forms of crowd-funding and the other two that are the subject of this report is that they do not provide any financial return in the form of a yield or return on investment.⁵

Consequently, peer-to-peer lending and equity crowd-funding can be referred to collectively as “financial return crowd-funding” or “FR crowd-funding”. Both types of FR crowd-funding are internet based. This paper focuses on peer-to-peer lending and equity crowd-funding due to the clear securities market implications and regulatory remit of IOSCO members. It is important to note the existence of the different subcategories of crowd-funding, and not to take crowd-funding as being synonymous with either peer-to-peer lending or equity crowd-funding only. Lack of such precision in legal documents could lead to complications in the implementation of rules by participants.

Peer-to-peer lending can be defined as the use of an online platform that matches lenders/investors with borrowers/issuers in order to provide unsecured loans. This particular form of crowd-based financing makes up the bulk of the FR crowd-funding market considered here. The borrower can either be an individual or a business requiring a loan. It is characterised by the ability of lenders to provide money for small fragments of the overall loan required by a borrower; these are called “loan parts” and can be as small as £10.⁶ These loan parts are then aggregated by the online platform and when there is enough to cover the required loan, the loan is originated and paid to the borrower. The interest rate is set by the platform. The borrower then pays back the loan with interest. This interest rate is usually higher than the savings rates available to the lender but lower than a traditional loan available to the borrower, though this depends on the borrower’s evaluated risk. The interest is paid to the lender until one of the following occurs: the loan matures; the borrower pays it back early or the borrower defaults.

Smaller peer-to-peer lending platforms also cater to niche markets. These include, though are not limited to, platforms with a specific focus specialising in transactions in real estate financing, venture capital, business-to-business, graduate financing, funeral financing, art project financing, technological start-ups or consumer-to-consumer loans for transactions such as eBay purchases.⁷

Equity crowd-funding is similar to peer-to-peer lending in terms of an online platform. Many individuals can invest in a business through the platform, gaining an equity stake. These

⁴ Robinson, D. (2013) ‘Naked Wines raises \$10 million for expansion into US and Australia’, *Financial Times* [Online] Available at: <http://www.ft.com/cms/s/0/8ef3ecdc-0a6f-11e3-aeab-00144feabdc0.html#axzz2gOGVQUUF> [Accessed: 01.10.2013]

⁵ Pierrakis and Collins, 2013, p11

⁶ FSA (2012) *crowd-funding: is your investment protected?* [Online] Available at: www.fsa.gov.uk/consumerinformation/product_news/saving_investments/crowd-funding [Accessed: 01.10.2013]

⁷ Verstein, A. (2012), “Misregulation of Person to Person Lending”, *Lecturer and Other Affiliate Scholarship Series*, Paper 8, Available at: <http://digitalcommons.law.yale.edu/vlas/8>, p 456

businesses are usually early stage small start-ups with no access to other forms of funding via the public-at-large due to their small size and maturity. Once the online platform completes the equity raising, the crowd investors hold equity stakes in the firm and assume all the risks associated with investing in equity. However, being start-ups, these businesses are inherently much more risky as an investment, with market intelligence indicating that there is a 50% chance of a start-up folding in the first 5 years of existence. Additionally, initial shareholdings in a company can be diluted in value through further issuances. A further risk is absence of any credible secondary market makes such equity stakes illiquid. Equity crowd-funding is currently a small sector, often with many regulatory impediments preventing such small public equity raisings or strictly limiting the size of retail investments.

FR crowd-funding is a new innovation of market based finance. Due to technological advancements making these markets viable, FR crowd-funding is solely an internet based market. In addition, the ability to allow many investors to invest small amounts of an overall funding request means it is accessible to a vast number of potential investors and borrowers. Not only this, but in the case of peer-to-peer lending it is open to many different types of investors, with varying capacities and risk appetites. This makes this industry different from private placement or other similar activities.

The purpose of this report

To date, there has been little research done into the current and future risks of FR crowd-funding.⁸ Though the market sizes are very small in comparison to the total loan origination globally, the pace of growth in these markets suggests that crowd-funding in general and peer-to-peer lending in particular become a more widely accessed investment option for the wider public. This raises investor protection issues. Due to the current spotlight on FR crowd-funding, as shown by the recent publication of consultation papers on this subject,⁹ it is now opportune to review these markets from a global perspective in order to facilitate an informed discussion on these new and innovative financial segments, and to demonstrate how current IOSCO principles are applicable in the regulation of these industries.

Box 1: Methodology

In the analysis that follows, the data used were collected from individual platforms across the globe, with the cut-off for the data collection as at end of September 2013. No central data hub exists for the industry at a global level. Therefore, what follows, to the authors' knowledge, is the first exercise of its kind to compile a global level overview of the industry. Every attempt has been made to ensure the accuracy of the data at the time of the analysis. Given the number participants in this space globally, however, only those entities identified

⁸ Recommended reading: United States Government Accountability Office report on crowd-funding entitled: *Person-to-Person Lending; New Regulatory Challenges Could Emerge as the Industry Grows*; Chaffee, E and Rapp, G. (2012) 'Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry', *Washington and Lee Law Review*, Vol. 69(2), pp485-533; Verstein, A.(2012), "Misregulation Of Person To Person Lending", *Lecturer and Other Affiliate Scholarship Series*. Paper 8. Available at: <http://digitalcommons.law.yale.edu/ylas/8>

⁹ See Box 3, p31 for more information

through desk research as being of material consequence in their relative jurisdiction and those that chose to provide data for the analysis have been included in the dataset. No attempt has been made to collect data from those entities that failed prior to September 2013 as access to data is difficult and information scarce. As such, the dataset used in the analysis only constitutes a subsample of the entire surviving population of the global industry. The charts, figures and findings that are presented in this report should be interpreted with this caveat in mind.

The report is structured as follows. Chapter 1 outlines the nature of FR crowd-funding, including how it has evolved and its variety of business models and legal structures employed by the platforms. Chapter 2 follows analysing the key benefits and risks associated with FR crowd-funding. The emerging global regulatory regimes are outlined in Chapter 3, while Chapter 4 uses the IOSCO Research Department's systemic risk identification framework to analyse the industries using quantitative and qualitative impact factors and to raise the issue of investor protection. The current toolbox of IOSCO principles and standards are conceptually applied to this subject in Chapter 5. Chapter 6 concludes.

Chapter 1: Nature of the industries

The evolution of the industry

Modern peer-to-peer lending and equity crowd-funding are relatively young; they started in the UK in 2006,¹⁰ spread to the US in 2007 and took off in China in 2009.¹¹ They are also still small, amounting to around \$6 billion in capital origination. Nevertheless, these industries are growing rapidly. There are two main factors contributing to the rapid rise of FR crowd-funding: 1) technological innovation; and 2) the financial crisis of 2008.

Technological advancement makes crowd-funding viable...

FR crowd-funding has been on the fringe of economic activity for many years in various forms predicated on convenience.¹² However, FR crowd-funding platforms only started to grow substantively in 2006 in the UK after the technological innovation of so-called Web 2.0 applications on the internet made it viable. Web 2.0 refers to a change in technology that allowed users of the internet to participate in the creation of content hosted on stable websites. It emphasises the “wisdom of the crowds” in website design¹³ and the development of software to enable participation.¹⁴ Two examples of this type of technology are Wikipedia and EBay, both of which allow multiple individuals to contribute to the overall architecture of the website. This technological leap provided the means to create peer-to-peer lending and equity crowd-funding websites¹⁵ making FR crowd-funding viable through reducing the cost of transactions associated with providing these services. This style of website architecture promotes user participation by allowing borrowers to set up a profile; add pictures and describe how they will use the loan or investment.¹⁶ This provides the online platforms with a social-networking aspect, with borrower/issuers voluntarily providing information to potential investor/lenders. The online aspect cuts cost and is convenient for both the borrower/issuer and lender/investor, in addition to increasing the potential reach of this form of investment opportunity or capital raising facilities.

... Financial crisis and reduced business lending by banks have left a gap in funding

The second factor explaining the evolution of FR crowd-funding platforms is the financial crisis. The 2008 financial crisis resulted in a number of bank failures and, consequently, the

¹⁰ Farnish, C (2013) *Peer-to-Peer Lenders Welcome FCA Regulation*, [Online] Available at: www.CCRMagazine.co.uk [Accessed: 30. 09.2013]

¹¹ Li Xiaoxiao and Yang Lu (2013) *Central Bank Raises the Red Flag over P2P Lending Risks*, [online] Available at: <http://english.caixin.com/2013-07-04/100551424.html> [Accessed: 16. 09. 2013]

¹² Chaffee and Rapp, 2012, pp495-501

¹³ Surowiecki, J (2005) *The Wisdom of Crowds*, Anchor Books - Surowiecki's theory posits that a large group of diverse individuals can make better decisions and display more intelligence than a small group of experts when averaged

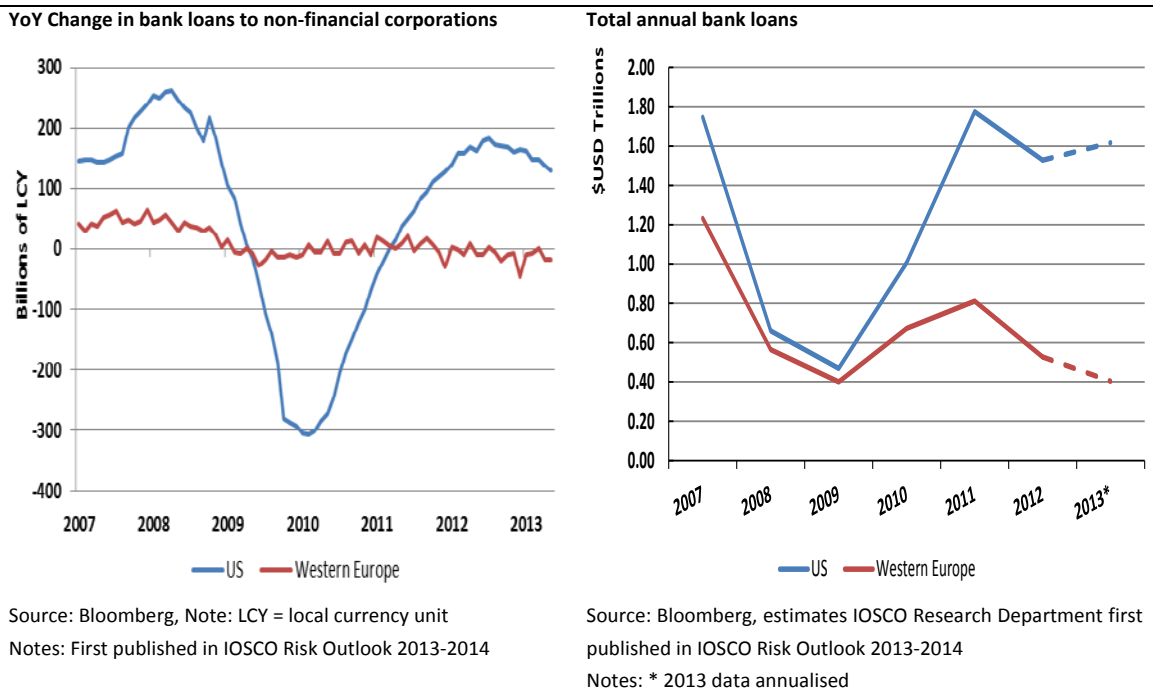
¹⁴ O’Rielly, T. (2007) *What Is Web 2.0: Design Patterns and Business Models for the Next Generation of Software* [pdf] Available at: http://mpira.ub.uni-muenchen.de/4578/1/MPRA_paper_4578.pdf

¹⁵ Chaffee and Rapp, 2012, p501

¹⁶ Herzenstein, M. Soenshein S. and Dholakia, U. (2011) *Tell Me a Good Story and I May Lend You Money: The Role of Narrative in Peer-to-Peer Lending Decisions*. Available at: <http://sonenshein.rice.edu/uploadedFiles/Publications/tell%20me%20a%20good%20story%20and%20I%20may%20lend%20money.pdf>

implementation of new capital adequacy regulations for banks, such as Basel III. As a result, credit providers have become increasingly constrained in their ability to lend money to the real economy. Figure 2 shows how the amount of bank loans made in Western Europe and the USA dropped significantly at the beginning of the crisis. While there have been some signs of recovery in the US (although the growth rate is still below pre-crisis levels), in Western Europe the growth rate in loans to the non-financial corporate sector has been negative, especially to SMEs in the EU.

Figure 2: Evolution of bank lending



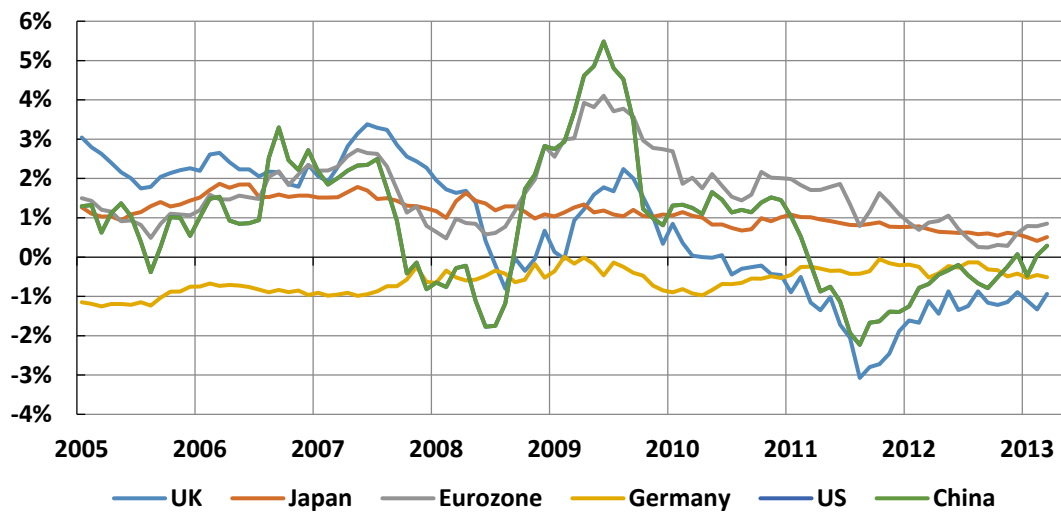
In this funding vacuum, peer-to-peer lending is growing in popularity as bank liquidity is reduced and new regulatory requirements make obtaining loans for small and medium enterprises and individuals difficult.¹⁷ Lending to SMEs, as well as the financing of personal loans fell during the crisis,¹⁸ leaving a gap in the market in loans to SMEs and personal loans. Additionally, as highlighted in IOSCO’s Risk Outlook 2013-2014,¹⁹ quantitative easing in many jurisdictions has driven interest rates close to their zero lower bound (see Figure 3). This in turn has driven a “search for yield” pushing investors towards alternative forms of income generation.

¹⁷ Frezza, B (2013) *Caveat Emptor Banking: Peer-to-Peer Lending Challenges Too-Big-To-Fail Status Quo*, [Online] Available at: <http://www.forbes.com/sites/billfrezza/2013/08/13/caveat-emptor-banking-peer-to-peer-lending-challenges-too-big-to-fail-status-quo/> [Accessed: 16.09.2013]

¹⁸ Pierrakis and Collins, 2013, pp7-10

¹⁹ IOSCO (2013): “*IOSCO Securities Markets Risk Outlook 2013-14*”

Figure 3: Real interest rates in selected countries



Source: Bloomberg

In this climate, peer-to-peer lending has developed as a vehicle for borrowers to obtain a loan at a lower interest rate than through using traditional avenues of credit provision such as banks. Additionally, peer-to-peer lending offers a higher rate of return than through traditional investments, such as a savings account or government bonds. Further, many savers have inflation adjusted deposit rates that are often negative, impelling them to search for better returns on their savings.

Consequently, growth in the peer-to-peer lending market has been exponential, particularly after 2010 when the industry self-imposed restrictions on borrower creditworthiness in order to tackle high default rates, e.g. when Prosper saw default rates of 30% in 2009.²⁰ Figures obtained through data gathering and market intelligence suggest a 100% year-on-year growth rate since 2010. This is discussed further later in this paper.²¹

The rise of Financial Return crowd-funding

Since its inception in the UK and USA in 2006, peer-to-peer lending has emerged in many other jurisdictions, spreading to China and South East Asia in 2009.²² However, most of the peer-to-peer platforms have only been set up in the last three years, with very small fledgling platforms in Argentina, Italy, Estonia and India, amongst others.

Figure 4 shows the percentage of the overall amount of loans originated through FR crowd-funding platforms by country. Collectively, the US, UK and China make up 96% of the overall FR crowd-funding market: the US market accounts for 51% of the global market, with China

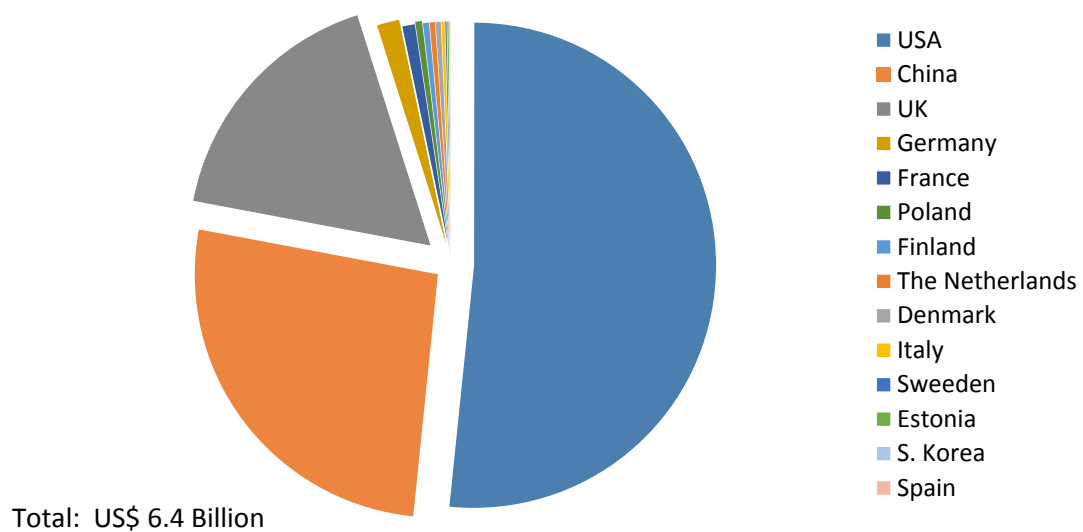
²⁰For further discussion see Chapter 2: risks

²¹ For a further discussion, please consult the "size" section of Chapter 4

²² Li and Yang (2013)

making up just over a quarter at 28%, and the UK just behind at 17%. The size of the US and UK market makes up 68% of the FR crowd-funding market, which amounts to just over \$4.3 billion. They are also the oldest markets, as these types of platforms were first established in these jurisdictions. Figure 5 also shows that the size of the FR crowd-funding market in South East Asia is quite large, making up 28% of the overall global market, according to the market data available. The lowest estimated market value for China, based on data available at the platform level, is half that of the US, at \$1.8 billion, though market intelligence suggests this figure is much higher than the data available. Current data shows that China and South Korea make up 95% of the total Asian market.²³

Figure 4: Pie chart showing peer-to-peer and equity crowd-funding market by country in 2013



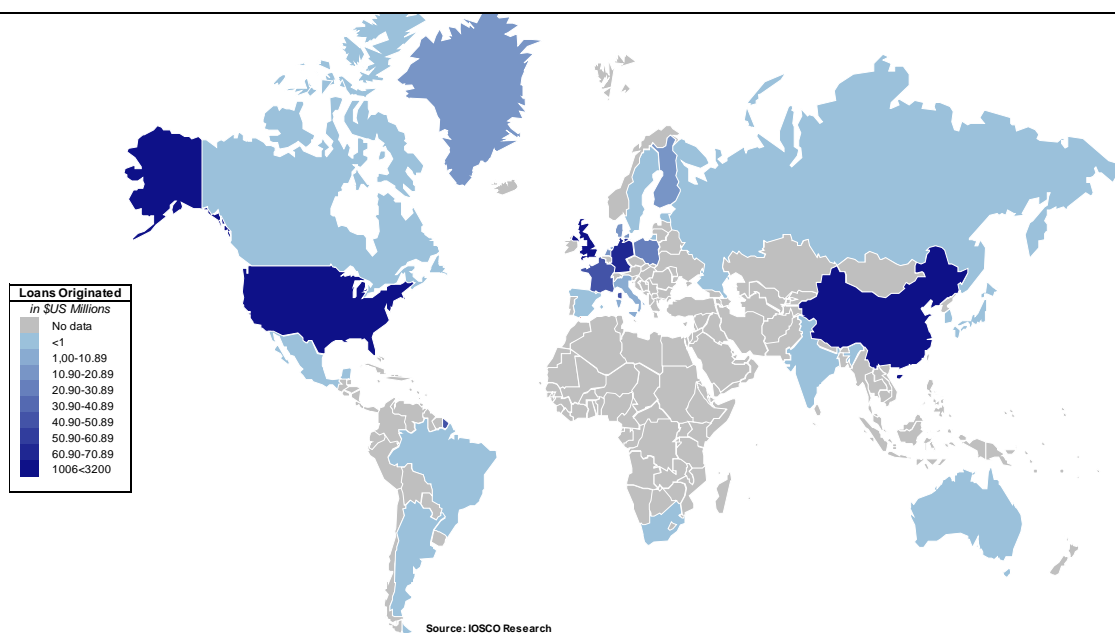
Source: IOSCO Research Department; Based on figures from selected peer-to-peer platforms within each country

Notes: 1) Peer-to-peer lending data is sourced directly from the websites of the largest providers. It therefore represents a lower bound estimate of the global loan pool. 2) Data as at 30th September 2013

Figure 5, provides a heat-map showing the amount of loans originated through peer-to-peer lending platforms according to country. It shows how the industry is concentrated in three jurisdictions, USA, UK and China. It also shows that for the majority of countries this market innovation has yet to develop substantially if at all.

²³ Consumer Fu (2013) *Peer to Peer lending: Investment and Loans Strategies*, [Online] Available at: <http://www.consumerfu.com/peer-peer-lending-investment-loan-strategies> [Accessed: 24.10.2013]

Figure 5: Global loan originations by peer-to-peer lending platforms by country since inception



Source: IOSCO Research Department; Based on data obtained directly from platforms, therefore represents the lowest estimated size for each country

Investor profile

Little research has been conducted on the demographics of the investors who use peer-to-peer lending and equity crowd-funding platforms. One study conducted by Pierrakis and Collins in 2013,²⁴ for a report by Nesta, is focused on the demographics of 600 lenders of Funding Circle in the UK. The report shows that most of the lenders are between 40 and 60 years old. Almost 90% are experienced investors in securities, while almost 40% have more than 10 years of experience working with SMEs, with 83% being male. The median investment size was £50 and the median number of investments is 35. The median total investment is £2,000. Although this study is not comparable with other platforms and countries and complete and comparable data is not publicly available, it shows relatively experienced retail investors investing small amounts of money in a great number of projects.

Business models

FR crowd-funding platforms are diverse in their business models. These business models depend on the regulatory system, as well as the principles by which the platforms found themselves on (some follow principles set by self-regulatory groups such as the P2P finance association).²⁵ All FR crowd-funding platforms are internet based. There are four major models of FR crowd-funding, which are outlined in more detail below.

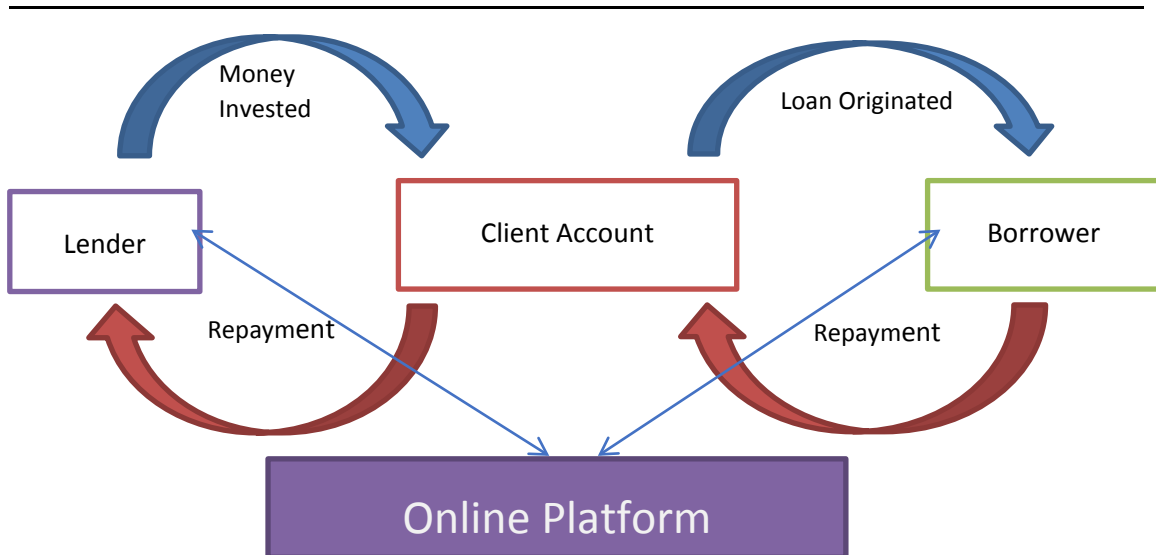
²⁴ Pierrakis and Collins, 2013.

²⁵ <http://www.p2pfinanceassociation.org.uk/>

Client segregated account model: This is a peer-to-peer lending business model. An individual lender is matched to an individual borrower through an intermediary platform, and a contract is set up between the individuals with little participation by the intermediary platform. Lenders can bid on loans in an auction style, with some services providing an automated bidding option, for example Funding Circle.²⁶ All funds from lenders and borrowers are separated from the platform's balance sheet and go through a legally segregated client account, over which the platform has no claim in the event of the platform's collapse. As such, the contractual obligation between borrower and lender still applies in the event of the platform's failure.

Fees are paid to the platform from both the lender and the borrower. The borrower pays an origination fee (either a flat rate fee or as a percentage of the loan amount funded) according to their risk category; they also pay late fees and an administration charge. The lender, depending on the platform, has to pay an administration fee and an additional fee if they choose to use any automated service the platform may provide. In addition, if the lender wants to sell their loan portfolio on a secondary market or to the platform there are some fees charged. The platform provides the service of collecting loan repayments and doing preliminary assessments on the borrower's creditworthiness. The fees go towards the cost of these services, the loan origination and compliance, as well as general business costs. Flow Chart 1 summarises this model.

Flow Chart 1: Client segregated account model



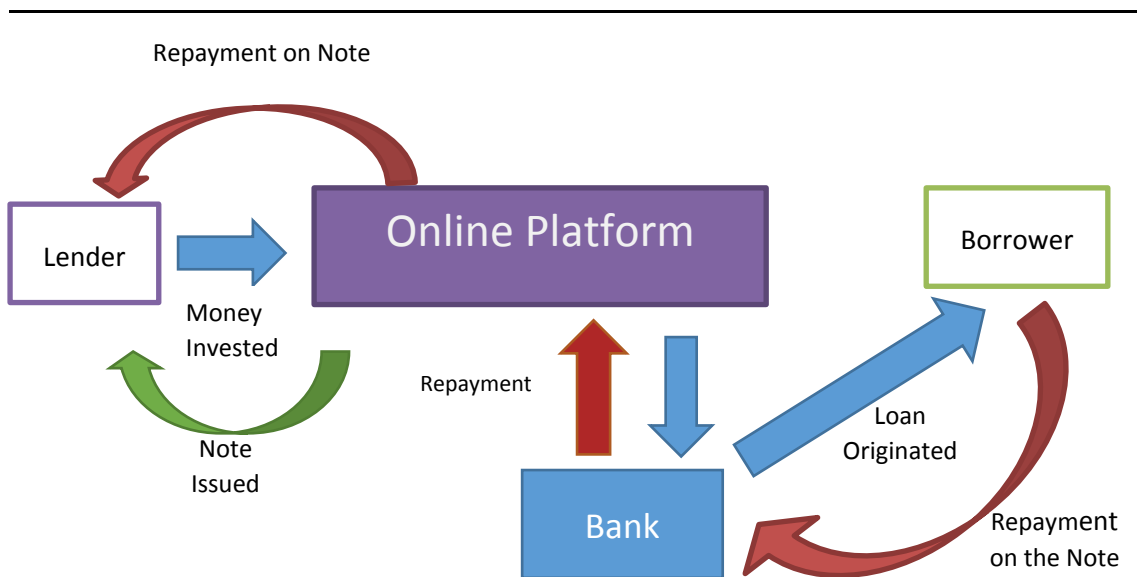
Source: IOSCO Research Department

²⁶ Pierrakis and Collins, 2013

A variation of this model is based on a trust fund, whereby lenders purchase units or shares in a trust structure, with the platform acting as the trustee who manages the fund. The platform then uses the fund to match borrowers with lenders, allowing the lenders some choice as to whom they finance. The platform then handles the administration of the loan and repayments. As it is a trust, it is legally distanced from the platform itself thereby preventing loss to the investors if the platform were to fail. An example of this business model would be Afluenta, based in Argentina.

Notary model: This is another peer-to-peer lending business model. As in the other models, the platform acts as an intermediary between the lender and the borrower, matching them to each other. The lender then bids on the loans they want in their portfolio; once the amount of money required is reached the loan is originated. However, instead of originating the loan themselves, a bank originates the loan. The platform then issues a note (the name “notary” stems from the issuance of notes instead of contracts) to the lender for the value of their contribution to the loan. This note is considered by many jurisdictions to be a security.²⁷ This, therefore, shifts the risk of loan non-payment to the lenders themselves and away from the bank originating the loan.²⁸ The fee structure is similar to that in the client segregated account model. This model is popular in the US, particularly with platforms such as Prosper and Lending Club. This is summarised in Flow Chart 2.

Flow Chart 2: Notary model



Source: IOSCO Research Department

²⁷ Chaffee and Rapp, 2012

²⁸ GAO United States Government Accountability Office (2011) Person-to-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows [pdf] Available at: <http://www.gao.gov/new.items/d11613.pdf> [Accessed: 30.09.2013], p13

“Guaranteed” return model: This is a peer-to-peer lending model. The model allows lenders to invest in peer-to-peer loans through the intermediary platform at a set rate of return on the investment guaranteed by the intermediary platform. This is depicted in Flow Chart 3.

A variation of this model is an Offline Guaranteed Return Model. The offline aspect refers to the soliciting of borrowers. This is done through the use of direct channels and through face to face sales techniques in the locality of the borrowers. The borrower is then manually assessed for creditworthiness. After this, the loan is listed on the online platform and lenders can choose to invest in the loan. Once the loan is originated the platform then collects on behalf of the lender. However, in this model the platform guarantees a return of between 8-10%²⁹ on the investment and it must adhere to this to remain in operation. This is the most popular model in China, and is the main model used by CreditEase, China’s largest platform. The offline aspect is necessary in order to attract borrowers and to check their creditworthiness. Market intelligence suggests that in China there is high investor interest but low borrower demand. This makes it necessary to actively attract borrowers through offline means.

Another variation of this model is an Automated Guaranteed Return Model, with the only known example of this so far being TrustBuddy International AB. The lender pays into a client account the amount they wish to invest overall. The platform then automatically lends this money to borrowers it has chosen through a metric created by the platform itself. The money is then lent for free for the first 14 days, after which there is a 12% interest rate and a fee applied to the loan. This interest rate increases over time at a rate set by the platform. The platform “guarantees” a return to the lender of 12%.

Flow Chart 3: Automated guaranteed return model



Source: IOSCO Research Department

Equity crowd-funding model: In this model lenders are able to invest online small sums of money in business start-ups by buying an equity stake in their chosen company. They take on the risk of the company failing but look to receive a return in the form of a dividend stream or

²⁹ Market intelligence

capital gain. This is similar to buying stock in a start-up company or a SME.³⁰ The platforms are funded through a fee of a percentage of the amount raised through the platform by the company looking for investment.³¹ There is no secondary market available for this type of start-up investment, making equity crowd-funding particularly illiquid. There are very few equity crowd-funding platforms due to the strict regulatory requirements that are in place to regulate public equity offerings. Crowdcube in the UK is one example of this type of platform. By law, most platforms can offer this type capital raising to sophisticated investors only (however defined by the jurisdiction they operate under) or to a limited number of individual investors (for example, in China an equity raising made to less than 200 individuals does not need to fulfil the public equity raising requirements as set out by the China Securities Regulatory Commission). These investments may also require the drawing up of a prospectus in some jurisdictions.

Most platforms operate locally but some are going cross-border

Although FR crowd-funding has the ability to go across borders due to the prevalence of internet access, the majority of business models for both peer-to-peer lending and equity crowd-funding choose to market themselves in only one locality. These models tend to have protocols in place to check the creditworthiness of borrowers through a mixture of third party databases, soft information and hard information collected from the borrower themselves, with some platforms manually checking and calling each borrower in order to mitigate the risk of fraudulent claims; only a small percentage of borrower applications gain approval. This is due to a number of factors such as: mitigating fraud, lowering the risk of default and applying with credit provision regulation. Another reason for the self-imposed creditworthiness checks is the need for FR crowd-funding to establish itself as a credible option for investors. As such there is a constant need to mitigate fraud and default which could jeopardise the industry in the long term if it is not managed effectively.

International, or cross-border, platforms also have these checks and tend to limit borrowers to only a few locations where they can gain data on the borrower through third party sources. However, the cross-border aspect of the platforms, and more particularly the uncertainty surrounding contract law application in different jurisdictions, has yet to be dealt with effectively by either of the international platforms, namely isePankur and TrustBuddy International. The ambiguity surrounding this aspect of the investment is of real concern.

³⁰ In Israel this is a potential model for funding high tech research and development start-ups, and will require approval from the Chief Scientists of Israel, a sophisticated investor's support as well as a recruitment coordinator to keep check on compliance. There may also be limits on the amount that can be borrowed and the amount that can be invested.

³¹ See Syndicate Room fees page: <http://www.syndicatoroom.com/entrepreneurs/our-fees.aspx>

Chapter 2: Benefits and Risks of Financial Return crowd-funding

Benefits

Many countries see the benefits of FR crowd-funding which is a form of market-based finance; primary among them is the ability to raise capital efficiently and effectively. An individual or organisation can raise the required capital they need, in most cases without giving up large parcels of equity interest. As a result, many jurisdictions have actively sought to encourage the development of these markets through various regulatory means. Other benefits associated with these innovative industries include:

a) Helping economic growth through new and increasing flows of credit to SMEs and other users in the real economy

Market-based finance provides credit to the real economy and FR crowd-funding is no exception. This is the benefit most cited by governments who want to encourage the growth of SMEs, and the role they play, in their respective economies. SMEs are an important engine of economic growth. As such, any mechanism that helps those entities more efficiently access capital for their development and expansion helps job creation and aids economic recovery. While some jurisdictions do not offer this form of capital raising, some others encourage investing in ventures like SMEs through this market activity. This has been the case in the USA with the introduction of the JOBS Act (*Jumpstart Our Business Startups Act*). The major benefit of peer-to-peer lending is its ability to efficiently and quickly lend money for personal loans, even if these personal loans include business projects. This has facilitated the flow of credit, which has been severely restricted since the outbreak of the financial crisis in 2008.

b) Fills a gap left by banks

The tighter restrictions on traditional lenders through higher capital requirements have reduced their appetite to issue uncollateralised credit, for personal loans or other loans. Market-based finance is an alternative to traditional lending and peer-to-peer lending and equity crowd-funding platforms have moved in to serve this niche market, and as a result have grown exponentially since the crisis.

c) Lower cost of capital/high returns - Leveraging off a lower cost basis

In an era of low returns for investors and scarce capital for those who need it, crowd-funding provides a low cost alternative for channelling savings to the real economy, usually at lower rates than through traditional funding. Additionally, venture and seed capital requests are rarely subscribed to in the current economic environment. Crowd-funding alternatives provide an affordable and attainable option for raising capital.

d) Provides a new product for portfolio diversification

Peer-to-peer lending platforms have in effect provided investors with a brand new asset in the form of un-collateralised debt. This innovation enables investors to further diversify their portfolios. The diversification of assets can reduce the build-up of systemic risk, as it reduces

the overreliance of investors on a single asset and reduces the amount each one invests in each product. Instead, funding requests are met by many investors, each investing a proportionately smaller amount.

e) Cost efficient

One benefit of all the different types of online platform is that, unlike banks, they have little need for a physical presence in a locale. This, coupled with the streamlined cost of using algorithms to determine the creditworthiness of applicants, allows for the platform to operate with a relatively low infrastructure cost. Hence, online platforms may be more cost efficient than traditional lenders who need a physical presence and manpower to operate effectively. Lower overhead reduces the cost of the loan for the borrower but also increases the return rate for investors as the administrative costs are lower.

f) Convenient

An online platform has the added benefit of convenience. Many platforms emphasise this advantage in their marketing campaigns. Online platforms are more accessible to users, who may find it easier to manage their portfolio as a result. Unlike traditional investments, which may be available only at certain times of day, these online portfolios are accessible at any time.

The online aspect of peer-to-peer lending and equity crowd-funding gives the platform more flexibility to update its operations and adapt its marketing and design quickly to an evolving business model. Though few platforms have offered their services internationally, their online business model makes it easy and convenient for them to expand.

g) Increases competition in a space traditionally dominated by a few providers

Increased competition benefits borrowers and lenders, as well as the economy as a whole. It lowers costs and helps establish value. In addition it creates the incentive for traditional entities to innovate, reduce cost and increase efficiency. This will not only help borrowers to access credit in a timely manner, but will also reduce the cost of contracting a loan: Traditional entities will compete with the effective credit assessment techniques currently used by the lower cost rivals, namely the online platforms. In addition the competition of traditional investments with online platforms can result in higher returns for investors and lower costs for business ventures or other borrowers.

Risks

There are a number of risks associated with FR crowd-funding, and which challenge retail investor protection. These include:

a) Risk of default

Default rates are an important consideration in FR crowd-funding. When Prosper, one of the largest peer-to-peer lending platforms in the USA, debuted in 2006 it had a low threshold on the creditworthiness of the borrowers able to obtain loans from the platform. Prosper accepted borrowers with a credit score as low as subprime 520.³² It expected lenders to differentiate between investment opportunities through consideration of interest rates, with higher interest rates relating to higher risk investment opportunities. The higher rates of return associated with the less credit-worthy borrowers was compounded by the auction system used by Prosper at the time, which pushed down interest rates as more lenders got involved.³³ The result was industry-wide high default rates, which at times reached 30% at Prosper.³⁴ The SEC issued a Cease and Desist order in 2009, arguing that Prosper was selling unregistered securities.³⁵ The platform closed for 6 months to put its accounts in order and comply with securities regulation. The platform also raised the minimum credit score to 660,³⁶ considered to be a satisfactory credit score in the US.

This episode resulted in an industry led review on the business practices of almost all peer-to-peer lending platforms. The industry imposed rules on itself which raised the minimum credit score allowed, assessed the borrower's capacity to repay their loan and used hard and soft information in order to categorise the borrowers into classes based on how safe an investment they are,³⁷ and to set the interest rate according to this classification. These and other policies created a stricter investment criteria resulting in 1 in 10 loans being accepted by Lending Club,³⁸ 1 in 5 being accepted at RateSetter, and similarly low acceptance rates at other platforms.³⁹ The consequence is an overall default rate that currently is reported to be in the range of 0.2% to 7% depending on the platform (see Table 1).

³² Lieber, R (2011) 'The Gamble of Lending Peer to Peer', *The New York Times*, [Online] Available at: http://www.nytimes.com/2011/02/05/your-money/05money.html?pagewanted=all&_r=0 [Accessed: 03.10.2013]. NOTE: The most frequently used credit score in the US is the FICO score. This ranges from 300 to 850. Anything below 560 is considered subprime. 560-659 is considered below average, anything above this is considered average or above average.

³³ Ceyhan, S. Xiaolin Shi, and Leskovec, J (2011) *Dynamics of Bidding in a P2P Lending Service: Effects of Herding and Predicting Loan Success*, [Pdf] Available at: <http://www.conference.org/www2011/proceeding/proceedings/p547.pdf> [Accessed: 02.10.2013]

³⁴ Lieber, 2011, See also Felding, A and Pinsker, B (2013) 'P2P lending pulls in big investors – should you bite?' *Reuters*, [Online] Available at: <http://www.reuters.com/article/2013/06/25/us-debt-loans-peer-to-peer-idUSBRE9500M220130625> [Accessed: 03.10.2013].

³⁵ Idem, p517

³⁶ Verstein, A.(2012), "Misregulation of Person To Person Lending", *Lecturer and Other Affiliate Scholarship Series*. Paper 8. Available at: <http://digitalcommons.law.yale.edu/yilas/8>, p453

³⁷ Lieber, 2011 see also Light, J (2012) 'Would You Lend Money to These People? Big Investors Are Piling Into the 'Peer-to-Peer Lending Market. Here's How to do it Safely', *The Wall Street Journal*, April 13th.

³⁸ Synthesis (2013) *Peer-to-Peer (P2P) Lending* [Online] Available at: <http://www.synthesis-sif.lu/surf/peer-to-peer-peer-to-peer-lending/> [Accessed: 03.10.2013]

³⁹ IOSCO Market Intelligence

Table 1: Default rates by selected peer-to-peer lending platforms

Platform	Default Rate	Average default rates in domicile	Country of Domicile
Prosper	7.0%	3.76%*	USA
Lending Club	4.3%	3.76%*	USA
Auxmoney	2.6%	< 1%***	Germany
CreditEase	2.0%	1% ~	China
Funding Circle	1.5%	0.15 - 2.6%**	UK
Afluenta	1.3%	1.5%^	Argentina
RateSetter	0.3%	0.15 - 2.6%**	UK
Zopa	0.2%	0.15 - 2.6%**	UK

Source: Compiled by IOSCO Research Department; Data sourced from individual platforms.

Notes: 1) These are based on the default rates advertised on individual platforms reported as at 30th September 2013. 2) Afluenta data is expected default rate. 3) SME Default rates provide are better rate for comparison. However no consistent data is available therefore is based on the following: a) * Delinquency rates for all loans and leases as reported by the Federal Reserve from March 2013; b) ** range based on Mortgage and Business loan write offs in Q1 2013 as reported by the Bank of England July 2013; c) *** as reported by the Bundesbank; d) ~ Non-performing loan ratio for Q4 2012 as reported by the CBRC; e) ^ Bank NPL ratio for 2012 as reported by the World Bank; 4) Rates are correct at the time of writing.

Although Table 1 highlights that default rates in the industry are quite low, rates may appear that way because they bias. The data is sourced from the largest, most successful platforms and does not include data from those that have left the industry. Further, many platforms have only been in existence for a short period of time, and the majority of the loans issued by peer-to-peer lending platforms have still to reach maturity;⁴⁰ the average maturity is 3 years.⁴¹ This means that even the oldest platforms, those that opened before 2008, have only just started to get data on the overall rate of default. There is a higher risk of default in equity crowd-funding. Start-up businesses, in some circumstances, have a 50%⁴² chance of failing within the first 5 years. Box 2 is an example of one such business collapse after crowd-funding through Crowdcube.

Investing in unsecured loans means that there is no collateral, other than that provided under standard bankruptcy legislation, if the debt goes bad. Even when peer-to-peer lenders specialise in home or business loans, the nature of the investment does not necessarily provide access to the borrower's assets in the event of default. The platforms and some outside organisations are in charge of debt collection, making the likelihood of regaining a return very low and costly if a borrower defaults. Note that some peer-to-peer platforms consider a default to be four failures to pay, which is four months between delinquency and default on the basis of monthly repayment schedules.

⁴⁰ Jenkins, P (2013) 'Why peer-to-peer lending remains inherently unsafe', Financial Times, [Online] available at: <http://www.ft.com/cms/s/0/04d6bdce-f2ee-11e2-802f-00144feabdc0.html#axzz2iKz7j0Sz> [Accessed: 23.10.2013]

⁴¹ IOSCO market intelligence

⁴² IOSCO market intelligence

One way to mitigate this risk is through the diversification of a lender's loan portfolio. In some instances diversification is a compulsory requirement for investing through some platforms (for example Afluenta and Sinolending). By diversifying the total investment through smaller loan parts across multiple loans, if one loan part within the portfolio defaults the cost can be absorbed by the other holdings. Additionally, peer-to-peer platforms expect their investors to execute due diligence and invest wisely, after assessing the risks; "Each peer-to-peer lender has its own method of mitigating credit risk...they are extremely prudent about which consumers or small businesses they lend to" according to Christine Farnish, Chair of P2P Financial Association in the UK.⁴³ This stance highlights the industry wide attitude towards lender choice; it is the lender, not the platforms, who chooses to whom to lend (in most circumstances).

Another method to mitigate this risk calls for a pooled insurance fund that provides compensation in the event of a borrower default. Some platforms have implemented such provisions and, at their discretion, can reimburse lenders in the event their loan holding defaults. The "compensation" fund is created by borrowers who contribute a percentage of their overall loan to this fund. This then exposes the lender to the risk of the "compensation" fund size rather than the risk of default. Additionally, it weakens incentives for the lender to conduct 'good' due diligence and investment management and may encourage them to take on more risk. A lender may choose to invest in riskier loans and avoid doing proper due diligence on potential investments, knowing that in the event of default their investment is underwritten by a compensation pool.

Box 2: Bubble and Balm Case Study: when equity crowd-funding goes wrong

Bubble and Balm was a fair trade soap company. In 2011 it became the first company to raise funding for its start-up through the equity crowd-funding platform Crowdcube, based in the UK. It raised £75,000 from 82 investors, who each contributed between £10 and £7,500 in return for 15 per cent of the company's equity.⁴⁴ In July 2013 the business closed overnight, leaving investors with no way of contacting the company or to recover losses. The investors lost 100% of their investment.

b) Platform risk

The platform risk is the risk of a platform being temporarily or permanently shut down. If the platform closes it could put the lender's portfolio of loans at risk of not being repaid as the intermediary position, responsible for the collection of repayment, is unable to be fulfilled.⁴⁵ As most FR crowd-funding platforms have yet to show a positive turnover, this raises the risk of this occurring. An example of this risk transpiring is the now defunct peer-to-peer platform

⁴³ Farnish, C (2013) Peer-to-Peer Lenders Welcome FCA Regulation, [Online] Available at: www.CCRMagazine.co.uk [Accessed: 30.09.2013]

⁴⁴ Warwick-Ching, L. Powley, T and Moore, E (2013) 'Alarm bells for crowd-funding as bubble pops for soap startup', *Financial Times* [Online] Available at: <http://www.ft.com/cms/s/0/8d680fd4-f9d9-11e2-b8ef-00144feabdc0.html#axzz2hg5wd8py> [Accessed: 14.10.2013]

⁴⁵ Lazy Traders (2011) *5 Lending Club Risks: Why peer to Peer May Lend Itself to Problems* [Online] Available at: www.lazytraders.com/insights/5-lending-club-risks-why-peer-to-peer-may-lend-itself-to-problems/ [Accessed: 16.09.2013]

Quackle. In 2011, Quackle closed suddenly overnight leaving no information on the borrowers or lenders. Consequently the contracts could not be fulfilled resulting in 100% loss.⁴⁶

In most business models, peer-to-peer lending platforms set up segregated accounts⁴⁷ so that client money goes through a separate account. In the event of a platform closure, the account can be taken over by another manager or organisation, allowing the existing loans to be run-off. Some platforms have also explicitly set out a “resolution and resolvability” plan, outlining all contractual obligations originated by the organisation, including mapping each loan to registered borrowers and investors. These “living wills”, coupled with legally segregated accounts, lessens the impact of a platform failure. However, this is not a universal business model and there is no legal requirement in some jurisdictions to have such a plan in the event of a platform’s failure.

c) Risk of fraud

Peer-to-peer lending suffers from the same risks associated with any other credit provision institution, which include: identity theft, money laundering, terrorism financing, consumer privacy, and data protection violations.⁴⁸ But, in order to take advantage of the lower costs associated with technology most platforms operate solely through an internet portal or website. This means that there is a higher chance of fraud in both peer-to-peer and equity crowd-funding platforms due to the inherent anonymity that the internet offers.

In some jurisdictions, the industry itself has taken the initiative for self-regulation in order to mitigate this risk. Some platforms report that they manually check each borrower for fraudulent motivations before allowing them to advertise for lenders on their sites; others use third party information as well as checking the identity of the borrowers before originating the loans. However, relatively few do similar background checks on the lenders, with most only doing the minimum required to bring them in line with anti-money laundering laws.

The risk of fraud can be high in equity crowd-funding, due to a lack of available information about the investment. This is the case for both the investor and the issuer. As online services, both equity crowd-funding and peer-to-peer lending face a high risk of fraud due to their dependence on the internet. This raises concerns about investor protection, especially as retail investors may not know what information to ask for that would lessen the risk of fraud.

d) Information asymmetry and quality

Due to the anonymous nature of the peer-to-peer lending market, the lender lacks hard information⁴⁹ on the borrower.⁵⁰ The only hard information available to the lender is the

⁴⁶ Morre, E and Moules, J (2011) ‘Peer-to-peer loans company closes’, *Financial Times*, [Online] Available at: <http://www.ft.com/cms/s/0/2db417a6-20c1-11e1-816d-00144feabdc0.html#axzz1fstap4xA> [Accessed: 05.11.2013]

⁴⁷ See client segregated account model, p16

⁴⁸ Chaffee and Rapp, 2012, p505

⁴⁹ Hard information is quantitative data including credit scores, income etc.

⁵⁰ Freeman, S and Ginger Zhe Jin (2009) Learning by Doing with Asymmetric Information: Evidence from Prosper.com, College Park, MD [pdf] Available at: <http://www.ecares.org/ecaresdocuments/seminars0910/jin.pdf>; Lin, M. Viswanatha, S. and Prabhala, N.R. (2013) ‘Judging Borrowers by the Company they Keep: Friendship networks and information Asymmetry in Online Peer-to-Peer Lending’, *Management Science*, Vol. 59(1), pp17-35

interest rate assigned by the lending platform to the borrower. This is to maintain the borrower's anonymity. Lenders must base their decisions⁵¹ on unverified soft information.⁵² This requires the lender to conduct due diligence in order to differentiate between a good and a bad investment, as well as to decrease the risk of fraud. Also, in some circumstances this requires an overreliance on the credit risk models used by the platforms themselves. This complicates peer-to-peer lending and requires the need for constant vigilance of the investment in order to achieve the advertised rates of return.

The risk posed by information asymmetry could be mitigated through the use of standardised templates, more transparency and hard information about the borrower, standardised accounting and disclosure of the intended use of the loan. In regards to equity crowd-funding information disclosure and transparency around finances of the issuer could aid the investor in making informed choices, as well as provide the issuer with investors who are knowledgeable about their business before investing.

e) Risk of investor inexperience

Another risk is the risk of investor inexperience particularly for retail investors. This risk could be increased by the perceived credibility and safety of these industries through governments lending money through these sites, and the continued regulatory changes in order to allow the industries to grow through the use of exempt markets. This may be perceived as the rubber stamping of FR crowd-funding, which less experienced retail investors may see as a sign of the industry's safety, and not follow due diligence when they invest in this industry. In peer-to-peer lending there is no investor protection so far by way of a compensation scheme to cover defaults. This is not widely known, nor is it disclosed on many peer-to-peer lending sites. As such, retail investors, who do not have the level of knowledge or the same capacity to absorb defaults as professional investors, may suffer proportionately larger losses.

f) Liquidity Risk:

The risk of illiquidity is an important risk as well as there is no secondary market for most platforms. Investors may not fully understand the risks involved in investing in illiquid stocks, and may be spurred by the promise of higher returns to invest in companies with a high chance of failing. Consequently a number of retail investors could lose money through equity crowd-funding.

Overall, the lack of liquidity is a risk that investors and regulators might want to consider in both equity crowd-funding and peer-to-peer lending. Given the widespread access of these investment choices to retail investors, the implications for unwary investors are clear. Once an investor's money is locked into a contract or has been invested in share equity there is little

⁵¹ Herzenstein, M. Soenshein S. and Dholakia, U. (2011) Tell Me a Good Story and I May Lend You Money: The Role of Narrative in Peer-to-Peer Lending Decisions [pdf] Available at: <http://sonenshein.rice.edu/uploadedFiles/Publications/tell%20me%20a%20good%20story%20and%20%20may%20lend%20money.pdf> [Accessed: 30.09.2013]

⁵² Soft information is qualitative data, such as a narrative or a picture.

scope to sell out except at a significant discount to the face value. The lack of liquidity is unlikely to cause systemic risk until the industry grows to a sizeable level.

g) Risk of cyber-attack:

As peer-to-peer lending and equity crowd-funding are largely an internet phenomenon, there is a significant risk related to cyber-security. This could come in many forms, from overloading the platform's infrastructure, to confusing accounts and/or identity theft. The platform's creators may need to ensure they have enough technical expertise to prevent such cyber-security issues.⁵³

⁵³ See R. Tendulkar, "Cyber-crime, securities markets and systemic risk", *IOSCO Research Department Staff Working Paper*, July 2013. Found at: <http://www.iosco.org/research/pdf/swp/Cyber-Crime-Securities-Markets-and-Systemic-Risk.pdf>

Chapter 3: Current regulatory regimes and trends

The regulation of FR crowd-funding varies from jurisdiction to jurisdiction, with each industry requiring a different regulatory approach. There are three aspects to regulating FR crowd-funding: these being the borrower/issuer side; the lender/investor side, and the online platform. This chapter outlines the major regimes used to regulate FR crowd-funding, taking peer-to-peer lending and equity crowd-funding in turn. It concludes with a description of the current trends in regulation and de-regulation.

The regulation of peer-to-peer lending

In general there are five regulatory regimes for peer-to-peer lending:

1) Exempt or unregulated through lack of definition

This is the case for some countries that have no peer-to-peer lending market and therefore do not have the need yet to regulate the industry. Other countries have not regulated this sector due to a lack of definition regarding the service provided to the investors and consider the market too small for regulation (Tunisia and the UK). However, in some cases there is regulation designed to protect borrowers and that mainly involves rules already in place to protect the borrower from unfair interest rates, unfair credit provision and false advertising (for example in the UK).

2) Regulated as an intermediary

Depending on the particular jurisdiction's definition peer-to-peer lenders can be classified as intermediaries or brokers. This classification usually requires the registration of the platform as an intermediary. The obligations and requirements for intermediaries vary according to the jurisdiction. Generally there are regulations that establish the prerequisites for the platforms to register in order to access the market. Other rules and requirements determine how the platform should conduct its business (for example, the licensing needed to provide credit and/or financial services).

3) Regulated as banking

In various jurisdictions platforms are classified as banks, due to their credit intermediation function, and are therefore regulated as banks. As such, the platforms must obtain a banking licence; fulfil disclosure requirements and other such regulations. In jurisdictions that require bank-like regulation, the industry is comparatively small (e.g. Germany and France).

4) The US model

The US regulatory regime, in summary, is structured as follows. At the Federal level, each platform is required to be registered with the SEC.⁵⁴ Additionally each loan originated by the platforms must be registered with the SEC. Each platform is also treated like a public company, having to fully disclose their finances, loan origination and practices.

⁵⁴ Chaffee and Rapp, 2012; Verstein, A. (2012)

One level below the federal requirements is state regulation. Some states outright ban the practice of peer-to-peer lending and equity crowd-funding (e.g. Texas). Other states place limits on the type of investors using the platforms to lend (e.g. California).⁵⁵ In addition, if a platform wishes to operate across multiple state boundaries, it must apply to each state separately, unless the platform becomes a public business through an initial public offering. This has led to some platforms operating in states where there are no competing platforms. As such, the operations of these platforms are spread across multiple states.

5) Prohibited:

Some jurisdictions ban the practice of peer-to-peer lending.

Other forms of regulation

Another possible form of regulation that could be implemented is the regulation of peer-to-peer lending as a collective investment scheme (CIS). Though this regulation does not seem to exist, some peer-to-peer lending business models do seem to act as a CIS. TrustBuddy International, for example, actively manages investors' money, and automatically invests their money while providing them with a limited choice. This can potentially qualify as a collective investment scheme for the purpose of regulation.

The regulation of equity crowd-funding

Three regulatory regimes can be identified in equity crowd-funding. The first regime is where regulation bans equity crowd-funding. In the second case, equity crowd-funding is legal but regulation creates high barriers to entry; in these jurisdictions there is no equity crowd-funding market. Under the last regime, regulation imposes strict limits on who can invest in this form of equity, usually limiting it to sophisticated investors, the number of investors allowed to invest, the size of the company issuing the equity and other similar regulatory requirements. As such, equity crowd-funding is a very small market.

Recent changes in legislation have been aimed at encouraging the equity crowd-funding market to grow, as is the case, for example, with the JOBS Act in the US. Equity crowd-funding has started to develop, boosted by the introduction of the JOBS Act. It is currently limited to sophisticated investors, as defined by US law. Platforms are required to check that investors comply with SEC rules. These rules could include a limit of \$2,000 or 5% of annual income on the amount an investor can invest, if his annual income and net worth are less than \$100,000. This limit increases to 10% if the investor's annual income is over \$100,000. However, the higher threshold may be extended to retail investors after the SEC has finalised the rules for the equity crowd-funding platforms and the issuers of the equity.⁵⁶

⁵⁵ GAO, 2012, P28, fig. 7

⁵⁶ The SEC is currently undertaking rule-making with proposed rules out for public comment at the time of writing. For an outline, please consult the commissions factsheet at: <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677>

Current regulatory trends

Many jurisdictions now consider peer-to-peer lending and equity crowd-funding platforms as an efficient vehicle for funding start-ups as well as small and medium enterprises. But many are seeking to encourage the practice without compromising investor protection through specific, targeted regulation of the industry. Given that the industry is relatively young (or non-existent) in many countries, a number of consultation papers have been issued on this topic balancing encouraging FR crowd-funding and investor protection (see Box 3). None of the changes proposed under these consultations have yet come into force.

Box 3: Recent consultation papers published on crowd-funding

There has been a number of consultation papers published on crowd-funding from different jurisdictions.⁵⁷ These include:

Australian Government – Corporations and Markets Advisory Committee:

*Crowd-Sourced Equity Funding*⁵⁸

Banque de France:

*Un Nouveau Cadre Pour Faciliter le Developpement du Financement Participatif*⁵⁹

European Commission:

Consultation document: *Crowdfunding in the EU - Exploring the added value of potential EU action.*⁶⁰

Financial Conduct Authority (FCA):

Consultation document: *The FCA's regulatory approach to crowdfunding (and similar activities)*⁶¹

Ontario Securities Commission:

*Exempt market review, staff consultation paper, considerations for new capital raising prospectus exemptions*⁶²

Securities and Exchange Commission (SEC):

*Proposed rules on crowdfunding*⁶³

Table 2 outlines the key points in regulation of peer-to-peer lending, and shows which country has currently adopted which regulatory regime.

⁵⁷ In most instances the type of crowd-funding addressed in these consultation papers is equity crowd-funding. However at points it goes into peer-to-peer lending regulation as well, though sometimes this is not clear.

⁵⁸ Available at: [http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/\\$file/CSEF_DP_Sept13.docx](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/$file/CSEF_DP_Sept13.docx)

⁵⁹ Available at: <http://www.tresor.economie.gouv.fr/File/390785>

⁶⁰ Available at: http://ec.europa.eu/internal_market/consultations/2013/crowdfunding/docs/consultation-document_en.pdf

⁶¹ Available at: <http://www.fca.org.uk/news/the-financial-conduct-authority-outlines-how-it-will-regulate-crowdfunding>

⁶² Available at: http://www.osc.gov.on.ca/documents/en/Securities-Category4/sn_20121214_45-710_exempt-market-review.pdf

⁶³ Available at: <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>

Table 2: Summary of the regulation of peer-to-peer lending

Regulatory Regime	Description	Countries currently using this regime
Exempt Market/ Unregulated through lack of definition	In these jurisdictions either the regulation has classified peer-to-peer lending as an exempt market or there is a lack of definition in legislation.	Brazil ⁺ , China ^x , Ecuador ⁺ , Egypt ⁺ , South Korea ⁺ , Tunisia ⁺ , United Kingdom ^x
Intermediary Regulation	This regulates peer-to-peer lending platforms as an intermediary. This usually requires registration as an intermediary, and other regulatory requirements depending on the jurisdiction.	Australia ⁺ , Argentina ⁺ , Brazil ⁺ , Canada (Ontario) ⁶⁴ , New Zealand ^{65 66}
Banking Regulation	This regulates peer-to-peer lending platforms as banks.	France ⁶⁷ , Germany ⁺ , Italy ^x
US Model	This is a two tier system. This requires the registration of peer-to-peer lending platforms with the SEC, as well as applying for a licence to conduct business on a state by state basis.	United States of America ⁶⁸
Prohibited	Both peer-to-peer lending and equity crowd-funding are banned under legislation	Israel ⁺ , Japan ⁺

Source: IOSCO Research Department

⁺ Based on information provided by the regulator to IOSCO Research Department; ^x Based on information provided through market intelligence gathering with industry

⁶⁴ OSC consultation paper on Exempt markets, 2012, Available at: http://www.osc.gov.on.ca/documents/en/Securities-Category4/sn_20121214_45-710_exempt-market-review.pdf

⁶⁵ FMA Consultation: Licencing Crowd-funding, 2013, available at: <https://www.fma.govt.nz/media/1902716/licensing-crowd-funding.pdf>

⁶⁶ Also see for p2p lending in NZ <https://www.fma.govt.nz/media/1902722/licensing-peer-to-peer-lending.pdf>

⁶⁷ Banque de France: *Un Nouveau Cadre Pour Faciliter le Developpement du Financement Participatif*, 2013, Available at: <http://www.tresor.economie.gouv.fr/File/390785>

⁶⁸ SEC consultation: *Proposed rules on crowdfunding*, 2013, Available at: <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>

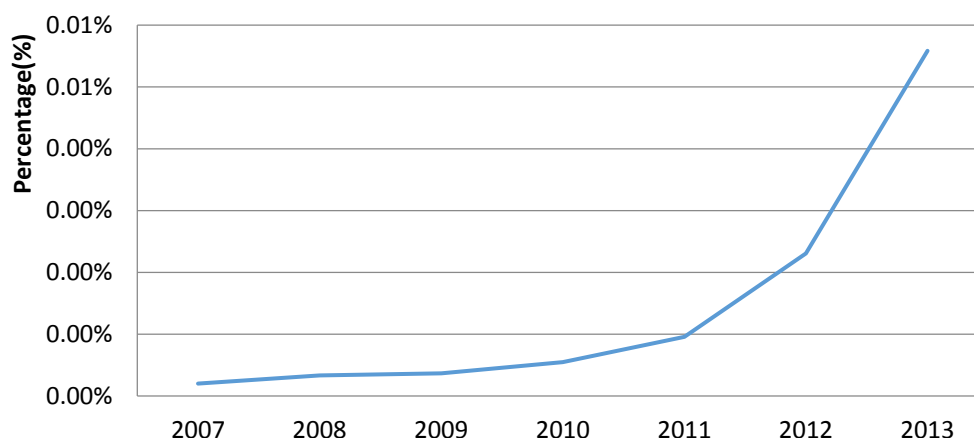
Chapter 4: Analysis of potential systemic risks and investor protection concerns

Using the systemic risk framework set out in IOSCO's Staff Working Paper *Systemic Risk Identification in Securities Markets*,⁶⁹ this section analyses the potential risks of FR crowd-funding to assess to what extent peer-to-peer lending and equity crowd-funding pose a systemic threat to the financial sector and to identify any issues of investor protection that may arise from these activities.

Size: Peer-to-peer lending

The peer-to-peer lending market is relatively small compared to other forms of lending. As pointed out in Chapter 1, the lower bound estimate of the size of the global market is \$6.2 billion (see Figure 4). As a proportion of the total credit originated by banks to the non-financial sector of the economy, the levels of crowd-funding are tiny, representing only 0.01% of the bank originated credit provided to the real economy (see Figure 6). As such, based on size, the industry poses little systemic concern so far.

Figure 6: Crowd-funding loans as a proportion of bank-originated credit to the non-financial sector



Source: IOSCO Research Department; compiled from Bank for International Settlements, Prosper, Lending Club, Auxmoney, Svava, Zopa, RateSetter, Thincats, Funding Circle, isePankur, Pret d'Union.

Notes: 1) Peer-to-peer lending data is sourced directly from the websites of the largest providers; it therefore represents a lower bound estimate of the global loan pool. 2) Data as at 30th September 2013.

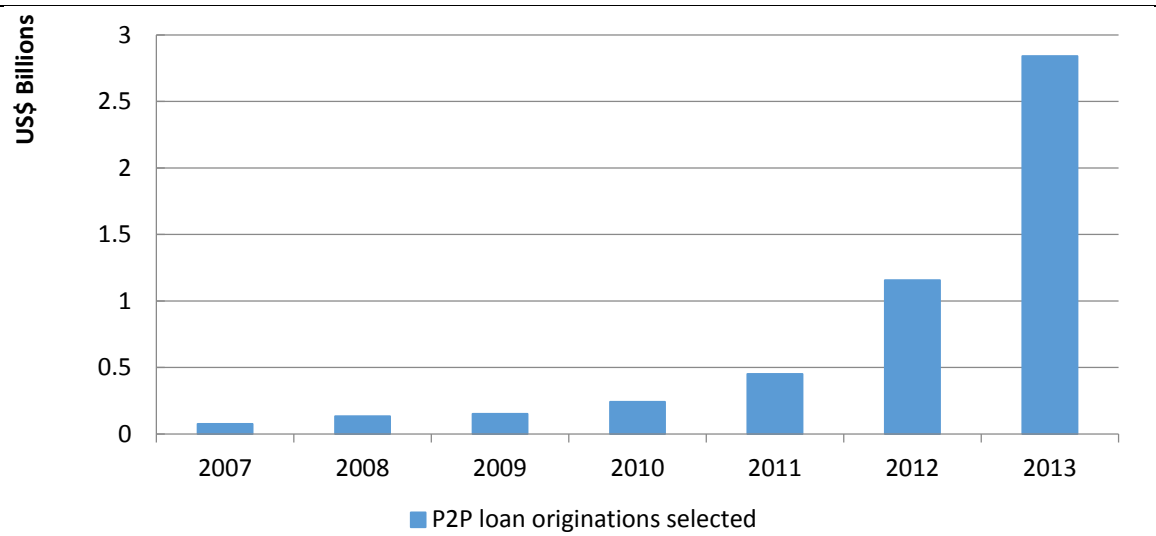
However further analysis reveals that the industry is growing fast. As highlighted by Figure 7, the overall market for peer-to-peer lending has grown exponentially so far.⁷⁰ Based on a time series of loan origination data from selected platforms, global origination for 2013 (so far) stands at \$2.8 billion, up 145% from 2012.

⁶⁹ W. Bijkerk, R. Tendulkar, S. Uddin, and S. Worner (2012) Systemic Risk Identification in Securities Markets, *IOSCO Research Department: Staff Working Paper 2012/1*[pdf] Available at:

<http://www.iosco.org/research/pdf/swp/Option%20for%20Systemic%20Risk%20Identification%20System.pdf?v=1>

⁷⁰ IOSCO Research based on the aggregated year on year data from Prosper, lending Club, Auxmoney, Svava, Zopa, RateSetter, Thincats, Funding Circle and isePankur.

Figure 7: Peer-to-peer lending

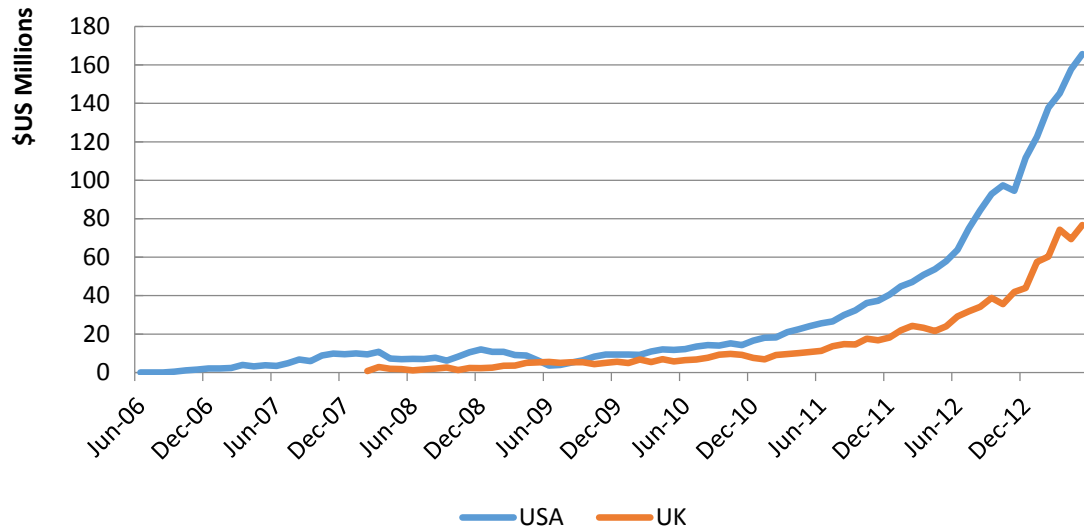


Source: IOSCO Research Department; Compiled from Prosper, Lending Club, Auxmoney, Svara, Zopa, RateSetter, Thincats, Funding Circle, ISE Pankur

Notes: 1) Peer-to-peer lending data is sourced directly from the websites of the largest providers. It therefore represents a lower bound estimate of the global loan pool. 2) Data as at 30th September 2013.

On a country-by-country basis, the USA and UK are experiencing a doubling year-on-year (see Figure 8 and Figure 10). Since 2008, the average year-on-year growth rate for the USA and UK is 79.1% and 99.5%, respectively.

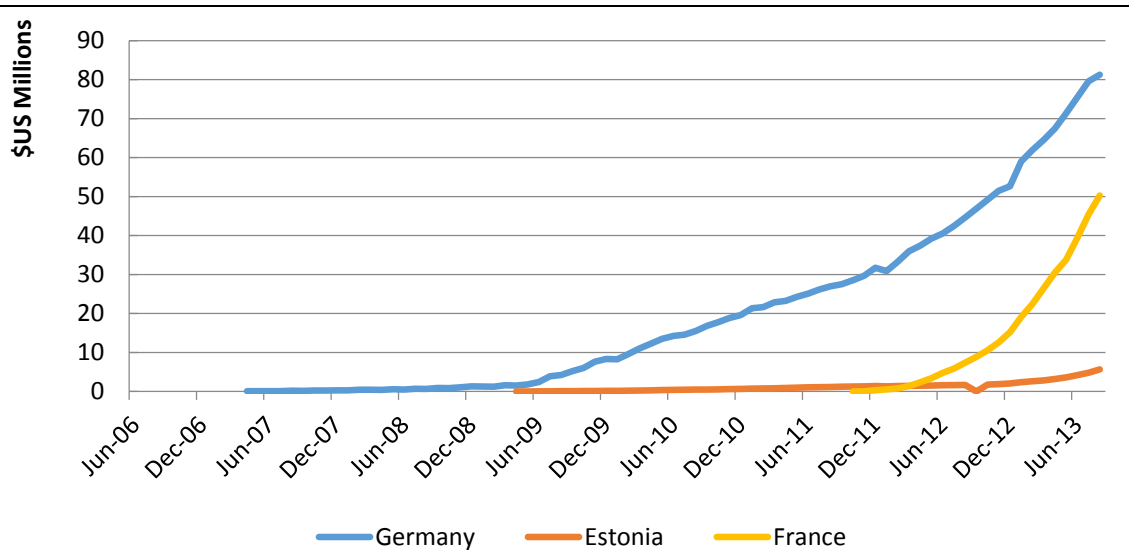
Figure 8: Peer-to-peer loans originated by month: USA and UK



Source: IOSCO Research Department.

Note: 1) USA figure based on Prosper and Lending Club, UK figure based on Funding Circle, Zopa, RateSetter and ThinCats. 2) Peer-to-peer lending data is sourced directly from the websites of the largest providers. It therefore represents a lower bound estimate of the local loan pool. 3) Based on data as at 30th September 2013

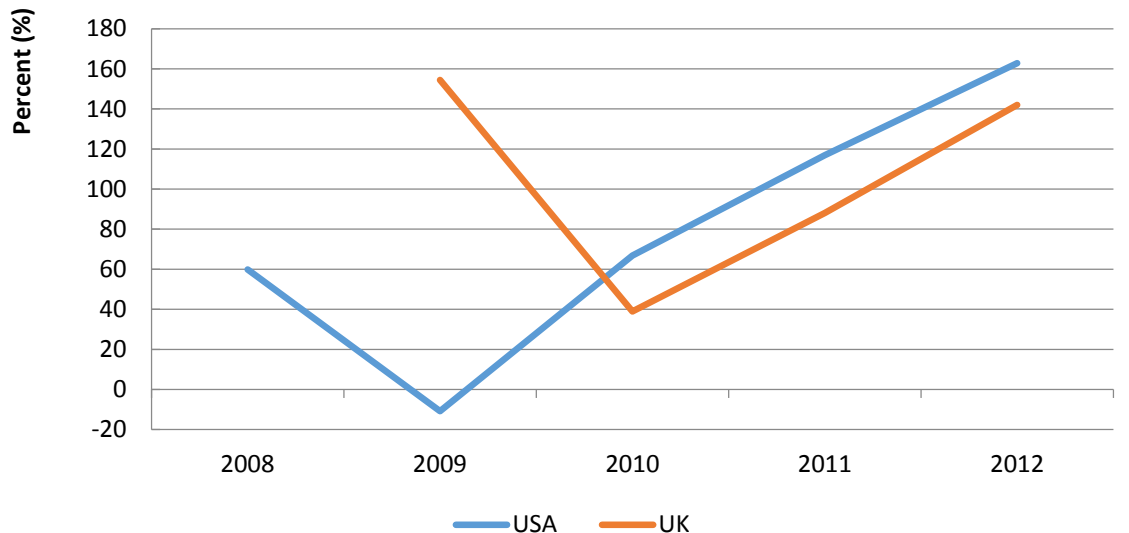
Figure 9: Peer-to-peer loans originated by month: Estonia, France, Germany



Source IOSCO Research Department: Based on Figures from Auxmoney, Smava, isePankur and Pret d'Union
 Notes: Peer-to-peer lending data is sourced directly from the websites of the largest providers. It therefore represents a lower bound estimate of the local loan pool. 3) Based on data as at 30th September 2013

This trend is replicated globally in many jurisdictions, with an estimated average year-on-year growth rate for the global industry as a whole standing at 89.6%. Figure 9 shows that there is strong growth in loan originations in relatively younger markets, demonstrating that the high growth rate is a characteristic of the peer-to-peer lending markets as a whole, and not just limited to the established markets. Based on this data, if the rapid growth rate continues the amount originated through peer-to-peer lending could potentially be around \$70 billion in 5 years. This shows the potential for peer-to-peer lending to become quite a sizeable market in a short timeframe.

Figure 10: Growth Rates since 2008: USA and UK



Source: IOSCO Research Department: based on aggregated year on year growth rates obtained from selected peer-to-peer platforms: USA: Prosper and Lending Club UK: Zopa, RateSetter, Funding Circle and ThinCats.
 Notes: 1) The reason for the negative growth rate in the USA in 2009 is that both Lending Club and Prosper were closed to new loan originations by the SEC while they aligned themselves with the correct regulatory requirements in this year. 2) The fall in the UK's growth rate in 2010 is accounted for by the lack of data from ThinCats and Funding Circle from that year.

Size: Equity crowd-funding

The equity crowd-funding market is small in size, with the lowest estimate being the equivalent of \$25 million in the UK,⁷¹ though market intelligence suggests the overall total in the UK is estimated at roughly \$80 million (£50 million equivalent). There are very few equity crowd-funding platforms, with the majority focusing on angel investors or sophisticated investors due to regulatory requirements. There is no data on the overall market size or growth rates relating solely to equity crowd-funding due to so few platforms operating in this area. Examples in the UK include: Syndicate Room, Crowdcube and Seedrs. In China there are two examples: Honglingchuangtou and AngelCrunch, although no single platform specialises in pure equity crowd-funding. Most other platforms that offer investment opportunities are either donation crowd-funding or reward crowd-funding, neither of which necessarily results in a financial return on the investment.

Liquidity

Liquidity in the peer-to-peer lending/equity crowd-funding is centred on the inability to liquidate an investment once it has been entered.

Overall, the ability to gain access to money invested in a portfolio of loans is best described as difficult. In many cases, it requires an investor to find another investor to take over the loan portfolio.⁷² Where no secondary market exists, and a contract is established between borrower and lender, the contractual constraints tend to render the investment illiquid. In that case, the investor is locked-in until maturity.

Some peer-to-peer lending platforms offer a secondary market to investors to facilitate liquidation of all or part of their loan portfolio,⁷³ but this is lightly traded and unlikely to bring any profit.⁷⁴ In some other cases, the platforms themselves can buy out the investors, and then securitise these loans, selling them on via an asset-backed security vehicle (see Box 4).⁷⁵ However, how a platform generates liquidity depends on its business model. They are by no means universal, and the platform is under no obligation to provide this service.

Additionally, where a secondary market is available it is generally thinly traded.⁷⁶ This is because most individuals who sell their notes/contracts/loan portfolios on these sites tend to sell delinquent notes. The lack of liquidity in the secondary market means many investors sell at a significant loss to face value.⁷⁷

In equity crowd-funding there is little to no secondary market for the equity of start-up companies. The equity itself is difficult to value. As most are private companies, start-ups face

⁷¹ This figure is based on the total equity funding of two platforms: Crowdcube and Seedrs

⁷² RateSetter website, 2013 Available at: http://www.ratesetter.com/lending/any_questions.aspx

⁷³ Examples include Lending Club, Prosper and Zopa

⁷⁴ Light, 2012 and Braverman, E (2012) 'Hedge Funds Move into P2P Lending', Wall Street Oasis, [Online] Available at: www.wallstreeoasis.com/blog/hedge-funds-move-into-peer-to-peer-lending [Accessed: 16.09.2013]

⁷⁵ IOSCO Market Intelligence

⁷⁶ Light, 2012

⁷⁷ Braverman, 2012

no requirements for disclosure or transparency. And if the company does survive its stock is likely to be diluted through further issues.⁷⁸ Generally, the only realistic chance an investor has of liquidating their holding in a start-up investment is if the company survives until a public float. But the probability to do this is not high given the high attrition rate among start-up companies.

Liquidity risk will depend on the type of investors involved. In essence the lack of liquidity is similar to other seed capital investments such as private equity. If the investors have experience with low liquidity investments, and are aware of the risks of being locked-in, the lack of liquidity will be of little concern. However, if the investors in equity crowd-funding are inexperienced and unaware, they might overreact in times of stressed market conditions or difficult personal circumstances. This raises concerns about investor protection and has led to many jurisdictions placing limits on who can invest in such equity. In some cases platforms are only allowed to market to sophisticated investors, and/or are limited to the number of individuals such investments can be marketed to.

Box 4: Securitisation

Recently, some peer-to-peer lenders have started to securitise loan bundles and sell them onto other financial entities in the form of asset-backed securities. The platforms themselves, in some cases, are able to buy out the loan portfolios of lenders at face value less fees. The platforms then consolidate and securitise these loans, selling them on to a third party, at times in different credit tranches.

For example: at the end of September 2013, Eaglewood Capital Management completed the first ever securitisation of peer-to-peer individual consumer loans into asset-backed securities. The trade totalled \$53 million with \$40 million going to an unnamed insurance company.⁷⁹ The loan characteristics of the securitised portfolio “include a weighted average borrower FICO score of 700+, weighted average borrower income north of \$90,000, and a weighted average interest rate of 12-14%. All of the securitized loans are 36-month term loans”.⁸⁰ Peer-to-peer lenders in the US also moved into providing “whole loan projects” which have attracted big investors, as this provides the ability to finance whole loans and not just loan parts.⁸¹ This securitisation and whole loan program creates new risks, in addition to increasing interconnectedness to the wider industry and exposing other investment industries to the risks of peer-to-peer lending. The nature of peer-to-peer loans means that they are often

⁷⁸ IOSCO Market Intelligence

⁷⁹ Alloway, T (2013) ‘P2P Lenders to turn to Securitisation deals’, Financial Times, Published October 1st 2013; Scully, M (2013) Eaglewood Taps Boutique to Arrange Novel P2P ABS, [Online] Available at: <http://www.securitizationintelligence.com/Article/3262332/Eaglewood-Taps-Boutique-To-Arrange-Novel-PEER-TO-PEER-ABS-Update.html> [Accessed: 04.10.2013]; Renton, P (2013) Eaglewood Capital Closes the First Securitization of Lending Club Loans [Online] Available at: <http://www.lendacademy.com/eaglewood-capital-closes-the-first-securitization-of-lending-club-loans/> [Accessed: 04.10.2013]

⁸⁰ PR Newswire (2013) Eaglewood Capital Management Launches First Securitization of Peer-to-Peer Consumer Loans [Online] Available at: <http://www.rfdtv.com/story/23579714/eaglewood-capital-management-launches-first-securitization-of-peer-to-peer-consumer-loans> [Accessed: 04.10.2013]

⁸¹ Alloway, 2013

unsecured; presenting questions over the practice of securitising such peer-to-peer loans. Even subprime loans were partially backed by some form of collateral.

Concentration

Market concentration: There are relatively few established players in peer-to-peer lending. This means that the industry is concentrated into relatively few providers. Table 3 lists the major players in peer-to-peer lending and Table 4 lists the major platforms in equity crowd-funding, along with information on their legal entity model,⁸² inception date and size.

Table 3: The major players in peer-to-peer lending, globally

Company	Date of Inception	Loans Originated (\$millions)	Business Model	Country of Domicile
Lending Club	2007	2,563	Notary	USA
CreditEase[^]	2006	1,600	Offline Guaranteed Return	China
Zopa[*]	2006	618	Client Segregated Account	UK
Prosper	2006	612	Notary	USA
Funding Circle[*]	2010	251	Client Segregated Account	UK
RateSetter[*]	2010	183	Client Segregated Account	UK
Auxmoney[~]	2007	87	Notary	Germany
Pre d'Union[~]	2009	57	Client Segregated Account	France
Honglingchuangtou	2013	15	(Unavailable)	China
TrustBuddy	2009	8	Guaranteed Return	Sweden
isePankur[~]	2008	6	Client Segregated Account	Estonia
Afluenta	2012	1	Trust Fund	Argentina

Source: IOSCO Research Department; Data sourced and compiled from individual platforms

⁸² For a discussion on the different types of legal entity models please consult chapter 1 in this paper.

Notes: 1) * USD figure is an equivalent based on a GBP conversion at 1.60; 2) ~ USD figure is an equivalent based on a EUR conversion of 1.34; 3) ^ USD figure is an equivalent based on a CNY conversion of 0.16. 4) This is not an exhaustive list of platforms. 5) Data as at 30th September 2013 and correct at the time of writing. It does not represent an exhaustive list of the industry globally.

In the US two major sites, Prosper and Lending Club, make up the majority of the peer-to-peer lending and equity crowd-funding market. They are both notary models of peer-to-peer lending, and both are regulated by the SEC after initially being closed down under the Securities Act 1933 for selling unregistered securities.⁸³ Lending Club is the larger of the two, originating \$2.5 billion in loans since its inception in 2007. In the US there are many crowd-funding sites, but most are very small scale, and they number only around 200 at most.⁸⁴ This suggests a high concentration in the US market.

In the UK the largest market is the peer-to-peer lending market. Zopa dominates the UK peer-to-peer lending market, making up 50% of the overall market in the UK, and Funding Circle and RateSetter making up the majority of the remainder of the market. All three are based on a client segregated account business model. Market intelligence suggests in the UK there are roughly 30 platforms registered to arrange peer-to-peer lending and only 3 regulated to carry out equity crowd-funding,⁸⁵ so concentration is very high.

In China, the largest platform is CreditEase which is an offline guaranteed return peer-to-peer lending platform. This means that it guarantees the investor a return rate of between 8-10% no matter where their investment is made. It has originated \$1.6 billion in loans which accounts for 27% of the global market in peer-to-peer lending. A recent report indicates that there are some 400 platforms active, most of them with a small size. Again, research suggests high concentration in the Chinese market, although the information is too scarce to make a final assessment.

It is difficult to know how many platforms for peer-to-peer lending and equity crowd-funding there are in existence. Reports are very varied, information about many markets is incomplete and, as stated earlier, our market intelligence efforts, despite covering many jurisdictions, does not provide all needed data. In general in many countries the markets are very concentrated and dominated by a couple of platforms. Some countries have only one active platform, for example in Australia (SocietyOne). But given the tiny levels of loan origination so far, concentration is unlikely to pose much concern for the foreseeable future.

⁸³ Lending Club was closed in April 2008 awaiting approval from SEC to issues promissory notes to lenders and to seek registration in order to allow the trading of these notes in a secondary market, it gained registration in October the same year and reopened. Box 2 describes how Prosper was closed in 2009 due to a cease and desist order from SEC due to the trading of unregistered securities under the Securities Act 1933.

⁸⁴ IOSCO Market Intelligence

⁸⁵ IOSCO Market Intelligence

Table 4: Major players in equity crowd-funding, globally

Company	Date of Inception	Equity Financed (\$ millions)	Country of Domicile
AngelCrunch	2011	40	China
Crowdcube	2010	23.35	UK
Seedrs	2013	1.36	UK
Banktothefuture.com Limited	2011	1.33	UK

Source: IOSCO Research Department Notes: 1) Data sourced and compiled from individual platforms and does not represent an exhaustive list of platforms. As such this list is a lower bound estimate of the industry; 2) * USD figure is an equivalent based on a GBP conversion at 1.60; RMB figure based on conversion of 6.09 3) Data is correct at the time of writing; 4) all are equity crowd-funding models.

Finally, in FR crowd-funding there is evidence of first mover advantage.⁸⁶ The larger platforms are able to take on the added cost of compliance with new regulations, whereas the smaller platforms are unable to absorb these costs. Further regulation could solidify the first mover advantage for the largest platforms; therefore the regulation of markets that were previously exempt has clear implications for competition.

Exposure to a Single Asset: Due to FR crowd-funding being an investment activity for individuals (for the moment), there is a possibility that investors may not practice good diversification principles, and may instead concentrate their portfolio into just a few loans. This risk is linked to the risk of bad debts and loan defaults, meaning an individual could lose their entire investment if not diversified adequately. If an individual's portfolio consists solely of debt securities through peer-to-peer lending then they are at risk of concentration. This is especially the case with retail investors who may not have the opportunity or means to diversify into other products. On some platforms this risk is compounded by the ability to fund entire loans.

To mitigate this risk some platforms place limits on the amount that can be invested in a single loan, and the overall percentage of a portfolio being placed in a single loan. In the US, with the introduction of the JOBS Act there will also be a limit placed on the percentage of an investor's money allowed in any particular loan.⁸⁷ On the other hand, other platforms, such as RateSetter, expect a certain level of competency and common sense on the part of the investors and do not place such limits, demonstrating the different approaches adopted across jurisdictions.

With regards to equity crowd-funding there are some regulations to protect investors from concentration risk. However they usually centre on restricting the type of investor to sophisticated investors (this was the case in the US before the JOBS Act and is the case in the

⁸⁶ IOSCO Market Intelligence

⁸⁷ OSC, 2013

UK). Both the practices and regulations are designed to protect investors from concentration risk and prevent them from incurring losses. Loss concentration could be a systemic risk if the market were to become sizeable, though this is unlikely due to the practices and regulations in place.

Transparency and awareness

Peer-to-peer lending and equity crowd-funding both market themselves as being different to banks, with an emphasis on the transparency of the industry. Most platforms freely publish data on overall total loan origination, default rates and selected statistics on their sites. In the US, Prosper and Lending Club both publish the details of every note they sell to their lenders, which are submitted to the SEC and made publically available by the SEC at a later date. There appears to be no obligation to publish this type of data elsewhere, although most sites do still publish some of this data. Some platforms only provide this data once an individual becomes its member.

Despite this broad access to data, a concern about awareness of risk still exists. Some platforms disclose the general risks, though not in detail, while others require the potential investor to become a member before outlining the potential risks of investments.

In addition to this, some platforms filter relevant information in an effort to: firstly, lower default rates and, secondly, increase headline rates of return through the omission of costs such as taxes, administration fees, and potential losses. A distorted view of the actual investment may cause investors to over-estimate the actual return, or cause them to invest in a product that under normal circumstances would not align with their risk appetite. Research confirms that some peer-to-peer lending platforms that advertise returns of above 10%, in effect, have an estimated real rate of return of between 1-5% lower once extra costs are taken into account.⁸⁸

Furthermore, the evolving regulatory regime for equity crowd-funding in certain jurisdictions could also imply there is no need to publish a prospectus if the issuer meets certain criteria to be classified as exempt. The lack of transparency surrounding the risks associated with FR crowd-funding has clear retail investor protection implications. The lack of disclosure surrounding the risks of investing in either peer-to-peer lending or equity crowd-funding could lead to loss for a retail investors, who may not adequately understand the risks involved, invest in a product not aligned with their risk appetite and ultimately incur a loss for which they may not have the resources to absorb. This is compounded in equity crowd-funding where retail investors could become locked into an investment that lacks a sufficiently liquid secondary market and is difficult to value.

Finally, due to the anonymous nature of the peer-to-peer lending market little hard information on the borrower is available to the lender.⁸⁹ As such, the lender is wholly reliant

⁸⁸ IOSCO Market Intelligence

⁸⁹ Freeman and Jin, 2009

on the efficacy of the platform and the value of their internal creditworthiness models. Freeman and Jin's paper illustrates the information asymmetry in peer-to-peer lending sites and its overall impact on investment prospects. The lack of hard information forces investors to rely on soft information based on the social networking aspect of peer-to-peer lending platforms. This results in additional adverse selection towards the lower end of each credit grade assigned by the peer-to-peer lending platforms, relative to traditional investments.⁹⁰ Although there is some evidence⁹¹ to suggest the use of soft information helps in the prediction of default, it is best if there is a combination of hard and soft information.

Overall, there appears to be some availability of data and transparency on a voluntary basis. However, transparency alone may not fully offset understanding the risks of any investment. Furthermore, not all the information is necessarily of good quality which can drive bad investment decisions with systemic consequences under certain conditions. The industry is not at a "critical mass" yet for this to be a concern, but as the industry grows, these considerations will need to be monitored, especially with respect to retail investor protection.

Cross-jurisdictional

Currently there is little cross-border activity in FR crowd-funding, with only two peer-to-peer platforms lending across national borders. However, these two business models raise questions such as: under what jurisdiction would the contracts produced by these lending platforms come under in order for them to be implemented? What type of contact data is available in the event of platform closure? Under which jurisdiction would the platform be regulated and would this regulation cover all its activities or only those in that jurisdiction?

Many peer-to-peer lending platforms have deliberately chosen not to go cross-border for these reasons. When a peer-to-peer lending platform has acquired a European banking licence, for example Smartika, it has had little incentive to create an international platform, especially for lending to borrowers outside its domicile (although it can do this under European passporting requirement imbedded in the payments systems directive). It considers the difficulties with contract law to be a hindrance as it is unclear under whose jurisdiction they fall under and therefore which law applies in the event of difficulties. Those that have created international platforms, such as isePankur, have to contend with these complications with little guidance or assurance. There seems to be little consensus on how to solve the contract law aspect. TrustBuddy, for example, sets up a separate client account and business under the franchise of TrustBuddy International in each jurisdiction it enters in order to comply with the different regulations, but it too has yet to test the contract law aspect of cross-border lending.

Market intelligence indicates that the next evolution of FR crowd-funding will be to develop cross border. However, basic minimum standards are needed if this is to occur successfully and without causing cross-border contagion to other international markets.

⁹⁰ Freeman and Jin, 2009, p16

⁹¹ Iyer, R. Khwaja, A. Luttmer, E. and Shue, K (2013) "Screening Peers Softly: Inferring the Quality of Small Borrowers", *NBER Working Papers 15242*, National Bureau of Economic Research, Inc.

Interconnectedness

In the US, the two largest lending platforms, Lending Club and Prosper, have both started to offer whole loan investments. This has significantly opened up their peer-to-peer lending market to larger investment entities such as banks, multinational corporations, hedge funds and pension funds, for example. This has been a deliberate move to encourage more investment from larger institutional entities. This trend towards embracing larger investors has started to be taken up in the UK, with Banco Santander looking to work with Funding Circle. The implications of banks and other investment firms investing in these types of loans will be to increase the interconnectedness of FR crowd-funding with the broader financial sector.

In addition, the platforms may start looking to expand their credit service to less creditworthy borrowers as larger investors can absorb more risk. This could expose other financial sectors to the risk of default inherent in peer-to-peer lending, as occurred during the subprime mortgage crisis. If the rapid growth rate in peer-to-peer lending continues, these risks could become systemic.

Another issue is how the investments are recorded in the books of large banks and other credit agencies using these platforms. Investing in un-collateralised loans, via peer-to-peer lending platforms, may be a way for banks and other large institutional investors to circumvent capital requirements or other regulatory requirements. There has already been a recorded case of a bank “investing” through a peer-to-peer platform in order to originate loans that were too risky to have on its balance sheet as a loan.⁹² Although currently not wide spread, this requires closer monitoring, especially in jurisdictions that have relatively little regulation on peer-to-peer lending or equity crowd-funding markets.

Behaviour

Fraud: This risk has been covered in depth in both the media and academic literature.⁹³ As the peer-to-peer lending market suffers from similar risks to traditional bank fraud, identity theft and money laundering are all concerns. This is compounded by the anonymity aspect of both the peer-to-peer lending platforms and the internet itself.⁹⁴ To combat this, platforms confirm the borrower’s identity before allowing them to advertise for a loan. However, lenders do not necessarily receive similar assessments. In most countries there are anti-money laundering laws with which peer-to-peer platforms have to comply. With the added reliance on soft information by the investors in peer-to-peer lending markets, and the social networking aspect meaning that online personas sometimes differ from the offline realities, the use of unverified information provided by the borrower, could mislead lenders into more risky investments. In some instances the platforms mitigate this risk to investors through manually checking borrower’s identities and reasons for requesting a loan through the use of hard information

⁹² Alloway, T (2013)

⁹³ Recommended Reading: Chaffee and Rapp, 2012; Herzenstein, M. Soenshein S. and Dholakia, U. (2011) *Tell Me a Good Story and I May Lend You Money: The Role of Narrative in Peer-to-Peer Lending Decisions*. Available at: <http://sonenshein.rice.edu/uploadedFiles/Publications/tell%20me%20a%20good%20story%20and%20%20may%20lend%20money.pdf> [Accessed: 30.09.2013]

⁹⁴ Chaffee and Rapp, 2012, p505

from a third party credit agency. However this is not a universal business practice meaning the risk of fraud is an ever present reality for FR crowd-funding markets.

Investor experience: Investors can and do make decisions based on personal biases and persuasive narrative, rather than on financial experience, due to the social networking aspect of peer-to-peer lending platforms. Neither government reviews nor the media have highlighted this point but it has been demonstrated substantially in academic work on the use of soft information, narrative, trust and pictures in peer-to-peer lending.

The platforms allow the formation of groups and networks on their sites, with group leaders giving endorsements to particular investments. However, unlike some micro-financing and crowd-funding formats, there is no joint liability within the group.⁹⁵ Iyer *et al*, suggest that the use of soft information helps predict default.⁹⁶ However, other works highlight that investors can be easily swayed by their personal biases.⁹⁷ They show that the use of buzzwords, such as 'trustworthy', can attract investors even though they are also more likely to default.⁹⁸ Ravina found that using an attractive picture on a peer-to-peer lending site also makes the loan more likely to be originated.⁹⁹ Other studies on the role of race on peer-to-peer lending platforms have found similar issues. This risk is due to peer-to-peer platforms acting in a similar way to social networking sites, allowing borrowers to post pictures of their choice and then write a narrative about why they would like the loan and how they are planning to use it. Currently, there is no restriction on these practices. However, it is important to note from a regulatory perspective that soft information can play a substantial role in successfully determining whether or not a particular loan could default.¹⁰⁰

A risk posed by moving to regulate a previously exempt sector could be perceived as rubber stamping the industry through regulation, lending credibility to the peer-to-peer lending and equity crowd-funding markets. This could attract less experienced investors to the FR crowd-funding market, who may not understand the risks involved in these types of investments. Considering the risks already mentioned,¹⁰¹ inexperienced investors may see regulation as lessening the risk of the investment or providing a safety net if their loans fail. Consequently they may neglect the undertaking of due diligence.

Furthermore, the use of peer-to-peer platforms to distribute government funds to SME borrowers could be seen as giving credibility to the market. This in turn could add to the risk posed by the market as investors may fail to follow due diligence due to the trust they place in government. Although not technically regulation in nature, this provides an extra pecuniary effect of perceived rubber stamping an industry.

⁹⁵ Freeman and Jin, 2009

⁹⁶ Iyer et al, 2013

⁹⁷ Herzenstein, Soenshein and Dholakia, 2011; Ravina, E (2012) 'Love and Loans: The Effect of Beauty and Personal Characteristics in Credit Markets', *Working Paper*, Columbia GSB.

⁹⁸ Herzenstein et al, 2011

⁹⁹ Ravina, 2012

¹⁰⁰ Iyer et al, 2013

¹⁰¹ See chapter 3, p28

Finally, if peer-to-peer lending were to provide a space for banks to lend off balance sheets,¹⁰² this raises questions to the effectiveness of banking regulation, which could be circumvented through the use of peer-to-peer lending platforms as an intermediary between banks and a borrower. Further work is required to comprehend how this would impact bank balance sheets and regulatory capital requirements. However, this paper has been written with the perspective and authority of securities markets regulation, and not of banking regulation, and therefore will not explore this space further.

Other considerations: potential conflicts of interest

As the industry increases in size investors could become over-reliant on some of the automated services offered by the online platforms for choosing their investment portfolio. Some sites, such as Prosper and Lending Club in the US, provide these services to investors. Other sites, such as TrustBuddy International, are fully automated and, as such, compulsorily eliminate the choice of the investor. Such services raise the question of conflicts of interest. Platforms charge based on the loan origination which gives them an incentive to push investors into larger loans that may not suit the investor's risk profile. In addition to this, the growing participation of larger investors is increasing the competition for the best notes/loan contracts. Smaller investors could be crowded out of high quality investments and forced into lower grade options; choices not aligned with their appetite for risk. Market intelligence suggests that smaller investors are turning to the automated services provided by the platforms simply to be able to invest in the best loans.

Does financial return crowd-funding pose a systemic risk?

In short: not yet. The markets for both peer-to-peer lending and equity crowd-funding are currently so small that they do not pose an immediate systemic risk. However, they raise significant investor protection issues, particularly in relation to retail investors.

Equity crowd-funding is a particularly small market. Though the risks posed by this industry are high, they are currently only posed only to a few investors, most of whom are sophisticated investors due to the strong regulation surrounding the issuance of this type of equity. These investors should already understand this type of investment, and be able to absorb any losses. Problems could arise as this market opens up to retail investors. Small investors may lack the experience to deal with the problems associated with start-up companies or illiquid investments, creating a high risk of instability and raising investor protection issues. These risks could increase as the industry expands through the use of exemptions. Less disclosure of information by issuers could increase the risk of fraud. Currently the strict regulation surrounding this form of crowd-funding prevents the industry from posing a systemic risk and mitigates some of the investor protection issues. The industry also accounts for a tiny percentage of the overall issuance of equity.

¹⁰² Alloway, T (2013)

Peer-to-peer lending may require future work to fully appreciate its impact on the wider financial sector. Growth rates are such that overall loan origination may become more significant going forward and more investors might participate. In addition, the tendency to securitise these unsecured loans will increase the complexity and interconnectedness with the broader financial market. The current high rates of return coupled with a lack of safe high-yield investments alternatives, could mainstream this type of investment. Government moves to actively finance business through these sites could dim the perception of risk and stimulate more retail investor interest, thereby increasing market size and the potential impact of any adverse market event. Actual default rates are unknown, increasing the potential for these platforms to fall short of the expectations created through advertising. As this market grows the likelihood of it posing a systemic risk also increases. The lack of collateral means that if these investments, and their securitised versions, do become undermined by borrower default the result could be grievous, especially for retail investors who might not have the funds to absorb the fallout. For all these reasons, peer-to-peer lending raises issues with investor protection.

Though these industries do not currently pose a systemic risk they do raise questions about investor protection. Retail investors are of particular concern. They may not fully understand the investment risks they are undertaking. Both equity crowd-funding and peer-to-peer lending are opaque when it comes to disclosing some risks. This and the illiquidity in their secondary markets place retail investors at a disadvantage; if the investment goes bad they may not have the collateral to absorb the loss.

Chapter 5: Financial Return Crowd-funding in the context of the IOSCO Objectives and Principles

IOSCO's objectives and principles were agreed upon to set standards for the regulation of securities markets. The full objectives and principles can be found in IOSCO's *Objectives and Principles of Security Regulation*,¹⁰³ which were extended in 2010 to more comprehensively cover the regulation of securities markets in light of the financial crisis, and provide, inter alia, new principles to help identify and mitigate potential systemic risks. These principles can be applied to both equity crowd-funding and peer-to-peer lending. This section aims to pick out some of the key principles and apply them to both peer-to-peer lending and equity crowd-funding, focusing on their application to the larger industry of peer-to-peer lending which is of growing concern to securities markets.

Both peer-to-peer lending and equity crowd-funding can arguably be classified as securities. In peer-to-peer lending some business models provide a note to the value of the investment made by the lender. Additionally, these notes can sometimes be traded on a secondary market. As such these notes are securities. In some cases the "securities" aspect of the product is emphasised by some peer-to-peer lending platforms acting as brokers in the selling of notes. Others sell securitised bundles of peer-to-peer loans. Although credit provision in nature, since in some instances the contracts between lenders and borrowers can be sold-on through a secondary market, they act and contain features similar to a security.

Consequently IOSCO Principles and Objectives, and the regulation by securities market regulators of these activities, are relevant, as seen in the chapter on regulatory regimes.¹⁰⁴ Some securities regulators, who are members of IOSCO, already have a remit for regulating peer-to-peer lending, while equity crowd funding, being the issuance of share equity is within securities market regulators jurisdiction. This chapter takes each section of the principles in order, and discusses their potential relevance to FR crowd-funding.

Section A: Principles relating to the regulator

Principle 6 states that the "regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate"¹⁰⁵ and **Principle 7** states the "regulator should have or contribute to a process to review the perimeter of regulation regularly".¹⁰⁶ This Staff Working Paper aims to provide the basis to assist regulators in understanding the application of these principles in relation to FR crowd-funding.

In addition, **Principle 8** is also relevant to this topic. It states that "The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated,

¹⁰³ Available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>

¹⁰⁴ See chapter 3.

¹⁰⁵ IOSCO *Objectives and Principles, 2010*, p4, Available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>,

¹⁰⁶ Ibid, p4

disclosed or otherwise managed”.¹⁰⁷ There is at least one case where the platform is fully automated, providing no choice to the investor in who they invest in. In other cases investors can use an automated service offered by some platforms, automating their investments through the platforms own matrix. As such there could be a conflict of interest or misalignment of incentives involved in these transactions.

Section B: Principles for self-regulation

In peer-to-peer lending particularly there has been evidence of industry self-regulation. This is the case in the UK where there is no regulation for the industry. In order to create trust and credibility in the industry the largest platforms formed into a self-regulatory body called the P2P Finance Association. In 2014 there will likely be regulation for peer-to-peer lending under the Financial Conduct Authority (FCA), as such principle 9 could potentially be taken into account; where self-regulation continues there could be some oversight of their practices to ensure fairness and confidentiality when exercising powers delegated to them.

Section E: Principles for issuers

Principle 16: “there should be a full and timely disclosure of financial results, risk and other information material to investor’s decision making.”¹⁰⁸

In peer-to-peer lending there is evidence to suggest that platforms initially failed to disclose fully the risks involved in peer-to-peer lending. This means that investors may not be aware of the risks involved in the funding of unsecured loans. In addition market intelligence shows that rates of return advertised are difficult to achieve unless the investor is constantly vigilant. Equity crowd-funding already has strong regulatory requirements of disclosure in most jurisdictions where it occurs.

Section G: Principles for collective investment schemes

Some peer-to-peer lending schemes can be seen as acting as collective investment schemes, for example TrustBuddy International and Afluenta, and as such some of the principles surrounding collective investment schemes could be applied to these peer-to-peer lending platforms. Particularly the following principle could be relevant:

Principle 25: “The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.”¹⁰⁹

Funds should be segregated from the platforms personal account in order to protect their client’s assets. In addition the governance of these funds should take into account the nature of these peer-to-peer lending platforms.

Section H: Principles for market intermediaries

All the principles for market intermediaries can be applied to FR crowd-funding. These include:

¹⁰⁷ Ibid, p4

¹⁰⁸ Ibid, p8

¹⁰⁹ Ibid, p10

Principle 29: “Regulation should provide for minimum entry standards for market intermediaries”;¹¹⁰

Principle 31: “Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.”¹¹¹

This principle is relevant for effective risk management of FR crowd-funding.

Principle 32: “There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.”¹¹²

This could be directly relevant to the regulatory governance of the online platforms operating as intermediaries. There has already been an example of a platform failure, i.e. Quackle, which left no data on the lenders and borrowers who used the site, meaning that contracts were unable to be fulfilled in the absence of the platform. This led to a 100% loss for the lenders. This principle could form the basis for the resolution and resolvability of platforms.

[Section I: Principle on secondary markets](#)

Some of the peer-to-peer lending platforms have secondary markets and as such these can be regulated from the secondary markets perspective in order to maintain their liquidity and to ensure investor protection.

Conclusion on the application of IOSCO Principles

FR crowd-funding, with both its constituent subcategories possibly qualifying as securities, is currently a very small market with high growth. The IOSCO Objectives and Principles already in place could help guide policy towards crowd-funding.

¹¹⁰ Ibid, p11

¹¹¹ Ibid, p11

¹¹² Ibid, p11

Chapter 6: Conclusions and next steps

Peer-to-peer lending and equity crowd-funding, collectively FR crowd-funding, are forms of market-based finance that are currently very small in comparison to traditional funding options, although they have experienced exceptional growth since 2010. This coupled with the focus of policymakers and regulators on growth and funding of the real economy means that this segment of the financial industry has the potential to develop into a credible investment option for sophisticated and retail investors alike.

There are a number of benefits associated with peer-to-peer lending and equity crowd-funding. These include the ability to raise capital without giving up large parcels of equity interest, the spreading of risk, higher returns for low cost capital and the boost to the economy through encouraging the growth of SMEs. However, these benefits need to be balanced with the risks posed by these innovative industries. These risks to retail investors include the risk of default or business failure, the risk of platform closure, the risk of fraud and the risk of concentration, the risk of illiquidity and cybercrime.

Although regulatory regimes are varied across jurisdictions, broadly speaking they can be classified into four regimes for regulating peer-to-peer lending: exempt market/unregulated due to lack of definition; regulated as an intermediary; regulated as a bank; and the US model, with a possibility of a fifth regime: regulating as a collective investment scheme.

Additionally, there are three for the regulation of equity crowd-funding: prohibited market; allowed market but regulated as public issues; and regulation which allows the industry but with strict requirements on the persons involved, including the number of investors, the company size and the type of investors.

Some regulatory requirements for FR crowd-funding mean that the barriers-of-entry are too high or burdensome for the platforms and their participants, resulting in little to no market in some jurisdictions. Through the use of potential impact factors, we have identified a number of potential areas contributing to systemic risk and investor protection concerns. The high growth rate in peer-to-peer lending, standing at around 100% means the industry could become a more mainstream investment opportunity; its interconnectedness could expose more of the risks of the industry to the wider economy. Although in its initial stages, the issue of the securitisation of loan bundles requires monitoring. The cross-border aspect of these platforms raises issues to what extent contract law and regulation is harmonised. The insolvency of a cross-border platform could raise uncertainty especially in identifying which contract law may apply when the parties are domiciled in differing jurisdictions with differing legal systems. This will need to be addressed in the future if this industry is to be able to grow into a viable source of investment and credit provision internationally.

In addition the small start-up investment opportunities provided through equity crowd-funding increase the risk to retail investors who may not fully understand the nature of their investment or comprehend the relatively high attrition rate these investments have. As such,

appropriate disclosure to retail investors of the significant risk imposed by such investment decisions is important along with consideration of suitability.

Overall, the evidence suggests that FR crowd-funding does not currently constitute a systemic concern, but if allowed to grow without proper management, and if the interconnectedness with other industries (for example, through its shadow banking activities, further enhanced by activities such as the securitisation of loan tranches) continues, then there is a possibility of it becoming an important issue, in a systemic context, in the future.

The IOSCO Objectives and Principles can be applicable to both industries and form the foundation on which to address the possible future regulation of this industry in order to protect these investors. In the meantime, further monitoring is required.

Issues for further consideration

There are still some clear questions on the future of the industry, both in terms of how the benefits of this type of market-based finance can be best directed to the real economy, and how the risks of this infant industry can be controlled. Given the access to retail investors, are there sufficient protections in place as this investment choice becomes more mainstream? Additionally, discussions with industry highlighted the next evolution of this industry is in the global nature of funding sources, thereby opening up cross-jurisdictional implications for contractual and legal harmonisation, dispute settlement and resolution issues. With the rapid evolution of this predominately online industry, however; future challenges may arise around enhanced cross-jurisdictional harmonisation and the quality and comparability of soft information. Finally, continued research focus on this topic would aid regulators in monitoring the development of the industry. Much of the impact factor assessment is qualitative in nature and further research towards developing indicators for those areas lacking hard data; as such the development of quantitative indicators, can help with this assessment.

Annex 1: Regulatory practices by country

All information enclosed in this annex was drawn from direct, bilateral communications with relevant jurisdictions and/or from freely available information existing in the public sphere. Every attempt has been made to ensure the accuracy of the information up to the date of publication.

Australia:

Peer-to-peer lending:

Peer-to-peer platforms need to be registered and have a licence specifically for financial services. In addition there are some capital requirements as well as further regulations in regards to responsible lending, due to peer-to-peer platforms being classified as investment management schemes. This creates a high cost to entry, which lessens their competitiveness with traditional credit lenders; as a result there is only one peer-to-peer lender, who only allows investments by wholesale clients, operating in Australia.

Equity crowd-funding:

This is regulated under the Corporations Act which was not designed to specifically address crowd-funding investment models. The platform requires an intermediary financial services licence, full product and platform disclosure, the need for due diligence and the monitoring of investments to manage how funds are spent. The alternative is for the start-ups themselves to open as public companies from the offset, requiring the production of a prospectus or short prospectus depending on the amount being issued. This is very costly to the start-up, especially if they are only raising a small amount. All prospectuses have to be lodged with ASIC as stipulated under the Corporations Act. For a more thorough review of the equity crowd-funding industry in Australia, please consult The Corporations and Advisory Committee Discussion Paper on Crowd Source Equity Funding.¹¹³

Brazil:

Regulation is dependent on the size of the company. If the platform is considered either small or micro, they are allowed to participate in this activity with little regulation. However, once the platform reaches a threshold, either in the size of the loans being originated or number of loans being originated then there is a more comprehensive regulation for these larger platforms. They need to be licenced as a financial service provider and meet the minimum standards to ensure this licence.

¹¹³ The report can be found at the following website:
[http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/\\$file/CSEF_DP_Sept13.docx](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/$file/CSEF_DP_Sept13.docx)

Canada - Ontario:

The Ontario Securities Commission (OSC) is currently conducting a review of the exempt market regulatory regime. The OSC conducted a consultation on whether it should introduce any new prospectus exemptions that would facilitate capital raising for business enterprises, particularly start-ups and small and medium-sized enterprises, while protecting the interest of investors. As part of the review, the OSC published OSC Staff Consultation Paper 45-710 Considerations for New Capital Raising Prospectus Exemptions on December 14, 2012. On August 28, 2013, the OSC provided an update on its review through OSC Notice 45-712 *Progress Report on Review of Prospectus Exemptions to Facilitate Capital Raising*. On December 4, 2013, the OSC announced that it intends to publish in the first quarter of 2014 four new capital raising prospectus exemptions, including a crowd-funding exemption, for a 90-day public comment period.¹¹⁴

Ecuador:

There is no current legislation or regulation regarding peer-to-peer lending or equity crowd-funding. There are also no platforms currently operating in Ecuador.

Egypt:

There is no market for peer-to-peer lending due to the unpopularity of lending in Egyptian culture. In regards to equity crowd-funding it tends to be limited to small transactions. Other possible reasons for the lack of either are:

- The charging of interest (or riba) is forbidden (haram) under Islam;
- The anti-lending culture enforced during the Muslim brotherhood government;
- Lack for the regulatory framework that supports enforcement of contracts in this area;
- The anti-borrowing culture among Egyptian in general, which also hinders them from dealing with banks (even if they are eligible); and
- Most of these mechanisms are usually web based, which limits the access of many small and micro enterprises and start-ups to these sources of finance.

This subject has yet to be researched into in any depth in order to draw any regulatory conclusions. In addition the work that had been started on this subject and micro-financing has been put on hold since the start of the revolution.

France:

The French government has published a consultation paper to outline possible new regulations for crowd-funding, it is important to note their aim is to open the market in order to promote the growth of SME's. The new regulations proposed may include:

¹¹⁴ http://www.osc.gov.on.ca/documents/en/Securities-Category4/sn_20121214_45-710_exempt-market-review.pdf

- A proposal to create a new statute on crowd-funding; - They propose a new title in the assigned status of crowd-funding platforms as an equity investment advisor (*conseiller en investissement participatifs –CIP*). This is similar to the status of financial investment advisors. By adopting this new status, regulated by the AMF, the crowd-funding platforms could grow their business without falling within the scope of an unsecured investment service (which requires € 730,000 capital) if they respect the constraints of the CIP. The CIP will be limited by size.
- The relaxation of the monopoly of banks; - Loans are considered to be under the banking monopoly as the reserved credit institutions. There are some exemptions listed in Article L. 511-6 of the Monetary and Financial Code (*code monétaire et financier*). To allow the growth of crowd-funding platforms a new exemption under Article L. 511-6 will be listed in order to allow an individual to make a payment to another individual or business when an operation is carried out so long as it meets the minimum number of investors required. There will be a limit on the amount a lender invest in any particular loan – currently considered at 250euros – and an overall investment ceiling of 300,000 euros.
- The creating of a prudential system for the exemption of certain payment institutions; - Currently Article 26 of Directive 2007/64/EC on payment services allow institutions, whose volume of payments does not exceed €3 million per month, to benefit from a prudential exemption regime. These institutions, subject to central bank supervision, will be allowed a reduction in the minimum capital and will be exempt from capital rules and internal control. They will still need to meet regulations concerning the fight against money laundering and the outsourcing of essential services.
- Adaptation of the regime to permit the offering to the public securities made by crowd-funding; - This is to provide a new exemption for offers of securities made via crowd-funding platforms upon the issuance of a minimum amount of information, at the expense of the platforms, such as the description of the specific risks of their activities or the description of the shareholders' rights. All information will be detailed in the General Regulations of the AMF.

Germany:

Depending on the model, a Peer-to-Peer lending/ Equity Crowd-Funding platform may require an authorisation pursuant licence under both the Banking Act (*Kreditwesengesetz - KWG*) or the Payment Services Supervision Act (*Zahlungsdiensteaufsichtsgesetz*) if they fulfil any of the following the criteria: of either

- provide a banking business or financial service in Germany commercially or on a scale which requires a commercially organized business undertaking ; or
- is an operator who wishes to offer a payment service as a payment institution in Germany.

A company does not require authorisation if it only operates investment broking and contract broking between customers and offerors or issuers of capital investments within the definition of section 1 (2) of the Capital Investment Act (*Vermögensanlagegesetz -VermAnlG*) – provided that the financial services are restricted to the specified capital investments and the company is not authorised to obtain ownership or possession of funds or securities of customers (section 2 (6) sentence 1 no. 8e of the KWG).

Depending on the investment there may be an obligation under the Securities Prospectus Act (*Wertpapierprospektgesetz*) for a prospectus to be provided. The obligation to draw up a prospectus under section 6 of the VermAnlG generally applies to a public offer of capital investments that is designed to raise investor funds for projects under the crowd-funding concept. In particular, section 2 no. 3 of the VermAnlG states that offers up to specific minimum limits are exempt from the obligation to draw up a prospectus. For example, the legislature proceeds on the assumption that an investor investing funds not exceeding €100,000 within a period of twelve months does not need protection. This is intended to prevent overregulation. The €100,000 threshold is also in the Securities Prospectus Act (WpPG) and is derived from the EU Prospectus Directive.

Due to customer loyalty and competitive lending rates provided by banks in Germany, there is little to no market for peer-to-peer lending or equity crowd-funding in Germany.

Italy:

Peer-to-peer lending is regulated by the central bank. The platforms shall be licensed as banks and must comply with bank-like regulations.

Crowd-funded equity capital is subject to special provisions recently introduced to channel resources to innovative startups and at the same time ensure investor protection. In particular, equity crowd-funding is regulated under Legislative decree no. 58/98 (Consolidated Law on Finance) and CONSOB *Regulation on the collection of risk capital on the part of innovative startups via online portals*, adopted on 26 June 2013.

Under this regulation there are requirements on:

- the running of equity crowd-funding portals: the activity is reserved to (i) licensed investment firms and banks and (ii) companies duly registered with CONSOB, but these latter cannot hold investors' assets or money and must avail themselves of the services of a licensed firm when executing trading orders. When providing investment services investment firms and banks must comply with all securities rules, with very limited exemptions;
- the registration process: companies that wish to run a crowd-funding web-portals must apply to CONSOB to be included in a special public register (that will list all the equity crowd-funding web-portals);
- the integrity and professional qualifications to act in managerial and supervisory roles, including proof of professional standing, business experience, and IT knowledge;

- professional investors' skin-in-the-game to foster reliability of the portal: at least 5% of the financial instruments offered by the start-up shall be subscribed by professional investors or by banking foundations or by innovative start-up incubators;
- the display of warnings to alert retail investors on the high risks of crowd-funding and provision of detailed information about the financial instruments available on the portal;
- conduct of business, including on processing of trading orders, use of back-up, devices and recordkeeping, and the information that should be available on the portals, including on any fees and expenses, conflicts of interests, complaints handling, and investor education materials. Retail investor may adhere to individual offers only at certain conditions;
- the comprehensive set of mandatory information which must be provided during the offer and be left available to investors afterwards;
- obligations towards investors and retail investors' rights of withdrawal or disinvesting, including where the start-up controlling shareholders transfer their controlling stake to a third party after the offer; and
- periodic and ongoing reporting to CONSOB.

This framework applies to newly established innovative starts-ups, as defined by the law, which are not listed on a stock exchange or multilateral trading system.

Japan:

Currently in Japan, among those platforms categorized into investment-type crowd-funding, there have been some instances of partnership-based crowd-funding. However, the present legislation does not permit the raising of funds through equity-based crowd-funding. Under the government's policy objective to promote economic growth through facilitating private investment, investment-type crowd-funding is expected to be an effective financing tool for providing risky money to start-ups and SMEs. With this in mind, the Financial System Council of the Japanese Financial Services Agency (JFSA) began in September 2013 to examine investment-type crowd-funding, including both equity-based and partnership-based crowd-funding, as a funding scheme for start-ups and SMEs.

Their focus is on how to introduce such new and flexible funding schemes while ensuring adequate investor protection. The Council started the discussion centring on the following five aspects of this issue:

- Scope of investment-type crowd-funding,
- Regulations of intermediaries,
- Desirability of placing ceilings of total and per investor amounts of funding through such a scheme,
- Registration or license requirement for intermediaries, and

- Information disclosure for investors.

The Council's discussion has not reached any conclusion at this stage. The Council aims at concluding its deliberation and issuing its policy recommendations by the end of 2013, taking other jurisdictions' experiences into account.

New Zealand:

Peer-to-peer current regulation:

In New Zealand peer-to-peer platforms are currently treated in the same way as issuers of debt securities. The Platform is considered a 'promoter' of these securities and as such is jointly liable under the Securities Act 1978. Obligations therefore include: the registration of a prospectus on each loan and ensuring every investor receives an investment statement in relation to that issue. The Securities Act 1978 requirements create a prohibitive cost/regulatory burden and as such there are no peer-to-peer lending platforms in New Zealand.

New regulation 2014:

In April 2014 new regulation will be introduced to encourage peer-to-peer lending.

A new licence category shall be issued of a "prescribed intermediary service", both peer-to-peer and equity crowd-funding will be able to be licenced in this way. Where a peer-to-peer platform or equity crowd-funding platform holds a licence an issuer of debt securities, or an issuer of equity securities will not have to comply with the rigorous disclosure obligations associated with current legislation. Licenced peer-to-peer platforms and equity crowd-funding will still have to comply with certain 'fair dealing' obligations under Part 2 of the FMC Act. This means that they (the issuers of equity and borrowers on peer-to-peer sites) will be under a duty to avoid misleading or deceptive conduct, false or misleading representations, and/or unsubstantiated representations.

Requirements for all intermediaries include (though they are not finalised):

- Directors and senior managers of the crowd-funding/peer-to-peer intermediary entity must fulfil the definition of 'fit and proper persons';
- The intermediary entity must be 'capable of effectively performing' the service (having regard to the proposed conditions of the licence) and meet minimum requirements for business practice;
- The entity must have 'fair, orderly and transparent systems and procedures for providing the service';
- The entity must maintain effective methods of monitoring compliance with their obligations and for identifying any material change of circumstance.
- The entity must report certain matters to FMA, for example solvency issues and any material change of circumstances;
- The crowd-funding/peer-to-peer intermediary entity (rather than the issuer/borrower) must provide disclosure statements to the investors/lenders. The

disclosure will not be as detailed as a full prospectus or PDS;

- The issuer/borrower must not raise more than NZ\$2,000,000 per year through these 'low disclosure' methods. There may also be caps on the maximum amount that retail investors/lenders can invest in any one year;
- The intermediary entities must conduct basic client identification of issuers/borrowers and their investors/lenders;
- The intermediary entities must enter into written client agreements with investors and lenders; and
- They must be a member of a recognised dispute resolution scheme.

Equity crowd-funding current regulation:

Equity issued through a crowd-funding website would be subject to the same requirements as any other public issuance of equity securities. Under the Securities Act 1978 the requirements include registration of a prospectus and ensuring that every investor receives a copy of an investment statement.

The crowd-funding service provider would be considered to be a 'promoter' of the securities and would be jointly liable for obligations under the Securities Act. These Securities Act requirements are considered to create a prohibitive cost/ regulatory burden. There are currently no active equity crowd-funding businesses in New Zealand (as at October 2013).

The Securities Act provisions do not apply if the investor is not entitled to any financial reward or interest. There are, therefore, unregulated crowd-funding sites that do not offer financial returns, such as www.pledgeme.co.nz. These types of sites are not subject to financial product regulation, although they could be subject to some supervision (by the Department of Internal Affairs) under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 if their business involves "*transferring money or value for, or on behalf of, a customer*".

Under the new regulation an intermediary platform will be subject to similar regulation as peer-to-peer lending platforms, stated above. In addition it is proposed to make the licensed intermediaries display a prominent warning, using prescribed language, which describes the risks of equity crowd-funding and reminds investors that they may lose their entire investment; and that they should only make the investment if they can bear this risk without undue hardship.

South Korea:

There is proposed new legislation in South Korea with the purpose to support start-up businesses. Although various methods exist to provide capital for new businesses, such as government funding and angel investment, available capital is still relatively low. Therefore, in addition to the current policies in place, there is a need to introduce alternative funding methods for starting businesses. Moreover, this alternative funding should include safety nets to protect start-ups as well as investors.

Preliminary regulatory framework for crowd-funding

- Amend the Financial Investment Services and Capital Markets Act (FSCMA) to include crowd-funding in the regulatory framework;
- Consider both pillars of 1) facilitate financing for start-up businesses and 2) protect investors;
- Alleviate requirements on broker or brokerage companies in regards to obligations on disclosure; and
- Install supplementary measures on investment limit (per person), subscription amount, etc.

Next steps

- The amendment for legislation on crowd-funding is at a standstill at the National Assembly, yet, amendments should be carried out within a year;
- Once the FSCMA is amended, rules & regulations will also be changed; and
- The aim is to enable crowd-funding within 2014.

Tunisia:

There currently is no specific regulation on peer-to-peer lending or crowd-funding in Tunisia, except for the regulatory requirements on credit provision to the borrower. In this instance the regulation focuses exclusively on the interest rates provided to the borrower, with sanctions in cases of abuse.

United Kingdom:

There is no current regulation for peer-to-peer lending other than that provided to the borrower from the obligation to register with the Office of Fair Trading. However, the industry, it shall be regulated from April 2014 by the FCA. Equity crowd-funding currently falls under equity rules and is regulated as such.

***New regulation 2014:*¹¹⁵**

As of 1st April consumer credit will come under the regulatory mandate of the FCA, covering peer-to-peer lending platforms. It does not cover business-to-business loans on a commercial arrangement through peer-to-peer platforms nor does it cover platforms which have more than one intermediary process.

The key proposals for ***loan-based crowd-funding platforms*** are as follows:

- Information about the platform must be clearly presented and easy to find so customers know with whom they are dealing;

¹¹⁵ For further reading please consult “The FCA’s regulatory approach to crowdfunding (and similar activities) - <http://www.fca.org.uk/news/cp13-13-regulatory-approach-to-crowdfunding>

- All communications must be presented in a way that the intended customer will understand. Platforms must not downplay risks or warnings;
- Platforms must have resolution plans in place that mean, in the event of the platform collapsing, loan repayments will continue to be collected so those lending to firms do not lose out;
- Any comparison of a peer-to-peer loan interest rate with a regular savings account interest rate must be fair, clear and not misleading;
- Any promotions (such as print, broadcast or online advertising) must be fair, clear and not misleading. Promotions that are not can be banned by the FCA;
- Where firms do not provide access to a secondary market, investors can cancel without penalty and without reason within 14 calendar days; and
- A minimum prudential requirement: either a percentage of loaned funds or a fixed minimum of £50,000 – whichever is higher (The fixed minimum will be lower (£20,000) until April 2017, to allow platforms to acclimatise to the new regime).

For **investment-based crowd-funding platforms**, the FCA is tailoring an existing rulebook rather than creating a new one so there are fewer proposed changes. The key proposals are:

- In the retail market, firms can only promote these platforms to:
 - Sophisticated investors, high net worth investors, retail clients who receive regulated investment advice or investment management services from an authorised person; or
 - Retail clients who certify that they will not invest more than 10% of their portfolio (i.e. excluding their primary residence, pensions and life cover) in unlisted shares or unlisted debt securities. This reflects the fact that most investments in start-up businesses result in a 100% loss of investment (between 50% and 70% of new businesses fail in the early years).
- For non-advised clients, firms must assess appropriateness before allowing them to invest through the platform;
- The restrictions the FCA has placed on the marketing of unregulated collective investment schemes, or UCIS, will apply to platforms that offer these investments;
- In addition, while most platforms will simply be providing an introduction to an investment, they will need to think carefully about whether any supporting information they provide (such as a star rating or 'investment of the week' award) amounts to advice. If it does, the firm will need to apply to FCA for permission in order to advise on investments.

United States of America:

Peer-to-peer:

There are two levels of securities regulation in the US: The federal regulator in the SEC and State level regulators.

SEC level regulation

The notes being sold under this model constitute a “security” under the Securities Act 1933. As such they must comply with SEC regulation. Peer-to-peer lenders are required to register each loan, in its entirety, which the platform arranges. The peer-to-peer platforms are considered public entities and therefore must make public details on loan origination, investors and borrowers by month.

As a bank originates the loan they and the platform are regulated in accordance to a number of federal statutes on credit provision, including but not limited to: the Bank Secrecy Act, the Electronic Fund Transfer Act, the Electronic Signatures in Global and National Commerce Act, the Equal Credit Opportunity Act and the Fair Credit Reporting Act.

State level regulation

State level regulation varies from state to state with three main responses:

- Complete banning of peer-to-peer platforms;
- Allowing peer-to-peer platforms to elicit borrowers and sophisticated lenders only; and
- Allowing peer-to-peer platform activity in accordance to SEC regulatory criteria.

All these regulations limit access to the peer-to-peer lending market to new platforms.

Equity crowd-funding:

Equity is an obvious remit of securities regulators and comes under usual equity regulation. With Equity crowd-funding the platform has to provide a prospectus to lenders.

Introduction of the Jumpstart Our Business Start-ups Act (JOBS Act):

The JOBS Act broadens access to investment opportunities through creating a new crowd-funding exemption (OSC, 2012). The crowd-funding exemption is dependent on SEC rulemaking and came into force on 23rd September 2013. This allows early stage private companies to advertise for investment (Barnett, 2013). It only allows accredited investors to invest in such firms, and the firm must file Form D with SEC before advertising to accredited investors.

To qualify as an accredited investor they must have either \$US 1 million in net worth or have an income of over \$US 200,000 a year for the last 3 years or a joint income with a spouse of \$US 300,000 a year for the last two years with reasonable expectation of continued income of that value for the next two years (SEC, 2013). There are limits placed on the amount any one investor can invest in a single company through equity crowd-funding, in order to encourage diversification of portfolios. There may also be limits on the overall amount that can be invested by a single investor. This includes:

- Investors, over the course of a 12-month period, would be permitted to invest up to:
 - \$2,000 or 5 percent of their annual income or net worth, whichever is greater, if both their annual income and net worth are less than \$100,000.

- 10 percent of their annual income or net worth, whichever is greater, if either their annual income or net worth is equal to or more than \$100,000. During the 12-month period, these investors would not be able to purchase more than \$100,000 of securities through crowd-funding.

To qualify for issuer exemption under the JOBS Act there are a number of specified requirements. This includes requirements with regard to the dollar amount of the securities being sold by an issuer of no more than \$1million over a 12 month period. In addition there are rules surrounding the advertisement of an issuance, disclosing conflicts of interest, disclosing information, preserving documents etc.

New rules may allow non-accredited investors to also invest in equity. SEC issued the proposed rules on crowd-funding on the 23rd October 2013. The rules have yet to be set in regards to the requirements on the platform or the start-up business; however it should include filling information, with SEC, on the issuer such as¹¹⁶:

- The name, legal status and address of the business, along with the names of directors, officers and key shareholders;
- A business plan and description of the business;
- Financial information that may include income tax returns, officer-certified financial statements, and audited financial statements if raising \$500,000 or more;
- A description of the purpose and intended use of the funds, the target offering amount and the price of the securities they are offering;
- The ownership and capital structure of the business, including the terms of each class of the issuer's securities and methods of valuation for the securities;
- Annual reports and financial statements; and
- And other issuer liabilities making it very expensive for businesses to raise funds through equity crowd-funding.

For the intermediaries (equity crowd-funding platforms) to comply they must be registered with SEC and FINRA, either as a broker-dealer or as a funding portal. They must comply with rules proposed by both. The rules have yet to be set by FINRA. Rules proposed by SEC include rules to reduce the risk of fraud, rules on advertisement, rules on payment and rules on conflicts of interest.

¹¹⁶ For Further Reading See: SEC Crowd-funding proposed rules, Release No. 33-9470 (Oct. 23, 2013) <http://www.sec.gov/rules/proposed/2013/33-9470.pdf> and Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act, Release No. 33-9497 (Dec. 18, 2013) <http://www.sec.gov/rules/proposed/2013/33-9497.pdf>; Davis Polk Memorandum: http://www.davispolk.com/sites/default/files/11.18.13.SEC_.Proposes.Rules_.Crowdfunding.Intermediaries.pdf

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