# CHAPTER 18

# CROWDFUNDING AND ITS REGULATION IN HONG KONG: ROOM FOR INERTIA?

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## *I INTRODUCTION*

The pace at which technology is developing and revolutionising the way we do things accelerates exponentially. With the blink of an eye, the world is presented with further technological advances that make what we thought was revolutionary yesterday, no longer so revolutionary. "Traditional" businessmen, policymakers, regulators and other stakeholders struggle to keep up to pace, and it is difficult to jump onto the bandwagon when it is difficult to find a suitable place take the leap.

From a broader perspective, disruptive technologies – like the Internet was and is – transform the way we live and work, enable new business models, and provide an opening for new players to upset and disrupt the established order.[1] Policymakers need to prepare for future technology, equipped with a clear understanding of how such technology may shape the global economy and society over the coming decade.[2] Governments need to create an environment in which citizens can continue to prosper, even as emerging technologies "disrupt" their lives.[3] Regulators will be challenged and pressured to achieve the fine balance of protecting the rights and privacy of citizens, while providing room for such an ecosystem promoting upward societal growth.

It will be too late for businesses, policymakers and citizens to plan their responses only after disruptive technologies have fully exerted their influence on

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* Barrister-At-Law, Garden Chambers, Hong Kong.

1 See McKinsey Global Institute (May 2013), Preface.

2 Ibid at p 1.

3 Ibid.

the economy and society as a whole.[4] In fact – it is clear to see how digital advances are already pervading every aspect of our professional, personal and social lives. Policymakers and regulators need to look ahead – particularly in light of the lengthy convoluted process involved in reforming the regulatory rubric – to determine how to shape markets and policies in ways that will serve the best interests of society today.[5] Though the digital universe seems to have been colonised by the millennials,[6] baby boomers need to catch on if they have not already.[7]

Technological advances are moving from just video games and smartphone apps to developments that will have profound and helpful impacts on all aspects of our lives.[8] In recent years, innovation in entrepreneurial finance emerged both as a result of imbalances between the supply and demand of capital and as a consequence of improvements in technology.[9]

Financial technology ("fintech") has seen a threefold increase in global investment, from under US$930 million in 2008 to over US$2.97 billion in 2013, and is being touted as a game changer for the global financial industry.[10] Investments in 122 Asia-Pacific fintech deals reached US$3.46 billion in the first 9 months of 2015, up from US$879 million spent on 117 projects for the whole of 2014.[11] The participation of large, non-traditional financial services companies as investors in innovative payment ventures have boosted the overall value of fintech projects in the Asia-Pacific region in the second half of 2015.[12] Global investments in fintech are predicted to surge to over US$46 billion in 2020.[13]

The fintech industry targets hundreds of millions of people who may not be independently wealthy, and may be based in emerging markets, or a long way from

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4 Ibid at p 148.

5 Ibid at Preface.

6 See Dodwell (28 February 2016).

7 See John C Tsang, Hong Kong 2016-2017 Budget Speech at §65, "Entrepreneurship is not exclusive to the young. Older people with societal experience and professional expertise can join the ranks of entrepreneurs to bring forth new possibilities by applying creativity and technology".

8 See Dodwell, above n 6.

9 See Bruton, Khavul, Siegel and Wright (2015) at p 10.

10 See Yeung (10 March 2015).

11 See Perez (4 November 2015).

12 Ibid.

13 See Tsang, Hong Kong 2016-2017 Budget Speech, above n 7 at §57.

big cities, or running SMEs.[14] Fintech by its nature takes the middleman out of traditional banking services and ideally, does this with a lower cost base, robust compliance, leading edge technology and oftentimes, aggressive social media marketing.[15] Fintech enterprises create significant reach by delivering these services through easy-to-access mobile and web-based platforms.[16]

The fintech revolution is being driven by two very different populations: radical new start-up disrupters who exploit the potential of new technologies to develop fundamentally new ways of living our financial lives; and incumbent behemoths that have on the one hand recognised that unstoppable forces have been unleashed, and on the other, have seen economies and efficiencies embedded in the new technologies that can save them big money, improve services for customers, and help them retain their hard-fought competitive leadership.[17]

Amongst the "new age" forms of entrepreneurial finance and innovative technological solutions,[18] crowdfunding has emerged at the forefront. Experience from other jurisdictions suggests that crowdfunding will happen and indeed flourish whether one regulates it or not, and the best response is to facilitate development within some rules.[19]

## *II DEFINITION OF CROWDFUNDING*

Crowdfunding is an umbrella term describing the use of small amounts of money, obtained from a large number of individuals or organisations, to fund (for example) a project, a business or personal loan, through an online web-based platform.[20] The concept itself is far from new and has been embedded in human culture since its early days – historically, mainly in the area of charitable donation campaigns.[21] However, the term crowdfunding today typically denotes raising funds through the use of the Internet.[22]

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14 See Spence (28 December 2015).

15 Ibid.

16 Ibid.

17 See Dodwell, above n 6.

18 See Yeung, above n 10.

19 See Hong Kong FSDC (18 March 2016) at §4.

20 See IOSCO at p 8; cited in Hong Kong SFC (7 May 2014).

21 See European Commission (2014) at p 1.

22 Ibid.

The emergence of "modern" crowdfunding dates back more than a decade, although the use of a dedicated platform for several crowdfunding campaigns has only gained traction in recent years.[23] The development of entrepreneurship, the creation of start-ups and the growth of SMEs are considered important contributors to the global economy in terms of innovation, competitiveness and growth.[24]

Crowdfunding adds value to this movement of economic growth and development by generating additional revenue from a much wider audience or by providing capital to start-ups and SMEs.[25] Additionally, the social network angle that fuels crowdfunding platforms brings together market participants from across the globe who – in an offline and historic context – would not have the opportunity to come together.[26]

Crowdfunding can be divided into 2 broad categories, each with 2 sub-categories:[27]

(1) Community Crowdfunding

  (a) "Donation-based crowdfunding", where people give money to enterprises or organisations whose activities they want to support; and

  (b) "Pre-payment or rewards-based crowdfunding", where people give money in return for a reward, service or product.

(2) Financial Return Crowdfunding

  (a) "Peer-to-peer lending" ("P2P lending"), or loan-based debt crowdfunding, where individuals or companies lend money in return for interest payments and a repayment of capital over time; and

  (b) "Equity crowdfunding", or investment-based crowdfunding, where individuals or companies invest directly or indirectly in new or established businesses[28] by investing in the company or campaign, through a variety of forms.

It is to be noted that besides the abovementioned categories of crowdfunding, there may be other subcategories or different permutations and combinations of

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23 Ibid.

24 Ibid.

25 Ibid.

26 Ibid.

27 See IOSCO at p 8; and UK FCA (2014).

28 Such businesses may be called "investees".

subcategories, particularly as the market develops and evolves. Hong Kong is still at an infant stage of development.[29]

Community crowdfunding involves fundraising for charitable causes, such that donors do not receive any financial return in the form of a return on investment.[30] Rewards-based crowdfunding receives little attention from regulators as it is a form of pre-sale and enjoys traditional consumer protection, such as breach of contract if a product is not delivered.[31]

The focus of governments and regulators has predominantly been on P2P lending and equity crowdfunding – which form the focus of this Paper – due to the securities regulatory implications. Both P2P lending and equity crowdfunding involve fundraising through online platforms, thus having a multi-jurisdictional reach. P2P lending directly "competes" with banks, which are facing increasingly stringent regulations post-financial crisis. It has been said that equity crowdfunding presents the biggest risk for fraud and failure, and usually involves higher risks.[32]

### *2.1 P2P Lending*

P2P lending involves the matching of lenders (investors) with borrowers (issuers) for the provision of unsecured loans through an online platform.[33] Investors can provide money for small fragments of the overall loan capital required by a borrower. The loan parts are aggregated by the online platform until funds have accumulated to cover the total loan capital required by the borrower.[34] The loan is then originated and paid to the borrower.[35]

The P2P business model is different from that of traditional banks, in that P2P platforms do not lend their own funds to borrowers.[36] The platform matches borrowers with lenders/investors who purchase notes or securities backed by notes issued by the P2P platforms.[37] The P2P platform generates revenue from

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29 See Yeung, above n 10.

30 See IOSCO, above n 20 at 9.

31 See Gabison (2015) at p 19.

32 Ibid at p 20.

33 See IOSCO, above n 20 at 9.

34 Ibid.

35 Ibid.

36 See PricewaterhouseCoopers (February 2015) at p 1.

37 Ibid.

origination fees charged to borrowers and from a portion of the interest charged to investors as servicing fees, as well as other additional charges.[38]

The platform runs a vetting or screening process that includes credit history checks, employment verification and an analysis of the borrower's debts and assets.[39]

The interest rates are set by the platform – assigned based on the judged riskiness of the loan[40] – typically at a rate higher than the savings rate available to the lender but usually lower than the rates for traditional loans available to the borrower.[41] The lender generates revenue from the remaining portion of interest that borrowers pay on the loan, after the servicing fees are paid to the platform.[42] Borrowers benefit from a streamlined application process, easier access to capital, quick funding decisions and 24/7 access to the status of their loan.[43]

### *2.2 Equity Crowdfunding*

Equity crowdfunding is a vehicle through which multiple investors can invest in a business or project, usually a start-up or SME, through an online platform. Once the online platform completes the equity raising, each of the investors hold an equity stake in the business or project,[44] for example, as shareholder.

The model permits anyone to acquire a share in privately held businesses by allowing a business to offer a certain proportion of its equity for a set amount of capital it is aiming to raise.[45] Investors can then (through the platform) buy small parts of this equity stake.[46] The platform essentially offers equity shares to a group of investors on analogy to an initial public offering ("IPO").[47] However,

38 Ibid.

39 See Frezza (13 August 2013).

40 Ibid.

41 See IOSCO, above n 20 at 9.

42 See PricewaterhouseCoopers, above n 36 at 1.

43 Ibid.

44 See IOSCO, above n 20 at 10.

45 See Collins and Pierrakis (2012) at p 10.

46 Ibid.

47 See Hong Kong FSDC, above n 19 at §40.

crowdfunded businesses do not have to adhere to the strict accounting and reporting standards required of publicly listed companies.[48]

Equity crowdfunding allows ad hoc networks of investors and entrepreneurs to be assembled in a manner that, previously, required either the kind of networks that have long existed between financial institutions or an organisation like an exchange trading floor.[49] It therefore resembles the process of an IPO because it creates network externalities to allow aggregation of both funds and information to solve a collective action problem inherent in focusing small investments into a single enterprise.[50] However, the scale and purpose of an IPO are markedly different to equity crowdfunding – not only will the issuer not "list" its securities on the crowdfunding platform (so that there will be no secondary market for the shares) but neither the issuer nor the investor is prepared to bear the regulatory costs associated with a traditional public offering.[51]

Equity financing is attractive from both sides of the relationship as the entrepreneur has no duty to repay a fixed sum (together with interest) and the investor has the possibility of participating in very significant value growth as the inchoate business concept progresses into a viable enterprise.[52] However, the investor takes on very significant risk.[53]

Stripped of its glamorous façade, equity crowdfunding is effectively a public offering of shares in a high-risk enterprise with less regulatory protections – there is a larger element of *caveat emptor*.[54] At the same time, investors can benefit from holdings in potentially high-growth enterprises while making relatively smaller investments that allow young innovative companies to grow and thrive, while supporting the economy and society.[55]

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48 See Collins and Pierrakis, above n 45 at 3 and 10. However, the investee would need to be open with information in order to attract investors.

49 See Hong Kong FSDC, above n 19 at §42.

50 Ibid.

51 Ibid.

52 Ibid at §27.

53 Ibid.

54 Ibid. at §43.

55 Ibid.

## *III EVOLUTION OF CROWDFUNDING*

Modern P2P lending and equity crowdfunding started in the UK in 2006, spreading to the United States in 2007 and then taking off in China in 2009.[56] There was a 111% increase in P2P lending from 2011 to 2012.[57] In 2014, P2P platforms in the United States issued approximately US$5.5 billion in loans.[58] Analysis by PricewaterhouseCoopers indicates the P2P lending market could reach US$150 billion or higher by 2025.[59]

Immediately after the global financial crisis in 2008, traditional financing dried up, paving the way for the exponential growth of debt and equity crowdfunding.[60]

In the wake of the financial crisis, the new regulatory requirements in place not only led to a compliance nightmare for financial institutions, but also brought about increased difficulties for SMEs and individuals to obtain loan facilities through traditional means.[61] Banks tightened their credit standards and their reputations were tarnished as a result of the financial crisis.[62]

## *IV BENEFITS OF CROWDFUNDING*

Crowdfunding and the capitalisation of the Internet as a medium for investments open many doors for investors and investees, democratising the industry.

The concept of crowdfunding is rooted in the broader concept of crowdsourcing, which uses the "crowd" to obtain ideas, feedback and solutions in order to develop activities.[63] In addition to providing investees with a new and bigger pool of capital, the model allows them to connect with potential customers or users and test ideas before proceeding with the project.[64] It also potentially gives investors the opportunity to be a part of the project from its very early stages.[65]

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56 See IOSCO, above n 20 at 12.

57 See European Commission, above n 21 at 8.

58 See PricewaterhouseCoopers, above n 36 at 1.

59 Ibid.

60 See Bruton, Khavul, Siegel and Wright (2015), above n 9 at 12.

61 See Frezza, above n 39.

62 See PricewaterhouseCoopers, above n 36 at 11.

63 See Collins and Pierrakis, above n 45 at 8.

64 Ibid.

65 Ibid.

In relation to P2P lending, commercial banks are sometimes reluctant to lend money to SMEs, whereas the general public may be more willing to share the risk amongst many others through the P2P model to bridge this uncertainty.[66] The main advantage to the borrower is that there is no equity dilution for the start-up's or SME's shareholders.[67] For the investor, the return is fixed as it is agreed in advance that the investment is paid back by the monthly principal and interest payments throughout a specified period.[68]

According to KPMG Director Howhow Zhang, P2P platforms are fragmented – they are not in themselves high-margin businesses as the platforms must rely on volume.[69] Through boosting turnover, the platforms may then become scalable.[70]

Equity crowdfunding has the potential to be a complementary source of risk capital to the traditional providers in the market (such as business angels and venture capitalists) offering finance to many businesses currently struggling to source investment and get off the ground.[71] Other businesses that may benefit from equity crowdfunding include those which may not have the potential to deliver the exceptional returns of venture capitalists targets, though overall they may be less risky than the high-risk, high-return ventures targeted by venture capitalists, and yet still provide significant value to the economy.[72]

## *V CHALLENGES AND RISKS OF CROWDFUNDING*

### *5.1 Lack of Information*

By its very nature, investing in young businesses such as start-ups comes with it a high potential of losing one's entire investment.[73] When the investee company is at a young or premature stage, barely off the ground, there is limited information available to investors in order to assess the risks involved.[74]

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66 See European Commission, above n 21 at 7.

67 Ibid.

68 Ibid.

69 See Mak (10 December 2015).

70 Ibid.

71 See Collins and Pierrakis, above n 45 at 4 and 17.

72 Ibid at 4 and 18.

73 Ibid at 21; and Hong Kong SFC (7 May 2014), above n 20.

74 See Hong Kong SFC (7 May 2014), above n 20.

### *5.2 Access to Information*

Though investee companies and ventures need not comply with the strict reporting requirements applicable to listed companies, a degree of information must be provided in order to attract investment. Investors will need details as to the company's financial performance, business plan and other relevant information.[75] Investees may require investors to sign Non-Disclosure Agreements in order to protect their interests (including intellectual property rights), although this would demand increased administrative resources.[76]

The risks of equity investments in start-ups are there for all to see,[77] and yet the trendy façade of technology and start-ups mean many are distracted from the high failure rates. More complex is the matter of handling success – the experience of stock markets clearly demonstrates that success breeds a growing detachment from the modest investors who provided the seed money, with control rapidly moving in the direction of bigger investors and professional managers.[78]

Demands for accountability and transparency are much more manageable among a relatively small group of people, and as the number of players grows, less attention is given to the small investors.[79]

### *5.3 VALUATIONS*

Specifically in relation to equity crowdfunding, there are many limitations on the valuation of the business, in order to decide how much equity should be offered for the amount of capital being raised.[80] It may be difficult to value the goodwill of the company, and the only asset may be intellectual property rights. Valuations would largely be based on risky predictions of future market size, competition, revenue and other variables.[81]

### *5.4 Fraud*

There is an inherent risk of fraud when investing through crowdfunding. Due to the anonymity created by the online medium of crowdfunding platforms, further

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75 See Collins and Pierrakis, above n 45 at 28.

76 Ibid.

77 See Vines (4 November 2015).

78 Ibid.

79 Ibid.

80 See Collins and Pierrakis, above n 45 at 23.

81 Ibid.

obstacles to fraud detection are created.[82] Safeguards in place rely on "policing by laypersons" and other indirect methods, such as platform administrators' vetting of investees and the reliance on forum discussions and social media.[83] Relatively few platforms conduct background checks on lenders, with most only doing the minimum required to comply with anti-money laundering laws.[84]

### *5.5 Illiquidity*

There is also a risk of illiquidity and dilution of stock value. For the most part, there is no secondary market for most platforms – once an investor's money is locked into a contract or has been invested in share equity, there is little scope to sell out except at a significant discount to the face value.[85]

### *5.6 Inexperience of Investors*

Further, the relative inexperience of investors engaging in equity crowdfunding and P2P lending, coupled with the fragmented or lack of regulation mean that investors are left in a precarious position. While venture capitalists or business angels may have experience in management of risky ventures and industry-specific knowledge, the democratisation of investments come with real risks that investors may make bad investments – whether in fraudulent businesses or, more often, in business that though non-fraudulent, have little chance of success.[86]

Investors must do their own homework thoroughly, in order to fully understand their speculative risks, illiquidity, cancellation restrictions, difficulties of valuation, limited disclosure and information, fraud and lack of professional advice.[87] Most importantly, investors must remember they are not betting on assets, but on individuals or teams.[88]

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82 See Hong Kong SFC (7 May 2014), above n 20.

83 See Collins and Pierrakis, above n 45 at 24. Through social media, one can alert others to issues they come across when assessing the quality and validity of a given proposal, although this relies on the general public being proactive and being concerned about others' interests as well as their own.

84 See IOSCO, above n 20 at 26.

85 Ibid at 27.

86 See Collins and Pierrakis, above n 45 at 21.

87 See Sheng (19 February 2016).

88 Ibid.

## *VI FACTORS RELEVANT TO THE REGULATION OF CROWDFUNDING*

Regulators are faced with the pressure from disruptors and consumers to regulate fintech. At the same time, banking behemoths are protesting that the burdensome regulations introduced since the 2008 global financial crisis have made it hard for them to compete with the spritely new disruptors.[89] Banking corporations who are trying to dip their feet into the new technologies are investing a lot of time and resources for driving efficiencies down to their own bottom lines and at the same time, protest that start-ups have unfair advantages because their novel business models tiptoe around current regulatory regimes.[90]

Fintech is a new concept to many – and regulators do not yet have the core knowledge and skills to draft regulations, or have staff with the skills needed to draw up appropriate regulations.[91] This creates a real challenge, when everyone is simultaneously learning alongside each other and learning from others' mistakes. Regulators do not know how to gather the digital data arising from the digital revolution or how to ensure data security.[92] They are uncertain about how to regulate cross-jurisdictional transfers, and they do not know how to respond to calls from the traditional finance sector for a "level playing field" that would subject the disruptors to the same regulations that banks struggle with.[93]

The difficulty in regulating equity crowdfunding lies in crafting a set of regulations to manage and control an activity that resembles an IPO without imposing the same (in this case, prohibitive) regulatory costs of an IPO.[94]

The necessity of regulators engaging with the fintech sector is two-pronged: from the input side, facilitation from regulators can reduce barriers and facilitate entry of fintech start-ups, while ensuring that the business models remain in line with the broad objectives of the regulatory regime.[95] From the output side, by working closely with fintech companies, regulators can examine whether there are outdated rules inhibiting a wholesome development of the fintech sector.[96]

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89 See Dodwell, above n 6.

90 Ibid.

91 Ibid.

92 Ibid.

93 Ibid.

94 See Hong Kong FSDC, above n 19 at §38.

95 See Hong Kong FSTB (26 February 2016) §4.18.

96 Ibid.

## *VII UNITED KINGDOM*

While some economies have developed or are developing dedicated new regulatory regimes for P2P lending and equity crowdfunding (such as Australia, Malaysia and New Zealand), the UK adopts a mixed approach – there is a new regulatory framework for P2P lending, whereas equity crowdfunding is regulated under existing rules,[97] with regulatory monitoring and governance through codes of conduct.[98]

Recent changes to UK regulations from the Financial Conduct Authority ("UK FCA") have made it easier for investors to utilise crowdfunding platforms for investments, whilst opening up the pool of potential investors to companies.[99] Previously, only high net-worth individuals, sophisticated investors (those with investment knowledge and experience) or certified investors could purchase equity in an unlisted company.[100] From 1 April 2014 onwards (subject to transitional arrangements),[101] any person could invest in unlisted companies, but must keep each of their first 2 investments under 10% of that investor's net assets – money that does not affect their house, pension or life insurance.[102] Thereafter, the investor could choose to self-certify himself or herself as a sophisticated investor, and thereby invest without a limit.[103]

## *VIII CHINA*

Under the existing Securities Law, any public offer of securities requires approval from the China Securities Regulatory Commission or other relevant ministries of the State Council.[104] The Securities Association of China has proposed a set of Administrative Measures on Private Equity Crowdfunding Financing and is undergoing a consultation process.[105]

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97 Ibid at §4.12. In the US, there is a new regime for equity crowdfunding, whereas P2P lending is regulated under existing rules. Equity crowdfunding platforms fall under the UK Conduct of Business Sourcebook (UK COBS), which requires that platforms meet requirements for "suitability" and "appropriateness": see UK COBS 9 and 10.

98 See Hong Kong FSDC, above n 19 at §58.

99 See Dawson (29 April 2014).

100 Ibid.

101 UK FCA, Policy Statement (PS 14/4) (6 March 2014) at p 11-13.

102 See Dawson, above n 99.

103 See Dawson, above n 99.

104 See Hong Kong Legislative Council (18 March 2015) at p 7255.

105 Ibid at 7256.

Under the "Measures for the Administration of Private Equity Crowd Funding (for Trial Implementation) (Consultation Draft)" ("the China Measures") released by the Securities Association in December 2014, equity crowdfunding projects in China must have no more than 200 investors per project.[106] To qualify as an accredited investor, an individual must:

(1) invest at least RMB 1 million in a single project;

(2) have net assets of RMB 10 million; and

(3) have net financial assets of at least RMB 3 million or an average annual income of RMB 500,000 for the previous 3 years.[107]

Some have suggested that the wealth requirement criteria is too high, and therefore at odds with the nature of crowdfunding.[108] Based on whether the offering is open to the general public or not, equity crowdfunding may be categorised as private placements to qualified investors or a public offering to the general public.[109] The China Measures aim to be a set of self-regulatory rules, applicable only to the "private" equity crowdfunding industry in China.[110] Such entry and suitability criteria are considered necessary to help prevent and control market risks while promoting innovation and development of the industry.[111]

On 18 July 2015, the People's Bank of China (along with 9 government ministries) jointly issued guidelines laying out the roadmap for the regulatory work of responsible authorities.[112]

Since the Chinese stock market rout in the summer of 2015, the People's Bank of China has been trying to rein in the unregulated world of online P2P lending.[113] The authorities blame these companies for the highly leveraged bets that pushed stocks to stratospheric levels before the crash.[114] The unregulated nature of the

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106 See Reuters and Ng E (27 September 2015).

107 See Liu (22 April 2015).

108 See CSRC (26 December 2014) at Q2.

109 Ibid.

110 Ibid. At the same time, the China Securities Regulatory Commission is exploring policies for equity crowdfunding through public offering.

111 Ibid.

112 "Guidelines on the Promotion of the Healthy Development of Internet Finance"; see Zhou, Arner, and Buckley (2015).

113 See Mak, above n 69.

114 Ibid.

industry means that these entities operate in grey areas, falling through the cracks between banking, securities and insurance regulations.[115]

(a) wAs at the end of November 2015, around 30% of some 3,600 P2P platforms in China had either been shut down or had problems meetings their obligations.[116]

In December 2015, the China Banking Regulatory Commission issued draft regulations to rein in on Internet financing. Online P2P lending platforms are prohibited from selling wealth management products, insurance and trust products.[117] The Commission acknowledged that an absence of risk controls and supervision, together with a shortage of rules, had allowed some online firms to illegally raise funds and then flee when the risks were exposed.[118]

At around the same time, Chinese authorities were conducting investigations into P2P lender Ezubao. In around January 2016, the investigations revealed Ezubao was a massive Ponzi scheme. Over HK$59bn and 900,000 investors across the country were involved, making it the largest illegal fundraising case in China thus far.[119] Behind the façade of a P2P platform, offering investors annual returns between 9% and over 14% when the economy was sluggish, in fact the majority of the projects were bogus and the operators used funds from new investors to pay off old debts.[120]

The Ezubao case has proved a challenge for Chinese authorities, as investigators had to confront a network of at least 200 computer services, and a multitude of places and people linked to the scheme.[121] Following the scandal, the Chinese Ministry of Public Security launched an online platform to gather information from the public about the case.[122]

The Ezubao case has highlighted the risks of online channels of financing and the challenges involved in "policing" Internet crimes – especially when a lot of money is involved and a lot of people are potentially affected. Even in China,

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115 Ibid.

116 See Hong Kong FSTB, above n 95 at 44.

117 See Wu and Kwong (29 December 2015).

118 Ibid.

119 See Zhou (31 January 2016).

120 Ibid.

121 Ibid.

122 See Ren (14 February 2016).

where it is apparently more difficult to hide one's identity and remain anonymous online, the nature of taking things online means there is an added dimension in terms of risk. The majority of investors through online platforms are dealing with an unfamiliar world, where the rules of the game are completely different to their traditional counterparts. It is all the more difficult to track fund flows. The limitless reach of the Internet means masses of people can be affected in a very short period of time, spreading like a virus. The online platform set up as a means to gather information only highlights the headaches involved in investigating and collecting evidence related to cybercrimes – particularly so when the net is cast so wide.

Xiang Songzuo, an economist at Agricultural Bank of China, warned that China would be vulnerable to severe and frequent financial crises as long as the desire persisted to make quick money from Internet investment instead of focusing on development advanced technology.[123]

Chinese authorities are anticipating more scandals and defaults in the middle of 2016 involving "runaway online private lending".[124] Tightened regulations mean business will become increasingly tough for P2P players.[125] However, this is a necessary evil. The years of unregulated rampant development and lack of regulatory oversight – despite there already having been progress in 2015 and early 2016 – has resulted in illegal fundraising sprees and loan sharking schemes, gradually revealing themselves.[126]

## *IX CURRENT REGULATORY FRAMEWORK IN HONG KONG*

Hong Kong has no specific regulation or any guidelines specifically in relation to crowdfunding.

As at the end of 2015, the most definitive authority from Hong Kong regulators was a "Notice on Potential Regulations Applicable to, and Risks of, Crowdfunding Activities" published by the Hong Kong Securities and Futures Commission ("SFC") in May 2014. Between February and March 2016, recommendations were put forward to the Hong Kong government,[127] although it will take some time before the next step is reached.

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123 See Wu (7 January 2016).

124 See Ren, above n 122.

125 See Gan and Ren (13 March 2016).

126 See Ren, above n 122.

127 See Hong Kong FSTB, above n 95 and Hong Kong FSDC, above n 19.

Under the current Hong Kong regulatory framework, equity crowdfunding and P2P lending may be subject to various restrictions, depending on the structure and features of the particular model.[128]

### *9.1 Offers of Investment*

Where the crowdfunding activity involves offers to the public to purchase securities (eg shares, debt instruments or interests in collective investment schemes), under the current regulatory framework, restrictions apply.[129]

#### *9.1.1 Offers of Investment under the C(WUMP)O*

The offer of shares in or debentures of a company to the public are subject to prospectus registration requirements under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32) ("C(WUMP)O") unless an exemption applies. It is an offence under the C(WUMP)O for the company and every person who is knowingly a party to the issue to issue a prospectus which does not comply with the relevant disclosure and registration requirements.[130]

The relevant exemptions are as follows:[131]

(1) Offers to not more than 50 persons[132]

(a) This limitation is on the number of offers made, rather than accepted. The exemption would therefore only be applicable if access to a crowdfunding platform could be restricted to 50 persons.[133]

(b) An offer would be taken together with any other offer of the same class of shares or debentures which was made by the same person in reliance on the same exemption made in the preceding 12 months, preventing offers from being staggered to make offers to a larger number of investors.[134]

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128 See Hong Kong SFC (7 May 2014), above n 20.

129 Ibid.

130 In the case of an issue by a company incorporated in Hong Kong, sections 38, 38B and 38D C(WUMP)O apply. In the case of an issue by a company incorporated outside Hong Kong, sections 342 and 342C C(WUMP)O apply. See Hong Kong SFC (7 May 2014), above n 20.

131 See Charltons Law (June 2015). Most of the exemptions set out in the 17th Schedule to the C(WUMP)O require access to information to be restricted, which may pose difficulties in practice for online crowdfunding platforms.

132 Section 2, Part 1 of 17th Schedule to C(WUMP)O.

133 See Charltons Law, above n 131.

134 Section 3, Part 4 of 17th Schedule to C(WUMP)O; and Charltons Law, above n 131.

(2) Offers to "professional investors" as defined in the Securities and Futures Ordinance (Cap 571) ("SFO")[135]

(a) There are 10 types of investors defined as "professional investors" under the SFO,[136] falling under 2 main categories, namely: (i) institutional investors (such as regulated banks, investment intermediaries, funds, insurers, pension schemes); and (ii) "high net worth investors" as defined under section 3 of the Securities and Futures (Professional Investor) Rules (Cap 571D) ("SF(PI)R")[137].

(3) Offers for which the total consideration payable for the shares/debentures is under HK$5 million (or its equivalent in another currency)[138]

(a) This limitation is on the number of offers made, rather than accepted. Where information is available online, the number of offers made is potentially unlimited, making it difficult for platforms to rely on this exemption.[139]

(b) An offer would be taken together with any other offer of the same class of shares or debentures which was made by the same person in reliance on the same exemption made in the preceding 12 months.[140]

(4) Offers where the minimum consideration payable for the shares or the minimum principal amount to be subscribed for the debentures is at least HK$500,000[141]

(a) This exemption requires a minimum investment of HK$500,000.

(b) An "offer" for the purposes of the above exemptions includes an offer of any right, option or interest in or in relation to the shares or

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135 Section 1, Part 1 of 17th Schedule to C(WUMP)O.

136 Section 1, Part 1 of 1st Schedule to SFO.

137 See paragraph (j) of the definition of "professional investor" under Section 1, Part 1 of 1st Schedule to SFO. This includes: (i) any trust corporation having been entrusted with the trust of which it acts as a trustee with total assets of at least HK$40 million (or its equivalent in any foreign currency); (ii) any individual having a portfolio of at least HK$8 million (or its equivalent in any foreign currency); and (iii) any corporation or partnership having a portfolio of at least HK$8 million or total assets of at least HK$40 million. See section 3 SF(PI)R.

138 Section 3, Part 1 of 17th Schedule to C(WUMP)O.

139 See Charltons Law, above n 131.

140 Section 3, Part 4 of 17th Schedule to C(WUMP)O; and Charltons Law, above n 131.

141 Section 4, Part 1 of 17th Schedule to C(WUMP)O.

debentures the subject of the offer, but does not include any offers to persons who are outside of Hong Kong.[142]

### *9.1.2 Offers of Investment under the SFO*

It is an offence under section 103(1) of the SFO for any person to issue unauthorised invitations to the public, unless the issue has been authorised by the SFC or an exemption applies. This includes issuing any advertisement, invitation or document which to the person's knowledge is or contains an invitation to the public to acquire securities[143] or participate in a collective investment scheme.[144]

The issue of an advertisement, invitation or document which consists of or contains information likely to lead (directly or indirectly) to the acquiring of securities or participation in a collective investment scheme would constitute an offence unless the issue is authorised by the SFC or an exemption applies.[145]

Likewise, the issue of an advertisement, invitation or document which is or contains an invitation directed at (or the contents of which are likely to be accessed or read by) the public would constitute an offence unless the issue is authorised by the SFC or an exemption applies.[146]

Under the current framework, information inviting investment in equity or debt securities online may be regarded as an "invitation to the public" requiring SFC authorisation unless an exemption applies.[147]

Some of the relevant exemptions are as follows:[148]

(1) Offers exempt under the 17th Schedule to the C(WUMP)O[149]

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142 Section 1, Part 4 of 17th Schedule to C(WUMP)O. This can be contrasted with the exemption in section 103(3)(j) SFO, which would only apply if the advertisement, invitation or document is or is intended to be disposed of **only** to persons outside Hong Kong.

143 Section 103(1)(a) SFO.

144 Section 103(1)(b) SFO; and See Hong Kong SFC, above n 20. A collective investment scheme **("CIS")** must be authorised by the SFC under section 104 SFO before it is marketed to the public, to ensure members of the investing public are properly and accurately informed about the key features of a securities product or an interest in a CIS when deciding to invest. In May 2013, Cheung Kong (Holdings) Limited entered into an agreement with the SFC to unwind the sale of hotel room units at its hotel development project, The Apex Horizon. The SFC was otherwise going to take legal action as it found that the offer to purchase hotel room units at The Apex Horizon appeared to be an invitation to acquire an interest in or participate in a CIS. See: Hong Kong SFC (13 May 2013).

145 Section 103(10)(a) SFO.

146 Section 103(10)(b) SFO.

147 See Charltons Law, above n 131.

148 Ibid.

(a) If the advertisement, invitation or document relates to an offer that comes under the exemptions specified in Part 1 of the 17th Schedule to the C(WUMP)O, then the issue of the same would be exempt from the section 103(1) SFO prohibition.

(2) Offers only to professional investors[150]

(a) The issue of any advertisement, invitation or document in respect of securities or structured products, or interests in any CIS that are intended to be disposed of only to professional investors would be exempt from the section 103(1) SFO prohibition.

(b) However, reliance on this exemption raises the same issues as the "professional investor" exemption under the C(WUMP)O.[151]

(3) Offers not to the public

(a) Although not strictly speaking an exemption, as the section 103(1) SFO prohibition is of invitation "to the public", an offer may not contravene this provision if it is structured not to be a public offer.[152] However, there is no bright line test as to how many offerees would constitute the public, and reliance on this "exemption" would require access to information to be restricted to a specific pool of offerees.[153]

### *9.2 Prohibition on Carrying on a "Regulated Activity" under the SFO without being Licensed/Registered to do so by the SFC*

Depending on the nature and model of the platform, a licence may be required to carry on one or more of the following types of regulated activities:[154]

(1) Type 1: dealing in securities[155]

(2) Type 4: advising on securities

(3) Type 6: advising on corporate finance

(4) Type 7: providing automated trading services; and

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149 Section 103(2)(ga) SFO

150 Section 103(3)(k) SFO

151 See Charltons Law, above n 131.

152 Ibid.

153 Ibid.

154 See Hong Kong SFC, above n 20.

155 "Securities" is defined in Schedule 1 of the SFO.

(5) Type 9: asset management.

### *9.3 Regulatory Requirements Applicable to Automated Trading Services and/or Recognised Exchange Companies*

Depending on the nature of services provided and type of products offered, under the current framework, platform operators may need to comply with the requirements under Part III of the SFO relating to automated trading services and recognised exchange companies.[156]

### *9.4 Prohibition on Carrying on a Money Lending Business*

P2P lending may constitute the carrying on of a money lending business requiring a moneylender licence under section 7 of the Money Lenders Ordinance (Cap 163).

## *X THE HONG KONG CONTEXT*

Hong Kong regulators seem to deal with the world of crowdfunding with lethargy; there seems to be no sense of urgency. It is difficult to understand what seems like a foreign creature, let alone to attempt to regulate and control it.

Each country faces the same problem of how to adapt its legislation to enable the growth of crowdfunding whilst ensuring protection of the general public.[157] A clear regulatory framework is essential for the market to unlock its potential.[158] It is unsatisfactory for the market to operate as it currently does, amongst overlapping grey areas.

Various market indicators influence the growth of crowdfunding in a particular country, such as crowdfunding awareness, the start-up ecosystem in that country, familiarity with e-commerce, tax incentives and governmental support, and supply of capital.[159]

### *10.1 The Position and Potential of Hong Kong*

While government agencies and bodies promote Hong Kong as an international finance centre, much of the focus in the past has been on Hong Kong's role in financing large corporations at the IPO stage.[160] However, this focus has shut out SMEs which are not in the same league. Even the Growth Enterprise Market

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156 See Hong Kong SFC, above n 20.

157 See European Commission, above n 21 at 57.

158 Ibid.

159 Ibid at 59.

160 See Hong Kong FSDC, above n 19 at §16.

(GEM) Board, which aims to promote innovative businesses, requires 2 years of business activity with a cash flow of at least HK$20 million in aggregate for the 2 years preceding listing, and a market capitalisation of at least HK$100 million at the time of listing.[161]

In the latest World Economic Forum Global Competitiveness Report released in September 2015, Hong Kong was ranked the 7th most competitive economy in the world (out of 140 economies studied).[162] However, innovation was singled out as one of Hong Kong's weakest areas, ranking only 27th in the world.[163] A study conducted by San Francisco based cloud analytics firm Compass found Hong Kong to be the 5th fastest growing ecosystem of start-ups in the world, out of a list of 40 ecosystems.[164]

In 2013, InvestHK[165] launched a large promotion campaign "StartmeupHK" to promote the city's advantages as a leading global hub for start-ups.[166] This is in line with the Hong Kong government's aim to move in the general direction of shifting the city's economy up the value chain and enabling local industries to diversify.[167] Since 2010, InvestHK has assisted 33 overseas fintech businesses in establishing themselves in Hong Kong.[168]

The Compass study noted that Hong Kong had significantly lower access to venture capital than cities like Singapore – attributable to local investors' lack of experience in dealing with the technology industry and a preference towards "traditional" investment areas such as manufacturing and trading.[169]

Given the city's position in relation to China, where the P2P lending market is predicted to reach US$7.8 billion in 2015, experts believe Hong Kong has all the conditions in place to sprint ahead in the race.[170] Technologically savvy, rich,

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161 Ibid.

162 See World Economic Forum (30 September 2015) at p xv.

163 See Cheung (7 November 2015) and World Economic Forum (30 September 2015) at p 14.

164 See Soo (5 August 2015). Note however that due to financial and time constraints, China, Japan and South Korea were excluded from the study.

165 A governmental body focusing on promoting foreign direct investment in Hong Kong. See InvestHK (2015).

166 See John C Tsang, Hong Kong 2015-2016 Budget Speech at §41.

167 Ibid at §48.

168 See Woodhouse (6 January 2016).

169 See Soo, above n 164.

170 See Yeung, above n 10.

minimally taxed, and with strong links to the world's second largest economy without the restrictions and risks of doing business in China proper, Hong Kong seems ideally suited to being a major regional innovation hub.[171]

Hong Kong enjoys the advantages of both "one country" and "two systems" in developing the innovation and technology industry – in addition to attracting top research and development institutions from around the world, including Karolinska Institutet of Sweden and Massachusetts Institute of Technology ("MIT"),[172] Hong Kong is positioned to foster cooperative opportunities with China at both national and local levels.[173]

Developments in technology have brought economic globalisation into a new phase.[174] The Hong Kong government recognises the need to lay a solid foundation for long-term development, adding value to traditional industries and developing diversified new industries.[175]

In early 2015, the Secretary for Financial Services and the Treasury was tasked to set up a Steering Group ("the Steering Group") to study how to develop Hong Kong into a fintech hub together with industries, research and development institutions and regulatory authorities.[176] The Steering Group was established in April 2015.

In his 2015-2016 Budget Speech, Financial Secretary John Tsang was bullish about the financial efforts of the government in encouraging the start-up ecosystem in Hong Kong. The Hong Kong Science and Technology Parks Corporation ("HKSTPC") will earmark HK$50 million to set up a corporate venture fund for co-investment, on a matching basis with private funds, in start-ups which are located in the Science Park[177] or have participated in its incubation programmes.[178]

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171 See Griffiths (20 April 2015). See also, Tsang, Hong Kong 2015-2016 Budget Speech, above n 166 at §35.

172 See Hong Kong FSTB, above n 95 at §3.26.Karolinska Institute of Sweden will establish its first overseas research facility at the Hong Kong Science Park in 2016. The MIT Hong Kong Innovation Node will be launched in July 2016.

173 See Hong Kong 2016 Policy Address §§69-70.

174 See Tsang, Hong Kong 2015-2016 Budget Speech, above n 166 at §31.

175 Ibid at §33.

176 Ibid at §47. The Steering Group would study views on crowdfunding and ways to formulate relevant policies. See: Hong Kong Legislative Council, above n 104 at p 7256-7257.

177 The Hong Kong Science and Technology Parks Corporation was set up in 2001 and the 22-hectare Hong Kong Science Park in Shatin provides laboratories and shared facilities to help technology companies design and develop new products. See Cheung, above n 163.

178 See Tsang, Hong Kong 2015-2016 Budget Speech, above n 166 at §43.

The Hong Kong Mortgage Corporation Limited (HKMC) would be "asked" to expand and enhance the Microfinance Scheme.[179] There is a HK$5 billion proposed injection to the Innovation and Technology Fund ("ITF").[180]

The 2015-2016 Budget Speech suggests the Hong Kong government wishes to take some steps to promote innovation and technology in Hong Kong – though the focus has been on money (in the form of proposed funding, which must still pass approval procedures), with little to no mention of regulation, guidelines, policies, and measures to ensure compliance of the same.

In the 2016 Policy Address, the following was announced:

(1) a new HK$2bn Innovation and Technology Venture Fund ("IT Venture Fund") to encourage investment from venture capital funds in local innovation and technology start-ups, where the Government will co-invest with private venture capital funds on a matching basis;[181]

(2) HK$2bn to encourage University Grants Committee-funded institutions to carry out more mid-stream applies research projects, with investment income generated deployed to fund research undertaken by the institutions;[182]

(3) a HK$500m Innovation and Technology Fund for Better Living to provide financing for projects using technology to improve the daily lives of citizens, from transportation to healthcare and education;[183] and

(4) HK$200m for the Cyberport Macro Fund for investment in information and communications technology start-ups at Cyberport.[184]

Further, in the 2016-2017 Budget Speech, Financial Secretary John Tsang stated:

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179 Ibid.

180 Ibid. In 1999, the government made one if its first moves to boost innovation and technology by spending HK$5 billion to set up the Innovation and Technology Fund. By the end of January 2015, more than 4,000 projects with a total funding of HK$9 billion were approved, of which 2,466 are R&D projects. See Cheung, above n 163.

181 See Hong Kong 2016 Policy Address, above n 173 at §83. See also, Woodhouse *"Hong Kong chief executive announces HK$2 billion fund to boost investment in innovation and technology"* (13 January 2016).

182 See Hong Kong 2016 Policy Address, above n 173 at §75.

183 See Woodhouse, above n 181.

184 See Hong Kong 2016 Policy Address, above n 173 at §82.

(1) A Pilot Technology Voucher Programme would be launched under the Innovation and Technology Fund (defined above, "ITF") to subsidise SMEs' use of technological services and solutions to improve productivity and upgrade or transform business processes. The 3-year pilot programme will provide, on a matching basis, a maximum subsidy of HK$200,000.00 for each eligible SME. The estimated expenditure of this programme is HK$500m;[185]

(2) HK$200m would be allocated to install traffic detectors along some strategic routes to provide the public with more real-time traffic information and enhance transport efficiency;[186]

(3) HK$500m has been earmarked to further increase the number of WiFi.HK hotspots to over 30,000;[187]

(4) The Hong Kong Monetary Authority, SFC and the Office of the Commissioner of Insurance will set up fintech dedicated platforms to liaise with the industry to ensure that the market will balance between market demand and investors' understanding and tolerance of risk when introducing innovative financial products and services;[188]

(5) The Hong Kong Science and Technology Parks Corporation (defined above as "HKSTPC") will expand in stages to provide additional floor area of 70,000 square metres for start-ups and technology companies by 2020, with the project estimate amounting to HK$4.4bn to be borne jointly by the Government and HKSTPC.

The rather aggressive allocation of government funds to innovation and technology is intended to drive economic growth, against a backdrop of economic downturn. The fundamental value of research is in creating new knowledge and nourishing talent.[189]

The Government indicates it will step up effort to promote STEM (Science, Technology, Engineering and Mathematics) education and encourage students to

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185 See Tsang, Hong Kong 2016-2017 Budget Speech, above n 7 at §25.

186 Ibid at §52.

187 Ibid at §54.

188 Ibid at §61. On 1 March 2016, the SFC established a "Fintech Contact Point" as a dedicated channel to encourage businesses involved in the development and application of fintech in Hong Kong to engage with the SFC. See: Hong Kong SFC (1 March 2016).

189 See Hor (27 January 2016).

pursue the study of such subjects.[190] However, local businesses need an energetic, forward-thinking workforce, willing to break the social norms in Hong Kong where youngsters are encouraged to pursue "traditional" careers such as becoming a doctor, lawyer or accountant. There are no specific policies on providing the "software" or "flesh" needed to support tech businesses, such as human talent.[191]

Effective innovation has to be embedded in the education system, and it requires learning outside as well as inside the classroom.[192] Students at all ends of the spectrum need to be encouraged to challenge conventional concepts, alongside an inherent deep quest for knowledge.[193] According to a report by US think tank Information Technology and Innovation Foundation (ITIF), human capital is vital to nurturing the next wave of innovators and entrepreneurs.[194] It estimated average spending on education for each primary and secondary student in Hong Kong totalled US$10,813, being the 12th highest in the ITIF study.[195]

While the latest policies aim at fostering development, the government has been criticised for not providing support for companies further down the line – which is necessary for their survival.[196] Michael Gazeley, founder of Hong Kong cybersecurity firm Network Box, observed that the government policies do not reflect any thought in the next step, or any thought in how to utilise the technology that gets developed.[197] A comprehensive synergised approach from all angles is crucial – including from the regulatory front. Skills from academia, business associations and civil societies must also be harnessed.[198]

Fintech start-ups have seen growing government support in Hong Kong, but critics say this has not transferred into favourable regulations for the sector as have been implemented overseas.[199] It is crucial for innovation to materialise within a properly regulated legal framework, in order to facilitate the long-term feasibility

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190 See Hong Kong 2016 Policy Address, above n 173 at §89.

191 See Woodhouse, above n 181.

192 See Hor, above n 189.

193 Ibid.

194 See Perez (26 January 2016).

195 Ibid.

196 See Woodhouse, *"Think long term: Hong Kong cybersecurity firm boss says support too focused on start-ups"* (13 January 2016).

197 See Woodhouse (24 February 2016).

198 See Sheng, above n 87.

199 See Woodhouse (18 March 2016).

and practicalities of novel ideas and models. At present, the situation in Hong Kong is ambiguous at best.[200]

In light of such ambiguities, companies are having to be increasingly creative to work around what they apparently can and cannot do under the present regulatory framework. In March 2016, a P2P lending company MoneySQ.com partnered with an asset management firm Bridgeway Prime Shop Fund Management Limited to create what is claimed to be Hong Kong's online lending service designed for professional investors.[201] In order to avoid regulatory issues, MoneySQ.com will work with Bridgeway which holds a Type 9 SFC licence (asset management) that allows it to operate a collective investment scheme and accept funding from professional investors.[202]

Policymakers pay a lot of lip service to the need to help nurture SMEs, but the record is uneven – throwing money at the problem is not the answer.[203] There is a real shortage of skills, both in the marketplace and even more so at the official and bureaucratic levels.[204]

### *10.2 Hurdles and Bureaucracy*

There appears to be a mismatch or void between the outward displays and aims of the Hong Kong government and reality, attributable predominantly to the inherent bureaucracy of Hong Kong.

Further hurdles standing in the way of governmental support include the divisive, alienated camps in the legislature and Hong Kong's notoriously tedious bureaucracy. Some describe the government support as lacklustre or misallocated.[205] Coupled with the risk-averse business culture and a conservative investment community,[206] all such factors cumulatively decelerate innovation and development in Hong Kong.[207]

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200 See Hong Kong Legislative Council, above n 104 at 7262. The Secretary for Financial Services and the Treasury said that if financing platforms are to fundraise in Hong Kong, they "may be subject to the existing legislation" of Hong Kong, but that the parties concerned should themselves gain an understanding of the laws of Hong Kong.

201 See Woodhouse (8 March 2016).

202 Ibid.

203 See Sheng, above n 87.

204 Ibid.

205 See Griffiths, above n 171.

206 Ibid.

207 See Yeung, above n 10.

Generally speaking, the local bureaucracy is very slow to embrace innovations and the prospects for delay are endless.[208] A recent report on fintech in Britain by accounting firm EY found that Hong Kong regulators were viewed as complex, conservative and in some cases opaque.[209]

Technology in Hong Kong moves at a fast pace, but the bureaucracy does not.[210] It has been argued that to add fuel to fire, the vested interests in Hong Kong – including accountants and lawyers who rely on a steady income stream from existing archaic processes – are mostly to blame for the current state of affairs.[211]

According to a report in early 2016 produced by the University of Hong Kong and InnoFoco for research firm Compass,[212] it is important for the government to take a progressive and proactive role in reviewing and updating the regulatory framework in sectors such as financial services to ensure that the regulations are keeping in pace with technological changes.[213]

### *10.2.1 The Innovation and Technology Bureau*

After strong opposition and more than 3 years' filibustering from pan-democrats, on 6 November 2015, the Hong Kong Legislative Council voted in favour of the government's request for funding for the long-awaited Innovation and Technology Bureau ("IT Bureau").[214] Whilst Hong Kong invests less than 1% of its GDP in research and development (specifically, around HK$9.9bn or 0.4% in innovation and technology)[215] – far behind Singapore, Taiwan and South Korea[216] – CY Leung acknowledged that innovation and technology are making huge strides every day and Hong Kong should not lag behind competitors.[217]

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208 See Vines, above n 77.

209 See Woodhouse (10 March 2016).

210 See Balakrishnan (1 March 2016).

211 Ibid.

212 See Wong, Kwok and Chan (29 January 2016).

213 See Woodhouse (29 January 2016).

214 See Lau (6 November 2015). 26 lawmakers voted in favour of the government's request for HK$36.5 million to cover annual staff costs, with 8 voting against and 1 abstaining. On the funding request for HK$25 million to start up the bureau, 29 lawmakers voted in favour, 9 opposed, and 1 abstained. The IT Bureau was set up on 20 November 2015.

215 See Tsang (18 December 2015).

216 Investment in research and development only accounts for about 0.7% of Hong Kong's GDP. This is far behind South Korea (3.6%), Singapore (2.6%), Taiwan (2.3%) and the Mainland (2%). See Cheung, above n 163.

217 See Lau, above n 214.

Innovations are harnessed by public bodies to deliver benefits for society.[218] Healthcare, housing, transport, environment and energy, recreation and municipal services and an aging population top the list in terms of major challenges facing Hong Kong.[219] In light of that, is it clear to see why innovation is high on the academic and public agenda.[220]

The perseverance and determination of the government in bringing the IT Bureau into fruition – despite equally persistent resistance – show that CY Leung's government acknowledges the dire need for Hong Kong to maintain a competitive edge. With the rise of Singapore and Shanghai as major financial centres, Hong Kong cannot afford to stand still with self-satisfaction as the international finance centre of Asia Pacific. Whilst Hong Kong stakeholders may take comfort in the fact that the government is conscious of the need to foster creativity and open new markets,[221] at the same time, there is no room for complacency from the government. Hong Kong would need to sharpen its edge to reposition itself from being solely a global financial, trading and logistics centre[222] to one of the world's fintech hubs.[223] In that sense – the difference between "international finance centre" and "international financial technology centre" is greater than meets the eye.

The government's relative expeditiousness in relation to the IT Bureau may be an isolated event, as the Bureau is openly known as the brainchild of CY Leung.[224] It is the first major government administrative reform initiative in years.[225] Yet there is no certainty as to whether we will see concrete results from the Bureau. While the Bureau will be responsible for "developing policies" and strengthening "linkages" among the government, industry and academia,[226] there is no express reference to regulatory development. At the same time, the Bureau lays the foundations for other interrelated development in the wider realm of new technologies. Stanley Ng Wing-fai, chairman of Professional Commons, a pro-

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218 See Hor, above n 189.

219 Ibid.

220 Ibid.

221 See Lau, above n 214.

222 See Tsang, Hong Kong 2015-2016 Budget Speech, above n 166 at §32.

223 See Yeung, above n 10.

224 See Lau, above n 214.

225 See Wong (15 December 2015).

226 See Cheung, above n 163.

democracy lobby group, urged the Bureau to review and improve outdated laws to complement the development of innovation and technology.[227]

Legislative councillor for the Information Technology sector Charles Mok has urged officials at the IT Bureau to come up with a blueprint within three to six months, outlining its consultation with the industry and its work priorities.[228] To make an impact on future economic growth, the IT Bureau will have to produce a policy strategy anchored in a deep understanding of how business opportunities are created.[229]

To succeed, the IT Bureau will need to focus its attention not only on a narrow set of scientific and technological issues, but also on lowering the barriers to market entry for new, innovative businesses and increasing the supply of new talent and skills in the workforce.[230]

## *XI LATEST DEVELOPMENTS IN HONG KONG*

The March 2015 Legislative Council debate on the regulation of crowdfunding proved unproductive at best:[231]

(1) Legislative councillor Starry Lee suggested that the Hong Kong government should formulate policies and supporting measures to encourage entrepreneurship, including actively gaining an understanding of whether existing rules and regulations are conducive to crowdfunding.[232]

(2) Fellow member Andrew Leung suggested that it may take a few years before the Steering Group can study an issue such as crowdfunding and then come to a conclusion, and asked whether the process could be expedited.[233]

(3) The Secretary for Financial Services the Treasury, the Hon. Professor K.C. Chan, was unable to point to any expediting measures, simply stating that the authorities need time for the public and society to "discuss the matter" through public consultation before taking the next step.[234] To date, there has not been any Consultation Paper on the topic.

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227 See Lau (10 November 2015).

228 Ibid.

229 See Wong, above n 225.

230 Ibid.

231 See Hong Kong Legislative Council, above n 104.

232 Ibid at p 7256.

233 Ibid at p 7257-7258.

234 Ibid at p 7259.

(4) Legislative councillor for the Information Technology sector Charles Mok reinforced the importance of certainty for the market, with greater transparency as to the policy direction and the time for implementation by the government.[235]

(5) When pressed for a consultation timetable, the Secretary for Financial Services and the Treasury suggested that Hong Kong would not have to wait "too long", and the Steering Group would come up with directional advice "after completing its work", though the future consultation will "take some time".[236]

The Hong Kong government has avoided amending the existing regulatory framework, on the basis that the existing legislation is adequate to handle the challenges from the growing fintech sector in Hong Kong, including crowdfunding and P2P.[237] What has not been mentioned is the headache of a process – and years and years of bureaucracy – involved in amending existing legislation, which in itself, would be enough of a deterrent.

On 26 February 2016, the Steering Group on Fintech produced a report with suggestions on how to develop the fintech sector in Hong Kong and concluding with various recommendations for the Hong Kong government.[238]

Unfortunately, the Steering Group's focus was on how the fintech sector could "understand regulators' expectations and approach",[239] rather than on how regulators could mould the regulatory landscape to keep up to pace with, better fit and promote the fintech industry.

The overall mind set of the Steering Group was still at the stage of engaging with the industry and the only recommendation for the government under the "regulations" bracket was to develop dedicated channels to communicate with the industry.[240] At the same time, the Steering Group stated that the government and regulators need to keep an "open mind" when examining whether existing rules should be amended or new rules introduced,[241] and acknowledged there are views

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235 Ibid at p 7260.

236 Ibid at p 7261.

237 See Woodhouse (26 February 2016).

238 See Hong Kong FSTB, above n 95.

239 Ibid at p 8-11, and §4.27.

240 Ibid at p11 and§§4.27, 6.18 to 6.22.

241 Ibid at §5.16.

(though supposedly misperceptions only) that the Hong Kong regulatory framework is posing hurdles for genuine financial innovation.[242] According to the Secretary for Financial Services and the Treasury, the current regulatory regime is not stopping any fintech development in the city.[243]

According to the Steering Group, though the government and regulators have a critical role to play in setting the rules for the fintech sector,[244] current laws were appropriate to regulate new technologies, and it was not anticipated that the regulatory regime would need to be changed "so much".[245]

Such views do raise cause for concern given that present regulations and legislation were drafted in the context of and specifically for products, services and matters that though on the face of it are related to fintech, are in fact very different altogether. For example, though they may boil down to finance and financial services – that only makes up half of the equation. The revolutionary, innovative nature of fintech and the fact that technology is involved – and technology that is 10 steps ahead, at that – mean the present regulatory framework under the SFO and C(WUMP)O is not satisfactory to control or manage this distant relative. The technology aspect makes up at least half of "fintech", and is and will always be fluid, dynamic and ever changing.

On 18 March 2016, the Hong Kong Financial Services Development Council ("FSDC") published a report specifically on regulation of equity crowdfunding in Hong Kong.[246] According to the FSDC report, the potential approaches to regulating equity crowdfunding range from full legislative action to maintaining the present status quo, with the ideal being a middle ground between the two.[247]

On one end of the extreme, legislative amendment would focus on the SFO and the C(WUMP)O, creating high legal certainty and allowing a custom-designed regulatory framework.[248] However, this would be the most time consuming

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242 Ibid at §5.32.

243 See Woodhouse, above n 237.

244 See Hong Kong FSTB, above n 95 at §2.11.

245 See Woodhouse, above n 237.

246 See Hong Kong FSDC, above n 19. The FSDC was established by the Hong Kong government in January 2013 in response to the financial services industry's call for a high-level government advisory body to support the sustained development of the industry.

247 Ibid at §§7, 12, 86.

248 Ibid at §§88-90. Further to the current exemptions to the prospectus requirements in the 3rd Schedule of the C(WUMP)O, a dedicated exemption could be created expressly to address crowdfunding by amending s 38B C(WUMP)O. A dedicated section of SFO could then be inserted to define the regulated activity of crowdfunding, which would resemble Title III of the

approach, as previous experience has shown with legislative initiatives in Hong Kong.[249] If crowdfunding in Hong Kong were to remain confined to the current exemptions in the present regulatory framework, its full economic benefits would be stifled.[250]

The middle ground would be in the form of regulatory initiatives or administrative regulations on the basis of the existing legal framework through:[251]

(1) conditional exemptions from the prospectus regime applicable to public offerings;

(2) licensing levers on the crowdfunding platforms; and

(3) limits on risk exposure by reference to how much an investor can invest, whether as a percentage of annual income and/or in terms of an absolute amount per issue.

According to the FSDC report, this middle ground would involve the SFC interpreting crowdfunding within an existing regulated activity, and issuing a conditioned exemption from the prospectus requirement.[252] Key components of this option are all at the level of SFC action, providing a new regulatory structure without legislative action – the SFC could issue a class exemption and its interpretation of crowdfunding as a regulated activity in a single consultation document with draft texts:[253]

(1) Crowdfunding could be considered to fall under automated trading services (Type 7), dealing in securities (Type 1) or advising on corporate finance (Type 6);

(2) The SFC could condition licensing a crowdfunding platform on some type of investor protection, such as that the platform receives declarations from each investor that he/she will not invest more than a specified amount or a specified percentage of annual personal income in the relevant equity

US JOBS Act, by regulating the platform, the disclosure of the offering and the exposure of an investor.

249 Ibid at §90.

250 Ibid at §93.

251 Ibid at §§7, 12.

252 Ibid at §97.

253 Ibid at §§97-116.

offering, including any crowdfunding investments made in the preceding 12 months;[254]

(3) A condition for exempting crowdfunding from the prospectus obligation could be that the issuer provides investors with disclosure equivalent to that required at the annual general meetings of public companies under existing Hong Kong company law.[255]

## *XII WHAT HONG KONG NEEDS*

It has been said that the regulatory regime in Hong Kong was established for a previous age, and covers hundreds and thousands of specific industries.[256] The development of new technology for economic growth requires a liberal regulatory regime to create platforms that can be accessed by all with ease and without barriers.[257]

In order to take advantage of the potential of crowdfunding, appropriate regulation is necessary and would be highly complementary to the aims of existing projects in Hong Kong, such as Cyberport and the Hong Kong Science and Technology Park.[258] With the government aggressively pumping billions of dollars into the fintech industry, exponential growth is expected and can be foreseen. Indeed, the billions of dollars would be wasted if the growth does not materialise. A definitive regulatory landscape is required to provide guidance or direction, as well as to ensure smooth development.

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254 See also, Ibid at §101: in light of the evolutions of crowdfunding rules globally, it appears 2 requirements should be added through supplementation or amendment of SFC guidelines: (i) the platform should be held to receive a declaration from each investor in connection with each crowdfunding investment that he/she understands the risks of the offering, has read the materials published by the issuer, and will not invest more than a certain amount; and (ii) the platform should be held to provide materials, and if possible, workshops on investor and financial education.

255 Under s 38A (2) C (WUMP) O, the SFC has the power to exempt any class of companies or any class of prospectuses issued by companies from the prospectus requirements. If an exemption formulated by the SFC under s 38A (2) C (WUMP) O is met, the offering would also be covered by the exemption provided in s 103 (3) SFO. One of the current exemptions is for companies listed on the Growth Enterprise Market (GEM) Board, who are exempted from reporting a multi-year economic track record and from producing a number of otherwise required reports. See: s 5 Companies (Exemption of Companies and Prospectuses from Compliance with Provisions) Notice (Cap 32L).

256 See Wong, above n 225.

257 Ibid.

258 See Hong Kong FSDC, above n 19 at §82.

## *XIII ASIA LAGGING BEHIND IN REFORM*

In a recent report published by a US think tank, Hong Kong was ranked 29th – behind Singapore, Japan, Taiwan and Korea – in the international study of how domestic policies can impact global innovation.[259] Hong Kong was in a category of economies called "Advanced Asian Tigers", which were committed to high levels of research and development investment, robust education systems and competitive tax environments.[260]

However, Mukesh Bubna, founder of P2P lender Monexo said dedicated regulations were being developed too slowly in Hong Kong even as compared to Singapore.[261] According to Bubna, Hong Kong needs to move fast if it wants to reinvent itself, before these industries die.[262]

Hong Kong and Singapore[263] have yet to introduce dedicated crowdfunding regulations. The respective governments are leveraging existing rules,[264] and platforms are currently relying on exemptions from prospectus rules and loopholes to sidestep capital-raising restrictions.[265] While there is no legal framework expressly allowing or disallowing crowdfunding in these jurisdictions, platforms appear to be operating unhindered for the most part.[266] In Australia, though there are no dedicated regulations for P2P lending and equity crowdfunding, in June 2014, the Companies and Markets Advisory Committee concluded a review on equity crowdfunding and in December 2015, the Australian government proposed amendments to the Corporations Act to allow businesses to raise capital through equity crowdfunding.[267] On the other hand, Japan, Taiwan and Malaysia have introduced legislation specifically for equity crowdfunding.[268]

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259 See Perez, above n 194.

260 Ibid.

261 See Woodhouse, above n 197.

262 Ibid.

263 In Singapore, the legal and regulatory frameworks are also underdeveloped and several creative platforms and structures have been devised to work around the existing grey areas. For example, platforms specifically exclude "securities" that can be offered to the public and instead use "rewards". See: InsightLegal Asia Consulting (15 April 2014).

264 See Hong Kong FSTB, above n 95 at §4.12.

265 See Coburn (February 2015).

266 Ibid.

267 See Hong Kong FSTB, above n 95 at §4.12.

268 See Wong (31 August 2015)

Failure to harmonise the rules between jurisdictions, or have any rules at all, mean that Asia is lagging behind in an area of significant and continuing growth.[269]

In the US, new regulations for equity crowdfunding were announced in November 2015 allowing companies to raise up to US$1m in a 12-month period.[270] The US regulations also set caps on the amount individuals can invest based on their income – with a maximum crowdfunding investment limit of US$100,000.00 in a 12-month period.[271] In the US, P2P lending is regulated under existing rules.[272]

In the EU, a report identified 2 key issues highlighting a clear need for evolution of the regulatory framework: (i) lack of transparency and education for both potential investors and investees; and (ii) lack of harmonisation of regulatory frameworks.[273]

If business and government leaders wait until these technologies are exerting their full influence on the economy before taking action, it will be too late to capture the benefits or react to the consequences.[274]

There is no room for inertia from policymakers, legislators and regulators. There is enough material and research from overseas jurisdictions in order for Hong Kong to pick and choose and learn from. The government must promptly fine-tune a tailor-made model for the unique socio-political-legal climate, to provide adequate protection to investors and the public while also facilitating SMEs to access capital and other funding avenues that were and are not traditionally available. While attempting to promote innovation and technology, the government is in fact stifling development and tying the industry's hands back.

According to Simon Loong, chief executive officer of internet finance start-up WeLab, the industry must flourish, but in a responsible fashion – through market players working closely with regulators to gather heads to see what the best practices are.[275] There are already lessons to be learnt from China, where masses of investors got burnt investing in crowdfunding platforms.

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269 See Coburn, above n 265.

270 See Woodhouse, above n 199.

271 Ibid.

272 See Hong Kong FSTB, above n 95 at §4.12.

273 See European Commission, above n 21 at 66-67.

274 See McKinsey Global Institute, above n 1.

275 See Tsang and Woodhouse (19 February 2016).

That may be the one advantage for countries lagging behind: to be able to observe and learn from the growing pains experienced abroad. Unfortunately, some growing pains may not be altogether avoidable, although delaying the process and avoiding the inevitable is no solution.

## *XIV HARMONISATION AND UNIFICATION*

### *14.1 Harmonisation and Unification of Regulations within Asia Pacific*

Though the Hong Kong government has attempted to start a dialogue, proactive and positive steps must be planned, thought-out and executed expediently to foster development, involving contribution from all stakeholders, including entrepreneurs, investors, platform operators, policymakers and regulators.

If Hong Kong is unable to get ahead in the race, it should at least keep up to pace through its actions rather than words.

From a broader perspective, the key players in the Asia Pacific Region must work together developing innovation and technology on a global front. As crowdfunding operates in the online world, the global and potentially international movement of funds means that platforms, fund-seekers and investors may be able to take advantage of the most advantageous regulations through "regulatory arbitrage".[276] The global movement of funds also means that platforms and projects compete worldwide for funds.[277] Though investors may not move to be able to invest, individuals are likely to start their companies and platforms in the most favourable ecosystem,[278] and Hong Kong and its Asian counterparts are likely to lose out or end up further back in the global race.

### *14.2 Harmonisation and Unification with the Traditional Financing Market*

In addition to a need for harmonisation and unification of regulation in Hong Kong within the Asia Pacific Region, there is also a need for harmonisation and unification of the crowdfunding and alternative financing market with its traditional counterparts. The innovative fintech market need not be so disruptive of traditional financing models, and in fact can complement traditional forms of financing.[279]

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276 See Gabison, above n 31 at 28.

277 Ibid.

278 Ibid.

279 Ibid. at 29.

One of the reasons why fintech enterprises have flourished is that the incumbent banks still do not serve large communities around the world.[280] It is estimated that 2.2 billion people around the world still do not have a bank account, let alone access to bank loans.[281] Fintech businesses have zeroed in on this massive hole – a huge "unbanked" population that with new technologies can provide rich pickings for the new disrupters.[282] Even China has a substantial 21% "unbanked" population[283], and a whole new world has been opened to them through mobile and web-based financial services such as Alibaba's Alipay.

Increasingly, banks engage with fintech start-ups or models to help streamline their operations, drive new business growth and comply with changing regulations.[284] The increasing deal sizes in fintech ventures should serve as a wakeup call to financial services companies in China and across the Asia Pacific Region that if they do not offer truly useful, customer-friendly digital solutions, competitors will step into the breach not just on the retail front but also in commercial transactions.[285] Recently in Hong Kong, the Bank of East Asia launched a secure and innovative person-to-person payment service to allow customers to make instant money transfers through the use of a phone number, without the need to collect any personal bank account information from recipients.[286]

Equity crowdfunding interacts in many ways with the established financial sector as a complementary or alternative financing method in the early stage financing market.[287] The traditional actors are starting to look at this form of crowdfunding, with business angel networks increasingly using crowdfunding-alike technology to organise their network and investment syndicates, but also with venture capital investors actively engaging on platforms.[288]

In particular, emerging market banks with large customer bases and deep understanding of the credit and regulatory environment need to take an active role

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280 See Dodwell, above n 6.

281 Ibid.

282 Ibid.

283 Ibid.

284 See Perez, above n 11.

285 Ibid.

286 See Bank of East Asia (Hong Kong) (8 October 2015).

287 See European Commission, above n 21 at IV.

288 Ibid at IV.

in shaping the future of crowdfunding by supporting the growth of new entrants and collaborating towards win-win relationships.[289]

Traditional financial institutions have 2 courses of action: either to collaborate with crowdfunding platforms or compete with them.[290] Collaboration or competition may take one of a variety of forms:[291]

(1) Traditional financial institutions may collaborate with platforms by purchasing loans as an investor;[292]

(2) Traditional financial institutions may form a "white label" partnership with platforms, with the platform serving as a distribution channel for financial institutions;[293]

(3) Alternatively, financial institutions may compete directly for market share, or compete indirectly by learning from crowdfunding platforms.[294]

The industry is at a pivotal point. Regulation of crowdfunding in Asia Pacific is fragmented and piecemeal, and economies would benefit from an overall consolidation. Though the different socio-economical contexts, cultural differences and other factors will affect the particular framework adopted, much can be done to improve the current disjointed situation.

In Hong Kong, the relevant stakeholders and the public at large are calling for transparency, clarity and certainty. The current outdated regulatory and legal framework must be brought into the 21st century.[295]

Fintech will continue to revolutionise the delivery of customer products and services.[296] Local banks facilitate relationships with fintech companies – it is in banks' long-term interests to do so, as greater transparency for customers and innovative technology and streamlined processes lead to more cost-effective and

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289 See Patwardhan (17 October 2015).

290 See PricewaterhouseCoopers, above n 36 at 2.

291 Ibid at 5.

292 Ibid.

293 Ibid.

294 Ibid.

295 See Lo (13 November 2015).

296 See Spence, above n 14.

efficient delivery of services.[297] Governments, regulators and banks must come together to undergo a mind-set overhaul, so that they can truly support fintech.[298]

There is a labyrinthine tension – between the new disruptors who are capturing the full potential of new technologies, and existing banking giants who want to take advantage of the technologies without losing their hard-earned market leadership.[299] While regulators are faced with many hurdles and headaches, the end result (and whole point of the exercise) should be cheaper and better services for customers.[300]

## *XV CONCLUSION*

In keeping with the *laissez faire* principle that the market leads and the government facilitates, policies put forward by the Hong Kong government to promote innovation would have a foundational role to play in creating a positive climate for investment and development.[301] However, innovation also depends on greater investment in education that channels and develops talent and fosters creativity.[302] Alongside that, there must be appropriate regulation that balances the tension between different actors involved, whether directly or indirectly.

Although Hong Kong has for decades been famous for its *laissez faire* approach to economic development, the Hong Kong government has usually been well-disposed to provide the necessary legal framework to allow business to develop.[303] This is particularly true of the financial sector, where a regulatory framework whose content and operation meet international best standards has been built up over a brief period of less than three decades.[304] Nevertheless, there is no time or place for complacency.

Just like Hong Kong, many cities have aspirations to keep up with or stay ahead of the tech game. Beijing's bid to attract Hong Kong's best and brightest to further its own high-tech ambitions would seem to threaten plans.[305] There is no better

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297 Ibid.

298 Ibid.

299 See Dodwell, above n 6.

300 Ibid.

301 See SCMP Editorial (18 January 2014).

302 Ibid.

303 See Hong Kong FSDC, above n 19 at §10.

304 Ibid. The SFC was established in 1989 and the Hong Kong Monetary Authority was established in 1993. The Securities and Futures Ordinance came into effect in 2003.

305 See SCMP Editorial (1 March 2016).

signal to the Hong Kong government that building such a sector requires more than policies, a strategy, digital infrastructure and hardware.[306]

There is no room for inertia from the Hong Kong government in educating, furthering and protecting the public through specific, targeted regulations and policies on crowdfunding. Delaying the regulation of a market that develops exponentially by the day compounds the risks involved, making matters which may inherently be risky even riskier. The market for crowdfunding and other fintech is at a pivotal point and shows no signs of shying away in the near future.

306 Ibid.

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