

# **Response of GRID Finance to the public consultation on the Regulation of CrowdFunding**

**Date: 02 June 2017**

**Inquiries to: [regulation@grid.finance](mailto:regulation@grid.finance) +353 1 524 1615**

## **Background on GRID Finance**

GRID Finance is the home of financial wellbeing in Ireland. GRID is building financial wellbeing in Ireland by providing credit-worthy small businesses with access to capital and investors with access to lending as an asset class. GRID Finance is composed of two distinct business units – GRID Business and GRID Wealth.

GRID Business is Ireland's leading next generation small business lender with a uniquely comprehensive small business capital solution. Leveraging the peer to peer financing model GRID connects credit-worthy small businesses with a range of capital providers. GRID's business customers are assessed through GRID's proprietary credit model and are provided with a GRID Score (0-100) which demonstrates the credit-worthiness and strength of each business. These businesses are listed on GRID's online marketplace for funding. Up to hundreds of lenders can support a single business on the GRID or a single institution or family office may fully fund a business's funding need. GRID administers the loan throughout the loan life-cycle on behalf of the lenders. The simple way of viewing the GRID model is that it acts as a broker between small businesses and a range of lenders on the GRID. GRID Wealth is GRID's dedicated business unit for retail investors.

GRID has committed to setting the highest possible standards in the non-bank lending space in Ireland so that the needs of all its stakeholders are served. As GRID has developed its risk management procedures and capital management protocols it has referenced the regulatory regime in the UK as the standard bearer of regulatory frameworks in Europe. GRID has implemented risk mitigation measures for all the identified key risks to retail investors on the GRID platform. GRID fully supports the development of a regulatory regime in Ireland that protects retail investors.



## The GRID Model

Crowdfunding has emerged in recent years as a catch all term for a variety of new funding models for individuals, charities, causes and businesses. In GRID's view, for a funding need to be deemed crowdfunded it must fulfill some basic requirements:

- 1) A clearly defined funding need
- 2) Clearly defined expected return for those funding this need (this can include a feeling of benevolence)
- 3) A significant number of individual retail investors (a minimum of 20) financing the funding need

The term peer to peer lending has also been used to describe the process of two parties entering a legally binding borrowing and lending contract, typically using a digital/online platform. Peer to peer lending involves matching borrowers with a minimum of one lender but potentially up to hundreds of lenders. These lenders can act singularly (fully funding a business's funding need) or collaboratively as a mixture of institutional, family office, government and retail lenders.

What is common among all types of peer to peer lending and crowdfunding platforms is that the platform acts as a matchmaker between entities and individuals seeking funding and those with funds to place on these platforms. The platforms do not carry balance sheet risk but are responsible for administering the relationship between those seeking funding and those receiving. Should the contractual relationship not be fulfilled the platform will typically suffer reputational risk with both parties. This is a powerful incentive for platform providers to administer their platforms to a high standard.

GRID's model is peer to peer as outlined above and serves to finance credit-worthy small businesses. Some funding needs on the GRID are fulfilled by a single lender (retail or institutional/family office) while others are financed exclusively by many retail lenders. Some funding needs are financed by both institutional and retail lenders.

## Benefits of the GRID model and other platforms

### Society

As a platform, GRID is supporting businesses to access capital to grow. Unlike traditional regulated credit institutions GRID does not carry balance sheet risk for the contracts entered into on the GRID. This results in GRID not being a threat to financial stability. The 2008 global financial crisis clearly demonstrated how balance sheet lenders can create enormous cost to government and citizens. Platforms such as the

GRID serve to finance small businesses without creating unquantifiable liabilities for government and society.

### Competition

Creating a diverse eco-system of SME finance providers (bank and non-bank) is good for our economy and has the capacity to create hundreds of thousands of jobs. In GRID's experience, there are thousands of credit-worthy businesses that operate in the Irish economy that cannot secure traditional bank finance. Policy initiatives that support the creation of competition in the SME finance space serves our country well.

### Access to Capital

GRID provides small businesses with access to capital. This capital is used to create sustainable business value and by extension new jobs and sustaining existing employment. The GRID platform is a key ingredient to help put the significant amounts of capital in Ireland to work in the economy.

### Access to Wealth Creation

Platforms such as the GRID serve to provide people with access to a new asset class – SME lending. This asset class carries certain risks but the returns available on the GRID compensates for additional risk. With broader participation in wealth creation, households will be stronger and more resilient over the long-term.

## Target of regulatory protection:

GRID has two primary customers: business borrowers and a diverse pool of lenders. GRID does believe there is a requirement to regulate the process of borrowing on platforms such as GRID. The process of borrowing is clearly laid out with clear contract terms and repayment expectations. Borrowers accept the terms and repay in line with these terms.

Lenders on the GRID include:

- Investment funds
- Family offices
- Retail lenders with semi-automated account management
- Retail lenders with self-directed accounts

Investment funds and family offices which lend on the GRID are professional investors who have evaluated the GRID with a range of tools and investment criteria. The Retail Investor is our stakeholder that requires the assurance and protection of a regulatory regime. Retail investors have varying degrees of investment education and awareness and necessarily deserve to receive a minimum level of information and disclosure about the risks and rewards of investing on the GRID. Additionally, should

a platform enter commercial difficulties and is not operating to a set of minimum basic standards, retail investors are likely to suffer a loss to their capital.

## Scope of regulatory regime:

A regulatory regime focused on protecting retail investors on platforms such as GRID should have 4 key pillars:

*Client asset protection:* Funds held on behalf of lenders, should be segregated from the operational funds of the underlying business. This protects client funds. Client asset regulations are currently in place for several financial services providers but do not include platforms such as GRID. GRID operates segregated accounts.

*Anti-money laundering:* Current risk-based anti-money laundering procedures should be extended to platforms such as GRID. This involves validating the identity and source of funds lodged into platforms such as GRID once the total amount of funds lodged reaches a certain pre-determined level. GRID undertakes anti-money laundering procedures.

*Consumer protection:* Once funds are invested by a retail investor there is a risk that the funds may not be repaid by the borrower. Ensuring that there is transparency around both the expected return from lending and the associated risks is important for ensuring that retail investors are adequately protected. GRID ensures this transparency.

*Contingency planning:* A contingency plan should be in place for platforms if they cannot continue to operate. This contingency plan will allow for an orderly wind down of the platform and the return of client funds. GRID has a contingency plan in place and has appointed a back-up loan administrator.

## Authorization and Supervision process

GRID recommends the following:

- Should a regulatory regime be introduced the authorization process should allow for existing operators in the Irish market to be regulated as a priority. Those platforms which have received financial investment through Enterprise Ireland's High Potential Start-up programme should take precedence over other platforms operating in the Irish market as these platforms have already been acutely assessed and evaluated by the Irish state to secure investment.
- SME lending platforms should take priority in an authorization process given that these platforms are the most developed and directly contribute to job creation.

- The costs of the supervisory process should be passed on to the industry on a phased basis. The costs of supervision should be proportionate to the level of retail funds placed on a platform as this should be the focus of a regulatory regime. Platforms with lower levels of retail funds compared to their competitors should not have to bear the same regulatory cost.

## Other considerations

GRID has closely monitored regulatory developments in other European jurisdictions. In our view the UK regulatory regime introduced by the Financial Conduct Authority (FCA) has proven to be the most successful regulatory framework for this emerging financing space. We recommend that the FCA framework form the basis of a future Irish regulatory regime. Other examples from across Europe have demonstrated how inappropriately designed regulation may negatively impact the development of the industry.

## Specific responses to questions

### Consultation Question 1: Should crowdfunding in Ireland be regulated?

Yes. As SME loan-based crowdfunding is the most developed it should take priority in the design and implementation of a regulatory regime.

### Consultation Question 2(a): What risks associated with crowdfunding should be considered and addressed in any potential regulatory regime? How could they be mitigated?

This response outlined clearly the risks which should be addressed. They are focused on protecting retail lenders on platforms such as GRID. **GRID has implemented all of the risk mitigation measures noted below.** In summary, these are:

Risk	Suggested response
A platform that a retail investor is lending through goes out of business	All authorised platforms should have a contingency plan and back-up servicing arrangement with a recognized third party in place
Retail investors' available cash is misappropriated	Client cash should be segregated from a platforms core business and subject to typical client asset management regulations

Platforms are used to launder funds	Typical anti-money laundering regulations should apply to retail lenders
Retail lenders do not fully understand the risks to their capital while lending on the GRID	Platforms should ensure that retail investors receive adequate, industry standard, disclosures regarding the risk to their capital by engaging in investing activity on a platform

**Consultation Question 2(b): If regulation is to be introduced, should there be minimum standards of due diligence, disclosure and a process in the event of default, insolvency or bankruptcy? Should there be a standard suggested procedure or best practice outlined? If so, what should this include and what would best practice entail?**

Each platform should be required to ensure that retail investors receive reasonably adequate, industry standard, disclosures regarding the risk to an investors capital. One of these disclosures should outline clearly the robustness of the risk evaluation process (if any) for each business. There is no requirement for an industry minimum standard as each retail investor will adjudicate whether the risk evaluation process is adequate or not.

**Consultation Question 2(c): Should businesses be required to provide specific information when seeking funding on crowdfunding platforms? If so, should there be different requirements for loan based and investment based crowdfunding? What specific information should be provided?**

Businesses should not be required to provide specific information as this information is often commercially sensitive. For this model of business funding to scale it is vital the businesses are not mandated to disclose certain information.

**Consultation Question 2(d): Crowdfunding platforms in Ireland are not currently covered by prudential rules (including capital and liquidity requirements), by client asset rules or conduct of business rules. Should there be such standards for crowdfunding platforms in Ireland? If so, what should these standards include?**

Back up servicing arrangements should be put in place (as outlined above) to mitigate the need for prudential rules. Reasonable client asset rules should apply which protect client's funds from the core platforms balance sheet. Certain conduct of business rules may be required as additional platforms enter the Irish market but at the current scale and level of growth none should be required.

**Consultation Question 2(e): Should the SME Regulations be applied to crowdfunding platforms?**

At the current anticipated scale of lending (over the next three years) these regulations should not apply.

**Consultation Question 2(f): Should there be a limit on the maximum level of investment in a 12 month period that an individual may invest in one or more crowdfunding projects/businesses that a crowdfunding platform can accept from an individual? Should there be other restrictions on retail investors before they can invest in both loan based and equity based crowdfunding?**

Once adequate risk disclosures are provided to retail investors no maximum level of investment should be required.

**Consultation Question 2(g): Are there any considerations that should be taken into account with respect to the cost of regulation or the cost of regulatory compliance?**

This is a critical element which if not correctly addressed may impact very negatively on the development of the industry. The approach to cost recovery must be viewed within the broader policy objective of creating a competitive eco-system for small business finance. It is not possible for platforms to pass on the cost to their customers as it will make their solutions uncompetitive.

GRID's views are:

- Each platform must cover the cost of managing the authorization process.
- The regulator should also cover their cost of designing and implementing an authorization process.
- Post authorization a platform should make a modest contribution to the regulators costs. This contribution should be commensurate with the size and scale of its retail investment pool i.e. the larger a pool of retail investment capital on a platform the larger a contribution to the supervisory regime.
- We do not believe that the industry is sufficiently developed with an adequate number of actors for the full cost of regulation to be absorbed by industry players. We recognise that the cost is yet to be determined.

**Consultation Question 2(h): Should regulation address situations where there could be a potential conflict of interest, for example, where a crowdfunding platform, its shareholders, managers or key employees can provide funds and potentially earn money from providing loans or having an equity share in enterprises through crowdfunding**

GRID's view on each of the elements in this question are:

- Related parties (platform staff, shareholders or other connected entities) should be disclosed where these parties are lending alongside retail lenders. Where these parties are not lending alongside retail lenders these disclosures are not required.
- All platforms operating in the Irish market should be required to adhere to providing certain standard risk disclosures which would include the performance of each asset class on a platform as well as the related risks of engaging in the investing activity on a given platform.
- Retail investors should be prompted on an annual basis to review the investment criteria set out as part of the automation of certain investment criteria.

**Consultation Question 3: Should Ireland consider developing non-regulatory supports to encourage the development of crowdfunding?**

Yes. It has been clearly shown in the UK that a supportive policy and fiscal environment has supported the rapid development of the industry. This has resulted in thousands of jobs being created. GRID have previously advocated for the following policy and fiscal support:

- A progressive regulatory regime that as its primary outcome protects retail investors.
- Government lending on platforms
- A tax incentive that allows the first €2500 of interest earned by retail investors on platforms to be tax free

**Specific responses to outlined risks**

Risk	Should this Risk be Regulated? Yes/No/Partially	Comment
Lack of understanding of risky nature of crowdfunding by consumers.	Partially	The risks associated with lending on a platform such as GRID should be clearly communicated. The correlation between the risks involved and how the taking of these risks is rewarded by the returns offered/available on platforms such as 'The GRID' should be clear. The disclosure of these risks and how they have been assessed by the platforms risk assessment of the investment opportunity should be made clear to the retail investor. Non-retail investors do not necessarily require regulatory protection as they typically have sophisticated



		risk-assessment tools and expertise on both the asset class and the platform at their disposal.
Risk of identity theft, money laundering, terrorism financing, data protection and fraud.	Yes	The Central Bank of Ireland's current anti-money laundering procedures should be extended to include retail investors on platforms such as the GRID.
Misleading and insufficient disclosure of information by businesses on crowdfunding platforms.	No	This risk is managed by the platforms own risk assessment process of each business/investment opportunity. The negative commercial impact of inadequately managing this risk and the requirement to disclose the robustness of a platforms risk management processes (at No.1 above) ensures that this risk does not need to be regulated.
Risk of unfair contract terms or misleading commercial practices resulting from information asymmetry.	No	As above – regulation should ensure that the risk management process platforms use for evaluating each business/investment opportunity is disclosed to retail lenders. Specific information asymmetry risks should be addressed via each platforms risk management process.

If the business fails or the crowdfunding platform itself fails, there is a risk that lenders or investors will lose all of their money.	Partially	There are two distinctly different risks here, of significantly differing magnitude, that require management. Platform failure risk: It is vital that retail investors are protected if a platform fails. In line with best practice in the UK GRID have
--	-----------	---

		engaged a leading back-up service administrator to provide assurance to GRID's retail investors that their interests are protected should GRID itself have commercial difficulties. GRID have also set up dedicated client asset accounts that ensures all client funds are segregated from GRID's core business.
Risk that the return on the investment is less than expected.	Partially	As with all investment there is a risk of expected returns not being earned. The risks of this happening should be clearly disclosed to the retail lenders. There should however be no regulatory protection if the expected return is not met. The nature of investing is such that gains and losses are managed by individual investors.
The lack of a secondary market for equity stakes means that it is difficult to value them and they can be diluted by further equity sales.	Partially	This is the reality of all types of equity investment outside of listed securities (of which even some listed securities have limited liquidity). This liquidity challenge should be clearly disclosed to retail investors in the platform. In time, platforms are likely to develop secondary markets. Outside of reasonable disclosures the risk should not be regulated for.
Absence of dispute resolution mechanism.	No	GRID sees no requirement for this. Each platform should have a complaint handling process in place as good practice.
Risk arising from conflict of interest.	Yes	Disclosure of any reasonable conflicts of interests should be required to be disclosed to retail

		lenders only. See above re 'Related parties'
Risks to businesses seeking funding through crowdfunding platforms (see page 10 for further detail).	No	The risks outlined in page 10 are negligible if a platform has been authorised via a robust authorisation process. <b>Consequently</b> these risks should <b>not be regulated</b> for.

GRID

www.grid.finance

