CONSULTATION PAPER NO. 124

PROPERTY CROWDFUNDING

13 DECEMBER 2018

PREFACE

Why are we issuing this Consultation Paper (CP)?

1. As part of the DFSA's efforts to support and enable new financial services business models, products and services, a regime was introduced in 2017, to accommodate Small and Medium Enterprise (SME) financing through loan and equity crowdfunding platforms. However, like many financial services, crowdfunding has evolved, and in addition to providing financing to SMEs and start-ups, it is now arranging financing for assets, such as property. In order to facilitate this additional type of crowdfunding we are proposing to amend our existing regime.

Who should read this CP?

2. The proposals in this Paper should be of interest to Relevant Persons, including Authorised Firms, Persons who intend to operate a Property Investment Crowdfunding Platform in the DIFC, Persons providing legal, accounting, audit, oversight of compliance services in the DIFC or who wish to provide such services; and potential investors.

Terminology

3. In this CP, defined terms have the initial letter of a word, or of each word in a phrase, capitalised and are defined in the Glossary Module (GLO). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

What are the next steps?

4. Please send any comments to **consultation@dfsa.ae** using the table provided in Appendix 6. Please refer to the CP number in the subject line. You may identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments. The deadline for providing comments is **13 January 2019.**

5. Once we receive your comments, we shall consider if any further refinements are required to these proposals. We shall then proceed to make the relevant changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the DFSA Rulebook are made. We shall issue a notice on our website telling you when this happens.

Structure of this CP

6. The remainder of this CP contains:

   a) Background information;

   b) Why further regulation is required;

   c) Proposals for Property Investment Crowdfunding Platforms;

   d) Appendix 1: draft amendments to the GEN Module;

   e) Appendix 2: draft amendments to the COB Module;

f) Appendix 3: draft amendments to the CIR Module;

g) Appendix 4: draft amendments to the MKT Module;

h) Appendix 5: draft amendments to the GLO Module; and

i) Appendix 6: table of comments.

A. Background information

What is crowdfunding?

7. Crowdfunding is a relatively simple concept. It is a term used to describe the use of small amounts of money, obtained from a large number of individuals, to fund a project through an online platform. The growth of this market accelerated in the wake of the 2008 financial crisis when access to capital became difficult for small businesses and start-ups.

Types of crowdfunding

8. While there are many crowdfunding models, which have very different purposes and business models, essentially four types of crowdfunding models have emerged. These are:

   a) Donation;

   b) Reward/royalty;

   c) Loan (sometimes called Debt or P2P lending); and

   d) Investment (sometimes called Equity).

9. There is an emerging consensus, globally, that only loan and investment crowdfunding need to be regulated by financial services regulators, to protect the public from fraud and swindles. The other types of crowdfunding do not involve, typically, any activity that would be a 'financial service'.[1]

DFSA developments

10. In response to market interest, the DFSA issued two crowdfunding consultation papers setting out our approach to regulating the activities of Loan and Investment Crowdfunding, in or from the DIFC, in early 2017. In mid-2017, the DFSA's Loan and Investment crowdfunding rules came into force.[2]

11. When developing our approach, we acknowledged that, while crowdfunding might benefit the economy, and those seeking finance, we were obliged to consider the wider market and the need to protect consumers generally. The lack in the UAE of, for example, a financial ombudsman, and a financial services compensation scheme, meant that we were quite prescriptive in our approach in order to provide adequate consumer protection measures. As with any regulatory approach, we believe that it is far easier to amend a regime and reduce the extent of prescription, in the light of experience, than it is to apply more prescriptive measures after a regime is in place.

12. As described above, since setting out our framework for crowdfunding, we have had further interest from those wishing to facilitate the financing of assets, in particular in the case of property. Property Investment Crowdfunding (as we term it) has emerged as an additional type of crowdfunding.

13. Property Investment Crowdfunding allows multiple investors to come together and

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[1] Nonetheless, attention needs to be paid to AML/CTF risks arising from the other types of crowdfunding.
[2] The crowdfunding framework can be found in Chapter 11 COB http://dfsa.complinet.com/en/display/display_main.html?rbid=1547&element_id=23522.

purchase a property. Typically, the investors are investing in an apartment or house via a special purpose vehicle – SPV - that holds title to the property. This investment generally offers the investors a rental return, which provides a regular income, as well as the potential for capital appreciation, which is determined by market forces.

14. A Property Investment Crowdfunding Platform ('PICP') operates in a similar manner to a typical Investment Crowdfunding Platform, but with some differences. Third parties will need to be appointed to value the property and a property manager will need to be appointed to manage the property.

B. Why additional regulation is required

15. We believe that Property Investment Crowdfunding presents some different risks that are not addressed by our current Investment Crowdfunding framework. The table below sets out the additional risks we have identified.

Risk	Explanation of the risk
Investor understanding	• Most PICPs are aimed at investors (often retail) who are not property experts and may lack knowledge to make appropriate decisions when investing in property (especially commercial property). Conversely, some investors may display 'overconfidence' in their knowledge of the property market and overestimate their ability to assess risk. • Some investors may not understand what they are getting when they invest (for example, they are receiving an interest in a SPV (as shareholders), which owns a property).
Illiquidity	Property itself is a relatively illiquid investment. Additionally, the investment in the SPV may also be illiquid. There is no publicly traded market and there may not be any other investor willing to buy the investor's interest in this private arrangement (if the investors wishes to exit the investment).
Loss of capital	Some may seek to use a PICP as a last resort to sell unwanted properties. Additionally, there could be a chance that a property is empty (for good reason) and it will be challenging for the property manager to find a tenant, resulting in an investor receiving a reduced income.
Conflicts of interest	• Incentives could be paid to the Platform Operator to appoint a certain property manager or valuer that could lead to investor detriment. • There is a risk that the Crowdfunding Platform could be used to offload properties by the platform operator's friends and family that they have been unable to sell.
Due Diligence	• There is a risk that a Platform Operator will rely on market commentary, and other subjective public information, which could be biased, unbalanced, and not verified by relevant professionals with competency in this area.

Risk	Explanation of the risk
	• There is a risk that a seller selling his property via a crowdfunding platform does not have valid legal title to the property.
Operator expertise	There is a risk that a Crowdfunding Operator will not fully understand the property market and/or have enough expertise in this field to make the right decisions about what properties to on-board.
Managing a Collective Investment Fund (CIF)	The business model of a PICP can, in some circumstances, be similar in substance to a CIF, but without being subject to the same regulatory requirements or offering the same consumer protections. This presents risks of regulatory arbitrage.

Issues for consideration

Q1: Do you think there are any other risks relating to Property Investment Crowdfunding Platforms that we should consider and address? If so, what are they?

C. Proposal for Property Investment Crowdfunding

16. In order to address the highlighted risks, we are proposing to add additional requirements to the current crowdfunding regime to accommodate the operations of PICPs. As with our previous approach to crowdfunding, we have set out a fairly cautious set of proposals. It is possible that, once we gain further experience with this market, the measures will need to be amended.

17. As is our normal practice, we looked to what is done in other jurisdictions in respect of property crowdfunding. To date, no jurisdiction has developed a bespoke regime for property crowdfunding, although many regulators agree that an absence of specific regulation in this area has led to a proliferation of platforms varying in quality and management. The UK Financial Conduct Authority (FCA) has recently consulted on an updated approach to crowdfunding, which included proposals applicable to property crowdfunding platforms. China, which has the largest property crowdfunding market, is in the process of introducing a regulatory framework for property crowdfunding.

All references to Rules are references to proposed Rules, which can be found in Appendices 1 to 5.

Section 1: The creation of an additional crowdfunding activity

Please see draft Rules GEN 2.29, COB 11 and GLO in Appendices 1, 2 & 5.

18. When we created our crowdfunding framework, we established a new financial service activity of 'Operating a Crowdfunding Platform', where a person carries on the activity of Operating a Crowdfunding Platform if they operate a Loan or Investment Platform.3 As we are proposing to expand our framework, for clarity, we are adding a new sub-category operating a 'Property Investment Crowdfunding

[3] Please see GEN 2.29.1.

Platform'.

19. As with our current approach, we have proposed Guidance to explain this activity and have proposed amendments to the Rules in Chapter 11 of COB to make it clear what Rules apply to Property Investment Crowdfunding Platforms. Please read this chapter carefully to see what Rules apply to this type of platforms as we are only detailing the new additions to this chapter in the sections below.

Issues for consideration

Q2: Do you agree with our proposal to add a new sub-category of Property Investment Crowdfunding Platforms? If not, why?

Section 2: Potential arbitrage with other financial services

Please see draft Rules COB 11.6.2, CIR 2.1.18 and MKT 2.3(m)(i) in Appendices 2, 3 and 4.

20. It is possible for an Operator of a PICP to carry out activities that may stray into other types of financial services activities, such as managing a Collective Investment Fund (CIF). When setting out our approach for Investment Crowdfunding, we said that an Operator must not, among other things, operate a CIF or manage assets.[4] Additionally, we cautioned Operators to consider carefully their business models to avoid such eventualities.

21. For clarity, we propose to include a new exclusion for PICPs in CIR. This exclusion lists certain conditions a PICP must meet to ensure it is not operating a CIF, for example, only allowing investments into single properties. We will also require applicants to demonstrate to us that they are not running a CIF or managing assets and will ask what steps they have taken to ensure they are not carrying on these activities.

Issues for consideration

Q3: Do you agree with our approach to deal with the potential arbitrage between Property Investment Crowdfunding Platforms and other types of financial services activities regulated by the DFSA? If not, why?

Section 3: Risk warnings

Please see draft Rule COB 11.3.1(2), 11.6.4 and 11.6.5 in Appendix 2.

22. COB 11.3.1 sets out risk warnings, which a Platform Operator must disclose prominently on its website. For PICPs, we believe additional risk warnings are required, and we propose that the following must be provided to investors:

   a) investment in property is speculative, the market value of property can fall and rental income is not guaranteed;

[4] GEN 2.2.10E.

b) the investor will not own the property, rather the investor will have an interest in a SPV that owns the property;

c) as the investor's interest in the SPV is not listed or traded, it is likely to be an 'illiquid' investment. That is, it may be difficult to sell the interest because of a lack of investors willing to buy such an interest; and

d) it may be difficult to sell the property at the end of the investment period, resulting in a delay in investors receiving their capital or in the property being sold at a loss.

23. The Platform Operator must prominently display these risk warnings on their website. They must also be included in a risk acknowledgement form, which must be signed by all retail investors to confirm they understand the risks associated with these investments. This must be done prior to, or at the same time as, the investor commits to making the investment.

24. As with the approach we have taken for Investment Crowdfunding, PICPs must allow investors who have made a commitment to make an Investment in a property to withdraw that commitment during the cooling-off period. The cooling-off period means the period of at least 48 hours starting at the end of the commitment period.

Issues for consideration

Q4: Do you agree with the amended risk warnings and requirements to obtain a signed risk acknowledgement statement and provide a cooling-off period? If not, why?

Section 4: Property characteristics

Single residential properties

Please see the draft Rules in GEN 2.29.1(7) & 2.29(9) and COB 11.6.2, 11.6.6, 11.6.7, 11.6.9 & 11.6.11 in Appendices 1 and 2.

25. We are proposing that any property offered through a PICP is:

a) a single residential property; and

b) that a SPV will hold title to a property on behalf of the investors.[5]

26. As with the approach taken for Investment Crowdfunding, Platform Operators should be aware that there is a limit applied to the value of the property offered on a PICP of USD 5 million[6] and that Retail Clients do not invest more than USD 50,000 on the platform in total in any calendar year.

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5 Thus negating the need to have a custodian to hold title to the property.

6 See MKT 2.3.1(m) which carves out an offer of securities made through a crowdfunding platform (and out of the prospectus requirements) if the total aggregate value of the offer is less than USD 5 million.

Off-plan properties

27. We have seen many crowdfunding platforms (in other jurisdictions) that offer access to both completed and off-plan properties. We recognise that the off-plan market is established as a route for property sales in the UAE, and particularly in Dubai. However, we have concerns about PICPs offering access to off-plan units, especially to retail clients. Our concerns relate to the complexities around these purchases: what you are and are not getting, how much you pay now and in the future, and what happens to the property if a developer defaults and the development is unfinished.

28. As we are exploring this option, albeit we are not convinced this is the appropriate path to take, we would ask Platform Operators or interested parties to respond to the following questions:

    a) What stage of off-plan developments would you be targeting (not started, half finished, nearly completely)?

    b) How would the Platform Operator carry out due diligence on the developer/seller?

    c) Have you engaged with the Real Estate Regulatory Authority, or other regulator, about facilitating this type of purchase via a Property Investment Crowdfunding Platform?

    d) How would you intend to deal with future milestone payments (and potential defaults) by investors?

Condition of the property

29. We are conscious that the type of properties sold via PICPs may vary, and several issues can arise. For example, does the seller hold a valid legal title, and can the property be rented in its current state? In order to keep the proposition simple we are proposing that:

    a) the seller must hold valid legal title to the property and is able to sell that property free of any encumbrance; and

    b) it is in a leased, or leasable, condition or, if it is not available for letting because it requires renovation or alteration, that planning permission for the renovation or alteration can be readily obtained.

    We do not consider these requirements onerous but, rather, see them as minimum criteria for selling a property.

Issues for consideration

Q5: In addition to the questions asked above, what are your views about allowing Property Investment Crowdfunding Platforms to offer access to off-plan properties? Do you have any concerns with this approach? If so, what are they?

Q6: Do you agree with our proposed approach regarding the condition of a

property offered on a Property Investment Crowdfunding Platform? If not, why?

Section 5: Due Diligence

Please see draft Rule COB 11.6.3 in Appendix 2.

Valuation of the property

30. In our current equity crowdfunding regime, we require the Platform Operator to obtain a valuation of the Issuer's business and disclose this to potential investors.[7] We kept this requirement high level due to the often start-up nature of the business being on-boarded and the fact they may not have had a (professional) valuation undertaken.

31. However, in respect of property, we do not see this requirement as being adequate. The appointment of a professional and independent valuer is needed in order to give investors a clear and impartial view on the value and state of the property.[8] On this basis, we are proposing that a valuation report must be obtained for every property listed on the platform. The valuation must be provided by a professional (reputable) valuer, not related to the platform operator, whom the operator believes is capable of providing an objective valuation.

32. This report must:

    a) be prepared on the basis of an 'open market' valuation;

    b) include the valuation and all material details about the basis of the valuation and assumptions used;

    c) outline the overall structure of the market including market trends;

    d) include a brief description of the property, its location, its existing use, any encumbrances concerning or affecting the property, the lease profile (if any), the capital value (in existing state), net monthly income expected from the property;

    e) confirm the professional status of the valuer and that the valuation report is prepared on a fair and unbiased basis; and

    f) be disclosed to investors/shareholders as soon as it is available.

33. We are proposing that this valuation is undertaken before a property is listed on the platform and not more than three

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[7] COB 11.3.6(2)(g) and 11.3.7(e).

[8] For clarification, we are not against other forms of information being shown on a platform, such as other market demographics or analysis, but the Platform Operator must explain the (often-speculative) nature of this information and where it has come from.

months before a property is due to be sold. We are also considering whether a valuation should be performed at least annually, after the property is purchased, in order to give shareholders an understanding of whether the property value had appreciated or depreciated, and would welcome views on this proposal.

Issues for consideration

Q7: Do you agree with the valuation requirements? If not, why? What is your view on the frequency of the valuations?

Section 6: Conflicts of Interest

Please see draft Rule COB 11.6.10 in Appendix 2.

34. A number of potential conflicts of interest on a PICP could lead to investor/shareholder detriment.[9] These include, but are not limited to, conflicts between the platform operator and:

a) the broker/seller selling the property on the Crowdfunding Platform;

b) the property manager appointed to manage the property on the investors' behalf or other persons providing services relating to the property; and

c) the independent valuer.

35. Given these potential conflicts of interest, we propose to limit any remuneration being provided to the Platform Operator (or any person related to it) from any property managers, valuers, custodians, trustees or any other person providing a service relating to a property on-boarded (and sold) via the platform. **This means the Platform Operator can only receive remuneration for its services from investors and/or sellers using the platform (e.g., through a listing fee).**

Issues for consideration

Q8: Do you agree with our proposed approach to managing conflicts of interest between the Platform Operators and third parties? If not, why?

Section 7: Disclosure requirements

Please see draft Rule COB 11.3.3(2) and 11.3.7(2) in Appendix 2.

36. For PICPs, we are proposing additional disclosure requirements, which include the following.

a) <u>General disclosure</u>: the Platform Operator must disclose:

i. full details about the property, including the location and condition of the property;

[9] COB 3.5 and COB 11.3.14 address some of these.

ii. the identity of the seller, including if it is a Body Corporate, details of its incorporation and business registration;

iii. the independent valuation report;

iv. the results of any due diligence carried out on the property; and

v. the estimated charges and expenses (annually) related to the property.

b) Selection of properties: Platform Operators must clearly explain how they have selected the properties. For example, are they looking to balance income and capital returns or are they looking at growth opportunities that include areas that will benefit from development?

c) Nature of the interest received: when an investment is made in a property, investors are typically issued shares or certificates in a SPV, which owns the property, in direct proportion to their level of investment. The SPV is formed for the sole purpose of holding the crowdfunded property asset. The nature of this ownership interest will need to be explained clearly to potential investors.

d) Rights, obligations and role of the shareholder: the Platform Operator will need to be clear as to what is expected of the shareholder and their rights and obligations in respect of the property. Operators must also be clear about whether the investor will be expected to contribute any further capital to cover vacant period or rental defaults and how various expenses relating to the property will be dealt with.

e) Management of the property: typically, a property manager will be appointed to find a tenant, collect the rent and organise maintenance and insurance of the property. These details, and the likely costs, must be made clear to investors.

f) Income to be received: Platform Operators must provide a clear explanation and estimate of what the investor will receive and when and what to expect (e.g., dividends/rental income, in direct proportion to the ownership of a SPV). For example, dividends available to property investors are usually calculated as the Gross Rent collected from tenants, minus property-related costs including: purchase costs, furnishings, cosmetic remedial works, forecast maintenance, annual voids, corporate taxation, all fees and mortgage interest payments (for geared properties).

g) What happens at the end of the investment term: Platforms Operator must be clear about the process at the end of the investment term (this term will usually be specified up front). For example, will shareholders be asked whether they wish to sell, or retain the property? Will any decision require a majority vote?

Issues for consideration

Q9: Do you agree with the additional disclosure requirements? If not, why?

Section 8: Restrictions on the use of credit cards for Property Investment Crowdfunding Platforms

Please see draft Rule COB 11.6.8 in Appendix 2.

37. The DFSA is concerned about Retail Clients being able to use forms of credit/debt financing to fund their crowdfunding accounts and the potential exposure for these types of clients.

38. Given this concern, we propose to prohibit all PICPs from letting Retail Clients fund their account using a credit card. Debit cards will be permissible, provided platform operators have in place systems and controls to distinguish debit cards from credit cards.[10]

Issues for consideration

Q10: Do you have any comments on, or concerns related to, the proposed restriction on the use of credit cards on Property Investment Crowdfunding Platforms? If so, what are they and how should they be addressed?

[10] This proposal is in line with the supervisory position we have taken in respect of Retail OTC derivatives, which can be found on the DFSA's website.

Appendix 6: Table of Comments

Name of commentator:		
Name of entity (if applicable)		
Is your response confidential?	☐ Yes	☐ No
If your response to the previous question is Yes, please state your reasons for such a request:		

Notes:

- The DFSA reserves the right to publish, including on its website, any comments you provide. However, if you wish your comments to be kept confidential, you must expressly request at the time of making comments that this should be the case. You must also provide an explanation of why you wish your comments to be kept confidential.
- Your answers may require explanations. Please include those in the second column.
- If you do not wish to comment on any issue, please select the “no comments” box.

Ref.	Response	Comments on proposal	
Q1:	**Do you think there are any other risks relating to Property Investment Crowdfunding Platforms that we should consider and address? If so, what are they?**		
	☐ Yes		☐ No comments
	☐ No		
Q2:	**Do you agree with our proposal to add a new sub-category of Property Investment Crowdfunding Platforms? If not, why?**		
	☐ Yes		☐ No comments
	☐ No		
Q3:	**Do you agree with our approach to deal with the potential arbitrage between Property Investment Crowdfunding Platforms and other types of financial services activities regulated by the DFSA? If not, why?**		
	☐ Yes		☐ No comments
	☐ No		
Q4:	**Do you agree with the amended risk warnings and requirements to obtain a signed risk acknowledgement statement and provide a cooling-off period? If not, why?**		
	☐ Yes		☐ No comments
	☐ No		
Q5:	**In addition to the questions asked above, what are your views about allowing Property Investment Crowdfunding Platforms to offer access to off-plan properties? Do you have any concerns with this approach? If so, what are they?**		
	☐ Yes		☐ No comments
	☐ No		
Q6:	**Do you agree with our proposed approach regarding the condition of a property offered on a Property Investment Crowdfunding Platform? If not, why?**		
	☐ Yes		☐ No comments
	☐ No		
Q7:	**Do you agree with the valuation requirements? If not, why? What is your view on the frequency of the valuations?**		
	☐ Yes		☐ No comments
	☐ No		
Q8:	**Do you agree with our proposed approach to managing conflicts of interest between the Platform Operators and third parties? If not, why?**		
	☐ Yes		☐ No comments
	☐ No		
Q9:	**Do you agree with the additional disclosure requirements? If not, why?**		
	☐ Yes		☐ No comments
	☐ No		
Q10:	**Do you have any comments on, or concerns related to, the proposed restriction on the use of credit cards on Property Investment Crowdfunding Platforms? If so, what are they and how should they be addressed?**		
	☐ Yes		☐ No comments
	☐ No		