Inter-American Development Bank

Alternative Finance (Crowdfunding) Regulation in Latin America and the Caribbean

A Balancing Act

Diego Herrera

Institutions for Development Sector

Capital Markets and Financial Institutions Division

DISCUSSION PAPER Nº IDB-DP-480

September 2016

Alternative Finance (Crowdfunding) Regulation in Latin America and the Caribbean

A Balancing Act

Diego Herrera

September 2016

http://www.iadb.org

Copyright © 2016 Inter-American Development Bank. This work is licensed under a Creative Commons IGO 3.0 Attribution-NonCommercial-NoDerivatives (CC-IGO BY-NC-ND 3.0 IGO) license (http://creativecommons.org/licenses/by-nc-nd/3.0/igo/legalcode) and may be reproduced with attribution to the IDB and for any non-commercial purpose. No derivative work is allowed.

Any dispute related to the use of the works of the IDB that cannot be settled amicably shall be submitted to arbitration pursuant to the UNCITRAL rules. The use of the IDB's name for any purpose other than for attribution, and the use of IDB's logo shall be subject to a separate written license agreement between the IDB and the user and is not authorized as part of this CC-IGO license.

Note that link provided above includes additional terms and conditions of the license.

The opinions expressed in this publication are those of the authors and do not necessarily reflect the views of the Inter-American Development Bank, its Board of Directors, or the countries they represent.

Contact: Diego Herrera, diegohe@iadb.org.

Abstract[*]

Alternative finance (AF) or "crowdfunding" is the most notable financial technology (fintech) business model in Latin America and the Caribbean. Although still small in volume, reaching US$110.46 million across the region, its rapid growth poses a challenge for regulators. This paper offers a conceptual understanding of the typical enterprise model for AF, and from it describes the main challenges for regulators. It proposes recommendations for policymakers and regulators, taking into account the need for balance and proportion in terms of the nature, size, and character of the platform.

JEL Codes: G23, G28
Keywords: Alternative finance, crowdfunding, financial institution, financial market, financial regulation, financial services, fintech

[*] This document follows the original discussion on the topic by Herrera (2015). The author wishes to express gratitude to the following people for their valuable comments and encouragement in preparing this paper: Juan Ketterer, César Tamayo, Carmen Fernández, Agustina Calatayud, Olver Bernal, Francisco Demichelis, Gloria Lugo (Inter-American Development Bank), Tania Ziegler (The Cambridge Centre For Alternative Finance, Cambridge Judge Business School), Monica Ramirez, and Sonia Vadillo.

1. Introduction

This discussion paper has a twofold objective. First, it conceptually describes the existing business models of the nascent financial subsector of alternative finance (AF) in Latin America and the Caribbean (LAC). Consequently, it briefly describes the size of the market in the region and the opportunity that arises with it. Second, based on the overwhelming challenges associated with the AF models found in the region, the document proposes some minimal recommendations for regulators across the region, taking into account the diversity of legal traditions and frameworks.

It is important to understand that AF, or crowdfunding, is a business model that already exists in several countries within the LAC region. Investors and promoters of personal or enterprise projects in many of the region's countries already use AF as a means to invest and obtain funding. In fact, as shown by a recent study supported by the Inter-American Development Bank (IDB), AF in LAC is growing fast. It nearly doubled in size in the 2014–15 period, reaching at least US$110.46 million in volume across the region. In fact, the study shows how AF itself represents an opportunity to serve financially excluded households, but to a larger extent, micro, small and medium enterprises (MSME) all across LAC (Wardrop et al., 2016). However, this also poses a huge challenge in terms of preparedness in regulation and oversight to mitigate the risks and allow sound growth of such an innovative subsector.

The document is informed by recent developments from the industry and regulators/supervisors abroad and some of the internationally accepted regulatory principles, applied to the region's context. It aims to contribute to the development of digital finance in the region, supporting other initiatives led by the IDB Group for the financial technology (fintech) industry. We believe that a proportionate and balanced approach to regulation will allow the industry to grow.

For these purposes, we define the subsector and its main activities in Section 2 and the size of the industry in the region Section 3. Section 4 offers some reasons to regulate the industry in LAC. Section 5 briefly summarizes regulations in the United Kingdom and Spain. Section 6 contains 10 regulatory recommendations for LAC, and Section 7 concludes.

2. Alternative Finance: Definitions and Categories

2.1. Main Definitions

Alternative finance, or crowdfunding (Baeck, Collins, and Chang, 2014; Kirby and Worner, 2014), is a blanket term denoting a subsector of the fintech industry. It consists of enterprises, namely platforms or originators, using electronic means to match supply from investors or

donors with the demand for funds, represented by promoters (individuals or enterprises) who have specific projects to be funded.

In the simplest AF model, demand and supply for funds are communicated through an "open call." Promoters typically on á la social-media through a "campaign" post such funding needs. The open call means that any person with broadband access, already signed up on the platform, can promote a project using a campaign (IDB, 2014), which often contains a description and a visual depiction of the project.[1] Multiple independent investors or donors electronically deliver collective monetary offerings to fund a selected project, possibly posted on the Internet or through mobile apps by a promoter in search of funds. The open call also means that anyone searching for returns, or otherwise willing to *donate* excess liquidity to a project, can access such platforms.

Platforms act essentially as a means to connect supply with demand for funds, using electronic means to transfer money from investors to promoters and, subsequently, reimbursing capital and interest or dividends to investors with the use of electronic payment systems. In some other cases, where monetary returns are not the driver for investors, platforms may deliver physical or electronic goods or services on behalf of promoters, or may just send information about the social or economic impact of a donation.

Nevertheless, it is important to keep in mind that AF is still relatively small in the region, and hence nonsystemic, and very new and changing, which increases the need for a proper framework to regulate the subsector. Some recommendations about the core of the business can be derived for regulators to act prudentially, letting the business grow as a complement to the traditional credit and capital market channels. Platforms might not be alone in the business in some of the LAC countries. Supplementary electronic enterprises from the fintech space can perform collection, risk scoring and securitization, among a large list of activities.

In the following paragraphs, we will lay out a general taxonomy for the AF platforms in terms of the use of the resources. Then, we will describe the typical models of AF, from the simplest to a complex ecosystem.

2.2. AF General Taxonomy and Categories in Brief

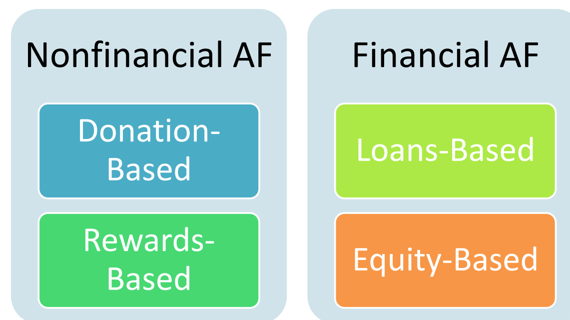
In general, AF taxonomy will be explained in this document in terms of the capital flow from investors to promoters, and vice versa, and their contractual relationships. Hence, AF platforms can be divided into the categories of nonfinancial and financial return, although many other taxonomies may exist (IDB, 2014; Kirby and Worner, 2014; Wardrop et al., 2016).

[1] See for example, www.kiva.com.

2.2.1. Nonfinancial Return Alternative Finance

Nonfinancial return alternative finance (NFRAF) is what in most countries of LAC is commonly known as crowdfunding. In this category, platforms are a mean to connect promoters of ideas or projects with people who are not expecting a financial return. This category of AF is usually subdivided into the categories of rewards-based and donation-based. Rewards-based AF occurs when investors and people with ideas meet up through the platform and the crowd is willing to fund a project with the hope of a reward. Most of the time, the final product coming from the project owner is the reward.[2] In this sense, this type of model very frequently funds music and other forms of art (Wardrop et al., 2016). The latter subcategory, donation-based AF, expects nothing but the feeling of having supported a cause and expects no monetary benefit from the money delivered by investors.[3] NFRAF is not thoroughly reviewed in this document.

Figure 1: General Taxonomy of AF from the Perspective of Capital Flows



Source: Author's elaboration.

2.2.2. Financial Return Alternative Finance

This document focuses on what is commonly known as Financial Return Alternative Finance (FRAF); that is, when we talk about AF or crowdfunding we are actually meaning FRAF. In this category, investors are expecting future monetary returns on their investment in the projects offered by the promoters. This category is usually subdivided into the categories of equity-based and loans-based.

Equity-based AF is the model where a platform connects projects and investors to raise capital. Investors select projects and invest, expecting financial return in the form of equity

[2] Examples of rewards-based platforms are: Kickstarter: https://www.kickstarter.com/learn?ref=nav, Kickante (Brazil): http://www.kickante.com.br/, idea.me (Argentina, Brazil, Mexico, Colombia, Uruguay and the United States): http://www.idea.me/about and Fondeadora (Mexico): https://fondeadora.mx/comofunciona as retrieved during February, 2016.

[3] Razoo is one example of this sort of AF: https://www.razoo.com/us/story/Operation-Rainbow-Helping-Kids-In-Mexico-March-16

and/or dividends.[4] Loans-based AF, alternatively known as online lending, among other credit-related terms, occurs when promoters are looking for financing through any form credit to fund their projects. Investors lend their money to promoters, expecting a monetary return in the shape of capital and interest. Loans-based AF is the fastest growing type of AF in Latin America (Wardrop et al., 2016), mainly directed to the consumption and MSME segments, which in many cases were previously underbanked or unbanked. For the latter segment, a wide range of categories exists, ranging from real estate to alternative energies or medical procedures. For example, in countries such as Chile, many of the loans-based platforms are financing unbanked MSMEs through online factoring. In this model, investors can select to finance a single invoice or a group of invoices to obtain returns.

Moreover, the next section will describe, conceptually, business models that we identified, followed by possible paths for AF businesses in the region, based on international experience. We will take as a starting point online marketplace lending, or loans-based AF, since it is the most widespread model all across the region. According to Wardrop et al. (2016), 70 percent of the AF market in LAC is devoted to financing MSMEs, which puts a spotlight on the topic for policymakers in the region in terms of creating opportunities for development through credit. Furthermore, a 77 percent share of AF in the region is online marketplace lending, while just 23 percent is related to equity-based platforms. Notwithstanding, some references about the equity model will be pointed out in the text.

2.3. Basic and Complex Models

2.3.1. The Basic or Direct Model

In its simplest version (Figure 2), the AF model closely describes the basic peer-to-peer (P2P) archetype used for quite some years by online lending platforms[5]. In this sense, we are using the most generic description of the actual business models we found in the region. However, the reader must be aware that many variations may exist depending on the jurisdictions.

The model described here consists of at least six elements: (i) the red silo represents investors who are seeking financial returns; (ii) the green silo represents promoters with projects, who need funds; (iii) the lower light blue arrows initially display capital moving from investors to the platform as an investment, and then in the form of proceeds of investment or lending from the platform to the promoters; (iv) a price for capital with its return and some

[4] The most prominent example of this type of business is CircleUp: https://circleup.com/. In Latin America and the Caribbean, there are examples such as Broota (Argentina, Bolivia, Brazil, Colombia, Mexico, Peru, Uruguay, among other countries). See https://www.broota.com/, retrieved in May, 2016.
[5] The most relevant example of such platforms might be Zopa (United Kingdom): www.zopa.com

deducted fees moves from the promoters to the platform, and then as capital and interest minus platform fees from the originator to the investors, in the upper purple arrows; (v) bilateral contracts between the platforms and investors, platforms and projects, and investors and projects, respectively, are described with inner blue arrows; and (vi) the platform or originatoris represented in yellow (Agrawal, Catalini, and Goldfarb, 2013).[6]

A very important point has to be made before we start with the description of our model: this is financial disintermediation. This is a different business model in at least two of many ways: the type of intermediation we see here is different from the one in banks; where banks manage a base of deposits to leverage loans they assign themselves, they are the decision-makers. In AF, the investors are the decision makers: they choose or signal where to invest their valued money by selecting one or more projects themselves. Platforms are mainly an electronic means to connect those investors with projects. In this sense, clients' money is frequently separated from the platform's own balance sheet or is kept for a very short time while the money goes from investors to projects. Secondly, the operational model is managed without the physical presence of any of the three participants mentioned above: investors, platforms and promoters interact electronically. For these and many other reasons we will attempt to describe later, regulators in many countries around the world have chosen to create new regulations for platforms in the industry. It is useful to understand this particular business process from the perspective of how capital flows. In this sense, we will start at the bottom-left and finish top-left, following the arrows and across the colored silos in Figure 2.

2.3.2. The Cycle of Money and Contractual Agreements

As said above, the red silo represents the investor. It can be an individual investor or an institutional investor. Such an investor would search for projects through an online lending platform (the yellow silo) directly. Typically, the platform would reveal information about the project, such as its description, estimated financial information, purpose, and owners. Each investor would select those projects that match its risk profile, based on the information provided by the platform. Furthermore, a video or pictures and a story, to create a more complete social media-based profile of the project, can accompany such information. Platforms may also use technology to create investors' risk profiles with the information they send out about their preferences. These are used as inputs, and with the use of algorithms and other technological tools, platforms automatically select the projects that best match investors' preferences. This

[6] We will define a later marketplace as an online platform providing services for electronic transactions between the investors (most of the time, institutional), and the projects in the form of equity, loans, and securitized packages of loans.

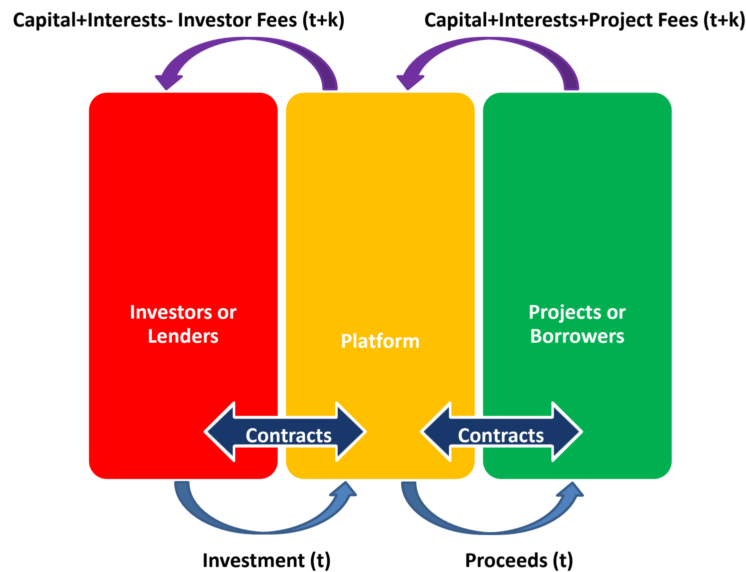
process is frequently known as automated investment. However, in LAC this process is still not popular and, in some cases, technology is replaced by human decisions on the side of the platforms, creating agency risks for investors.

In this respect, it is important to point out that since there is no physical interaction between the platform and the investors, platforms in LAC typically use electronic banking or electronic payment systems accounts as the primary means of identification. However, platforms in the region have moved forward toward requiring the full identity of investors through national identification, social security numbers, or other national identification numbers.

Returning to the flow, after selecting a project to invest in, the individual investor would select and authorize a transfer through an electronic mechanism from its bank account, debit or credit card, or electronic money suppliers to the selected project. Sometimes, platforms can constitute their own electronic money or payments platforms or even create another enterprise to issue electronic money. All in all, payment systems play a fundamental role in the industry. However, in LAC, platforms are using traditional bank accounts, their networks, and electronic payment systems as means to transfer monies. In this sense, following the flow in Figure 2, and particularly in LAC, the model of using a separate traditional bank account exclusively for clients, even in a different bank from the firm's operational accounts, is the most widely seen case. It is very important to point out that most of the time, platforms transfer monies immediately, or in the worst case, they keep them for very short periods of time. Platforms might not maintain clients' money in their balance sheets, unlike traditional banks. In this sense, in the basic model in LAC, platforms do not hold client money or, at the very least, the money is segregated from its own balance sheet.

To conclude this first section, it is also important to remark that several investors can fund one project, mitigating its credit and market risks through funding diversification. Conversely, investors can invest in several projects instead of just one, diversifying their credit and liquidity risks. Investments from the red silo in time *t* (time of the investment) are initially represented by the bottom-left blue arrow appearing in Figure 2.

Figure 2: The Simple AF Model



Source: Author's elaboration.

Thereafter, the proceeds are sent from the electronic accounts of platforms or investors to promoters, as Figure 2 shows in the blue arrow in the bottom right. They may receive the total amount requested or a portion of it, depending on the rules of the platform. In LAC, platforms frequently display projects for limited periods of time, and if a project is only partially funded in such a window, resources are not transferred to the projects and are returned to investors. This is known as the all-or-nothing model. In the case of equity, this characteristic is even more common, with platforms performing a stricter screening process on projects and sometimes even charging for the evaluation of the project in areas such as valuation, profile, and legal issues. Some of the platforms in the region require platforms to pre-fund projects to reduce the probability of having "lemons" and to ensure that funding will be completed. An alternative to all-or-nothing funding in the region is the keep-it-all model, where promoters can keep any amount raised for their projects, even if the total amount needed is not reached. This model is more frequently found in rewards-based platforms in the region. However, some of the loans-based AF platforms in the region allow this model. Nonetheless, and in relation to the information for projects, with respect to project screening, regional platforms still have room for improvement.

Across the region, it is common to find that platforms charge fees to both investors and promoters. For the former group, originators charge a commission for the use of the platform and money transfers. Typically, fees for investors are low and, depending on the country, rates

may vary in terms of the size of each individual operation. On the side of promoters, platforms charge fees mainly for the transfer of the money and operating costs. In addition, in the case of loans-based AF, platforms require promoters to repay interest and capital for their financing. We will expand on this last point later in the figure.

As can be seen from this first inspection of the model, AF reduces transaction costs between investors and promoters. Platforms act as matching mechanisms between them. Secondly, as Belleflamme, Omrani, and Peitz (2016) have shown, there are many positive and negative cross-group external effects. For investors, platforms create higher probabilities for projects to get funded and better market testing. However, if information is not clear enough on the platform, since investors rely on it to make their investment decisions, adverse selection could be an issue. On the project side, there are incentives to provide more and better information to make projects attractive to investors. However, to a large extent, there might be a larger information asymmetry than in the traditional banking model if information is not efficiently transmitted. On the other hand, successful platforms create opportunities for both groups to fund projects efficiently.

To finish with this initial segment of our chart, it is important to take a look at the contractual relationships between investors and platforms, investors and promoters, and promoters and platforms. Typically, such contracts are electronically signed within the platform. First, in this basic model, it is frequent to find that originator's contractual bilateral obligations with investors are limited to basically matching investors and projects, transferring their money to projects, and collecting or recovering the respective financial returns.[7] These contracts may include a disclosure on the risk associated with these investments, including credit, exchange, operation, or even systemic risks. For example, it is frequent to find indemnity clauses for the platforms, and in some cases dispute resolution, arbitration, and waiver procedures, usually conducted electronically or in courts in the legal domicile of the platform.

Second, promoters sign an electronic contract with the platform. Contractual obligations may include a commitment to repay the loans by the agreed date, payments for platform services, and information about the development of the project, among others. Moreover, in the case of default, promoters are subject to monetary penalties (such as interest on arrears), reporting of default to credit bureaus, the lowering of their credit rating, and sometimes even a negative impact on their reputation on the Internet. Contracts might resemble those used in traditional banking, at least in their financial components. Additionally, contracts may include

[7] See for example: https://www.afluenta.com/legales/terminos_y_condiciones_generales_version_5#introduccion or https://www.kiva.org/legal/terms#Section 7

obligations for the platforms. For example, contracts may include clauses to obligate them to deliver money to projects, to display project status on their websites or apps, and to comply with data privacy regulations. Also, clauses may include disclosure of fees, interest, and other financial charges. Dispute resolution mechanisms and a physical jurisdiction for any legal causes in contracts are also frequent components in contracts. However, both transparency and fees and other financial charges have been a cause of complaint about clients and a concern to regulators in other jurisdictions.[8]

Finally, for the loans-based AF models, a direct contract between investors and promoters may be signed for each individual operation, establishing the obligation of repayment of interest and capital for the latter, among other details.

A view of the contracts for both investors and promoters poses the issue of consumer protection for both regulators and platforms, as we will see later. To this extent, some electronic commerce companies, which are specialized in dispute resolution, are starting to appear in the ecosystem to solve small disputes more cheaply.

Box 1: AF and Technology: A Way to Cut Costs

Technology is, allegedly, the competitive advantage of Alternative Finance vis-à-vis the traditional financial sector, and it is the factor behind the competition for individual platforms and marketplaces. It lowers operating and transaction costs mainly through the substitution of human labor and traditional processes. In this sense, platforms use technology to optimize the processes for loan applications, credit scoring and rating, funding, or even collection. It also improves processes such as underwriting, in the cases where it is needed, creating efficiencies in the issuance of equity or asset-backed securities. For example, in terms of operating costs, measured as the percentage of outstanding loans, costs in traditional banking can be as high as 625 basis points (bp), while in AF they only reach 270 bp (*Lending Club,* 2016). Much of the cost reduction is explained by the lack of branches (-220 bp), and the differences in collection (170 bp in traditional banking, while 39 bp in AF) and origination (100 bp vs 39 bp, respectively). For instance, online lenders can be 60 percent more efficient than traditional banks. To be fair, it is also important to keep in mind that AF, typically, does not have the burden of traditional banking's regulatory capital requirements, which also reduces costs for industry participants.

Source: Morse (2015).

The Repayment. Following the flow of money, at a certain point after money is disbursed to promoters and their projects begin to yield some returns (or not), they must comply with a repayment schedule, very similar to those applied for traditional credit. In this sense, promoters

[8] This happens to be one of the main issues in some jurisdictions such as the United States. For reference, see: Federal Reserve Banks (New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, St. Louis): "2015 Small Business Survey". Available at: https://www.newyorkfed.org/medialibrary/media/smallbusiness/2015/Report-SBCS-2015.pdf

typically pay interest in installments (e.g., monthly or semiannually) and capital in the last installment of the loan. Investors receive capital and interest for the money they lent in the past until the conditions stipulated in the bilateral contract they electronically signed with promoters are met. The collection process is very straightforward, using electronic means for the payments; hence it is automatic and low-cost. This process is depicted in Figure 2 as the upper blue arrows in the scheme. Finally, it is worth mentioning that in the process until the completion of payments, information about the behavior of payments and even the evolution of projects might be privately shared with investors for each individual loan and the consolidated information made public.

The Default. On the other hand, in the case of a default, LAC platforms have many different approaches to the definition of when and how it happens. The most frequent approach is delinquency ageing. However, we have found that there is no consensus on the number of days, even within the same type of credit in the same country. Platforms do not rely on the definitions for banks, when they exist.

In the LAC region, platforms typically use people, telephones, and the internet as means of recovery after a default. To this extent, platforms frequently rely on existing credit regulations as the framework for recovery and collection. In some other cases, platforms hire another specialized platform devoted to this task. To close this topic, it has proven difficult to find statistics on past due loans by delinquency ageing for the LAC platforms.

Finally, with the exception of Chile,[9] it is very important to keep in mind that AF loans are mainly unsecured, in the sense that they usually lack collateral. Hence, information retrieved by the platform from prospective projects must be complete to avoid fraud, lemons, and default risk. Secondly, information about recovery must be transparent and should be shared with supervisors or even publicly.

2.3.3. The Complex Ecosystem

The simple model has evolved in different ways, depending on the jurisdiction, yielding to a whole fintech ecosystem with additional participants besides investors, platforms, and promoters. To start off with the obvious, we could add institutional investors to the red silo. Actually, several institutional investors, such as BlackRock[10] or Santander Consumer USA,[11]

---

[9] AF is growing very fast in Chile leveraged under the figure of Mutual Guarantee Societies (Sociedades de Garantía Recírpocas) and the indirect guarantee of the national development agency: Corporación para el Fomento de la Producción (CORFO).

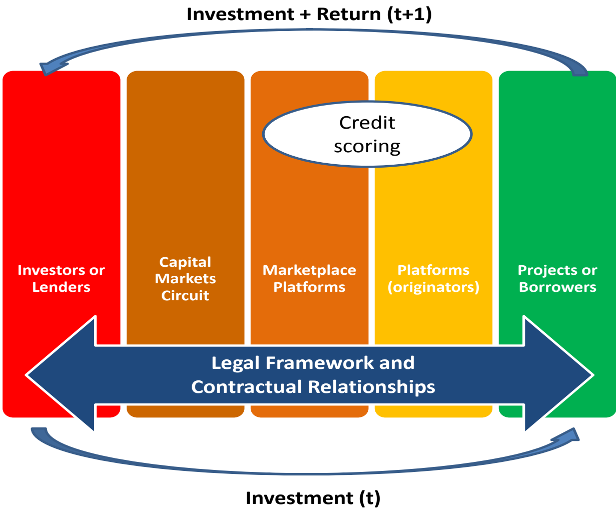
[10] http://www.bloomberg.com/news/articles/2015-02-02/blackrock-finds-few-peers-with-330-million-book-of-online-loans

[11] http://www.risk.net/risk-magazine/feature/2372612/hedge-funds-securitisation-and-leverage-change-p2p-game

have been investing in these loans directly in the United States, mainly by buying a stake of the loans or loan-based notes. The case for LAC is not as large and deep as in the United States. However, in LAC, some pension funds and investment banks are investing in unsecured loans in small amounts, mainly in Mexico and Brazil (Wardrop et al., 2016). Furthermore, securitization opens space for platforms to gather their own loans to sell them to the public. This activity clearly changes the basic model in the sense of creating balance sheet accounts, which actually belong to the platform but also leverage their business.

Moreover, although not reaching scale in LAC, a new participant known as "marketplace" might surface to securitize loans from originators in the form of rated notes which might start off as private issuances but might turn public if there is space for liquidity.[12] Marketplaces are included in a new orange silo, since such type of business is different from pure origination. Additionally, with notes, a whole capital markets circuit appears, including new participants to our ecosystem: specialized rating agencies, custody services, trading platforms, to mention some of the services linked to such platforms. These services are offered most of the times as innovative versions of the traditional financial industry equivalents. All of the above-mentioned participants base their business relationships in contracts and legal agreements, which make this ecosystem more complex (Figure 3).

Figure 3: The More Complex AF ecosystem



Source: Author's elaboration.

[12] One of the best-known marketplaces is Orchard Platform: http://www.orchardplatform.com/about/

Box 2: Credit Scoring

Around the world, it is frequent to find platforms that perform screening and credit scoring processes, which are commonly based on online information from bank accounts, online suppliers, payment platforms, or another electronic source. These scorings are used as the promoters' credit risk assessment by investors and may be a complement for regular credit bureau-based scorings. With information from both sources, a platform-generated credit score can be offered, usually with estimated interest rates or returns on investment that are correlated to the risk taken. All of this information is regularly displayed on the screen for investors, and they use it to judge the quality of the projects. On the upside, there is constant use of positive data, such as flows extracted from bank accounts, payments to providers, or any other electronic transactions. Also, big data, psychometric tests, and other technology-based advances are being used to create alternative ways to measure credit risk. This means more chances for households and enterprises formerly unbanked to get a loan. On the downside, many such models need to be tested, and lack of sufficient time series and relevant data pose a challenge for the platforms themselves and their regulators. However, few platforms in the region offer these services to their clients. This is a big difference from potential competitors from Europe or the United States that could enter LAC markets in the foreseeable future.

3. The Size of the Industry: Rapid Growth, Not Yet Systemic

Alternative finance is a growing business worldwide (Agrawal, Catalini, and Goldfarb, 2011), accounting for almost US$16.2 billion in money raised to fund projects through platforms as of the end of 2014.[13] According to BBVA, the Spanish banking group, by the end of 2013, these platforms were financing 1 cent per every US$100 financed through traditional channels. These numbers can vary according to the source of information, and since platforms are starting to be regulated, the data are in the process of consolidation.

3.1. Latin America

As said in the introduction of this document, AF in LAC countries is still small in volume, reaching around US$110 million in total in 2015 (Wardrop et al., 2016). The number is basically 0 percent when measured as a ratio of LAC Gross Domestic Product. For instance, Domestic Credit to private sector in the region is measured around 53.3 percent in the region.[14] To put this in context, in the Americas, AF reached US$36.49 billion for the same year. However, and since the base is small and it is a continually growing market, AF in LAC has reached year-on-year growth rates of 164 percent for 2014 and 97 percent for 2015. It is important to note that 66

[13] See http://www.economist.com/news/economic-and-financial-indicators/21647603-global-crowdfunding.

[14] See http://www.tradingeconomics.com/latin-america-and-caribbean/domestic-credit-to-private-sector-percent-of-gdp-wb-data.html.

percent of the total volume is directed towards enterprises, reaching almost US$73 million. Many of the platforms in the region do think that the main cause for the direction of the volume is that MSME are underserved by traditional banking (Wardrop et al., 2016).

Moreover, one of the reasons for the still small size of the industry is the lack of regulation, which prevents entrepreneurs and investors from creating AF platforms. It is very important to point out that unlike in the United States, East Asia, or Europe, it is very infrequent to find regulations or policies in LAC to encourage diverse and accessible financing for MSMEs and individuals. Such policies typically were a reaction to the financial crisis of 2008 and the tightening of capital requirements for banks. Furthermore, the regulatory agenda for fintech is still very small or nonexistent in some jurisdictions in LAC where such businesses already exist.

Loans-based AF is the most popular model across the region. This model, when directed toward businesses, reached almost US$105 million for the period between 2013 and 2015. The average size of business loans was US$57,200, with 18.5 lenders funding each loan. On the other hand, consumer lending is also important, growing very fast (553 percent) from 2014 to 2015, reaching US$19.43 million with an average loan size of US$3,539 and 201 investors. Conversely, equity-based AF is still very small, with a reported volume of only US$2.05 million, but it is a great opportunity for the future, mainly for entrepreneurs who are creating innovative businesses.

In this regard, it is of vital importance to take a look at the size of the country markets in LAC. First, in terms of volume, Chile is in first place, with US$47.6 million, basically originated through loans-based AF. In second place is Brazil, with a more diverse market than Chile's, reaching US$24.2 million divided among consumer loans-based (US$9.6 million), reward-based (US$5.6 million), equity-based (US$1.7) and business loans-based AF (US$1.3 million). It is worth mentioning that the invoice trading sector and real estate crowdfunding have some volume in Brazil. In third place is Mexico, with a volume of US$13.2 million and triple-digit growth for the 2013–15 period. Business loans-based AF (US$5.8 million) leads AF in Mexico, followed by rewards-based (US$3.6 million) and consumer loans-based AF (US$2.8 million). Finally, in Argentina, consumer loans-based (US$7 million) and business loans-based AF (US$1.2 million) are the most important categories. Some other countries in the region, namely Colombia, Paraguay, and Peru, have small but fast-growing ecosystems.

Several messages come from the data in Wardrop et al. (2016). First, the driving force of AF ecosystem in LAC is loans-based AF, but more specifically, business loans-based AF. This is a possible path for the industry in future years, and policymakers should closely follow its trajectory. This could be an alternative, but also a complement to traditional banking and a

solution for the problem of how to finance productive development, especially that directed towards MSME. Secondly, although it is not systemic, AF has been growing at a fast pace all across the region, and unless a large reputational risk materializes, we expect this pace to continue. Regulation should minimize such risks. Third, equity crowdfunding is still very small in the region. To some extent, this is the same trend that can be found in North America. However, this category of AF represents an opportunity itself for entrepreneurs to finance their ideas, and we also expect rates of growth to be high in future years. We may fall short in the analysis of the data, but we strongly recommend taking a look at Wardrop et al. (2016) as a basis for understanding what is going on in the region in terms of AF.

One way to foster the growth of this promising business is regulation. Prudential regulation with requirements that actually allow the AF industry to grow, with proper adequacy in terms of governance, risk management, capital, and liquidity, could actually reduce or eliminate regulatory uncertainty and foster industry growth. This has been the case for jurisdictions in Europe and even in the United States. In the next section, we will talk about the reasons to regulate and we will propose some principles for regulation in LAC, based on the experience from abroad but also from the dialogue that IDB has been sustaining with policymakers and regulators in the region.

4. Reasons to Regulate AF in LAC: Productive Development Financing, Risks, and Consumer Protection

There is a set of factors that create the need for regulation in this industry. In this section, we will briefly discuss the challenges for regulators and policymakers in terms of what we have seen within AF platforms in LAC. This is by no means a comprehensive and exhaustive list, but we are covering the most visible risks identified in the regional platforms. Some of the issues will be related directly to the recommendations in the last sections of this document. We will divide this brief analysis into three groups: policies for productive development financing, risks, and consumer protection.

4.1. Policies for Productive Development Financing

MSME growth, productivity, and competitiveness depend on a wide range of factors, such as the business climate, formalization incentives, human capital, the quality of infrastructure services, and access to financing. There is extensive literature on the empirical evidence of the

latter problem and the rationale behind the correlation between access to financing and productivity.[15]

Some governments across the region are aware of this and have included AF as one of the possible solutions for the problem of access to financing for MSMEs. For example, the Government of Chile has recently issued their "Productivity, Innovation and Growth Agenda" where there is an explicit support to "emerging financial products." Crowdfunding is specifically mentioned within the text.[16] It is not a coincidence that Chile is one of the most rapidly growing markets. Such support has materialized in the form of guarantees backed by the public development bank (CORFO), which in turn have been used by loan-based AF platforms to secure loans, mainly to MSMEs. Such policies fostering alternative financial instruments and institutions have also worked all across the European Union (both at the regional and the country levels), the United Kingdom, and the United States. One of the results has been the emergence and development of platforms.[17]

To conclude, policymakers across the region can complement traditional financing tools by creating a framework to foster AF. Such policies may seek to diversify financing sources, and create access, use, and competition for unbanked or underbanked individuals, but more importantly, for MSMEs. Coordination within governments is needed. Financial regulators and financing, productivity innovation, and information technology policymakers should engage each other when regulating the AF sector.

4.2. Risks by Silos in the Basic Model

4.2.1. Platforms

As we have seen above, AF platforms are mainly a coordination tool and a means to match supply and demand for funds. In the basic model, operational and cybersecurity risks are the most immediate risks they face. A potential platform collapse due to a failure in its systems, controls, network, or infrastructure is an issue that platforms certainly face. There are no regulations in terms of resolution mechanisms or living wills to solve this issue in the region. Conversely, since platforms manage a lot of valuable financial consumer data (coming from both investors and promoters), including identification and credit scores, among others,

---

[15] For a review of the literature and an explanation of the rationale for productive development financing programs, see: “Support to SMEs and Financial Access/Supervision Sector Framework Document” (Inter-American Development Bank, document GN-2768). Available at: http://www.iadb.org/en/sector/financial-markets/sector-framework,18392.html.

[16] The Agenda is available at: http://www.agendaproductividad.cl/.

[17] Several references for the UK case appear at Cambridge Centre for Alternative Finance Web page: https://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/publications/

cybersecurity risk is very relevant because of security breaches. Finally, platforms are also exposed to malicious attacks from hackers with purposes beyond just breaching data.

In addition, platforms face money laundering and terrorism-financing risks, which are magnified by the fact that customer knowledge is difficult to achieve in some jurisdictions with the use of electronic identification. Although the business is not financially regulated, many of the provisions coming from laws on anti-money laundering and combating the financing of terrorism (AML/CFT) may apply to platforms, mainly if they manage clients' monetary resources. This particular risk is not precisely identified in many platforms across the region.

4.2.2. Investors

Investors, in particular, are exposed to a series of financial risks when investing in FRAF. First, given the unsecured character of loans and the uncertainty related to the type of equity investments that we have seen across LAC, investors face capital risk. This risk is defined as the probability of losing all or a portion of capital investment. This risk is particularly important in the equity-based model, where investors absorb the losses more directly. Secondly, investors face the credit risks associated with defaults on the repayment of interest and capital in the loans-based model. This is related to at least two factors: (i) the information that the platform delivers to potential investors before investments, and (ii) the ability of investors to identify lemons and to efficiently perform screening on projects (this is related to consumer protection issues). To this extent, we have found some platforms in the region that have compensation funds to partially cover these risks. However, these funds could create adverse incentives to reduce screening by investors. Third, since investors in LAC have no secondary markets for debt and equity in FRAF, when they need to exit, investors face illiquidity risk. Even when other investors are willing to take the loans, the lack of a formal secondary market is an issue.

4.3. Consumer Protection Issues

Consumer protection is a key issue in AF. Clearly information asymmetries are important in the basic model. First, as explained above, investors may not have the knowledge and/or the experience to correctly screen projects, creating an adverse-selection problem. Furthermore, investors may lack the ability to properly identify the probability of success of a project. The effects of this information asymmetry may multiply to a large number of investors if the first investors funding a project signal its financial and operational soundness, which creates herding (Lee and Lee, 2012).

The information that platforms deliver to investors may also be asymmetric in the sense that investors are unaware or only partially aware of two actions of promoters: first, the actual use of the funds and second, the situation of interest and capital or dividends payments. This is the moral hazard problem for AF platforms.

Moreover, investors face fraud risk in the case where projects are completely anonymous or the identification verification mechanisms on the side of platforms are nonexistent or weak. Some of the platforms in the region have wisely coped with this issue by requiring financial consumers to have a traditional bank account as a mechanism to mitigate this risk.

Another agency problem may arise when platforms are making investment decisions on behalf of their clients. Although robo-advisors and robo-investors or any other technology-based investment decision tools are not well developed in the region, such mechanisms may lead to model risks and potential conflicts of interest, to the detriment of financial consumers. This is even more important when platforms invest in the projects they promote. By the same token, investors' risk profiles might not match the project platforms assigned to them. It is very important to point out that some platforms in the region assign projects manually, based on the investor's risk profile. On the other hand, as pointed out above, the lack of transparent fees and commissions for both investors and projects is one of the most frequent consumer protection issues in the industry. It is essential for the market to create a culture of transparency to this extent.

Finally, there is no standard model to administer clients' assets across the region. In the case of the basic model, monies are managed in a variety of approaches: omnibus accounts, separate consolidated accounts, and so forth. In the particular case of invoices, a frequent treatment is to use the same methods used by the traditional factoring industry for custody, administration, and transfer of such assets. Much still needs to be done to protect clients' assets across the region.

5. Regulations around the World and in LAC Countries

5.1. Regulations around the World

Several countries around the world have already regulated AF with specific acts and laws devoted to the topic. Kirby and Worner (2014) provide a rigorous and clear review up to 2014. It is important to point out, however, that regulators around the world offer different approaches to the issues that we described in the last section.

As a reference point, we will briefly summarize topics included in Spanish and British regulations. The former is set in a legal tradition and a language that happens to be closer to the ones we have in Spanish-speaking LAC countries, while the latter happens to be framed within the Anglo-Saxon tradition, to fit some of the Caribbean countries. The purpose of this subsection is to serve as a reference for regulators who want to review their regulatory proposals based on existing experiences from abroad.

i. **Spain:** For Spanish-speaking countries, we strongly recommend reviewing AF Spanish regulation, Law 5/2015[18] because of its legal framework, which is closer to that of many LAC countries, and the approach that it takes. This young regulation has not been reviewed yet, but it is logically constructed towards the development of the basic model described above. In this sense, it rules out the more complex ecosystem. In Spain, the securities supervisor, the Securities Commission (Comisión Nacional de Mercados de Valores, or CNMV), is in charge of supervising AF. The main components of this law are: **(1) A comprehensive MSME approach:** It is important to say that the framework set for this law is the improvement of financing conditions for MSMEs in Spain. Thus, a complete policy for this purpose falls under the platform's regulations. **(2) Clear definitions:** This particular Spanish law clearly defines what constitutes a platform, even discarding other institutions. They define platforms as: "(…) authorized companies whose business involves contacting, in a professional manner and through web pages or other electronic means, a plurality of individuals or legal entities that provide funding in exchange for monetary performance, called investors, natural or legal persons applying for funding on their own behalf to invest in participatory project financing, called promoters (…).[19]" This definition is close to what we understand in this document as FRAF. Furthermore, Spanish regulators define a domicile for the platforms' activities and an authorization and registration regime under the CNMV. Moreover, in contrast to its European peers such as France or Italy, Spain does not consider platforms to be financial intermediaries but rather exclusively social enterprises. **(3) Authorized activities:** This regulatory body describes platforms' authorized activities and does not define investors' activities as deposits, ruling out their implications for banking regulation and separating the activities. This is a very sensitive topic in many LAC countries that is cleverly solved by this regulation. In addition, platforms are divided into loans-based and equity-based, just as we did in this document. **(4) Prohibition regime:** Prohibitions are

[18] Gobierno de España: "*Ley 5/2015, de 27 de abril, de fomento de la financiación empresarial.*" Available at: https://www.boe.es/boe/dias/2015/04/28/pdfs/BOE-A-2015-4607.pdf
[19] Ibid.

established for platforms, including automated investments, advisory, and direct participation in loans, among other activities. In this sense, it is also clear that a separate, distinct license is required for those platforms that want to be payment entities. **(5) Capital requirements:** Capital requirements are established for the platforms to operate, basically covering the minimum requirements for their operation. These capital requirements begin at €60,000 and increase depending on the volume of transactions or civic responsibility insurance as an alternative. **(6) Proper conduct regime:** The law establishes proper conduct requirements, including information disclosure obligations, conflicts of interest management, disclosure of related projects for platforms, advertising, and information keeping. **(7) Due diligence and maximum amounts and time windows for projects:** This law imposes requirements on platforms in terms of due diligence towards promoters, including the obligation to identify it. Also, a maximum amount of €2 million is imposed on each individual project in each platform and €5 million when directed to qualified investors. In this sense a requirement to maintain projects for a limited time is proposed, as well as requirements regarding the information for each project. To this extent, the responsibility of promoters in terms of information is explicitly stated. These requirements are specifically and separately determined for both equity and loans-based platforms. **(8) Investor protection:** The law defines the types of investors and separates them between accredited and non-accredited investors, creating different requirements for the former, including minimum income of €50,000 or capital above €100,000. This law also declares previously stated provisions for consumer protection to be applicable. **(9) Supervision:** A supervision and sanctions regime is clearly established, including the annual obligation to report to the supervisor, sanctions, and the description of infringements.

ii. **United Kingdom[20]:** The United Kingdom was one of the very first jurisdictions to issue a specific regulation for AF. It is important to note that supervision, oversight and regulation rely on the Financial Conduct Authority (FCA) (FCA, 2016). This is a rather dynamic regulatory body that is under constant review and amendment, having at least three large reforms during the period 2013 to 2014. Last changes refer to segregation of clients' money for loan-based crowdfunding (FCA, 2016). These changes come as a result of periodic back and forth between the industry, the general public, and the FCA through consultation papers, policy statements and other documents that allow

[20] UK regulation is to a large extent aligned with the Markets in Financial Instruments Directive –MiFID- within the European Union Law.

discussion among groups of interest and the FCA.[21] The result of this process and the evolution of the regulation are pending. It also draws a big lesson for other jurisdictions: the need for regulatory authorities to talk with the industry. As a result, platforms are satisfied with regulations in the UK: 91 percent of Lending-based platforms consider that FCA regulation for AF is "adequate and appropriate." Furthermore, 5.7 percent of such platforms consider that "tighter or stricter" regulation is needed (Zhang et al, 2016). For purposes of comparison, although acknowledging the differences, we will follow the order we followed to describe Spanish regulation. In this sense, the components of UK regulation are: **(1) Clear definitions:** The United Kingdom uses a very simple definition for AF: "(…) Crowdfunding is a way in which people and businesses (including start-ups) can try to raise money from the public to support a business, project, campaign or individual (…)." The FCA divides the activity into: donation-based, pre-payment or rewards-based, exempt, loan-based and investment-based. This last category refers to AF platforms issuing securities mainly in the form of shares and debt. It is fair to say, however, that the existence of a secondary market for these types of securities is still being developed. Now, regulation covers both loan and investment-based. This is a different taxonomy to the one applied in this document and also different from the Spanish standard. **(2) Authorization regime:** The FCA establishes an authorization regime within the Perimeter Guidance Manual to explain authorized activities and exclusions.[22] Requirements include previous conditions known as "threshold conditions." These are minimum requirements to accept the authorization for platforms. In this sense, platforms should: (i) submit the current legal status of the firm, including its physical location and a business model; (ii) send a description of platform's non-financial and financial resources; (iii) detail the appropriateness of the platform and its personnel, (iv) send details about the current operational situation of the platform, which should be operational or nearly operational; and (v) understand the requirements for FCA authorization and the permission profile. One huge difference between the United Kingdom and Spain is the fact that platforms are recognized as financial institutions but also by their ability to advise clients. **(3) Capital requirements:** The UK standard for capital is kind of a "golden rule" for other jurisdictions, including Spain. Such minimum capital requirements are intended to ensure continuity of operations in the event of

[21] See for example: FCA: "PS14/4: The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media", 2014. Available at: https://www.fca.org.uk/news/ps14-04-crowdfunding and Call for input to the post-implementation review of the FCA's crowdfunding rules." 2016, available at: https://www.fca.org.uk/your-fca/documents/call-input-crowdfunding
[22] See: http://fshandbook.info/FS/html/FCA/PERG/2.

exogenous shocks. It is the maximum of: a fixed minimum amount of £20,000, or a volume-based amount calculated as the sum of the following amounts of loaned funds outstanding: 0.2 percent of the first £50m, 0.15 percent of the next £200m, 0.1 percent of the next £250m, and 0.05 percent of any remaining balance above £500m. However, starting on April 1, 2017, the minimum capital requirement will be £50,000. Regulation has considered several transition periods and changes to let firms accommodate over time[23]. No insurance is considered as an alternative, unlike Spain. Investment-based platforms, as it appears to be obvious at this point, have higher minimum capital requirements. **(4) Proper conduct regime:** In the area of conduct, the United Kingdom has been more detailed than many jurisdictions. They define clear principles for business, including among others: integrity; skill, care and diligence; financial prudence; conflicts of interest management; and obligations for platforms to deal openly and cooperatively with regulators. Specific conduct rules include requirements for acting honestly, fairly and professionally; information disclosure prior to the provision of services; acting always in the clients' best interest; advisory, among other topics.[24] **(5) Due diligence:** In particular, loan-based platforms are responsible for assessing the creditworthiness of borrowers, including their ability to repay. Also, the evaluations they perform for such duty must be revealed as the risks that such investments represent for investors. On the other hand, platforms are obligated to establish controls to diminish the possibility of fraud and money laundering in accordance with regulation on the subject. A specific financial crime guide was published for platforms and the general public, recognizing its possibility to exist on investor or projects side of each transaction.[25] In summary, the burden of identifying both financial crimes and money laundering falls on the platforms. **(6) Financial consumer protection:** On this subject, UK regulation is very explicit and detailed and the range of topics it covers is rather wide. We will cover the main aspects of the regulation, starting with the types of investors. In the case of retail consumers, there are three categories: Certified or high net-worth investors, ordinary investors who receive advice, and ordinary investors who invest less than 10 percent of their net assets, with requirements on understanding of the risks. Each category requires disclosure by the investor, with the regulatory burden falling on the platform to clearly identify the type of investor. With respect to specific investor

[23] This is a result of appearing in the latest FCA document addressing AF. See FCA (2016).
[24] See for further detail: https://www.handbook.fca.org.uk/handbook/COBS/2/?view=chapter.
[25] Financial crime guide is available at: https://www.handbook.fca.org.uk/handbook/FC/link/?view=chapter.

protection, the FCA issued a complete document on the subject in 2014[26] in which, after explaining the authorization regime, some specific disclosure practices are detailed. Requirements include standards for promotions, disclosure of rates, and even specific rules for payday loans. For example, a specific obligation to disclose sufficient explanation about the risks an investor is taking, before signing any agreement, is included in the rules. Also, on the project side, there is an obligation to provide notices to borrowers in arrears about the payable fees and the procedures in case of default before the platform provides its services. Moreover, in terms of fees, a complete manual exists. The bottom line on this subject is that the total prices or the basis for their calculation, including commissions, charges and expenses, and even taxes must be disclosed to investors and project owners before the provision of any service. Finally, it is worth mentioning that after a review, FCA will publish additional rules for promotion and advice. For reference, the Conduct of Business (COB) section from the FCA Handbook sets the standards for the platforms in relation to prospective lenders and lenders in the loan-based space.[27] **(7) Separation of client money:** Specific rules and guidance are included in the UK regulation for platforms that safeguard and administer assets or money on behalf of clients. These include the provisions and classification of client money, resolution, among others. Rules are oriented towards protecting client money, including the maintenance of information in cases of insolvency. **(8) Dispute resolution:** Most of the dispute resolution complaints (DISP) procedures are applicable to AF activities. They include provisions about what a firm must do in case of a dispute with a financial consumer, time for resolution of the disputes, obligations to report disputes and resolutions to FCA, the role of the ombudsman, territorial scope of jurisdictions for complaints, and their resolution. **(9) Corporate governance, senior management, controls:** Regulation includes governance requirements for platforms, including a clear organizational structure, lines of responsibility, processes to identify, monitor, and report risks, among other specifications. Minimum requirements in terms of skill, knowledge, and expertise of staff include suitability and competence of personnel in every position. Approved persons[28] within a platform should comply with integrity, due skill, care and diligence, market conduct practices, among other requirements included in the

[26] FCA: "Detailed rules for the FCA regime for consumer credit (including feedback on FCA QCP13/18 and 'made rules' (PS14/3), 2014, available at: www.fca.org.uk/static/documents/policy-statements/ps14-03.pdf.
[27] Available at: https://www.handbook.fca.org.uk/handbook/COBS/.
[28] A fit and proper test is applied to determine if a person is considered to be an "approved person," including provisions for such personnel to act with honesty, integrity, competence and capability. Financial soundness is also required.

"Statements of Principle and Code of Practice for Approved Persons."[29] Such requirements are proportional to the scale and complexity of the business. Finally, record-keeping rules are required as a mechanism of control for all the services provided, with the obligation to keep records in mediums that allow future access and the decomposition of every transaction at any of its stages. **(10) Non-readily realizable securities:** UK regulation contemplated the creation of a new type of asset denominated Non-Readily Realizable Security to represent those assets issued through Investment-Based platforms, which in turn have no or limited secondary markets and are have non-easily-to-determine pricing. **(11) Decision procedures and penalties:** The Enforcement Guide[30] is applicable to enforcement in the AF space, including information gathering, investigatory powers, and proposed monetary and disciplinary sanctions, as well as guidance on whether what constitutes criminal acts is contained in such document. A very important point to mention here is international cooperation, where at the request of an overseas regulator, the FCA may dedicate resources to exercise its investigatory powers to cooperate, including information requirements and consultations with approved persons, among other powers. Finally, for UK regulation we strongly recommend taking a look at Wardrop and Ziegler (2016) for a detailed review on the topic and even foreseeable risks.

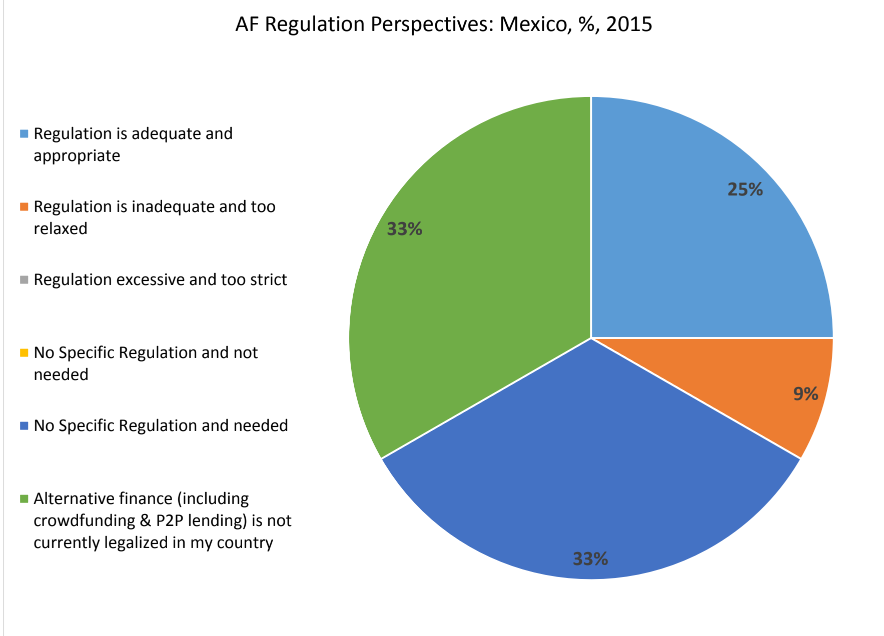
5.2. The AF LAC Industry Claims to be Regulated

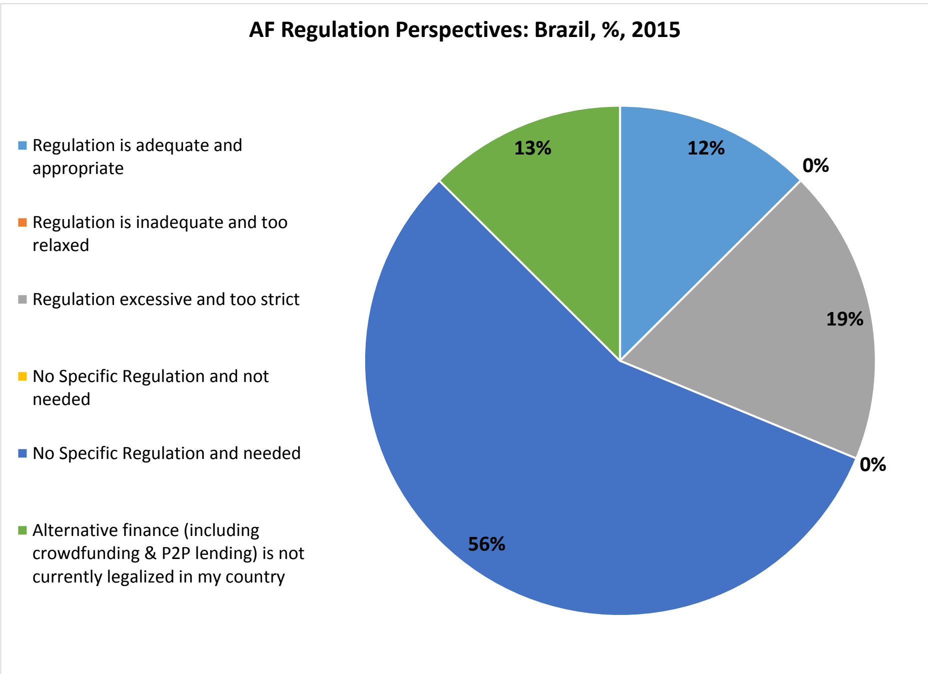
As said before, as of the time of this study, there are no specific AF regulations existing in LAC. We also noted that input from the industry is very important for regulators to shape their regulations. In this sense, we are using unpublished, selected data provided by the Cambridge Centre for Alternative Finance to depict what LAC platforms think about the future of regulation in the AF space. To the question of what they thought about the perspective on AF regulation, there is an apparent consensus on the non-existence of specific regulations in a sample of countries composed of Argentina, Brazil, Chile, and Mexico. However, the need for specific regulation is not as evident for the consulted platforms. For example, platforms from Brazil (56 percent), Argentina (33 percent), and Mexico (33) consider that there is no specific regulation and think that it is needed. Moreover, in Chile 100 percent of the platforms think that AF is not currently legalized, in contrast to Argentina (67 percent), Mexico (33 percent), and Brazil (13 percent). In the latter, 19 percent of the respondent platforms consider that regulation is

[29] See https://www.handbook.fca.org.uk/handbook/APER/.
[30] See https://www.handbook.fca.org.uk/handbook/document/eg/EG_Full_20160422.pdf.

excessive and too strict, and another 13 percent think that regulation is adequate and appropriate. Finally, 8 percent of the Mexican platforms think that regulation is inadequate and too relaxed (see Figure 4 for further reference).

Figure 4: Perspectives on AF Regulation: Mexico and Brazil, 2015 *(in percent)*





Source: The Cambridge Centre For Alternative Finance, Cambridge Judge Business School (2015).

6. Recommendations for Regulation of the AF Space

Alternative finance regulation is not an easy task: this industry is very new, complex, and changing, as it is technology. It is obvious to state that good regulation will allow better oversight, supervision, and enforcement, but it is less obvious that it will foster industry growth. Taking into account the diverse legal traditions within the LAC region and the characteristics of the industry, we will propose a set of minimum recommendations for regulation. Such recommendations taken as a set could act as a framework to allow regulators to adapt and change regulation through time. Best practices show that this process should be accompanied by constant dialogue with the industry. Finally, we strongly recommend adopting regulations that are balanced and proportional to the nature, size, and character of the platforms.

Regulators must strike a balance between being specific in the regulation (in many LAC countries this should be in the form of an act or law) and leaving room for regulatory specifications in the rules implementing it. One approach could be to create a principles-based regulation and specific rules. We propose 10 recommendations with the minimum contents of regulation (or its principles), keeping in mind that regulators can adopt them in part or as a whole.

6.1. Regulatory Recommendations for AF Regulation

6.1.1. Recommendation 1: Clearly define the subjects of supervision and oversight

We strongly recommend identifying present, and if possible, future participants within the AF ecosystem. A good starting point could be the simple ecosystem described in Section 2 of this document. A definition of the platforms, investors, and promoters can easily prepare the terrain for the rest of the regulation text. Defining the platforms that are the objects of oversight and supervision will also determine whether or not they constitute financial intermediaries. In addition, the definition of investors is relevant in terms of choosing, or not, the path of categories of accredited and non-accredited investors. The regulatory implications of one or the other regime will affect the type of investor protection that the regulation should include.

6.1.2. Recommendation 2: Taxonomy

Along with the subjects of supervision and oversight, a clear taxonomy of the activity should define the scope of regulation. As explained above, and because of the types of risks they

involve, it is useful to define what constitutes financial AF to frame the regulatory scope. In this sense, the approaches are diverse in compared regulations, as shown in the last section. Hence, it is a pivotal decision whether or not to include the issuance of loan-backed, equity, or other types of securities within the taxonomy of AF business. Experience in several jurisdictions shows how AF needs securities issuance to grow in size. If positive, this decision poses a challenge to supervision in the sense that platforms create accounts in their balance sheets. Additionally, specialized online platforms, the marketplaces, might appear in the ecosystem, requiring specific regulation for their activities. In any case, it is important to leave space for further details in taxonomy in rules implementing the regulation, including the possibility of including a category of Alternative Finance related activities. These could include auxiliary activities for AF business, such as: credit scoring and rating, custody and administration of assets, dispute resolution, among others, to be defined in rules for the regulation.

6.1.3. Recommendation 3: AF definition

It will be useful to define AF as separate from banking and other financial activities. It is necessary to define its scope and prohibitions. These should include the types of activities a platform can perform, such as loan and equity contracts subscription; equity and other types of securities issuances; projects selection, classification, scoring, publication and promotion; use and development of electronic channels to communicate investors and projects; fund collection; and any other activities considered by the regulator to be performed by platforms. In this sense, another pivotal decision appears in the sense of determining whether or not platforms are allowed to perform advisory activities for their clients, posing another issue in terms of consumer protection. This is a very important decision because of the implications for consumer protection and the possibility of misconduct by platforms. Finally, the definition of investment and fundraising activities within the AF framework should be differentiated from deposits to avoid confusion and to separate this activity from the already regulated traditional financial services.

6.1.4. Recommendation 4: Authorization regime

A clear and specific process giving authorization powers to an economic or financial authority should be specified in the regulation. This is not an easy task because of the variety of institutional structures that we have across LAC. When a banking supervisor is separated from a securities supervisor, it is frequent to find that the former takes charge of the AF business. However, this is not written in stone. After defining the supervisor, specific and proportional requirements and specific due dates should be established within the regulation. A platform

should be operational or close to being operational when asking for authorization to operate, and a list of requirements, which should at least include but not be extensive to the following criteria, should be developed:

i. **Domicile and legal status of the platform:** A domicile, including a physical address in the local jurisdiction and the creation of a corporation or whatever kind of society the regulator requires. With respect to the domicile, cross-border operations, and fiscal implications of platforms, some jurisdictions have opted to authorize investors and promoters who actually have a local tax registry or a local bank account, closing the chances for foreign platforms. Given the nature of the authorization regime for financial intermediaries in the region, this could be a good approach.

ii. **Business model and services:** Firms should apply for a license for a loan-based or equity-based model platform. At the international level, licenses are usually independent, since the level of knowledge and specialization, technology, among other characteristics is different for each type of businesses. A description of the business model, including the technology it uses and the essential processes, should also be included.

iii. **Operational, technology, and cybersecurity risk management[31]:** A detail on operational and cybersecurity risk management is a vital regulatory requirement for platforms. Regulations should include provisions to identify, control, and mitigate such risks because AF is a technology-based industry.

iv. **Governance and personnel:** A standard on the financial soundness, reputation, competence, experience, and knowledge of directors and managers should be established. If decided by the regulator, proper tests or physical interviews should accompany this process, at least for the approved person(s) who will act as legal representatives for the company and/or persons legally authorized to speak with the regulator. Knowledge of finance should be demonstrated and proven with experience in any case. Regulators should also create minimum criteria for platform governance, which should be proportional to their size, nature, and business model. Finally, conflict of interest rules should be established.

[31] A complete report on the state of cyber-security in LAC was published by the IDB. It is available at: https://digital-iadb.leadpages.co/ciberseguridad-en-la-region/

v. **Resolution and living wills:** Regulation should provide guidance on the minimum requirements for platforms to guarantee the continuity of financial transactions and operations in case of partial or total collapse. This includes processes such as collection.

   Minimum social capital: A minimum social capital should be demonstrable by the prospective platform.

6.1.5. Recommendation 5: Minimum capital requirement

A minimum capital requirement for platforms is recommended to guarantee their operational activities when developing the simple model. We insist on the criterion of proportion and in this sense we recommend adding a variable volume according to the amount *a là* FCA. Furthermore, every license for a platform should have an independent minimum capital requirement. Additional capital requirements should apply for platforms that actually have a balance sheet (i.e., which manage clients' assets in any way).

6.1.6. Recommendation 6: Due diligence

Standards should be addressed in at least two ways. First, a minimum standard for the identification of promoters and investors should be performed by platforms. This, despite the fact that in many cases, both types of financial consumers use existing payment systems managed by banks or other institutions with AML/CFT provisions. Secondly, regulations could include obligations for platforms to assess the creditworthiness of borrowers in loans-based AF. Moreover, minimum provisions to verify the destination of the monetary resources towards the promoted projects could be included in the regulation. This provision could also help reduce the risk of financial fraud and other criminal activities.

6.1.7. Recommendation 7: Conduct of business

Different rules should apply for loans-based and equity-based platforms or investment-based platforms in wider taxonomies. Also, a conduct of business applies for platforms in two different directions: investors and promoters, being the base for mitigating potential financial consumer abuses. In this sense, we recommend as minimum contents:

i. ***Information to be delivered by platforms to both investors and promoters* before *any services are provided:*** In any case, information requirements should follow the basic criteria of being homogeneous, non-discriminatory, and easy to find. Information about the firm, including the services provided, contact

information and personnel, references to the technology used, qualification and application criteria, types of financing, types of investments, risks of investments, terms of service, resolution mechanisms for disputes, among others, could be included in the regulation.

ii. ***Information to be*** **required** ***by platforms to investors*** **before** ***any services are provided: Types of investors:*** To further guarantee investor protection, regulation should provide an investor categorization regime. This is not to add red tape to the AF space, but rather to mitigate potential financial consumer issues. A reference for the types of investors could be the aforementioned UK regime. Many of the current LAC regulatory bodies already have a client categorization rule and, in some cases, it could be applicable or adjusted to AF. In this sense and beyond due diligence, it is a responsibility of each platform to correctly address the issue of client categorization and it should be pointed out in the regulations, differentiating obligations to each type of client. It is also important to include provisions for the conditions under which institutional investors can enter the AF investment space.

iii. ***Information for investors after sign up in a platform:*** Following the same basic criteria, primary regulation should include:

- **Risk disclosures:** The obligation for platforms to disclose risks for investors, including the possibility of total loss of capital when investing in loans, equity, or other AF-related securities. For example, dilution risks in equity investments should be properly explained to equity investors as well as their rights as shareholders.
- **Contracts:** Minimum requirements on electronic contracts to be signed with investors should be included for the platforms.
- **Information about the projects in the simple model:** Rules about the description, characteristics, and purpose of the projects that platforms should disclose to investors should be included. When applicable, for loan-based models, a rating, including its methodology, could be included as information and should be regulated.
- **Investments information:** Regulators should also set a standard for the information that investors need for the securities they are investing in, such as prospectuses for asset-backed securities. Since such assets are

not immediately liquid, a risk disclosure on liquidity could be required from regulators in such cases.

- **Project's financial information:** This should be included but not restricted to project's total amount, including capital and interest and/or amortization tables for the case of loan-based AF; dividends and dates for their delivery for equity-based AF; estimated return; guarantees; borrowers repayment status, and any other information considered relevant by the regulator for the investors.
- **Fees and other financial charges:** Regulations should require disclosure of fees, commissions, or any other financial charges applicable to investors.
- ***The character of investments:*** Platforms should be required to disclose that investments acquired through the platform are not subject to any deposit insurance scheme and do not constitute a deposit.

iv. ***Information to be* required *by platforms to promoters* before *any services are provided:*** Since taxonomy may vary, we assume the simple model depicted above first. In general, requirements for individuals and legal entities must be different, and it is an option to increase requirements depending on the size of the investment. Now, when securities issuance is promoted, appropriate and proportional regulatory requirements should be established.

v. ***Collection:*** Regulations for collection could be also included for platforms to mitigate the risk of potential abuses.

Client money and other asset rules: There should be specific provisions for the existence of Chinese firewalls between the platforms' capital and monetary resources and clients' monies. The regulator should decide whether or not to allow platforms to hold clients' money and the rules for its segregation (escrow accounts, trusts or any other mechanism). It is also important to bear in mind that specific asset management rules should apply for firms managing receivables or other commercial documents from clients.

6.1.8. Recommendation 9: Financial consumer protection

Regulation should include explicit provisions for investor and promoter protection. In some of the LAC jurisdictions existing general consumer protection regulations might be applicable to AF, and the regulator should specify which provisions apply. In this sense, strong coordination

with public institutions dealing with consumer protection is recommended for supervision and oversight but, more importantly, for disputes resolution. In any case, firms must be able to internally resolve financial consumer disputes and complaints, and time limits, records, and obligations for the report could be included in the regulations.

6.1.9. Recommendation 9: Supervision, oversight and sanction authority

Depending on the legal tradition and the institutional arrangements of each country, the appointed AF supervisor should have ample authority and faculties to perform its duties. Some of the topics to be included are:

i. ***Information delivery:*** In terms of oversight, whenever possible, regulation should grant authority to the supervisor to receive real-time information from platforms, using technology and setting a standard of information delivery. Otherwise, the delivery of periodic information should be established, including at least the financial status of projects, default and delinquency rates, and reserves. The establishment of a default standard could be a transitional rule with benefits for the industry and financial consumers, not to mention the supervisors.

ii. ***Financial statements and annexes:*** Periodic delivery of financial statements should be required of platforms to state their financial position. Some other information could be included as an additional requirement for platforms, including rejected projects, financial consumer disputes and complaints, among any other information considered useful by the supervisor.

iii. ***Inspection faculties:*** On-site, but mainly off-site supervisory powers should be granted to the oversight authority. The reason for this emphasis is the electronic and digital character of the business. An obligation for platforms to cooperate and deliver timely information to the supervisor, when required, should be established, within the legal framework of each jurisdiction. Also, powers to interview and investigate platforms and related persons should be established in the regulation. Supervisors should be aware that specialized inspectors should be put in place to perform off-site and on-site supervision, meaning monetary, experience, and knowledge costs for the responsible authorities.

iv. ***Misconduct and financial crime definition:*** Primary regulation should include provisions for the definition and types of misconduct that could be present in the AF space. The gravity of infringements should be categorized in the primary regulation. Infringements could include contraventions to the authorization and operation regime,

market misconduct, lack of due diligence, non-compliance with respect to information delivery, and any breach of the legal framework determined by the regulator.

v. ***Enforcement:*** Regulations should provide civil, regulatory, and when possible, criminal enforcement powers to the supervisor authority when misconduct and financial crimes materialize. A sanction regime should be provided and clearly specified with monetary and non-monetary sanctions, including administrative decisions such as suspension of activities or other considerations. A clear application regime for the supervisor's enforcement should be included in the regulation and cross-referenced with current, applicable regulations.

6.1.10 Other Considerations

The following is a set of considerations for supervisors and regulators in the LAC region to take into account in relation to the AF industry.

i. **MSME policy and policymakers:** It is customary to find that the AF industry is backed with development policies focused on the creation of financing options for MSME. Consistency with such policies is a key for the regulatory and supervisory processes. Furthermore, we recommend strong coordination with such policymakers, aiming for a comprehensive framework for regulators.

ii. **A new type of asset:** There is a demand from the industry for the creation of a new category of assets for AF. With respect to loan-backed assets, it makes sense to create a special category when originated in AF platforms. This could encourage the appetite for these assets by pension and mutual funds in some jurisdictions, fostering the growth of the industry.

i. ***Capital Markets Circuit:*** This new industry must have regulations for participants within the so-called Capital Markets Circuit, in the brown silo of Figure 3. First, the creation of new platforms for trading the new type of assets must have rules that match requirements coming from existing regulations or create regulations for these new platforms where they do not exist. The same is true for platforms issuing equity, in case they want to create secondary markets for such assets. This implies regulations not only for spot markets but also for repo markets, IPOs, and other types of public offerings. Custody and administration of notes should also be reviewed; they must be regulated in at least two respects. First, the activity per se is being performed by new companies that are based on the same technology as platforms, and for some jurisdictions, current regulation might fall short. Second,

conflict of interest: many originators and marketplace platforms are also serving as custodians of the loans they are originating as well as those coming from other platforms. For the former, it is important to set rules to avoid potential conflicts of interest while packaging and securitizing loans.

ii. **Marketplace platforms:** Marketplace lending platforms are a new type of animal for regulators (or maybe not). As explained before, they package loans to turn them into securities that are offered to the market for investors. In some jurisdictions, these platforms are actually the same type of already supervised companies that structure securitizations and other asset-backed figures. In some others, since their duty might not be fully recognized as such and given that they are technological platforms using algorithms and other technology-based procedures to issue assets, they might need a whole new type of regulation.

iii. **Credit scoring and ratings[32]:** Creative thinking and the development of technological algorithms and ad hoc techniques has given birth to—sometimes complementary, sometimes alternative—credit risk measurement and management. This is a very critical point of the industry, since many platforms offer their loans to some formerly unbanked people and enterprises. Many of these new clients could not get scores from the typical companies such as FICO or Equifax. It is very important to create the conditions for equilibrium between innovation and responsible, tested, reliable credit risk measurement. This is a huge challenge for regulators. A recommendation for this issue is to require platforms that perform these activities to have minimum standards of data processing in terms of cybersecurity and efficiency, including maximum times to safeguard information, long-term data series, or big data requirements, stress testing, and back testing.

iv. **Data management:** Since there are many countries where *habeas data* and other data protection acts exist, it is vital to adapt specific AF regulations. However, we recommend the establishment of requirements for security, reliability, time of data keeping, transparency, effectiveness, and data protection, among others.

v. **Territorial application of regulation:** Finally, a huge challenge for regulatory, but mostly supervisory bodies is cross-border business. The Internet is not a physical territory and it is not as easy to control. As long as you have a valid credit or debit

---

[32] A good standard for credit reporting is that coming from the International Committee on Credit Reporting (IICR). General Principles for Credit Reporting are available at: https://openknowledge.worldbank.org/bitstream/handle/10986/12792/701930ESW0P1180ting0pub010028011web.pdf?sequence=1&isAllowed=y

card, most of the platforms can be sought across borders without the need for any nationality or a requirement for the platform to be established within the country. Strong coordination with an information and communications technology agency should be undertaken to address this issue.

vi. **Related businesses:** Some of the activities within the AF ecosystem could be outsourced by platforms. These include credit scoring and ratings, collection, electronic dispute resolution, asset custody and administration, securities trading, and marketing, among many others. It is important to keep in mind that only platforms are accountable for their businesses. However, regulators should allow space for creating rules for vital activities such as credit scoring to diminish systemic risks within the industry. For example, minimum requirements on stress and back testing could be applied to the innovative models that are emerging to measure credit risk in the AF environment.

vii. ***Regulatory sandboxes:*** Some regulators, particularly the FCA in the United Kingdom[33] and the Monetary Authority of Singapore,[34] have proposed and are currently in the process of implementing so-called "regulatory sandboxes." This is a novel approach to the powers of regulators and supervisors where they allow experimentation within the fintech ecosystem to test financial products within a very restricted and limited framework. The sandbox basically allows participant fintech industry enterprises to offer their products, testing their outcomes and allowing regulators to understand and monitor first-hand how a particular product or service works. The final outcomes of the sandbox, if the tests are positive, are regulations for the new product or service and also the "graduation" of the new firms to authorized financial intermediaries or any other "legalized" category. This approach has at least three benefits: (i) lower costs in time-to-market for innovation, (ii) faster and better access to investment in innovative enterprises taking part in the sandbox, and (iii) more innovations in the market.[35]

viii. **It is better to regulate:** Lack of regulation creates space for regulatory arbitrage, potential client abuses, and gray lines, among other potential damages to a promising market. Moreover, potential investors will not enter the business until the rules are clear.

---

[33] For information about the FCA's regulatory Sandbox: http://www.fca.org.uk/news/regulatory-sandbox
[34] For information about the MAS's regulatory Sandbox: http://www.mas.gov.sg/News-and-Publications/Media-Releases/2016/MAS-Proposes-a-Regulatory-Sandbox-for-FinTech-Experiments.aspx
[35] FCA: "Regulatory Sandbox", 2015. Available at: http://www.fca.org.uk/static/documents/regulatory-sandbox.pdf

7. Conclusions

AF is a disruptive industry, serving banked and unbanked populations and delivering financial services hand in hand with technology. The services offered by this emerging industry can be an efficient channel to move capital from savers/investors to projects/borrowers. However, this business is still young, very complicated, and evolving fast. With this in mind, regulators have a huge responsibility in dealing with AF to strike a balance between requirements and enforcement on the one hand, and sustainable and responsible growth on the other. This document aims to deliver a comprehensive view of prudential regulation for the AF industry, bearing in mind that we want it to grow and deliver alternatives for financing productive development.

References

Agrawal, A., C. Catalini, and A. Goldfarb. 2013. "Some Simple Economics of Crowdfunding." In: Lerner. J. and S. Stern (eds.). *Innovation Policy and The Economy.* Vol 14. Cambridge, MA: National Bureau of Economic Research.

_____2011. "The Geography of Crowdfunding." NBER Working Paper Nº 16820. Cambridge, MA: National Bureau of Economic Research.

Baeck, P., L. Collins, and B. Zhang. 2014. "Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014." Cambridge, United Kingdom: University of Cambridge.

Belleflamme, P., N. Omrani, and M. Peitz. 2016. "Understanding the Strategies of Crowdfunding Platforms." *CESifo DICE Report* 14(2). Available at: https://www.cesifo-group.de/DocDL/dice-report-2016-2-wardrop-ziegler-june.pdf

FCA (Financial Conduct Authority). "FCA Handbook. Client Assets Sourcebook (CASS): 4 Chapter 7 Client Money Rules CASS 7." Available at: https://www.handbook.fca.org.uk/handbook/CASS/7/10.html

_____. 2014. "PS14/4: The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-readily Realisable Securities by Other Media." Available at: https://www.fca.org.uk/news/ps14-04-crowdfunding.

_____. 2016. "Call for Input to the Post-implementation Review of the FCA's Crowdfunding Rules." Available at: https://www.fca.org.uk/your-fca/documents/call-input-crowdfunding

Federal Reserve Banks (New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, St. Louis). *2015 Small Business Survey*. Available at: https://www.newyorkfed.org/medialibrary/media/smallbusiness/2015/Report-SBCS-2015.pdf

IDB (Inter-American Development Bank). 2014. "Crowdfunding in Mexico: The Power of Digital Technologies to Transform Innovation, Entrepreneurship and Economic Inclusion." Multilateral Investment Fund, Access to Markets and Skills. Washington, DC: IDB.

_____. Undated. "Support to SMEs and Financial Access/Supervision Sector Framework Document." (GN-2768). Available at: http://www.iadb.org/en/sector/financial-markets/sector-framework,18392.html

Kirby, E. and S. Worner. 2014. "Crowd-Funding: An Infant Industry Growing Fast." Madrid, Spain: International Organization of Securities Commissions (IOSCO).

Herrera, D. 2015. "Financiamiento alternativo: cambio y regulación." *Revista Iberoamericana de Mercados de Valores* No. 45.

Lee, E. and B. Lee. 2012. "Herding Behavior in Online P2P Lending: An Empirical Investigation." *Electronic Commerce Research and Applications* 11: 495–503.

Morse, A. 2015. "Peer-to-Peer Crowdfunding: Information and the Potential for Disruption in Consumer Lending." *Annual Review of Financial Economics* 7: 463–82. Available at: http://www.annualreviews.org/doi/abs/10.1146/annurev-financial-111914-041939

Wardrop et al. 2016. "Breaking New Ground: The Americas' Alternative Finance Benchmarking Report." Cambridge, United Kingdom/Chicago, IL: University of Cambridge and University of Chicago.

Wardrop, R. and T. Ziegler. 2016. "A Case of Regulatory Evolution-A Review of the UK Financial Conduct Authority's Approach to Crowdfunding." *CESifo DICE Report* 14(2). Available at: https://www.cesifo-group.de/DocDL/dice-report-2016-2-wardrop-ziegler-june.pdf

Zhang, et al. 2016. *Pushing Boundaries. The 2015 UK Alternative Finance Industry Report.* Cambridge, United Kingdom: The Cambridge Centre for Alternative Finance. Available at: http://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/publications/pushing-boundaries/#.V3FC62grLb0.