By email

14 February 2023

To: Senior Executive Officers (SEO)

Re: Operating a Crowdfunding Platform in or from the DIFC

Dear SEO,

From 2017 to 2019, the DFSA rolled out its crowdfunding regulatory regime in the DIFC (the **CF Regime**) to accommodate Loan, Investment, and Property Crowdfunding. While the CF Regime has been largely successful in establishing and developing the crowdfunding sector in the DIFC, certain concerns remain regarding regulatory compliance by firms in the DIFC. Although the DFSA has engaged with crowdfunding operators to address the various challenges and issues they face, including via one-to-one engagement and outreach sessions, regulatory compliance remains a concern. Therefore, the DFSA considers it prudent to remind firms of their regulatory obligations, and also to set out certain expectations concerning Operating a Crowdfunding Platform in or from the DIFC.

Appendix-A sets out certain areas of non-compliance that require attention. Appendix-B includes other expectations concerning Operating a Crowdfunding Platform in or from the DIFC. Please refer to the appendices for further details.

The DFSA considers this an important reminder for crowdfunding operators to remain regulatory compliant. Maintaining compliance is in the mutual interests of firms, their clients and the DIFC. You should consider the contents carefully and adopt it as part of your management, operations, systems and controls. These will form part of the DFSA's future regulatory assessments of crowdfunding operators.

Unless otherwise stated, the contents of this letter apply to all DFSA authorised crowdfunding operators, including Loan, Investment and Property Crowdfunding. Please note that any referenced examples are not all encompassing.

If you have any questions in relation to this letter, please contact us using the DFSA Supervised Firm Contact Form found on the DFSA eportal.

Yours faithfully,

Justin Baldacchino
Managing Director, Supervision

CC: Compliance Officers of Authorised Firms

Appendix A – Areas of Non-Compliance

Below are certain areas of non-compliance with DFSA Rules that apply to the financial services activity of Operating a Crowdfunding Platform.

A. AML systems and controls

1. The DFSA observed a number of failures by Relevant Persons to properly identify and verify the identity of their customers as mandated by the DFSA Rules and UAE Federal Anti-Money Laundering Legislation as it applies in the DIFC.

2. The DFSA also observed that crowdfunding operators:
   a. applied Simplified Due Diligence without appropriately risk rating a Client; and
   b. applied Simplified Due Diligence without considering the Clients' assigned risk rating.

3. Article 8 of Cabinet Decision No. 10/2019 (*amended*) and AML Sections 7.1 and 7.3 require firms to properly identify and verify their Clients, including for Simplified Due Diligence.

4. AML Rule 6.1.1 obligates Relevant Persons to undertake a customer risk assessment prior to undertaking Customer Due Diligence for new customers. Once a risk rating is assigned, the Relevant Person must determine whether the Client qualifies for Simplified or Enhanced Due Diligence and take appropriate actions.

B. Financial Promotions

5. The DFSA observed instances of misleading information being directed to Clients either via the platform website or other marketing materials, including press releases.

6. Examples include:
   a. Using terms such as "assets under management" and "secondary market" which are references to financial services that crowdfunding operators are not permitted to offer.
   b. Using inaccurate or misleading terminology when referring to volume of traffic on the platform. For example, the DFSA observed failures to distinguish between website visitors, registered platform users, and active investors or borrowers.
   c. Expected returns published on certain platform websites failed to present a fair and balanced view. For example, future projected returns were displayed as factual information rather than forecasts and no scenarios were included to cover potential losses. Similarly, publishing gross returns without the related net returns, and failure to clarify the assumptions underlying the projected returns/forecasts.

7. Pursuant to COB Rule 3.2.1, when communicating information to a Person in relation to a financial product or financial service, an Authorised Firm must ensure that the communication is clear, fair and not misleading. This requires the use of correct terminology on websites, applications, press releases, marketing materials, Client documents, and any other communications to existing or prospective customers.

8. Moreover, COB Rule 3.2.6 requires an Authorised Firm to ensure that any information or representations relating to past performance, or future forecasts based on past performance or

other assumptions, present a fair and balanced view, and identify, in an easy-to-understand manner, the source of the information from which past performance is derived. The Firm must also ensure that key facts and assumptions are clear and appropriate.

C. Advertising proposals outside the platform

9. The DFSA observed operators advertising or displaying proposed or active proposals on their platform (website and application) as well as outside the platform to Persons who are not Clients.

10. COB Rule 11.3.8 prohibits an operator from advertising or displaying specific lending or investment proposals "outside the platform". 'Outside the platform' includes any channel including websites, applications, emails directed to non-clients, social media platforms, or any other medium or communication that allows for the sharing of information.

11. Operators are permitted to promote their crowdfunding service in a general manner. This includes the public dissemination of general information about previous, inactive, proposals, for illustrative purposes. However, any information that may be attributed to a proposed or active proposal on the platform, such as expected returns, pictures of the property, name and logo of the issuer, must not be shared with Persons who are not Clients of the platform, nor advertised or displayed outside the platform on any basis.

D. Staff/family investing via the platform

12. The DFSA observed multiple instances where operators' employees, including the directors of the operator or related family members, invested in proposals that were offered on the platform.

13. COB Rule 11.3.14 prohibits operators' officers and employees and their family members (the **Concerned Persons**) from participating in the platform on any basis, including as a lender, financier, borrower, investor, renter, seller or investor; or holding *any* interest in the capital or voting rights of a borrower or lender, issuer or investor. There are no exceptions.

14. The prohibition prevents Concerned Persons from entering into transactions with Clients of the operator because such persons may have access to additional confidential information about a borrower, issuer, seller, proposal or property that is not available to platform investors or lenders. Having access to such information creates conflicts of interest, information asymmetry, and an unequal market, whereby Concerned Persons have an information advantage over platform investors and lenders.

15. The DFSA requires all crowdfunding operators to adopt and implement appropriate policies, systems, controls and governance oversight to ensure Concerned Persons [and the operator] comply with the above prohibition. This includes maintaining clear policies and definitions on what constitutes "family" and implementing appropriate controls and assurance to ensure regulatory compliance.

E. Client Money

16. The DFSA observed instances where Client Money was not properly recognised in accordance with COB Rule 6.12.1, which applies to all money held on behalf of the investors or lenders. The DFSA also observed breaches of COB Rule A5.11 where certain operators failed to implement proper systems and controls to ensure accurate reconciliations of Client Accounts.

17. COB Rules 6.11, 6.12, 6.14 and COB APP5 require operators to implement appropriate systems and controls to ensure compliance with the DFSA Client Money Rules, including segregation of Client Money and accounts, and maintain proper Client Accounts and accurate Client Account reconciliation. Moreover, operators must ensure segregation and independence between staff performing Client Account reconciliations and staff undertaking assurance of those reconciliations.

F. Record Keeping

18. The DFSA observed that crowdfunding operators were unable to provide evidence of sanctions and PEP screening conducted at the time of onboarding.

19. AML Rule 14.4.1 requires operators to maintain records of all documents and information, including but not limited to evidence relating to client onboarding, initial and ongoing Customer Due Diligence, screening documents, SAR logs and reports and FIU communications, records of the customer business relationship, risks assessments and other records stipulated in the AML Rules.

20. The DFSA also reminds operators of their record keeping obligations under COB Section 2.5 (*Record keeping*), COB Section 3.6 (*Record keeping*), COB Rule 6.12.5 (*Record Keeping*) and COB Rule 6.14.1(1)(a).

21. Any failure to maintain appropriate records as mandated by the DFSA Rules will be considered a breach of the DFSA Rules and actioned accordingly.

G. Senior management capacity, skills and capability

22. The DFSA observed that senior management of certain operators, particularly start-up entities, lacked sufficient resources and capacity to conduct and manage the affairs of the concerned entity in a sound and prudent manner and failed to meet compliance and corporate governance requirements required by GEN Rules 4.2.4, 4.2.11, 4.4.5, 5.3.9 and 5.3.30 and AML Rule 11.3.1(b). For example, certain compliance and AML functions:

    a. had insufficient resources to deal with large business volumes, resulting in those functions failing to adequately discharge their responsibilities;

    b. did not sufficiently understand the rules and regulations applicable to crowdfunding firms;

    c. had insufficient authority to influence business decisions; and

    d. outsourced the role of Compliance Officer and Money Laundering Reporting Officer to professional service firms with engagement defined for an insufficient number of hours.

23. Each Authorised Firm and its Authorised Individuals, including the SEO, Compliance Officer, MLRO and Finance Officer, are responsible to ensure they have sufficient resources and capacity commensurate to the nature, scale and complexity of the business, and which is adequate to ensure sound and prudent management, and effective oversight of the management of the firm.

H. Client Agreements

24. A review of certain client agreements revealed:
    a. The absence of any obligation on the part of a borrower or issuer to notify the operator where there is a material adverse change concerning the borrower or issuer, its business or the carrying out of the relevant proposal.
    b. Voting mechanisms put in place to administer the investments which have the effect of undermining the DFSA crowdfunding regulatory regime, the capacity and status of investors, and, in some cases, the structure and key fundamentals upon which investors rely when making their financial commitment.
    c. The absence of active and explicit acknowledgements and requirements to read the client/investor terms and conditions of the platform as a condition precedent to participating on the platform.
    d. Operators excluding or disclaiming responsibility for information published on the platform and/or investments administered via the platform.

25. GEN Rule 4.2.6. and COB Rule 3.2.1 require Authorised Firms to pay due regard to the interests of their customers and communicate information to them in a way which is clear, fair and not misleading. Moreover, COB Rule 3.2.2 prohibits an Authorised Firm in any communication with a Person, including any agreement, from attempting to limit or avoid any duty or liability it may have, to that Person or any other Person under legislation administered by the DFSA.

26. All client agreements should include key information as mandated by DFSA Rules including COB Section 3.3 and COB App2. Operators must ensure that the terms and conditions in the client agreement are clear, fair and not misleading. Operators must also take reasonable steps to ensure that the Clients read and understand such terms and conditions and provide active consent to those terms and conditions before participating on the platform.

I. Risk Disclosures

27. The DFSA observed various forms of risk disclosures on platforms. However, these disclosures were not prominently displayed nor published on all channels used by the platform to offer its services, and in certain instances were inadequately stated. For example, applications.

28. COB Rules 11.3.1, 11.3.2 and 11.3.3 require operators to disclose prominently on their website the main risks to investors and lenders, information about default or failure rates, and key information about the services offered.

29. Irrespective of the channels used by operators to offer their services [e.g. platform website or application], failure to publish the required disclosures and risk warnings in a prominent manner is a breach of DFSA Rules. Moreover, such failures fundamentally undermine the Client protections provided for in the DFSA Rules and will not be tolerated.

J. Retail Clients Risk Acknowledgement Form

30. The DFSA observed that operators were not seeking an active and explicit acknowledgement of understanding of risks from Retail Clients for ***each*** investment made via the platform. In most instances, the risks were simply displayed without any evidence of active and explicit consent being provided by the Client.

31. COB Rules 11.5.1 and 11.6.4 require Investment Crowdfunding and Property Investment Crowdfunding operators to ensure that Retail Clients provide a signed risk acknowledgement form for *each* investment that they make via the platform. These Rules also prescribe the content of that risk acknowledgement form, which must clearly set out the applicable risks; seek explicit confirmation from the Retail Client that they understand those risks; and must be provided simultaneously when the Retail Client commits to making the investment.

K. Interest in the Special Purpose Vehicle – Property Investment Crowdfunding

32. The DFSA observed certain Property Investment Crowdfunding Firms holding ownership rights in the Special Purpose Vehicle (SPV), and the SPV's Articles of Association vesting those Firms [via their directors] with exclusive management and voting rights.

33. COB Rule 11.6.6 requires that an SPV be established for the sole purpose of holding title to the property being funded by investors. Operators are prohibited from investing in a property through the SPV using the platform. See COB Rule 11.3.14 and Item D of this Appendix A.

L. Valuation report – Property Investment Crowdfunding

34. The DFSA observed that Property Investment Crowdfunding Firms were not conducting appropriate due diligence while appointing the service provider that provides the independent valuation report on the property listed on the platform. Additionally, the valuation report was not provided to the users of the platform prior to listing the property on the platform. Operators must undertake appropriate due diligence before selecting a service provider [to provide the valuation report]. Please refer to Appendix B for further details.

35. COB Rule 11.6.3 requires Property Investment Crowdfunding operators to obtain an independent valuation report for *each* property listed on their platform and stipulates the required attributes of the report provider, report content and required timing and disclosure of the valuation report.

Appendix B – Expectations

The below expectations will form part of the DFSA's future assessments of firms conducting the financial service of Operating a Crowdfunding Platform.

A. Operator as an investor

1. *Information asymmetry*: Allowing an operator to be an 'investor' [or otherwise underwrite shares] raises capacity questions [before considering legal and regulatory compliance issues] and creates additional risks, complexities, resource and operational requirements. Where a platform operator is also an investor, it will automatically have access to a much broader spectrum of information by reason of its due diligence, its direct dealings with concerned persons, its day-to-day oversight of the investment or property and the 'market' for that investment or property as conducted on the operator's platform. Accordingly, irrespective of the assurances, controls and disclosures made and given by the operator, the enhanced levels of information available to the operator will automatically create information asymmetry to the potential detriment of platform investors.

2. *Conflicts of interest*: While an investment by the operator would result in the operator having certain 'skin in the game' (monetary risk), incentivise the operator to ensure that the property or investments on its platform succeed, and hopefully also bring about an improved standard of due diligence, it will also bring about various material conflicts of interest. For example, the operator could exit the property or investment early based on greater access to information, instead of holding to maturity. This type of conflict of interest is one example that may lead to investor detriment.

3. *Bias*: If an operator is permitted to participate as a lender or investor on its platform, this may result in a biased view being given to the market [other investors] in relation to 'investor interest and demand' for the particular investment or property. The operator may make an initial investment to support the investment or property acquisition with a view to an early exit once investors are committed, and it has collected its fees.

4. *Financial resources*: An operator participating as an investor or lender on its own platform would also mean it has less available financial resources to support its day-to-day operations, which may be problematic where the investment is illiquid and may raise questions of systemic risk for the platform.

5. Accordingly, the DFSA expects the role and capacity of operators to be strictly limited to providing an electronic platform as an intermediary that brings together potential investors/lenders and borrowers/issuers/sellers.

B. Class B shares and erosion of shareholder rights

6. The DFSA observed instance where investors of the property were allocated Class B shares that had no material voting rights on decisions related to the property held by the SPV.

7. This raises an important issue about operators utilising the company's Articles of Association to effectively water down 'investors' rights. This erodes a fundamental value of the DFSA crowdfunding regime and does not align with COB Rule 11.3.11 (*Equal treatment of lenders and investors*), nor other DFSA Rules.

C. Quorums for shareholder voting – property crowdfunding

8. The DFSA has observed instances where a very small number of investors are deemed an acceptable voting quorum to approve shareholder resolutions that have a material impact on *all* investors. For example, the sale of the investment property.

9. Given that investor protection comprises a significant element of the DFSA's crowdfunding regime, the DFSA expects shareholder voting quorums to be aligned with the expected impact of the decision to be made on the property held by the SPV. For example, material decisions that impact *all* investors, such as the sale of the property, would be expected to be voted on and passed by at least 75% of the total investors [shareholders] for the particular property.

D. Operator Participation - property crowdfunding

10. The DFSA observed property crowdfunding operators reserving exclusive management rights for themselves, including control of voting rights over the relevant property and key decision making, via senior class of shares.

11. The creation of different classes of shares with different rights attached to each class, and the fact the operator, by reason of its various roles and functions, will have access to various sensitive, non-public information, does not align with COB Rule 11.3.11 (*Equal treatment of lenders and investors*).

12. Operators who seek to vest all voting rights to strategic decision-making for managing the asset, liquidation or sale of the asset etc. in the operator, itself, encroaches on the rights vested in shareholders, and also creates uncertainty as to the 'term of the investment' and 'what happens at the end of the term'. Any operator that vests itself with a subjective, unilateral discretion as to the 'sale of the asset' and 'end of the investment term' will likely contravene COB Rule 11.3.3(2).

13. Accordingly, the DFSA expects the role and capacity of operators to be strictly limited to providing an electronic platform that brings together potential investors and sellers. Any investment decision is expected to be driven by the investors themselves via a fair voting mechanism that complies with DFSA Rules. Please also note Item A of this Appendix B.

E. Valuer due diligence and records - property crowdfunding

14. Keeping in mind COB Rule 11.6.3, Operators should undertake 'appropriate' due diligence before selecting a valuer, including assessment of the valuer's:

    a. reputation and standing;

    b. number of years of operations;

    c. independence and objectivity;

    d. professional expertise; and

    e. track record in providing such valuations.

15. DFSA observed that property crowdfunding operators were not maintaining records of the due diligence conduced prior to appointment of independent property valuation company.

16. Operators must maintain records of the above due diligence and rationale for selecting a particular valuer. Absence of adequate records will be treated as a failure to undertake the required due diligence.

F. Operator conducting other financial services

17. DFSA received a number of enquiries from crowdfunding operators enquiring about carrying out other financial services activities.

18. GEN Rule 2.2.10E explicitly prohibits a crowdfunding operator from carrying on the following activities: *Managing Assets, Advising on Financial Products, Managing a Collective Investment Fund and Advising on Credit*. The DFSA expects that the other financial services in GEN 2.2.2 are, by their very nature, mutually exclusive to 'Operating a Crowdfunding Platform'.

19. While Guidance Note 2 in COB Rule 11.13.14 refers to the possibility of an operator being separately authorised for Providing Credit or Dealing in Investments as Principal, the nature of crowdfunding platforms is, of itself, a 'standalone market' for transacting between investors and issuers/borrowers/sellers concerning specific projects/businesses/properties listed on the platform. Moreover, the DFSA has shaped its crowdfunding regime on the basis that the 'core' actor is the 'operator' whose role and capacity are that of an intermediary with 'neutral standing' who brings together willing investors and sellers [etc.] exclusively on its platform to conduct the above transactions. Accordingly, it would be difficult to envisage a crowdfunding operator being authorised for any other financial services [excluding a Licence endorsement for Retail Clients and Holding and Controlling Client Assets, as applicable].

20. Accordingly, the DFSA would expect a separate legal entity [to the operator] to be established to carry on these other financial services activities for a number of reasons, including ring fencing risks related to 'Providing Credit' or 'Dealing in [own] Investments as Principal', lack of operator capacity, resources and expertise, and various material conflicts of interest (to name a few).