

ISLAMIC EQUITY-BASED CROWDFUNDING REGULATORY MODEL: A LEGAL ANALYSIS IN SAUDI ARABIA

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Abstract: *One of the initiatives of the Saudi Vision 2030 is the Financial Sector Development Program, which has created the Financial Technology Lab by the Capital Market Authority (CMA). It is in July 2018 that the Saudi CMA declared, for the first time, the approval of two equity-based crowdfunding platforms licenses to two Fintech companies: Scopeer and Manafa Capital. Even though the lawfulness of equity-based crowdfunding was determined from a legal point of view in these two first Saudi crowdfunding platforms, there is no official law, regulation, or rule to legalize the crowdfunding activities. It seems that, determining the landscape and mechanisms of equity-based crowdfunding platforms are two prerequisites for drawing the legal framework for equity-based crowdfunding as a financial innovation.*

Keywords: *equity-based crowdfunding, legal framework, financial innovation,*

Introduction

Over the past decades, the financial sector has undergone many changes, like other sectors, because of technological development and perpetual changing of user needs. To be in tune with these changes, Saudi Arabia have launched the Kingdom's Vision 2030. One of its initiatives is the Financial Sector Development Program, which has created new opportunities in the financial sector in line with the requirements of the 21st century. Among the initiatives of the program was the creation of the Financial Technology Lab by the Capital Market Authority (CMA). This Lab is an opportunity to establish a company that aims to open the door for investment in small and medium-sized companies by digitizing the investment process and making it available to the largest possible group of potential entrepreneurs. The financial technology companies (Fintech) was been created as an online business solutions that provide services promptly and with more efficient manner. Innovative alternative finance, such as peer-to-peer lending (P2P) or crowdfunding, aims to help plug the SME and startup financing gap.

While it has been recognized as one of the most promising tool of funding in Europe and the US, crowdfunding is deemed as a new financial approach to Saudi Arabia. In 2017, Moody's Investor Service stated that Saudi Arabia is deemed as the biggest market for Islamic finance in the world, with Islamic finance assets about \$292 billion. In fact, the Islamic banking dissemination in the Gulf

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Cooperation Countries (GCC) has increased from 31% in 2008 to 45% of the total banking market at September 2017. Nevertheless, Islamic finance assets represent only around 1% of the global financial market in developing world.

1. Types of crowdfunding

The novelty of the explanation of Lambert and Schwienbacher relies on the segmentation of different types of crowdfunding according to the types of the compensation that creators give to funders. In fact Crowd-funders make voluntary financial contributions with or without the expectation of receiving compensation. This can take various forms, including cash, bonds, stocks, profit sharing and pre-ordering of products. At times, this can be accompanied by voting rights or other active involvement in the crowdfunding initiative. (Belleflamme et al., 2010, p: 5) Most of the crowdfunding platforms have chosen to specialize in one out of four types of crowdfunding operations to avoid getting lost in a wide variety of procedures.

1.1. Donation based crowdfunding

This type of crowdfunding can also be called Charity crowdfunding; financial contributions are given “for free”. (Gleasure., 2015). It is a collective effort of individuals to help finance certain charitable causes and non-profit initiatives or enterprises like social enterprises. Social enterprises can be defined as private organizations whose mission is to produce goods and services in the pursuit of general interest objectives, referred to local communities, persons or social groups (Borzaga and Defourny, 2001). The figure 1 recapitulate the operation process of the functioning of a donation based crowdfunding platform.

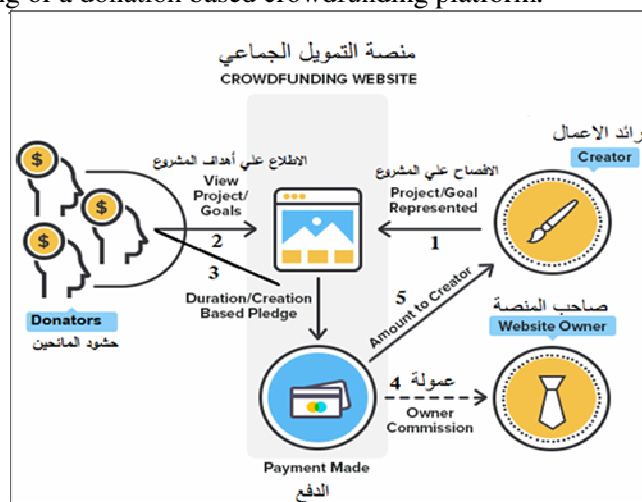


Fig1. operation process of of a donation based crowdfunding platform (Jaziri et Miralam, 2019).

1.2. Reward based crowdfunding

Reward-based crowdfunding allows fundraisers to provide non-equity returns on the funds received from crowdfunders who donate money to a project with the expectation of tangible or intangible (material or in-material) rewards. Reward-based projects usually provide non-monetary return (such as product/service) (Belleflamme et al., 2014). It offers both material as well as immaterial compensation for non-monetary rewards that are normally the result of the entrepreneurial activity. Figure 2 outlines the operation process of a reward based crowdfunding platform.

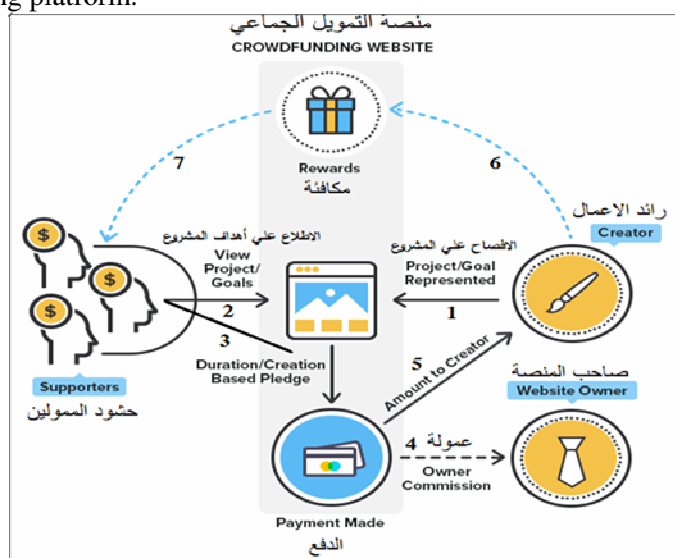


Figure 2. operation process of a Reward based crowdfunding platform (Jaziri et Miralam, 2019).

1.3. Lending-based Crowdfunding

This type of crowdfunding is also known as debt-based crowdfunding or peer-to-peer (P2P) crowdfunding. In this crowdfunding model, contributions are small loans to be reimbursed with a convenient interest rate., individuals post their borrowing needs and personal profiles on a P2P platform such as Lending Club or Prosper. Individual and institutional investors then can view and fund consumer loans through the platform. (Adair Morse, 2015) the platform is offering a provision of financial services through microlending to entrepreneurs with lack of access to the banks and traditional systems.

It also has two differentiated models, the first one is based in the “microlending supporting” where investors provide funds for low-income clients, customers and self-employed entrepreneurs. And the second sub-model is based

in a “peer to peer” lending system that occurs directly between individuals without the intermediation of a traditional financial institution. (Martínez-Cañas et al., 2012).

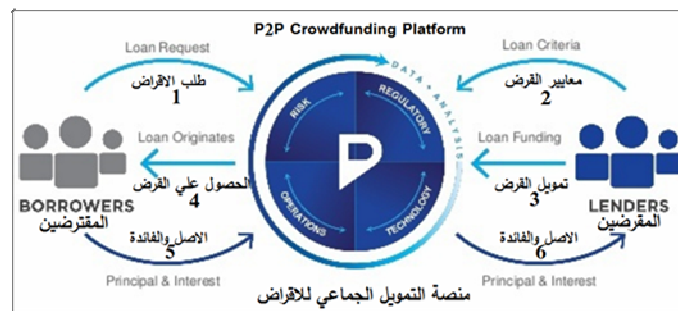


Figure 3. sketches the operation process of a reward based crowdfunding platform.

Equity based crowdfunding equity-based” is one of the most important types of crowdfunding, it is a model where contributions are in the form of equity investments (participation to the share capital) for financial and participation returns that means “the investor becomes a shareholder in the company, with future interest in the growth of the enterprise. The funder may have the right to participate and vote on some decisions, being entitled to dividends out of eventual revenues, or even to get a share of the value in the company if the company is sold” (Pedro de Miranda, 2012, p: 20). Equity crowdfunding provide crowdfunders with the opportunity to participate actively to project evaluation and development, and creating social links with other funders (Ahlers, Cumming, Gunter and Schweizer, 2015). So, the equity-based crowdfunding model treats project funders as investors by making them equity stakeholders in return for their support (Mollick, 2013).

The crowd acts in the same context as “traditional” private equity providers such as business angels (BAs) or venture capitalists (VCs); it invests in new ventures with little verified information, low transparency, and high risks. However, the crowd differs from business angels or venture capitals in the sense that it forms a large group of heterogeneous and often anonymous investors (Heminway, 2014; Mollick, 2013), investing mostly small amounts of money through the Internet.

2. The emergence of islamic crowdfunding

2.1. The Islamic crowdfunding is Sharia compliant

The concept of Islamic crowdfunding is synonym to Islam-based crowdfunding. Both the entrepreneurial project and the product that are financed by the platform are halal and allowed by the Islamic religion (Shukri et al., 2015) .

Consequently, the used funds have to be assured halal. To identify the halal aspect of an entrepreneurial project, it is indispensable to create a Sharia Supervisory Board. The role of this board was to guarantee that the offered funds are used to finance an entrepreneurial project conform to sharia law. In fact, the investor or the crowdfunder is obliged to fill out a declaration form halal fund. The new conceptual of Islamic crowdfunding platform is shown in Figure 4.

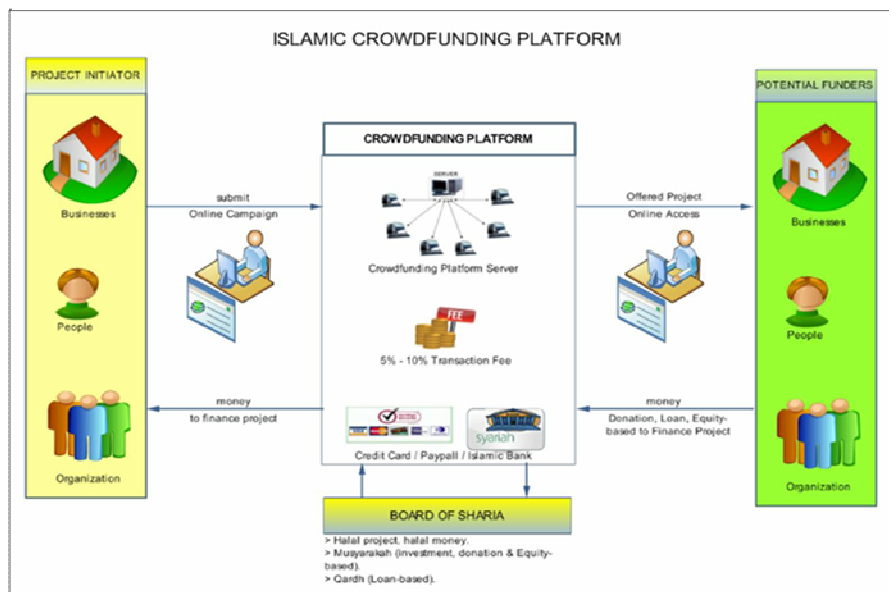


Figure 4: Islamic crowdfunding platform (Shukri et al., 2015)

There are four actors in an Islamic crowdfunding transaction especially:

1. Project Initiator (PI) or the potential entrepreneur. It could be eventually startup or SMEs
2. Potential Funders (PF) also called the investor or the crowdfunder
3. Crowdfunding Operator (CFO) or the Islamic crowdfunding platform
4. Board of Sharia (BS), which represents the governance board of the Islamic crowdfunding platform.

All financial transactions are conducted online via the Islamic crowdfunding platform. The Project initiator (PI) have to reveal online all information (videos, presentations, photos, etc.) about his entrepreneurial project by uploading them in the Crowdfunding Operator platform (CFO). All uploaded materials by the novice entrepreneur or the project initiator (PI) will be labeled in his account name into the crowdfunding platform (CFO). Moreover, potential investors or Funders (PF) will choose an entrepreneurial project that suits their interests, and then would transfer an amount of money in accordance with the options available as donations, loans or equity-based.

All the transferred funds through the crowdfunding platform (CFO) will be cut by transaction fee about 5 to 10%, and transfer the rest to the entrepreneur or project initiator (PI) account, in condition that the collected funds have reached the campaigned budget.

Islamic Crowdfunding is worthy to be implemented essentially in Muslim countries or Muslim-majority countries. Crowdfunding as a financial innovation is very appropriate to be implemented because it is easier for entrepreneurs as a PI, especially those not bankable. The role of the board of Sharia is very interesting and essential to choose entrepreneurial projects respecting Islamic values and principles and which are characterized as halal. For that reason, the board of sharia (BS) is deemed as halal guarantee institution for both the entrepreneur or project initiator (PI) and potential investors or Funders (PF).

2.2. Islamic crowdfunding Versus conventional crowdfunding

In 2017, Moody's Investor Service stated that Saudi Arabia is deemed as the biggest market for Islamic finance in the world, with Islamic finance assets about \$292 billion. In fact, the Islamic banking dissemination in the Gulf Cooperation Countries (GCC) has increased from 31% in 2008 to 45% of the total banking market at September 2017. Nevertheless, Islamic finance assets represent only around 1% of the global financial market.

Certainly, Islamic finance is governed by the Sharia law. It requires a social responsible investment having a real impact on the community. While, practicing the interest ("riba" in Arabic) on loans and speculation are prohibited by the Quran, the fees for the provision of a service are allowed. As a result, Alberto Brugnoli, managing partner of Assaif, the oldest Islamic finance consultancy in Europe argued that "The concept and structure of crowdfunding are perfectly Sharia compliant (...) Crowdfunding has the same participatory methods that are the cornerstone of Islamic finance".

If we compare, on one hand, reward or equity-based crowdfunding platforms and, on the other hand, Islamic platforms, we notice that there is no virtually difference. In the first case, an entrepreneur presents an entrepreneurial project, asking the community for funding in return of a reward that is proportional to the financial contribution. Those who participate are not considered as investors but also as contributors.

According to Zakaria Abouabid, "an islamic finance expert Equity crowdfunding is Sharia-friendly too, because investors purchase a share in the company, participating in gains and losses,".

The first difference between Islamic and conventional crowdfunding is the prohibiting of interest, considered as an incentive on some crowdfunding platforms such as the British Abundance. The second difference is "the legality" of the entrepreneurial project, which have to be "halal" and permitted by Sharia law. In

fact, crowdfunding should refuse the funding of forbidden products and activities such as gambling, alcohol and animal fats.

Differences between Islamic and conventional crowdfunding can be related to the topic of “ethical” platform. Umberto Piattelli partner of the international legal practice Osborne Clarke argued that there is “no legal definition or list of platforms exists, nor any figures about their turnover”. He emphasize the ethical issue of financial practices apprehended by crowdfunding platforms “What changes is the aim, (...) The ethical quality is to be found in the project, or in the individual, association, company or institution, like those dealing with crowdfunding donations or social lending to support charity projects.” However, while ethical platforms detain the same fundraising system, Islamic crowdfunding platforms dictate severer financing guidelines. For instance the interest prohibition as well as funding only “halal” entrepreneurial projects. That’s why, Piattelli says “The concept of ‘ethical’ is not comparable with Islamic platforms.”

3. The emergence of a crowdfunding market in Saudi Arabia: the need of new regulation

3.1. Saudi Capital Market Authority (CMA) and the implementation of two crowdfunding platforms

It is in July 2018 that the Saudi Capital Market Authority (CMA) declared, for the first time, the approval of two crowdfunding technology licenses to two Fintech companies especially: Scooper and Manafa Capital. These two financial institutions are allowed to provide crowdfunding services in Saudi Arabia as the primary outcomes of the Financial Technology Laboratory initiative (FTIL) established by the CMA.

In its announcement, the CEO of the Saudi Capital Market Authority said: “The Financial Technology Laboratory License is one of the CMA’s strategic initiatives resulting from the CMA’s ‘Financial Leadership 2020’ program which works under the umbrella of the Financial Sector Development Program, one of the Kingdom’s 2030 Vision execution programs.”

The CEO of the crowdfunding institution Scooper Abdulrahman Altheeb, said “We worked with the CMA since March 2017 on developing the crowdfunding framework before obtaining the announced license. Through benefiting from other newly developed regulations and practices around the world, such as the Financial Conduct Authority in the United Kingdom, the CMA launched its FITL to introduce a set of regulations for the P2P sector that fits the Saudi market needs and behavior. It is aimed that the FITL will function for two years for research and investigatory work which will end with comprehensive market regulations.”

3.2. The crowdfunding platform SCOPER

Scopeer is a Saudi equity-based crowdfunding platform that joins entrepreneurs with potential local and international crowdfunders or investors. The CEO of Scooper Altheeb argued “We consider ourselves a startup, and we understand the issue faced by both startups and SMEs in raising funds, and obtaining financing. The main goal of Scopeer is to fill the financing gap in Saudi Arabia and provide alternative financing options for startups and SMEs by introducing crowdfunding to the market.”

Crowdfunding is deemed among one of the financial technology solutions. It is the best solution for financing an entrepreneurial project, start-up or SME by raising funds through the internet community where each one contributes with a small amount. In addition, it helps novice entrepreneurs by highlighting their entrepreneurial projects via an online platform. As a result, the Scooper’s CEO explained: “There are a variety of crowdfunding types that include donation-based crowdfunding, rewards-based crowdfunding, lending-based crowdfunding, and equity-based crowdfunding.” He argued also, that “CMA is only issuing licenses for equity-based crowdfunding, which is what we do.”

As its name suggests, equity-based crowdfunding allows contributors or investors to become owners of the company by trading capital for equity shares. As equity owners, contributors receive a financial return on their investment and ultimately receive a share of the profits in the form of a dividend or distribution. In addition to crowdfunding activities, Scopeer will offer a comprehensive entrepreneurial network that facilitates entrepreneurs’ communication with each other and with investors.

3.3. The crowdfunding platform Manafa

In July 2019, The Capital Market Authority (CMA) Grants a Financial Technology experimental permit (FinTech ExPermit) to Manafa Capital to Create Equity Crowdfunding Platform. In fact, Manafa is a crowdfunding platform dedicated to Saudi novice entrepreneurs. It helps them for investing equity into innovative, early-stage companies. The platform provides investors free access to invest directly in innovative entrepreneurial opportunities. MANAFA is an efficient technology to access a network of investors as well as leading partners.

Manafa aims to change the future of investment in the Kingdom with the support of its investor, and ambitious potential entrepreneurs. The company’s business model is based on the concept of the participative finance or collective financing. Manafa allows novice entrepreneurs, startups and SMEs to get funds from individuals registered on the platform to support the company’s growth and operational business in return for a stake in its governance. It does not manage the benefits of corporate shareholders’ money but allows investors to finance directly

in companies. This means that the benefits of predicting future profits for investors cannot be obtained because it depends on the performance of each company invested separately. Granting this investment asset to the public is new in Saudi Arabia, which is usually confined to high-net-worth investors because of the high risk of investing in this type of company.

4. The Legal Dilemma of Islamic Equity-Based Crowdfunding

The expansion of crowdfunding will certainly help solve the problems small- and medium-sized companies face in securing financing, as it brings new opportunities for the Saudi economy. However, many issues within the crowdfunding industry must be highlighted, especially the intrinsic concern in equity-based crowdfunding: equity-based crowdfunding cannot simply be deemed as an evolutionary advancement to existing financing tools in the kingdom of Saudi Arabia, and it seems hard to place crowdfunding technology inside the existing legal framework. As an innovative financing tool, equity-based crowdfunding have to find an equilibrium between “risk control and prevention” and “capital accumulation and activity”. Inappropriately, the current financial legal system in Saudi Arabia leaves a lacuna in the norms and standards of equity-based crowdfunding.

The Procedures failed to elucidate the correlation between equity-based crowdfunding and private equity¹ or private placement. It identified strict necessities for experienced investors that seemed to destabilize the initial incentive for crowdfunding. Consequently, the procedures stimulated wide controversy in Saudi Arabia academic spheres. In fact, both CMA and the Central Bank encourage the promotion of electronic funding. However, the Opinions were just a strategically advantageous framework, policy document, and this document did not directly affect the practical operations of equity-based crowdfunding.

The rise of the two first Crowdfunding platforms in Saudi Arabia show the willingness of the government to encourage and support novice entrepreneurs and SME in terms of the current legal framework. Nevertheless, the regulation have to elucidate the contractual relationship between the crowdfunding platform and the entrepreneur, also to take into account the complex relationships between the entrepreneur and investor as crowdfunder.

Based on the specificity of equity-based crowdfunding, the problem will be in its random incorporation into the existing regulatory rules. There is a confusion about concept of equity-based crowdfunding and the illegal offerings of shares. The failure to normalize equity-based crowdfunding regulation will contribute to an incapacity to protect crowdfunders as investors, leading to a systemic risk.

¹ Private equity refers to investment funds organized as limited partnerships, that buy and restructure companies that are not publicly traded.

Consequently, recent consideration have to concentrate on two points associated to equity-based crowdfunding rules: first, meanings and connotations of the concept of equity-based crowdfunding. It is necessary to clarify the scope of this concept, particularly the relationship between public and private equity-based crowdfunding. Second, concerning the regulation of new rules of different types of crowdfunding in Saudi Arabia. In fact, regulatory measures must be reserved for equity-based crowdfunding. In the meantime, specific rules have to be recognized related to the “open, public, small-sum” characteristics of the equity-based crowdfunding. Specifically, the relationship between the rights and obligations of crowdfunders as investor, intermediary crowdfunding platform and entrepreneurs as beneficiaries. This relationship must be scrutinized accurately, in order to apprehend an equilibrium between financial innovation and investor protection.

5. Conclusion

Islamic crowdfunding as a financial innovation in Saudi Arabia is a bottom-up approach, linking simultaneously economic and social facets. It's an opportunity for novice entrepreneurs to solve their financial problems. As a result, Freund (2010) argued that crowdfunding is deemed as the key factor to overcome obstacles between the two disciplines of economics and sociology. Furthermore, Islamic crowdfunding platforms afford for both entrepreneurs and crowdfunders as investors a virtual space to exchange values.

The expansion of the crowdfunding industry in Saudi Arabia will continue to face challenges of developing entrepreneurship and the national economy. To do so, it is required to elucidate the nature of crowdfunding to all citizens, ameliorate its regulatory system, and promote developing innovative entrepreneurial projects that have a real potential. We must notice that Islamic crowdfunding is fundamentally a tool to anchor the Islamic values of solidarity and risk participation among communities in order to develop innovation and entrepreneurship. It symbolizes the social solidarity and lead to economic dynamics. Finally, Islamic crowdfunding is not only as a facet of financial innovation, but also it reflects both social values and social justice.

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