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The Framework for Property Crowdfunding

The Securities Commission Malaysia ("SC") issued the revised Guidelines on Recognised Markets ("Guidelines") on 17 May 2019 to introduce a framework for property crowdfunding in Malaysia.

This article will discuss the specific requirements that apply to a property crowdfunding platform and an operator of such platform. It should be noted that, unless otherwise specified, all other requirements stated in the Guidelines apply to the operator of a property crowdfunding platform.

Key definitions

Among others, the Guidelines define:

- "PCF operator" as a Recognised Market Operator who operates a property crowdfunding platform ("PCF operator");

- "PCF platform" as an electronic platform that facilitates (i) crowdfunding for residential property; and (ii) secondary trading of the investment note or Islamic investment note (severally a "note" and collectively "notes")("PCF platform"); and

- "residential property" as a house, a condominium unit, an apartment or a flat, purchased or obtained solely as a dwelling house, and includes a service apartment ("residential property").

The SC has in its Frequently Asked Questions on Property Crowdfunding Framework ("FAQ") issued on 17 May 2019 clarified that it is not mandatory for a PCF operator to offer a secondary market for trading and advised investors to check with the PCF operator as to whether it will offer a secondary market on its PCF platform. Hence it can be seen from the FAQ that it is not mandatory for a PCF operator to offer secondary trading of notes on its PCF platform.

Property Crowdfunding 101

In essence, property crowdfunding under the Guidelines is a form of fundraising whereby a homebuyer raises funds to part-finance the purchase of a residential property from a relatively large number of investors through a PCF platform. The investors will receive an investment note as security for their investment.

Upon the maturity of the note (i) the property will be revalued and any gain or loss in the value of the property since the commencement of the investment will be shared between the homebuyer and the investors in the manner agreed upon at the inception of the transaction; and (ii) the homebuyer will be entitled to purchase the property outright by paying the amount due under the note. If the homebuyer is unable or decides not to do so, the property will be disposed and the gains or losses from the disposal will be shared by the homebuyer and the investors in the agreed manner.

The notes may also be traded on the secondary market if the PCF operator provides a platform for such trading.

The PCF Operator

Registration Requirements

A person or entity that intends to operate a PCF platform must be registered as a Recognised Market Operator under section 34 of the Capital Markets and Services Act 2007 and the Guidelines.

An applicant to be a PCF operator must be incorporated in Malaysia and have a minimum paid-up capital of RM10 million, of which RM5 million is to be set aside and maintained is a segregated bank account throughout the operation of the PCF platform. The RM5 million which is to be set aside must be utilised only for the purposes of ensuring and facilitating exit certainty of the notes hosted on the PCF platform. The SC may impose additional financial requirements or other terms and conditions on a PCF operator that commensurate with the nature, operations and risks posed by the PCF operator.

Obligations of the PCF operator

A PCF operator must: (a) ensure that its PCF platform is operating in an orderly, fair and transparent manner; (b) have in place rules and procedures for hosting of residential property and the issuance, trading, clearing and settlement of notes on its PCF platform; (c) obtain and retain a self-declared acknowledgment form from each homebuyer confirming that he has satisfied the eligibility criteria and will comply with his obligations under the property crowdfunding scheme; (d) inform an investor of any material adverse change in relation to the homebuyer or the note; (e) ensure that all fees, charges and other costs payable in relation to the sale and purchase of the residential property, trading fees, management fees imposed are fair and transparent; (f) appoint an independent registered valuer to carry out the valuation of the residential property to ascertain its market value, upon hosting and before the expiry of the tenor of the note; (g) maintain a register of homebuyers and investors for each residential property; and (h) have in place policies and processes relating to the obligation of each party at the end of the tenor of the note, including using its best endeavours to recover any amount due to an investor.

Exit Certainty

A PCF operator must also have in place policies and processes to ensure exit certainty for homebuyers and investors at the end of the tenor of the note and disclose these exit terms, including how returns, if any, will be distributed to the investors and homebuyers.

The FAQ provides three examples of exit strategies. The PCF operator may (a) facilitate the public sale of the property on its website; (b) provide a warehousing facility where a homebuyer has the right to sell the property to the PCF operator or a third party that the PCF operator has an arrangement with, based on a market value to be determined by an independent valuer; or (c) have in place an underwriting arrangement with a bank to provide a loan to pay off the investors.

Managing Conflict of Interest

A PCF operator's framework relating to conflict of interest must, among others, include policies and procedures relating to: (a) the PCF operator or its officers seeking to participate on any PCF platform as a user; (b) any transaction entered into by the PCF operator in which any of its directors, major shareholders or person connected with such director or major shareholder may have an interest; (c) the prevention of abuse of non-public material information by the PCF operator or its officers; and (d) any fees or remuneration received for hosting of a residential property or any note on its PCF platform.

Prohibition of Financial Assistance

The Guidelines prohibit a PCF operator from providing direct or indirect financial assistance to investors to invest or trade in any note hosted on its PCF platform and to homebuyers seeking residential property financing, investing or trading in any note hosted on its PCF platform.

Risk Management

A PCF operator must, among others: (a) establish a robust operational risk-management framework with appropriate systems, policies, procedures and controls to identify, monitor, mitigate and manage operational risks; (b) have in place clearly defined roles and responsibilities for addressing

operational risks; and (c) have a comprehensive physical and information security policy that addresses all potential vulnerabilities and threats.

Internal Audit

A PCF operator is required to establish and maintain an internal audit framework that commensurate with its business and operations.

Disclosure Requirements

A PCF operator must disclose and display prominently the relevant information on its PCF platform, including information relating to: (a) the residential property, upon hosting and throughout the tenor of the note; (b) the homebuyer throughout the tenor of the note; (c) the developer or, in the case of a sub-sale, the existing owner, upon the hosting of the residential property on the PCF platform; (d) the independent valuer appointed to prepare the valuation reports on the residential property; and (e) all applicable fees and charges to be borne by a homebuyer and the investors under the property crowdfunding scheme. A PCF operator is also required to provide communications channels to permit discussion among the users of its PCF platform.

The Homebuyers

Eligibility

A PCF operator must ensure that a homebuyer must be: (a) an individual who is a Malaysian citizen; (b) at least 21 years of age; and (c) a first time homebuyer.

Obligations of a Homebuyer

During the tenor of the note, a homebuyer must: (a) ensure that he occupies the residential property; (b) not sell or transfer the residential property; and (c) use his best endeavours to maintain the property in good condition.

The FAQ has clarified that although a homebuyer must reside in the property during the scheme's tenor, he is not prohibited from renting out one or more rooms in the property.

A homebuyer must also ensure that all information submitted or disclosed to the PCF operator is true and accurate and does not contain any information which is false or misleading or from which there is a material omission.

Eligible Properties

To be hosted on a PCF platform, a property must: (a) be a completed residential property located in Malaysia; (b) have a valid, effective and unencumbered legal title; (c) have been issued with a certificate of completion and compliance by the relevant authority; and (d) have a value of RM500,000 or less.

According to the FAQ, the RM500,000 value refers to the price of the residential property before the deduction of any discount, rebate or other reduction provided in the price of the property.

Based on paragraph 16.21(c) of the Guideline, pre-owned residential properties are eligible to be hosted on a PCF platform for sub-sales.

The PCF operator is obliged to ensure delivery of vacant possession of the residential property to the homebuyer.

Limit on Fund Raising

A homebuyer is permitted to seek financing of up to a maximum of 90% of the value of a residential property on a PCF platform. However, he is not permitted to retain any amount raised which exceeds the target financing amount.

Asset Protection

The Guidelines prescribe various measures to safeguard moneys received by a PCF operator. First, a PCF operator must: (a) establish and maintain in a licensed Malaysian financial institution one or more trust accounts, designated for monies received from users; (b) ensure that such trust accounts are administered by an independent registered trustee; (c) establish systems and controls for maintaining accurate and up to date records of users' monies held; and (d) ensure users' monies are properly segregated from conversion or inappropriate use by any person.

Further, a PCF operator may only release the monies to a person entitled to it when the following conditions are met: (a) the targeted amount sought to be raised has been met; or (b) upon the sale of the residential property at the end of the tenor of the note. In each case, the monies may be withheld if a material adverse change has occurred during that period. A PCF operator is permitted to include additional conditions precedent before releasing the monies, provided that they serve the investors' interest.

Secondary Trading of Notes

Secondary trading of notes that have been successfully funded through the PCF platform is permitted subject to compliance with the prescribed requirements set out in the Guidelines.

The PCF operator must disclose: (a) information about its market structure, order types and the interactions of the order types; (b) pre-trade and post-trade information to all users on a non-discriminatory and timely basis; and (c) all material information or changes relating to the note in a comprehensive and timely manner.

The PCF operator must have adequate arrangements to: (a) deter market manipulation and abuse and ensure proper execution of trades; and (b) manage error trades, system errors, failure or malfunction. In addition, the PCF operator must also have policies and procedures: (a) for trading pause/halt; and (b) to monitor, manage and mitigate risks of any system failure or malfunction, including suspension of trading or taking other action the PCF operator deems fit.

A PCF operator must determine and disclose the anomalous order threshold for the notes offered on its secondary market. The SC may notify the PCF operator where its anomalous order threshold is not appropriate to promote market integrity or a fair, orderly and transparent market.

A PCF operator must also ensure that there are orderly, clear and efficient clearing arrangements for notes traded on its secondary market.

Comments

The launch of the framework for property crowdfunding has been much anticipated by housing developers seeking to reduce their inventory of unsold residential property and by prospective first-time homebuyers who for whatever reason decide against adopting a conventional means of financing their purchase. Property crowdfunding will also be of interest to investors seeking an alternative form of investment on the primary and secondary market.

The Guidelines provide a broad framework and set out the minimum requirements to safeguard the interest of the parties who seek funding or invest through a PCF platform. As stated in the FAQ, the SC does not endorse or prescribe for any specific property crowdfunding model so as to encourage innovation by the industry and PCF operators. For example, the tenor of the notes and the exit strategies, including the profit and loss sharing ratios between the stakeholders, as well as the

structure of the legal and beneficial ownership of the residential property during the tenor of the note are matters to be determined by each PCF operator.

The prohibition against selling the residential property during the tenor of the note means that a homebuyer will not be able to divest the property to "*cut losses*" before the maturity of the note. This can be a daunting prospect if property prices are on a declining trend during the tenor of the note. Another area of concern for a homebuyer is that the property will be disposed if he is unable to raise financing to redeem the note upon its maturity.

Whilst property crowdfunding is an interesting alternative form of financing a purchase of residential property, it is more complex and entails more uncertainties than plain vanilla housing loans. Homebuyers must understand the additional risks in a property crowdfunding transaction before taking the plunge. Perhaps it is not for the fainthearted?