Crowdfunding: Commercial and Regulatory Developments

Philip Morgan, Partner, K&L Gates LLP, London
Richard Jordan, Senior Associate, K&L Gates LLP, London
Paul Higgins, Founder and COO, Crowd Valley

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Introduction

- What is crowdfunding?
- Development of the crowd
- Types of crowdfunding
- Statistics
- Political approach to crowdfunding
- Risks of crowdfunding
- Current UK regulation
- Regulatory proposals: FCA, SEC and IOSCO
- Future professionalisation of crowdfunding and opportunities for the City
What is crowdfunding?

- Crowdsourcing = outsourcing to the crowd
  - “Simply defined, crowdsourcing represents the act of a company or institution taking a function once performed by employees and outsourcing it to an undefined (and generally large) network of people in the form of an open call.” (Jeff Howe, Wired, 2005)

- Examples
  - Distributed knowledge
  - Open innovation
  - Crowd creativity
  - Crowd labour
  - Crowdfunding

- Crowdfunding = outsourced finance
Crowdfunding characteristics

- Enabled by internet technologies
  - Platform
  - Payment systems
- Leverage social media
- For start-ups and SMEs
- Lack of access to traditional finance
- Pitch, Q&A, limited timeframe
- Platform takes fees on money invested
- Sometimes also on profits
- Minimum investment very low
Crowdfunding characteristics (2)

Source: Crowdfunding’s Potential for the Developing World, World Bank, October 2013
Funds raised by fund stage focus

Q1 2007 - Q3 2013 - Distribution and total incremental amount raised during the quarter

Source: EVCA / PEREP Analytics
- data as of 1/11/2013 and subject to change -
Development of the crowd

- 1997 – Marillion fans raised £60k through email, IM and fan pages
- 2000 – JustGiving: the first donation model
- 2003 – ArtistShare: music fan funding
- 2005/6 – Kiva, Zupa and Prosper: peer-to-peer lending
- 2006 – The term “crowdfunding” is coined

Financial Crisis

- 2008 – Indiegogo: US rewards-based crowdfunding, initially for film-makers
- 2009 – Kickstarter: US rewards-based for arts, design and technology
- 2010 – CrowdCube: UK equity crowdfunding
- 2011 – Abundance Generation: crowdfunding for project finance
Types of Crowdfunding

(Source: Financial Conduct Authority)

- Donation-based (typically small amounts being raised)
- Pre-payment or rewards-based (where reward typically of a lower value)
- Exempt [from FCA regulation] – e.g. Enterprise schemes or withdrawable shares issued by Industrial and Provident Societies
- Loan-based (peer-to-peer lending)
- Investment or bond/equity-based (by far the most significant in terms of the amount of money raised according to the EU Commission)
Donation / reward

- Kickstarter
- Sponsume.com
- Indiegogo
- Peoplefund.it
- Crowdfunder.co.uk
Donation / reward (Pebble watch)

Pledge $89 or more
200 backers  All gone!
EARLY BIRDS Help us get started!
One Jet Black Pebble watch. This watch will retail for more than $150.
Free shipping to USA. (Add $10 for shipping to Canada, $15 for international shipping.)

Pledge $115 or more
40799 backers  All gone!
One Jet Black Pebble watch. Free shipping to USA. (Add $10 for shipping to Canada, $15 for international shipping.)

Pledge $125 or more
14350 backers  All gone!
One Pebble in any color (choose from Arctic White, Cherry Red, Voter’s choice or Jet Black). Free shipping to USA. (Add $10 for shipping to Canada, $15 for international shipping.)

Pledge $10,000 or more
31 backers  All gone!
MEGA DISTRIBUTOR PACK One Hundred Pebbles in any color (choose from Arctic White, Cherry Red, Voter’s choice or Jet Black). Free shipping to USA. (Add $10 for shipping to Canada, $15 for international shipping.)
Debt

- P2P lending
  - Pre-determined rate of return for lenders based on bids submitted
  - Requires cashflow positive business
  - Generally subordinate to other lenders

- Renewable energy
  - Invest in specific projects
  - Predictable returns
  - 20-25 year investments
Debt

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<th>Avg Rate</th>
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Doing Our Job Asbestos We Can
Property and Construction, North West - 3757

Growth Capital for New Premises
Leisure & Hospitality, Midlands - 3758
Equity

crowdcube.com

GAMBITION

SEEDRS

BANKtothefUTURE.com

CrowdBnk

Adventure Capital

Crowdalisim:
Power to the Crowd
Equity

crowdcube.com

This pitch is fully funded. Please take a look at our active pitches.

Successfully funded £1,500,000
Invested (for 21.00% total equity)

262 investors

Investment Target
£1,000,000 for 14% equity

100%

EMAIL ENTREPRENEUR

WEBSITE
FACEBOOK

ANY QUESTIONS?

Click here to discuss this pitch with the Entrepreneur and other Crowdcube members.
Market size and forecasts

- Globally, $2.7 billion in 2012
  - $1.6 billion North America
  - $945 million Europe
  - $110 million ROW
- Forecast $3 billion in 2013 in the US
- Crowdfunding platforms
  - US 344
  - UK 87
  - France 53
  - Canada 34
  - Netherlands 34
  - Spain 27
  - Germany 26
  - Others 67
Equity crowdfunding in the UK

- Three platforms have had significant completed dealflow
  - Seedrs £3.2 million / 45 deals
  - Crowdcube £20 million / 103 deals
- Hab Housing raised £2 million
- European Commission consultation document (October 2013)
- Crowdcube raised £1.5 million
- Rushmore Group raised £1 million
- Notable sectors:
  - Breweries and other alcoholic drinks
  - Boutique food and delivery systems
  - Online and app development
  - Tech and innovative devices
Key Trends in Securities Crowdfunding

Paul Higgins
Co-founder, Crowd Valley
Overview

- About Crowd Valley
- The Global Crowdfunding Market
- Five Key Trends in Securities Crowdfunding
Crowd Valley – Crowdfunding Infrastructure

- Technology and back-office service provider to online crowdfunding and peer-to-peer marketplaces
- Spin-off from Grow VC Group in 2012
- US company headquartered in San Francisco
Locations of Crowd Valley Customers
Sectors of Crowd Valley Customers

- Early-Stage Tech: 53%
- Real Estate: 21%
- Late-Stage / High-Tech / IP: 10%
- Energy / Natural Resources: 11%
- Infrastructure Assets: 5%
The Global Crowdfunding Market
Five Key Trends in Securities Crowdfunding

1. There has been noticeable growth in the interest in alternative asset classes beyond startups;

2. The majority of market entrants are not yet authorized with financial regulators and therefore will be working with financial regulators for the first time;

3. Most interest has emerged from North America and Europe, showing an apparent correlation between interest in the sector and forthcoming regulatory activity;

4. Within the US, already active asset managers and broker dealers are showing significant interest in the new regulations applications, perhaps due to opportunities in syndication and new distribution channels;

5. A support ecosystem is developing for the sector.
1. Crowdfunding goes beyond startups

- Expanding a mezzanine fund for Oil & Gas investments in Rio de Janeiro
- Enabling franchisees to access equity and debt capital for their first franchise units in the UK
- Doctors financing R&D for new medical device companies in Sydney
- Alumni supporting their university’s entrepreneurship in Boston
- Offering investment opportunities in London real estate to investors in Asia
- Connecting traders of precious stones with professional investors in New York
1. Crowdfunding goes beyond startups
2. Most new entrants do not have a securities background
3. Correlation between market interest and regulatory activity.

**TOP 7 LOCATIONS (Q4 + Q3 2013)**

- United States: 37% (Q4), 36% (Q3)
- India: 4% (Q4), 3% (Q3)
- United Kingdom: 14% (Q4), 13% (Q3)
- France: 3% (Q4), 3% (Q3)
- Spain: 2% (Q4), 3% (Q3)
- Italy: 5% (Q4), 5% (Q3)
- Canada: 4% (Q4), 4% (Q3)
- Other: 31% (Q4), 33% (Q3)
3. Correlation between market interest and regulatory activity

- **North America**: 42%
- **Europe**: 34%
- **Asia**: 11%
- **Africa**: 7%
- **Oceania**: 2%
- **South America**: 4%
4. Opportunities in co-investment and syndication models
5. Development of a support ecosystem

- Front-end and back-end technology and services
- Investor accreditation
- Online payments
- Escrow and custodial services
- Credit and background checks
- Due diligence and valuation services
- Online documentation filing and investor relations
- Funding analytics
Five Key Trends in Securities Crowdfunding

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Key Trends in Securities Crowdfunding

Paul Higgins

@paulhigginz @crowdvalley

paul@crowdvalley.com
Political approach to crowdfunding

- European Commission consultation document (October 2013)
  - “Crowdfunding has many promising benefits…”
  - Entrepreneurship 2020 Action Plan invites Member States to “assess the need of amending current national financial legislation with the aim of facilitating new, alternative forms of financing for start-ups and SMEs in general, in particular as regards platforms for crowdfunding”
  - “any potential legal change should strike a careful balance between market opening and investor protection.”

- IOSCO comments that “many jurisdictions have actively sought to encourage the development of these markets through various regulatory means.”
Risks of crowdfunding

(source: EU Commission; FCA)

- fraud (money not used for stated purposes; misleading advertising etc) – N.B. most businesses operate solely through internet portal;
- project failure (FCA estimates that investors will lose all investment capital around 50% to 70% of the time);
- platform failure
- equity crowdfunding – lack of secondary market; potential dilution through future equity issues; difficulties in executing shareholder rights;
- entrepreneurs may have concerns about protection of their intellectual property;
- credit and/or investment risk is mispriced;
- insufficient consumer understanding;
- conflicts – e.g. platforms on a commission down-play risks;
- professional investors may pick the best offers;
- risk of cyber-attack.
Current UK regulation

- No specific regulation but crowdfunding lies at the intersection of multiple regulatory regimes and some areas that are unregulated and the regulatory position is therefore potentially very complex:
  - do platforms need an FCA licence to arrange deals in investments; advise on investments; operate a collective investment scheme; accept deposits; engage in safekeeping of assets? NB case by case restrictions
  - are platforms effectively operators of collective investment schemes? (NB: FCA has clamped down on the selling of unregulated collective investment schemes); the Alternative Investment Fund Managers Directive could also be in point
  - national implementation of Payment Services Directive can sometimes include peer-to-peer lending platforms, depending on business model
  - OFT consumer credit regulation in relation to loan-based crowdfunding (but very light touch)
  - financial promotion rules where underlying investment is a ‘security’ e.g. shares/bonds – can be made/approved only by FCA authorised persons unless exemption applies – N.B. self-certification categories
  - AML requirements – know-your-customer hurdles
Current UK regulation (2)

- if trading of purchased equity is permitted, platform could qualify as a multilateral trading facility
- Companies Act 2006 prohibits “public offers” by private companies
- prospectus rules – but NB that there is an exemption for offers in the EU under €5 million over a 12 month period
- FCA has authorised 10 investment-based crowdfunding platforms; there are 11 appointed representatives of authorised firms that operate platforms and applications in progress (information correct at October 2013)
- FCA estimates that there are around 25 loan-based crowdfunding platforms
- In 2012 Crowdcube and Seedrs became authorised and regulated by the FCA
Regulatory proposals: FCA, SEC and IOSCO

- **FCA**
Regulatory proposals: FCA, SEC and IOSCO (2)

- FCA: loan-based crowdfunding
  - Platforms will be regulated from 1 April 2014 as ‘peer-to-peer’ lending platforms; considered to be lower risk than equity-based platforms (but market may become riskier).
  - Minimum Prudential Requirements - Requirement for firms to maintain adequate capital buffers – this will be the higher of a fixed capital amount (£50,000) and a percentage of a volume-based measure (e.g. 0.3% of the volume of loaned funds up to £50m). The volume-based measure will be a percentage of the total amount of loaned funds on the platform. Transitional regime until 1 April 2017.
  - Client Money Rules - CASS rules already apply to investment-based crowdfunding platforms. FCA is proposing that CASS rules be applied to loan-based crowdfunding platforms insofar as the firm holds money on behalf of clients. No FSCS protection proposed.
  - FCA Reporting Requirements - Requirement to provide FCA with client money reports, financial position reports, complaints reports.
Regulatory proposals: FCA, SEC and IOSCO (3)

- FCA: loan-based crowdfunding
  - Requirements for firms to take reasonable steps to ensure that existing loans continue to be managed in the event of platform failure.
  - Communications, clear, fair and not misleading and investors to be provided with all the information they need to make informed investment decisions.
Regulatory proposals: FCA, SEC and IOSCO (4)

- FCA: investment-based crowdfunding
  - Firms already subject, for example, to prudential requirements.
  - Proposals will impose requirements upon all firms that promote and sell unlisted shares or debt securities whether web-based or not.
  - Proposals will apply to authorised firms and their appointed representatives.
  - Will apply to firms that use internet, telephone, meetings, mailings or any other media to communicate and transact with customers.
  - Overarching goal is consumer protection.
  - FCA has “no evidence to show that the wrong type of investor is investing in unlisted shares or debt securities” and acknowledges possibility that current approach is working. However, FCA has historically identified instances of non-compliant promotion of unlisted shares by firms using mailings or telephone-based business models and expects its proposals to minimise the risk of such promotions in future.
Regulatory proposals: FCA, SEC and IOSCO (5)

- FCA: investment-based crowdfunding
  - FCA proposes to restrict direct offer financial promotion of unlisted shares or debt securities by firms to one or more of the following retail clients:
    - certified or self-certified sophisticated investors;
    - self-certified high net worth investors;
    - those who confirm that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorised person; or
    - those who certify that they will not invest more than 10% of their net investment portfolio in unlisted shares or unlisted debt securities (excluding their primary residence, pensions and life cover).
  - Should mean crowdfunding investment opportunities are available to more retail investors than currently (because currently restrictions are being imposed at the point of FCA authorisation of the platform firm).
Regulatory proposals: FCA, SEC and IOSCO (6)

FCA: investment-based crowdfunding

- “Appropriateness Test”
  - Where advice is not provided, the FCA will expect firms to apply an “appropriateness test” to clients before issuing to them promotions for unlisted equity or debt securities. This may involve firms needing to design automated systems to assess client knowledge and experience and to check clients’ understanding of risks.
  - Firms will need to ensure compliance with the FCA’s rules on appropriateness.
- Where crowdfunding platforms allow investment in units in unregulated collective investment schemes (UCIS), the existing marketing restrictions applying to UCIS will apply (a possible bear trap).
- FCA will consider feedback to the Consultation Paper and publish its rules in a Policy Statement in February or March 2014.
- FCA plans to conduct a formal review of the crowdfunding regime in 2016.
Regulatory proposals: FCA, SEC and IOSCO (7)

- SEC/the U.S. model
  - Peer-to-peer lending platforms required by Federal law to be SEC registered, and each loan originated also SEC registered (N.B. notes giving exposure to bank loan); extensive public disclosure requirements; but at a state level there are also other requirements and some states ban it, e.g. Texas which also bans equity crowdfunding.
  - Equity crowdfunding platforms must provide a prospectus to lenders.
  - Equity crowdfunding boosted by the introduction of the JOBS Act – limited to accredited investors ($1 million net worth or income over $200,000/yr for last 3 years); investors must comply with SEC rules – could include a limit of $2,000 or 5% of annual income on amount an investor could invest, if his annual income is less than $100,000; limit increases to 10% where annual income over $100,000 (subject to proposed rule changes).
  - Under the JOBS Act there is also a limit on the percentage of an investor’s money allowed in any particular loan to encourage diversification.
  - JOBS Act issuer exemption – sale of no more than $1 million over 12 month period.
Regulatory proposals: FCA, SEC and IOSCO (8)

- SEC/the U.S. model
  - Proposed rule changes (SEC paper 23 October 2013): new rules may allow non-accredited investors to invest in equity.
  - Likely to include requirements on platform to file with the SEC quite detailed information on the issuer; platform would need to be SEC and FINRA registered.
  - Rules proposed by the SEC include rules to reduce the risk of fraud, rules on advertisement, rules on payment and rules on conflicts of interest.
Regulatory proposals: FCA, SEC and IOSCO (9)

- IOSCO Working Paper
  - February 2014
  - Information gathering exercise
  - Financial return crowdfunding worth c. $6 billion in the USA, UK and China (96% of overall global market)
  - Equity crowdfunding default risk is c. 50%; industry still small, e.g. $80 million in the UK
  - Peer-to-peer lending default rate high of 30% in 2009 but current figure perhaps only up to 7% depending on platform N.B. Funding Circle 1.5%, RateSetter 0.3%
Regulatory proposals: FCA, SEC and IOSCO (10)

- **IOSCO Working Paper**
  - Finding that crowdfunding does not pose systemic risk yet – but future rapid growth could change this
  - Mention of recent securitisation of peer-to-peer unsecured loans, but currently market extremely small
  - Recognises possible need for international harmonisation of regulation
  - Interesting information on different legal relationships between the parties in different jurisdictions’ models – e.g. trust fund or notes giving exposure to bank loan for peer-to-peer lending
  - Also discusses guaranteed return models prevalent in China as a feature of peer-to-peer lending (platform is guarantor)
Future professionalism of crowdfunding and opportunities for the City

- A new product for portfolio diversification?
- Increased regulation of platforms
- Likely exponential growth
- Role for professional advisers
- U.S. and UK experiencing a year on year doubling in peer-to-peer lending
- Increasing “whole loan” options where bank or institution can invest in loan through peer-to-peer lending platforms – e.g. Banco Santander looking to work with Funding Circle (source: IOSCO)
PHILIP MORGAN

Philip Morgan is a partner in the firm’s Investment Management practice group and has wide experience in all aspects of law and regulation in the UK financial services industry. He works closely with U.S. and other colleagues to provide international financial services regulatory advice and his practice also focuses on investment funds, particularly hedge funds, real estate funds, private equity funds and listed investment funds.

His transactional work also encompasses corporate projects such as joint ventures and establishment of limited liability partnerships, with a particular emphasis on the investment management and real estate sectors.

He has advised a number of U.S. clients on the establishment of their business in the UK.
RICHARD JORDAN

Richard Jordan is a senior associate in the firm’s London office. He is a corporate lawyer with experience in general company law, corporate finance, equity and debt capital markets, mergers and acquisitions, public company takeovers, joint ventures, and project finance.

He has experience in a diverse range of businesses and sectors, with particular focus on renewable energy, cleantech and natural resources.

Senior Associate  
K&L Gates, London  
T +44(0)20 7360 8119  
Richard.jordan@klgates.com
PAUL HIGGINS

Serial entrepreneur with an operational background in finance and technology companies. Paul was previously responsible for the development of the Crowd Valley product suite as part of the Grow VC Group. Paul is a regular speaker on new financial models and crowdfunding and has been involved in working with Crowd Valley’s pioneering customers across the financial services sector, as well as advising global institutions such as the World Bank and national regulators such as Italy’s CONSOB.

Paul has over a decade’s experience working in various operational, sales, marketing, and product roles within technology companies, including two B2B startups that have achieved eight-figure exits following 100% year-on-year growth. He started his career in product development and testing roles at IBM’s Hursley Research Lab in the UK before going on to eBay, UBS, and Barclays. Paul holds an M.A. (Hons) in Computer Science and Philosophy from Churchill College, Cambridge University. He has lived and worked in Texas in the US and Portugal, and speaks fluent Portuguese and French.

Founder and COO
Crowd Valley
paul@crowdvalley.com
K&L GATES