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Equity Crowdfunding

April 2015

Comment on equity crowdfunding: speed read

The Foot Anstey venture capital team are increasingly fielding questions from clients about crowdfunding, and in particular equity crowdfunding.

This note is designed to explain how equity crowdfunding works in the UK, highlighting some of the risks and benefits and then touching briefly on the regulatory background.

If you are a company thinking about using an equity crowdfunding platform, or wondering whether to go with a VC or the crowd, then this note is aimed at you along with followers of the crowdfunding scene generally.

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What is crowdfunding?

Crowdfunding is a way of using the internet to raise finance from the general public. The theory goes that if a large number of people - the crowd - each provide a small contribution then it is possible to raise substantial amounts of funding.

The digital revolution and the proliferation of technology have created vast professional and social networks; and crowdfunding platforms allow businesses, consumers, charities and social enterprises access to those alternative sources of finance and investment. Crowdfunding evangelists will be quick to explain that by 'alternative' they mean an alternative to bank funding.

The crowdfunding platforms are start-ups or early stage ventures and many have raised funds themselves from the crowd using their own technology. Crowdfunding has been around in the UK since the mid to late noughties but in recent years – operating in the post-credit crunch economy – it has emerged from obscurity and started to disrupt the world of finance.

UK equity crowdfunding: key stats[1]

- Raised £84m/ grew 201% in 2014
- Average amount raised: £199,095
- 95% of funded deals eligible for SEIS/ EIS
- Average investor age: 40
- Average portfolio size: £5,414
- Average investor holds: 2.48 investments
- Two thirds of investors invest more than £1,000

Types of crowdfunding

There are over 900[2] crowdfunding platforms globally and crowdfunding is already a multi-billion pound industry[3]. The platforms fall into three distinct types:

Type of platform			How it works	Active platforms
Investment	**Debt**	B2C	Businesses obtain (unsecured) loans and the crowd becomes a lender using the platform	Funding Circle
		Peer 2 Peer	Consumer to consumer lending	Zopa
	Equity		Facilitates subscriptions for new shares and allows the crowd to become shareholders	CrowdCube Seedrs
Philanthropic	**Donations / Rewards**		Used by businesses/ individuals/ charities/ social enterprises to raise cash donated by the crowd often in exchange for a reward of some kind, perhaps a 'free' version of the product to be developed using the funds raised	Kickstarter Indiegogo Crowdfunder

The platforms tend to stick to one type of crowdfunding, but some of the equity based platforms also offer some debt (and/or convertible debt) products.

The investment platforms are subject to securities and/ or consumer credit legislation; but the donations/ rewards platforms are not specifically regulated.

The debt platforms dominate crowdfunding for investment purposes, making up 90 per cent of the UK industry by value[4]. The equity platforms, however, seem to attract a disproportionate amount of publicity; and they are the focus of this note.

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Equity crowdfunding platforms

In and around the venture capital 'scene', people generally talk about crowdfunding as a source of seed, early stage or growth equity capital. There are around 35 equity platforms operating in the UK,[5] but two platforms are competing for market dominance: CrowdCube and Seedrs.

Some commenters have been dismissive of equity crowdfunding as a concept and certainly the aggregate funds raised are still miniscule when looked at as a percentage of the wider financial markets or even venture capital and angel investing generally[6]. Nonetheless, funds raised on equity platforms in the UK grew by 201 per cent in 2014 and £84 million was raised in capital (up from £3.9 million in 2012)[7]. Equity crowdfunding is a concept that venture capitalists are starting to take seriously.

The equity model typically makes finance available before the venture capital funds might invest; or, to put it another way, it digitises and scales the traditional angel or friends and family round. There are benefits and risks applicable to both investors and investee companies, and the merits of the model are subject to continuing analysis and debate.

Across the portfolio of crowd funded businesses, and the investors on the platforms, there will of course be many exceptions and counter examples. Nonetheless, companies and investors should be thinking about the issues outlined opposite when considering whether to use an equity platform.

Using an equity platform

Some of the benefits and risks of using an equity platform are set out below:

	Benefits	Risks
Company	▪ Access to the crowd and its capital ▪ Companies set their own valuation (often unrealistically high) ▪ Generates PR through marketing the fundraising on the platform to the crowd ▪ Friends/ family/ known investors can use the platform to execute their investment at the same time	▪ Funding is not 'smart money'; there is generally no access to the wider networks of contacts and opportunities offered by a good VC/ angel[8] ▪ Regulatory status is still somewhat unclear and likely to change/ evolve ▪ Marketing on the platform may involve a wide distribution of confidential information ▪ Appetite for VCs to invest in crowd funded businesses is unclear ▪ Unclear what proportion of the crowd genuinely understands the risks – one day the company may need to deal with dissident (diluted) shareholders
Investors	▪ Opportunity to invest in a wide variety of businesses at an early stage ▪ Risk can be spread across a diversified portfolio ▪ Being one of the crowd may mean that due diligence is effectively crowdsourced ▪ Returns on the equity platforms have the potential to greatly exceed those on the debt platforms and also on the public equity capital markets	▪ Investments are high risk. The likely success and long term returns of crowd funded investments are largely unknown[9] ▪ Levels of due diligence carried out may be unclear and following the crowd is no guarantee that any financial or legal due diligence has taken place. 62% of investors have no prior investment experience[10] ▪ Many of the businesses on the platforms are 'lifestyle' businesses that are unlikely to provide an exit for the investors within an acceptable time-line ▪ As with all investments into early stage private companies: – The investment is highly illiquid and the investor is unlikely to see any dividends for the short to medium term – There is no formal secondary market for the shares – As minority shareholders, investors will have no influence on the management of the company and very little protection generally

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CrowdCube and Seedrs: alternative structures

Equity crowdfunding platforms have had to address a key legal, structural issue: how does the investee company and the platform control the crowd? The two principal equity platforms in the UK, CrowdCube and Seedrs, have taken radically different structural approaches and each should be carefully considered by companies choosing between the two platforms.

The CrowdCube model sees the crowd invest directly into the company which in return issues new shares. The Seedrs model sees a nominee company collect in the funds and issue shares in itself to the investors; and that nominee company then invests in the company seeking finance, which in turn issues shares to the nominee. There are advantages and disadvantages of each approach.

Equity crowdfunding platforms have had to address a key legal, structural issue: how does the investee company and the platform control the crowd?

No-nominee structure

Some of the advantages and disadvantages of using the no-nominee structure are set out below

	Advantages	Disadvantages
Company	▪ The (limited) rights of the crowd are not consolidated in hands of a nominee	▪ Potentially hundreds of shareholders are on the cap table and sign the shareholders' agreement ▪ Company deals with most of the paperwork (rather than the nominee)
Investors	▪ Each investor is a shareholder in the company (with very limited minority (unfair prejudice) protections) ▪ Each investor is a party to the shareholders' agreement (if there is one)	▪ Shares may be non-voting and may lack adequate (or any) anti-dilution protection

Nominee structure

Some of the advantages and disadvantages of using the nominee structure are set out below:

	Advantages	Disadvantages
Company	▪ Single name (the nominee) on the cap table ▪ The nominee should be able to make decisions more quickly than the crowd ▪ Arguably more attractive to a VC ▪ Nominee takes care of much of investment paperwork	▪ Rights of the crowd consolidated in the hands of the nominee, giving the crowd more bargaining power
Investors	▪ Administrative efficiency. Nominee takes decisions for the investors ▪ Rights of the crowd consolidated in the hands of the nominee, giving the crowd more bargaining power	▪ Loss of unfair prejudice protection at company level (as the investors are not legal owners of the shares) ▪ Not a party to the shareholders' agreement (at company level) ▪ Nominee will be able to take certain decisions on behalf of the crowd by way of majority decision (but the investor may be in the minority!)

Burden of administration

Whether using the nominee or no-nominee structure, issuing shares (whether in the company or the nominee company) to hundreds (thousands?) of shareholders requires a great deal of paperwork and administration.

Relatively recent legislation has sought to streamline private company administration and in particular now caters for electronic communications. None of that legislation, however, was drafted with equity crowdfunding in mind and there remains a substantial administrative burden on the company and/ or the nominee when dealing with a large volume of shareholders.

A commonly heard criticism of crowdfunding as a concept, and particularly the no-nominee structure, is that the practicalities of dealing with a cap table populated by the crowd acts as a block to further investment, for example by a venture capital fund. Some argue that this criticism is unfounded and point to the various follow on rounds closed by crowd funded companies and also to CrowdCube's own funding round in 2014 where Balderton Capital invested in the platform alongside the crowd[11]. Crowd funded companies' future access to institutional funds remains, however, a concern for many investors.

Recent legislation sought to streamline private company administration, but was not drafted with equity crowdfunding in mind

Equity platforms - regulatory position

The regulation of crowdfunding is a complicated business and it is beyond the scope of this note to provide a detailed summary. It is worth noting, however, that the applicable regulatory framework was not created with equity crowdfunding in mind and the regulatory status of equity crowdfunding has been subject to much debate**.**

Companies and investors using equity platforms, and the platforms themselves, should be aware of the following key regulatory requirements:

- Under s19 of FSMA[12], it is a criminal offence to carry out a regulated activity without being authorised by the FCA to do so. The list of regulated activities is extensive and includes arranging deals in investments, which common sense would suggest catches the operation of a crowdfunding platform[13]. The question as to whether equity platforms need to be authorised was probably conclusively answered when Seedrs obtained its FCA authorisation in March 2012 and when CrowdCube followed suit and became FCA authorised in January 2013. Previously the platforms were operating under a combination of exemptions and exclusions from the regulated activities regime.

- s21 of FSMA prevents the issue of a financial promotion unless it is either issued by, or its contents have either been approved by, an authorised person. Financial promotion covers any communication (written or verbal) which could constitute an invitation or inducement to engage in investment activity[14]. Contravention is a criminal offence.

- s85(1) of FSMA requires a prospectus to be published where transferable securities are offered to the public. Crowdfunding offers will generally fall within one or more of the available exemptions and if so will not trigger the requirement to produce a prospectus.

- s755 of the Companies Act 2006 prohibits the offer of shares in a private company to members of the public.

General prohibition on financial promotion

Much of the promotional literature circulated by a company raising funds on an equity platform will be a financial promotion. In order to comply with s21 of FSMA, the company is usually unable to rely on the authorised status of the equity platform itself which will not be issuing the promotions nor approving their contents. Instead the company will likely rely on three of the available exemptions and take steps to ensure that the promotions are received only by:

- self-certified high net worth individuals;

- self-certified sophisticated investors; and

- retail investors who self-certify that they will not invest more than 10% of their portfolio in unlisted shares/ debt securities[15].

The FCA currently takes the view that these categories of person understand the risks involved and/or have the financial capacity to cope with any loss.

To what extent does the use of social media to market investments comply with the regulations?

Key regulatory concerns/ issues

The key regulatory questions still under consideration are:

- To what extent – bearing in mind their use of social media – are the companies using equity platform communicating their promotions exclusively to persons falling within the exemptions?[16] Probably many are not.
- To what extent are the platforms holding the required authorisation for all the activities they are carrying out? The FCA have publicly stated that they are monitoring this issue closely, although possibly it is of greater concern to the debt platforms than the equity platforms.
- Does self-certification work? Typically this involves ticking a box and moving onto the next screen.

The FCA is due to review the crowdfunding market and the applicable regulatory framework in 2016.

What view will the FCA take of the ability of current regulation to protect retail investors?

Equity crowdfunding in the US

Crowdfunding is already incredibly popular in the US but the platforms in operation are debt, rewards or donations based. An aggregate amount of $886 million was raised on those platforms in 2014[17].

Equity crowdfunding in the US has to date been prohibited by law, but when (if?) the JOBS Act[18] comes into full effect and widens the classes of investor who could use an equity platform (beyond the existing class of 'accredited investor') then we may see a 'big bang' in equity crowdfunding as SMEs and start-ups seek to gain access to vast untapped reserves of private capital[19]. The Securities and Exchange Commission missed the implementation deadline for the JOBS Act in 2012 and it is unclear when or if we will see a change in the legislation.

Seedrs sought to position itself in readiness for the potential opening of the US market by acquiring Junction Investments, based in California, in October 2014[20].

SEIS/ EIS

The vast majority of crowd funded companies in the UK have been eligible for SEIS and/or EIS treatment[21]. Many of the investors looking at equity platforms are doing so to find a home for their annual SEIS and/or EIS allowance. Clearly SEIS relief in particular drives significant traffic to the equity platforms in the UK; and query how many investors would use an equity platform without the accompanying tax benefits.

SEIS is driving significant traffic to the equity platforms in the UK

Convertible loan notes

Current legislation does not extend the SEIS (or the EIS) tax benefits to investments made by way of debt convertible at some later stage into equity. This is one reason why, in the UK, early stage venture capital investing is usually structured as equity rather than debt transactions. From a paperwork and administrative perspective, a convertible round has the significant advantages of speed and simplicity (although note that much of the administration is deferred until the debt converts into equity). Convertibles also defer the question of valuation.

The valuation problem

Agreeing a valuation for an early stage company - including most crowd funded companies - is a difficult exercise and typically involves a huge amount of guess work. Set the valuation too high and it may not be possible to raise funds again at that price and the company may be required to persuade investors to sanction a down round in the future. Set the valuation too low, however, and the founders may be dis-incentivised by dilution and there may not be room on the cap table for an institutional investor.

With a convertible, the valuation is postponed until the first significant funding round takes place at which point the debt converts into equity at a discount to the subscription price for that round.

Various commentators[22] argue that the SEIS should be extended to convertible debt and are lobbying for this change. If SEIS is extended to convertible debt, the market (or a significant part of it) may decide that the valuation problem is best solved by using convertibles and the equity platforms may need to change and/or adjust their structure. Seedrs, hedging its bets, started offering convertible debt in 2014.

Companies generally set the valuation high and the investors have little scope to negotiate

Looking ahead

We expect to see some of the following issues play out as equity crowdfunding continues to grow and develop:

- Will the CrowdCube (no-nominee) model or the Seedrs (nominee) model gain market dominance? Or will they continue to co-exist as alternative options?
- Will the FCA look more closely at the equity crowdfunding market in general and start legislating?
- As statistics continue to be collected, and rates of failure and exit are better known, what effect will that have on the market, the type of investor and the type of company seeking funding?
- Will equity crowdfunding take off in the US?
- Will the equity crowdfunding model be affected if the SEIS is extended to convertible loan notes?
- Will there be a platform failure? When will the first significant crowd funded company fail? How will the market react?

Like all good technology ventures, the equity platforms would no doubt tell you that they are sufficiently nimble such that they will be able to adapt and adjust to whatever the market throws at them. We will continue to monitor this space with interest.

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About Foot Anstey Ventures

The Foot Anstey venture capital team advises fast growth digital technology ventures and the venture capital funds and angels who invest in them.

If you have a question about crowdfunding, or venture capital generally, you can contact the author, Henry Humphreys, by **email here**.

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12 Financial Services and Markets Act 2000.

13 The full list is set out in the Financial Services and Markets Act 2000 (financial promotion) Order 2005 ("FPO").

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