

INVESTMENT-BASED CROWDFUNDING

The regulation of "non-readily realisable securities" and investment-based crowdfunding platforms

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Overview

What is crowdfunding?

Crowdfunding is a way in which people, organisations and business, including start-ups, can raise money through online portals (crowdfunding platforms) to finance or re-finance their activities. Money is subscribed by individuals and institutions.

Regulation of crowdfunding platforms

Some crowdfunding is regulated and some is exempt from regulation. The FCA is responsible for regulating the following types of crowdfunding:

- ▶ **loan-based crowdfunding platforms** on which people lend money to individuals or businesses in the hope of a financial return in the form of interest payments and a repayment of capital over time (this excludes some business-to-business loans); and
- ▶ **investment-based crowdfunding platforms** on which people invest in unlisted shares or debt securities issued by businesses.

The FCA does not regulate other forms of crowdfunding, such as rewards-based or donation-based crowdfunding.

This paper focuses on the regulatory regime surrounding **investment-based crowdfunding**.

UK crowdfunding market

The crowdfunding market has grown rapidly since 2014. In a paper released by the FCA in July 2016 it is noted that an estimated £2.7bn was invested on regulated crowdfunding platforms over the course of 2015, compared to an estimated £500m invested over the course of 2013. The FCA notes that (as of July 2016) 23 authorised firms and 11 appointed representatives operate investment based crowdfunding platforms.

Products on investment based crowdfunding

In addition to the expansion of the UK crowdfunding market, the 2015 UK Alternative Finance Industry Report notes that a number of new products are also now offered on investment based-crowdfunding platforms, including mini-bonds, convertible notes, real estate investment trusts and accelerator funds (in addition to equity based investment products).

Mini-bonds, in particular, have become a popular investment-based crowdfunding product. These are bonds aimed at retail investors which are structured so that they fall outside the requirements of the EU prospectus regime and so do not require the same high level of disclosure as retail and wholesale bonds. This is achieved by issuing bonds which cannot be traded on a regulated market (such as the Main Market of the London Stock Exchange), and which are either non-transferable or where the total consideration of the offer is less than €5 million.

Regulatory scrutiny

The new FCA rules on investment-based crowdfunding came into force in April 2014. The rules represented a change in the FCA's approach to the regulation of firms operating investment-based crowdfunding platforms to make the market more accessible to retail clients whilst ensuring only investors who understood and could bear the risks participated in the market.

In light of the rapid growth of the UK crowdfunding market, the FCA has since looked in detail at whether its rules need to be changed to reflect the current scale and status of the market, as well as potential risks to investors.

In February 2015 the FCA published a paper titled "A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media". The paper considered the implementation of the FCA rules and was intended as a precursor to a full post-implementation review.

In July 2016 the FCA took its first steps in launching the full post-implementation review of its crowdfunding rules, through the publication of a "call for input". This sets out the FCA's initial thinking on areas where it might be appropriate to adjust rules. In December 2016 the FCA published a statement containing interim feedback from the call for input.

The post-implementation review is still ongoing and the FCA plans to publish a consultation paper in the first quarter of this year proposing new rules to address some of the concerns surrounding potential investor detriment, particularly around the quality of investor communications and financial promotions. This article considers the rules introduced in April 2014 in relation to investment-based crowdfunding and the promotion of mini-bonds and other non-readily realisable investments, and considers the FCA's reviews of the rules and its proposals to adjust them.

Financial Promotions and Non-Readily Realisable Securities

Firms operating investment-based crowdfunding platforms are subject to the standard FCA rules for investment firms (including, for example, capital requirements and requirements in relation to the fair, clear and not misleading provision of information).

In addition to the rules on financial promotions, there are specific marketing restrictions in relation to the "direct offer financial promotion" of certain types of equities and debt securities typically sold on crowdfunding platforms (which the FCA terms "non-readily realisable securities"). These rules came into force in April 2014 further to a FCA consultation titled "the FCA's regulatory approach to crowdfunding over the internet and the promotion of non-readily securities by other media".

What is a non-readily realisable security?

A "non-readily realisable security" is defined as a security which is not: (i) a readily realisable security; (ii) a packaged product; (iii) a non-mainstream pooled investment; or (iv) a mutual society share. A "readily realisable security" includes securities which are admitted to listing/regularly traded on an exchange in an EEA State.

A mini-bond would therefore be a "non-readily realisable security" but a bond traded on the London Stock Exchange or Professional Securities Market would not be (although it would still be subject to other regulation).

What is a direct promotion?

To be a "direct offer" the promotion needs to contain an offer or invitation, and specify the manner of response or include a form by which a response may be made. So, if a promotion does not specify how to respond, then that promotion will not be caught by the additional marketing restrictions. For example, if a communication simply gives marketing information about the firm operating the crowdfunding platform or information about who can be invited to invest, then the marketing restrictions will not apply to it.

What are the rules?

The rules state that a firm must not communicate or approve a direct offer financial promotion relating to a non-readily realisable security to or for communication to a retail client unless:

- ▶ the firm complies with FCA suitability rules in relation to the investment (or the client has confirmed before the promotion is made that they are a client of another firm that will comply with the FCA suitability rules in relation to the investment) or the retail client is a corporate finance contact or venture capital contact; OR
- ▶ the following conditions are satisfied:
 - ▶ the investor is certified as either "high net worth", "sophisticated" or "restricted"; AND
 - ▶ the firm or person arranging or dealing in the non-readily realisable security complies with the FCA rules on appropriateness or equivalent.

The concept of a "restricted investor" is newly introduced by the rules. To qualify as a restricted investor the individual must certify that they will not invest more than 10% of their net investible assets in non-readily realisable securities.

FCA Review

In February 2015 the FCA published a paper titled "A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media". The paper considered the implementation of the FCA rules which came into force in April 2014, such as those relating to marketing restrictions set out above. It was intended as a precursor to the full post-implementation review which took place in 2016 (see further below).

Financial promotions of mini-bonds

The FCA reviewed the financial promotions of a number of mini-bonds (both those on crowdfunding and in direct marketing) and noted the following concerns:

- ▶ firms are failing to make clear that mini-bonds are investments that place investors' capital at risk, and are not deposit-based or capital-protected products. While the returns on mini-bonds can appear competitive in the current low interest environment, it is misleading to compare their interest rates with those obtainable from savings accounts where investors' capital is not at risk;

- ▶ it is important that the promotion is balanced, in particular, the risks to capital and the lack of FSCS cover should be highlighted; and
- ▶ comparisons are sometimes made to retail bonds (such as corporate bonds listed on the stock market) but there are important differences. For example, mini-bonds are generally not traded, so investors' money is effectively locked in until maturity as the mini-bond cannot be sold on before the end of its term. This should be made clear to prospective investors.

The FCA also reiterated that, where a firm is asked to approve a financial promotion on behalf of an unauthorised firm, the firm must satisfy itself that the financial promotion is clear, fair and not misleading and it must not approve the promotion if it does not comply with the FCA's rules.

Investment-based crowdfunding platforms

The FCA also identified the following problems with regard to investment-based crowdfunding platforms from the websites it reviewed:

- ▶ a lack of balance, where many benefits are emphasised without a prominent indication of risks;
- ▶ insufficient, omitted or cherry picking of information, leading to a potentially misleading or unrealistically optimistic impression of the investment; and
- ▶ the downplaying of important information- for example, risk warnings being diminished by claims that no capital had been lost or the relevant risk warnings being less prominent than performance information.

Post-implementation review of the FCA's crowdfunding rules

In its July 2016 call for input the FCA raised the following initial thoughts about its future regulation of the investment-based crowdfunding sector:

▶ Market developments

- ▶ There is an increase in institutional investment on investment-based crowd funding and the FCA is keen to explore the implications of this trend. The FCA notes that it would be concerned if institutional investors are granted more favourable treatment than less knowledgeable or experienced retail investors.
- ▶ The FCA is also growing increasingly concerned about the speed of change in the investment-based (and loan-based) crowdfunding sectors and in particular the potential for arbitrage with other financial services such as asset management. It will continue to explore the risks as part of the post-implementation review.

▶ Managing conflicts of interest

- ▶ The FCA is considering whether the current requirements adequately address issues specific to the management of conflicts of interest on investment-based crowdfunding platforms.
- ▶ The FCA notes that it may be in the interests of firms to make available as many projects as possible, in order to maximise profit, but this may not be in the best interests of retail investors who expect higher due diligence standards.
- ▶ Some respondents similarly felt that platform incentives are more closely aligned with issuers than investors. Some suggested that interests of the platform could be better aligned with that of investors by partly linking the firm's remuneration with the success of the fundraising entities (rather than only taking a fee for the amount invested).
- ▶ The FCA believes that it is important that crowdfunding platforms treat those on both sides of the transactions they facilitate as clients and notes that this does not create conflicts of interest, but clarifies that conflicts are likely and must be considered appropriately. It emphasises that conflicts must be identified and managed (ideally by avoiding the conflict) and disclosure should be considered if a firm cannot manage the conflict to avoid consumer detriment.

▶ Due diligence standards

- ▶ The current rules allow for flexibility in terms of the levels and standards of due diligence. Firms can conduct due diligence on behalf of investors, or allow investors to undertake their own analysis, provided the level of undertaken by firms is made clear, so that investors can determine how much additional work is required.

- ▶ As some businesses raising money through crowdfunding fail shortly afterwards, the FCA is concerned about whether the current approach is working and whether investors are being exposed to risks they are not well placed to assess in advance. The FCA is considering minimum due diligence standards, such as a third party review of business plans.
- ▶ Most respondents felt that the FCA should not impose minimum due diligence standards and were also against third party responsibility for reviewing pitches. The FCA is going to continue to analyse due diligence standards in the ongoing post-implementation review and consider consulting on further rules on disclosures.

▶ Client assessment

- ▶ The FCA is performing an in-depth assessment of how firms are meeting the requirements in relation to the appropriateness test (where a firm relies on this to make a direct promotion of a non-readily realisable security) and whether client outcomes are fair. The FCA will consider providing more guidance or rules to help firms.
- ▶ The FCA is also looking at how well firms are meeting the client classification requirements when assessing clients as "high net worth", "experienced" or "sophisticated". The FCA is concerned by some responses to the call for input, which question if firms must assess whether clients meet the criteria to be considered high net worth or sophisticated. It is considering if there should be greater supervision of client assessment procedures due to this misunderstanding, as well as general respondent concerns that current market practice is insufficient.
- ▶ Some respondents suggested changes to the restricted investor category, proposing that all investors could invest up to a certain amount. Others suggested that a minimum investment of, say, £250, would offer protection by limiting the exposure to the market by those unable to take the high level of risk. Another proposal was for firms to monitor the activities of those with low declared incomes and intervene if investments appear disproportionate to income. This would clearly be onerous on firms.
- ▶ The FCA states that the current rules aim to strike a balance between granting ordinary retail investors freedom to invest in high-risk investments while providing appropriate investor protections. The FCA will continue to survey consumers to find out if this balance is being maintained and may revisit the client assessment rules in the future if not.

▶ Disclosures

- ▶ The current requirements are contained within high level rules which require firms to provide potential investors with information so that they are reasonably able to understand the nature and risks and to invest on an informed basis.
- ▶ The FCA is reviewing its current standards and if the current rules are not delivering adequate standards of consumer protection, it will consider a full range of options, including taking supervisory or enforcement action against firms, introducing additional requirements and, potentially, requiring mandatory disclosures of information and risk warnings.
- ▶ These mandatory disclosures might include requiring a firm to set out how many businesses that raised funds have since failed and how many have had successful pay-outs. It might also require firms, when setting out the money raised so far on a pitch, to only include money contributed on the platform from persons unconnected to the business.

▶ Innovative finance ISAs

- ▶ In 2015 the Government consulted on allowing assets sold on investment-based crowdfunding platforms to be held within the Innovative Finance ISA wrapper. In light of these changes, the FCA is considering mandating the disclosure of required information in relation to ISA investments in non-readily realisable securities. For example, highlighting the risk that investors may lose their ISA allowance for a year if they hold equities in a business that goes on to fail.

▶ Other issues

- ▶ Respondents to the call for input also raised some additional issues including the monitoring of fundraiser performance (so that investors get mandatory updates on the performance of businesses that raise funds) and encouraging of affordable independent research into fundraisers to support due diligence, which the FCA has said it will consider further as it continues with its review.

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