# CROWD FE

## *DRAGON'S DEN* IS SOOOOO LAST YEAR, SAYS **KAM PATEL**. THESE DAYS, SAVVY INVESTORS ARE DOING IT FOR THEMSELVES. BUT WHAT'S IN IT FOR ADVISERS?

**With traditional credit markets remaining sclerotic, it's not so very surprising that individuals, small enterprises and start-ups seeking backing for projects are turning to other means of securing funds. And the latest of these is something called crowdfunding - an internet-based market for connecting entrepreneurs with potential investors who may only want to invest small amounts in start-up equity, often just for the fun of it.**

The premise of crowdfunding is simple. If a project is deemed good enough, and desired enough – for whatever reason – by enough people, and if each of them is willing to back it with small amounts of money, then it can be realised. The trouble is that there's no sign yet that the FSA or the Treasury have figured out what level of regulation crowdfunding requires. The Americans seem to have made a much better fist of the matter so far.

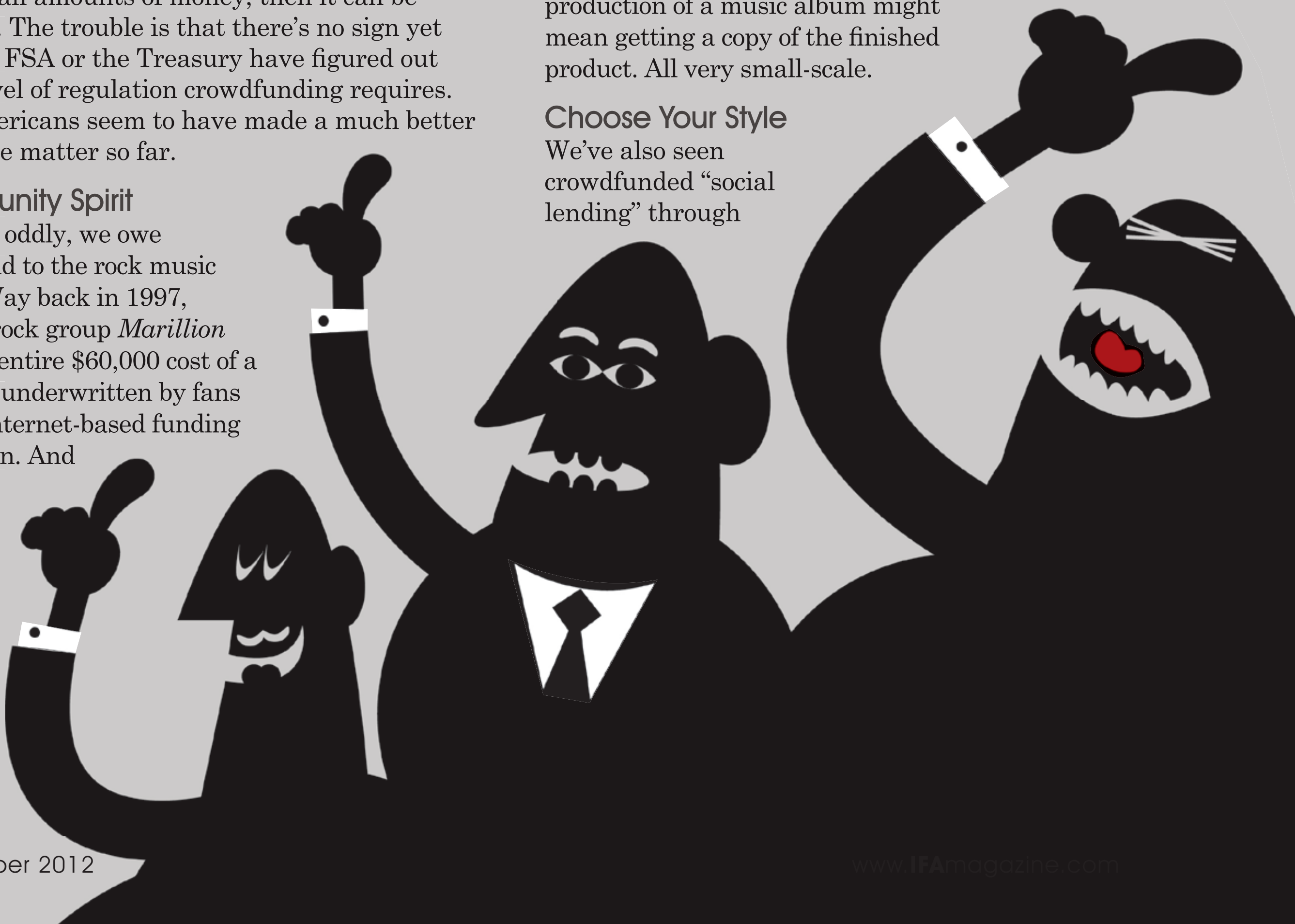
### Community Spirit

Perhaps oddly, we owe this trend to the rock music scene. Way back in 1997, British rock group *Marillion* had the entire $60,000 cost of a US tour underwritten by fans via an internet-based funding campaign. And since then the increasing sophistication of the internet, coupled with the recent explosion of social media channels, has further revolutionised the general awareness of this extraordinary new trend.

Let's be clear about one thing. It's still the community and culture spectrum that tends to dominate the sphere. Local communities are using crowdfunding to achieve goals such as saving a much-loved pub from closure, or to build local healthcare facilities. And the rewards tend to be non-financial. Helping to save a pub might mean that each funder is repaid in beer. Backing the production of a music album might mean getting a copy of the finished product. All very small-scale.

### Choose Your Style

We've also seen crowdfunded "social lending" through



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online agencies such as Zopa, which combine social and financial motivation: there is repayment of loan with interest but some of the loan, being socially motivated, is interest free.

But other models are now emerging which have intrigued more sophisticated investors - most notably equity crowdfunding, which invites individuals to invest smallish sums of money in an stake in what will probably be a privately-owned start-up or young business venture. If the business does well, there is likely to be a hefty return on investment - plus, potentially, other intangible benefits for the investor. And if it all goes pear-shaped, the sums aren't so large as to be grievous.

## Gateways and Regulatory Issues

It is, of course, crucial that the gateways for connecting networks of potential investors with individuals and businesses should be effective and well-managed if the task is to succeed. This is where online platforms come into their own - with site operators responsible for vetting, promoting and managing funding of propositions as well as dealing with investor protection issues.

But the levels of protection on offer still need careful research in many cases. It's only been in the last three months that the first online crowdfunder has gained formal FSA authorisation, - making Seedrs, an online platform for investing in startups, the first platform anywhere in the world of its kind to receive regulatory approval.

Seedrs was launched with £1 million of investment from venture capitalists DFJ Esprit and Digital Prophets - the latter backed by entrepreneur Luke Johnson. It allows investors – friends, families and crowds - to invest a combined total of up to £150,000 in startups that they choose through a simple online process. Jeff Lynn, co-founder and chief executive of Seedrs, says the £150,000 equity limit is based on the

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management's observation that the overwhelming majority of entrepreneurs need this amount, or less, to take their first step before launching or seeking later-stage capital.

But if the capital amounts are small, so are the individual investments. Seedrs says that many people would like to invest small amounts of money in startups – some of them building a portfolio in order to get exposure to a high-growth, high-risk asset class, and others simply wanting to support friends, family and community members while also getting the benefit of upside if they succeed. Still others, of course, hanker for the excitement of being an "armchair dragon".

The small investment sums involved also favour the platform approach. Due diligence costs mean that normally it's extremely difficult to invest less than £10,000 in a startup. At Seedrs, however, people can invest as little as £10.

## Sweeteners and Safety Checks

There are also tax breaks available to investors who back new and small businesses. The Seed Enterprise Investment Scheme, announced last year by Chancellor George Osborne, offers 50% income tax relief on qualifying investments of up to £100,000, with a potential further 28% from an exemption of capital gains tax.

In practice, investors keen on backing a Seedrs business must first pass a short online test to prove they understand the risks involved in investing in start-ups. Following the completion of an investment, Seedrs holds and manages the shares on the investors' behalf, which helps protect investors' interests and minimises the administrative burden for the start-ups.

Seedrs's fees comprise two separate charges. First, the entrepreneur pays a 7.5% fee on any amount raised through the platform. There is no 'pay to pitch', and if the start-up does not succeed in raising the money then everyone walks away with no fees paid by anyone.

The second charge is a 7.5% fee levied on any returns that investors receive above their original investment - whether through the proceeds of a sale, dividends or other payments from the startup to the investors. Any returns paid to the investor up to the amount of their original investment are paid free of any charge.

Lynn is confident Seedrs can deliver both for its businesses and investors: "As people in Britain look for more tangible and 'real' places to invest their money, beyond the conventional and poorly performing products they have been sold in the past by institutions that have let them down, the launch of Seedrs is particularly timely."

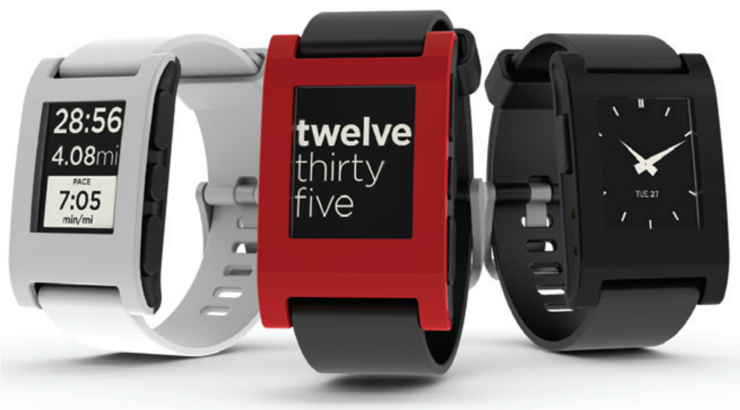
## An International Phenomenon

Of the six major equity crowdfunding platforms in Europe, three (Seedrs, BankToTheFuture and Crowdcube) are based in the UK, with the Netherlands, Germany, Belgium and France accounting for one each. Another UK-based site, CrowdMission, is due to launch later this year.

There is currently talk that the US crowdfunding phenomenon Kickstarter may be planning to open for business in the UK later this year. Since launching in 2009, Kickstarter has funded tens of thousands of projects, including film, photography, and video game projects. Several of its offerings have topped the $1m mark in pledges, including Pebble, an electronic paper watch, which secured nearly £2m in less than a week of being promoted on the Kickstarter site.

A new report by researcher Nesta, *The Venture Crowd (http://tinyurl.com/c4t7ywk)* claims that the number of active crowdfunding sites globally grew by 54% in 2011 to 453. Between them they raised $1.5 billion in project and business financing over the year. Nesta expects further strong growth this year, with Kickstarter, the global market-leader, alone expected to raise $150m.

As so often, our American cousins are ahead of us. Crowdfunding has received the combined support of both Republicans and Democrats - with the Obama administration pass new legislation specifically designed to encourage ordinary citizens to pool their money behind an




## "They wanted $100k - they got $10.2m"

The designers of the Pebble watch *(pictured left)* raised more than £6.4m to develop the product simply by explaining its concept online – and the joke is they were only looking for £64,000 to fund their ambition! This is one of the most successful results for Kickstarter, the crowdfunding website launched three years ago in New York.

entrepreneur or a business. But developments over here have been rather less oxygenated.

Business Secretary Vince Cable has been making positive noises about innovations like crowdfunding, and their potential to become important alternatives to bank lending, but the FSA still advises caution. In mid-August the agency posted a note on its website warning that:

*"Most crowdfunding should be targeted at sophisticated investors who know how to value a startup business [and] understand the risks involved....We want it to be clear that investors in a crowdfund have little or no protection if the business or project fails, and that they will probably lose all their investment if it does."*

## Get Your Act Together, Regulators

Fair enough. But the FSA's warning sidesteps the fact that UK regulators have yet to get fully to grips with the emerging crowdfunding market. As Nesta noted in its July report, "the process for allowing platforms to gain accreditation needs to be improved". And it adds: "Once regulators have developed a clearer view on how the model works, guidelines on what the requirements are to gain accreditation should be made public and efforts made to speed up the process."

Nesta adds that all platform operators consulted for its report, including Crowdcube and the FSA-authorised Seedrs, agree that that "clear and defined supervision of activities in the area will go a long way to improving investor confidence... and increasing the number of businesses willing to raise this type of finance."

But it warns: "As this is quite a new model of finance, it is important that those providing oversight are sufficiently knowledgeable of the nuances of the model and the protections that are required for investors."

## The Charity Angle

Faced with an uncomfortably urgent wall of demands for clarity, the government has been calling for input from outside agencies. One of the most important contributors to date has been the law firm Bates Wells & Braithwate (BWB), which recently outlined ten reforms needed to transform the social investment market in the UK. BWB's proposals focus on charitable activities in particular, but they also have implications for the broader crowdfunding sector.

BWB's suggestions include a social investment duty being placed on the Financial Conduct Authority and the Prudential Regulation Authority to ensure sensitive regulation of the sector, and a reform of rules governing financial promotions to take account of investors who invest with social motives and engage with crowdfunding and peer-to-peer lending. The firm also calls for a specific authorisation regime to be introduced by the Financial Conduct Authority to facilitate crowdfunding, peer-to-peer lending and other online direct investment facilities.

Luke Fletcher, senior associate at BWB, believes the UK could learn from America's enlightened approach. The US, he says, has recognised that a "one-size-fits-all" approach to regulation does not work, and that if crowdfunded investments are capped, as they are under the US JOBS Act, a lighter touch can be applied. "It's an example of how financial services law needs to be reformed to recognise that new ways need to be found to help businesses to raise capital in difficult times," says Fletcher. He adds: "The JOBS Act is a recognition that technology is going to play an increasingly important role in investor behaviour and in disintermediating and disrupting traditional financial institutions."

But Fletcher doesn't see much sign of flexibility in HM Treasury, which he says is in "reactive" mode. Unless the crowdfunding and peer-to-peer market gets to a size where it cannot be ignored, or unless something goes wrong, he says, there is no sign of the Treasury bringing forward proposals for a new regulatory framework.

## The Way Ahead

However, he believes it is only a matter of time before this changes. The very rapid volume growth in social lending platforms like Zopa, and the emergence of a whole variety of new websites and platforms in the marketplace, are creating "an opportunity for the UK to lead the way in crowdfunding and to develop a whole new market." But," he adds, "this can only be done safely with sensitively tailored regulation."

It does leave an open question for IFAs – namely, how are they to make a fee if the typical investment amounts are so small and the investment process is entirely online? We'll have to see how this shapes up in the coming years. Will it be seen as inimical to IFAs' activities, or can it be handled through a paid-for advice channel? IFA