CrowdfundingHub

Equity Crowdfunding

Considering potential risks and liabilities as the industry grows and matures

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Introduction:

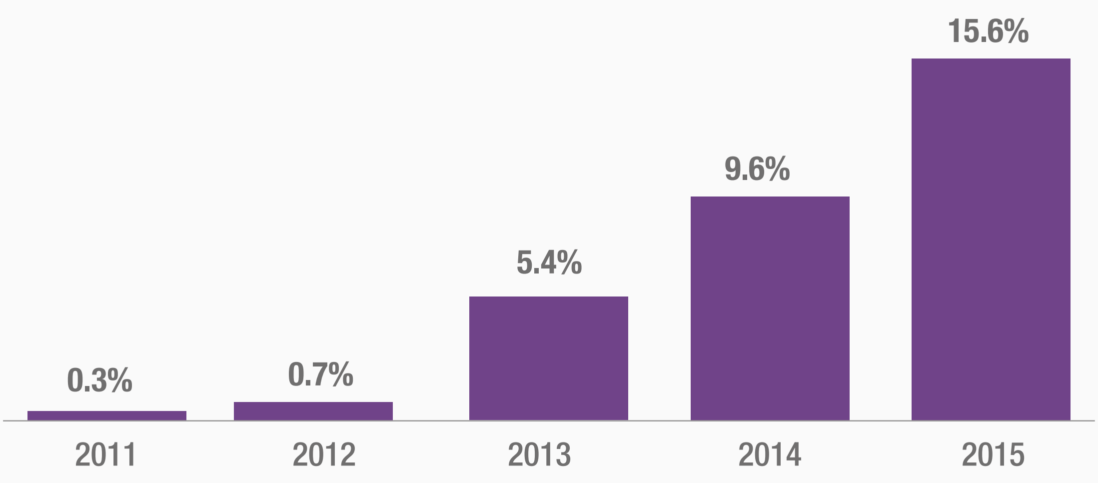
The rise and rise of equity crowdfunding

Within the rapidly-expanding alternative finance industry, equity crowdfunding is emerging as a popular method of growth finance. Equity crowdfunding is a mechanism by which a broad group of investors can fund start-up companies and small businesses in return for equity.

Globally, the total crowdfunding industry's estimated fundraising volume was $34 billion in 2015, of which equity crowdfunding represented $2.5 billion. Real estate continues to be a popular sector for equity crowdfunding, with more than 125 real estate crowdfunding sites in the US alone.

Crowdfunding markets within Europe are at different stages of maturity. In the UK equity crowdfunding has grown extremely rapidly, up by 295% in 2015 according to research by the University of Cambridge Centre for Alternative Finance and Nesta. It now represents 15.6% of all UK seed and venture funding. In Norway, by comparison, this form of alternative financing is still very much in its infancy.

Equity-based Crowdfunding Share of the UK Seed and Venture Stage Equity Investment Market

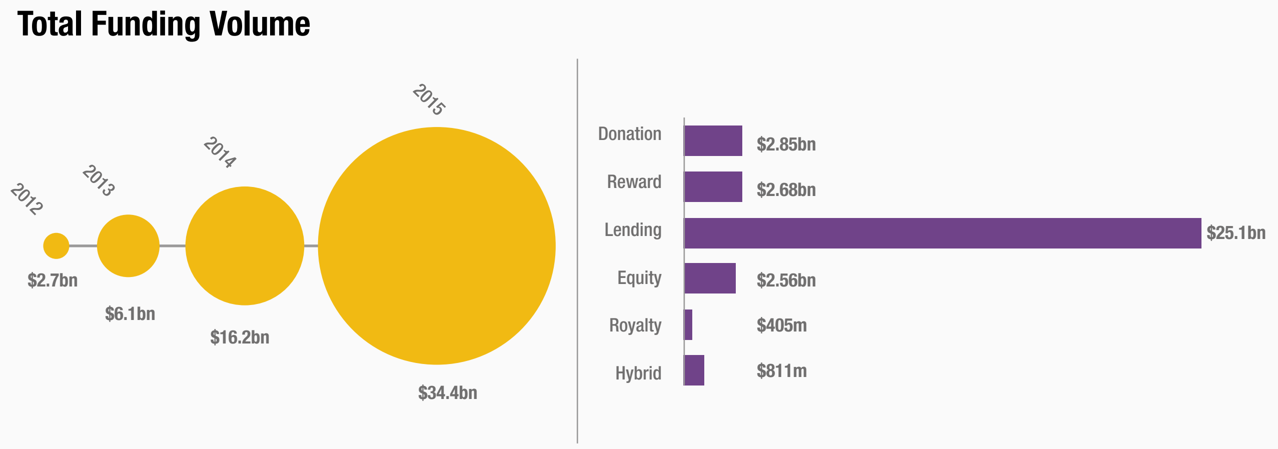


(Based on Beauhurst Data 2011-2015 Source: University of Cambridge Centre for Alternative Finance, Nesta, KPMG and CME Group Foundation)

Proponents of equity crowdfunding argue it is an alternative financing option that benefits all parties. This includes entrepreneurs that are not interested or able to access traditional bank, venture capital (VC) or business angel funding while also lowering barriers to entry for investors.

The equity crowdfunding market is set for spectacular growth across Europe.

Growth by crowdfunding model prediction for 2015 in millions of USD (research based estimate).



Source: Massolution 2015

While it is still early days, the market is set for spectacular growth across Europe. It is estimated that €5.4 billion was successfully raised through alternative finance platforms (websites that enable interaction between fundraisers and the crowd) in 2015, according to Cambridge Centre for Alternative Finance's research "Sustaining Momentum".

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Most platforms are currently located in the UK (143), followed by France (77) and Germany (65), according to research by the European Commission in 2015, executed by Crowdsurfer. The majority were involved in reward-based crowdfunding (30%), followed by platforms involved in equity crowdfunding (23%).

Across the EU between 2013 and 2014, amounts raised through equity crowdfunding platforms grew by 167%, according to the Commission, with the majority of investors citing interest or excitement about a specific company or project as their main reason for investing via this route.

While overall, crowdfunding platforms appear to have gained investors' trust and are building a sound reputation, there are nevertheless potential risks and liabilities associated with equity crowdfunding. These need to be considered by both crowdfunding associations and investors. Furthermore, methods of risk management and risk financing should be discussed with insurer and broker partners if this important method of alternative financing is to reach its full potential.

Chapter 1:

Latest developments in equity crowdfunding

As the equity crowdfunding market grows and evolves, one of the biggest trends to watch is the development of a fully accessible secondary market. This is essential to the sector's future growth as it provides an exit strategy for investors who do not want their funds to be tied up for several years.

Other developments underway in the sector include growing collaboration between business angel networks and equity crowdfunding platforms, as both types of investors seek to gain from combined strengths and experience. And all the while, the sector is witnessing the steady growth of maximum deal size.

Urgent need for a secondary market

Since the first equity crowdfunding platforms launched, the need for a secondary market to trade the shares was recognised as an essential means of providing liquidity. But currently there is no fully functioning and efficient secondary market leaving equity crowdfunding investors with no options to trade their shares.

In order to take the next step in its evolution a secondary market for equity crowdfunding will be necessary. Without it, investors will be forced to sit on unrealised profits that they will be unable to access in the absence of an efficient exit strategy. This is an unpopular state of play for investors who do not like their money to be tied-up long term.

There are currently two scenarios in terms of how this secondary market could develop. Either the leading platforms will become big enough to create an internal market to trade shares from campaigns on their own platform, or specialised secondary markets will be launched. These can be new Fintech companies, but because of stricter regulations, most likely these will be initiatives that are created or backed by existing stock exchanges.

In the near term it is likely that these models will co-exist side by side until a clear leader emerges. Until it does, it will create fragmentation within the industry and continuing difficulties for investors seeking to trade their assets. The best option long term is for specialised secondary platforms to join forces with smaller platforms.

Equity crowdfunding versus business angels: No longer a case of either-or

Until recently, business angels were the only source of equity funding for start-ups and scale-ups before they were able to attract venture capital. With equity crowdfunding companies now have another source of potential equity funding. Experts anticipate these two industries will merge in the near future to benefit from and exploit their mutual strengths.

Anecdotally, business angels are already carrying out due diligence exercises on certain deals, opening up the investment for crowd investors under the same terms. For business angels, equity crowdfunding offers the opportunity to spread their risks. The cost of investing is also lower by virtue of tapping into the automated processes of an equity crowdfunding platform. In this way, a typical business angel will be able to spread investment capital (and risk) over 50 or more companies as oppose to five large investments.

Steady growth in deal size

Currently equity crowdfunding is typically used for seed rounds of <€500,000, with a smaller number raising over a million euros. The maximum deal size for an equity crowdfunding campaign is €5m. This limit is based on EU regulations (EU Prospectus Directive) that determines the maximum deal size to raise investment capital without the use of a prospectus. However, it is anticipated that next year under the new EU Prospectus Directive this limit will be raised to €10m.

Crowdfunding platforms are also expected to support higher investment rounds with the use of an individual prospectus per offering. This way investment rounds of €5m-€50m, or even higher, can be raised through crowdfunding, creating new competition for the venture capital industry and offering larger groups of investors the opportunity to co-invest in these later stage deals.

Serial crowdfunding

The first equity crowdfunding raising initiatives were undertaken by companies looking for a one-off investment as seed capital to get them started. However, many of the start-ups originally funded by equity crowdfunding are now experiencing growth and are looking for additional growth capital. Enter the concept of serial crowdfunding, whereby crowdfunding is used as a continuous source of funding throughout the lifetime of the business.

Instead of traditional Series A-B-C rounds, serial crowdfunders use equity crowdfunding in Crowd A, B and C rounds, sometimes combined with traditional venture capital or business angel funding. A common characteristic of serial equity crowdfunded enterprises is the steady growth in deal size over time as the company grows and matures.

One example of a serial equity crowdfunder is Brewdog, a brewery started with a £750,000 seed round in 2009, followed by a £2.2m round in 2011, a £4.25m round in 2013 and a £19m round in 2015. In a total of four rounds the business raised over £26m in total investment from 42,000 individual investors. Currently they have an open investment round, raising £50m in the US[1].

DIY crowdfunding

An ongoing challenge for equity crowdfunding platforms is in establishing the “sweet spot” for deal sizes and demonstrating their added value for companies raising larger funding rounds. While larger rounds are of great financial interest to equity crowdfunding platforms, companies raising over €1m generally have a strong existing network of potential investors and are in a better position to raise funds directly via their own website.

DIY crowdfunders are obliged to pay additional legal fees and costs for organising their own investment rounds, but they avoid platform fees. Especially when it comes to large investment rounds, such as for real estate firms or companies that already have a strong network of investors, it can be beneficial to opt for DIY crowdfunding rather than going down the more traditional equity crowdfunding platform route.

1. www.bankroll.ventures/deal/brewdog/

Chapter 2:

Striking the right regulatory balance

Initially, equity crowdfunding in the UK was a largely unregulated space where only common law principles applied. This allowed market participants to undertake activities that may not have been permissible under other regulatory frameworks.

Then in April 2014, new rules authorised by the FCA came into force concerning the regulation of crowdfunding platforms. Primarily the regulations require platforms to be authorised (licensed) or to have regulated activities managed by authorised parties. A screening process must also be in place to identify between sophisticated and non-sophisticated investors.

If an investor is deemed "non-sophisticated", constraints are placed on how much they are permitted to invest. These investors are urged not to invest more than 10% of their net investable assets via crowdfunding platforms. According to the regulator, this is to prevent non-sophisticated investors from putting too many eggs in one basket by allocating a disproportionate amount of their net worth to this alternative asset class. Similar restrictions are in place in the US under Title III Crowdfunding, which came into law in May 2016.

The FCA has also committed to carrying out a full post-implementation review of the crowdfunding market and its regulatory framework in 2016 to identify whether further changes were required[2].
In October 2016, the FCA announced it would start this review together with researchers from Cambridge University[3].

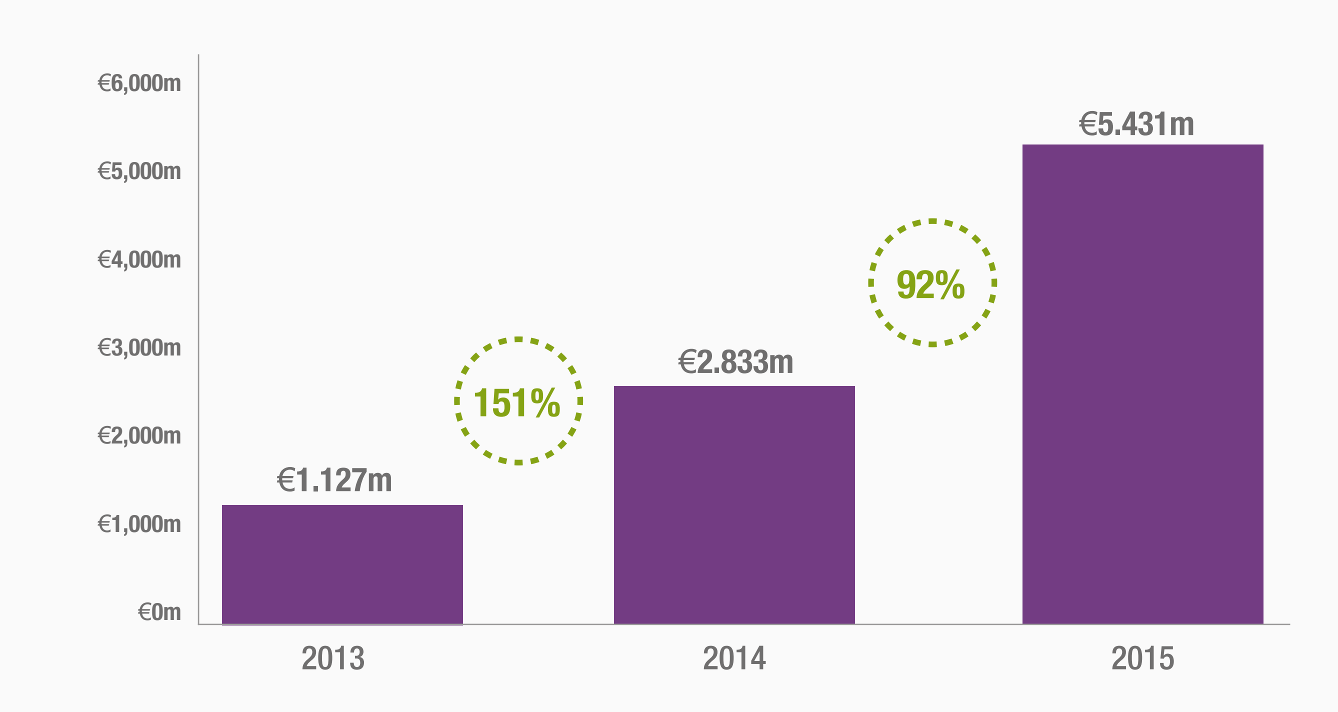
The equity fundraising industry has greeted the new rules and the promise of a greater compliance burden with mixed feelings. "When considering the regulation of crowdfunding in the UK it is important to acknowledge that equity crowdfunding was successfully taking place in the UK prior to the introduction by the FCA of the additional crowdfunding specific regulations in April 2014," said Tim Wright, director and co-founder, Twintangibles.

Rising to the challenge

The promise of more stringent legislation has not dampened growth in the alternative finance sector. In 2015, total volume in the online alternative finance market in Europe reached €5.4 billion, up from €2.8 billion in 2014 with an annual growth rate of 92%, according to the Cambridge Centre for Alternative Finance. The UK remains the largest market for alternative finance within Europe, providing €4.4 billion for 2015, followed by France at €319m.

2. www.fca.org.uk/static/documents/call-input-crowdfunding-rules.pdf
3. www.ft.com/content/d5635e3a-8642-11e6-8897-2359a58ac7a5

Volume in the Online Alternative Finance Market in Europe 2013-2015



Source: Cambridge Centre for Alternative Finance, in partnership with CrowdfundingHub, KPMG and supported by CME Group Foundation

In spite of this bullish growth, there is a feeling among some market practitioners that the new regulation does not meet the expectations of the market. In response to mixed feedback on current and proposed changes to legislation the FCA has entered into a period of consultation[4]. The UK financial regulator is looking for clarity on whether its requirements remain appropriate, and in particular, whether the rules currently in place support the development of the crowdfunding market and adequately protect investors and start-ups.

The industry has demonstrated its support for clear and proportionate regulation. Feedback so far from equity crowdfunding platforms is generally positive with a feeling that legislation dedicated to online alternative finance enhances the legitimacy of the platforms and builds trust amongst (institutional) investors. Nevertheless, a balanced set of regulations is required to ensure investor protection while on the other hand offering flexibility for platforms seeking to innovate and experiment with new business models and structures.

Balanced regulations are required to ensure investor protection while also offering flexibility for platforms seeking to innovate.

4. www.fca.org.uk/news/press-releases/fca-launches-call-input-crowdfunding-rules

Brexit concerns

Given the UK currently dominates the European equity crowdfunding market, the outcome of the UK referendum is being watched closely by industry practitioners. It is still early days and very uncertain whether and how the UK's exit from the EU will impact the wider European equity crowdfunding industry. Ultimately any fallout will depend on the UK's pre-exit strategy planning and the subsequent two-year exit negotiation process.

The UK must determine whether its ability to continue trading with Europe is best achieved by continuing to opt into all single markets legislation, pick and choose the legislation it opts into or whether it simply operates as any other non-member state under a bilateral series of trade deals. "On the basis that the UK equity crowdfunding industry is already operating under EU rules, but not making great use of the passporting freedoms associated with them, it would not appear to make a fundamental difference to the industry which route is adopted," says David Blair, principal, Legal Alternative.

Chapter 3:

Tackling investor protection

Direct shareholder versus nominee structure

Different approaches have emerged to address investor protection, with the direct shareholder and nominee structure emerging as the most popular. Of the three largest equity crowdfunding platforms in the UK, Seedrs (minimum investment of £10) and SyndicateRoom (minimum investment of £1,000) have opted for a nominee structure while Crowdcube offers both structures.

Poor returns or losses are the biggest concerns from an investor perspective.

In the case of a direct shareholder model, investors hold the shares in each investee company directly as registered shareholder. Each investor is left to manage the administration of their investments on their own, tracking corporate events, attending meetings and issuing consents where necessary.

A common remark on this model is that there is no coordinated effort to monitor and enforce shareholder rights. On the other hand, having a direct shareholding gives people a clear sense of ownership and control. Luke Lang, co-founder and managing director of Crowdcube, argues that his platform's direct shareholder model "gives investors direct ownership in the business without the middleman".

Nevertheless, Crowdcube recently acquired FCA approval to operate a nominee service to act on behalf of investors as a nominee to carry out the technical shareholder work on their behalf. In November 2015 SyndicateRoom changed its direct shareholder model in favour of a nominee structure in response to feedback from a number of high-growth business owners. These moves suggest the nominee structure is gaining ground on the direct shareholder model.

In the case of a nominee structure, the platform is the legal shareholder and as such it holds and manages the shares of startups on behalf of the underlying investors after an investment has been completed. This arrangement is very similar to a trustee relationship, as well as to the structures used by stockbrokers and other types of intermediary platform.

"The Seedrs nominee structure enables every investor to benefit from professional grade investor protections (for example, pre-emption, tag-along rights and information rights), regardless of whether they invest £10 or £100,000." According to Karen Kerrigan, Seedrs chief legal officer, Seedrs does this by aggregating the investments made by investors in an investee company and investing as their nominee, using a subscription and shareholders agreement which sets out these key rights.

SyndicateRoom argues the nominee structure not only enables startups to raise easier follow-on funding, because of a clean cap table, but also ensures investors' interests are protected. "If set up properly, a nominee structure allows all the upsides of direct shareholding and all the protections of a nominee structure, with the added benefit to companies in that they only deal with one shareholder," explains SyndicateRoom CEO Goncalo de Vasconcelos.

Due diligence and cross-border considerations

In the industry several models are used for due diligence in order to meet certain financial reporting standards, evaluate the attractiveness of the investment opportunity and protect against liability. This can be carried out by external professional organisations, the platform or by a lead investor.

Seedrs carries out its own due diligence, while SyndicateRoom uses a lead investor to carry it out on their behalf. Most of Crowdcube's due diligence process takes place before a pitch goes live and is not visible to investors.

Regulatory cross-border considerations are also important due diligence considerations as equity crowdfunding platforms operate in a borderless economy. Holding an investment firm licence within the EEA mitigates the regulatory risk with a harmonised framework of rules in Markets in Financial Instruments Directive (MiFID).

However, the current directive, as well as the upcoming MiFID II merely sets the minimum for the conduct of business. "The EU Member States may opt for stricter investor protection rules in their national legislation," says Lasse Mäkelä, co-founder and CEO of Nordic equity crowdfunding platform Invesdor. "Crowdfunding companies operating in the EEA with a MiFID licence, relying on the harmonised rules, still need to do their market due diligence before entering a new market."

Prospectus limits and company legislation on which kind of companies can offer equity to the public are probably the most restrictive regulatory hurdles while operating cross-border. Many EEA countries have rules that prevent private limited liability companies from crowdfunding and only public limited liability companies, with stricter capital requirements, can use this form of funding.

On digital platforms, it is not always clear in which countries the equity or debt issue is offered. Having different investment limits in different countries poses a potential regulatory risk for crowdfunding companies offering their services on a digital platform to investors all over the world.

In Europe, proposals to overhaul the Prospectus Directive are intended to better harmonise capital market rules and ease cross border transactions. The proposed changes have the twin goals of bringing the regulation in line with both the needs of issuers of securities and investors in those securities, a move that has been welcomed by crowdfunding associations.

While there are still many uncertainties surrounding the UK's referendum decision to exit the EU, there are potential Brexit implications for equity crowdfunding portals. Ahead of the prime minister's decision to trigger Article 50, the 143 platforms located within the UK should be considering how they may be impacted and making contingency plans where necessary.

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Chapter 4:
Mind the gap

Risks and liabilities associated with crowdfunding platforms

As equity crowdfunding is still a relatively new form of alternative financing, the risks surrounding the professional liability of the platform are largely untested. As with any emerging industry there are risks relating to misconceptions and market inexperience. Usage and definition of the term "crowdfunding" varies greatly from one country to the next.

"The broader the variety of operating models grouped under the crowdfunding umbrella, and the bigger the difference in country-specific nuances and connotations, the higher the risk of misunderstandings," explains Invesdor's Lasse Mäkelä.

The theft of issuer assets can cause a direct loss to the individual crowdfunding investor.

Inevitably, the industry is receiving growing attention from regulators, especially with regard to investor protection. Poor returns or losses are the biggest concerns from an investor perspective. Platforms need to adopt robust practices by demonstrating their selection processes are clear, fair and not misleading. Regulators will also want to see evidence of best practice surrounding investor protection.

According to research by the European Commission, some of the risks associated with equity crowdfunding include:

- Investors losing part or all of their capital or not getting the returns they expect;
- Dilution, in the case of equity crowdfunding (if the company engages in further rounds of capital raising);
- Inability to exit investments (ie for lack of a secondary market);
- Insufficient information or inability to price correctly the securities invested in, or misinformation (both in the pre-investment phase and over the lifetime of the investment);
- Conflict and misalignment of interests between issuers, platforms and investors;
- Insolvency of the platform operators, in particular as regards the continuous servicing of existing claims (eg dividend and interest payments) and protection of clients' assets;
- Security of client data;
- The use of platforms for illicit activities;
- Fraud and related reputational risk for platforms (eg the theft of issuer assets by issuer directors, officers, or general employees which cause a direct loss to the individual investor).

According to Fred Ling, commercial institutions underwriting manager at AIG, some of the exposures faced by crowdfunding companies can vary considerably from the normal operating risks of a private company. Directors & officers of companies making representations to the public face additional risks, including breach of duty, trust, neglect, errors & omissions and misleading statements.

The employees, clients and counterparties of equity-based crowdfunding platforms may require the platforms to buy a minimum level of insurance in order to secure the confidence of their suppliers, contractors, employees or investors. In the absence of insurance, directors & officers are personally liable for such wrongful acts which put their personal assets at risk.

Insurance as mechanism for sustainable growth of platforms

Insurance in its basic form is a means of protection from financial loss. The emergence of equity crowdfunding is presenting new and unique risks the insurance industry has not fully experienced before. Retail and non-accredited investors, for instance, now have the ability to invest in businesses that were previously only available to accredited and institutional investors. Before the general public will invest in this new asset class, they want to be sure their potential risks are minimised.

One of the options to minimise risk is to introduce insurance products for unexpected events, such as fraud. In addition, the development of such products will advocate and promote best practice and proactive risk management as the equity crowdfunding sector continues to grow and evolve. The presence of insurance also offers peace of mind for investors, platform owners and entrepreneurs alike.

Fraud risk case studies

To date there have been three high-profile situations in which crowdfunded companies have been involved with the defrauding investors for personal use.

The most notable instance of equity crowdfunding fraud occurred in the US, where an oil and gas company called Ascenergy raised $5 million from crowdfunding platforms. Around $1.2 million of that was then spent by the founders on non-business items, as well as payments to other companies owned by the founders. In late 2015, the Securities and Exchange Commission froze the assets of the company for fraud.

Fraud has not been limited to just equity crowdfunding. In August 2016 it transpired that Skully, a San Francisco start-up aimed to design a motorcycle helmet using augmented reality had allegedly used fraudulent bookkeeping practices designed to defraud investors. The start-up had raised nearly $2.5m from crowdfunding platform IndieGogo and an additional $11m in a subsequent round of venture financing. It is alleged the company's founders used these funds to cover personal expenses including cars, apartments, meals and entertainment. The company has since filed for Chapter 7 bankruptcy in California.

In another example of crowdfunding fraud, a former business manager from Peachy Printers, a Canadian-based start-up which had raised $650,000 via Kickstarter, was accused of embezzling company proceeds to fund the construction cost for his new home. In total, $250,000 was stolen, materially impacting the business' ability to deliver on their promise.

These situations demonstrate the inherent risk for the backers and investors of start-up companies that do not necessarily exhibit the same operational controls as an established and more tightly-regulated organisation. Although these cases are isolated, it does underline the importance of strong due diligence in the fundraising process as well as the need for risk management controls and insurance.

Notes

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Acknowledgements

CrowdfundingHub would like to thank the following experts who contributed to this paper:

Goncalo de Vasconcelos, CEO of SyndicateRoom

Karen Kerrigan, chief legal officer, Seedrs

Fred Ling, commercial institutions underwriting manager at AIG

Luke Lang, co-founder and managing director of Crowdcube

Lasse Mäkelä, co-founder and CEO, Invesdor

Tim Wright, director and co-founder, Twintangibles

David Blair, Principal, Legal Alternative

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