



CROWDFUNDING FOR SOCIAL VENTURES

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ACKNOWLEDGEMENTS

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INTRODUCTION



What is crowdfunding?

Crowdfunding is a way for businesses, including startups, to raise money from the public (or, the crowd) to finance their business activities.

The financial crisis resulted in many of the more traditional forms of financing for smaller businesses (such as bank lending and angel investment) drying up. Crowdfunding has grown in popularity as a means of raising finance from a more diverse pool of potential backers, such as from the local community or the wider public.

As more people turn to crowdfunding to help solve their business finance challenges, we felt it would be helpful to clarify the regulations applicable to UK fundraisers and investors. These are considered below and you can read on in the Appendix for more detail. Regulations applicable when raising funds from non-UK investors are not considered in this guide and should be considered separately.

How does it work?

Crowdfunding generally involves at least three parties:

- the business, project or event seeking finance (the **Project Owner**);
- the platform that links the Project Owner and the investor (the **Platform**); and
- the investor who provides the funding to the Project Owner.

Whilst it is technically possible for the Platform and the Project Owner to be one single entity, this is not the usual approach and rarely seen. As we have mentioned, there is a UK regulatory framework relating to crowdfunding, so it is advisable (particularly for smaller projects or startups) to approach the market via an existing Platform which has the relevant regulatory approvals to guard against any accidental breaches of regulations. There are a wide range of Platforms that exist. These vary in size and offer different types of crowdfunding. Fees charged, the level of assistance provided, and due diligence checks conducted on Project Owners will also vary between Platforms.

The Process

In the first instance, a Project Owner will submit its pitch to the Platform. This is generally an explanation of the project, usually displayed on a website together with the target amount of funding to be reached. Typically, the funds raised are only made available to the Project Owner if the whole of the target amount is committed by investors, though some Platforms allow 'milestones' part way through the funding. In this case, as each milestone is reached, the funding up to that milestone is made available. Whilst there is usually a timetable within which the target must be reached, this may be extendable (usually at the Platform's discretion).

Subject to regulatory requirements, some Platforms offer the choice to launch privately, which provides an opportunity to approach bigger, institutional investors, with the intention that they will invest a significant percentage of the target investment sought. The hope is that this

Crowdfunding provides an alternative source of financing for organisations and projects that may otherwise struggle to secure financing from more traditional sources.

is already significant interest in the campaign. This is less common though, especially for smaller projects.

For regulatory reasons, potential investors will have to register with the Platform before seeing the full pitch information. While some Platforms have criteria that investors need to satisfy before registering, having access to this information or investing is generally driven by the particular type of crowdfunding and the applicable regulatory requirements (explored in more detail below).

When an investor decides to invest in a particular project, they generally communicate this decision to the Platform, which in turn communicates it to the Project Owner. For example, if an investor puts his or her money into a crowdfunding campaign, that investor will technically be telling the Platform, who in turn will send a message to the Project Owner informing them that someone has made an investment. An investor won't communicate directly with the Project Owner at this stage.

Once the target investment amount is reached, the funds will be transferred to the Project Owner. Depending on the type of crowdfunding, and the scope of the authorisation that the Project Owner holds with the UK Financial Conduct Authority (the **FCA**), the Platform may either manage payments itself or outsource to a third party. Alternatively, investors may be required to transfer funds directly to the Project Owner. Further, where investors are taking part in investment based crowdfunding, the Project Owner will also issue shares in their business at completion.

Fees

Some Platforms charge fees to investors as well as to the Project Owners seeking finance, although others take a fee from the Project Owners alone. Where fees are charged to investors, these are generally either a proportion of the amount invested or a proportion of any profit made by the investor. As a potential Project Owner, you should consider carefully what amount of your total investment you will pay in fees if your campaign is successful.

Why should small and medium-sized enterprises (SMEs) be interested in crowdfunding?

Crowdfunding provides an alternative source of financing for organisations and projects that may otherwise struggle to secure financing from more traditional sources. Further, crowdfunding provides access to finance that more traditional lenders may either not provide, or may only be willing to provide at a higher cost or at a later stage of a business's lifecycle.

Aside from any financial reasons, crowdfunding also provides businesses with an opportunity to approach their existing network of users/customers to participate in the growth of the business, building on its reputation and helping to prove its viability as a business proposition going forward.

However, as set out below, certain forms of crowdfunding are regulated by the FCA. If the type of crowdfunding you are interested in using is regulated, you should understand the scope of such regulation to protect yourself from the legal, and potentially reputational, effects of any breach.

2. TYPES OF CROWDFUNDING

There are four main types of crowdfunding, which are distinguished from each other based on the type of return that the investor can expect to receive:

- investment based, where consumers invest directly or indirectly in a new or established business, for example, through the purchase of shares or bonds;
- loan based (also known as peer-to-peer lending), where consumers lend money in return for interest payments and a repayment of capital over time;
- donations based, where people give money to enterprises or organisations whose activities they want to support (similar to charitable donations or grants); or
- rewards based, where people give money in return for a reward, service or product (such as concert tickets, an innovative product, or a computer game).

3. CURRENT UK REGULATION

In the UK, the FCA regulates only those types of crowdfunding which offer a form of financial return to the investor. This is due to the increased risk to the investor posed by such activities. As such, loan based crowdfunding and investment based crowdfunding are regulated. However, donation based crowdfunding and rewards based crowdfunding are not.

TYPE OF CROWDFUNDING	REGULATED BY THE FCA?	RESTRICTIONS ON MARKETING?
Investment based	✓	✓
Loan based	✓	✓
Rewards based	✗	✗
Donation based	✗	✗

The Financial Services and Markets Act 2000 (**FSMA**) states that carrying on certain kinds of activities in relation to particular types of investments is a regulated activity. Carrying on a regulated activity without being properly authorised by the FCA, unless an exemption applies, is a criminal offence. If you engage in loan based or investment based crowdfunding, you will need to comply with the regulations.

The regulatory regime also extends to the making of financial promotions which, if carried on by a person not authorised by the FCA, is generally prohibited under FSMA. These rules regulate the marketing of investments to investors where such marketing is undertaken in the course of business. In other words, if you encourage people to invest in, or lend to, a crowdfunding project, you need to be authorised to do so (unless an exemption applies).

Make sure you consult with someone who understands these regulations before putting any information out in the world about an investment or loan opportunity – it is very easy to fall foul of these regulations if you do not understand them fully.

The regulatory pitfalls associated with both investment and loan based crowdfunding, which may affect a Project Owner, are considered below and are set out in more detail in the Appendix to this guide.

3.1 REGULATED ACTIVITIES

Investment Based Crowdfunding:

Investment based crowdfunding falls within the scope of regulation by the FCA broadly on the basis that shares (or occasionally bonds) in a company are being offered for purchase by investors via the Platform. The impact that these regulations have on the Project Owner if they engage in these types of activities is considered in more detail below.

Regulated Activities

Certain activities, when undertaken in relation to shares (or bonds) in a company, will be regulated activities for the purposes of FSMA where those activities are carried on in the UK by way of business. Whether or not any particular person will meet the requirement that he carries on a regulated activity by way of business (and so needs to be an authorised person) will be a question of judgement that takes into account several factors, including the existence of any commercial element (for example, the raising of cash for a business).

Assume that the Project Owner's activities in marketing and issuing its shares will meet these requirements (i.e. the Project Owner is offering its shares to UK investors to raise cash for working capital). However, so long as the Project Owner is dealing only by issuing its own shares to investors it should not be caught by the regulations and will therefore not need FCA authorisation.

Separately, the Platform operator itself will need to be authorised by the FCA. The Project Owner should therefore check that the Platform operator has the appropriate FCA permissions to undertake the type of crowdfunding that it undertakes. This information can be found on the Financial Services Register at <http://www.fsa.gov.uk/register/home.do>. It is worth bearing in mind that even an authorised person will only have permission to undertake specific types of activities. So it is important that you check with someone who is familiar with the relevant regulations, that the Platform operator's permission scope is sufficient.

EXAMPLE 1

Claire studied art and design at university and, whilst she was there, created her own company. Claire collected unwanted accessories and worked to revamp the accessories and then sold them on for a small profit. Most of the money Claire made was donated to the local community centre's arts programme. Students at the university, together with the local community, have been extremely supportive of Claire's business.

Claire is now leaving university and she would like to try to grow the business (both in terms of profit generation and also its social reach). Claire has put together a business plan and initially only needs £25,000 investment. She has made some enquiries with local banks but, as the company is only a start-up, and not solely focussed on profit generation, she is finding it difficult to raise the money she needs. Claire has heard about crowdfunding and thinks it would be an excellent opportunity to raise money from the people that she knows already support her business.

Claire knows that there are different types of crowdfunding open to her but, as her business is a company limited by shares, Claire is considering offering shares to her investors – especially to some quite large local investors who she knows will be used to their investments being structured this way. To widen the group of potential investors, and as people are already excited about the accessories, she thinks giving some of these away will be a good incentive to help raise more money.

Claire is confident that the offer of equity, together with the rewards she is offering, will help raise the investment that she needs.

Loan Based Crowdfunding

Loan based crowdfunding will generally fall within the scope of regulation by the FCA if the Platform provider is operating the Platform to facilitate the entry into loan arrangements between Project Owners and investors. In these circumstances, so long as the Project Owner is not operating the Platform itself, nor accepting the loans by way of business as a form of bank deposit (i.e. the funds are being raised to build the business and not for the purposes of on-lending), then it should not be carrying on a regulated activity.

However, as above, the Project Owner should ensure that the Platform operator is appropriately authorised (i.e. holds the correct FCA permissions) to carry on the relevant activities (see link to Financial Services Register at <http://www.fsa.gov.uk/register/home.do>).

3.2 FINANCIAL PROMOTION RULES

The general principle regarding the regulation of financial promotions is that a person cannot, in the course of business, communicate an invitation or inducement to engage in investment activity unless that person is authorised by the FCA, the communication has been approved by an FCA authorised person, or an exemption applies.

Generally, when it comes to crowdfunding, the types of marketing materials a Project Owner may consider using include notices posted on the Project Owner's website directing investors to invest in the project via the Platform, and also posts on social networking sites alerting the general public to the opportunity to invest in the Project Owner's project via the Platform. All of these will require prior approval from an FCA authorised person (usually, the Platform operator or its nominee).

There are some exemptions (for example, relating to investors who are high net worth individuals or investment professionals) that mean you can invite people to invest without FCA authorisation, but it's very unlikely these would apply in a crowdfunding context. So, assuming that the Project Owner is not authorised by the FCA, all marketing materials must be approved by the Platform operator (or other person authorised by the FCA) before they are released (including information on the Project Owner's website or published via social media). However, it may be difficult in practice to obtain approval on short notice, particularly for any instant messaging, and so this is probably not advisable in practice.

The pitch presented on the Platform will also be a form of financial promotion and therefore subject to the same regulatory rules.

Depending on the type of crowdfunding, further restrictions may apply as to the types of investor that may be targeted by the Platform. For example, in relation to investment based crowdfunding, restrictions also apply in terms of the category and suitability of investors being approached. Further, depending on, for example, the numbers of investors targeted and the target fundraising amount, the Project Owner may also be required to issue an approved prospectus.

When marketing material is approved by an FCA authorised person, they will need to ensure it complies with additional rules and regulations. For example, the financial promotion material must be clear, fair and not misleading. The materials must also include (where relevant) wording/information prescribed by various FCA rules. Again, this wording should be provided by the Platform operator.

Q&A



Crowdfunding is available to all types of businesses, but it isn't a 'magic bullet' to solve all funding needs. You should consider whether crowdfunding is the most appropriate solution before you embark on it.

4.1 What kind of businesses can use crowdfunding?

Crowdfunding is available to all types of businesses, but it isn't a 'magic bullet' to solve all funding needs. You should consider whether crowdfunding is the most appropriate solution before you embark on it. In the first instance, you should consider your business structure in order to determine what type of crowdfunding is appropriate. For example, many social enterprises, structured as companies limited by guarantee, are not able to engage in investment based crowdfunding but may be more suited to donations or rewards based crowdfunding.

In a similar vein, it is important to consider your target investors, and what you are proposing to offer in return for their investment. For example, is your target investor likely to engage with the crowdfunding process, or, importantly, are you consumer-facing at all? If you are considering rewards based crowdfunding, do you have a product that will entice or encourage the general public to invest, or is it too niche to work from a crowdfunding perspective? In addition to all of these – do you have a crowd? Many crowdfunding campaigns are driven by a core of investors who are already engaged, with or known to, the Project Owner.

There are also time costs and other legal and administrative costs to consider, which will vary depending on the type of crowdfunding method you choose. Do not underestimate the time it takes to plan, run and wrap up a successful crowdfunding campaign – the case study at the end of this document will tell you more.

Once you have decided to go ahead with crowdfunding, also bear in mind that different Platforms have different strengths, such as size of investor network, marketing approach and reputation. Some Platforms may be more attuned to your type of business and, depending on the type of crowdfunding you are looking to engage in, may structure their participation in the process differently.

EXAMPLE 2

Michael runs a large online business, through which customers from around the world can purchase healing crystals. He has a wide customer base but wants to raise £3 million in order to fund building up his global presence.

Michael has considered his options, spoken to a number of banks and angel investors, and decided that he wants to try out crowdfunding to raise the funds he needs. Michael has signed up with a crowdfunding platform and they have agreed certain milestones that he will need to reach in order to receive his target amount.

Michael embarks on a big marketing campaign, reaching out to all his existing customers telling them about this new crowdfunding opportunity. Unfortunately for Michael, despite his large customer base, the level of financing that he is seeking to raise is just too high for those existing customers. Consequently Michael is unable to reach the milestones set for him by the platform and his target financing is not reached. He is pursuing other possible funding options, for example, an initial public offering.

4.2 What is the difference between investment and loan based crowd funding?

Investment based crowdfunding involves the offering of shares (or certain other securities) to investors. This means that, where shares are issued, the investors will become shareholders in the Project Owner and as such, acquire certain rights in respect of the Project Owner. However, this type of investor is unlikely to receive back the capital that they have invested in the Project Owner and will only receive a return (by way of dividend) once the Project Owner starts to turn a profit (if at all) or if the business is sold and there is sufficient cash to repay investors. Conversely, if the Project Owner is very profitable, that profit will need to be shared with the investors.

In contrast, with loan based financing, the relationship between the borrower (i.e. the Project Owner) and the lender (or Platform user/investor) is different. In these circumstances, the terms of the loan or credit agreement are likely to be such that the lender will receive back the principal amount of the loan and potentially also interest payments, subject to the borrower reaching certain milestones. However, it will not get further "upside" if the business is very profitable nor will it have any right to receive proceeds on any sale of the business.

4.3 Can I set up my own crowdfunding platform?

As noted above, whilst it is possible to set up your own crowdfunding platform, it is necessary to ensure that you seek proper legal and regulatory advice before doing so if you intend to undertake investment or loan based crowdfunding. This is so as to

ensure that you have the proper infrastructure and FCA authorisations in place. There are also significant costs and time implications of obtaining FCA authorisation to operate a Platform which will likely influence your decision.

4.4 Can shares in my company be marketed to anyone using the crowdfunding platform?

Depending on the type of crowdfunding involved, different restrictions will apply as to the types of investors that can be approached.

Additional restrictions apply in relation to investment based crowdfunding. Here:

- the type of investor to whom the Project Owner can market the share will be restricted; and
- there is an obligation on the Platform to assess the appropriateness of the investment for the potential investors. It may be the case that different Platforms adopt differing approaches as to how to determine such suitability.

It is important to note that, save for in very limited circumstances, the Project Owner cannot market directly to potential investors.

4.5 Is there a limit to the amount I can raise for my company using crowdfunding?

If the Project Owner is seeking to raise more than EUR5 million (or an equivalent amount) then the FCA's prospectus rules will apply. This means that additional rules will need to be complied with and an authorised prospectus will be required. In any event, to the extent that a Project Owner is seeking to raise such large sums, crowdfunding may, in reality, not be the most suitable approach. Crowdfunding is often better suited to raising relatively small amounts from the "crowd" rather than much larger sums that may be raised by listing shares on a publicly traded market or from more traditional lenders, such as banks or angel investors.

4.6 Can I do a "road show" to people interested in investing in my company via crowdfunding?

The general principle regarding the regulation of financial promotions is that a person cannot, in the course of business, communicate a financial promotion (being an inducement or invitation to engage in investment activity) unless:

- the communicator is authorised by the FCA;
- the communication has been approved by an FCA authorised person; or
- an exemption applies.

As attending a roadshow would entail a “real time” conversation with potential investors, it would not be possible for any such communications to be pre-approved by an FCA authorised person. It would also be difficult to ensure that the attendees at the roadshow fitted into an available financial promotion exemption. As such, roadshows should not be undertaken.

4.7 Can I target people directly about investing in my company via crowdfunding?

As with roadshows, targeting people directly is potentially risky. However, if it is possible to ensure that those approached are exempt from the financial promotion restriction (e.g. institutional investors), in such circumstances, the Project Owner would be able to approach them to discuss the prospect of investment.

However, the rules relating to this type of communication are complex, and require, among other things, certain disclaimers to be added to any such communication. Also, as noted above, additional restrictions apply as to which investors can be targeted in relation to investment based crowdfunding. Therefore, in practice, it is best to ensure that the Platform reviews, and pre-approves, all marketing material prior to distribution.

Generally, all communications should be made via the Platform, or approved by it in advance.

4.8 I have people interested in investing in my company who are based outside the UK – can I approach them?

Generally, provided certain conditions are met, the financial promotion restriction will not apply to any communication made by the Project Owner in respect of the proposal, to the extent that:

- the communication is made to a person who receives it outside of the UK; or
- the communication is directed only at persons outside of the UK.

However, please note that there will be local restrictions in the jurisdictions in which the potential investors are based. Local legal advice should be obtained before marketing to non-UK investors.

4.9 What is the difference between establishing an investment fund and crowdfunding?

With crowdfunding, investors will provide funds to the Project Owner via a Platform. The Project Owner must be seeking to raise funds for a trading business only. As a trading business, the Project Owner should fall outside of the scope of the rules and regulations applicable to funds.

As such, the Platform provider, by acting as an intermediary, must (as regards

investments and loan based crowdfunding) be appropriately authorised by the FCA. Here, generally the Project Owner will fall outside of the scope of FCA regulation. However, if the Project Owner wishes to set up an investment fund, this would usually (although not always) involve establishing a separate entity into which the investors would provide funds.

The management by the Project Owner of this entity (i.e. the fund) is highly regulated both at the UK level and throughout Europe. As such, the costs involved in raising a fund are significantly higher – both in terms of establishing the necessary infrastructure, paying legal and other advisory fees, and also time costs in respect of applying for appropriate FCA approvals.

EXAMPLE 3

Amy has spent many years working in the real estate sector, developing properties in and around London.

She has recently become aware of an excellent new opportunity to buy and develop her local library in central London. Whilst Amy has good relationships with banks who will finance the development of the project, she needs to raise £15m in order to purchase the property and cannot do this herself.

Amy speaks to a lawyer about the best way to proceed. Amy explains the purpose of the fundraising, that she plans on approaching a number of her existing contacts from her work in the real estate sector, and that she will manage the investment on their behalf.

Amy is advised that she will be raising a real estate fund and therefore needs the appropriate FCA authorisations to do so. This sort of proposal is not crowdfunding.

4.10 Why do I care if the rules are complied with?

If either the Project Owner or the Platform is carrying on crowdfunding activities in breach of the regulations then they will be committing a criminal offence, punishable by up to two years imprisonment or an unlimited fine. Further, any agreement entered into in connection with those activities (such as an investment agreement) may be unenforceable.

There may also be reputational and other forms of damage arising from acting in breach, including for the Project Owner, being able to raise future finance and for the Platform, maintaining its FCA authorised status.

5. CASE STUDY

Hermione Taylor is the founder of DoNation. DoNation was initially established as a not for profit organisation, Donate by Doing, and was set up to raise pledges from people to do (or refrain from doing) various actions, focussed on the environment and climate change. The intention behind the venture was to turn the pledges received through their platform into real, positive, environmental change.

DoNation considered crowdfunding during its early stages but, as a company limited by guarantee, had limited options as investment based crowdfunding was not available. Having decided that the venture did not have much to offer by way of rewards, the crowdfunding concept was parked for the time being.

In the meantime, DoNation was being approached by companies who wanted help to engage their employees with the types of actions that formed the backbone of DoNation. This led to the venture establishing a new entity (Do Good for Business), set up as a company limited by shares which would act as the profit generating entity in the group. This is an online platform which, for a subscription fee, a business can tailor the platform to pick its own requirements and pick from a number of different actions to incentivise and engage its employees. Through the aggregation of various types of data, the platform allows different teams to compete against each other in a bid to be, for example, the most carbon neutral.

DoNation spent some time hosted by an incubator which was focussed on emphasising the importance of raising funds from investors. With this in mind, when it became apparent that the company required additional funding to fund its day-to-day activities, Hermione considered her options. Intimidated by the thought of approaching angel investors and already enthused by the concept of crowdfunding, this quickly became the most promising option. DoNation had already built up a crowd of users and supporters which Hermione felt would be willing to invest in the company and considered that investment based, or equity, crowdfunding would be the best approach.

The Platform provider chosen in this instance was one of the biggest Platforms for investment based crowdfunding, therefore offering a much broader network of potential investors. An understanding of the nature of social enterprises was also key to the Platform choice for DoNation. Having submitted an initial pitch document, the Platform provider undertook a significant level of due diligence on DoNation, permitting Hermione and her team to verify the contents of the pitch before they agreed to launch. Further, due to regulatory requirements (as mentioned above), the Platform provider reviewed DoNation's marketing materials, including providing

appropriate disclaimer wording. This applied not only to leaflets and fliers, but also to posts on facebook and other links to the DoNation pitch on the Platform.

DoNation sought a target investment of £150,000, to be raised over a set period of 60 days.

DoNation not only reached but exceeded the target fundraising amount (albeit at the final hour). Whilst Hermione would be keen to raise further funds from the crowd, she does say that she would probably do it differently next time. For example, possibly using a Platform that has a nominee entity issuing shares to investors, to avoid the time and costs involved in issuing shares in her company directly, and using the window of opportunity provided by an initial private launch.

A nominee would hold shares in the Project Owner on behalf of the investors. This would mean that the Project Owner is only required to issue shares to one shareholder (the Platform) and the Platform will deal with the administrative work involved in holding those shares on behalf of multiple investors.

Further, an initial private launch would have provided a window in which to approach institutional investors, willing to invest a significant proportion of the target amount, creating a “buzz” around the project when it went public.

APPENDIX

1. INVESTMENT BASED CROWDFUNDING

Public Offers and the Prospectus Rules

It is unlawful to offer transferable securities (which would likely include the shares of a start-up company) to the public in the UK unless the company produces a formal prospectus and such prospectus has been approved by the FCA.

Certain offers are excluded from this prohibition. Of particular relevance to small businesses considering crowdfunding is an offer of shares to the public where the total consideration for the shares being offered within the European Economic Area is less than EUR5million (or an equivalent amount). If you are raising more than this, an approved prospectus will be required. Please note that such offers to the public may require the project owner to become publically listed and therefore need to comply with additional laws and regulations.

Regulated Activities

The test to determine a regulated activity is whether the relevant activity is a specified activity that relates to a specified investment which is carried on in the UK by way of business. Specified activities and investments are set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

Shares and bonds are classed as specified investments; therefore this element of the test is satisfied.

There are two further elements of the test which, for these purposes, we can assume will be satisfied. The Project Owner's activities in marketing and issuing its shares:

- will be carried on in the UK; and
- will likely be undertaken "by way of business" i.e. there are clear commercial reasons for the Project Owner offering its shares, which include promoting the brand, loyalty and receiving cash for working capital.

We must also consider what specified activities (if any) the Project Owner will be performing by marketing and issuing its shares to the public via the platform. These are likely to fall into the following categories:

Dealing in investments as principal:

By issuing shares for cash to members of the public, the Project Owner will be dealing in investments as principal and, therefore, performing a regulated activity. However, as the Project Owner is selling its own shares it should be able to rely on a specific exclusion (subject to certain carve-outs) and will therefore, not be performing this regulated activity.

Arranging or bringing about deals in and making arrangements with a view to transactions in investments:

Offering shares via a platform, marketing shares directly to potential investors and encouraging potential investors to join a platform are all arrangements undertaken for the sole purpose of an investor engaging in an investment transaction. We would usually expect the Project Owner to undertake such activities as part of generating interest in its project, and therefore it will be performing a regulated activity. However, in these circumstances, as the Project Owner will be arranging a transaction to which it will be a party (i.e. issuing its own shares), it can rely on an exemption which excludes any arrangements to which the arranger is a party.

On the other hand, the Platform operator will be facilitating or making arrangements (via the Platform) for the Project Owner and the investors to enter into such investment transactions. The scope of its engagement by the Project Owner will usually mean that the Platform is acting as more than a mere introducer in bringing the Project Owner and the investors together.

As the Platform will not itself be party to the investment transactions, it will therefore need to be authorised by the FCA to carry on the relevant crowdfunding activities.

2. LOAN BASED CROWDFUNDING

Regulated Activities

As above, the test to determine if an activity is a regulated activity is whether it is a specified activity that relates to a specified investment which is carried on in the UK by way of business.

Whilst there are a number of potential specified investments involved in loan based crowdfunding, the most relevant of these is rights under an “article 36H agreement”. This is an agreement by which one person provides another person with credit (for example, a loan) and either:

- the lender (i.e. the Platform user) is an individual; or
- the borrower (i.e. the Project Owner) is an individual **and** the amount of credit provided is less than or equal to £25,000; or
- the agreement is not entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower. This last factor is unlikely to apply in normal fundraising circumstances.

However, the specified activity in these circumstances is the activity of operating an electronic system in relation to lending (for example, a loan based crowdfunding platform). Here, a person (“A”) will be operating an electronic system in relation to lending if he **operates an**

electronic system which enables him to facilitate persons (“B” and “C”) becoming the lender and borrower under an article 36H agreement.

Based on this definition, it is the crowdfunding Platform operator that requires FCA authorisation and not the Project Owner, assuming again that the Project Owner is not also the Platform operator.

However, as above, there are other potential specified investments/activities which may draw the Project Owner back within the scope of FCA regulation. These include:

- (i) credit broking;
- (ii) deposit taking; and
- (iii) arranging transactions in securities

Credit Broking:

There are a number of specified activities that fall within the definition of credit broking, relating to arranging activities undertaken in respect of credit agreements. A credit agreement is an agreement between an individual (“A”) and any other person (“B”) under which B provides A with credit of any amount. So any agreement by which an investor is lending money to a Project Owner (including via a Platform) would be a credit agreement. However, so long as the loan is for less than £25,000, and used wholly or predominantly for the Project Owner’s business, the agreement will be exempt and the Project Owner will not be performing a regulated activity by effecting entry into the agreement by the investor.

Accepting Deposits:

A deposit is a sum of money paid by one person to another on terms that it will be repaid when a specified event occurs (for example, a demand is made).

Whether there is a specified investment in these circumstances will depend on the terms of the loan agreement being entered into. Generally, the terms of loan will be such that the investor acknowledges that capital will be lost unless specific milestones are met by the relevant Project Owner.

Whether or not accepting deposits is a regulated activity depends on the use to which the money is put. The activity is caught if money received by way of deposit is lent to others or if any other activity of the person accepting the deposit is financed wholly (or to a material extent) out of the capital of, or interest on, money received by way of deposit.

However, accepting deposits will only be a regulated activity if it is carried on by way of business, which in the case of the Project Owner, is unlikely to be the case.

Arranging

So long as the Project Owner is a party to the agreement it is promoting, it will fall outside of the scope of the relevant regulated activity.

3. FINANCIAL PROMOTION RULES

Financial Promotion Rules

The general principle regarding the regulation of financial promotions is that a person cannot, in the course of business, communicate a financial promotion (in broad terms an inducement or invitation to engage in investment activity) unless:

- that person is authorised by the FCA;
- the communication has been approved by an FCA authorised person; or
- an exemption applies.

Generally, when it comes to crowdfunding, the intention is to target the greater public in the UK. The types of marketing materials and activities envisaged may include a notice posted on the Project Owner's website directing investors to invest in the project via a platform, posts on social networking sites, and also advertisements alerting the general public to the opportunity to invest in the Project Owner via a Platform.

The communications set out above are forms of financial promotion, the main purpose of which is to induce people to invest in the Project Owner. Assuming that the Project Owner is not authorised by the FCA, it cannot communicate any form of financial promotion unless it has been approved by an FCA authorised entity, which may be the Platform Operator. Depending on the target investor, it may be that the Project Owner could on certain available exemptions (such as those relating to high net worth individuals or sophisticated investors) but, given the scale of the offer and the broad cross-section of people who are likely to be approached, this will not generally be the case. Therefore, the most suitable and practical option would be to have all marketing material approved by the Platform (or a nominee entity of the Platform authorised by the FCA).

Any financial promotion material approved by such an authorised entity will need to comply with additional rules and regulations to which the Platform is subject. For example, the financial promotion material must be clear, fair and not misleading. The communications should therefore avoid describing the investment as "guaranteed", "protected" or "secure", or using similar terms unless they can be justified. As the communication is going to the general public, the standards to meet the requirement being of clear, fair and not misleading financial promotions are set high on the basis that the recipients are not sophisticated investors.

Are there specific rules that will apply to the pitch document posted on the Platform?

The pitch presented on the Platform will be a form of financial promotion and therefore subject to the rules referred to above.

It is likely that the purpose of the pitch will be to invite potential investors to make an offer to invest in the Project Company. It is also likely that the pitch, and/or ancillary information provided with the pitch, will include details of how such investor can respond to the pitch in order to make an offer to invest. This type of financial promotion would be classified as a direct offer financial promotion. There are specific rules dealing with this.

With regards to investment based crowdfunding, it is the FCA's general position that all genuine trading companies selling their unlisted shares will be selling a non-readily realisable security. On the assumption that the Project Owner is operating a genuine trading business, its shares are not listed and there is no imminent intention to list its shares once they are being traded/sold, the shares on offer will constitute non-readily realisable securities.

The FCA has introduced specific marketing restrictions for the communication of a direct offer financial promotion relating to a non-readily realisable security. The key effect of the FCA's enhanced rules is to apply two conditions that must be satisfied:

- the first condition restricts the type of investor to whom businesses can send such financial promotions; and
- the second condition introduces an obligation on the FCA authorised firm approving the communication, or on the persons who will arrange or deal in relation to the non-readily realisable security, to assess the appropriateness of the investment for the relevant potential investors.

The pitch must also include (where relevant) information prescribed by various FCA rules.

Misleading Statements

It is a criminal offence, in very broad terms, to knowingly or recklessly make misleading statements or dishonestly conceal facts with the intention of inducing (or being reckless as to whether or not it may induce) a person to engage in investment activity (e.g. acquire shares in the Project Owner). When marketing the Project Owner investment opportunity, it is therefore important that the content of any marketing materials is reviewed in the context of the above standard.

