CP13/13: The FCA's Approach to Crowdfunding (and similar activities)

Consultation response by Microgenius – operated by the Community Shares Unit

December 2013

Background

About Microgenius

Microgenius (www.microgenius.org.uk) acts as a dedicated web platform for community shares and has hosted a number of successful individual offers since it was established in 2012.

The platform provides a secure, online mechanism for societies to accept funds from new members. By providing these tools, the aim of the platform is to reduce the workload for societies running share offers, provide a tailored and secure payment process for investors, and provide an easier means of finding and investing in share offers for interested supporters.

About the Community Shares Unit

At the beginning of 2013, the Community Shares Unit (CSU) became responsible for Microgenius after it was first developed to support community-based renewable energy ventures. It was recognised that the technology could be utilised for all community share offers and so the platform was re-launched in June 2013 to cater for community shares offers across all sectors, operated by the CSU.

The CSU is a joint venture between Co-operatives UK and Locality, acting as a pioneering programme to support the growing community shares market. The CSU launched in October 2012 and is funded by the Department for Communities and Local Government (DCLG) and is overseen by a steering group composed of a range of government departments and agencies including the FCA, Treasury, HMRC, Charity Commission and Department for Energy and Climate Change.

It aims to support the growth of community shares, which refers to the sale of shares in enterprises which serve a community purpose. Broadly, the CSU's remit is to develop and promote the use of the Industrial and Provident Society (IPS) form as the vehicle for such community investment, given its unique type of share capital.

About Community Shares

Crucially, community shares is a term used to describe withdrawable share capital which has a number of important attributes making it ideally suited to enterprises serving a co-operative, community or charitable purpose. Shareholders have the right to withdraw their share capital, subject to the terms and conditions stated in the society's rules and share offer document.

Withdrawability solves a liquidity problem faced by any minority shareholder in a small enterprise. Shares in companies are normally transferable, not withdrawable. Under normal circumstances, companies are not allowed to redeem their shares. Instead, the shareholder must find a willing buyer for the shares, which can be very difficult for minority shareholders, especially if the company is too small to be listed on a stock market.

Shares in societies have other important attributes. Control of a society is based on the democratic principle of one-member-one-vote rather than the principle of one-share-one-vote enshrined in company law.

Withdrawable shares are not subject to price speculation. They cannot go up in value, but may go down, at the discretion of the directors, if a society has long-term accumulated losses. Societies are restricted in how much financial return they can offer to shareholders by way of interest on share capital. Interest rates can be no more than is sufficient to attract and retain the investment. Supporting the social purpose and business activities of the society should always be more important for members than the prospect of private financial gain.

All these attributes are underpinned by an overall recognition that purpose of investing in a society is not for personal financial gain, but to further the society's business activities for the benefit of its members or the broader community, or for charitable purposes.

For this reason, when making financial investment offers, societies are exempt from most forms of regulation under the Financial Services Markets Act 2000 and the Financial Services Act 2012.

Consultation Response

Q1 – Do you have any comments on our assessment of the equality and diversity considerations?

No.

Q2 - Do you agree with our assessment of unregulated, exempt and regulated crowdfunding activities?

We do agree on the overall distinction of the different types of crowdfunding activities. In particular, we welcome the recognition that the offer of withdrawable share capital in Industrial Provident Societies through an electronic facility is an exempt practice, in line with the current statutory exemptions that are in place.

Similarly, we welcome the FCA's recognition of Enterprise Schemes as an exempt form of crowdfunding. However, there is very little information or evidence of such Schemes, and therefore we request that the FCA invest in developing what is meant by an Enterprise Scheme by developing PERG guidance and investigate the scope for accreditation of such Schemes.

While we welcome these distinctions in the different types of crowdfunding, much of the research literature and reports on crowdfunding fail to make these distinctions clear, and frequently conflate data on different types of crowdfunding, leading to a misrepresentation of what crowdfunding means to the public - which we believe is primarily responding to donation and reward based platforms.

It is crucial to make these distinctions when looking at research evidence on the scale, behaviour and motivation of individuals giving/investing via crowdfunding platforms. This conflation also causes a lot of consumer confusion, and a widespread belief that crowdfunding has some form of social purpose akin to public, social or community benefit.

Q3 – Do you agree with our proposals for transitional periods?

Yes.

Q4 – Do you think there are any other risks relating to crowdfunding that we should consider and seek to address

We think that the stated risks are all pertinent ones when considering investors, and we recognise the rationale for isolating the risks for regulated activities of loan-based and investment-based crowdfunding.

However, in terms of risks applying to all types of crowdfunding activities, we believe there is an important consideration to make with regard to the risks concerning *Consumer understanding, inexperience and behaviours and Platform failure and poor administration,* that has not been emphasised sufficiently.

Specifically, there are important reputational risks for investment-based crowdfunding in which platforms, where there is a significantly high-risk profile, will more likely experience significant failure and subsequent negative coverage and profile. Such negative exposure is likely to spillover into other forms of crowdfunding in which the risk-profile is more appropriate and effectively conveyed but will unduly suffer from the negative consumer reaction of the wider market.

We feel this is particularly pertinent for community enterprises raising equity investment through community shares, in the context of other equity-based platforms. The growth in social enterprises using community shares as a way to raise much-needed risk capital has been the result of sensible promotion of the model - recognising the principles and practicalities that withdrawable share capital affords community-based ventures, as set out in the first section of this paper.

However equally, there is recognition that the future growth of the community shares market requires more involved oversight, with the FCA as registrar for I&Ps, interested in ensuring that community share offers do not transgress the terms of their status of sitting outside the scope of FCA regulation, and encourage good practice in all forms of financial promotion, as part of its consumer protection responsibilities.

It is this position which informs the close working relationship between the Community Shares Unit and the Financial Conduct Authority, in order to promote good practice through tools such as the production of a Community Shares Handbook, along with the prospects for introducing training and accreditation for professional advisers and the quality assurance of offer documents. Under such an arrangement, the basis for the exemption will be ensured while introducing proportionate oversight of societies undertaking an exempt form of crowdfunding.

With such an arrangement in place, there is a risk that enterprises will consider other equity-crowdfunding platforms which offer an “easier and cheaper” service without having to comply with CSU guidance, or even register an IPS. The result being that the enterprises deciding on this route are unable to ensure liquidity and are more likely to fail or will simply be unable to allow investors to realise their investment.

Such an eventuality will likely discredit the overall equity-crowdfunding sector despite the positive social impact which community shares has been and will continue to generate in giving communities the ability to participate through meaningful and democratic investment in ventures that generate significant community benefit.

This concern is compounded by the relative lack evidence of who is investing in equity-based crowdfunding, and we wish to challenge the assumption that this is predominantly high-net-worth individuals. The type of investment opportunity offered by equity-based crowdfunding is highly unlikely to appeal to a sophisticated investor, who understands the risks associated with buying shares in unlisted companies – business angels would usually require sufficient stakes to have influence over the decision making of the company and to be involved in exit strategies such as a trade sale. They would normally want protection against the potential dilution of their share capital.

It is therefore reasonable to assume that investors in equity crowdfunding are not sophisticated investors, although evidence on the composition of investors would be increasingly valuable and we would encourage the FCA to ensure this evidence base is in place.

Based on our focus on investment-based, exempt crowdfunding, we do not feel in a position to respond to Questions 5 to 16 regarding loan-based crowdfunding.

Q17 - Do you agree with our proposals to revise our approach to investment-based crowdfunding platforms?

We recognise that the proposals do not have direct implications for the operation of Microgenius given its exempt status. However we have some comments on the proposals, both on the specific suggestions, as well as wider implications that are likely to have an impact on the crowdfunding and the alternative finance market.

Direct Proposals

In terms of the direct proposals, we recognise the merit of introducing a Restricted Investor category as it offers an appropriate arrangement to enable individuals to participate in equity investment, while introducing the necessary safeguards. Such an approach complements the wider vision of the Community Shares Unit in which it promotes direct share ownership and the value of equity investment for all enterprises, social or otherwise.

However, the effectiveness of the Restricted Investor category is directly linked to the nature of the appropriateness test which is offered. While there is guidance regarding the obligations for assessing appropriateness within the FCA Handbook, it is suggested that there is value in going beyond the provisions and so recognising the ability to ensure transparency within the crowdfunding market.

The value of transparency is a principle central to Microgenius and the wider work of Community Shares Unit, in which a directory of all share offers are made available to the public. This database includes the key figures associated with the share offer itself i.e. the amount raised, number of members – but also the subsequent business performance of societies in which the level of share capital and turnover of members is published via the societies' annual returns. This enables the CSU to monitor and track the relative performance of enterprises using this form of equity investment and so ensure that potential investors have the necessary knowledge to understand the risks involved before investing.

We feel that such a commitment on transparency, where practicable, should be shared across all investment-based platforms, in which sites display clear and easy to understand information about the performance of pitches hosted and historical data on enterprises utilising platforms regarding rates of business failure, levels of return and rates at which retail clients have been able to realise their investments and exit.

Wider Considerations

Beyond the direct proposals as outlined in the consultation paper, there is a wider consideration which we wish to highlight concerning the interaction between Sections of the Companies Act and FSMA in relation to equity-based crowdfunding.

Specifically it our understanding that FCA recognises that need to satisfy themselves they are meeting the requirements of the Companies Act 2006 when seeking to raise investment by selling their equity. Then, if they are able to make the offer, they will also need to ensure that they promote the shares in a way that does not contravene the financial promotions restriction in FSMA s21.

However, Section 755 of the Companies Act 2006 expressly prohibits a private company from making a public offer of securities and section 756 goes on to define what is meant by a public offer. From our understanding, this prohibition is especially relevant to many investment-based crowdfunding platforms which appear to be facilitating public offers of securities in private limited companies.

It is acknowledged that the activities of the platforms may not be regarded in this manner but as part of the overall programme of work on the regulatory treatment of investment-based crowdfunding platforms it seems appropriate to gain clarification on this matter.

In particular, clarification would be gratefully received as to whether the understanding is that equity crowdfunding platforms are promoting equity in private companies because it is regarded as a private offer to members of the crowdfunding platform. If this is the case, then we feel that the publicly accessible pages of the websites should not promote individual investment opportunities, and instead should confine itself to promoting the virtues of becoming a member of the crowdfunding platform.

We feel that the distinction between a public and private promotion is particularly important in this context. Furthermore the procedures for becoming a member of these crowdfunding sites needs to be more transparent – currently we see that the majority of sites are not sufficiently clear that in registering with the site you are joining as a member – nor is there any membership fee. Furthermore, all the emphasis in these sites is placed on communicating how much has already been invested, suggesting that potential investors are heavily reliant on this information in making their investment decision; this information should be given less prominence in equity crowdfunding sites, indeed it should probably not be mentioned at all.

Q 18 - Do you have any comments on our analysis of the crowdfunding market or further information about it?

Definitions of crowdfunding

We feel that the basis on which the consultation has been determined takes too narrow a view of the scale and scope of what should be constituted as ‘crowdfunding’. The opening paragraph of the paper sets out that “*Crowdfunding is a way in which people, organisations and businesses (including business startups) can raise money through online portals (crowdfunding platforms) to finance or re-finance their activities and enterprises”.*

Our perspective is that the sector is not restricted to raising investment solely through online portals and the community shares market exemplifies this clearly. Specifically the majority of community share offers take place offline using paper-based systems to raise investment and build membership.

In the last five years there have been almost 200 share offers, raising almost £35m in equity from over 35,000 members. Indeed, in 2013 alone there have been 60 share offers, raising nearly £15m.

Microgenius has successfully hosted six share offers in 2013, raising £800,000 from 1,250 members. It is recognised as the only online platform to facilitate community share offers and so represents 10% of the share offers launching this year, and just over 5% of the overall equity raised. This demonstrates the relative dominance of community shares activity in the offline space.

This is a position shared by Ethex in which their observations on their platform, acting as a social investment marketplace, is dominated by people of 40 or more years who are not necessarily high net worth but have paid off their mortgages and contributed to their pensions over many years, thereby taking care of their immediate financial needs. They tend to invest some of their surplus cash into social investments. However, by virtue of their age, they are not comfortable with making investments over the internet, and prefer to make applications on paper and by cheque.

Crowdfunding, high-net-worths and tax reliefs

Another important aspect which the community shares market highlights is the relationship between crowdfunding, high-net-worths and tax reliefs. The FCA consultation paper states: “*The information we have on investors in crowdfunded investments indicates that they tend to be high-net worth individuals with investment experience. Investment-based crowdfunding often gives access to Enterprise Investment Scheme or Seed Enterprise Investment Scheme tax reliefs. It is higher-rate tax payers who gain most benefit from such schemes.”*

The community shares market would challenge this assumption on the basis that investors come from a wide-range of socio-economic backgrounds and varied income brackets. Similarly, over half of all community share offers receive advanced assurance for Enterprise Investment Scheme which would suggest that over 10,000 have had the opportunity to benefit from the relief, in which many would not be considered high-net-worth individuals.

Overall community share offers are offering mass participation in equity investment activities in which the individuals are not sophisticated or high-net-worth investors, but rather are supporters of community-based enterprise and are investing based for a social purpose. We feel that this is an important consideration when taking into account the dynamics of the overall crowdfunding market.

Research into community investment

The CSU is commencing a research exercise with Manchester Business School in early 2014 to boost the level of intelligence and understanding of the community shares market. We would be keen to share any of the outputs of the research with the FCA as it builds an evidence base on the market. The research will cover the following areas:

An in-depth review of community share offer documents

The CSU has an extensive library of share offer documents but has not had the opportunity to date to review them as a single unit of evidence. With this a comprehensive analysis of the documents will be provided, offering key data and findings on the following elements:

- Share offer targets
- Min and max investments
- Levels of return
- Suspension of withdrawals
- Leverage
- Community benefit
- Engagement

An insight into investor behaviour

This research exercise will focus specifically on the motivations and behaviours of investors. It will use Microgenius as a key source of information, both analysing the raw data generated by the platform as well as undertaking an in-depth survey of Microgenius users.

Community Shares and enterprise performance

There has been limited research into how community shares factor into the performance of the enterprises. With this, a specific research exercise will be undertaken to analyse annual returns of those enterprises which have traded for a number of years to start to understand more about how liquidity is working in practice, alongside membership churn and returns to investors. Furthermore, it will be a valuable insight into the relationship into the level of investment and the annual turnover of societies, to identify any potential risks around over-capitalisation.

Microgenius, Community Shares Unit

communityshares@uk.coop
www.microgenius.org.uk

www.communityshares.org.uk