KEYNOTES

Crowdfunding
Offering shares to potential investors and the limits of crowdfunding

Introduction

People often ask what they can do to approach others for investment. There is a very clear investment process for major companies listed on the stock markets, but what about smaller companies? What steps can you take to secure equity investment in your limited company and how can you ensure you stay the right side of reams of financial services legislation?

Private companies can issue shares to investors, this happens all the time. But there are criminal penalties for failing to comply with the relevant processes and procedures. Compliance requires an understanding of the relevant law, which is very complicated. This note looks at the main areas of concern for a company seeking to issue shares to investors, but each case will turn on its own facts and accordingly you will need to approach how you offer your shares to investors very carefully.

Why can’t I just go out and raise the capital I need?

The law starts from the premise that the ordinary person in the street deserves to be protected from people offering investments, and in particular shares, for sale to them. The logic is, that these sorts of investments often require relatively significant sums of money and further that it is not easy for an investor to know at first glance what constitutes a ‘good’ investment. The law therefore is very prescriptive about what you can do to raise investment.

What does the law say then?

There are actually several overlapping layers of legislation and you will need to comply with them all to avoid committing an offence. European law, companies legislation and financial services rules all apply. The position can usefully be simplified by looking first at how you can lawfully attract the interest of potential investors and then by considering how the investment itself is made.

Attracting potential investors lawfully

Let’s assume that you have prepared a general executive summary of your business and now want to approach an investor. The executive summary and any other materials you have prepared are designed to tell investors about the potential investment. As a result (in the eyes of the law) you have prepared an ‘invitation or inducement’ to subscribe for or buy shares or debt securities (and potentially some other categories of investment). This is termed ‘financial promotion’. Financial promotions can be written or oral. Financial promotions must either be communicated or approved by someone who is authorised under the financial services legislation (e.g. an investment bank or an IFA), though this may be expensive and impractical, or financial promotions must be entirely covered by the statutory exceptions. These exceptions cover both what you say and to whom you say it. As mentioned this is a particularly complicated area and there are numerous exceptions. There is not time or space to discuss these in detail, but set out below are the most commonly used exceptions – and these have been simplified, because the exceptions themselves are very complex.
One-off communications – these are highly personalised, non-standardised communications to the person being contacted – this may be more helpful, for example, when you have already lawfully contacted an investor and you are now answering questions about the potential investment.

Communications to some overseas persons – communications can be made to individuals resident outside the UK, but need to be accompanied with a required set of bespoke and tightly drafted conditions and risk warnings. Do note though that this is an exception for the UK laws, you will also need to check the laws of the country in which the communication is being received.

Investment professionals – communications can be made to FSMA regulated persons including investment funds, Venture Capital firms as well as some others. If you are relying on this exception then you should require sufficient evidence that the recipient is an investment professional in the eyes of the law before making the communication and you should place an appropriate warning in the terms required by the legislation on the communication.

High net worth individuals – some communications can be made to wealthy individuals with a sufficiently high income and personal wealth – within the levels set out in detail the legislation. If you are relying on this exception then you will need a certificate (dated not more than 12 months before the communication) following the strict terms required by the legislation that the recipient is a high net worth person before making the communication and again you will need to give strict warnings, usually on the communication. This exception only applies to written communications or oral communications which the potential investor has requested.

Sophisticated Investors – this is similar to the exception relating to high net worth individuals. Communications can be made either to individuals who have certified themselves as sophisticated not more than 12 months before the communication or those who have been certified by an FSMA authorised person as sophisticated not more than three years before the communication. The onus is on you to check the certificate has been issued and yet again, you will need to give further (different) warnings, as part of the communication. If an investor certifies himself as sophisticated, then this only covers investment in unlisted companies, whereas certification by an FSMA authorised persons covers a wider range of investments.

Associations of high net worth or sophisticated individuals – groups of people falling into the preceding two categories.

Untrue statements and giving inaccurate profit forecasts

Lastly in relation to the materials you provide to potential investors, you must avoid making untrue statements and giving inaccurate profit forecasts, and this may lead to you having to compensate investors in certain circumstances. There are also specific criminal offences under FSMA relating to making statements, promises or forecasts which are misleading or untrue. Remember also that if you do not comply with the rules on financial promotions described above, an investor may be entitled to sue you for their money back.
Once I have an interested investor, how can I lawfully offer securities?

Making a financial promotion is just the first step; it is to gauge interest. The next step is the actual and definite offer of the securities themselves. This offer is subject to another layer of legislation. First there are the Companies Act requirements preventing anyone but public companies from offering securities to the public. Accordingly, your offer must be made only to a limited group of pre-selected recipients or to one recipient. Second, there are the requirements from Brussels (in the shape of the Prospectus Directive). The general rule is that any offer of “transferable securities” to the public must be made in a prospectus. This is a heavily regulated, long and prohibitively expensive document requiring regulatory approval. The Prospectus Directive will not apply in various circumstances including if:

- the size of the offer is less than €2.5 million – the legislation provides for aggregation of offers so that not more than that amount is offered in a period of 12 months;
- the minimum investment is greater than €50,000;
- the offer is directed only at a maximum number of 100 people in each state in the European Economic Area; or
- the offer is only made to ‘Qualified Investors’ (which includes FSMA authorised firms and certain others, including some sophisticated individuals who appear on a register);
- it may sometimes be possible to structure the securities so that do not qualify as “transferable”.

So what about crowdfunding?

The law was designed before the idea of crowdfunding came into being. There is nothing illegal about crowdfunding per se, but to be used lawfully it must comply with all the layers of legislation touched on in this note (this article does simplify the law, there is a lot of detail it does not mention that may well be relevant to your circumstances). If the crowdfunding structure complies with the rules about communications/financial promotions and the rules about offering debt and equity securities (and subject to one point about collective investment schemes below) then it may be fine. But a word a warning: the rules have been designed to regulate and restrict any type of investment or potential investment being communicated to and sold to the public. Therefore, crowdfunding, which relies on many small investments being made by a large number of people, may be in conflict with these rules. This makes it very hard to achieve. Some companies have successfully carried out a type of crowdfunding, but their minimum investment was £10,000 and they have used the exceptions to financial promotions and offers of securities described above. Some others have used the approved prospectus route, looking for small subscriptions of shares or debt securities to a PLC. A third group of companies has stayed away from offering securities and has offered club membership or the like instead but sometimes these face another possible pitfall described below. Each method has its risks and needs to be carefully considered.

Finally, there is one last pitfall to avoid. There is another kind of structure known as a collective investment scheme (“CIS”) based on (among other things) pooled investment. Even some companies can fall foul of this if they are regarded as ‘open-ended’ (a complicated and technical term relating to how shares/investments can be redeemed). The risk is that you inadvertently create a CIS, while looking for funding and in particular crowdfunding. A CIS may only be operated in the UK by an FSMA authorised firm. Breach of the CIS rules is a criminal offence and careful adherence to the rules is advised; if in doubt you will need legal advice.
In summary

- Know what you are doing, it is easy to risk prosecution through ignorance.
- If you are advised you need a warning or disclaimer on your communication, then make it prominent and make sure it is the right one, there is no standard wording that works in every situation.
- Where you are relying on an exception, be sure it actually applies and all necessary certificates etc have been obtained.

Tony Watts is an expert in financial services legislation having spent 25 years as a lawyer in the financial services industry. His practice with Keystone covers all the above areas and he would be happy to discuss any specific issues you may have.

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Crowdfunding entrepreneur commentary

I have been asked to contribute to this excellent legal summary by Keystone Law on crowdfunding from an Entrepreneurs perspective having experience in this domain and in preparation of my company’s launch of an online platform which facilitates crowdfunding.

What is “crowdfunding”?  

Crowdfunding is nothing new, despite what you might have read in the press or seen on blogs with recent commentaries about how entrepreneurs and companies are increasingly turning to new and innovative funding methods. Crowdfunding, as a term, is simply an approach to raising the capital required for a new project or enterprise by appealing to a large group of people (a Crowd) for small contributions. Typically crowdfunding relies on a small contribution which reduces the exposure and risk to each person contributing. The more people who contribute: the more money is raised, and the smaller the contribution: the more likelihood of a larger uptake. For example, one million people putting in £1 each may be a lot easier to secure than trying to get 10 people to invest £100,000 each.

Whilst crowdfunding is not a new invention and has existed in various forms as a legitimate means of fundraising, what is new is an increasing number of entrepreneurs and companies (issuers) looking to crowdfunding as a means of securing seed stage or early stage investment capital.

Why are companies increasingly looking to crowdfunding?  

This should not be surprising given the fact that traditional sources of funding for start ups have almost all but disappeared in this deep global recession. Without bank lending in the form of overdrafts or secured loans and with investors seeking more market traction (profits) before they invest; companies have few alternatives for raising capital. For many, crowdfunding offers an alternative, if not the ONLY alternative to traditional fundraising.

The internet, and in particular, social networks provide issuers with both a source of information and a platform with which to publicise their crowdfunding initiative and hopefully secure contributions from a large crowd for little or no expenditure. The internet and social media have made crowdfunding more viable and attractive than ever before. Compare this method of fundraising to the traditional funding method of numerous meetings with investors across various locations and one can easily identify significant cost savings to the issuer both in terms of time saved and expenses saved. Anyone who has pursued the traditional method of fundraising can testify how exhausting and expensive this process can be. Furthermore, as a crowdfunding strategy can be conducted almost exclusively online, this enables entrepreneurs to focus more on business development rather than fundraising activities.

Another rationale for crowdfunding is that the terms on offer can be much more attractive to an issuer. For example, with crowdfunding proposals the issuer usually does not provide such restrictive provisions as preference shares, cumulative dividends, veto rights, vesting rights, full ratchets etc., and whereas most seed or early stage investments will be at a cost of up to 40% of equity for any given funding round, the percentage of equity sold is usually SUBSTANTIALLY less than would have been demanded of by traditional funding methods.
For all these reasons, it’s quite clear to see how crowdfunding has caught the attention of so many entrepreneurs recently.

What are the various forms of crowdfunding?

As one can imagine, there are numerous creative variations of crowdfunding including for example:

- the giving of a privilege in exchange for a contribution, investment or donation (film credits for film sponsors, memberships, free services or services in kind, etc)
- contributions in the form of a loan (secured or unsecured) usually bearing interest (debentures, convertible notes, fixed term, variable term loans etc)
- the assignment of shares or warrants to buy shares in the enterprise in exchange for a contribution or investment
- the granting of a percentage share or fixed return from any revenues (or profits) generated by the enterprise in future, in exchange for a contribution or investment

There is no limit to which an issuer can be creative in coming up with a value exchange (tangible or intangible) for a contribution or investment in their enterprise.

So why is there so much fuss from the lawyers about this?

There are complex laws governing the issuance and promotion of financial securities and financial investments as identified by Keystone’s legal summary. The consequences for a company which breaks these laws (inadvertently or not) can be quite severe. It is therefore important from a legal and business perspective to identify if a crowdfunding proposal is one which falls under legislative controls for the sale and promotion of securities. For example, a bona fide donation (i.e. giving the money without expecting a return on it) by a crowd to fund a project would normally not fall under these controls. However, a sale of, and or financial promotion of securities would be. This is where the counsel of lawyers specialised in securities and investment laws must be sought beforehand.

What is a Security?

Entrepreneurs I meet are often very confused about what a security is. I have met some who have told me they won’t have any problems with their crowdfunding offer as the offer does not include any transfer of shares (just a debenture!). Let me explain..., shares are an example of a security, but there are other types of securities beyond just shares. It’s important to know that a “security” can be a range of financial instruments, some examples include:

- shares (incl. warrants, preferred, ordinary etc)
- loans (incl. debentures, convertible notes, bonds etc)

It is vitally important that the issuer understands fully whether what he is offering in his crowdfunding proposal represents a security or not, and this is not always clear cut! Assuming the crowdfunding proposal includes an offer of a financial security then it is necessary to understand the restrictions imposed on the promotion of such securities. There are also other pitfalls – some crowdfunding schemes can constitute some other form of regulated investment – such as a collective investment scheme, as mentioned in Keystone’s note.
What is a financial promotion?

Keystone Law have provided an excellent summary of what constitutes a financial promotion and a brief explanation of the EU Prospectus Directive 2003/71/EC (PD) which also governs this. I just want to highlight one aspect of the PD that is often misunderstood.

There is an exemption from the requirement to produce a prospectus providing “the offer of securities is made to fewer than 100 natural or legal persons other than qualified investors”. What it really means is “99 or fewer”. I have seen high profile companies make this and other common mistakes, even after taking legal advice. My point is that crowdfunding is a very complex legal quagmire.

How are crowdfunding proposals issued?

“Crowdfunding” as far as it applies to the issue of financial securities (such as shares) is a relatively new and trendy term for what has been historically referred to as a “Private Placement”. Do a Google search for private placement and you’ll get loads of results. In a private placement, an issuer puts out an offer to a select (private) group of qualifying recipients. The issuer will comply with the rules on offering securities and be exempt from having to produce a prospectus on account of, in the US, REG D (rule 506) of the SEC laws and, in the EU, the 100 person exemption under the PD. The document which contains the private placement is often referred to as a Private Placement Memorandum (PPM) and will include various legal disclaimers and statements.

Unfortunately US issuers have an enormous advantage over European issuers in that a Rule 506 issue has no limit to the number of qualifying recipients to which the offer can be sent. In the EU the exemption limit is set at 99 qualifying recipients per EEA country. Talk about stifling innovation! In this regard US issuers will find it much easier to secure 1 million contributors to a crowd fund without a prospectus than EU issuers (99 per country).

Most companies fall foul of the law

I’m now going to say something which is a very controversial, but is, in my experience, entirely true. That is; most companies at some time or other fall foul of the relevant securities laws when fundraising. Usually this is unintentional and often done without any awareness of such violations by the company. Furthermore, the FSA seldom acts upon such violations (again, controversial I know). In my experience they concentrate their limited resources on high profile cases and matters they feel are of public interest. Perhaps it is for this reason that you will have seen issuers with crowdfunding proposals in place which are not in compliance with the law.

OK, so if this is the case, why should issuers be concerned about the legalities? Let me give you an unequivocal answer to that: just because the FSA does not prevent some non compliant crowdfund funding proposals, DO NOT assume they never will act. YOU DO NOT want to be the case they choose to prosecute. This is not a game of roulette you want to play. Stay within the law, even if others don’t. To do otherwise is foolish and you do so at your peril. (enough said?). Also in some cases if you break the rules, investors are entitled to their money back, whether FSA pursues this or not.
What are the risks associated with crowdfunding?

Apart from the risk of falling foul of the law which is easily done and can have dire consequences, there are other fundamental risks with this method of fundraising:

1) In addition to the FSA, shareholders can derail a non-compliant crowdfunding proposal. Imagine the case where you issued a private placement seeking to raise £500,000 from up to 99 investors. Let’s say you had an investment threshold of £250,000 to be held in escrow, transferred upon that threshold being met. Now assume you reached your £250k threshold (assume 50 investors put in £5k each) and you start utilising the funds. Now assume one of the investors is unhappy and he finds out there was a legal flaw in the issuance of this crowd fund offer and decides to sue for his money back. Now let’s say he gets his £5k back (plus costs). You are now down to £245k in terms of your investment (£5k less than the threshold). Perhaps the other 49 investors are unhappy now and say “hey, the threshold was never met, we want our money back too now!” My point here is; you don’t want to give cause for someone to pursue a legal claim against you at a later date. If you are falling foul of the law, you are effectively at risk of every investor suing you. This is compounded if you have a large crowd of investors. Also, bear in mind the last thing a start up needs is the distraction and cost of legal proceedings. Even if you win the case, this can be the kiss of death for a start up due to time lost and costs of defending. Also, future investors will be put off if your crowdfunding process was not in strict legal compliance or if there was a negative investor reaction.

2) By putting your business idea out to a large crowd you potentially run the risk of the idea being copied and developed ahead of you by better-financed competitors.

3) Disclaimers don’t always protect you. Just because you put in big bold capital letters “THIS OFFER DOES NOT CONSTITUTE AN OFFER TO THE PUBLIC” do not rely on this disclosure if you have just sent this offer to a mailing list of 10,000 people!

4) Beware of foreigners. If you think UK and EU securities laws are complex, try US securities laws! If you are using the internet to promote your crowd fund offer bear in mind that 60% of the English speaking audience on the internet are from the US. If a US citizen in the US is capable of accepting your offer, then you are offering securities in the US and so you must comply with US securities laws too! This can get very complicated and costly for you when your subscribers are from outside of the EU.

What to do, if you are considering crowdfunding

So we probably have scared you off crowdfunding by now. That wasn’t our intention! Crowdfunding is an emerging method for fundraising and will be increasingly relied upon by entrepreneurs who are cut off from other, more traditional methods of raising start up capital. Crowdfunding can work and can be marvellous for your enterprise. It just requires significant preparation and expert legal advice to ensure it is a success and not a liability for you.

As a prospective issuer you must educate yourself on the basic legal principles of fundraising. You need to speak with issuers who have done this before as well as get as much practical advice on this as you possibly can. Then, identify some options for the type of crowd fund offer you want to issue, and then seek out expert legal advice.
Not all lawyers are created equal

I might get some grief for saying this, but as an entrepreneur who’s been there before, let me offer on last important piece of advice: choose your legal advisers carefully!

If you are seriously considering crowdfunding and are about to seek out or employ legal advice I would strongly urge you to only approach law firms who have corporate expertise and more specifically, securities expertise. Not all legal firms do. I’ve seen too many entrepreneurs employ their solicitor friend or relation to review securities contracts only to suffer from having received very poor legal advice.

Also, please do not make the mistake of having a high street solicitor advise you on this process. Forgive me if I sound elitist here, but most high street lawyers are not qualified to give securities advice. Think of them as a general practitioner (GP). Just as a GP would refer his patient to a specialist for a condition which was beyond his general expertise, so too should a high street solicitor refer you to a specialist. Securities law is a speciality; if you need legal advice on securities then you need to speak to a securities expert. I’m not saying you have to go to a big name law firm in the City as there are some really good regional practices, just make sure you’re speaking with a securities lawyer.

In the same regard do not substitute advice from your chartered accountant or company secretary for legal advice from a securities lawyer. Again, they may well be experts, but they are not legal experts with securities expertise (and insurance in place!).

Disclaimer

We have written these materials to help you, but no article can address all the issues. The benefit of using an experienced lawyer is that they ask the right questions and build the solution around you. Please therefore note that these materials only provide you with general information and should not be regarded as a substitute for taking legal advice.

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