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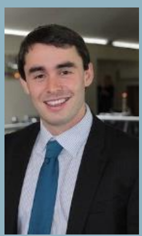

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The regulatory outlook for Crowd-funding

With equity crowd funding platforms to be regulated from April 1st, this paper considers the strengths and weaknesses of this relatively new source of funding for businesses as well as the pitfalls of the regulation that is to be enforced.

Crowd-Funding is not child's play.

Mark Sisson, Managing Director at 4most Europe warns would-be investors to take heed and act with caution and in full knowledge of the risks involved, as well as the best ways for investors to project themselves.

Since recession took hold, lending to small businesses has reduced significantly as banks look to boost balance sheets to meet stringent capital adequacy requirements. Indeed, the impact of this is plain to see with lending to businesses down in January 2014 to £600 million, despite an economic recovery taking place.[i] Crowd-funding or peer-to peer-lending exists with the aim of filling this void. Add to that the low interest rate environment which has resulted in savers getting a very poor return via the traditional savings routes, and the returns offered by crowd-funders starts to look very appealing indeed.

There is evidence to suggest that the growth of equity crowd funding may not be purely down to an absence of available bank credit, however, with only 40% of all UK SMEs making an application for credit in the last year, and only 1 in 25 of those that applied being refused.[ii] Its flexibility and ease of access are also clear attractions for businesses seeking funding. Following a 600% increase[iii] in funds raised via investment based crowd funding, the FCA have turned their focus to regulating this growing industry. The risk is that they kill it off in its early stages.

From the borrower perspective, there are certainly a string of benefits to be had; speed of decision for one – after all, banks are bound by process and may take months to make lending decisions, but a crowd-funder could make an advance in half the time. But while limited due diligence is required to secure start-up funding, significant equity is often expected as part of the deal and so it is possible to argue it is not a panacea. Then you have choice of investment; given they have chosen which sort of business to invest in, the owners feel their investors are genuine enthusiasts and endorsers of their business idea. Furthermore, you have the spread of invested funds across multiple opportunities (often hundreds) so any individual failure has an insignificant effect on return.

There are, however, a number of risks and weaknesses of the crowd funding model at present. This briefing considers some of these risks as well as how to effectively regulate the sector without smothering it at birth.

The problem for the investor: A lack of robust data analysis

While the quality of accepted loans and equity stakes sold via crowd-funding has typically been good in the past, it is likely that as the market grows, a more diverse set of applicants will use this route to gain funding. Simultaneously, investors will become more willing to move down the risk curve in search of higher returns. That in itself is fine; however, growing larger and more diverse requires a significant improvement in the quality of the analysis available to investors; ideally, to mitigate the information asymmetry between traditional lenders and retail investors using crowd-funding sites.

Credit risk is not child's play and pricing correctly for the long term has taxed experts' minds and only yielded limited success thus far. Crowd-funded lending is by its very nature a market; markets are good at discovering the price of commodity items which are easily transferable, be that company shares or bushels of corn. The difficulty here is that loans and finance via equity sales to individuals and small companies are not in themselves a commodity with the loans and finance being granted to individuals and small companies that differ widely in their ability to repay or deliver a return and the ability to predict how they might react in an economic downturn.

In the case of loans, although large financial institutions can treat pools of loans as a commodity, they can only do so with the backing of robust and comprehensive data and analysis. Sloppy underwriting and inaccurate information can quickly catch even relatively large well-capitalised investors out. To expect individuals to compete with volume players is unrealistic; they will more likely get their fingers burnt to the detriment of the industry and possibly the economy.

Furthermore, when investing in equity stakes of larger companies, investors have access to independently audited financial reports that often have a length history for comparison of previous results. Clearly the history is not always possible to provide, though it should be made clearer who has prepared the accounts and forecasts for the company in the case of crowd-funding projects.

When is a good idea not a good idea?

The other danger of crowd funding- both lending and equity based funding- is that business ideas that would ordinarily fail the rigour and scrutiny of the traditional bank loan would nevertheless gain funding approval through less-rigorous channels, regardless of whether they are particularly good or innovative. This results in a market somewhat akin to the dotcom boom in the late nineties. One has to question if you you can't convince educated, savvy backers to invest in a business perhaps the idea isn't so good after-all?

From an investor perspective, even with funds spread thinly and widely across multiple investments, there remains the possibility that the crowd-funding company itself will fail for the above reasons alone which could result in total loss being incurred.

Investor check-list

To avoid the potential of total loss, would-be investors need to understand the risks via:

1) Publishing detailed tracking information. This should include expected and measured performance of risk grades for similar assets lent to in the past as well as the performance of the debt collection function on debts that have defaulted or rates of return in the case of equity funding.
2) Providing the underlying anonymised facility level data so independent parties can verify that performance and check model assumptions.
3) Providing a flexible online tool to make it easy for prospective investors to understand the potential losses of their portfolio under different stressed economic conditions.

Closing this information gap would be a big step forward in countering potential regulatory concerns of the downsides of crowd-funding that are not fully apparent to investors.

Capitalisation

One of the key risks for potential investors is also to understand the liquidity and credit risk of their pool of loans or equity based financing. In basic terms, this translates to how easy would it be to get your money out before the legal maturity of the loans or equity and how much will you be able to recover if the counterparty you are lending to defaults on their obligations, or if it is impossible to find a buyer for your holding? In a standard bank account or share dealing account for listed, large-cap stock the answer is that unless the bank (or nominee company) is made bankrupt you can take your money out at any time and the counterparty risk is nil (the bank covers any losses out of capital). To ensure that banks can live up to those promises and always give your money back the regulators require them to hold sizeable capital buffers. Beyond this, the FSCS protection scheme ensures the first £80,000 of losses are protected even if the bank does go bust. This makes banks pretty safe to ordinary depositors and investors and is part of their attraction despite low rates of return.

While returns may be much healthier for peer-to-peer lenders and crowd-funding sites, there is either no guarantee on liquidity and credit risks (buyer beware), or the crowd-funding site assumes this risk. If the latter then for this to mean anything it would need to be capitalised in the same way as banks are and currently they are not.

Although the sector has only been very lightly regulated, changes are afoot. The PRA and FCA are under pressure from outside bodies such as credit unions who are bringing pressure to bear on these organisations. This will undoubtedly push up their cost base resulting in lower returns to investors and more punitive terms to borrowers.

What's next for crowd-funding?

We can expect more scrutiny from the PRA in terms of ensuring crowd-funding organisations retain sufficient capital to meet potential losses and stand behind any guarantees they have made. Now separate from the FCA, the PRA will want to ensure that consumers are given appropriate, transparent and accurate information about the potential investments they are making. Comparing the investments returns to standard bank savings in marketing material has already been highlighted as inappropriate given the different nature of the risks involved.

Bow Group recommendations

Regulation: What it should and shouldn't do.

Despite the risks, it is important that equity based crowd funding does not become another highly regulated arm of the finance industry that loses its edge in providing finance to start-up businesses.

From 1st April 2014, the FCA will enact regulation of the sector with the intention of protecting investors. Any such regulation should focus on a number of aspects that promote transparency and highlight the risks attaches. This can be done by sensible measures that oblige the crowd funding websites to reveal their own risk control measures, 'success rates' and assessing investors' awareness of risk. It is important, however, that regulation does not throttle this nascent sector of finance by either becoming too burdensome for the crowd funding platforms or by enforcing tighter restrictions on who can invest that the sector almost becomes an extension of angel investment or private equity. The current proposed regulation may very well fail that test and is at risk of both imposing a heavy burden on platforms and, ultimately, restricting who can invest.

The FCA will adopt a series of measures, with the focus being on restricting the ability of retail investors to invest. Restrictions include:

- An appropriateness test to ensure individuals are 'sophisticated investors'. This means they have been a member of a network or syndicate of business angels for at least six months; they have made more than one investment in an unlisted company; they are working or have worked in private equity or SME finance or they are, or have been, a director of a company with an annual turnover of at least £1m.
- A maximum of 10% of an individual's 'investible assets' that can be allocated to equity based crowd funding schemes where they are not advised or sophisticated investors.

The problem with the regulators approach

There are a number of ways in which overregulation could damage the sector. Firstly, it could increase the required associated costs involved in compliance and join the 67%[iv] of firms in the financial sector that expected compliance costs to increase over 2013. This would potentially reduce the number of choices for consumers to choose from if certain operators cannot meet these costs, and likely raise the associated fees involved in investing through the platforms.

What's more, although the FCA has stated it will not demand a 'prescriptive approach' in terms of due diligence of underlying assets, the industry is making a mistake if it believes if it is off the hook for engaging in thorough due diligence. As the Wealth Management and IFA industry has found out, autonomy to determine how you assess appropriateness does not mean you are not liable to undertake it- it simply means the regulator will not tell you how to do it with the threat of financial sanctions in the event of a perceived failure to do so.

There is therefore a risk that this is just the beginning of what could turn out to be a more heavy handed approach by the regulator in requiring Crowd funding platforms to carry out more rigorous assessments of an investor's suitability beyond the current online self-assessment. This is certainly likely to be the case if the FCA becomes convinced that the self-assessment is being short circuited by would be investors. Placing such a burden on the platforms would require significantly larger compliance functions, the cost of which would be passed on in the form of potentially prohibitive fees or simply the sectors eventual 'voluntary' exclusion of retail investors altogether should it become too great a burden to undertake due diligence and properly assess appropriateness.

One precedent that may be set by making investors identify either as a professional investor or otherwise cap the amount of their annual savings invested in crowd funding at 10% is that it will act to restrict who can invest. At present, it is possible for an investor to 'self-certify' after having clarified their attitude to risk and satisfied a test that they are comfortable with taking high levels of risk. The Conduct of Business (chiefly COBS 3.5 definitions) should not be applied to this industry in the future, which would requires 'elective professionals' to have in excess of €500,000, to be a frequent trader, or to have worked in the financial sector. [v] This would severely impinge the ability of the sector to be a true 'crowd' with a wide range of investors involved. A fairer approach would be to educate rather than regulate who can invest based on arbitrary figures relating to how wealthy an individual is, as the regulator appears set on.

The alternative approach

Although the principle of self-certification is a reasonable approach, the FCA's focus on limiting crowd funding investments to sophisticated, wealthy investors is not the right approach and risks platforms being liable to conduct rigorous due diligence and restricting those who may well be able to demonstrate that they understand the risks but end up being prevented from investing. Instead, self-certification should focus on enquiring about the investors understanding of the risks involved through means of a test. Such an approach would ensure that the door isn't closed to anyone, whilst offering a reasonable guarantee that only those who properly understand the risks involved are able to move forward in what is a niche area of investment that offers the potential for high returns that may not be available elsewhere.

Such a test would be easily carried out prior to the account opening, and the response could be instant. What's more, it would be harder to 'game the system' and would remove the risk that platforms may ultimately end up becoming responsible for conducting further due diligence regarding a client's overall financial position.

As such, there are a number of steps that can be taken by the regulator to ensure that investors are being equipped with the necessary knowledge to make an informed decision and be aware of the risks. Indeed, the big advantage of the sector is that it can be quick and nimble, enabling small businesses to access funding streams they would be unable to obtain via the banks. Therefore, the following measures are recommended:

- Given that one in two equity crowd funded businesses will default and fail thus becoming completely worthless [vi] crowd funding groups should be obliged to **record and publicise the success rate of businesses that have obtained funding on their website. There should also be a ranking of the amount of due diligence that the company has satisfied.** This could be a simple traffic light system outlining the level of risk, this should not be deemed to constitute risk.
- **To avoid imposing a burden on platforms to conduct due diligence on an assets and external holdings and shutting retail investors out of this sector, the self-certification should be limited to a knowledge based test of the investors understanding of risk.** This avoids the imposition of arbitrary figures for wealth and portfolio composition that or both labour intensive for the platform to prove or disprove, as well as overly restrictive on the individuals that can invest.
- **A 'warning' system should be used to grade the differing levels of scrutiny** that different crowd funding websites subject businesses seeking funding to in order to effectively categorise just how risky each platform is in terms of prior due diligence. Those that conduct less due diligence are not 'wrong' to do so necessarily and blanket requirements should be avoided to ensure that start-ups at all stages of their life can obtain funding. That said, investors should be made aware of the due diligence being undertaken in a manner that is as easy to understand as possible.
- Where companies have already secured funding in the form of loans, they **should be obliged to detail the terms on which the lending has been acquired** (such as its duration, whether it is secured or unsecured, and what rate it is at). This will help investors better understand both the burden of any debt repayments as well as the ability to raise further funds in the future, which is complicated if the lending has been secured against assets.

- **Company's financial reports should include more prominent disclaimers** as to how valuations and future forecasts have been arrived at, and who has made them. Rather than a mere footnote at the end, it should be a requirement that it is disclosed from the outset where forecasts have been prepared solely by the company
- **Crowd investors should be entitled to representation to oversee their interests**. This could be achieved by creating a statutory entitlement to elect a non-exec director from among the investors once the funds being pitched for have been raised. Creating such a buffer of protection is preferable to restricting who can and can't invest in the companies.

There are, however, a number of things that should be avoided. These are:

- **Burdensome suitability assessments.** If the individual is able to demonstrate that they are aware of the risks and is comfortable with the risks involved, there should be no regulatory barriers that preventing them from investing in these companies, with whatever sum they wish. Although there are provisions for retail investors, imposing a 10% limit on monthly savings may prove overly restrictive for many- particularly young investors who may well have low levels of disposable income but seek extra high levels of return and are prepared to accept higher levels of risk in pursuit of such returns.
- **Size shouldn't matter.** By placing restrictions on the percentage of assets that can be invested in equity-based crowd funding projects, the FCA would be likely to cut young investors out of the picture or at least significantly curtail the extent to which they could choose to invest in the businesses on crowd funding platforms. These are exactly the kind of people who may in fact understand the kind of innovative businesses that are pitching, as well as not requiring the money for any major liabilities such as retirement or ailing health. They are also at the stage where they seek additional risk, and should remain free to do so should they so wish.

Conclusion: The issues for regulators and investors

In conclusion, the key question for investors is a case of asking whether crowd-funding and peer-to-peer lending sites offer better returns because they cut out the middle man and provide a more efficient market, or whether the improved returns a financial sleight of hand borne out of regulatory arbitrage that hides risk in the system? At present the answer is both. To this end, it is essential that investors are made fully aware of the risks involved whilst remaining free to make the final decision as to how much they invest as well as whether they wish to invest via crowd-funding platforms at all.

The regulator, meanwhile, needs to ensure that more is done to bring the risks to the fore whilst avoiding the imposition of a burden that is so heavy that it erases the key advantages the sector has in providing lending to small businesses whilst providing investors a chance to invest in genuine start-ups. Such an outcome would be undesirable for investors, borrowers and capital markets.

About 4most Europe (www.4-most.co.uk)

4most Europe Ltd is a specialist credit risk analytics consultancy with offices in London and Edinburgh. The company provides a range of products and services across credit risk, fraud and pricing, working with blue chip clients predominantly in the retail banking and mobile sectors. The company offers a flexible, competitive model, either working with clients to manage regulatory change or delivering and implementing business critical solutions.

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[i] http://www.standard.co.uk/business/business-news/blow-for-bank-of-englands-mark-carney-as-business-lending-falls-again-9165602.html

[ii] http://www.ftadviser.com/2014/03/06/regulation/regulators/fca-confirms-tougher-crowdfunding-rules-sbwXEJqrSb6s850iju2QpL/article.html

[iii] http://www.demos.co.uk/files/DF_-_Finance_for_Growth_-_web.pdf?1378216438[i]

[iv] http://accelus.thomsonreuters.com/sites/default/files/GRC00186.pdf

[v] http://fshandbook.info/FS/html/handbook/COBS/3/5

[vi] http://www.journalofaccountancy.com/News/20149550.htm