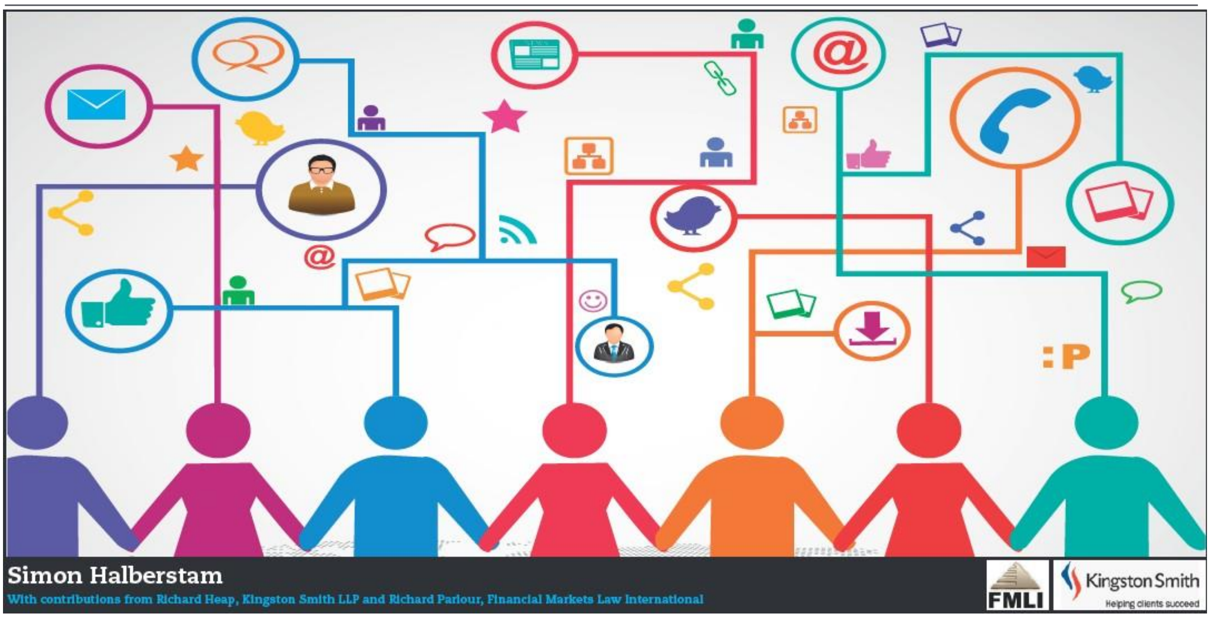
SIMONS MUIRHEAD & BURTON LLP

How to set up and run a crowdfunding platform – legal, financial, fiscal and exit issues



Further Information and Disclaimer

This is a general guide for UK entities involved in setting up a Crowdfunding Platform and is no substitute for full professional advice. All content, figures, rates and bands are believed to be accurate at the time of writing but should be checked at the time of reading. To this end, relevant contact details of the principal author, editor and contributors are set out below:

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1. INTRODUCTION

This E-book is intended for people based in the UK and running or wishing to set up a Crowdfunding Platform ("CFP") who want to further their understanding of the legal, fiscal and accountancy issues and to adopt the appropriate legal structure.

The dramatic proliferation of CFPs is due not just to technological developments but also, in part, to the aftermath of the recession. Banks, VCs and other institutions are still loath to lend to pre-revenue businesses. Angel investors are inundated and reject 99% of the applications they receive and demand a big slice of equity from the 1% in which they are interested. "Friends and Family" are wary and have little if any spare cash.

The continued financial depression and lack of growth plans on both sides of the Atlantic are making the difficulties of funding more acute. However, life is also tough for high-street investors as banks continue to offer unattractive rates of interest to savers. At the same time, the development of the internet and social networks has reduced degrees of separation from six to fewer than two, and considerably increased potential marketing reach for new businesses.

Crowdfunding may offer a potential escape from both of these key issues.

At the time of writing, CFPs may not be covered by the Financial Services Compensation Scheme. In short, this means that investors may not be protected if the business or venture in which they have invested via the CFP fails, unless effective protections similar to the regulatory ones have been built in contractually. Whilst debate rages about the degree of regulation required for CFPs in the UK (especially with the possibility of savers being permitted to 'wrap' crowdfunding products into their ISA allowances in the near future) there can be little doubt the sector is likely to become more regulated rather than less. Investors will become increasingly alive to this issue as stories of failed CFP investments materialise and spread and those setting up CFP should therefore carefully consider getting themselves positioned to survive the Darwinian process that will doubtless ensue in the event that consumer confidence is shaken.

1.1. Brave New World

The rush to set up CFPs is at full gallop and every week new CFP ventures emerge. There are different legal structures (see Section 5 below) and different investment return models (see Section 2 below) and often the implications of selecting one option over others are not well understood.

Whereas certain CFP are dedicated to specific sectors and/or areas of activity, others are agnostic ranging from children's nurseries to raising funds for a concert tour by a new pop group. However, all CFP are on- line platforms connecting those seeking to raise funds with potential investors using a low-cost and generally transparent model.

In this E-book, we set out some general guidelines, and highlight some of the major pitfalls and issues a CFP needs to consider in order to achieve the best outcome.

There is much ignorance in the marketplace regarding both CFP and entrepreneurs setting up CFPs, and those intending to enter the market should seek guidance from professionals who deal with these issues on a daily basis.

1.2. Choosing Professional Advisers

Setting up a CFP entails a multitude of decisions, decisions which can seem overwhelming without the right professional advice.

The right accountant and solicitor can eliminate a host of problems and potentially costly errors a CFP might make as it builds the financial foundation of a successful business. Their expertise can help save money that in turn can be used to increase profits.

One should enlist the expertise of an accountant and solicitor who specialise in the CFP area and will be able to devise strategies to facilitate success.

1.3. Key Players

There are three key players in the CFP firmament. There is of course the CFP itself. Secondly, there is the company, individual or enterprise in which the investment is being made. We shall refer to this as the "Venture". In many cases this will be a Startup but it may equally well be a mature business. Finally, of course, there is the investor.

2. CROWDFUNDING MODEL OPTIONS

To date there are three fundamental models which prevail, namely Reward, Equity and Loan. The terms "Alternative finance", "Peer to Peer Lending" and "crowdinvesting" are often used to refer to the Equity and Loan models, indicating that the investor expects or, at least, hopes to receive a financial return on its money.

2.1. Reward Based

In this scenario, the investor makes a pledge and receives a reward which may have no or little intrinsic value. The backer does not anticipate any serious return on his "investment" and in many ways this might best be viewed as a donation rather than an investment.

Typically an investment level target is set and individual pledges towards that target are made via an online payment channel such as Paypal.

Generally speaking, if the fundraising target is reached, the pledged sums are debited directly to the investor's bank account with the CFP taking its commission, which is typically in the region of 5%.

Some CFP are set up so that pledges are transmitted directly to the Venture's bank account. This means that the CFP does not get involved in holding investor monies. However, other CFP do accept the funds directly, take their commission and then distribute the balance to the Venture.

In some cases, the Venture does not have a specific funding target and the transmission of the pledged sums to the Venture is not deferred.

In the "reward-based" model, the backer is not really making an investment and the so-called reward is generally known at the time of donation.

Examples of this kind of CFP include Kickstarter (www.kickstart.com) and Crowdfunder (www.crowdfunder.co.uk).

2.1.1. Accounting

From the perspective of the Venture, funds raised are income, and should be accounted for on a receivables basis, typically this is the date on which the funds hit the company's bank account.

In terms of accounting for the cost of rewards given to the investors, this should be recorded at the cost incurred by the business. So if the reward given is a signed photograph, this might simply be the cost of developing the photograph. For an event programme or a special feature in a casual or social game there may well only be printing and publishing costs for which to account.

For the CFP, its commission is a receivable to be entered in the profit and loss account on a receivable basis. Generally, the relevant date is when the funds are released to the Venture. The funds received and distributed should be netted to show one line in the profit and loss for "commissions receivable".

2.1.2. Tax

Principal taxes for the Venture to consider include corporation tax (in the case of a company), income tax (in the case of an individual), and VAT.

2.1.3. Corporation Tax

If the Venture is a company, it is liable to corporation tax if the investment provided is to fund a commercial activity, and this will apply in many cases of reward based crowd funding. At the time of writing, tax is paid in the UK at 20% on profits up to £300,000, and at 23% over £1.5m. An effective rate of 23.75% applies between these two limits.

Therefore if the net of funds received minus costs incurred means a profit has been made at the end of the year, corporation tax will be due, and some of the funds raised should be retained to meet those liabilities after the year end.

2.1.4. Income Tax

If it is an individual rather than a corporate Venture, the investment is a donation and not liable to income tax, unless he or she is considered to be involved in a taxable activity in which case the funds are likely to become chargeable to income tax, although of course everyone has a personal allowance which, at the time of writing is set at £8,105.

Should the funds raised be a genuine gift, and the purpose is not to fund a taxable commercial activity, then they will usually be treated as a donation or gift for tax purposes.

2.1.5. Gift Aid

If the Venture is a registered charity, gift aid can be reclaimed on the funds received from individuals, although care has to be taken to ensure that the value of the rewards does not exceed certain set limits. For example, the value of the reward given must be 25% or less of the donation given, and for a pledge up to £1,000 the value of the reward must not exceed £25.

2.1.6. VAT

A business is required to register for VAT once it expects annual turnover to exceed £79,000. The primary reason for the donation should be established, and whether this was done for the purpose of obtaining the reward, or for social reasons. In most instances if what the funder has received is of intrinsic value in return for its investment, HMRC will look to argue that there is a taxable supply for VAT purposes, even if the rewards in question are worth less than the sum invested.

However, for those investments which might be described as broadly philanthropic, it might be possible to argue that rewards of limited value, like signed programmes or photographs are no more than a simple “thank you” and as such not subject to VAT.

2.2. Loan Based

CFPs adopting this model are highly varied in nature and constitute the majority of “alternative finance” activity in the UK when measured by turnover. The actual structure of the repayable finance terms vary from platform to platform. Two of the more common types are those based on revenue participation or interest.

In the case of revenue participation, the investor receives a percentage of sales for a given period of time from the Venture. There is no repayment of the loan principal.

In the case of those based on interest, the investor receives a fixed interest payment for a given period of time from the Venture and at the end of the loan period, the loan is to be repaid in full.

Fees are payable to the CFP by the investor and the Venture. The investor typically pays a servicing fee each time a return is received, and may pay a sales fee when a loan is sold before the end of the term. The Venture typically pays an arrangement fee up-front to the CFP.

Examples of this kind of CFP include Buzzbnk (www.buzzbnk.org) and Funding Circle (www.fundingcircle.com).

2.2.1. Accounting

For the Venture receiving the loan, it should recognise a liability on its balance sheet within creditors, analysing the loan into amounts due before and after one year. It must also disclose the principal terms of the loan, such as rate of interest and loan period.

Arrangement fees payable to the CFP should be deducted from the cash received and accounted for over the period of the loan as part of the finance cost.

For the CFP, given the principal activity is that of the provision of finance, all arrangement fees and commissions earned will be its principal source of revenue, and should be shown as revenue. The timing of the recognition of revenue from the arrangement fees will depend on whether or not there are ongoing obligations for the CFP; if they do not exist, this would suggest the revenues can be recognised immediately. From a balance sheet perspective, since the actual loans bypass the CPF itself, these will not be shown.

2.2.2. Taxation

For the Venture, the interest payable is deductible against corporation tax as a trading expense. The CFP is liable to corporation tax on its revenues earned in the year. For the individual investor, he or she should receive interest net of basic rate tax, and is liable to further tax if a higher rate tax payer.

2.2.3. Regulation

Loan based CFP are regulated by the FCA and cannot be operated without authorisation, and must be managed and operated in compliance with the relevant FCA rules. Advice should be sought from qualified legal advisors well in advance of the launch of such ventures as the application process is not simple or speedy (see Section 7 below).

2.3. Equity Based

Offered by CFP such as CrowdCube (www.crowdcube.com), these CFP give the investor "skin in the game" by giving them shares in the Venture in which they are investing. The investor is looking to share in the success of the Venture but may of course end up participating in its failure. The terms of participation in the equity of the Venture are set by the CFP. This is generally the riskiest form of CFP participation from the investor's point of view and, wherever possible, the potential investor should seek to do due diligence not only on the Venture but also the CFP itself.

2.3.1. EIS and SEIS

Often the key driver for UK investors via this model of CFP is tax relief. Typically, this is dependent on the company being registered for EIS, where income tax relief is 30% or SEIS where it is 50% and in the case of the latter this can mean up to 72% total relief.

This is a complex area with companies engaged in certain "financial activities" excluded from offering SEIS/EIS relief. Companies need to ensure they do not act in such a way as to make their investors unable to benefit from the tax relief. Investors must not receive anything of "significant" value from the company in which they have invested, otherwise EIS and SEIS benefits may disappear. "Significant" can be subjective, and HMRC might not share the view of the investor.

2.3.2. VAT

For VAT purposes, shares, and other forms of equity are treated as an exempt supply, so there will be no need to charge VAT to the individual investor. However, the Venture will generally be unable to recover VAT on any associated costs.

2.3.3. Regulation

As with Loan based CFP, Equity based platforms require FCA authorisation before they can be launched and must be operated in compliance with FCA rules. There are significant penalties for failure to comply and qualified legal advice should always be sought before launching such an equity based CFP (see Section 7 below).

2.4. Other Models

There are, in addition, two other variants. The first is the donation model which is similar to the Reward model but with no return whatsoever. The second is the funds model which is somewhat similar to the Equity model but different in that the investor receives units in a collective investment scheme rather than shares in a specific corporate vehicle. The former will not require FCA authorisation, but the latter will (see Section 7 below).

3. PLATFORM USAGE RIGHTS, INTELLECTUAL PROPERTY RIGHTS (“IPR”) AND BRANDING

3.1. CFP’s Rights in the Platform

It is highly improbable that the CFP will own any IPR in the actual software platform through which investors make pledges/investments. This will typically be a standard offering from a software company which will grant a licence to the CFP. The CFP should ensure that its contractual rights to use the platform are secure and that the licensor provides appropriate warranties and indemnities in respect of a range of matters, notably any third party claims that the licensor was not entitled to license the platform.

In the event that the CFP has actually commissioned the creation of a bespoke platform, there will need to be a proper software development agreement, dealing with issues such as acceptance testing, assignment of IPR and a broad IPR indemnity.

3.2. Branding

The proliferation of CFP means that brand differentiation is key. Only those CFP which establish a strong reputation through brand awareness are likely to survive. Trademarks and domain names are the two key IPR issues involved in establishing and protecting a brand.

3.2.1. Trademarks

The key thing to remember about trademarks is that they only protect the brand not the underlying technology.

Trademarks can protect names or brands, words or logos. Success depends on various factors, notably distinctiveness. For example, a very descriptive name e.g. “thecrowdfundingplatformsolution” will be very unlikely to secure trademark protection whereas an original distinctive CFP name e.g. “virginiacreeper” would be highly likely to succeed. Additionally, any name which is too similar to that of another CFP or other financial services business is unlikely to attract registered trademark protection.

They are territorial in nature and obtaining a registered trademark necessitates an application to the relevant authority. In the UK, this is the UK IPO (see www.ipo.gov.uk). Pan European protection may be available.

A registered trademark lasts for 10 years from the date of registration but may be renewed.

Trademarks can be registered or unregistered. The former provide very strong monopoly-type protection whereas the latter depend on evidencing the creation of sufficient goodwill in a particular name and its association with the product/services in question.

Those who encroach on such goodwill can be pursued for “passing off”.

3.2.2. Domain Names.

These are largely available on a “first come first served” basis and a CFP should protect its brand(s) by registering the name with the key suffixes, notably .com, .net, .mobi and, if the CFP is based in the UK, .co.uk. Pluralised and hyphenated variants should also be covered.

CFP should, however, be cautious about registering any names which are likely to infringe on the rights of third parties who have already registered identical or very similar trademarks or domain names. There are various levels of check that can be carried out to minimise that risk. It is wise, and cost effective to start with an internet search.

If someone gets there first and the CFP has not by that time established any material goodwill in the name in question, it should re-consider its branding instead of crossing swords. If on the other hand, the CFP brand is already established and, ideally, the CFP has already registered an associated trademark it may well be able to wrest control of the brand via dispute resolution or court proceedings.

A good way to get a global view of what is already registered is by visiting the facility at www.whois.net.

Appropriate domain name registrations will reinforce trademark protection and make it more difficult for unscrupulous "cybersquatters" to prey on burgeoning reputations by registering variants of the CFP's name and seeking to extort large sums from the CFP for the transfer of such domains.

4. LEGAL EXPOSURE, TERMS AND CONDITIONS ("T&C")

4.1. Due Diligence on Startups

The CFP should carry out appropriate due diligence on the Ventures it accepts onto the platform and clearly draw the attention of potential backers/ investors to relevant risks and exposure. The CFP should seek to ensure and confirm that the information in the financial promotion of the Venture is fair, clear and not misleading.

Despite the CFP's best intentions and efforts, it is axiomatic that many of the Ventures invested in via the CFP will end up in insolvency. This, of course, will produce many disappointed or angry investors. The CFP therefore needs to put into place terms and conditions to maximise its potential redress and minimise its potential exposure.

There are two sets of terms and conditions that should be considered in this context, namely those between the CFP and the Venture and those between the CFP and the investor. Indeed, properly drafted terms and conditions may make the CFP more legally secure and therefore more commercially attractive to potential investors in the CFP itself.

With regard to the Equity and Loan models, if possible, the investor is trying to secure a decent return on investment. Before committing to such investments, the investor should ensure that is has carried out due diligence on the Venture's track record, its credit record and management. In order to seek to protect itself from potential exposure to liability where investments have failed, the platform's T&Cs should take steps to oblige investors to carry out these steps before investing.

Indeed, in many cases, due diligence may only be possible at one step removed with the potential investor being able to vet the track record of the CFP itself but not the Venture, which generally will have no relevant history. Where possible, the investor should carry out enhanced due diligence on the founders of Crowdfunded ventures to review their past successes and failures.

4.2. Terms and Conditions between CFP and Venture

Obviously these T&Cs will have to address the terms on which the CFP is made available to the Venture notably commission arrangements, transfer of funds and appropriate warranties and indemnities from the Venture, including protection for the CFP against any action by investors against the CFP due to misleading or otherwise inaccurate details forming part of the investment memorandum. In addition, the CFP may seek personal guarantees from the people behind the Venture, as the Venture itself is unlikely to have the financial wherewithal should the CFP wish to make any claim under the T&C.

4.3. Insurance

CFP should seek to protect themselves against liability to investors not only via their T&Cs but also, if available, through an appropriate insurance policy.

Terms and Conditions between CFP and Investors

We deal with Financial Services and Markets Act considerations below (see Section 7) but at this juncture we are just looking at the contractual relationship between the CFP and the potential investors. Certainly, the CFP should seek to disclaim any responsibility for the viability and financial suitability of the investment and to impose responsibility on the investor for making its own decision based on its own due diligence and its own financial resources and preferred risk profile.

However, many investors will be individuals rather than business and, from the point of view of the CFP, this substantially increases potential exposure as a result of the wide range of consumer protection regulation in the UK.

4.3.1. B2B or B2C?

The function of all CFP is to raise money from individuals and in this context it is important to note that the law seeks to protect individual consumers in their dealings with businesses. It is therefore particularly important to get the drafting of a consumer contract right. Clear terms provide a clear framework for the CFP's dealings with consumers and thereby reduce the scope for misunderstandings and disputes. It is very important that the terms are fair to consumers and lawful.

4.3.2. Legislation

There is a considerable amount of legislation which deals with consumer contracts and ensures that consumer rights are protected, notably:

- the Unfair Contract Terms Act ("UCTA") 1977. In relation to a consumer contract, UCTA applies to any term(s) which seeks to restrict, exclude or avoid liability, for example, a clause may be inserted into a contract which aims to exclude or limit the CFP's liability for breach of contract or negligence

- the Unfair Terms in Consumer Contracts Regulations 1999.

These regulations deal specifically with contracts between a consumer

and a seller of goods or supplier of services. The Regulations state that an unfair term is one that causes a significant imbalance in the parties' rights and obligations in favour of the seller or supplier.

For those authorised by the Financial Conduct Authority, the Treating Customers Fairly (TCF) Rules will also apply.

4.3.3. Jurisdiction

CFP must be careful not to target or accept investors from jurisdictions where the law prohibits the form or the subject of the investment in question, whether that be CFPs generally or just the offerings of certain types of Venture which might seek to raise funds via the CFP. If that is the case, the CFP's website should make it very clear that it will not accept investors from certain jurisdictions.

If a CFP does a considerable amount of business with consumers in different countries, then, despite being based in the UK, the CFP may be subject to the jurisdiction of another country where the investor is based. This could affect the CFP's obligations to the investor and the rights of the investor against the CFP.

It is important that the CFP's T&C specify not only the laws but also the jurisdiction which will govern the agreement between it and the investors. Typically, for UK CFP this will mean the laws of England and the jurisdiction of the courts of England.

CFP should however be aware that where investment is accepted from overseas investors, international treaties may result in such jurisdictional clauses being overridden in favour of the jurisdiction where the investor is based.

4.4. Incorporation of Terms and Conditions

Whilst it is easy to dismiss T&C as mere 'boilerplates' which nobody takes seriously, CFP should ensure not only that they are properly drafted but also that users i.e. potential investors are forced to scroll through and accept them before being able to participate in any CFP investment. It is not sufficient merely to provide a link to the T&C or to place a notice on the CFP website with words such as “all investments made via this CFP are subject to our T&C”. By properly “incorporating” the T&C into the website, the CFP is enhancing its chances of successfully relying on them should it be attacked by disgruntled investors at a later stage.

4.5. Residual Exposure

However well the CFP's T&C are drafted and incorporated into the CFP's processes, exposure will remain. As intimated above, there is no such thing as a watertight exclusion of liability. Possibly, the most serious threat falls under the rubric of fraudulent misrepresentation. Moreover, investors and other third parties might seek to bring action against the CFP outside of any contractual nexus by invoking concepts such as “negligent misstatement” and “special relationships”.

4.6. Insurance

Besides seeking to protect itself contractually, the CFP should seek to procure appropriate insurance cover whether this be by way of professional indemnity insurance or otherwise. We are unaware of any CFP with professional indemnity insurance cover of less than £1 million but this is not necessarily an appropriate level or a benchmark which others should follow. If in doubt, advice should be taken from a professional insurance broker.

5. BUSINESS STRUCTURES

5.1. Choice

Choosing the right business structure is not necessarily difficult. However, the CFP founders should appreciate that they might have to change at a later stage, perhaps as founding partners and funders drop out and/or they want to attract outside capital which may necessitate a more formal structure than the structure adopted at the outset.

A competent accountant or solicitor should be able to advise on the best way of changing the business structure without needless expense, complications and anxiety.

The CFP founders have several options when considering what type of trading vehicle they wish to adopt. Essentially their choice is between a corporate entity – a Company or Limited Liability Partnership (LLP) and a Partnership. The relevant factors include expense, liability, management structure, taxation and disclosure requirements.

5.2. Partnership

Although it is not a prerequisite, it is advisable that a partnership agreement is drawn up upon the inception of a partnership. This agreement will cover many areas, notably the parties, the duration, the nature of the business, the name, financial matters, property issues, management, restrictions on competing activities, disputes, dissolution, death, retirement and admission of additional partners.

One of the main disadvantages of a partnership is that the liability of the partners is unlimited. This means that the default position is that each partner is jointly and severally liable for all the debts of the partnership. Therefore, upon liquidation, unless dealt with otherwise in the partnership agreement, each partner loses its investment in the business and is likely to become personally liable for the unsatisfied debts of the partnership. As pointed out previously, the CFP universe is fraught with risk and, other considerations being equal, a partnership would not seem to be a suitable legal structure.

5.3. Limited Company

The most common form of limited company is one that is 'limited by shares', which means that the liability of the shareholders in the company's debts is limited to the amount of their, shareholding.

Companies must be set up in accordance with the Companies Act 2006. To create a company, the following documents need to be prepared and completed:

- Memorandum of association
- Articles of association
- Form 10, setting out details of registered office, directors and secretary
- Form 12, a statutory declaration of compliance with the Companies Act 2006

In addition, the application for registration must state:

- the proposed name of the company;
- the proposed location of the registered office;
- any limitation on liability, either by shares or guarantee; and
- whether the company is to be public or private.

Once a company has been created, information about it has to be made available to the public. Disclosure obligations include keeping at its registered office, its register of shareholders and directors for inspection, records of shareholder resolutions and service contracts. Companies must also disclose financial information in their annual accounts. Additionally, companies must also record and maintain minutes of all board meetings for 10 years.

The administrative running costs of a company are greater than those of a partnership. When creating a company, certain expenses will be incurred which do not arise in relation to a partnership. There is a registration fee and the cost of preparing the memorandum and articles of association. More important, following incorporation, a company has statutory obligations to keep and file accounts annually. This will need to be done by an accountant in compliance with the Companies Act.

Furthermore, depending on its size, a company's accounts may need to be audited by an independent accountant. A company is also required to prepare an annual return and the Companies Act will require other returns to be filed from time to time, for example, any charges and any changes to its basic details since the time of registration, such as its registered office.

It should be noted that a CFP could take the form of a company limited by guarantee and that this could be coupled with charitable status.

5.4. Limited Liability Partnership (LLP)

An LLP is best described as a hybrid of a limited company and partnership. It is a distinct legal entity like a company, and therefore the members' liability is limited. However it maintains the flexibility of a partnership in its management structure and has less onerous reporting obligations than a company.

To register an LLP, the following information must be provided:

- name of the LLP
- statement about intended location of registered office
- names and addresses of those who are to be members.

This information should be provided with the signature of two or more persons associated with the business.

As with a company, an LLP must file:

- annual accounts
- annual returns
- notifications of appointments
- notifications of any termination of membership; and
- notifications of any change in members or registered address.

In conclusion, each form of trading vehicle has its own advantages and disadvantages and it is impossible to lay down hard and fast rules as to which is more beneficial as there are too many variables and each case must be determined according to the particular circumstances and wishes of the partners of the business.

NB Advice should be taken from qualified professionals before determining the most appropriate form to adopt. Tax and liability considerations are likely to impact on this decision.

6. DATA PROTECTION AND COOKIES

6.1. Personal Data

The Data Protection Act 1998 (**"DPA"**) imposes certain obligations on those who process individuals' personal data. 'Personal data' is defined under the legislation as anything from which a living individual can be identified, either from the information in question alone, or in conjunction with any other information in the possession of the data controller. A data controller is subject to the terms of the DPA, and is essentially any entity which determines the purpose for which data is to be processed. A data processor, on the other hand, is any entity which merely processes data on behalf of a data controller.

CFP will be viewed as data controllers in respect of the personal data of individuals who are part of a Venture or investing therein. All CFP should be registered with the Information Commissioner – see http://ico.org.uk/for_organisations/data_protection/registration and have rigorous Privacy and Cookies policies in place to ensure that they are in compliance with their statutory obligations.

Indeed, if the CFP, as data controller, hires a third party to process the data it collects, it may need to enter into a data processing agreement with such third party to ensure that it adheres to the DPA principles.

Applying for a DPA licence is a relatively simple and inexpensive undertaking, unlike the more onerous process of an FCA authorisation.

6.2. Data Protection Principles

The DPA requires data controllers to adhere to certain principles when processing personal data, which include:

- Only collect personal data when it is absolutely necessary
- Personal data should be retained by the data controller only for as long as is necessary for the purpose for which the data was collected
- Personal data must be kept secure
- Those who provide their data must be given sufficient information about how it is used. Commonly this information will be contained within a privacy policy, which must be brought to the attention of the users before their information is collected
- Personal data should not be transferred outside of the 31 Member States of the European Economic Area (EEA). (For more specific information on this see Section 6.3 below.)

6.3. Data Transfer

Personal data should not be transferred outside of the EEA (and certain other non-EEA jurisdictions deemed to have adequate data protection regimes (see http://ec.europa.eu/justice/data-protection/document/international-transfers/adequacy/index_en.htm) without the consent of the data protection subject. This has become particularly difficult to police in the cloud where data may pass through a variety of jurisdictions.

As the CFP site will be accessible by users around the world, the CFP may find itself collecting the data of a user in an overseas jurisdiction. Strictly speaking, this requires the CFP to adhere to the user's local data protection/privacy laws. However, the Information Commissioner takes the view that compliance with the DPA should serve as a reliable foundation for international compliance, despite differences in international laws. Therefore, if the CFP is targeting another jurisdiction, particularly if outside of the EU, it is advisable to take specific advice in respect of that jurisdiction.

If personal data is being transferred to the US, it is advisable that the company to which it is being transferred has signed up to the 'safe harbor principles' agreed between the EU and the US in 2000, which provide that the signatories adhere to principles broadly similar to those in the DPA.

Note also that Data Protection and "Cyber Security" are becoming hot topics in both the EU and the US and that US regulation which may well impact on EU operators who target or deal with US customers is anticipated soon.

6.4. Cookies

If the CFP website deposits cookies onto the PCs or other devices of those accessing the website, additional compliance is needed in respect of recently implemented EU regulations concerning cookies. Users of the CFP will need to be given full and frank information about the purpose of cookies used by the CFP and to provide their consent prior to the download of cookies onto their machines.

Ideally, this should be express "opt-in" consent but the gold standard is rarely achieved, and implied consent based on a prominent cookie notification on the website is now the norm. Simple reference to cookies in a privacy policy buried in the website is not adequate.

CFP should bear in mind that the Information Commissioner can impose fines of up to £500,000 for those who are delinquent in terms of compliance with the data protection regime.

7. FINANCIAL REGULATORY COMPLIANCE

7.1. General

We now assess whether a CFP needs to be authorised. There are two key questions which need to be considered separately from each other:

- does the CFP require authorisation?
- does the financial promotion regime apply?

The answer will vary from CFP to CFP. The role of various participants will need to be evaluated, notably potential investors, those wishing to raise funds, the CFP platform and its operators, those managing relevant funds and holding client money, those involved in marketing and any others to whom certain functions may be outsourced.

The answer will also depend on the model of CFP under consideration, with Debt and Equity based schemes almost always requiring authorisation by the Financial Conduct Authority

(FCA) but with Donation/Reward based schemes usually falling outside of its ambit. For more specific information on the models, see Section 2 above.

The FCA has shown a certain amount of regulatory unease towards crowdfunding in general. Given that one of the key selling points of CFPs is that they streamline investing by removing regulated intermediaries and advisors from the picture, enabling retail consumers to invest in the same way as sophisticated institutional investors with direct access to financial products, this unease is not hard to understand. Given also that CFPs are only just beginning to demonstrate their ability to provide returns to consumers, it is hard to criticise the FCA's position as unreasonable.

In order to ensure proper regulation of the sector the FCA conducted a

consultation on CFPs and subsequently published new rules regulating the sector which came into force in April 2014. The net result for those operating, or seeking to operate, a debt or loan based CFP in the UK is that they need to be FCA authorised.

Entrepreneurs should note that the FCA has recently expressed concern at CFPs holding out their products as alternatives to savings accounts, indicating that it considers that CFP ought to be clear in describing their products as investments and ensuring that customers are not mislead into considering them as being strongly analogous to traditional bank deposits.

Those looking to the future of Alternative Finance should note that Loan Based schemes are likely to be permitted to take advantage of ISA rules in the near future, allowing investors to avoid paying tax on their returns from such platforms.

However, on the Equity Based side of the market, there remain concerns about the industry's ability to provide returns to consumers. There is a material possibility of a collapse of a high-profile platform, which may well damage the market by eroding consumer confidence and inviting more stringent regulation by the FCA. It is therefore in the commercial interests of CFP providers to ensure that they comply with relevant regulations and that their customers are prevented from exposing themselves to unsafe levels of risk.

7.2. Authorisation

There are many forms of CFP and the exact format being considered and products offered/Ventures promoted will need to be assessed against the terms of the Financial Services and Markets Act 2000 (FSMA). Under the terms of section 19 of FSMA, anyone carrying on investment business in the UK needs to be authorised to do so, or fall within the terms of a relevant exemption. The consequences of carrying on investment business illegally can be severe. First, a criminal offence may be committed, which carries a potential jail term of two years, an unlimited fine, or both. Secondly, any transaction entered into is voidable by the counterparty. Thirdly, those carrying on business illegally are likely to suffer dramatic reputational damage and are unlikely to endear themselves to the regulator if authorisation is subsequently desired.

The Financial Services and Markets Act 2000 (Regulated Activities Order), as amended (RAO) is the delegated secondary legislation which sets out the activities and investments which are regulated, and the exemptions. The key activities include:

- dealing in investments as principal
- dealing in investments as agent

- arranging deals in investments
- managing investments
- advising on investments
- establishing collective investment schemes

"Investments" is a technical term, and includes shares and units in collective investment schemes, etc. There are a number of narrowly drawn potential exemptions available. However, any CFP attempting to rely on exemptions will need to stay on top of regulatory developments to ensure that the exemptions are not narrowed or removed, and render its operational business model uncommercial or even illegal. A number of CFPs have now been authorised, and more are expected as the CFP model grows in popularity. Any CFP wanting to establish a Fund should be aware that the Fund will require separate authorisation.

7.2.1. Loan Based

CFPs offering debt-based investments (e.g. peer-to-peer loans) to consumers are likely to be regulated by the FCA as 'electronic systems in relation to lending'.

Debt based CFPs are obliged to meet prudential requirements, holding sums of money in reserve proportional to the total value of loaned funds managed by the platform. The FCA specifies a minimum value of funds to be held in any event, but the value required to be held in reserve by a CFP will rise as it increases the value of its loan book.

The FCA also obliges debt based platforms to put in place failsafe measures to ensure that the loans which they facilitate between users will be honoured and managed in the event that the platform collapses or closes. There are a number of permissible contingency plans listed in the FCA Handbook, which include the possibility of entering into an agreement with a competitor that would see that competitor step in to take over the loans in the event of failure, or signing up a guarantor to effectively underwrite the platform's loans.

7.2.2. Equity Based

Equity Based CFP are likely, in the eyes of the FCA, to be offering 'non-readily realisable' securities to investors, thus attracting stricter regulation in order to ensure that consumers are properly protected.

In offering investments in non-readily realisable securities to consumers, loan based CFP must comply with various aspects of the FCA rules when describing and marketing their products.

Further, firms must take the greatest of care to ensure that consumers are vetted in advance of investing to determine whether they are 'restricted', 'sophisticated' or 'high net-worth' investors. Those investors who fall into the 'restricted' category (which will be the majority of retail customers) are to be limited to investing only a small percentage of their total net assets in crowdfunding products.

Authorised firms are obliged by the FCA to have vetting procedures in place, as well as to have the necessary processes for making customers aware of the restrictions and to oblige them to make a specific declaration that they have understood and accepted the restrictions before proceeding to purchase an investment product.

Finally, the FCA sets a cap (which is not CFP specific) on the total value of equity that may be offered to the public without the publication of a formal prospectus. The publication of such a document would likely be cost inefficient for CFP and thus represents a soft cap on the total value of funds that can be raised in any given round of CFP fundraising.

7.3. Individual Approval

In addition to authorisation of the CFP, the individuals who own and operate it may also require personal approval.

These include prior sign off by FCA of those who are to be the directors, partners, CEO, significant managers, compliance officer, Money Laundering Reporting Officer and customer facing staff, as well as significant shareholders in the Venture. All will need to pass the FCA fitness and propriety test.

7.4. Financial Promotion

The question of financial promotion needs to be considered separately to the issue of authorisation. The concept of “financial promotion” is broadly interpreted and includes oral communications, seminars, websites, email and social media campaigns, as well as traditional hard copy brochures. It covers all communications of invitations or inducements to engage in investment activity in the course of business. Like the issue of authorisation however, the detail is contained in secondary delegated legislation. In this case, the order is the Financial Services and Markets Act 2000 (Financial Promotion Order) 2005 as amended (FPO).

The FPO sets out what amounts to a financial promotion and contains a list of over 60 exemptions, including in relation to certain sophisticated investors or high net worth individuals. Broadly speaking, the marketing of a CFP needs to comply with the FPO, fall within an exemption, or be approved by an authorised person.

CFP also need to be aware of general regulation on advertising, such as misleading and comparative advertising restrictions, the general law on misrepresentation, and advertising codes of conduct

7.5. Other Regulatory Issues

Issues of consumer credit may arise if the lending model is used. FCA has recently taken over responsibility for issuance of consumer credit licences. Certain specific corporate law issues may arise if the equity model is used. Depending on the way in which the CFP is structured and the size involved, a prospectus may be needed. The information held on investors and others may require authorisation under the data protection regime and construction of the business so as to follow data protection principles (see Sections 6.1-6.3 above).

7.6. International Dimension

Onerous though the regulatory regime may seem, the UK is a comparatively liberalised jurisdiction for CFP and has established itself as a global leader in alternative finance products. In terms of funds raised to date, the US dominates on the Reward or “donation” based model whereas the UK is well ahead on the Equity model.

The European economy as a whole could benefit from the introduction of a more relaxed unified regime for crowdfunding. However, to do so would require amendment of not only the UCITS regime (Undertakings for Collective Investment in Transferable Securities), but also the Prospectus Directive and Markets in Financial Instruments Directive (MiFID), as well as other European legislation. This would be likely to be controversial and also take considerable time.

For the moment, regulation of crowdfunding is likely to remain at the state level, however.

7.7. Investment Risk

There is a potential risk attached to making investments via a CFP. Obviously if it is a CFP which has been authorised and is regulated, the risks are substantially reduced. There is no access to the Financial Ombudsman Service for investors in crowdfunding platforms which are not regulated.

7.7.1. Financial Ombudsman

The Financial Ombudsman is the official independent expert in settling complaints between consumers and businesses providing financial services.

The Financial Ombudsman’s services are free and it can make awards of up to £150,000.

7.7.2. Financial Services Compensation Scheme

The FSCS is the UK's statutory fund of last resort for customers of financial services firms. This means that FSCS can pay compensation to consumers if a financial services firm is unable, or likely to be unable, to pay claims against it. At the time of writing, in the case of investments, the cap on compensation is £50,000 per person per firm for claims against firms declared in default, as opposed to £85,000 in the case of deposits. It is not available in respect of loan based CFP however.

7.8. Self-Regulation

Crowdfunding in the UK has experienced strong growth over recent years. CFP provide a much-needed alternative source of finance for businesses looking to raise funds, and it is an easy and transparent way for investors to put money into projects and small businesses they wish to back. For example, Funding Circle has now lent over £535 million to UK business, and Crowd Cube has raised over £61 million for nearly 200 businesses.

7.8.1. UK Crowd Funding Association (UKCFA)

Fourteen of the UK’s leading crowdfunding businesses joined together in 2012 to launch a trade body, called the UK Crowdfunding Association (UKCFA) (www.ukcfa.org.uk), aimed at providing clarity and consumer protection for the whole industry. There were 43 members by the start of 2015.

7.8.2. UKCFA Code of Conduct

The UKCFA has set out a number of principles which are designed to work across a range of businesses, some of which are FCA authorised and some of which are outside the scope of regulation. All UKCFA members agree that the principles laid out in the Code are important

for both business and individuals. Adherence to these principles is a requirement of membership of the UKCFA. Each of these principles applies to each UKCFA member in respect of its investors and donors. As will be seen, they set high standards and are similar to requirements imposed by the FCA and under general law.

- Investments and donations will be kept separate from our business, in client accounts or similar segregated money-handling structures.

- We will ensure transparency so that at all times investors or donors can see information on their money; including where it is kept, amount and transactions.

- We will put in place processes to ensure that our investor and donor information is kept safe and secure and that it can still be accessed in the event that we cease to operate.

- We will also put in place processes to ensure that holdings of investments can continue to be accessed in the event that we cease to operate.

- We agree to provide a cooling off period in case our investors or donors change their mind after making an investment or donation.

- Our terms and conditions will be clearly written and will explain exactly how the investment process works, what our duties and responsibilities are, and what fees and charges will apply and when.

- We will hire competent, professional, honest people and make sure we have the right systems and processes to run our businesses safely. Our Executive Directors' details will be published on the UKCFA website.

- We will ensure that our IT systems and business processes are secure, reliable and proportionate to the nature, scale and complexity of our business and are sufficiently robust to facilitate compliance with applicable law, regulations and this Code of Conduct.

- We will comply with the laws and regulations applicable to our sales and marketing activity, and ensure that all UKCFA members' communications are fair clear and not misleading, that risks and potential returns are presented in a balanced way and that investors and donors are treated fairly.

- If investors or donors are unhappy about any aspect of a member's service, they will be able to complain and we will publish our performance on complaints on the UKCFA website every year.

UKCF
UK Crowdfunding

Members of the UK Crowdfunding Association that have signed up to this Code may display this box on their websites and other presentation and marketing material.

7.9. Money Laundering Regulations 2007

This is a very important and somewhat convoluted area and we are not attempting to deal with it comprehensively in the context of this guide. However, those running or looking to establish a CFP must put in place suitable anti-money laundering, terrorist financing and anti-sanctions breaking controls.

The controls are designed to prevent businesses from being abused by criminals and terrorists. A CFP will need to appoint a Money Laundering Reporting Officer, a 'nominated officer', check the identity of customers, keep all relevant documents, report any suspicious activity to the National Crime Agency and carry out staff training.

If a CFP is established which is not regulated by the FCA or by a professional body, it will probably be necessary to register with HM Revenue & Customs (HMRC) for these purposes. For further information, see www.hmrc.gov.uk/mlr/getstarted/intro.htm

8. EXIT

8.1. Due Diligence

Of course, a successful CFP may itself attract investment and possibly even acquirers. Interested parties will want to ensure that they obtain sufficient information about the CFP's business to enable them to decide whether the investment or acquisition represents a sound commercial transaction. Interested parties will gain this information through the due diligence process, which is essentially an audit of the CFP's commercial, legal and financial affairs.

Given that the outcome of a due diligence review may determine whether or not a potential investor or purchaser wants to proceed with the transaction, it is important that the CFP keeps its house in order. A non-exhaustive list of relevant matters is set out below:

- keep the company's statutory books updated and be sure to adhere to all Companies House filing requirements (e.g. accounts, annual returns etc.)
- record and keep minutes of all board meetings
- ensure that all the material agreements into which the CFP has entered to are documented in professionally drafted contracts which have been fully executed. Examples of material agreements include IP licences, service contracts for staff, agreements with Ventures, agreements with investors, leases for premises etc.
- maintain lists containing details of all the assets owned by the company
- ensure that the company's financial affairs and records are clean and up to date.

8.2. Minimising CGT

Whilst this E-book focuses on issues relating to the trading life of a CFP and not the issues on exist, there is a wide range of fiscal factors to consider on exit which can impact significantly on the net exit price. We will highlight a few below but CFP nearing exit should take timely advice in relation to all relevant fiscal issues.

Various reliefs are available which can help to mitigate CGT.

8.2.1. Entrepreneurs' Relief

This is often available on the occasion of the sale of a business and can diminish the applicable rate of CGT from 28% to 10%. Under this concession, every entrepreneur has a lifetime CGT limit of £10 million which is chargeable at 10%. To qualify, you have to have met the qualifying conditions throughout a one year qualifying period either up to the date of disposal or the date the business ceased.

8.2.2. Rollover Relief

This enables a seller to reinvest the proceeds of a disposal in a replacement asset operates by reducing the cost of the new asset by part or the whole of the gain realised on disposal of the old asset.

8.2.3. Holdover Relief

This applies to gifts of business assets and generally eliminates CGT by deeming the donor's gain to be attached to the asset thereby adding the donor's gain to any gain realised later by the donee. Both seller and buyer must specifically claim this relief. Often this is relevant in the context of a business transfer between members of the same family whether or not this is a step in an onward sale to a third party.

8.2.4. Eliminate CGT

CGT can be reduced to nil if the vendor remains non-resident for tax purposes for five complete tax years and there is no CGT liability on any asset appreciation assessed at the time of death. It should be noted that HMRC is likely to see through and challenge any artificial claim of non-residence – through the courts if necessary. Obviously if this option is considered, local tax advice should be obtained in the country of intended residence.

Further Information and Disclaimer

This is a general guide for UK entities involved in setting up and running a Crowdfunding Platform and is no substitute for full professional advice applied to a particular scenario. All content, figures, rates and bands are believed to be accurate at time of writing but should be checked at time of reading. To this end, relevant contact details of the principal author, editor and contributors are set out below:

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