UKIE Crowd Funding Report: A Proposal to Facilitate Crowd Funding in the UK
February 2012
Executive Summary

The Association for UK Interactive Entertainment (UKIE) is the trade association that represents a wide range of businesses and organisations involved in the games and interactive entertainment industry in the UK.

UKIE exists to make the UK the best place in the world to develop and publish games and interactive entertainment. UKIE’s membership includes games publishers, developers and the academic institutions that support the industry. We represent the majority of the UK video games industry; in 2011 UKIE members were responsible for 97% of the games sold as physical products in the UK and UKIE is the only trade body in the UK to represent all the major console manufacturers (Nintendo, Microsoft and Sony).

Access to finance is a key barrier to growing the interactive entertainment industry in the UK. UKIE believes that crowd funding models can provide a valuable source of finance for games and interactive entertainment businesses, particularly the large number of innovative and creative start-ups and SMEs that are emerging in the UK.

The interactive entertainment industry is at the forefront of the adoption of crowd funding and crowd sourcing in the digital sector; a recent American crowd funding project (Double Fine Adventure) recently broke records by raising over $1.8 million on the crowd funding platform Kickstarter. However, we also believe that crowd funding has the potential for much wider use by SMEs in other sectors and wider community based projects throughout the UK.

What is crowd funding?

The basic idea behind crowd funding (which is also sometimes called crowd financing and crowd sourced capital) is that many individuals contribute (generally fairly small amounts) to fund a company or a project in return for the possibility of some reward. This is not a new idea but the internet has now considerably increased the size of the potential investment crowd and made managing individual investors’ pledges more manageable.

The term crowd funding is used quite widely to refer to three quite different methods of raising funds:

- **The Donations Model:** Funders provide money to a company or for a project either for no return or in return for some form of non-financial reward. For example a credit or bespoke recognition in the product or a meeting with the creators.

- **The Lending Model:** Funders provide money by way of a loan with a requirement that the loan is repaid with interest.

- **The Investment Model:** Funders provide money in return for a share of profits. The Investment Model can itself take one of two forms:
  - **The Securities Model:** A funder invests money in a company and receives shares in that company.
  - **The Collective Investment Scheme (CIS) Model:** A funder invests money in a project in return for a right to a share in the profits or in the revenues generated by that project, but does not receive shares in the company undertaking that project.

What are the barriers to crowd funding?

There are already businesses offering crowd funding platforms based on the models above and many examples of creative businesses using them.

However, the growth and application of crowd funding in the UK is restricted by the current legal and regulatory framework – particularly in limiting the potential of the investment model. These barriers principally exist to protect consumers from unsuitably high risk or fraudulent investments, but also prevent platforms from offering simple ways for fans to invest in the creation of projects and be rewarded for doing so.

A recent video games crowd funding project broke records by raising over $1.8 million

UKIE’s Crowd Funding Report outlines how the UK’s current regulatory environment can be improved to allow investors, content producers and crowd funding platforms to take maximum advantage of crowd funding.

We believe that these improvements can be made with minimal changes to legislation and that crowd funding can then operate as a viable route to finance for UK businesses with no extra cost to Her Majesty’s Treasury.
What can be done to improve the potential of crowd funding in the UK?

The key elements of the changes that we propose are as follows:

- **Crowd funding to be permitted generally:** Although this report primarily looks at crowd funding for the interactive entertainment industry, the recommended changes can have many benefits for SMEs from other sectors and wider community based projects throughout the UK.

- **A “light touch” regulatory regime:** Allowing for fast moving investment in businesses and projects whilst maintaining an appropriate level of protection for potential investors.

- **No requirement to issue shares to investors:** It should be possible to effect crowd funding projects as collective investment schemes and therefore without the need to issue shares to individual investors.

- **No limit on what can be raised per project:** There should be no limit on the amount that can be generated by crowd funded collective investment schemes, provided that a fund that is seeking to raise over £5 million would have to produce a prospectus (this derives from the Prospectus Directive).

- **An investment limit per person per project:** It is important to have a limit to reduce the possibility of any individual investing too great an amount in a project that is unsuccessful.
1. Introduction

1.1 We welcome the Government’s initiative in establishing the Business Funding Taskforce in December and we understand that this Taskforce has looked at crowd funding as part of its overall remit. The purpose of this report is to call on the Government to change the regulatory framework in the UK to allow a limited exception to permit crowd funding arrangements which offer a financial return to investors.

1.2 We believe that crowd funding has particular application and relevance for the creative industries and especially for the games and interactive entertainment industry. Indeed, as we outline in paragraph 3 below, the limited forms of crowd funding presently permitted have already achieved notable successes for certain UK interactive entertainment businesses. In addition, there are features of the creative industries which will need to be reflected in the way that crowd funding is implemented to ensure that it can be used effectively in these industries.

1.3 We set out in Appendix 1 the current regulatory hurdles to crowd funding arrangements in the UK. We set out in Appendix 2 our detailed proposals as to how the regulatory framework should be changed to remove these hurdles. These proposed changes accommodate the particular requirements of the creative industries and also, we believe, provide the simplest and most effective way to make crowd funding accessible for all industries. We believe that these changes can be made relatively easily and in a way that is consistent with the overall approach of the regulatory framework.

1.4 The key elements of the changes that we propose are as follows:

(a) Crowd funding to be permitted generally: Although we have considered the application of crowd funding with particular reference to the creative industries and especially the interactive entertainment industry, we propose that the changes apply to crowd funding generally so that crowd funding is made more available for all industries.

(b) A “light touch” regulatory regime: We propose that crowd funding is facilitated by means of a limited regulatory regime applicable to crowd funding, rather than being taken outside the scope of the regulatory regime. We think the rationale behind the existing regime is largely fit for purpose and it is more a question of adapting tried and tested concepts to cater for crowd funding.

(c) No requirement to issue shares to investors: We propose that it should be possible to effect crowd funding projects as collective investment schemes and therefore without the need to issue shares to individual investors.

(d) No limit on what can be raised per project: We do not believe there is merit in setting a maximum aggregate investment amount for crowd funding by way of collective investment schemes, provided that a fund that is seeking to raise over €5 million would be subject to a requirement to produce a prospectus (this derives from the Prospectus Directive).

(e) An investment limit per person per project: It will be important to have a limit to reduce the possibility of any individual investing too great an amount in a project that is unsuccessful. There are various ways to approach this limit which we address in Appendix 2.

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We are not seeking any financial support from the Government for crowd funding

1.5 Clearly, the proposed changes only relate to the UK regulatory regime and would therefore only apply to UK operated crowd funding platforms and to the promotion of investments to UK residents. However, this would not prevent a UK crowd funding platform from accepting unsolicited investments from individuals resident in another country. If however a UK crowd funding platform wished to promote investments to residents of another country, then it would need to comply with the applicable regulatory regime of that country. In the same way, a crowd funding platform in a different country has to comply with the UK regulatory regime if it wished to promote investments to UK residents.

1.6 We are not seeking any financial support from the Government for crowd funding. The facilitation of crowd funding in the manner proposed by this report would only require the Government to implement the changes to the UK regulatory regime outlined in Appendix 2.
2. **What is Crowd Funding?**

2.1 Crowd funding (which is also sometimes called crowd financing and crowd sourced capital) simply means raising money for a project or a business from a large number of funders, each of whom generally contributes a relatively small amount. However, the term crowd funding is used quite widely to refer to three quite different methods of raising money:

(a) **Donations or sponsorship:** Funders provide money to a company or for a project either for no return or in return for some form of non-financial reward. Projects generally invite different levels of contributions for different levels of rewards, ranging from things such as a credit in the product or some low value merchandise such as a T-shirt, through to some form of bespoke recognition in the product or a meeting with the creators. We refer to this model as the "Donations Model".

(b) **Lending:** Funders provide money by way of a loan with a requirement that the loan is repaid with interest. We refer to this model as the "Lending Model".

(c) **Investment:** Funders provide money in return for a share of profits. We refer to this model as the "Investment Model". The Investment Model can itself take one of two forms:

(i) A funder invests money in a company and receives shares in that company. We refer to this model as the "Securities Model".

(ii) A funder invests money in a project in return for a right to a share in the profits or in the revenues generated by that project, but does not receive shares in the company undertaking that project. We refer to this model as the "Collective Investment Scheme (CIS) Model".

2.2 It is important to distinguish between these different forms of crowd funding, since the way that the regulatory regime relates to them is very different. Some of these models are capable of sitting reasonably comfortably within the current regulatory regime but others are effectively prohibited by that regime. We have set out the current regulatory hurdles to crowd funding in Appendix 1, but in summary, the current position in relation to each of these models is as follows:

(a) **Donations Model:** It is possible for a company to raise funds by crowd funding by means of a Donations Model. This is because the Donations Model falls outside the UK regulatory regime as those providing money do not participate in the profits or revenues generated by the company or project to which they make the donation.

(b) **Lending Model:** It is possible for a company to raise funds by crowd funding by means of a Lending Model, provided that the loans do not involve the provision of consumer credit. This is because the activity of arranging for the provision of loans falls outside the UK regulatory regime.

(c) **Securities Model:** As a general rule, it is not possible for a company to raise money by crowd funding by means of a Securities Model. This activity falls within the UK regulatory regime which, with some limited exceptions, prohibits the raising of money in this way.

(d) **CIS Model:** As a general rule, it is not possible for a company to raise money by crowd funding by means of a CIS Model. This activity is likely to fall within the UK regulatory regime relating to unregulated collective investment schemes which prohibits the raising of money in this way.

2.3 This proposal is primarily concerned with how more can be done to enable the crowd funding of projects through the CIS Model. We believe that this is the most suitable model for crowd funding, particularly in the creative industries. This is because the CIS Model is consistent with the current crowd funding initiatives that use the Donations Model and also because the CIS Model avoids the administrative and procedural burdens that would arise in order to issue shares to a large number of individual investors. However, there are elements of cross-over between the different models, so in our proposed changes detailed in Appendix 2, we also consider some refinements to existing securities laws that would help facilitate crowd funding scheme operators (and others) operating businesses using the Securities Model and the Lending Model.

2.4 As a backdrop to our proposals, we have summarised in paragraphs 3, 4, and 5 below some current examples of the growth in crowd funding using the Donations Model, the Lending Model and the Investment Model respectively. We then summarise in paragraph 6 below the particular issues being faced by the interactive entertainment industry which we believe means that crowd funding has particular value for this industry.
3. The Donations Model

3.1 The nature of crowd funding means that it is particularly well suited for raising funds for social or community projects where those making a contribution would not expect to receive any form of financial return. One example of a crowd funding platform in the UK that is used in this way is People Fund www.peoplefund.it, which is a platform that enables funds to be raised for community projects.

3.2 However, crowd funding is becoming an increasingly popular way of raising funds for commercial creative projects. The leading crowd funding platform that is used in this way is probably the US based Kickstarter (www.kickstarter.com) which claims to be "the world’s largest funding platform for creative projects". There are numerous examples of companies successfully using Kickstarter to raise funds for their projects. These include:

(a) Six to Start (UK) with "Zombies! Run!": This project had a target of $12,500 but actually raised $73,000: http://www.kickstarter.com/projects/sixtostart/zombies-run-a-running-game-and-audio-adventure-for?

(b) Rik Falch (USA) with "D-Day Dice Board Game": This project had a target of $13,000 but actually raised $172,000: www.kickstarter.com/projects/1325766284/d-day-dice-board-game?

(c) Double Fine (USA) with a PC game "Double Fine Adventure": This project had a target of $400,000 which it raised in just over eight hours. At the time of writing, this project had raised over $1.8 million with a further 26 days of the promotion still left to run: http://www.kickstarter.com/projects/66710809/double-fine-adventure?

3.3 Other crowd funding platforms are emerging which focus on specific industries in the creative sector. For example, the platform Film Interactor is a crowd funding platform that focuses on films www.filminteractor.com. This platform is currently being used by UK based producers Itchy Fish Films to raise money for their film "The Bromley Boys": http://opsmail.nma.co.uk/re?i=4551ju15m3ekfle.

3.4 A few companies within the interactive entertainment industry have raised funds through crowd funding projects by directly engaging their own network of players and supporters. Examples of this approach include:

(a) Warballoon Games (USA) with “Star Command”: This project raised $20,000 in five days: http://www.develop-online.net/news/38617/Crowdfunding-indies-raise-20k-in-five-days

(b) Harry Mylonadis with CPU Wars (UK): This project raised $17,752 from 746 backers, although the initial target was only $3,500: http://www.kickstarter.com/projects/harrymylo/cpu-wars-volume-10-the-card-game?

(c) Zero Point Software (Denmark) with “Interstellar Marines”: This project raised over $125,000: http://www.develop-online.net/news/37516/Euro-studio-makes-125k-in-crowdsourced-cash.

(d) Mojang (Sweden) with “Minecraft”: Although not technically a crowd funded game, Mojang have raised a substantial amount of money (in the millions of pounds) through activities that were crowd funding in nature.

3.5 Although a few businesses have been able to raise surprisingly large amounts of money through the Donations Model, these are exceptional cases generally involving relatively high profile companies or brands which have already built up a large network of enthusiastic supporters. It is much more difficult and in many cases impossible for newer and smaller businesses to raise money for commercial projects in this way, given that they are not able to offer any financial return.

4. The Lending Model

4.1 This has proved to be an increasingly popular model and provides businesses with a useful alternative to bank lending. The most high profile example of a crowd funding platform adopting the Lending Model is probably the UK based company Funding Circle www.fundingcircle.com.

4.2 However, this form of funding will not be accessible to some creative businesses, given...
the high level of credit risk that they often carry. In addition, this form of funding is unlikely to be an appropriate way to raise money for the development of creative products and services since they often carry a high level of potential risk and reward. Even if a creative business is able to raise money in this way, it may not wish to do so since there will be a fixed obligation to repay the debt and interest which, if not met, carries the risk that the business will become insolvent.

Access to finance is a particular issue for interactive entertainment studios in the UK

5. The Investment Model

5.1 As explained in paragraph 2.2 above, this is the most highly regulated form of crowd funding. Nevertheless, in the UK there are several platforms that seek to enable companies to raise money through crowd funding in this way.

5.2 In the UK, the two best known examples of crowd funding platforms adopting the Investment Model are CrowdCube (www.crowdcube.com) and Seedrs (www.seedrs.com). These two platforms have approached the UK regulatory regime administered by the Financial Services Authority ("FSA") in different ways:

(a) FSA authorisation not required: The platform CrowdCube appears to rely on certain exemptions from the UK regulatory regime and has therefore not obtained authorisation from the FSA (other than limited FSA authorisation for the company behind the CrowdCube platform itself). However, this has inevitably made the platform more difficult to operate and to use than platforms using the Donations Model such as Kickstarter.

(b) FSA authorisation required: The platform Seedrs has applied for FSA authorisation to arrange deals in units in a collective investment scheme. Seedrs will rely on an exemption from the prohibition on promoting unregulated collective investment schemes by restricting access to its services to investors that it has assessed as adequately knowledgeable to understand the risks of investing in a collective investment scheme. However, this approach requires a discretionary vetting process and therefore restricts the number of potential investors. Any test will also be subject to subjective and retrospective regulatory criticism in the event that an investor claims not to have understood the nature of an investment.

6. The Role of Crowd funding in the Games and Interactive Entertainment Industry

6.1 Although access to finance is clearly a key issue for all businesses, it is a particular issue for interactive entertainment studios in the UK. The interactive entertainment industry is currently going through a process of considerable change. There are many aspects to this change, but the key elements are as follows:

(a) The methods of distribution: Traditionally, games have been published as boxed products sold at retail; increasingly games are being distributed by means of digital distribution direct to a consumer’s hardware device or made available online through a browser or on platforms such as Facebook.

(b) The nature of the games: Traditionally, games have been relatively complex comprising many hours of gameplay; there is now a huge market for games that are very simple and can be picked up and played very easily and for very short periods of time.

(c) The financial models: Traditionally, games have required substantial amounts of money to develop, manufacture, market and sell; the newer forms of games can have low development costs, carry no manufacturing costs and deliver significant returns in investment.

(d) The business models: Traditionally, games have been sold at retail for a relatively high price and then often only had a limited shelf life with the overwhelming majority of sales made within a short period of time after first release; increasingly games are being offered either at a much lower price or as free to play, with games businesses generating revenues by offering a range of additional content or benefits, enabling different consumers to enjoy the games at different levels of engagement and at different price points.
6.2 These changes provide interactive entertainment studios in the UK with considerable challenges and opportunities. The business of some studios has been to develop boxed product games for their clients, typically a major publisher. With less of these projects available and with increasing competition from other lower cost jurisdictions, some of these studios have found business increasingly challenging.

6.3 However, these and newer studios now have the opportunity to develop their own products for the newer platforms such as the iPhone and to publish these products themselves. At present in the UK there is a strong groundswell of these newer studios, many of which have been formed by individuals with considerable technical and creative experience. By operating in this way, studios are able to create and retain their own intellectual property rights and therefore to build value in their business. For example, there has been speculation that the value of Rovio, the Finnish mobile games studio which created the game "Angry Birds", is now $1.2 billion: http://www.bloomberg.com/news/2011-08-11/-angry-birds-maker-seeks-1-2b-valuation.html

6.4 In order to capitalise on these opportunities, studios require independent sources of finance. Some studios finance these developments through income generated from their “work for hire” business. Other studios manage to raise enough through friends and family contacts to develop a project to a point at which it is able to attract venture capital investment. However, many studios could develop more quickly and more effectively with greater access to finance. We believe that crowd funding would be one very effective way for at least some of these studios to raise finance for certain products and services.

6.5 Furthermore, crowd funding could dovetail with other forms of finance available to games studios, such as finance from publishing partners, games funds, broadcasters or other media businesses and even, in some cases, bank lending. Crowd funding might therefore enable studios to leverage some of these other sources of finance. Although the Donation Model of crowd funding has led to some notable successes already, we consider crowd funding in interactive entertainment to be still at the ‘proof of concept’ stage and has yet to evolve into maturity as a genuine funding alternative or supplement for most UK interactive entertainment studios. As we mention above, this is in part because the current Donation Model is inherently better suited to studios that already have an existing market reputation and a product portfolio with which to encourage individuals to contribute to new products. Newer and smaller studios have comparatively fewer selling points.

6.6 As a result, we consider that giving studios the ability to offer individuals the ultimate prospect of a financial return on their investment could open up crowd funding to a substantial number of businesses and therefore to give real impetus to the application of crowd funding in the interactive entertainment and other creative industries in the UK.

6.7 We would add that although meaningful empirical data on the general development or use of crowd funding is not yet available, we are aware that there is already considerable interest in the games and interactive entertainment industry regarding the use of crowd funding involving a financial return to investors. Indeed, we understand that a few interactive entertainment businesses have already launched, or are proposing to launch, such projects using platforms located in other countries.

Crowd funding could dovetail with other forms of finance available to games businesses

7. US Proposals for Crowd Funding Arrangements

7.1 As we mention above, the leading crowd funding platform at least for the creative industries is probably the US platform, Kickstarter. In addition, the US has taken a lead in encouraging crowd funding through generating draft legislation aimed at breaking down existing regulatory impediments to crowd funding.

7.2 The regulatory regime in the US is of course different from that in the UK. However, it is instructive to look at the experience in the US and the approach that the US is taking to facilitate crowd funding using the Investment Model. We have therefore summarised the draft US legislation in Appendix 3.
8. Conclusions

8.1 The examples summarised in paragraphs 3, 4, and 5 above show that there is already a considerable demand for crowd funding, both from those seeking to raise funds and from those seeking to participate in creative projects.

8.2 The proposal set out in this report provides a limited and controlled way to facilitate the growth of crowd funding in the UK. We believe that this would greatly facilitate the availability of crowd funded projects in the UK and provide UK interactive entertainment studios and other businesses in the creative industries with a valuable new source of funds.
Appendix 1
The Current Regulatory Hurdles

1. Establishing, operating and winding up collective investment schemes:

1.1 Where a project is funded by a diverse group of investors, the person running the project will generally be required to become authorised by the FSA pursuant to article 51 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the “RAO”).

1.2 The collective investment scheme regime does not apply where the project is run by a special purpose company which offers shares to investors (i.e. the Securities Model). However, incorporating a company to receive the funding may be disproportionately expensive and time-consuming where the funding takes the form of a large number of small investments, such as the administrative burden of complying with corporate filing requirements and catering for rights granted to shareholders under the Companies Act 2006.

1.3 If the project takes a purely contractual form (i.e. the CIS Model), the current UK regime can be unclear as to whether the person(s) running the project on a day-to-day basis is conducting the article 51 activity.

2. Promoting unregulated collective investment schemes

Sections 238 and 240 of the Financial Services and Markets Act 2000 prohibit authorised firms from issuing financial promotions relating to unregulated collective investment schemes unless the promotion falls within certain exclusions. This would mean that contractual crowd funding would have to be restricted to investors that have been vetted. Where the size of investment is small, the costs of operating the vetting process could wipe out the value of the investment.

3. Appropriateness of investments

As with the vetting process for financial promotions, assessing appropriateness for non-advised arrangements would be likely to challenge the profitability of crowd funding with high volume, low value investments.

4. Offering shares in private companies to the public

There is limited guidance around the restriction contained in section 755 of the Companies Act 2006 that prohibits private companies from offering their shares to the public. There is a risk that private companies using crowd funding could be said to be in breach of that section.

5. Uncertainty as to the distinction between a loan, a debenture and a deposit

5.1 Although it is generally recognised that non-consumer lending is not regulated in the UK, it would be helpful to clarify the legislation surrounding the regulation of debentures and deposit-taking.

5.2 The definition of a debenture covers any instrument creating or acknowledging indebtedness, which appears to be wide enough to capture an IOU. Articles 17 and 31 of the RAO contain exemptions from conducting regulated activities in respect of providing or arranging the provision of finance. However these exemptions do not apply across the whole range of regulated activities or to financial promotions. The part-application of the exemptions has the potential to create confusion for crowd funding operators using the Lending Model.

5.3 The definition of debentures is also highly relevant to deposit taking business, as article 9 provides an exemption for sums received in consideration for the receipt of debt securities. Where a business accepts loans through crowd funding, it would be helpful for the law to be clarified to make it completely clear that the business is not engaging in banking activity.
Appendix 2
Proposed Changes to the UK regime

1. A good time for change

1.1 As noted above, the major obstacle to crowd funding is the UK-centric method of regulating activities relating to collective investment schemes. This is a particularly opportune moment to consider amendments to the UK’s regime for a number of reasons:

(a) The existing UK regime was not formed as a result of any international or EU initiatives, so the UK has the flexibility to adapt this regime.

(b) The US has showed appetite for evolving and adapting its regulatory structures to promote crowd funding (as discussed further in Appendix 3), so evolution is necessary to keep the UK competitive as one of the pioneers of crowd funding.

(c) The introduction of the Alternative Investment Fund Managers Directive ("AIFMD") will require the UK to adapt its current regime for unregulated collective investment schemes in any event. The AIFMD does not seek to provide an exhaustive definition of what constitutes a "fund", which suggests that the UK can retain discretion as to what it classifies as a collective investment scheme. (We understand that other European jurisdictions are likely to continue to apply a narrower interpretation of “fund” pursuant to the AIFMD than the UK currently applies through the collective investment scheme regime).

2. Principles behind proposed crowd funding regulatory regime

2.1 We do not think that the existing UK regime requires a major overhaul. The rationale behind the existing regime is largely fit for purpose and it is more a question of adapting tried and tested concepts to cater for the specific opportunities that crowd funding technology and innovation provide.

2.2 In this spirit, we believe that any proposals relating to crowd funding should achieve the following results:

(a) Crowd funding involves investment business. Therefore crowd funding operators should be subject to regulation. This will help ensure that the public perception of crowd funding is of an industry that is trustworthy.

(b) Crowd funding should encourage innovation, entrepreneurship and the release of capital. It should therefore be subject to light-touch regulation in the same manner as venture capital and corporate finance business.

(c) The CIS model of crowd funding may easily result in investors losing all of their investment. Investors must receive extremely prominent warnings that this is the case and, more generally, should understand exactly what crowd funding entails and under what circumstances they may expect to receive any return on their investment.

(d) Crowd funding operators must take responsibility for ensuring that the recipient of the funding operates adequate accounting systems before taking it on.

(e) Crowd funding relies on a mass market of low level investment. In order to tap into this market, it is imperative that the regulatory regime does not require high levels of investor vetting. Investor vetting processes should more closely resemble those used by responsible participants in the gambling industry, rather than those used by, say, pensions providers.

The existing UK regime does not require a major overhaul

3. New concepts for a crowd funding regulatory regime

3.1 Investors in a crowd funded enterprise will acquire an investment, so we believe that the existing investment categories (e.g. shares and units under articles 76 and 81 of the RAO) should be able to accommodate crowd funding. What is required is a specialist regime for crowd funding to distinguish what conduct of business rules ought to apply to providers. Consequently, we propose a regime that recognises the following concepts:

(a) "Crowd Funding Scheme"

(i) A Crowd Funding Scheme would be a sub-category of an unregulated collective investment scheme. The
definition would also apply to sub-funds within an unregulated collective investment scheme (so that part of the scheme could be operated as a Crowd Funding Scheme without obliging the whole scheme to seek crowd funding as the sole source of financing).

(ii) A Crowd Funding Scheme should not amount to an alternative investment fund for the purposes of the UK’s implementation of the AIFMD to ensure UK competitiveness with jurisdictions that would not categorise crowd funding as falling within the scope of this Directive.

(iii) A Crowd Funding Scheme should be subject to a maximum level of investment per investor per Crowd Funding Scheme to ensure that investor losses are limited. A simple approach would be to have a single fixed limit, (which we believe would need to be a minimum of £250 and ideally at least £1,000). However, it is clear that many individuals already contribute much greater amounts in schemes set up under the Donations Model, which means that a single fixed amount may be too low and too restrictive. An alternative approach would be that set out in the draft legislation in the US which uses an alternative limit based on either a fixed amount or a percentage of the investor’s annual income. Although this would enable higher individual investments, it would of course make it necessary to seek information about an investor’s personal income as part of the investment process. As part of taking this proposal forward, we would be happy to consult with the industry further on this point.

(iv) We do not believe there is merit in setting a maximum aggregate investment amount for the Crowd Funding Scheme, provided that a fund raising over £5 million would be subject to a requirement to produce a prospectus (as required by the Prospectus Directive).

(b) “Crowd Funding Scheme Operator”

A Crowd Funding Scheme Operator would be the person who arranges the funding of the crowd funding scheme. This role entails arranging deals in units in a Crowd Funding Scheme and establishing, operating or winding up a Crowd Funding Scheme.

(c) “Crowd Funding”

(i) Given that crowd funding does not always take the form of a collective investment scheme, it would be useful to define Crowd Funding using the principles noted above in respect of Crowd Funding Schemes (e.g. a maximum investment per investor) but omitting the reference to collective investment schemes. (It would however also be possible for a crowd funding platform to invite individuals to invest a greater amount, subject to first qualifying as a “knowledgeable investor” (along the lines set up by Seedrs referred to in paragraph 5.2(b) above), or by first being certified as a “certified high net worth individual”).

(ii) The arranger of non-CIS Crowd Funding would be a “Crowd Funding Intermediary”, instead of a Crowd Funding Scheme Operator.

4. Article 51 of the RAO

4.1 The very existence of a collective investment scheme indicates that a person must be conducting the regulated activity of operating that scheme. Regulatory guidance should make it clear that the Crowd Funding Scheme Operator will be the person conducting the article 51 activity, rather than the person responsible for day-to-day operations (such as the organisation that hosts the platform, if separate from the Crowd Funding Scheme Operator).

4.2 The conduct of business requirements applying to a Crowd Funding Scheme Operator would be based on the requirements set out in chapter 18.5 of the FSA’s Conduct of Business Sourcebook, although the reporting requirements should be relaxed to recognise that the costs of obtaining mandatory valuations may not be justified in relation to many small projects. Crowd Funding Scheme Operators should not be subjected to the conduct of business standards that will apply to alternative investment fund managers pursuant to the AIFMD.

5. Financial promotion restriction

5.1 Sections 238 and 240 of FSMA should not apply in respect of Crowd Funding Schemes.

5.2 Financial promotions relating to Crowd Funding Schemes should instead be subject to specific contents requirements in chapter 4 of the Conduct of Business Sourcebook. Developing short-form standardised wording for Crowd Funding Schemes should be capable of engendering the
same levels of investor familiarity as have been achieved in the field of retail lending and banking.

5.3 Articles 48 and 50A of the FSMA Financial Promotion Order 2005 (and its counterparts in sections 21 and 23 of the FSMA (Promotion of Collective Investment Schemes) (Exemption) (Promotion) Order 2001) should be extended to apply to a Crowd Funding Scheme.

6. **Appropriateness and suitability**

6.1 Crowdfunding is most likely to work on an execution-only model, so there should not be any need to amend the current suitability regime for firms that wish to provide personal recommendations.

6.2 However, if a disclosure-based regime is to operate effectively, it would be necessary to permit firms to rely on standard-form disclosures as being adequate to ensure that investors understood the risks of investing in a Crowd Funding Scheme. To enquire into the individual state of mind of each investor would not be practicable. For this reason, it might be helpful to clarify that Crowd Funding Schemes that are purely contractual do not amount to investments for the purposes of the Markets in Financial Instruments Directive (which imposes the appropriateness standard). Alternatively, the FSA could provide guidance, similar to its guidance in respect of appropriateness for professional clients that clarifies what is expected of Crowd Funding Scheme Operators.

7. **Restriction on offering shares in private companies**

It would be helpful to provide guidance for private limited companies to the effect that offering shares through a Crowd Funding Intermediary, where such offering does not entail the issuance of a prospectus, is not prohibited by virtue of section 755 of the Companies Act 2006. Indeed this guidance could apply more widely to the raising of capital through corporate finance firms, rather than merely to Crowd Funding.

8. **Definitions of debenture and accepting deposits**

8.1 It would be helpful to include within the definition of “debenture” a requirement that the investment be a transferable security that was freely negotiable on the capital market. This would bring the UK definition in line with the European standard imposed in the Markets in Financial Instruments Directive.

8.2 The exemption in respect of accepting deposits should be extended to any person who accepts money in respect of a loan or in relation to Crowd Funding.
Appendix 3
US Proposals for Crowd Funding Arrangements

1. Introduction

1.1 To date, three legislative bills have been put forward:

(a) The Entrepreneur Access to Capital Bill (the “House Bill”) was passed by the House of Representatives in November 2011. The House Bill was then presented to the Senate for approval.

(b) The Senate proposed two separate bills as alternatives. The first bill does not appear likely to be used, but the second bill, known as the Crowdfunding Bill, is still with the Senate for discussion (the "Senate Bill").

1.2 It is still not clear whether the House Bill or the Senate Bill will prevail, so we have set out certain key proposals from both below.

2. Key Aspects of the Draft Legislation

2.1 The House Bill provides that a company may sell securities via crowd funding sites provided that the following conditions are met:

(a) An investee company may raise a maximum of $1 million (or $2 million if the company provides audited financial statements to potential investors).

(b) Each investor may invest a maximum of the lesser of (i) $10,000 or (ii) 10% of his/her annual income.

(c) The issuer or intermediary must take steps to warn investors of the risk of investing, including: (i) warning of the speculative nature of investments and limitations on resale; (ii) requiring investors to answer questions demonstrating their understanding of risks; and (iii) providing notice to the SEC of the offering, including certain prescribed information.

2.2 Key aspects of the Senate Bill are as follows:

(a) Securities may only be issued through a crowd funding intermediary (not through pure social networking sites).

(b) The crowd funding intermediary must be registered in the state where the investee company is organised.

(c) Each investor may only invest $1,000 per company per 12 months (limited to $500 if the investor’s income is under $50,000).
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