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## FINAL NEWSLETTER 2017

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The diverse topics covered in our Newsletter: for those doing deals, “Letters of Intent – beware!” (p. 2); and “Crowdfunding, an alternative source of financing” (p. 3-9).

It goes without saying that if you need any help in the Alternative Asset sector, whether it is with general contracts review, a more in depth due diligence of targeted companies, executing or structuring a transaction and all such related documentation, UK and International tax law, amongst many other services, we are delighted to help you in a number of geographies and sectors.

We wish all of you a fabulous start to 2018!

**The Team**  
**JAG Capital Advisors**



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## Letters of Intent – beware!

**Summary:** The High Court of the United Kingdom has held that parties were bound by a Letter of Intent even when there was no cap on liability.

**Background:** To determine if a binding contract has been formed between parties, an objective conclusion must be reached that the parties intended to create legal relations and that they agreed on the terms which they regarded as essential for the formation of a legally binding contract. Where work has been carried out by one of the parties it will usually be very difficult if not impossible to argue that there was no intention to have a legal relationship.

**Facts.** A and AM discussed how A could provide design work to AM for two large construction projects. AM instructed A, by letter of intent, to start work. The letter of intent was **not** marked "subject to contract". Both parties anticipated that there would be a written agreement, but this did not materialise. There were discussions between the parties over many months and many topics, including a proposed cap of £600,000 on A's liability. Emails were exchanged, and terms and conditions were put forward by both parties with detailed discussions and exchanges in writing about the different terms. Both parties expressly rejected certain terms put forward by the other party. AM alleged that the car park was defective and was at risk of being demolished and rebuilt. AM issued proceedings against A for £40m. A denied liability for the design fault and argued that the liability was capped at £600,000.

**Decision.** The court held in favour of AM. It held that A had no limit of liability for a claim for defective design. The parties had entered into a binding contract based on the letter of intent even though none of the parties' terms and conditions were incorporated into that letter. In addition, on an objective analysis of the correspondence between the parties, they had not reached agreement on the liability cap. While a court should always strive to find a concluded contract in circumstances where a contract has been performed, the court is not entitled to rewrite history so as to incorporate into that contract express terms which were not the subject of a clear and binding agreement.

**Comment.** The court stated that the case demonstrates that it is usually better for a party to reach full agreement through a process of negotiation, rather than to delay and then fail to reach any detailed agreement at all. Persons negotiating a letter of intent where it is anticipated that work may start before a full agreement is reached, should definitely consider where appropriate to include a cap of liability in the letter of intent in case the final contract is not concluded.





## Crowdfunding: an alternative source of financing?

Crowdfunding is a rapidly developing sector and has become an increasingly popular source of alternative capital for businesses. In its wider sense, the concept of crowdfunding has existed in different forms for many years. The term now usually refers to the ways in which companies can raise finance through internet-based crowdfunding platforms. In this context, "platform" refers to the online portal that brings together investors or lenders with companies seeking either investment or to borrow, and also refers to the platform owner which makes the necessary arrangements to bring those parties together.

Many of the activities carried on by crowdfunding platforms are regulated in the UK under the Financial Services and Markets Act 2000 (FSMA) where the activity is a specified kind of activity under the Financial Services and Markets Act 2000 (Regulated Activities) Order (SI 2001/544) (RAO). The combined effect of FSMA and RAO is to require a crowdfunding platform to be authorised (or to be an appointed representative of an authorised firm) by the Financial Conduct Authority (FCA) to carry on regulated activities and to approve financial promotions (sections 19(1) and 21, FSMA). There are currently over one hundred FCA authorised crowdfunding platforms active in the market or seeking FCA authorisation.

The global financial crisis of 2008 caused a collapse in the availability of commercial funding from retail banks in many western countries. Higher capital adequacy requirements also increased banks' costs of lending despite falling interest rates. These developments brought into focus the monolithic, conservative and, arguably, inefficient structures of the traditional sources of debt finance for SME businesses. At the same time, limited access to equity finance, particularly for start-ups or early-stage companies, fed a desire by those companies to find alternative, accessible sources of investment. The demand for finance was met on the supply side by individuals willing to invest in private investment opportunities or seeking higher interest yields on their savings, with a commensurate willingness to accept increased investment risks. This process of investors and businesses transacting directly between themselves through crowdfunding platforms, effectively bypassing the traditional banks and investment fund managers, has been referred to as disintermediation. It is an example of the application of technology, in particular internet-based technology, to remove barriers and, at least in theory, to reduce costs and increase market efficiency. The development of crowdfunding has been supported by governments and financial sector regulators as they recognise the need to increase diversity and competition in sources of funding. It also reduces your reliance on the retail banking sector and traditional investment fund managers, particularly for early-stage businesses. The FCA's July 2016 consultation on the sector estimated that the total amount invested through crowdfunding platforms has grown from £500 million in 2013 to £2.7 billion in 2015. The crowdfunding model was initially and primarily a source of capital for early-stage companies raising money from a retail network in their local markets, but now crowdfunding platforms are increasingly being used to bring together the supply of capital where demand is being used to fund an increasingly expanding pool of investment opportunities across different investment models, asset classes and jurisdictions.

### Different ways to Crowdfund:

Crowdfunding takes different forms but generally falls within the following four categories:

Investment-based; that is, companies can raise equity finance by offering investors an opportunity to subscribe for equity.

Loan-based, also known as peer-to-peer (P2P) lending: business or individuals can raise finance by borrowing from lenders on fixed terms for repayment and interest rates. There are usually a large number of lenders that make relatively small loans, sometimes supplemented with government or institutional finance. P2P lending is now relatively mature, with a number of established platforms. New platforms continue to enter the market.



Donation-based; that is, raising funds by asking people to give money to an enterprise, organisation or for a social or artistic cause. Donors do not directly receive anything in return for their donations.

Rewards-based or pre-payment; that is, a business offers the opportunity to subscribe for a reward, service or product. For example, a subscriber can buy a new product before its launch, usually at a discounted price, which enables the seller business to fund its development and production costs by pre-selling the first production run.

There are also other forms of crowdfunding platforms such as property investment platforms.

### **UK regulation**

In the UK, the activities of loan-based and investment-based crowdfunding platforms are regulated activities under FSMA and RAO. Operating an investment-based crowdfunding platform is a regulated activity under Article 25 of RAO, and operating a loan-based crowdfunding platform is a regulated activity under Article 36H of RAO. Other types of platforms, including donation-based and rewards-based platforms, are generally not subject to financial services regulation.

To avoid breaching the general prohibition in section 19 of FSMA, a crowdfunding platform operator must obtain FCA authorisation with the appropriate permissions under Part 4a of FSMA before carrying on a regulated activity (*section 19, FSMA*).

The operator of a crowdfunding platform may also receive, hold and process money from investors or lenders on behalf of the company offering its shares or receiving loans. In these cases, the operator must also obtain client money permission from the FCA and comply with the rules and guidance in Chapter 7 of the FCA's Client Assets sourcebook (CASS). Alternatively, the operator may outsource client money handling activities to an appropriately authorised third party.

Any communications made to potential investors or lenders by the crowdfunding platform to advertise, promote or offer an investment or lending opportunity (including information published on the crowdfunding platform) will constitute financial promotions for the purposes of section 21 of FSMA. Unless one or more of the exemptions in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (*SI 2005/1529*) applies, any financial promotion must be made or approved by an FCA authorised firm, which will usually be the crowdfunding platform operator, as part of the services it offers its fundraising client companies. The communications must satisfy the rules and guidance set out in Chapter 4 of the FCA's Conduct of Business sourcebook (COBS). The FCA recognises that crowdfunding is a growing industry and an increasingly important source of alternative finance.

The FCA's intention is to support the growth of the crowdfunding sector while, at the same time, recognising the inherent risks involved when investing in or making loans to start-up or early-stage companies. Those risks include the following:

**Liquidity risk.** Debt or equity securities offered through crowdfunding platforms are usually not listed. The lack of a market in such securities increases the risk that an investor will be unable to realise their investment. The FCA defines these as "non-readily realisable securities". It is important that investors are given information to enable them to understand the nature of their investment including, for example, the requirement to "follow their money" in subsequent investment rounds or otherwise their investment will be diluted.

**Capital risk.** Equity investors take a risk that the capital that is ultimately returned to them could be less than the amount they invested or may be lost altogether. Many of the companies' investment opportunities on crowdfunding platforms are early-stage, thus increasing the level of risk.

**Platform risk.** Risks associated with operating an online platform include the risk of cyber attack, security of client data, and fraud.



In order to address these risks, the FCA's regulatory regime for investment-based crowdfunding platforms has required inter alia:

**Regulatory capital:** Crowdfunding platforms need to observe the minimum capital requirement of €50,000 of own funds.

**Know your client checks:** Platforms need to carry out due diligence on their members in accordance with the Money Laundering Regulations 2007 before members make any investments.

**Restrictions on platform members:** Crowdfunding platforms cannot make direct offer financial promotions, except to certain professional clients or eligible counterparties.

**Investment limit:** Save as set out above in relation to restricted investors, there are no prescribed upper investment limits or maximum investable amounts. There is, however, an effective cap imposed on equity fundraisings of over €5 million, which generally requires the production of an FCA approved prospectus unless another exemption applies (*Schedule 11a, FSMA*).

**Disclosure:** The FCA does not have any specific prescribed requirements in relation to the marketing materials that companies can use to raise funds through crowdfunding platforms. The FCA sets a subjective standard that materials are fair, clear and not misleading and provide appropriate information about the designated investments so that the investors are able to understand the nature and risks, and to take investment decisions on an informed basis. There is also a requirement not to disguise, diminish or obscure important items, statements or warnings. The materials will usually be approved by the platforms as a financial promotion.

**Professional requirements:** Platforms need to make sure that they are appropriately resourced with people who are competent, fit and proper for their role. They must also have an appropriate conflicts of interest policy in place.

#### **Constitution and structure of offer**

As part of its determination of valuation and the amount of shares to be issued as part of the fundraising, the company will want to consider whether it wishes to offer the same or a different class of shares. If a new share class is to be created, the articles of association will need to be altered and the usual shareholder consents will need to be obtained. There is a general restriction under section 755 of the Companies Act 2006 (2006 Act) against private companies issuing shares to the public. For many companies wishing to raise funds through crowdfunding, it is generally undesirable to re-register as a public limited company given, among other things, the less flexible company law regime applicable to public companies over private companies. Historically, some practitioners took the view that, because the offer was only being made to a select number of people, that is, the crowdfunding platform's members, it was not to the public at large. However, as crowdfunding continues to proliferate and attract new investors and followers, and platforms get more members, this argument becomes harder to maintain, particularly in light of section 756(2) of the 2006 Act, which provides that an offer to the public includes an offer to any section of the public, howsoever selected. There is an exemption in section 756(3) of the 2006 Act, which provides that an offer is not regarded as an offer to the public if it can properly be regarded, in all the circumstances, as not being calculated to result, directly or indirectly, in securities of the company becoming available to persons other than those receiving the offer. Private companies considering crowdfunding should therefore exercise considerable care to ensure that they, and the platform they use, fall within this exemption.

**Prospectus Directive restrictions.** Under the Prospectus Directive (2003/71/EU), which is implemented in the UK under FSMA, it is unlawful for transferable securities to be offered to the public in the UK unless an



approved prospectus has been made available (*section 85(1), FSMA*). There are various exemptions to this requirement but the one that is most commonly relied on in the crowdfunding context is the exclusion for offers under €5 million (*paragraph 9, Schedule 11A, FSMA*).

### **Marketing the offer**

The company raising funds will also need to prepare its marketing materials. Typically, these would include some form of company summary, explanation of the business and the opportunity and, in some cases, financial projections. In some cases, there may also be a video presentation from management. These materials will likely constitute a direct offer of financial promotion under section 21 of FSMA. Notwithstanding that the platform may approve the marketing materials as a financial promotion, various heads of criminal and civil liability can attach to both the company and its directors in the event it transpires that any of the materials are untrue. These can include misleading statements under section 89 of the Financial Services Act 2012, fraud under section 2 of the Fraud Act 2006, a false statement under section 19 of the Theft Act 1968, or potential liability in tort or under contract for misrepresentation or negligent misstatement, and deceit.

### **TAX ISSUES**

A number of tax issues should be considered when shares are acquired through a crowdfunding platform or when making P2P loans.

#### **Equity investments**

Income and capital gains arising on shares acquired through a crowdfunding platform will be taxed in the same way as those arising on other shares. Dividends received by an individual are taxed as income. From 6 April 2016, the first £5,000 of dividends received in a tax year by an individual is tax free. Any additional dividends are taxed at 7.5% for basic rate taxpayers, 32.5% for higher rate taxpayers, and at 38.1% for additional rate taxpayers (*section 82, Finance Act 2016*).

A UK resident individual investor in shares in an unlisted trading company will pay capital gains tax (CGT) on a gain realised on disposal of the shares. An individual has a CGT-free allowance of £11,100 each tax year. Since 6 April 2016, any chargeable gains on shares realised in excess of that tax-free allowance are taxed at 10% for a basic rate taxpayer and 20% for a higher rate taxpayer. Section 86 of the Finance Act 2016 introduced investor's relief, which reduces the rate of CGT to 10%, from a maximum of 20%, of the chargeable gains on disposal of fully paid ordinary shares issued to an investor in return for cash on or after 17 March 2016 by an unlisted trading company or the holding company of a trading group, if the shares have been held for a period of at least three years starting from 6 April 2016.

#### **Enterprise Investment Scheme**

Various reliefs are available to individual investors under the Enterprise Investment Scheme (EIS) where equity shares qualify. The reliefs, when available, are extensive and potentially very attractive for investors.

The investment must be for full-risk ordinary shares, which must not be redeemable or carry preferential rights to the company's assets in the event of a winding up. EIS tax reliefs are also subject to other conditions relating to the issuing company, the investor, and the connection between the investor and the issuing company. For example, employees of the issuing company or its group cannot generally claim EIS tax reliefs and directors may only do so subject to certain conditions. The reliefs may be withdrawn or lost if any of the conditions cease to be satisfied during the period of ownership of the shares.

The available EIS reliefs are:

**Income tax relief.** An individual can claim EIS income tax relief for up to £1 million subscriptions for eligible shares in any tax year (*Part 5, Income Tax Act 2007*) (**2007 Act**). The relief is available for the same tax year in which the shares are issued, or can be carried back and claimed for the previous year in full or in part.



The relief reduces the amount of income tax payable for the relevant year by 30% of the amount invested but cannot reduce the investor's income tax liability by more than the income tax payable for the relevant tax year. For example, an investor investing £100,000 for eligible shares will reduce his income tax liability by £30,000, so effectively reducing the cost of investment (and the capital at risk) to £70,000.

**Deferral relief.** Liability to pay CGT on a chargeable gain arising on the disposal of an asset that was acquired on or after 6 April 1998 can be deferred if the amount of the chargeable gain is reinvested into EIS qualifying shares (*Schedule 5B, Taxation of Chargeable Gains Act 1992*) (1992 Act). The qualifying shares must be issued in the period beginning 12 months before, and ending 36 months after, the date of the disposal for which deferral relief is claimed. If the qualifying shares are disposed of within three years, the deferral relief is lost and the chargeable gain on the original disposal remains taxable. As its name suggests, deferral relief allows an investor to defer CGT liability that would otherwise be payable but it does not cancel the liability. There are no restrictions on how long the liability can be deferred. The original chargeable gain becomes taxable on the disposal of the EIS qualifying shares into which the chargeable gain has been reinvested. The chargeable gain can be deferred again when brought back into charge by a further reinvestment into EIS qualifying shares. For example, if an investor has realised chargeable gains of £100,000, deferral relief could enable the investor to defer CGT liability of up to £20,000 or £28,000 at the current higher rate taxpayer's rate of CGT of 20% (for chargeable gains arising on the disposal of shares on or after 6 April 2016), or of 28% (on gains on other assets, or on the disposal of shares before 6 April 2016).

If the deferral relief is combined with income tax relief, the amount required to invest in EIS qualifying shares (and so the capital at risk) can effectively be reduced by up to 58%, that is, £42,000 would be required to subscribe for £100,000 of shares in the example above.

**Exemption from CGT on disposal.** Investors who have received EIS income tax relief (which has not subsequently been withdrawn) on the cost of their shares can dispose of their shares after five years free from CGT (*section 150A, 1992 Act*). This can relieve an investor of a CGT liability on any gain arising on the disposal of the shares that would otherwise be taxable at up to 20% (at current CGT rates).

**Loss relief on disposal.** Investors making a loss on the disposal of eligible shares at any time can set off that loss against any realised chargeable gains in the usual way or can elect to set off the losses against any income tax liability for the tax year in which the loss is incurred, the previous tax year, or both years (*sections 131 and 132, 2007 Act*). When calculating the loss available to set off against income tax, the cost of the eligible shares is reduced by the amount of any income tax relief received and not withdrawn.

## Loans

Interest received by lenders on loans is taxable as part of the taxpayer's total income. A UK taxpayer has a tax-free personal allowance (against all income) of £11,000, then pays basic rate income tax of 20% on income in excess of £11,000 up to £43,000; higher rate tax at 40% on income in excess of £43,000 to £150,000; and additional rate tax at 45% on income in excess of £150,000. The £11,000 personal allowance is reduced by £1 for every £2 that a taxpayer's taxable income exceeds £100,000, so that the allowance is zero when taxable income is £122,000 or more.

As from 6 April 2016, a taxpayer is entitled to an additional tax-free allowance on interest received of £1,000 a tax year for ordinary rate taxpayers, reduced to £500 a tax year for higher rate and additional rate taxpayers (*section 4, Finance Act 2016*).

Tax relief is available where the principal amount of a P2P loan becomes unrecoverable, other than by legal proceedings or by the exercise of any right granted by way of security for the loan, on or after 6 April 2015. The relief is given by deducting the outstanding amount of the loan in calculating the lender's net income for the tax year in which the amount became irrecoverable. However, the deduction may only be made against interest received on the relevant loan, or a loan made through the same P2P operator (*section 32, Finance Act 2016*).



Where the loss arises after 6 April 2015 but before 6 April 2016, the lender is entitled to relief only on the making of a claim to HM Revenue & Customs (HMRC). On or after 6 April 2016, lenders that are not otherwise required to submit a tax return will only need to declare to HMRC the net amount of interest they receive through the same crowdfunding platform after making a deduction for bad debts. If tax has already been deducted on the full amount of interest received, without adjustment for bad debts, the lender can make a claim for repayment of the tax.

### **Crowdfunding in the EU**

Strengthening different sources of alternative finance, including crowdfunding, remains a core component of the European Commission's ("EC") capital markets union (CMU) action plan. The Commission recognises the importance of providing access to capital to early-stage and other unlisted companies, and how crowdfunding can bring more competition into retail and capital markets.

In May 2016, the Commission published a report on crowdfunding in the capital markets union, in which it published the results of its findings on the industry following various stakeholder responses, workshops and analysis of the regulatory regimes in certain member States. It noted that several EU member states have introduced domestic legislation specifically aimed at regulating the sector while, at the same time, drawing on the existing EU legislative framework. Overall, the Commission concluded that the introduction of specific EU legislation was not necessary at this stage, particularly given that crowdfunding is predominantly domestic in nature and is still a relatively nascent industry that needs space to innovate and develop. As with the Financial Conduct Authority, the Commission has said that it will keep the industry under review and maintain regular dialogue with market participants.

### **Real estate platforms**

Several crowdfunding platforms have now been set up to invest in real estate assets and development projects. Typically, these investments are made through special purpose vehicles. Under the Alternative Investment Fund Managers Directive (2011/61/EU) (AIFM Directive), these special purpose vehicles fall within the definition of an alternative investment fund. This is defined in Article 4(1)(a) of the AIFM Directive as a collective investment undertaking, including sub-funds, that (i) raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; (ii) does not require authorisation under Article 5 of the UCITS IV Directive (2009/65/EC). It requires alternative investment fund managers to be authorised or registered unless the total assets under management are less than: (i) €500 million, if the funds are unleveraged and have no redemption rights exercisable during a period of five years following the date of initial investment in each fund; or (ii) €100 million in other cases.

### **FCA authorisation**

Investment-based platforms will usually need to be authorised by the FCA to carry out their business, or obtain appointed representative status from an authorised firm with existing appropriate permissions under FSMA. To apply for authorisation, a platform must (i) submit a suitable and detailed regulatory business plan, setting out its planned activities and risks, budget and resources; (ii) have adequate non-financial resources, for example, the management board should have adequate knowledge and experience of financial regulation; (iii) have adequate financial resources when submitting its application; (iv) have a website that is either operational or at a suitably advanced stage, including a test site or app, or screen shots of a planned website or app, that would demonstrate the user interface and functionality available to users to show how it will operate should the firm be authorized; and (v) understand the requirements for FCA authorisation and the permission profile for which it wishes to apply, then submit a complete application including an outline of which regulated activities the firm plans to conduct.

The FCA aims to make a decision within six months of receiving a complete application, or within 12 months of receiving an incomplete application.



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