Research into Non-Transferable Debt Securities

A report by London Economics and YouGov for HM Treasury

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Acronyms

CCAF – Cambridge Centre for Alternative Finance

COBS – Conduct of Business Sourcebook

FCA – Financial Conduct Authority

FPO – Financial Promotion Order 2005

FOS – Financial Ombudsman Service

FSCS – Financial Services Compensation Scheme

HMRC – HM Revenue and Customs

HMT – HM Treasury

IFA – Independent Financial Adviser

IFISA – Innovative Finance ISA

IPM – Independent Portfolio Managers

ISA – Individual Savings Account

LCF – London Capital & Finance

LE – London Economics

LSE – London Stock Exchange

LSEG – London Stock Exchange Group

MiFID - Markets in Financial Instruments Directive

NPV – Net present value

NTDS – Non-transferable debt security

P2P – Peer-to-peer

PERG – The Perimeter Guidance manual

PRIN – Principles for Businesses

PRR – Prospectus Regulation Rules

SEB – Secured Energy Bonds

SME – Small and medium-sized enterprises

Executive Summary

About NTDSs

Non-transferable debt securities (NTDSs) – also called 'mini-bonds' in this report – are unlisted bonds and debentures issued by companies for retail investors.[1] Unlike listed retail bonds, mini-bonds cannot legally be sold onwards by the investor and must be held to maturity.

NTDSs grew to prominence after 2009, partly as a response to the cutbacks in bank lending to small- and medium-sized businesses in the wake of the financial crisis. This supply-side driver was met by demand from consumers searching for higher return on their savings in the low-rate post-crisis climate. Most commonly, mini-bonds have been issued for a term of 3-5 years and an interest rate of 6-9%.

A NTDS is a high-risk investment product. Lower regulatory protections, illiquidity, junior creditor ranking and the short track record of many borrowers increase the risk of an average NTDS compared to listed bonds. The concentration of the risk in an individual company increases the risk relative to diversified investments such as mutual funds.

There is no secondary market and often little due diligence by third parties. NTDS investors need to value the security independently. But this is more difficult compared to other securities because the documentation requirements are lower for NTDSs.

Market size

At least 68 businesses issued more than 152 mini-bonds in the UK between 2009 and 2019, together worth more than £815 million. This estimate understates the true issuance volume because there were several mini-bonds for which there was no available information on the amount they raised and because there may have been mini-bond issues that the research did not identify. However, it is not an underestimate by a large degree, as the missing value and issuance information is unlikely to be substantial.

Approximately 80,000 to 150,000 retail investors currently hold one or more mini-bonds. This corresponds to approximately 0.9–1.7% of UK investors, or less than 0.2% of the UK total population. The estimate is based on the observed incidence of mini-bond holders in a representative sample of 4,426 UK investors. The total value of mini-bonds outstanding in 2019 is estimated at around £570 million.

At present, the NTDS market is in decline. The retreat was accelerated by the recent failures of several large issuers. These incidents highlighted the riskiness of mini-bond investments and exposed potentially deceptive practices of some of the failed issuers. Many issuers, intermediaries and investors consulted as part of this study noted that these scandals and their reputational consequences have led them to withdraw from the market or become less inclined to participate.

[1] Charitable companies are also able to issue mini-bonds.

However, the number of companies choosing to issue mini-bonds had already been shrinking before the reputational crisis erupted. This appears to be largely driven by substitution towards unlisted but transferable debt securities.

Issuers

The typical characteristics of mini-bond issuers have changed over time. Before 2015, mini-bonds were most commonly issued by consumer-facing businesses that used the instrument to raise finance for business expansions while simultaneously encouraging company-customer engagement. Most frequently, these issuers operated in the food and drink, renewable energy, sports and retail sectors. The fundraising success of these issuers is attributable not only to the high returns they offered to investors, but also to their ability to market the offer to their member or customer base and the investors' desire to support and feel a part of a brand, company or cause they know, like or support.

After 2015, issuers tended to be smaller, younger and more concentrated in the financial services sector. The change has been driven by an influx of young financial services micro-enterprises, whose business model typically involves raising funds through mini-bond issues to invest into projects by third parties rather than expanding their own business or building brand value. The total volume of issuance by the financial services issuers has dwarfed the volume issued by consumer-facing businesses.

Mini-bonds have been popular among issuers because they are often cheaper than other forms of debt finance, due to lighter regulatory regimes and lower issuance costs associated with intermediation and/or marketing. Another consequence of the lower regulatory and administrative burdens is that mini-bonds are considered a faster way of accessing finance than alternatives.

Encouraging customer engagement is a further driver of mini-bond issuance, but its importance is likely to have declined as consumer-facing businesses have become less important in the market and the small, young financial services firms have grown in prominence.

Investors

Most mini-bond investors are consumers. Like other retail investors, NTDS holders tend to be somewhat older, wealthier and more often male compared to the general population. NTDS investors are relatively younger and more likely to be based in London in comparison to the investor population.

The consumer survey also shows that the willingness to take risk of mini-bond holders and respondents who are considering investing in mini-bonds is, on average, slightly higher than the willingness to take risk of other investors. However, in a statistical analysis of the factors influencing investment in NTDSs, the risk appetite factor is marginally not statistically significant. The analysis, therefore, does not find robust evidence that higher risk tolerance is a driver of investing in NTDSs.

The average amount of funds that past and current NTDS holders invested in mini-bonds is estimated at £11,100. Investors held on average 2.28 mini-bonds. At £4,000, the median investment is substantially lower than the average investment. This is because many investors put relatively low amounts into mini-bonds. The investor with the lowest exposure in the survey sample invested £300; the highest investment amounts to £100,000.

The most common route of consumers to mini-bond investments is from savings products rather than conventional investments (e.g. investment funds). Consumers are attracted by the higher return on mini-bonds than they receive on their cash ISAs or term deposits. Those who invested in consumer-facing businesses are also often motivated by the opportunity to support a brand or product that they have some relationship with. This driver was not observed among investors in mini-bonds issued by financial services firms; these investors tended to be more narrowly focused on yield and often less experienced.

Most investors are aware that they could lose money on a mini-bond investment, but few appear to be able to distinguish risk levels between different mini-bonds or between mini-bonds and other investments. The stakeholders consulted as part of this study are particularly concerned that retail investors may not be able to fully assess the concentration risk associated with undiversified investments, the implications of creditor ranking, the quality of the debtor’s assets or the adequacy of the security structure of bonds that are sold as being secured.

Investors are also often unclear on regulatory protections. This issue is particularly acute if information is presented to investors in an unclear or misleading way. For example, advertisements and price comparison websites that compare the interest rates on unlisted bonds with FSCS-protected fixed-rate ‘bonds’ may encourage the confusion of the two products. Labels such as ‘FCA-authorised’ may, in turn, suggest to investors a level of scrutiny by a trusted authority or a degree of protection that in fact does not exist.

During the research, some marketing practices were observed that might be construed as misleading and may aggravate retail investors’ lack of understanding of the product.

Less than one in five NTDS investors accessed professional advice before investing. The share of advised investors is relatively low both because most consumers do not seek professional advice before investing and advisors do not tend to recommend NTDSs. IFAs are generally reluctant to get involved with NTDSs because they prefer diversified investments, but also because recommending NTDSs would require substantial due diligence and research.

Intermediation

Intermediaries active in the mini-bond market include FCA-authorised firms that approve financial promotions, crowdfunding platforms, specialist law firms, communication consultancies, promotion advisors, accountants, registrar companies and other professional services firms. For most, mini-bond intermediation is not the primary activity.

Three models were observed with respect to financial promotions. Most commonly, the issuer issues the mini-bond ‘directly’ and its financial promotions are approved by an FCA-authorised third party. In other cases, the issuance takes place via a crowdfunding platform. In the third, the issuer issues ‘directly’ and either ‘approves’ its own financial promotions (being FCA-authorised) or gets approval from a related company.

Overall, about a third of issuers used a crowdfunding platform, but these issues represented only about 6% of the total volume of mini-bonds in the UK. In the investor survey, 74% of mini-bond holders said that they purchased their mini-bond directly with the issuer, while 10% reported that they invested through a crowdfunding platform.

Different forms of mini-bond intermediation may involve dissimilar levels of pre-issuance scrutiny and post-issuance regulatory protection. For example, professionally advised investors may have access to compensation through the FSCS if the relevant institution concludes that the advice was unsuitable or negligent.

However, the level of investor protection may differ even among unadvised investors, depending on how financial promotion was intermediated. The regulatory expectations in 'direct' issuance are lower than in platform-mediated issuance, which involves the regulated activity of arranging deals. However, firms approving financial promotions in 'direct' issuance often operate in markets where the required levels of scrutiny are higher and where requirements on firms, including reporting requirements, are more onerous than those in the mini-bond market. If they apply these higher standards when approving mini-bond promotions, their checks and due diligence may, in fact, be superior to those applied by platforms.

The third route, where the issuer's promotions are approved by itself or by a related company set up just to approve those promotions, will likely entail the least pre-issuance scrutiny because of the lack of involvement of an independent third party. It is unlikely that investors understand the differences in regulatory protections associated with different modes of intermediation.

Economic value of the NTDS market

NTDSs can improve access to funding for some credit-constrained businesses by reducing transaction costs associated with intermediation and regulatory requirements. For example, an NTDS issue does not require the production of an FCA-approved prospectus. NTDS issuers may also save on marketing. Consumer-facing businesses typically advertised their mini-bonds to their members or customers, which was cheaper than, for example, advertising through IFAs or the media.

In some cases, mini-bonds may also reduce information asymmetries that prevent some small and medium-sized businesses from accessing conventional sources of finance. For example, buyers of fine wine are likely to be better informed about the value of the asset than banks. They are therefore in a better position to lend funds to wine producers and accept the product as collateral.

The research indeed suggests that some issuers would have scaled down or cancelled the activity for which the funding was to be used if they had been unable to issue a NTDS.

Another way in which NTDSs can provide economic value is through giving investors non-monetary benefits beyond the financial return they receive. Investing in a brand one believes in, in a club one supports or in a project with a positive social or environmental impact is likely to have a psychological reward in addition to the financial return. The importance of this source of economic value has fallen in importance after 2015, when mini-bond issues by finance companies started gaining prominence.

However, NTDSs can misallocate capital if consumers misjudge the risk and return of mini-bond investments. Economically unviable or overly risky projects may receive funding if investors are unsophisticated, uninformed, misled or unfairly compensated for the risks they are taking. It is also possible that disintermediation or lighter regulatory standards give rise to a net economic loss because the value that intermediaries and regulation add – for example in reducing information asymmetries or protecting investors – is greater than their costs.

Of the £570 million in outstanding mini-bonds in 2019, £330 million is accounted for by mini-bonds issued by failed businesses. At least 16 of the 68 companies that issued at least one mini-bond went into administration or liquidation before they repaid the debt.

This suggests a very high level of credit risk that does not seem to be sufficiently priced in mini-bond interest rates. The price discovery mechanism may be impaired because mini-bonds are illiquid and because investors are often unsophisticated or have limited access to information.

1 Introduction

In August 2019, London Economics and YouGov were commissioned by HM Treasury (HMT) to undertake an economic study to build an evidence base on the market for non-transferable debt securities (NTDSs) in the UK. The objective was to assist HMT to more deeply understand the market and inform their consideration of the regulatory arrangements currently in place for the issuance of NTDSs. It did not intend to make any policy recommendations. The research involved a mix of primary and secondary research and was undertaken in September and October 2019.

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On 23 May 2019, HMT announced its intention to consider the regulatory arrangements currently in place for the issuance of these instruments. The decision followed the collapse of a large mini-bond issuer, London Capital & Finance (LCF), in January 2019 (Glen, 2019). After LCF entered administration, it has been estimated that the 11,600 creditors who invested in LCF’s mini-bonds may lose as much as 75% of their initial investment, collectively worth £237 million (Smith & Williamson, 2019a). Prior to this, the Financial Conduct Authority (FCA) found that the firm’s promotion of the mini-bonds was “misleading, not fair and not clear” (FCA, 2019a), while HM Revenue and Customs (HMRC) confirmed that the mini-bonds “were not qualifying ISA investments” despite being promoted as ISA-eligible by LCF (HMRC, 2019). The LCF case is also being investigated by the FCA and the Serious Fraud Office (FCA, 2019b).

This independent economic study supports HMT’s review by providing broader research into NTDSs and their role within the wider UK economy. After a brief explanation of the main features of NTDSs, the study estimates the size of the NTDS market in the UK, including how this has changed in recent years. It further produces insight on the participants active in the market, including their characteristics, experiences and the factors that influence their decisions. Building on this evidence, the report outlines the channels of impact of NTDSs on the UK economy, quantifying the effects where possible.

1.1 Research approach

There are considerable challenges to researching NTDSs. Mini-bonds are not listed on official exchanges, so the conventional sources of financial data from stock exchanges or third-party vendors (such as Bloomberg or Thomson Reuters) do not provide relevant information. Similarly, since NTDS issuance is unregulated, administrative or regulatory data are also not available.

The NTDS market is new and niche. The existing academic and policy literature is therefore thin, and NTDSs are typically studied in the context of more widespread alternative finance products, such as peer-to-peer (P2P) lending or equity-based crowdfunding. Given the UK’s status as an international leader in innovative finance models, evidence from outside the UK is even poorer.

Table 1 summarises the research approaches adopted by London Economics (LE) and YouGov in this economic study. They combine both primary and secondary research methods. Primary research includes quantitative and qualitative consultations with issuers of NTDSs, intermediaries, investors and other stakeholders in the market. The quantitative component comprises of an issuer survey and an investor survey. A diverse sub-set of respondents, as well as some other selected stakeholders, were subsequently invited to in-depth qualitative interviews. Secondary research consisted of a comprehensive review of publicly available information, proprietary databases and existing literature. It also included an examination of financial promotion and marketing materials.

The research aimed to capture a broad range of perspectives. Consultations with issuers cover the supply-side of the market, while investor surveys and interviews provide the demand-side perspective. The views of intermediaries elucidate the space where supply and demand meet. Lastly, market observers such as specialist journalists, consultants, academics or independent financial advisers (IFAs) provide valuable independent points of view.

The research faced three crucial risks:

1. **Incompleteness**. The challenges with researching a small and unregulated market create the risk of missing important information such as, for example, a sizeable NTDS issuer. This risk is particularly significant if the research relies to an extent on voluntary information-sharing by market participants.
2. **Inaccuracy**. It is possible that the information provided by stakeholders is in some cases inaccurate. For example, retail investors may be confused by the complexity of mini-bonds and their close resemblance to other financial instruments. As a result, they may incorrectly identify their investments as NTDSs or fail to recognise that their investments are NTDSs.
3. **Bias**. Voluntary participation in a research project entails the risk of self-selection bias. For example, it is conceivable that the more responsible issuers are more likely to respond to a survey that asks for commercially sensitive information than issuers whose business models resemble the failed issuer LCF. The survey results would then not be representative of NTDS issuers. Conversely, investors affected by issuer malpractice may be more willing to participate in the investor consultations, affecting their representativeness.

Table 1 shows the strategies adopted by the research team to mitigate these risks. To ensure the findings are as complete as possible, a wide range of primary and secondary sources were consulted. While there is no guarantee that the research did not miss any issuers, we are confident that an overwhelming majority of the NTDS market is covered.

To avoid inaccuracies, the research team built in checks to enable verification of the survey answers. For example, although 145 respondents self-identified as mini-bond holders in the investor survey, 34 were subsequently removed from the dataset because their detailed answers suggested that their investment was in fact not a mini-bond.[2] Similarly – to the extent possible – responses by issuers were cross-checked with other information (e.g. from contemporary press releases, annual reports or financial information in proprietary databases).

Investor bias was avoided by opting for a survey representative of the UK investor population. From the survey sample, investors were carefully selected for the follow-up in-depth interviews such that a broad spectrum of individuals is chosen in terms of, for example, age, region, the number of bonds or the mini-bond provider. The issuer sample did not display any evident source of bias either. Both

[2] The instruments that investors confused with mini-bonds included, for example, shares in a company, unlisted transferable bonds, listed bonds or fixed-rate 'bonds'. For more details about these products, see Section 2.

non-financial businesses and companies with business models similar to LCF (i.e. lenders) are represented.

Table 1 Research methodology

Primary research

Survey of issuers and intermediaries
52 issuers (some issuers are now in administration or liquidation or have been dissolved) were invited to participate in a survey that examined their characteristics, motivations and experiences. It also asked them about the size and structure of their past NTDS issues and potential plans for future issues. Intermediaries, including promotion advisors, platforms, accountants, and law firms were also invited to participate in a version of the survey tailored to their role. In total, 17 firms completed the survey, including 14 issuers and 3 intermediaries.

Stakeholder interviews
The research team conducted in-depth telephone and face-to-face interviews with a diverse group of 22 stakeholders, including 11 issuers, 3 intermediaries, 1 crowdfunding platform, 2 independent financial advisers, 3 public authorities (FCA,FSCS,FOS), 1 administrator of a failed issuer and 1 academic researcher.

Investor survey
Approximately 5,800 investors on YouGov's panel were screened to identify and survey mini-bond holders. The identified 111 current and past mini-bond holders were asked about the provider, size and structure of their mini-bond(s), as well as questions exploring their views and understanding of mini-bond investments more generally. In addition, the survey also collected views of 188 investors who have not invested in mini-bonds but are considering it in the future.

Investor interviews
A diverse subset of the respondents in the investor survey were invited to participate in an in-depth telephone interview. Guided by senior YouGov researchers, the 20 selected participants explained their pathway to investing in a mini-bond, motivations for the investment choice, as well as their perception of and experience with the product.

Secondary research

Review of publicly available information
The research team reviewed over 200 public sources (policy and academic literature, press articles, personal finance blogs, company websites, price comparison websites, platforms, annual reports, Companies House records, etc.) and proprietary databases (Fame) to build a comprehensive register of mini-bond issuers and their characteristics.

Examination of marketing and promotional materials
LE's behavioural economics experts undertook a review of financial promotion materials, including 26 mini-bond offer documents, a variety of press, social media and online search advertisements, as well as direct marketing on websites.

Analysis

Register of mini-bonds
All research techniques contributed to the building of a comprehensive database of mini-bonds and their characteristics, including information about the issuer (size, age, sector…) and the structure of the debt security (size, yield, origination year, maturity…). Information from public sources and proprietary databases formed the backbone of the database, but consultations with issuers, intermediaries, investors and other stakeholders all led to the identification of more mini-bonds and issuers. Whenever possible, information from multiple sources were used to cross-check data entries. For example, information from the issuer of a particular bond was checked against the information received from the investor in the bond, the intermediary who facilitated the issuance and/or the information in the press or other public sources.
The final database contained information on 152 mini-bonds issued by 68 companies between 2009 and 2019.

Market sizing
The multi-source bond register was used to size the NTDS market, estimating its value both at present and over time. Given that the amount issued should in theory be the same as the amount invested, LE and YouGov researchers also used the investor survey to size the market from the demand perspective. This measure is less accurate given the small investor sample, but it could act as a useful robustness check.

Quantitative and qualitative analysis of market participants
Using the quantitative surveys and qualitative interviews, LE and YouGov researchers analysed the motivations and experiences of issuers, investors and intermediaries in the NTDS market.

Assessment of the economic value of the NTDS market
Combining economic theory and the insights from the primary and secondary research methods, LE researchers identified the key channels that determine the economic contribution of NTDSs. Where possible, these effects are also quantified.

1.2 Main findings

Non-transferable debt securities

- NTDSs or 'mini-bonds' are non-transferable, unlisted debt securities issued by corporates for retail investors. Most commonly, mini-bonds were issued for a term of 3-5 years and an interest rate of 6-9% over the period 2009-2019.
- A NTDS is a high-risk investment product. Lighter regulation, illiquidity, junior creditor ranking and the short track record of many borrowers increase the risk of an average NTDS compared to listed bonds. The concentration of the risk in an individual company increases the risk relative to diversified investments such as mutual funds.
- NTDSs benefit from less regulatory protections than listed bonds. The most significant protection for most NTDSs are the rules on financial promotion.
- There is often little due diligence by third parties and no secondary market. NTDS investors need to value the security independently. But this is more difficult compared to other securities because the documentation requirements are lower for NTDSs.

Market size

- At least 68 businesses issued more than 152 mini-bonds in the UK between 2009 and 2019, together worth more than £815 million.
- Approximately 80,000 to 150,000 retail investors currently hold one or more mini-bonds. The total value of mini-bonds outstanding in 2019 is estimated at more than £570 million.
- The mini-bond market is in decline. The retreat was accelerated by the recent failures of several large issuers. However, the number of companies choosing to issue mini-bonds had already been shrinking before the reputational crisis erupted. This appears to be largely driven by substitution towards transferable, unlisted debt securities.

Issuers

- The typical characteristics of mini-bond issuers have changed over time. Before 2015, mini-bonds were most commonly issued by consumer-facing businesses that used the instrument to raise finance for business expansions while simultaneously encouraging company-customer engagement.
- After 2015, issuers were smaller, younger and more concentrated in the financial services sector. The issuance has been more commonly used by the issuer to make their own financial investments rather than expanding or building brand value. The total volume of issuance by the financial services issuers has dwarfed the volume issued by consumer-facing businesses.
- One attraction to issuers of mini-bonds is that they are often cheaper than other forms of debt-based finance, because of lighter regulatory regimes and fewer costs associated with intermediation. Encouraging customer engagement is another driver of mini-bond issuance, but its importance is likely to have declined as consumer-facing businesses have become less important in the market and the small, young financial services firms have grown in prominence.

Investors

- Most mini-bond investors are consumers. Like other retail investors, NTDS holders tend to be somewhat older, wealthier and more often male compared to the general population. However, NTDS investors are relatively younger and more likely to be based in London than other investors.
- The average and median amount of funds that past and current NTDS holders invested in mini-bonds is estimated at £11,100 and £4,000, respectively. Investors held on average 2.28 mini-bonds.
- The most common route to mini-bond investments is from savings products rather than conventional investments (e.g. investment funds). Consumers are attracted by the higher return on mini-bonds than they receive on their cash ISAs or term deposits. Those who invested in consumer-facing businesses are also often motivated by the opportunity to support a brand or product that they have some relationship with. This driver was not observed among investors in mini-bonds issued by financial services firms; these investors tended to be more narrowly focused on yield and often less experienced.
- Most investors are aware that they could lose money on a mini-bond investment, but few appear able to distinguish risk levels between different mini-bonds or between mini-bonds and other investments. Investors are also often unclear on regulatory protections.

Intermediation

- Intermediaries active in the mini-bond market include FCA-authorised firms that approve financial promotions, crowdfunding platforms, specialist law firms, communication consultancies, promotion advisors, accountants and registrar companies. For most, mini-bond intermediation is not the primary activity.
- Three models were observed with respect to financial promotions. Most commonly, the issuer issues the mini-bond 'directly' and its financial promotions are approved by an FCA-authorised third party. In other cases, the issuance takes place via a crowdfunding platform. In the third, the issuer issues 'directly' and either 'approves' its own financial promotions (being FCA-authorised)[3] or gets approval from a related company.[4] The three types may involve dissimilar levels of pre-issuance scrutiny and post-issuance regulatory protection, but it is unlikely that investors understand this.
- Some marketing practices were observed that might be construed as misleading and may aggravate failures of retail investors' understanding of risks and regulatory protections.

Economic value

- NTDSs can improve access to funding for some credit-constrained businesses by reducing transaction costs associated with intermediation and regulatory requirements. In some cases, mini-bonds may also reduce information asymmetries that prevent some small and medium-sized businesses from accessing conventional sources of finance.

[3] An authorised person does not need to 'approve' its promotion if it is simply communicating its own financial promotion; it will only need to 'approve' the promotion if that promotion is to be communicated by another, unauthorised person (see PERG 8.9.2 G – PERG 8.9.3 G).

[4] An issuer can make use of an exemption within the FPO exemptions in the Financial Promotion Order 2005 (FPO). In this case, an unauthorised issuer of mini-bonds does not need to have the content of the promotion approved. It is very difficult, though, to market to ordinary retail investors using the FPO exemptions.

- However, NTDSs can also misallocate capital if uninformed or misled investors accept excessive risks. It is also possible that disintermediation or lighter regulatory standards bring net economic loss because the value that intermediaries and regulation add – for example in reducing information asymmetries or protecting investors – is greater than their costs.
- Of the £570 million in outstanding mini-bonds, £330 million is accounted for by mini-bonds issued by failed businesses. At least 16 of the 68 companies that issued at least one mini-bond entered administration or liquidation before they repaid the debt.
- This suggests a high level of credit risk that does not seem to be sufficiently priced in mini-bond interest rates. The price discovery mechanism may be impaired because mini-bonds are illiquid and because investors are often unsophisticated or have limited access to information.

2 About NTDSs

This section describes the key features of NTDSs and compares them with similar instruments. It then describes the risk characteristics of NTDSs. Lastly, it describes the regulatory regime around NTDSs and the nature of investor protection before and after investing.

2.1 Key features

2.1.1 Defining 'NTDS' and 'mini-bond'

A 'non-transferable debt security' (NTDS) is defined in this research report as a non-readily realisable, non-transferable debt security issued by corporates to retail investors to raise capital. It is worth unpicking this definition:

- **Non-readily realisable** securities are financial instruments that are not listed on regulated investment exchanges (such as the London Stock Exchange (LSE)) or tradable on other liquid secondary markets specified by the FCA.[5]
- A subset of non-readily realisable securities, **non-transferable** securities not only lack a liquid secondary market, but cannot *legally* be transferred from one owner to another. A non-transferability clause is included in the bond agreement, preventing a transfer even if there are matching buyers and sellers. Non-transferability does not always mean the bond has to be held until maturity, because some issuers may offer investors the option to redeem early. However, this was observed in an almost negligible minority of cases. Overwhelmingly, a NTDS must be held to maturity.
- In contrast to equity investments, **debt securities** do not entitle the investors to a share of ownership of the company. An issuer undertakes to pay the bondholder a regular, defined coupon for a fixed term.[6] At the end of this pre-defined period, the issuer repays the capital to the bondholder (unless they agree to roll over the debt).
- **Corporate** bonds are debt securities issued by corporate entities rather than governments or other public sector issuers. NTDSs can be issued by a variety of incorporated organisations, including charitable companies.
- **Retail investor** is anyone who is not a professional investor. Professional investors are, generally, institutional investors and large businesses. Consumers and smaller businesses are retail investors.[7]

After the NTDS market started growing in 2009, the term 'mini-bond' has been adopted by the media and commentators to denote the non-transferable bonds that businesses were offering to consumers. Soon, many issuers and intermediaries also embraced the term. This report will follow this convention and use the terms 'NTDS' and 'mini-bond' interchangeably.

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[5] Listed securities are always transferable because transferability is a requirement for listing (FCA Handbook LR 2/3). They are also always readily realisable (in virtue of the regulatory definition of "readily realisable"). Some securities that are not officially listed are still considered readily realisable (FCA Handbook Glossary G948). "Non-readily realisable securities" can therefore be seen as a subset of unlisted securities. Similarly, all non-transferable securities are non-readily realisable, but not all non-readily realisable securities are non-transferable. "Non-transferable" securities are therefore a subset of non-readily realisable securities.

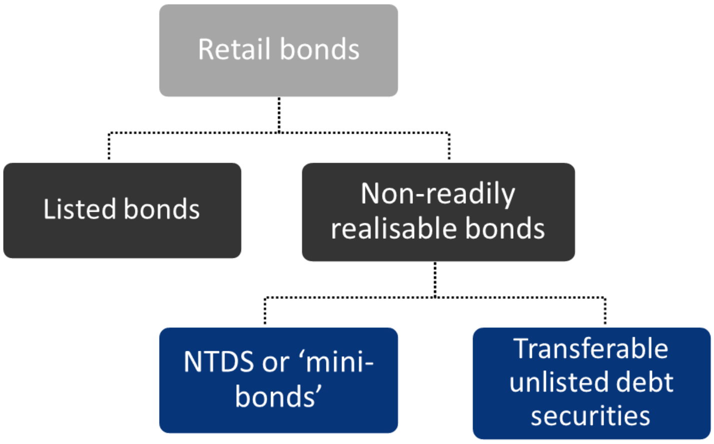
[6] Some NTDS issuers offered investors the choice between receiving interest payments in cash or in the form of benefits in kind such as vouchers, loyalty points, store credit or other similar rewards.

[7] This distinction between retail and professional investors is based on the distinction between retail and professional clients set out in FCA Conduct of Business Sourcebook (COBS).

However, we note that the term 'mini-bond' does not have a regulatory definition and is not always used to denote a NTDS. The FCA, for example, notes the term 'mini-bond' usually describes an 'illiquid' (i.e. non-readily realisable) corporate bond – but recognises this is not a legal definition (FCA, 2019c). This broader usage was also adopted by some recent issuers of securities, which are transferable but for which there is no liquid secondary market.[8]

There has also been growth in the issuance of unlisted, legally transferable debt securities. These unlisted transferable debt securities are often illiquid, if no secondary market exists. Some crowdfunding platforms which facilitate this kind of bond issue do operate secondary markets, but liquidity will depend on demand for these securities. However, this report is primarily concerned with 'mini-bonds' i.e. debt securities that are legally non-transferable for the purposes of the Markets in Financial Instruments Directive (MiFID).

Figure 1 Taxonomy of retail corporate bonds adopted in this report



Please note that the diagram is non-exhaustive. Other types of retail bonds may exist.

Source: London Economics

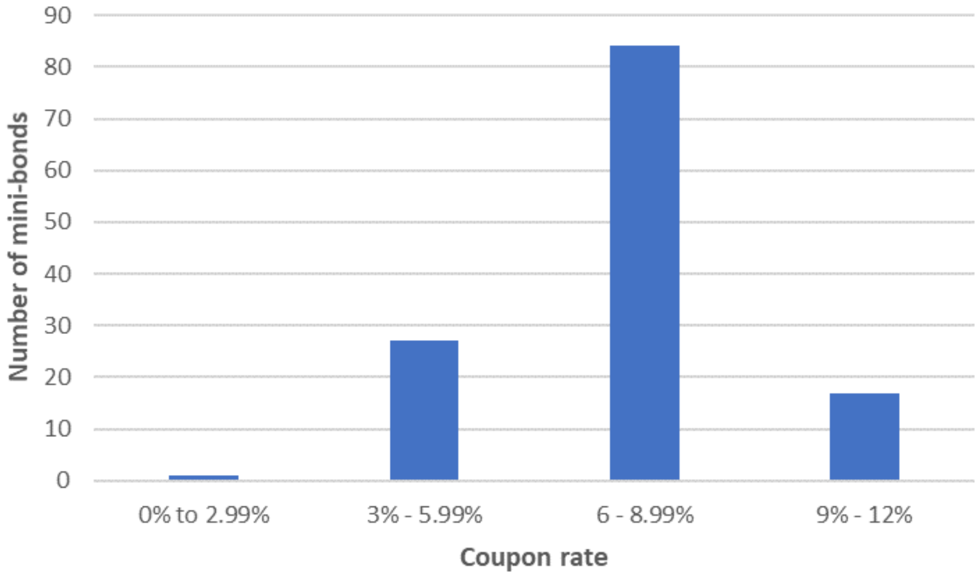
2.1.2 A brief overview of NTDSs in the UK

NTDSs grew to prominence after the financial crisis, partly as a response to the cutbacks in bank lending to small- and medium-sized businesses in the wake of the crisis (see Section 7.1). This supply-side driver was met by demand from consumers searching for higher return on their savings in the low-rate post-crisis climate. Companies such as King of Shaves, John Lewis, Hotel Chocolat, Caxton FX and Wind Prospect Group were amongst the first companies to have issued mini-bonds.[9]

[8] For example, Shojin Property Partners called their IFISA-eligible, transferable unlisted debt securities 'mini-bonds'.

[9] Note that the mini-bond issued by John Lewis is distinct from the scheme in which the firm distributes shares to staff.

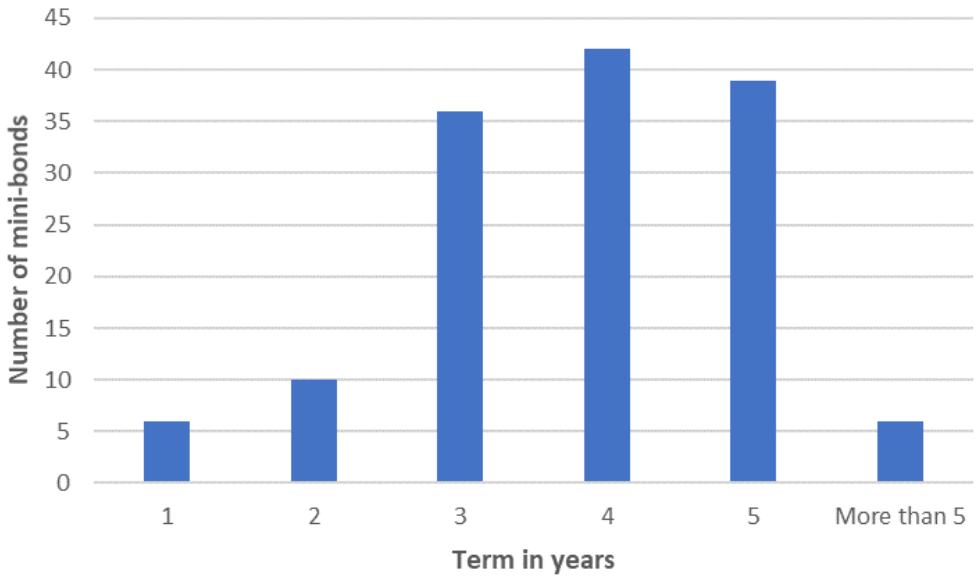
Figure 2 Distribution of mini-bond coupon rates



Base: Mini-bonds issued in the UK, 2009-2019 (N=129).
LE mini-bond register

NTDSs tend to offer relatively high interest rates, often between 6% and 9% (see Figure 2). The bond maturity has ranged in most cases from three to five years (Figure 3).

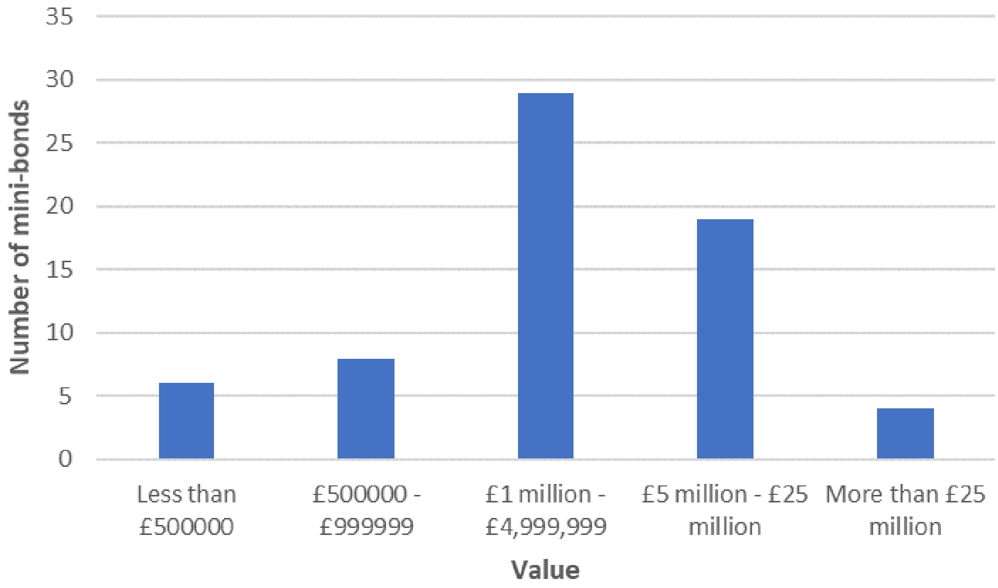
Figure 3 Distribution of mini-bond terms



Base: Mini-bonds issued in the UK, 2009-2019 (N=139).
LE mini-bond register

In terms of the size of issue, mini-bonds are smaller than listed retail bonds. The typical issue size of a retail listed bond is £25-£30 million (London Stock Exchange Group (LSEG), 2014). By contrast, mini-bonds were most commonly issued in amounts from £1-£25 million (see Figure 4).

Figure 4 Distribution of mini-bond issue values



Base: Mini-bonds issued in the UK, 2009-2019 (N=66).
LE mini-bond register

Like many other investments, mini-bonds are not covered by the Financial Services Compensation Scheme (FSCS) for the failure of the product itself. Moreover, a company does not have to be regulated by the Financial Conduct Authority (FCA) in order to issue its own securities, including a NTDS, as this is not a regulated activity (FCA 2019c).

In the early years – approximately 2009 to 2011 – mini-bonds were issued predominantly by consumer-facing companies with a large customer base or a well-established brand. The target investors included mainly existing and potential customers or, in some cases, also own employees.

In the second phase, crowdfunding platforms entered the market and facilitated easier issuance and access to broader investor groups. This allowed businesses to target investors beyond their own customers or network, opening the mini-bond route to more issuers. Issuance by non-financial businesses hit its peak around 2014–2015.[10]

The consumer-facing model of fundraising created another peculiarity of the mini-bond market. Many issuers offered investors the choice between receiving interest payments in cash or in the form of vouchers, loyalty points, store credit or other similar rewards. This option has been most common in NTDSs issued by retailers and food and drink companies, who have perceived NTDS issue as a way of encouraging customer engagement and developing customer relationships while raising finance.

More recently, there has been a growth in the proportion of financial sector issuers, notably non-bank lenders and property investment firms. More generally, there appears to be a trend where the proportion of issuers issuing NTDSs to raise finance to make their own investments in a third party has grown, while the proportion of issuers issuing NTDSs to raise finance to expand their own

[10] Chapter 3 provides a more detailed overview of the NTDS market over time.

businesses has shrunk. The drivers of this development and the consequences for investors are described in sections 4 and 5 of this report.

At present, the NTDS market is in decline. The retreat was accelerated by the recent failures of LCF, Harewood Associates, Colarb Capital, HAB Land and other mini-bond issuers. These incidents – prominently covered in the media – highlighted the riskiness of mini-bond investments and exposed potentially deceptive practices of some of the failed issuers. Many issuers, intermediaries and investors consulted as part of this study said that these scandals and their reputational consequences have led them to withdraw from the market or become less inclined to participate.

Nevertheless, the number of companies choosing to issue mini-bonds was shrinking before the reputational crisis erupted. The key driver appears to be the advent of unlisted legally transferable debt securities. These products are often very similar to mini-bonds, but an investor retains the legal right to re-sell.

2.2 Comparison with similar instruments

There are two perspectives from which NTDSs can appear similar to other financial instruments:

1. Close **investment alternatives** as perceived by consumers. Consumers can, for example, compare NTDSs with investment opportunities they encounter in similar contexts (e.g. on crowdfunding platforms), investments that have a similar structure (defined outcome, regular coupon payments) or even those that have a similar name (fixed rate 'bonds'). Consumers could also compare NTDSs with investments that offer similarly high returns, notably mutual investment funds.
2. Close **fundraising alternatives** as perceived by issuers. Businesses seeking to raise capital may compare NTDSs with other debt-based finance, such as bank loans, credit from a non-bank lender or issuing a listed bond. Recent start-ups or less established businesses may also compare NTDSs with equity-based financing, such as venture capital, private equity or an IPO.

The two sets of 'similar' products are likely to overlap significantly. However, because of the different perspectives adopted by lenders and borrowers when assessing their choices, it is useful to consider the investment and fundraising alternatives separately.

2.2.1 Investment alternatives

Many NTDSs have been sold through investment-based crowdfunding platforms. Potential investors are therefore likely to compare them with other products marketed and sold this way, including, for example, equity shares. The investors may also compare NTDSs with investments offered by loan-based crowdfunding platforms, notably P2P platforms facilitating business loans. Other investors may compare NTDSs to more traditional investments, such as mutual bond or equity funds. Section 2.3 provides a limited comparison between NTDSs and these products in terms of risk characteristics.

However, our main focus is on comparing NTDSs to other bonds available to retail investors. Table 1 provides a detailed overview of the similarities and differences between listed retail bonds, NTDSs, unlisted legally transferable debt securities and 'fixed rate bonds'. The latter instrument is a form of FSCS-protected term deposit rather than a tradable asset, but because it is commonly marketed as a 'bond' by banks and offers a similar repayment structure to a NTDS – for example, regular interest payments and capital repayment on maturity – consumers may perceive the two as close alternatives or be falsely reassured by the 'bond' name when purchasing a NTDS. Section 5 provides empirical evidence showing that some consumers indeed compare NTDSs with savings products. Section 6 shows that NTDSs were also sometimes marketed alongside savings products, for example on some price comparison websites.

Table 2 Comparison of products marketed as 'bonds' to retail clients in the UK

	Listed retail bond	Mini-bond	Unlisted legally transferable debt security	Fixed rate 'bond'
Listing	Listed on an exchange. For example, The Order book for Retail Bonds (ORB) on the London Stock Exchange is an EU Regulated Market. The ORB is subject to market supervision and all bonds admitted to the market must comply with both the requirements of the ORB and the FCA.	Not listed.	Not listed.	Not listed.
Transferability	Fully transferable and tradable in the secondary market at market prices. Redeemed at maturity subject to any put or call rights (i.e. either the bondholder's or the issuer's right to early repayment).	Non-transferable and not tradable in any secondary market. Typically, not redeemable before maturity.	Not listed on a stock exchange, but transferable. Crowdfunding platforms sometimes allow trades among investors registered on the platform, but these markets tend are not guaranteed to be liquid. Others may be offered without any secondary market at all.	Non-transferable and typically not redeemable early without a penalty.
Interest	Typically, an annual or semi-annual payment of a fixed amount of interest. Index linked and floating-rate instruments with variable coupons are also available.	A fixed amount of interest is paid. There are examples of NTDSs where interest is paid annually, semi-annually, quarterly, monthly and on maturity.	A fixed amount of interest is paid (annually, semi-annually, quarterly, monthly or on maturity).	Usually structured as an interest-bearing fixed term savings deposit.
ISA eligibility	Eligible for Stocks and Shares ISA in most cases.	Not eligible, because the bond is non-transferable.	May be eligible for Innovative Finance ISA.	Not eligible.
Ranking	Rankings vary depending on whether bond is senior or subordinated (senior debt takes priority) but all bonds would normally have credit seniority over equity shares.	As with listed retail bonds. Many - but not all - NTDSs are unsecured and so are subordinated.	As with listed retail bonds. Many - but not all - are unsecured and so are subordinated.	Protected by the FSCS up to a maximum value of £85,000
Disclosure / reporting obligations	By listing a bond on an exchange, the issuers commit to comply with the exchange's Admission and Disclosure standards and the FCA's Listing Rules, Prospectus Rules and Disclosure and Transparency Rules.	Not subject to the disclosure requirements of the exchange and the FCA's Listing Rules or Prospectus Rules.	Not subject to the disclosure requirements of the exchange and the FCA's Listing Rules. May be subject to the Prospectus Rules if the size of the issue is over €8 million.	Any provisions (if any) will be set out in the terms and conditions of the 'bond'.

Note: An updated and expanded version of LSE (2011)

Source: London Economics

NTDSs differ from listed corporate bonds in several ways. Listed retail bonds are listed on an investment exchange, such as the LSE's Order book for Retail Bonds (ORB), while NTDSs are unlisted (LSE, 2011). As a result, listed corporate bonds in the UK are subject to the requirements of the ORB and the FCA, while NTDSs are not (LSE, 2011). These obligations include the ORB's Admission and Disclosure standards and the FCA's Listing Rules, Prospectus Rules and Disclosure and Transparency Rules (LSEG, 2014).

While NTDSs are non-transferable and not tradable, listed corporate bonds can be transferred and traded on secondary markets, where nominated market makers provide liquidity. As a result, a NTDS must be held until maturity, whereas one can sell listed corporate bonds before they mature. Another difference is that NTDSs are not ISA-eligible, whereas listed corporate bonds typically are (LSE, 2011).

Unlisted but legally transferable debt securities (with variable liquidity) have risen to prominence recently. They are issued by companies and may involve the use of a crowdfunding platform as an intermediary. Like NTDSs, they are unlisted and tend to offer high returns. Neither type is generally covered by the FSCS (Brodbeck, 2016) though may be if professional advice is provided but they differ in that mini-bonds are not legally transferable. In practice, there is not always a developed secondary market for legally transferable unlisted debt securities, and an investor is likely to have to hold it until it matures (Williams, 2016).

2.2.2 Fundraising alternatives

The relevant alternative(s) to mini-bonds for raising funds depend on a number of factors. One of these factors is the amount of finance the business needs and the term over which it needs it. Another of these factors is the business's existing leverage. A business that is already highly leveraged may not wish to increase its debt. The availability of other sources of finance also determines what are the relevant alternatives to mini-bonds; for some businesses, bank finance is simply not obtainable because they have no 'track record'. This subsection will describe three sources of finance that are relevant alternatives to mini-bonds for a significant number of (would-be) issuers: bank finance, a listed bond issue, and equity. Section 4.2 discusses issuers' motivations for issuing mini-bonds rather than using these fundraising alternatives.

Bank finance represents an alternative source of funds for mini-bond issuers. Bank loans are one sort of bank finance; with a bank loan, a business borrows a defined sum from the bank and repays the principal with interest over a set repayment period in agreed instalments. Bank loans to businesses can be secured or unsecured, and are available with terms as long as 30 years ("Medium to long-term business loans", undated). Another form of bank finance is revolving credit facilities. These agreements allow businesses to borrow on a rolling basis, whereby after repaying some portion of their existing borrowing, they are permitted to borrow further ("Revolving credit facilities", undated). Terms are typically between six months and two years, though the facility can be renewed when the term finishes ("Revolving credit facilities", undated).

Another alternative method of raising funds for mini-bond issuers is a listed bond issue. The differences between mini-bonds and listed bonds are described above, in Section 2.2.1.

Equity fundraising is another alternative method of raising funds for mini-bond issuers. Equity fundraising involves the fundraising business giving investors shares in the company in exchange for funds. Investors in an equity fundraise will, like other shareholders, generally receive regular dividends. Equity does not have a term in the way that debt does; there is not some point in time at which all the issuing business's obligations to the investor disappear.

2.3 Risk characteristics

Investing in the corporate bond of a company is generally considered to be less risky than investing in the same company's shares. This is because, in the event of the company going into bankruptcy, the bondholders take priority over equity shareholders in terms of repayment.

Nevertheless, NTDSs are risky investments. There is no FSCS protection for the failure of the product itself. Some or all of the invested capital may be lost if the issuer becomes insolvent. Several of the characteristics of NTDSs further increase the risk for the investor:

- **Concentration**. Unlike managed bond funds that expose retail investors to tens, hundreds or thousands of companies, individual bonds concentrate the credit risk in a single company. A bankruptcy of the issuer can lead to large capital losses. Moreover, the risk of a single company collapsing is much harder to estimate than expected bond defaults in a broad portfolio. This risk is common to all individual bond investments and not unique to NTDSs.
- **Ranking**. In the event of a default, the creditors of a company are not all treated equally. 'Senior' debt is repaid before 'subordinated' debt and bonds secured by assets before those that are unsecured. Mini-bond holders were often the most junior creditors. Some mini-bonds were secured on assets; however, this did not always afford the protection consumers may have expected. The assets were sometimes of low value or quality, or no robust security structure was put in place that prevented a sale or a failure to purchase these assets by the issuer. This is discussed further in sub-section 4.3.1.
- **Borrowers with a short track record.** Many NTDSs have been issued by small early-stage businesses, which are generally less creditworthy borrowers than established companies. However, a considerable share of NTDSs (especially until 2015) were established businesses (see section 4).
- **Low disclosure standards** limit the investors' opportunity to perform their own due diligence. NTDSs are exempt from the requirement to produce a detailed and standardised prospectus.
- **Limited third-party due diligence**. An offer of unlisted, non-transferable bonds does not need to undergo approval processes by the FCA or a registered exchange. NTDSs are also not scrutinised and rated by independent rating agencies. The bond's non-transferability further means that the investor cannot rely on other investors' due diligence, which would be reflected in the price signal if the bond was tradable.
- **No put option.** Unlike some listed bonds, NTDSs rarely give investors the option to redeem their investment early.
- **Non-transferability** of NTDSs means that the bondholder cannot sell the asset to another investor and their capital is therefore locked in until the bond matures. The investor is unable to convert their NTDS into cash if they lose trust in the borrower's creditworthiness or require liquid funds at short notice. The absence of a secondary market also means that each investor must value the bond independently.

NTDSs clearly share some risk characteristics with listed bonds, but other risks are unique to NTDSs. The risk profile of both legally transferable and non-transferable debt securities are nearly identical. Those that are legally transferable often ack a liquid secondary market and are therefore not tradable in practice. By contrast, due to FSCS protection, 'fixed rate bonds' are risk-free for all retail investors who have invested less than £85,000.

The concentration risk is the key difference between NTDSs and diversified bond funds. In addition, bond funds are regulated and managed by investment professionals. The investor is also typically able to buy or sell shares in the investment fund without restrictions.

Finally, P2P loans are a potential investment alternative to NTDSs. Neither NTDSs nor P2P investing are themselves covered by the FSCS (Money Advice Service, undated). But P2P platforms are regulated by the FCA, which affords investors more protection in this market (ibid.). Another difference in risk between the two products is that some P2P platforms diversify the investor's exposure to a large number of loans rather than one individual loan, while others use a 'provision fund' to cover the investor's losses if the borrower stops repaying. By contrast, if an investor invests in one mini-bond, the performance of their investment depends entirely on the fortunes of one company. The two sorts of product also differ in that NTDSs are, by definition, not tradable, while some diversified P2P platforms have secondary markets for P2P loans (Wear, 2019).

2.4 Investor protection

Retail investors may lack relevant knowledge or experience, putting them at risk of harm when investing in complex financial instruments such as NTDSs. Investors are particularly vulnerable if disclosure of important information is poor, due diligence by third parties lacking or if the promotion of investments is unclear, unfair or misleading.

Recognising the vulnerability of retail investors, the regulatory architecture contains various measures to protect investors, both prior to the investment decision and ex post. This sub-section reviews the protections available to NTDS investors.

2.4.1 Regulatory regime

It is not a regulated activity for a company to issue their own securities - including a mini-bond or another corporate bond - for the purposes of the Regulated Activities Order 2001. However, unlike listed bonds, NTDSs issued in the UK are also not subject to the FCA's Listing Rules, the Prospectus Rules or to any rules set up by the stock exchange.[11]

Despite this, mini-bonds can still enter the regulated perimeter of financial services, principally through three channels:

- **Financial promotion** targeting retail investors must be approved by an FCA-authorised entity.[12] In line with the FCA's rules (COBS 4.2.1R), the approver must ensure that the communication is fair, clear and not misleading. In addition, the FCA introduced in 2014 restrictions on the marketing of unlisted securities (COBS 4.7.7). NTDSs can be marketed only to retail investors that are professionally advised, high net worth or sophisticated. Financial promotion may target other investors only if they certify that unlisted securities constitute less than 10% of their investable assets. These categories and restrictions are discussed in more detail in Section 6.

[11] NTDSs are exempt from the Listing Rules because they are not listed. They are exempt from Prospectus Rules because they are non-transferable.

[12] This is not true in the case of an FCA-authorised entity communicating its own promotion; see Footnote 2. Also, there are exemptions from the requirement of approval of a financial promotion targeting retail investors by an FCA-authorised firm within the FPO; see Footnote 3.

- **Arranging investments** is a regulated activity that requires a permission from the FCA. When mini-bonds are sold to investors by an intermediary authorised to arrange investment deals – e.g. crowdfunding platforms – the intermediary has both general and specific obligations towards the investors. These stem, for example, from the FCA's Principles of Businesses rules[13], the client's best interest rule[14], or the rules on assessing appropriateness[15]. The FCA's recent consultation paper on loan-based and investment-based crowdfunding platforms (FCA, 2018a) interprets these rules as committing the intermediary to:
  - Take reasonable steps to counter the risk of the platform being used to further financial crime. At a minimum, these should involve "obvious checks such as ensuring the company exists and that the founders are who they say they are." (p. 24)
  - Undertake "enough due diligence to satisfy itself on the essential information on which any communication or promotion is based", including "a basic plausibility check". The intermediary must complete any due diligence before they market the investments, but also undertake continuous checks and "respond appropriately to any information they receive" until "money has been irrevocably committed by investors". The FCA offers an example: "[I]f a borrower says it is going to build a block of flats within 6 months but it does not have the relevant construction permissions, it would seem reasonable for a platform to question the plausibility of the project." (p. 25)
  - Ensure it provides enough information about the offer to allow investors to "undertake due diligence of their own" and "make informed decisions" (p. 25).
  - "Comply with the rules on appropriateness (COBS 10)" in cases where the investor did not receive regulated advice (p. 30). Depending on individual circumstances, these could entail the duty to assess whether the investor has the necessary experience and knowledge in order to understand the risks associated with the product. If the intermediary concludes that the product is not appropriate, it must warn the investor (COBS 10.2 and 10.3).
- **Advice** is also a regulated activity. Regulated advice includes any communication with the customer which goes beyond the mere provision of information (e.g. involves value judgments or recommendations) and is therefore objectively likely to influence the customer's decision whether to invest (FCA Handbook, PERG 8.28.2). Unlike more general guidance, regulated advice is personal to the customer and based on their specific circumstances and financial objectives. Regulated advice will take the form of a recommendation that is related to specific investments rather than simply providing information about different types of investments or setting out general principles to consider before investing. Advisers are responsible and liable for the accuracy, quality and suitability of the recommendations they make (FCA, 2018b).

[13] For example, Principles 2 and 6 of PRIN 2.1.1R mandate that "A firm must conduct its business with due skill, care and diligence" and "A firm must pay due regard to the interests of its customers and treat them fairly"

[14] COBS 2.1.1R requires that "A firm must act honestly, fairly and professionally in accordance with the best interests of its clients".

[15] Principles 1 and 2 of COBS 10.2.1 require that if a client was not professionally advised, "a firm must ask the client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the firm to assess whether the service or product envisaged is appropriate for the client" and "When assessing appropriateness, a firm must determine whether the client has the necessary experience and knowledge in order to understand the risks involved in relation to the product or service offered or demanded."

2.4.2 Protection before investing

Before investing, consumers can access the services of an IFA. After assessing the investor's situation and preferences, the regulated advisor would help the investor understand the risks and offer them suitable recommendations. However, most NTDS investors do not access regulated advice before investing. Section 5 shows that only 18% of respondents in the investor survey used a professional advisor before investing. Patrick Connolly, Head of Communications at Chase de Vere, confirms that IFAs see "only the tip of the iceberg".

A further source of assistance available to investors is due diligence performed by third parties. However, as the previous sub-sections explain, NTDS issuers are not required to produce a prospectus that must be approved by the FCA before it can be used. The bond is also not scrutinised by a stock exchange (unlike listed bonds) or credit rating agencies. The investor cannot rely on due diligence by fellow investors either. The non-transferability of the bond reduces the signalling power of the price mechanism; each investor must value the bond independently (see Section 7.3).

The FCA's expectations of firms that "arrange investments" represent one source of third-party due diligence. However, the FCA's language, prescribing only "obvious checks" of "essential information", makes it clear that the minimum requirements are limited. The due diligence standards applied by intermediaries are therefore likely to vary considerably. More importantly, most mini-bonds are not sold through crowdfunding platforms or other regulated intermediaries (see Section 6). The role of the FCA-authorised company has in most cases been restricted to approving the financial promotion. This role alone is (typically) unlikely to be interpreted as the regulated activity of arranging deals.[16]

As a result, investors largely rely on their own due diligence. However, the information available to them is highly variable because the mandatory documentation disclosures are minimal for NTDSs. Beyond the scope of the Listing Rules and Prospectus Rules, NTDSs must be assessed using materials that are regulated only by rules on financial promotion.[17]

These rules therefore constitute the most robust protection mechanism available to investors. All financial promotion targeting retail investors must be approved by an FCA-authorised entity to ensure that it is fair, clear, and not misleading.[18] In practice, however, this third-party review entails dis-similar levels of due diligence and scrutiny (see Section 6). Moreover, even if the promotion fails the "fair, clear and not misleading" standard, this does not automatically open the route to potential compensation (see Sub-section 2.4.3 below).

The second key protection mechanism associated with financial promotion was introduced by the FCA in 2014. As explained in the previous sub-section, the new rule (COBS 4.7.7) restricts the marketing of unlisted securities to retail investors that are professionally advised, sophisticated, high net worth or not excessively exposed to unlisted securities.

[16] In some cases, notably FOS (2018a), FOS (2018b) and FOS (2018c), the Financial Ombudsman ruled that role of the FCA-authorised business did amount to arranging deals. However, in these cases, the authorised business also acted as the Security Trustee and Corporate Director in addition to its role as approver of financial promotion.

[17] For a document to be considered a financial promotion, it must involve an element of invitation or inducement; documents that merely set out factual information are not considered financial promotions.

[18] There are exceptions to the requirement of approval by an FCA-authorised entity – see Footnotes 2 and 3.

2.4.3 Protection after investing

Consumers who believe that they suffered harm as a result of negligent or unfair conduct of an FCA- or PRA-authorised business have access to a complaint process with the Financial Ombudsman Service (FOS), which has the power to award redress. If the provider against which the claim is raised is authorised and stops trading or is in default, the consumer may be able to obtain compensation from the FSCS

However, these avenues are only open to the investor if their claim is related to a regulated activity performed by an FCA- or PRA-authorised firm. Investors in the mini-bonds of failed issuers are not automatically entitled to compensation through the FSCS. This is because it is not a regulated activity for a company to issue their own securities such as a mini-bond, and most mini-bond issuers do not have FCA or PRA authorisation.

There are, however, certain activities related to the issuance of securities such as a mini-bond are regulated; these can provide a route to a FOS complaint or a claim under the FSCS. These are most likely to be the activities of arranging deals in investments and of advising on investments. To our knowledge, there has been only one successful NTDS-related case so far, where the FOS awarded redress and the FSCS is now accepting claims (see below). It is important to note, though, that the FOS always make decisions on individual complaints, according to the individual circumstances of a complaint. At least one other case is currently being considered by the FSCS. Both are instructive for understanding the *ex post* protection regime.

The FSCS is currently accepting claims against Independent Portfolio Managers (IPM) (FSCS, 2019), an FCA-authorised business which approved promotions for the failed mini-bond issuers Secured Energy Bonds (SEB) and Providence Bonds (Connington, 2018). IPM went into administration after the FOS ordered it to compensate mini-bond holders for approving financial promotion that was not fair, clear and not misleading. The bonds were advertised as secured but the security system was, according to the ombudsman, “not fit for purpose”. As a result, the bonds “were no more secure, or less risky, than other non-secured mini-bonds” (FOS, 2018a).

The judgment is particularly notable for its jurisdictional remarks because approving financial promotion is not a regulated activity. In his decision, the ombudsman argued that “IPM approved the promotion for the SEB bonds but a number of factors take IPM’s acts beyond just approving and amount to the regulated activity of making arrangements under Article 25(2) of the Regulated Activities Order 2000” (FOS, 2018a). The fact that IPM also agreed to act as a Security Trustee and Corporate Director to protect the bondholders’ interests led the ombudsman to conclude that IPM was, in effect, undertaking a regulated activity. According to the ombudsman, the issuer “used the expertise of IPM to help sell the investment” by advertising IPM “as a manager of the investor’s assets” (FOS, 2018a).

The second case – currently being considered by the FSCS – is the failed issuer LCF. The FCA (2019a) deemed that LCF’s marketing was misleading and gave “undue prominence” to the fact that it was FCA-authorised. In reality, LCF’s FCA authorisations were for other, unrelated activities and did not mean that investment in LCF’s mini-bonds were covered by the FSCS. The FCA authorisation gave reassurance to investors that they were investing in a legitimate, mainstream product.

LCF was unusual in that it approved its own promotions. Since arranging deals *to which one is a party* is not a regulated activity (Financial Services and Markets Act 2000 [Regulated Activities] Order 2001), investors cannot access FSCS protection on the grounds that LCF’s promotions failed the “clear, fair and not misleading” criterion. Two routes for LCF’s investors to FSCS compensation have been identified by LCF's administrators. The first is advice given by LCF's representatives to potential investors(Smith & Williamson, 2019b). The second is LCF arranging transfers from Stocks and Shares ISAs into its mini-bonds, which would represent arranging deals in investments (Smith and Williamson, 2019b).

Both the cases of IPM and LCF illustrate the point that the specific technical parameters in which an authorised business is involved in NTDS issuance can be decisive for the investors' *ex post* protection. Section 6 explores this theme further, while Section 5 studies the investors' awareness of risk and regulatory protection.

3 The size of the NTDS market

Sizing a small, off-exchange financial market is notoriously difficult. Unsurprisingly, the few existing estimates do not converge even on the order of magnitude. A 2013 estimate by a prominent intermediary in the market, Capita put the value of the NTDS market at £90m in 2012 and predicted a rise to £1bn before the end of 2013 (Eley, 2013). Meanwhile, in the same year, a report by Nesta, the University of California, Berkeley, and Cambridge University estimated its value at only £2.7m (Collins et al, 2013).

The most robust analysis to date by the Cambridge Centre for Alternative Finance (CCAF) produced a figure of £72m in 2017 (Zhang et al, 2018). However, the CCAF research only covers NTDSs issued through a crowdfunding platform. Moreover, the CCAF do not distinguish between non-transferable and non-readily realisable bonds. Their estimate includes all unlisted debt securities.

The mini-bond market is far larger than suggested by the CCAF estimate. This is because most mini-bonds (and typically the larger ones) have been issued outside of platforms. The failed issuer LCF alone attracted NTDS investment worth £236m (Smith & Williamson, 2019a).

In this section, we address this research gap by estimating the size of NTDS market in the UK, including how this has changed in recent years.

3.1 Number of participants

Our research has identified 68 businesses that together issued at least 152 mini-bonds between 2009 and 2019. The characteristics of these business are described in Section 4.

The estimated number of investors who currently hold at least one mini-bond is between 80,000 and 150,000.[19] This corresponds to approximately 0.9–1.7% of UK investors, or less than 0.2% of the UK total population. The estimate is based on the observed incidence of mini-bond holders in the representative sample of 4,426 investors screened by YouGov. Sub-section 3.2.2 below explains the methodology in more detail.

The number of intermediaries is harder to estimate. The FCA keeps track of the number of firms authorised in relation to investment-based crowdfunding (FCA, 2015). However, this mostly captures platforms that facilitate investments in equity or debt-based crowdfunding. Moreover, although some mini-bonds were issued through similar platforms (e.g. Crowdcube or CODE investing), most were not.

Most intermediaries that assisted with mini-bond issuance are law firms, promotion advisors, communication specialists, accountants, registrars and other professional services firms, for whom mini-bond intermediation was not the primary business activity. Section 6 provides more detail on intermediation in the NTDS market.

[19] The figures have been rounded to the nearest ten thousand.

3.2 Value of NTDS market

Most (possibly all) mini-bonds in the UK have been marketed only to UK residents. The amount issued by UK businesses should therefore be equal to the amount invested by UK-based investors. It follows that the size of the mini-bond market can be estimated either by measuring the total issuance (supply-side) or the total investment (demand-side).

In this study, we follow the former approach and use the latter only as a robustness check. There are several reasons for this choice:

- There are far fewer issuers than investors. This makes it possible to survey the entire population instead of making extrapolations based on a limited sample.
- Issuers are easier to identify and contact. NTDS investors can only be identified by screening thousands of consumers. As our own investor survey shows, even a targeted search through almost six thousand investors on YouGov's panel only produced 111 mini-bond holders – a sample too small to support a robust market sizing.
- There is a wealth of publicly available information on the amounts issued by individual businesses, but no such data on NTDS holdings of retail investors. Publicly available information from press releases, newspaper articles, marketing materials and other sources has been crucial in constructing our comprehensive register of mini-bonds.
- Retail investors are often unsure about the amounts they invested in NTDSs. They are also more prone to errors when classifying their investments. From the investor's perspective, NTDSs closely resemble similar products. By contrast, the issuer will be aware of the precise structure of their bonds (for example, whether they are transferable).

Nevertheless, the investor survey still provided two important contributions to the market sizing. Firstly, the investors identified a small number of issuers that had been missing in the mini-bond register. Secondly, a demand-side market sizing provides an independent check of the supply-side estimate.

3.2.1 Supply-side estimate

The total value of mini-bonds issued over the lifetime of the market is greater than £815 million. This figure, obtained by summing the known values of mini-bond issues identified through our primary and secondary research, is an underestimate, because there were a number of mini-bonds for which there was no available information on the amount they raised and because there may have been mini-bond issues that our research did not identify. It is not likely to be an underestimate by a huge degree, though. It was only a small minority of mini-bonds for which the required data was unavailable, and they are not likely to have been large ones.[20] Similarly, any mini-bonds that our research failed to identify are likely to be few in number and small in value (larger issues are more likely to be prominent).

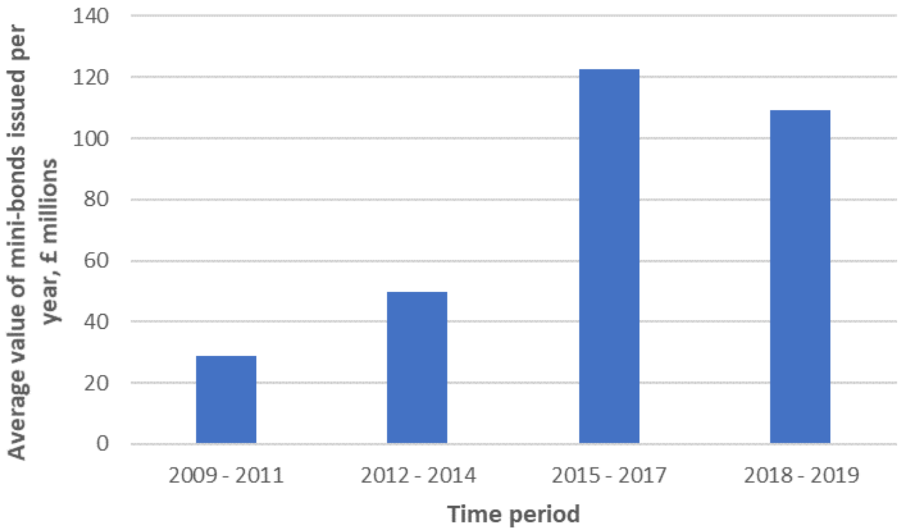
Using the same method, the total value of mini-bonds outstanding in 2019 is estimated at around £570 million.[21] This is, again, an underestimate, for the reasons discussed above in relation to the market lifetime value estimate and also because some investors may have chosen to roll over their investments at the end of the mini-bonds' initial terms. Of this amount, approximately £330 million

[20] Based on the fact that data is unavailable, and based on information about the issuer and information about the target issue size.

[21] This simply sums the value of all mini-bonds, where the origination year plus the term length is greater or equal to 2019.

was accounted for by mini-bonds issued by issuers in administration or liquidation (with the majority of the latter amount being accounted for by LCF).

Figure 5 The average value of mini-bond issues per year over time



This information is not presented at the yearly level because the level of disaggregation in the available data is insufficient to do so without losing a significant proportion of the data. The last period shown in this figure is two years in length while the other periods are three years in length, but this is immaterial because the figure displays annual averages.

Base: Mini-bonds issued in the UK, 2009-2019 (N=141).

Source: LE mini-bond register

Activity in the mini-bond market grew from the market's advent in 2009 until the 2015-2017 period (Figure 5). It was in this peak 2015-2017 period that activity by financial services firms was greatest. The lower value of mini-bond issues in the 2018-2019 period reflects the slowdown in the market driven by the rise of legally transferable unlisted debt securities and the reputational damage and increased scrutiny caused by high-profile issuer failures. There were fewer new issuers in 2018 and in 2019 than in 2015, 2016 and 2017. 2018 was, in fact, the year in which the value of new mini-bond issues was greatest, because of massive activity by LCF; the slowdown by value in the 2018-2019 period reflects the massive reduction in activity in 2019, after the failure of LCF early in that year as well as other large issuer failures. These trends are discussed in more detail below.

3.2.2 Demand-side estimate

The total amount currently invested in NTDSs is estimated in five steps:

1. Calculate the number of identified NTDS holders as a share of all investors screened. The sample of investors was drawn from the YouGov's panel of UK adults who had reported that they own at least one investment product.[22] Of the 4,426 investors who answered the screening question, 74 were current mini-bond holders, but only 42 could be verified by the research team because they indicated the issuer's name. The share of NTDS holders among UK investors is therefore estimated as 0.9–1.7%.
2. Calculate the average number of mini-bonds per NTDS holder in the sample and the average amount invested per NTDS. The number of held mini-bonds was counted for each of the 42

[22] More information on this is provided in Annex 2.

NTDS investors who provided the names of the issuers. With 77 verified mini-bonds in this group, the average number of mini-bonds per investor was estimated at 1.83. The average size of investment was calculated using only those mini-bond holders who also provided the value of their investments. The 35 such investors hold 53 mini-bonds worth £396,400 or £7,480 per mini-bond.

3. Estimate the share of investors on YouGov panels in the UK population. This was done using YouGov's audience analytics and profiling tool, YouGov Profiles, which can reveal the natural incidence rate of people that hold one of the investment products tracked by YouGov. The resulting estimate shows that 13.9% of the UK population hold at least one of the investment products.
4. Using [1] and [3], estimate the share (and number) of NTDS holders in the UK population. Taking 0.9–1.7% of 13.9% of 63.8 million, we estimate that there are 84,135 to 148,238 NTDS investors in the UK.
5. Using [2] and [4], estimate the total value of mini-bonds held by all NTDS holders in the population. With an average 1.83 NTDS bonds per bondholder and an average value of £7,480 per mini-bond, UK mini-bond investors are estimated to hold NTDSs in the total value of £1.2 billion to £2.0 billion. The low end of the range uses in the calculation only the survey respondents who named their mini-bond and the research team verified it. The upper end uses both the verified mini-bond holders and those who say they have a mini-bond but did not name the issuer in the survey.

The demand-side estimate is somewhat higher than the supply-side estimate. However, given the low accuracy of this method,[23] the difference is relatively small.

[23] The calculation is highly sensitive to the estimates from step [2], which rely on a very small sample of NTDS investors.

4 Issuers

This section concerns the issuers of mini-bonds. Sub-section 4.1 examines their characteristics. It analyses the ages and sizes of mini-bond issuers and the business sectors they operate in, and how these have changed over time. Sub-section 4.2 explores the drivers of mini-bond issuance, describing why firms choose mini-bond issuance over other methods of raising finance. Finally, sub-section 4.3 describes common features and themes in failures of mini-bond issuers.

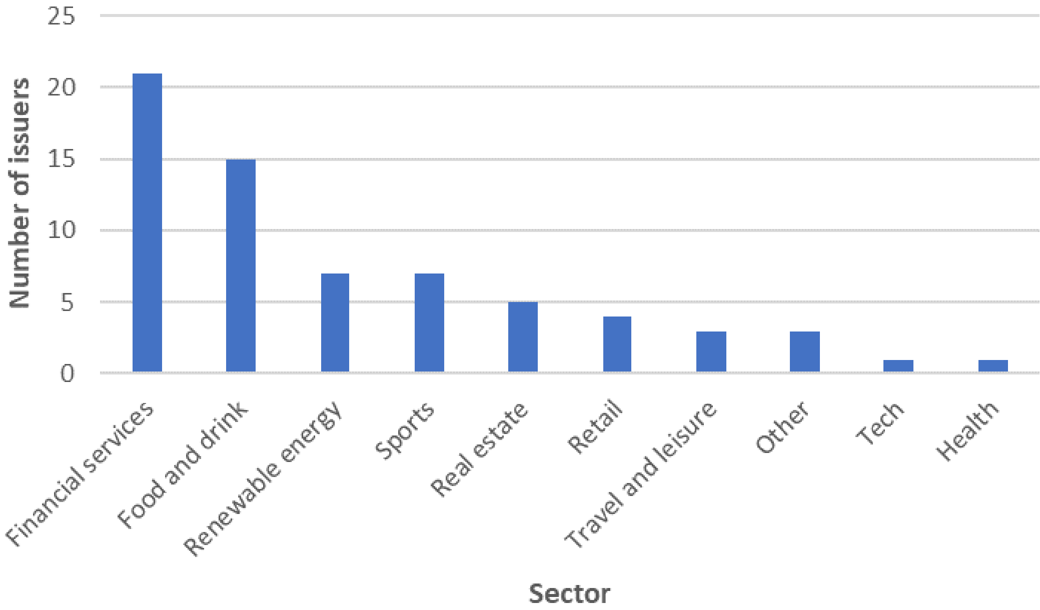
4.1 Characteristics of NTDS issuers

This sub-section examines the characteristics of mini-bond issuers. It presents an analysis of both overall statistics and changes that have occurred over time. Considering the ages and sizes of issuers and the sectors they operate in, a consistent narrative emerges. The profile of issuers in the second half of the market's lifetime (between 2015 and 2019) is very different from how it was in the first half of the market's lifetime (between 2009 and 2014). In the second half of the market's lifetime, issuers have been smaller, younger and more concentrated in the financial services sector. These differences reflect an influx of young micro-enterprises in the financial services sector, whose business model typically involves raising funds through mini-bond issues to invest into projects by third parties.

4.1.1 Sector

Previous research that sheds light on the sectors of firms issuing mini-bonds includes the CCAF's 4th Alternative Finance Industry Report (Zhang et al, 2017). Where relevant, the findings of this research are compared with the findings of this study below. The CCAF's research, though, had a number of key differences in scope from this study. Firstly, the CCAF examines all unlisted bonds, not just NTDSs. Secondly, the CCAF considers only bonds issued through crowdfunding platforms. Finally, the CCAF does not examine data over the same time periods that this research does.

Figure 6 Number of mini-bond issuers by sector from 2009 to 2019

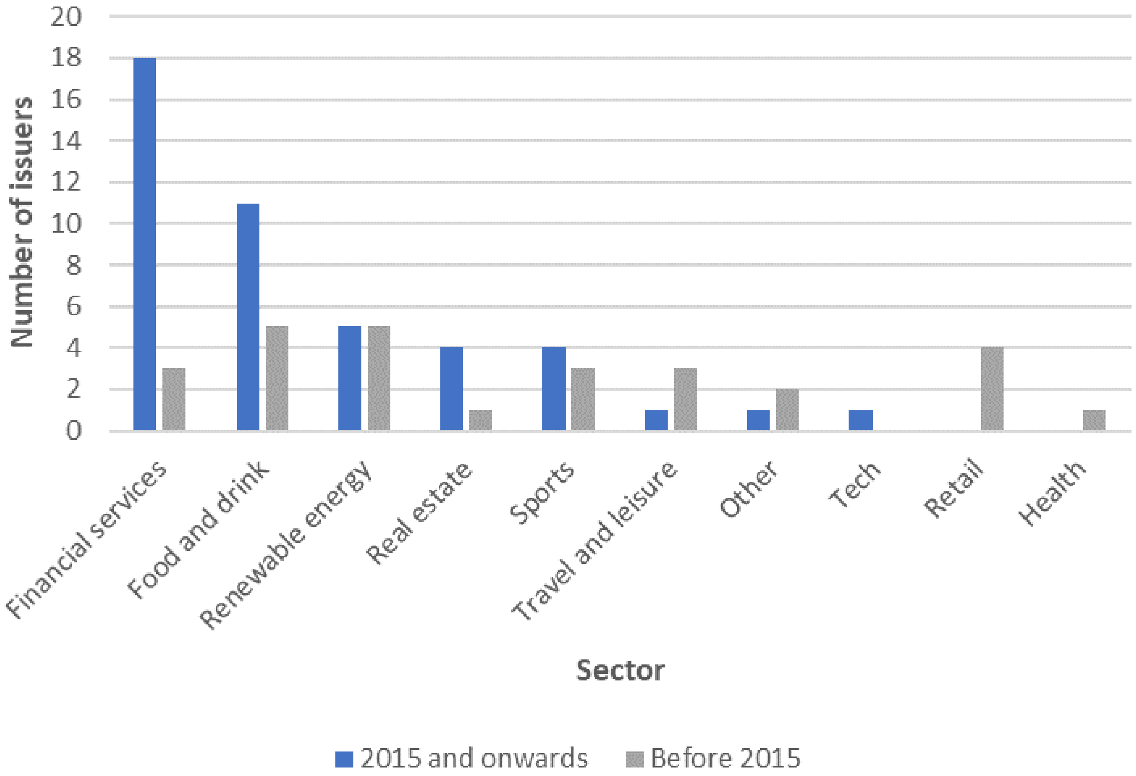


Some companies issued multiple mini-bonds, but they are counted only once in this figure.
Base: Mini-bond issuers in the UK whose sectors have been identified, 2009-2019 (N=67)
LE mini-bond register and FAME data

The four sectors represented by the issuers of the greatest number of mini-bonds are financial services, food and drink, renewable energy and sports (see Figure 6). This broadly corresponds with the CCAF's finding that top five most represented sectors for debt-based securities in 2016 were 'Finance', 'Food & Drink', 'Renewable Energy', 'Real Estate and Housing' and 'Community & Social Enterprise'.

The prominence of financial services firms within the mini-bond market has grown significantly over time; this will be discussed further below. The prominence of firms from the food and drink, renewable energy and sports sectors reflects the fact, discussed in Section 5, that one of the drivers for retail investors investing in mini-bonds is a desire to support and feel a part of a brand, company or cause they know, like or support. Food and drink firms are likely, because of the repeat-business-heavy and consumer-facing nature of their business, to have a base of loyal customers, while some investors will support the mission of renewable energy companies. The issuers from the sports sector are almost exclusively professional clubs in popular sports, who have a committed fanbase from whom they could seek investment.

Figure 7 Comparison of number of mini-bond issuers by sector before 2015 and from 2015 to 2019



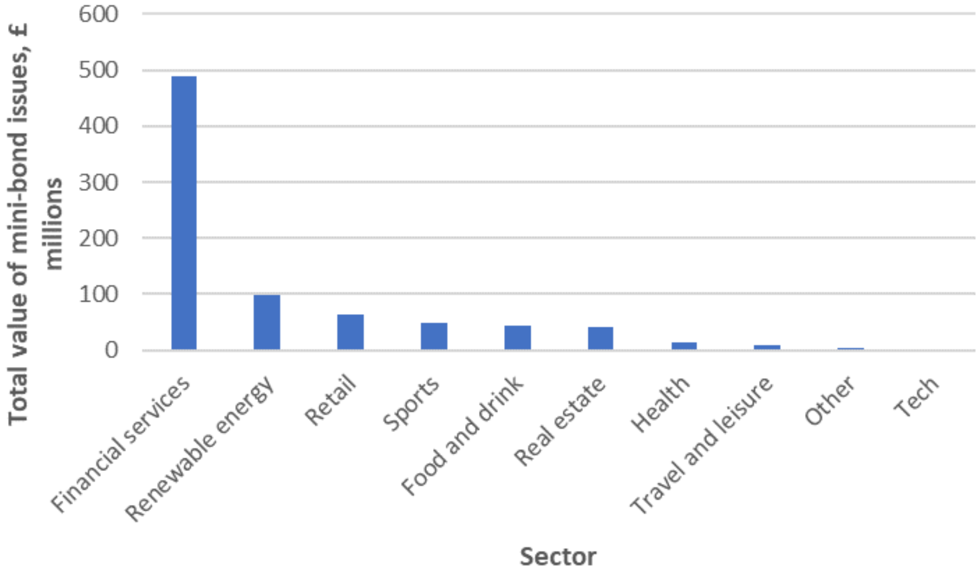
This figure shows the number of mini-bond issuers from different sectors in the time periods displayed. Each issuer is counted at most once in each period. Note that the number of issuers in each sector obtained by adding the 'Before 2015' and '2015 and onwards' counts for that sector will not necessarily equal the number of issuers in Figure 6. This is because a firm who issued a mini-bond before 2015 and in 2015 or later will be counted once in Figure 6 but will be counted in both periods in Figure 7.

Base: Mini-bond issuers in the UK, 2009-2014 (N=27) and 2015-2019 (N=45)
LE mini-bond register and FAME data

The most notable change in the number of mini-bond issuers in each sector over time is the rise of financial firms amongst mini-bond issuers (Figure 7). Most of these firms use the funds raised by their mini-bond issues to invest into the projects of a third party, rather than to invest in expanding their own businesses. While financial services firms accounted for one in nine mini-bond issuers before 2015, they accounted for 40% of issuers from 2015 to 2019.

Financial services firms differ from other firms, including those firms who were more active in the early years of the mini-bond market, in their characteristics as mini-bond issuers. These firms are not consumer-facing in the way that a retailer or a restaurant chain is. Financial services firms issuing mini-bonds tend to be much younger than other mini-bond issuers; this is discussed in more detail in section 4.1.3 below. These two facts mean that when issuing a mini-bond they lack a pre-existing, committed customer base. For these firms, mini-bond issues are not exercises in customer engagement or reputation enhancement as they are for some other issuers. Relatedly, investors in mini-bonds issued by these firms are likely to be motivated by the return offered and not by a desire to support a brand they like and believe in, and the marketing materials for reflect this. Financial services firms also account for all of the mini-bond issuers found to be micro-enterprises with nine or fewer employees.

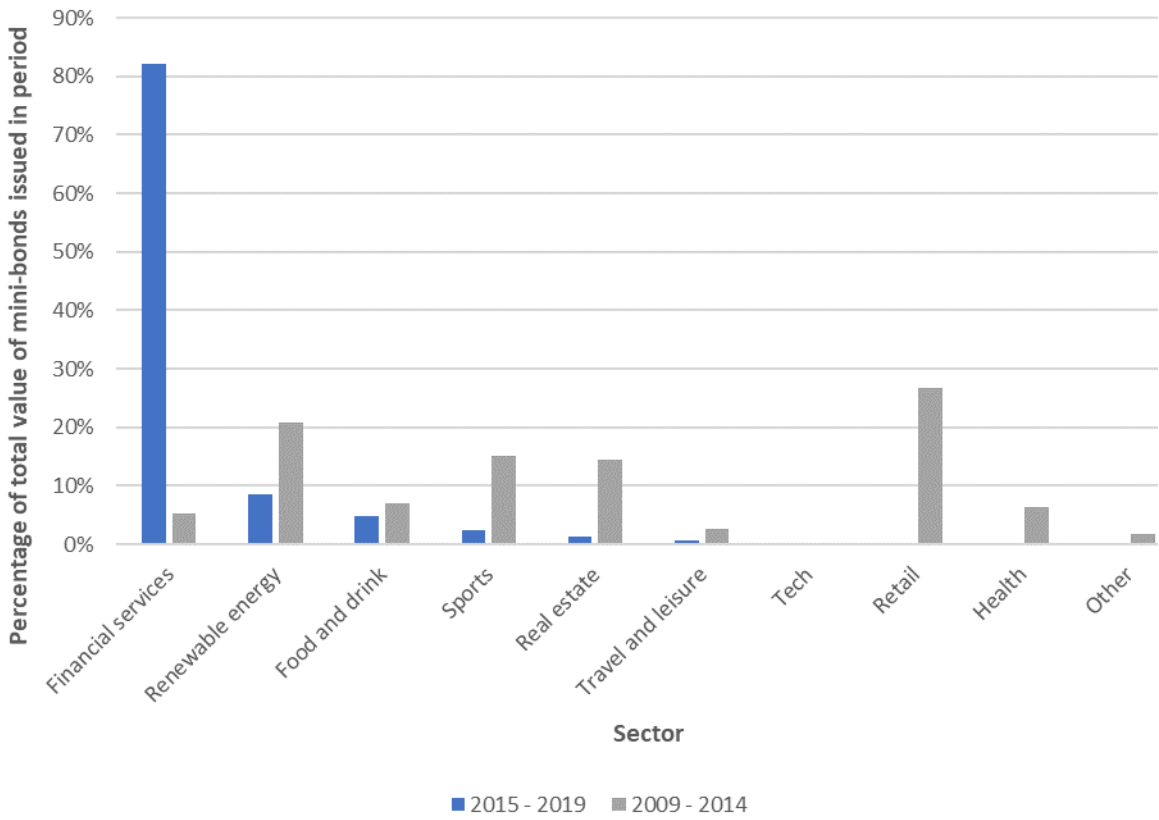
Figure 8 Total value of mini-bond issues from 2009 to 2019, by sector of issuer



Base: Mini-bonds issued in the UK 2009-2019, (N=132)
LE mini-bond register and FAME data

Financial services firms are more dominant in the value of mini-bonds issued than in their number (see Figure 8; cf. Figure 6). Mini-bonds issued by financial services firms account for more than half of the market by value. LCF alone accounts for nearly half of the financial services total. The renewable energy, food and drink and sports sectors are also amongst the top five sectors by value of mini-bond issues; this can be attributed to the fact that firms in these sectors are, for reasons described above, likely to have a pool of people receptive to being investors in the form of their customers and fans. The retail sector is the third biggest by total value of mini-bond issues. John Lewis's £57 million issue in 2011 accounts for a large proportion of the retail sector's total. This issue was one of the largest issues in the mini-bond market's history, and its success reflects the level of buy-in to John Lewis's brand; John Lewis's mini-bond was open to investment only from staff and customers with Partnership Card credit cards or Account cards (Macalister, 2011).

Figure 9 Comparison of the percentage by value of mini-bonds issued by firms in different sectors before 2015 and from 2015 to 2019



Base: Mini-bonds issued in the UK, 2009-2019 (N=132)
LE mini-bond register and FAME data

Two features of the percentages by value of mini-bonds issued by firms in different sectors between the period from 2009 to 2014 and the period from 2015 to 2019 are particularly notable (see Figure 9). The first of these is the huge increase in the percentage by value of mini-bonds issued by financial services firms from the first period to the second period. The second of these is the sheer scale of financial services firms' dominance of the mini-bond market by value in the 2015 to 2019 period, with over 80% of mini-bonds by value being issued by financial services firms.

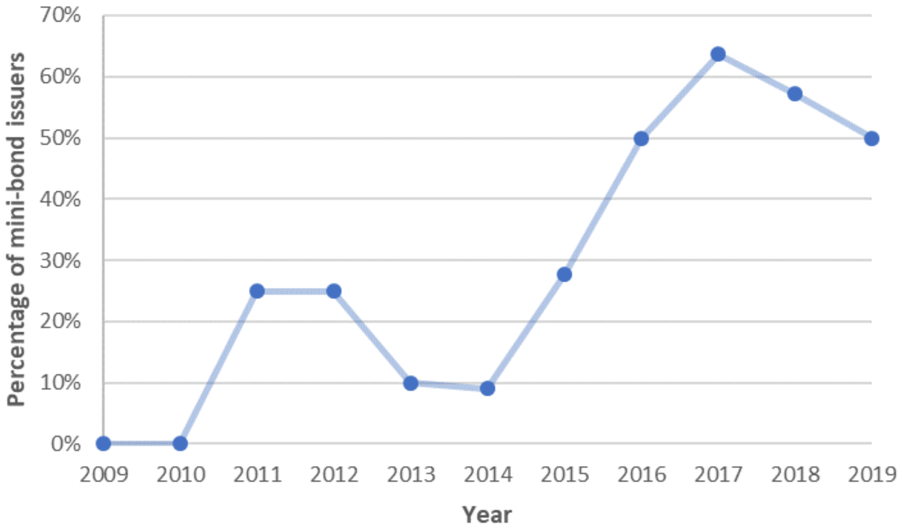
In interviews conducted as part of the research for this study, stakeholders stated that the FCA's February 2017 'Dear CEO' letter to loan-based crowdfunding platforms about loans to lending businesses was a driver of the influx of financial services firms into the mini-bond market. This letter informed loan-based platforms that if a business that lent borrowed money to others (a common business model for financial services firms issuing mini-bonds) borrowed through their platform, that business may be performing the regulated activity of "accepting deposits" and that a platform facilitating the performance of this regulated activity by a firm without the relevant permissions "would not be acting in a manner consistent with [the FCA's] expectations for regulated firms and may be in breach of certain regulatory requirements" (FCA, 2017). These stakeholders reported that following this letter, such lending businesses were not able to secure funding through loan-based crowdfunding platforms and so turned to mini-bond issuance as a way of raising funds.

However, analysis of the data suggests that the rise of financial services firms was already underway by 2017, with financial services firms' share of the market having significantly increased in 2015 and

2016. The FCA's 'Dear CEO' letter is therefore likely to have reinforced rather than initiated the influx of financial services firms into the mini-bond market.

The percentage of mini-bond issuers in each year that were financial services firms has changed over time (Figure 10).

Figure 10 The rise of financial services firms in the mini-bond market over time



The vertical axis displays the percentage of mini-bond issuers accounted for by firms in the financial services sector in each year.
Base: Mini-bond issuers in the UK in each year 2009-2019 (2009: N=1, 2010: N=2, 2011: N = 4, 2012: N=4, 2013: N=10, 2014: N=11, 2015: N=18, 2016: N=18, 2017, N=11, 2018: N=7, 2019: N=4)
LE mini-bond register and FAME data

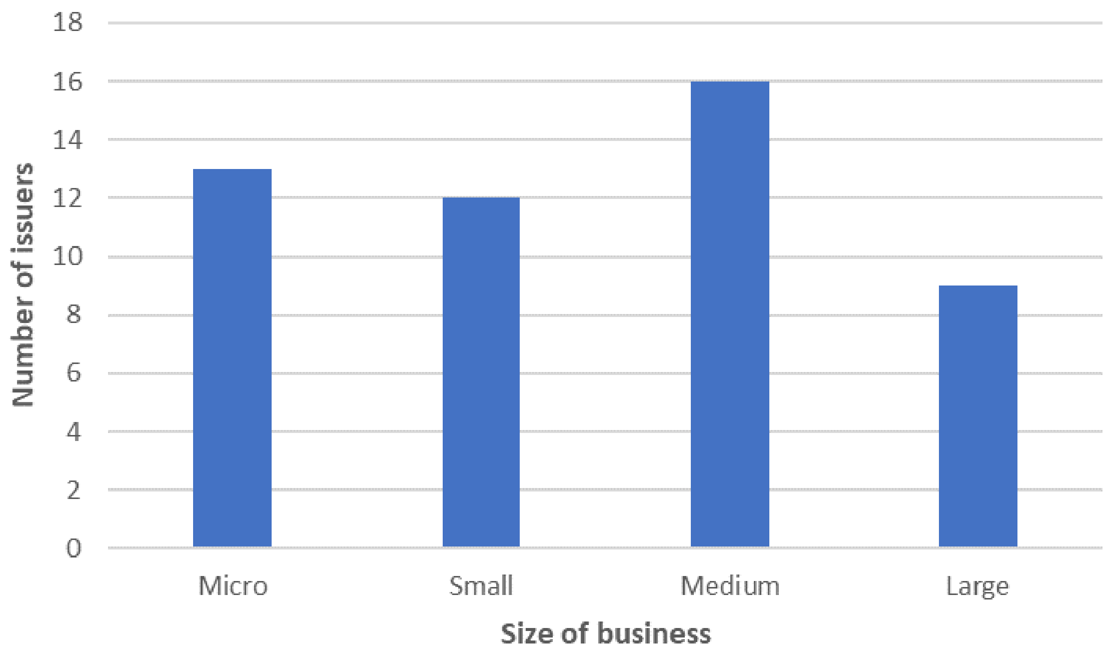
The first financial services issuer entered the market in 2011; the high proportion of issuers that the financial services issuers accounts for in 2011 and 2012 is a function of the mini-bond market's small size in these years. Financial services firms accounted for a smaller fraction of the market in 2013 and 2014 as their number remained constant while the rest of the market grew. Financial services firms accounted for a growing proportion of the market from 2015 through to 2017; this reflects a surge in the number of mini-bond issuers rather than a decline in the number of issuers from other sectors. The share of issuers accounted for by financial services firms peaked in 2017; it was early in this year that the FCA's 'Dear CEO' letter to loan-based crowdfunding platforms, discussed above, was published.

The share of issuers accounted for by financial services firms fell in 2018 and 2019. The total number of issuers was lower in each of these years than in the years immediately before, mirroring the decline of the mini-bond market that we have identified, but the number of financial services firms exhibited a larger fall in proportional terms though again in the context of a small sample size. The rise of the Innovative Finance ISA (IFISA) may be one of the drivers of this decline in mini-bond activity by financial services firms. Several stakeholders interviewed as part of the research for this study reported that IFISA eligibility is attractive both because of the tax advantage the IFISA confers and because the IFISA 'badge' is seen as a sign of legitimacy. Financial services firms, like many other firms, may therefore be choosing to issue legally transferable unlisted debt securities rather than mini-bonds, but that market is not considered as part of this study.

Reputational damage and heightened scrutiny as a result of the high-profile failures of financial services issuers such as LCF and MJS (later Colarb) Capital means the trend of declining activity in the mini-bond market by financial services firms is likely to continue.

4.1.2 Size

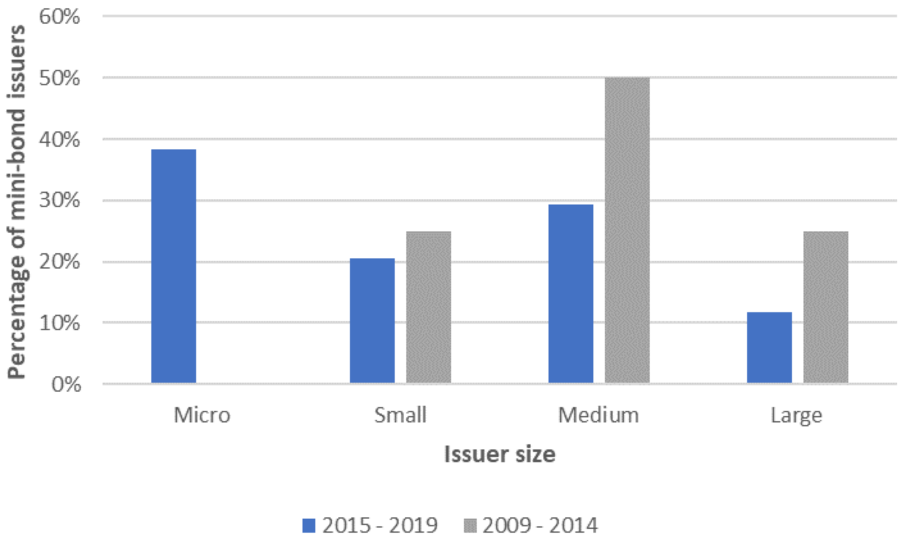
Figure 11 Number of mini-bond issuers by business size



Here, firms with one to nine employees are classified as micro-enterprises, firms with 10 to 49 employees are classified as small businesses, firms with 50 to 249 employees are classified as medium-sized businesses, and firms with 250 employees are classified as large businesses. The data for issuers' number of employees is taken from the year of the mini-bond issue where this is available (as was the case for the majority of issuers); otherwise, the data is taken from the first year after the issue for which data is available. Companies for which size data is unavailable are omitted from the calculations. Each issuer is counted once; if an issuer issued mini-bonds in more than one year, its size in the year in which its first mini-bond issue occurred is used.
Base: Mini-bond issuers in UK, 2009-2019 (N=50)
LE mini-bond register and FAME data

Similar numbers of micro-enterprises and small, medium-sized and large businesses issue mini-bonds (Figure 11). Medium-sized businesses are the most numerous class of mini-bond issuers, while large businesses are the least numerous class. It is worth noting, though, that large businesses are the least numerous of these categories within the population of UK companies. They are in fact overrepresented amongst mini-bond issuers. This is also true of medium-sized firms.

Figure 12 Comparison of mini-bond issuer size before 2015 and from 2015 and onwards



The same assumptions are made for this chart as for Figure 11.

Base: Mini-bond issuers from 2009 to 2014 (N=20) and from 2015 to 2019 (N=34)

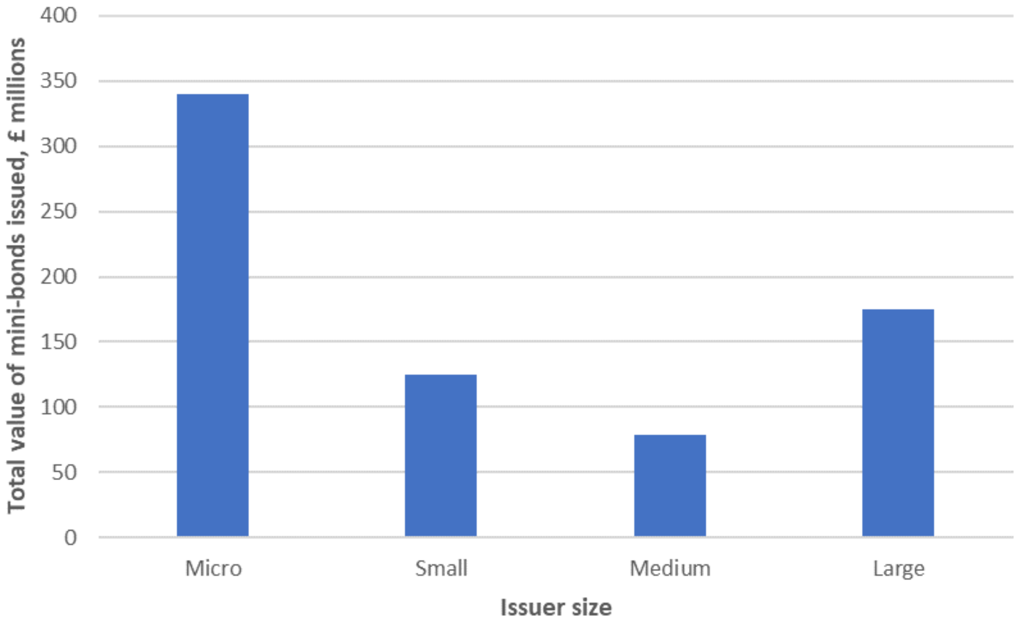
LE mini-bond register and FAME data

Two main differences can be discerned in the composition in terms of size of mini-bond issuers from 2015 to 2019 compared to 2009 to 2014 (Figure 12).

The first of these differences is that micro-enterprises account for a far larger proportion of issuers in the later period than in the earlier period. Having not been present in the market in the first period, these micro-enterprises accounted for nearly 40% of issuers in the second period. This is another manifestation of the increased presence of financial services firms in the mini-bond market; all of these micro-enterprises are financial services firms.

Another notable point of difference between the two periods is that the share of mini-bond issuers accounted for by medium-sized and large businesses fell markedly from the first period to the second. This is both because of the influx of small financial services firms into the market and an absolute decline in the number of medium-sized and large businesses.

Figure 13 Value of mini-bond issues by issuers of different sizes



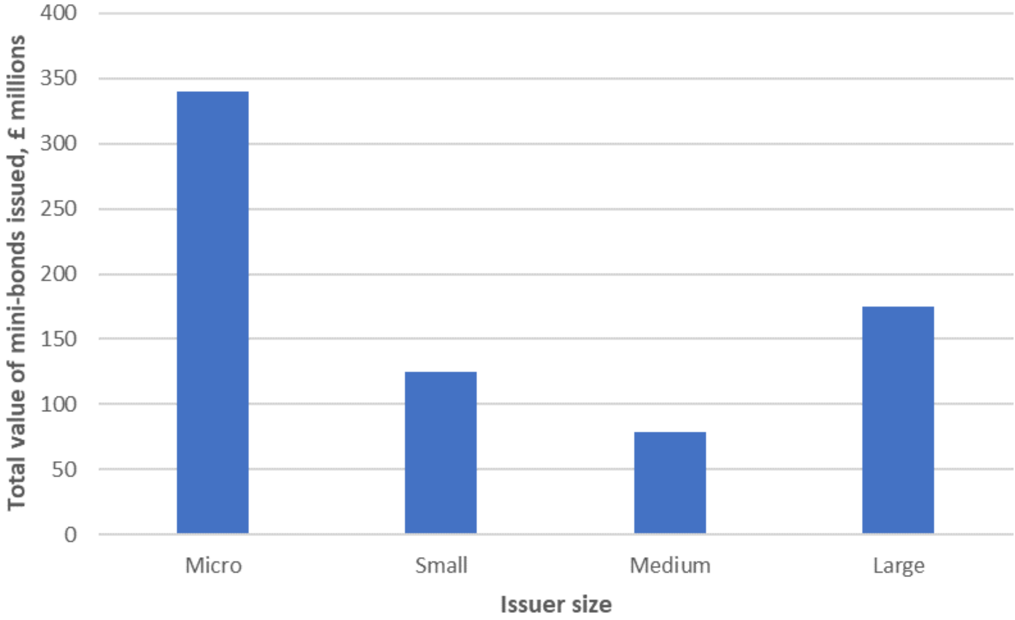
The assumptions for this chart are the same as for Figure 11 above.

Base: Mini-bonds issued in the UK, 2009 to 2019 (N=132)

LE mini-bond register and FAME data

Micro-enterprises and large businesses are the two firm sizes that have issued the most mini-bonds by value (Figure 13). The micro-enterprises are all financial services firms; LCF accounts for the majority by value of the mini-bonds issued by micro-enterprises. The fact that large firms account for a relatively large proportion of mini-bond issues by value can be explained by two factors. Firstly, large firms are likely to need finance for larger projects and therefore have greater funding needs than smaller firms (although they will also tend to have superior access to other sources of finance than smaller businesses do). Secondly, large firms are likely to be older and, therefore, to have a greater level of customer loyalty and brand recognition than smaller firms. Their issues are therefore likely, all else equal, to be larger in value.

Figure 14 Comparison of percentage of mini-bonds by value issued by businesses of different sizes



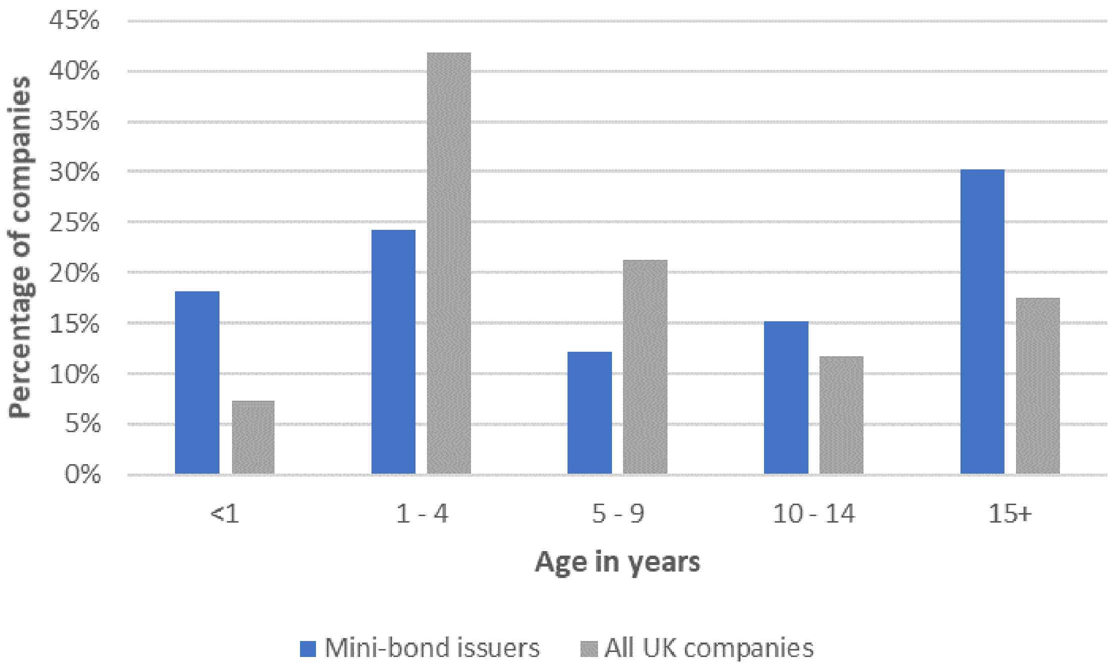
Firms are classified by size by the same method described in Figure 11.

Base: Mini-bonds issued in the UK, 2009 to 2019 (N=132)
LE mini-bond register and FAME data

From 2015 to 2019, the percentages of mini-bonds by value that were issued by micro-enterprises and small businesses is far higher than in the between 2009 and 2014; in contrast, the percentages by value of mini-bonds that were issued by medium-sized and large businesses is far lower in the latter period than in the former period (Figure 14). This reflects the rise of financial services firms in the mini-bond market; these firms account for all of the micro-enterprises and a large fraction (by number or by value) of small businesses issuing mini-bonds.

4.1.3 Age

Figure 15 Comparison of ages of companies issuing mini-bonds with all UK companies



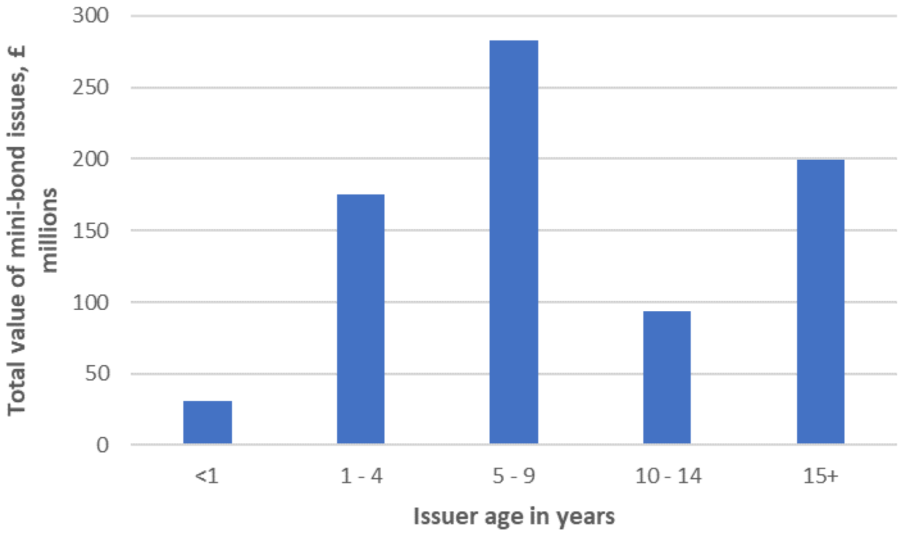
Mini-bond issuers' ages are given for the end of the year in which the mini-bond issue occurred. Each issuer is counted once; if an issuer issued mini-bonds in more than one year, its age in the year in which its first mini-bond issue occurred is used. The data for all UK companies is taken from the Companies House Companies Register Activity 2017-18, and uses the effective register (Companies House, 2018).

Base: Mini-bond issuers in the UK, 2009 to 2019 (N=66) and all UK companies (N=3,896,755)
LE mini-bond register and FAME data

Companies less than a year old are overrepresented amongst mini-bond issuers relative to the population of UK companies (Figure 15). This is a potential cause for concern. Mini-bonds are a debt-based product, and the company's performance dictates whether or not the investor's principal will be returned to them when the bond matures. As such, mini-bonds appear more appropriate for companies with a 'track record' from which inferences about their likely future performance can be made.

Meanwhile, though, companies 10 or more years old are also overrepresented amongst mini-bond issuers relative to the population of UK companies. This fact supports our thesis that two distinct models of mini-bond issuance are simultaneously present in the market: one by new, financial services companies raising funds to invest into projects by third parties, and one by existing companies who are seeking to mobilise an existing customer base in pursuit of cheaper funds for expansion.

Figure 16 Value of mini-bond issues by issuers of different ages



Issuers' ages at the end of the year in which the mini-bond issue are used. In a minority of cases, there was not data at a sufficient level of disaggregation to perform this analysis; in such cases the mini-bond issue(s) in question was omitted from this analysis.

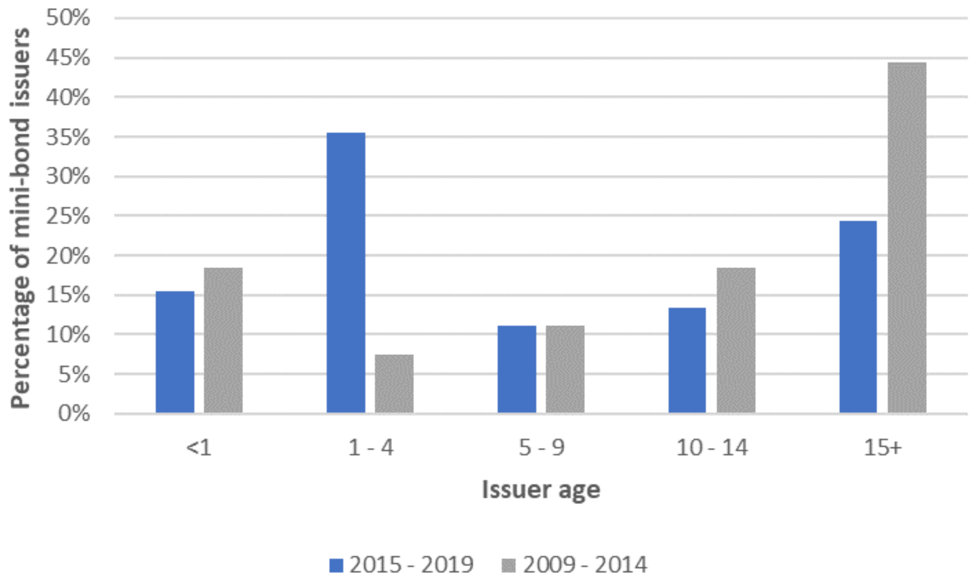
Base: Mini-bonds issued in the UK, 2009 to 2019 (N=127)

LE mini-bond register and FAME data

Issuers aged between five- and nine-years account for a greater value of mini-bond issues than any of the other age groups considered (Figure 16). This is striking given that this age group is the least numerous one – see Figure 15. This initially surprising finding can be explained by the fact that LCF was aged between five and nine years old for all but one of its mini-bond issues (and that one was by far its smallest issue by value). Having issued around £237 million of mini-bonds, LCF was by far the biggest issuer of mini-bonds and accounted for a very significant share of the market by value.

It is notable, and perhaps of concern, that investors chose to invest at least £30 million in debt-based products with companies less than a year old, with no 'track record' of performance. The value of £34 million is likely to be an underestimate as it was this was one of the age categories for which sufficiently disaggregated data was least likely to be available.

Figure 17 Comparison of mini-bond issuer ages before 2015 and from 2015 to 2019



Mini-bond issuers' ages are given for the end of the year in which the mini-bond issue occurred. If an issuer issued mini-bonds in more than one year before 2015, its age in the year of its earliest issue in that period is used. The chart uses percentages of issuers, rather than absolute numbers.

Base: mini-bond issuers 2009 to 2014 (N=27) and 2015 to 2019 (N=45).

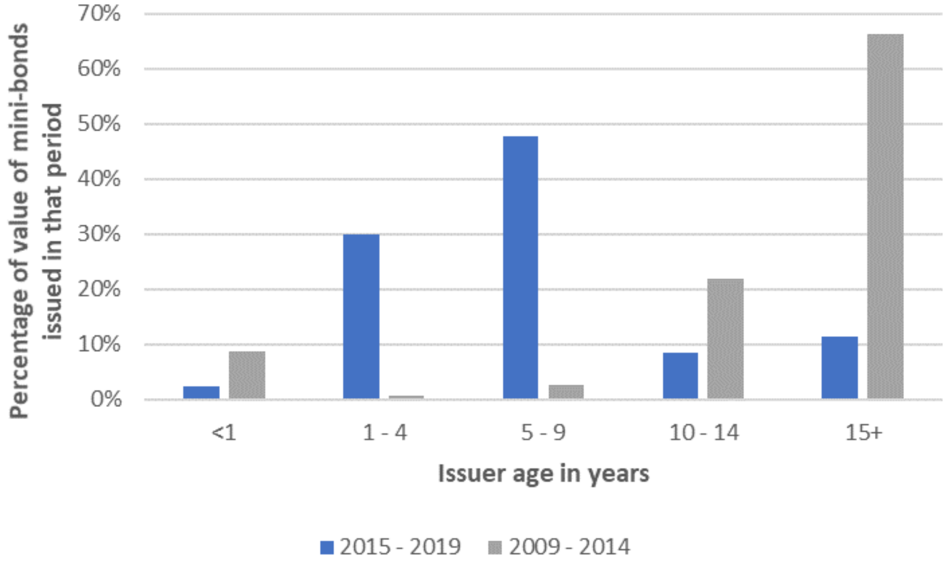
LE mini-bond register and FAME data

The age profile of companies issuing NTDSs differed between the period 2009 to 2014 and the period 2015 to 2019. The principal differences between the two periods are as follows. Firstly, the proportion of issuers that were at least 10 years old is significantly higher before 2015 than from 2015 onwards (it is approximately 60% in the former period, compared to less than 40% in the latter). Secondly, the proportion of issuers that were between one and five years old from 2015 onwards is more than triple the proportion of issuers before 2015 who fell in this category.

This growth in the proportion of relatively young firms amongst mini-bond issuers is another result of the rise of financial services firms as mini-bond issuers. Financial services firms issuing mini-bonds are significantly younger than other mini-bond issuers; the average age of a financial services firm issuing a mini-bond is less than three years old, while the average of firms from other sectors issuing a mini-bond is nearly 16 years old.[24] The implications of this were described above, in section 4.1.1 and earlier in this section.

[24] In calculating this average, each issuer is considered only once; if an issuer issued mini-bonds in more than one year, its age in the year in which its first mini-bond issue occurred is used. Issuers' ages at the end of the year in which they issued the mini-bond are used. This average concerns issuers throughout the lifetime of the mini-bond market.

Figure 18 Comparison of percentage of value of mini-bonds issued by companies of different ages, before 2015 and from 2015 to 2019



Issuers' ages at the end of the year in which the mini-bond issue are used. In a minority of cases, there was not data at a sufficient level of disaggregation to perform this analysis; in such cases the mini-bond issue(s) in question was omitted from this analysis.
Base: Mini-bonds issued in the UK, 2009-2019 (N=132)
LE mini-bond register and FAME data

When one compares the periods 2009 to 2014 and 2015 to 2019, two changes in the percentage of the value of mini-bonds issued by companies of different ages are particularly marked. Firstly, the percentage by value of mini-bonds issued by companies at least 10 years old is far lower between 2015 and 2019 than between 2009 and 2014. Secondly, the percentage by value of mini-bonds issued by firms between one year old and nine years old is considerably higher from 2015 than before 2015. These changes can be explained by the rise of financial services firms in the mini-bond market from 2015. Financial services are disproportionately represented amongst mini-bond issuers younger than 10 years old. LCF, a financial services firm, accounts for a very large proportion of the value of mini-bonds issued by firms aged between five and nine years.

4.2 Drivers of NTDS issuance

This section explores what motivates firms to choose to issue a mini-bond rather than pursuing other routes to finance. The motivations identified includes easier access or better terms than other forms of debt-based capital, advantages of debt-based finance over equity-based finance, and the potential to build brand equity. It concludes by noting some drawbacks and risks associated with min-bonds for the issuing firm.

4.2.1 Easier access or better terms than other debt-based capital

One attraction of mini-bonds is that they are often easier to access and cheaper, either in terms of the cost of credit or in terms of regulatory and other administrative costs, than other debt-based funding sources.

Mini-bond issuance is attractive to some firms as it is cheaper for some firms than bank finance; a number of issuers interviewed in the research for this study reported that they faced lower interest rates with mini-bonds than with bank loans. This may be attributed to two factors. Retail investors may demand a lower risk premium than banks – either because they are less risk-averse or because they assess the risk as being lower – or it may be that the cost to issuers is lower in the case of mini-bonds as disintermediation cuts out intermediation costs.

Mini-bonds may also be preferable to bank finance because of terms other than interest rates; mini-bond issuance may allow them to access finance without facing other requirements (perhaps reporting requirements or constraints on further borrowing) that banks would otherwise impose on them.

Mini-bonds also offer a potential source of debt-based funding when banks are unwilling to provide further finance. Multiple stakeholders interviewed as part of the research for this study reported that they turned to mini-bonds when they already had bank finance but were unable to get any further such finance (at a reasonable cost); seven of 14 issuers responding to the relevant question in our stakeholder survey gave “insufficient finance being offered by banks” as one of the top three drivers of their mini-bond issue.

The regulatory treatment of mini-bonds means that they are cheaper to issue than listed bonds. Since they are non-transferable, they are exempt from the Prospectus Regulation Rules. Listed bonds, meanwhile, are transferable and generally require an FCA-approved prospectus (FCA Handbook PRR 1.2). An Impact Assessment by HMT on the Prospectus Regulations 2018 finds that the “estimated cost of producing a prospectus ranges from 7 to 12 percent of the funds raised” (HM Treasury, 2018). This is a significant cost. Issues of listed bonds in the UK are also subject to the FCA’s Listing Rules, which add further administrative costs which are likely to be felt particularly by smaller firms. In addition, the stock exchange where the bond is issued may have a set of its own further requirements.

Another consequence of the lower regulatory and administrative burdens associated with mini-bonds compared to alternative sources of finance is that mini-bonds are a faster way of accessing finance than alternatives are. Multiple stakeholders interviewed during the research for this study reported that the speed of access to finance mini-bonds permitted was a key attraction of the product.

“Most small businesses are more interested in the speed of access to finance than the cost of that finance” - Rich Wagner, CEO of APS Financial (trading as Cashplus)

4.2.2 Advantages of debt-based finance

In the interviews conducted as part of the research for this study, several stakeholders compared mini-bonds to equity-based fundraising. These stakeholders commented that it was an advantage of mini-bonds that they did not involve a loss of control of the company or a dilution of the equity of existing shareholders, as an equity issue would. A mini-bond issue also involves defined commitments over (typically) a defined, relatively short term for the issuer, whereas an equity issue can bring with it long-term commitments.

These considerations are perhaps particularly pertinent for firms less than a year old, which account for around twice as large a fraction of mini-bond issuers than of all UK companies. As they lack a ’track record‘ of performance and historical financial information, firms of this age are intuitively more suited to equity-based finance than to debt-based finance.

4.2.3 Brand value

Another driver for mini-bond issuance by firms is that mini-bond issuance is seen as an opportunity for company-customer engagement that would otherwise not occur, which can ultimately lead to greater sales. When retail investors invest in a mini-bond, this represents an interaction between the issuing company and the retail investors. Such an interaction can increase the issuing company's brand equity – where 'brand equity' is the value to a company of its brand and the recognition of and attachment to it that consumers have (Aaker, 1991) – through two mechanisms. A mini-bond launch is likely to increase consumers' knowledge and understanding of a brand. When consumers see the NTDS issue advertised or reported on, they will see the brand name and be reminded of it, and may be prompted to do research into the company and its products, plans and ethos. In addition, investing in a brand is likely to deepen a consumer's relationship with that brand. Someone who has invested in a company has a stake in it doing well and is likely to feel some sort of affinity with it.

The second of these mechanisms appears to be particularly important. Many of the stakeholders interviewed as part of the research conducted to inform this study reported that the ability to engage with customers through a mini-bond issue was a key motivation for choosing a mini-bond over alternative sources of finance.

"We were not interested in reaching out to people who knew nothing about us and just wanted a financial reward…we wanted people who had skin in the game." – Mark Adams, Managing Director of Vitsoe

Five out of 14 issuers who responded to the question in the stakeholder survey conducted as part of the research for this study about motivations for issuing a mini-bond stated that developing their relationship with their customers was their primary motivation in choosing to issue a mini-bond. Another respondent said that it was their second most important motivation in choosing to issue a mini-bond.

The fact that companies issuing mini-bonds view their mini-bond issue as an opportunity for engagement with consumers that they can derive benefit from is further evidenced by the fact that some NTDS issues have offered investors the choice between cash and loyalty points or store credits as coupon payments. Some have included products – such as burritos or boxes of chocolate – as some or all of the coupon payments.

The significance of this customer-engagement-based driver is likely to have been greater in the earlier stages of the mini-bond market. More recently, there has been an influx of young, small financial services firms entering the mini-bond market (see Section 4.1 for more detailed analysis and discussion of this trend). These firms are likely not to choose to issue a mini-bond for the sake of building brand equity, since their businesses do not involve 'passion brands' and are not consumer-facing in the way that businesses in, for instance, the food and drink sector are.

4.2.4 Caveats and barriers

There are, however, caveats to the foregoing analysis. Mini-bond issuance does have risks, barriers and drawbacks associated with it for issuers.

Mini-bond issues have the disadvantage for issuers that there is uncertainty about the amount of finance they will raise. Not all mini-bond issues have been successful in raising the desired amount of finance. This uncertainty hampers firms' ability to conduct financial planning.

Several stakeholders interviewed as part of the research for this study stated that one of the primary risks of mini-bond issuance for firms is the risk of reputational damage if they are unable to fulfil their obligations to bondholders, since in the case of a mini-bond these bondholders are often ordinary members of the public.

Finally, while the administrative costs and regulatory burdens associated with mini-bond issuance are lower than for listed bond issuance, they are not non-existent. Especially in light of the uncertainty around the amount of finance that a mini-bond issue will raise, this is a potential barrier to mini-bond issuance for firms. One issuer interviewed as part of the research for this study reported that the administrative and regulatory difficulties involved in issuance were such that they nearly abandoned the issue.

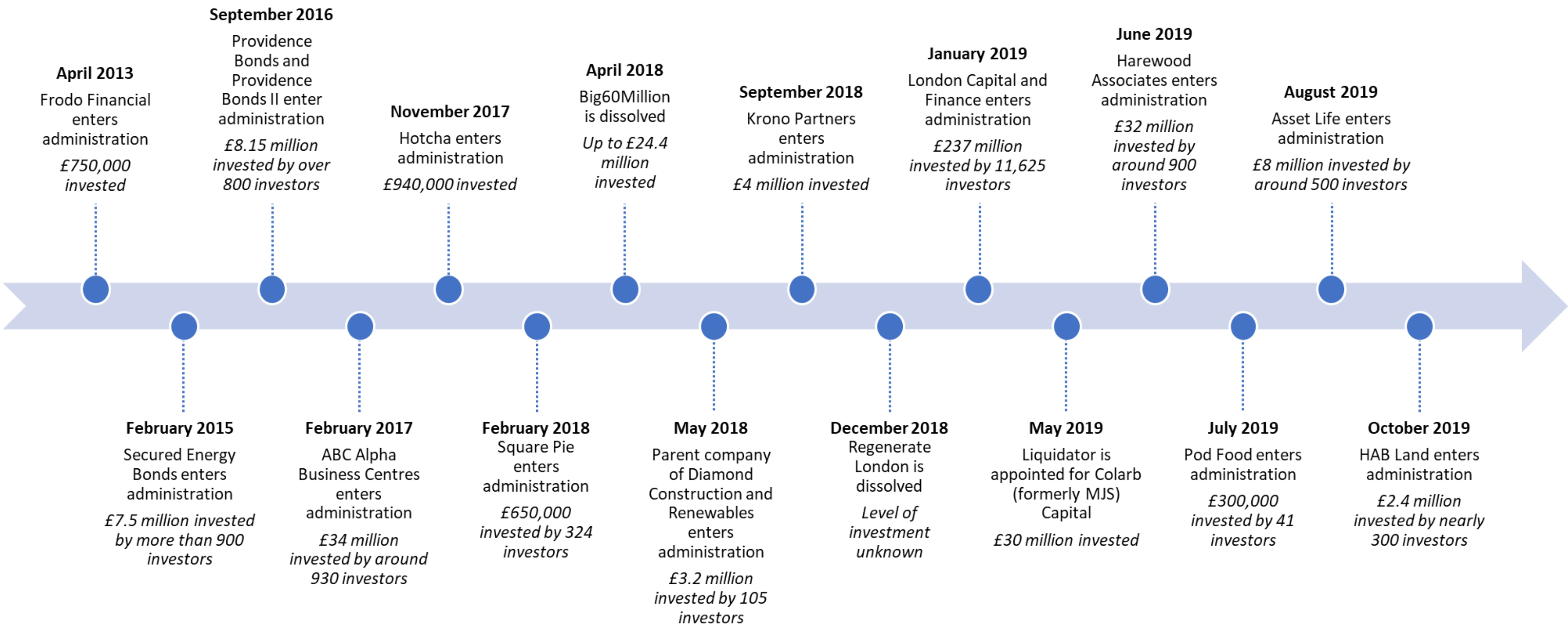
4.3 Failed issuers

At least 16 issuers of mini-bonds have entered administration or liquidation after issuing their mini-bond, and at least one mini-bond intermediary has entered administration. This means that almost a quarter (24%) of all issuers identified during the research defaulted. If this historical record was interpreted as a probability of losing capital when investing in mini-bonds, this implies a one in four chance. This level of credit risk is very high compared to other bond markets. The statistic is even more concerning considering that mini-bonds have only existed during a sustained economic expansion. It is likely that the default rate would be even higher in a recession.

The most prominent failure by a mini-bond issuer was that by LCF, which entered administration in January 2019 after issuing mini-bonds worth around £237 million to over 11,600 investors (Smith & Williamson, 2019b). Other large failures include those by Harewood Associates (Stanley, 2019) and MJS (later Colarb) Capital (Armitage, 2019), which entered administration after issuing mini-bonds worth around £30 million each. This section will describe some common themes and features relating to failures by mini-bond issuers.

The following timeline shows when mini-bond issuers entered administration or liquidation, as well as the level of investment and number of investors in their mini-bonds.

Figure 19 Failed issuers timeline



Time is not displayed linearly here.

LE stakeholder register and LE mini-bond register

4.3.1 Investor returns

When a mini-bond issuer fails, an investor faces losing a large amount of their initial investment. The administrators of LCF estimate that bondholders may receive back as little as 25% of their initial investment (Smith & Williamson, 2019a). Meanwhile, the administrators of Providence Bonds, which went into administration after issuing mini-bonds totalling over £8 million in value (Boyce, 2016), were unable to recover enough assets to make any payments to the bondholders (Deloitte, 2017).

When the mini-bonds issued by companies going into administration were secured, often this has not provided the protection to investors that they might have expected. LCF's mini-bonds were secured, but as described above, investors face receiving back just 25% of their initial investment. LCF's mini-bonds were secured by a debenture over LCF's assets. These assets were mostly loans to a small number of companies, a number of which were not independent of LCF. These companies do not, according to the most recent report of LCF's administrators at the time of writing, have sufficient assets to pay these loans (Smith & Williamson, 2019a). The mini-bonds of SEB, which went into administration in 2015 after issuing around £7.5 million in mini-bonds (Boyce, 2018), were sold as secured bonds – but they were to be secured against the solar projects whose installation the funds were to pay for and the revenue from them, and only less than a quarter of these installations actually took place (see below).

Sub-section 2.4.3 provides more information on FSCS compensation for investors in failed mini-bonds. Sub-section 5.3.3 explores investors' perceptions around failed issuers.

4.3.2 Use of funds by failed issuers

Some failed mini-bond issues have seen the funds raised through the mini-bonds used for purposes other than those investors believed they would be used for. In the case of LCF, investors were led to believe that LCF was going to invest the funds it received into a large number of other companies. In fact, 25% of the money raised was paid as commission to the marketing firm Surge Financial Ltd, and the funds which were actually invested went into just 12 companies, many of which were in some way related to LCF and which "can be further consolidated into only four controlling groups/entities" (Smith and Williamson 2019a). Another case where investors' expectations as to how the money they invested was going to be used was that of SEB. Investors believed that their invested funds would pay for the installation of solar panels in 22 British schools (Donovan, 2018); in fact, a large portion of the invested funds were "siphoned off" by SEB's Australian parent company (Boyce 2018), which itself entered administration in 2014. Just six of the planned 22 installation projects were completed as of September 2015 (Collinson 2015). Providence Bonds, meanwhile, spent around 20% of the funds its mini-bond issues raised on launching the bonds and marketing (Boyce 2016).

Firms raising funds through a mini-bond issue to then invest on into other projects, as opposed to firms raising funds to expand their own businesses, are overrepresented amongst failed mini-bond issuers. LCF was one of these firms. The increasing presence of such firms in the mini-bond market has been a noticeable trend in recent years.

5 Investors

This section focuses on the investor perspective of mini-bonds. First, it reviews the characteristics of people who invested in NTDSs and explores the main drivers for investing in the product. The section then describes the experiences of investors with mini-bonds and assesses their understanding of the risks.

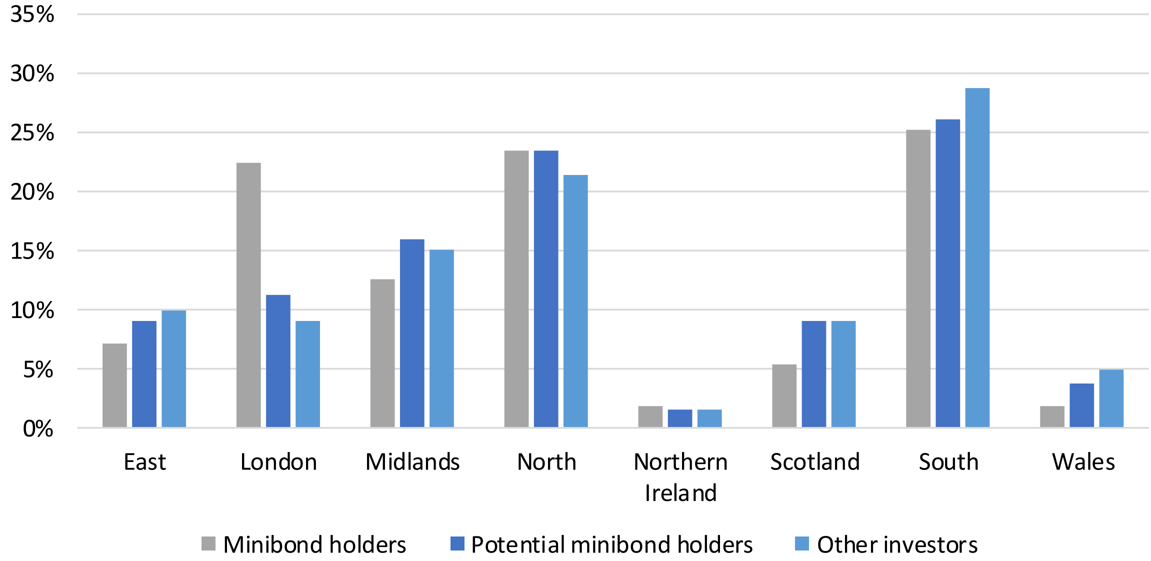
5.1 Investor characteristics

5.1.1 Socio-demographic characteristics and attitude to risk

The investor survey shows that NTDS holders span all socio-demographic groups, but on average they tend to be older and wealthier compared to the general population. There is also a skew towards men. However, all of these characteristics are typical also of other types of investors in the survey sample. To identify any distinguishing features of NTDS investors, their characteristics should therefore be compared to other investors rather than to the population at large.

The most obvious difference is the disproportionate concentration of minibond holders in London. Almost a quarter (23%) of NTDS holders in the survey sample live in London (Figure 20). By contrast, only 9% of people who hold other investment products reside in London. The rest of NTDS holders are distributed across the country in a similar way to other investors.

Figure 20 Minibond holders and other investors by region



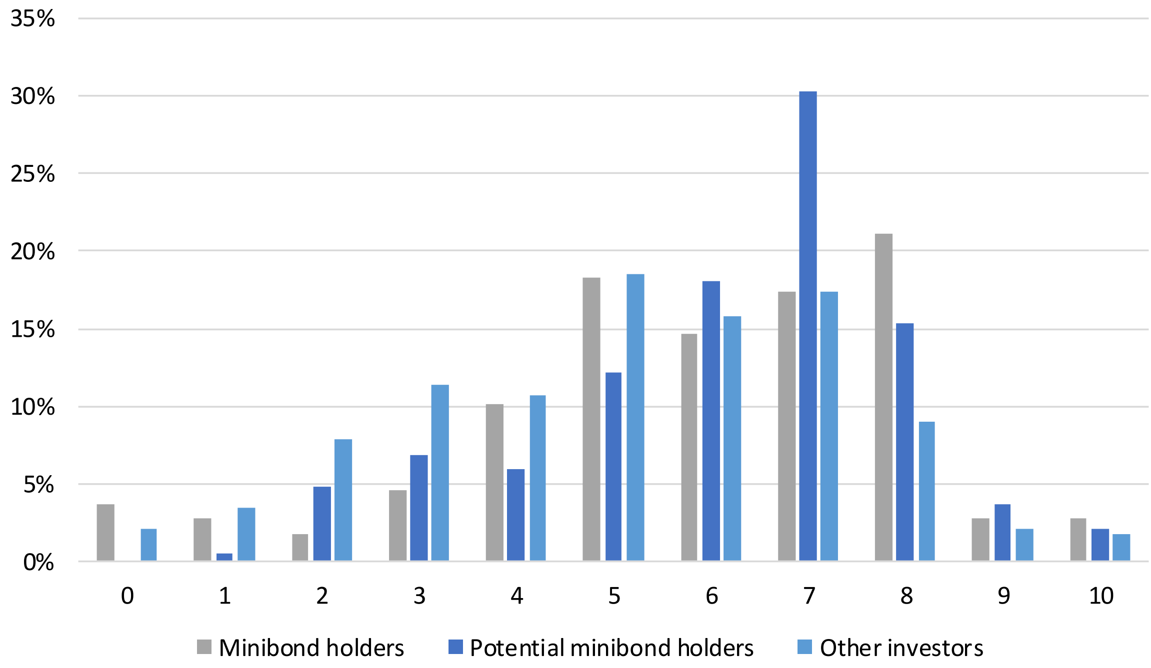
Base: current and past mini-bond holders (N=111), respondents considering investment in mini-bonds (N=188), other investors (N=4,220).

YouGov and LE investor survey

Another difference can be observed in attitude to risk. Mini-bonds are riskier products than most other investments recorded by YouGov. We would therefore expect a higher degree of risk tolerance among NTDS holders than other investors in the sample.

Figure 21 shows that this is indeed the case. The willingness to take risk of mini-bond holders and respondents who are considering investing in mini-bonds is, on average, higher than the willingness to take risk of other investors. Attitude to risk is measured on a scale from 0 to 10, where 0 indicates low willingness to take risks while 10 represents high willingness. Nearly half (44%) of mini-bond holders in the survey sample had a score higher than 6, while only 30% of other investors exhibited this level of risk appetite. Respondents who are currently considering investing in mini-bonds displayed highest willingness to take risks, with 52% scoring higher than 6.

Figure 21 Attitude to risk (0 = unwilling to take risk, 10 = fully prepared to take risks)



Base: current and past mini-bond holders (N=111), respondents considering investment in mini-bonds (N=188), other investors (N=4,004).

YouGov and LE investor survey

Descriptive statistics can show interesting differences between different investor groups, but they cannot isolate the effect of an individual characteristic on the choice of an investment product. For example, it is not necessarily the case that higher willingness to take risks makes people more attracted to mini-bonds. On average, mini-bond holders tend to have more investable assets than other investors in the survey sample.[25] And people with more money to invest may be more likely to accept more risks. Descriptive analysis cannot disentangle whether larger savings or higher risk tolerance leads investors to choose NTDSs.

This question can be addressed with an econometric analysis that estimates the effects of socio-demographic characteristics, while controlling for other influences. The binary choice between NTDS or other investment is best modelled using a logistic regression, with explanatory variables including gender, age, region, income, social grade, investable assets and risk attitude.[26] Annex A2.1.3 provides the detailed estimation approach and the full set of results.

[25] "Investable assets" include types of assets from a pre-defined list of common investments maintained by YouGov. The full list is available in Annex A2.1.

[26] Social grade is a classification widely used in market research. It is based on the occupation of the chief income earner of the household and the two main categories can broadly be interpreted as middle class and working class.

The key findings are:

- The econometric analysis confirms the result that **London residents are more likely to invest in NTDSs**. The effect is statistically significantly even when other variables are controlled for.
- The analysis also finds that **younger investors are more likely to invest in NTDSs** compared to older investors.
- NTDS holders have a higher risk appetite, but this effect marginally fails the test of statistical significance.
- No other socio-demographic characteristics are found to be statistically significant predictors of choices between NTDSs and other investments.

The characteristics of NTDS investors were also studied in the 2016 'Funder Survey' by the CCAF, disseminated through alternative finance platforms. The survey attracted responses from 8,370 alternative finance investors in the UK, including 578 investors in unlisted debt securities. The disaggregated results suggest, for example, that 80% of unlisted debt securities investors are male, 25% earn less than £25,000 and 59% are aged over 55 (Zhang et al, 2017).

In the YouGov/LE survey, 66% of NTDS investors are male, 29% earn less than £25,000 and 35% are aged over 55. Compared to the CCAF survey, our survey relies on a smaller sample, but it isolates NTDS investors and captures both those who invested through a platform and those who invested directly. Most importantly, the YouGov/LE survey is able to compare the characteristics of NTDS investors with owners of more conventional investment products.

5.1.2 Investor exposure

Based on the investor survey, the average amount of funds that past and current NTDS holders invested in mini-bonds is estimated at £11,100.[27] Investors split their investment between 2.28 mini-bonds on average, suggesting low levels of diversification. Moreover, this measure may understate the actual risk concentration because some mini-bond investors in the sample invested in several mini-bonds issued by the same company.

At £4,000, the median investment is substantially lower than the average investment. This is because many investors put relatively low amounts into mini-bonds. The investor with the lowest exposure in the sample invested £300. The highest investment amounts to £100,000, but this value is an outlier; the other highly exposed investors in the sample invested funds in the low tens of thousands. Investments in one individual mini-bond range from £100 to £80,000.

5.2 Drivers for investing in NTDSs

The research identified two principal drivers of mini-bond investments: higher return than low-risk savings products and – in cases where the issuer is a consumer-facing business – the investor's relationship with or perception of the firm.

[27] The summary statistics are based on 45 past and current mini-bond holders, who reported in the survey the amount they invested in each of the mini-bonds they hold or held in the past.

5.2.1 Higher return than savings products

The consulted IFAs indicated that for experienced investors comfortable with taking risks, there is a case for allocating a small share of their portfolio to mini-bonds (ideally a broad spectrum to spread risk). Mini-bonds can provide a diversification from equity investments with attractive features including high return, defined outcome, regular income and lower risk compared to equity investments in similar companies.

However, our in-depth interviews with issuers, intermediaries and investors suggest that the more common route to mini-bond investments is from low-risk savings products. The investors are motivated by the high interest rates offered compared to cash ISAs and time deposits (fixed-rate 'bonds'), often stating that their money would be invested in a low interest ISA if not in a mini-bond. Many have become frustrated with the low interest rates of more secure financial products and have started to take greater risks in search of higher income (especially if nearing or in retirement).

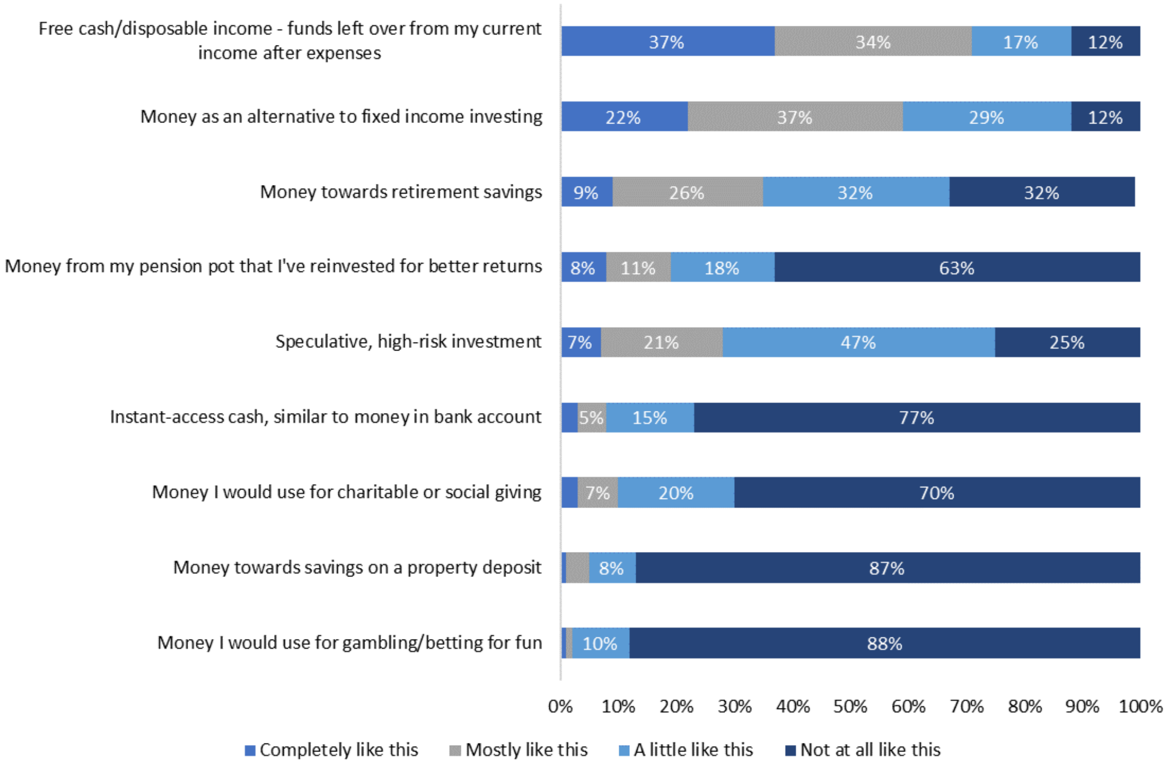
"I was attracted by the interest rates… 4x what I would get with my bank. It boosts my monthly earnings – extra £100 per month on my savings." (Male, 65)

"Mini-bonds tend to appeal more to people moving their money from cash than to those moving from 'pure' investments." Adrian Lowcock, Head of Personal Investing at Willis Owen

Mini bonds are often appealing to investors who have some financial knowledge and experience, from either working in the finance sector or from having invested over a number of years. They often have a varied portfolio and are looking for something they can enjoy investing in with a good return (and interesting perks). For investors who may feel overwhelmed by the stock market, mini bonds are filling a gap in the market where traditional fixed-rate 'bonds' or cash ISAs used to sit, when they offered higher returns.

The 2016 CCAF survey of investors in platform-facilitated unlisted debt securities confirms this finding (see Figure 22). Most respondents perceive the funds they invested in unlisted bonds as savings ("funds left over from my current income after expenses"). A large majority considers their mini-bond investment "an alternative to fixed income investing". Only 28% think of the investment primarily as "speculative, high-risk investment" although a further 47% admit that it is "a little like this". This suggests that investors are mostly aware that unlisted bonds are riskier than traditional savings products, but still view mini-bonds as an alternative to such low-risk investments.

Figure 22 Investor perceptions of the funds invested in unlisted bonds



Base: Investors in platform-mediated unlisted debt securities (N=578)

Zhang et al (2017), chart recreated by London Economics

5.2.2 Relationship with issuer

"I saw Ecotricity wanting to grow. I liked their idea and ethos. It was about the company rather than the mini bond product. We are long term customers of them. I thought it sounded good as eco and ethical." (Female, 59)

The second key driver of mini-bond investments is the attitude of the investor towards the brand or the product of the issuer. Those investing in consumer-facing businesses (e.g. Ecotricity, Chilango, BrewDog), either directly or via a platform, are often motivated by a belief and trust in the brand, their products and the company's ethos. Many spoke of feeling confident in the mini bond because they like the issuer's product and have seen, purchased or tasted it. They want to feel part of the company and to help it grow. The investors are often regular customers, shareholders or members/employees of the provider.

Benefits in kind (e.g. discounts on the products, weekly credit, and investor events) make the bonds more attractive to those who are engaged with the firm, but also play a role in feeling part of the company. This aspect can make the investment an emotional experience for some. In some cases, investors recalculate the perks into a financial return. For example, a respondent who works in the finance sector added up the amount of money he would save per week on his lunch by gaining a £10 weekly credit on burritos. He then calculated the percentage gain from this on the total return on the mini-bond.

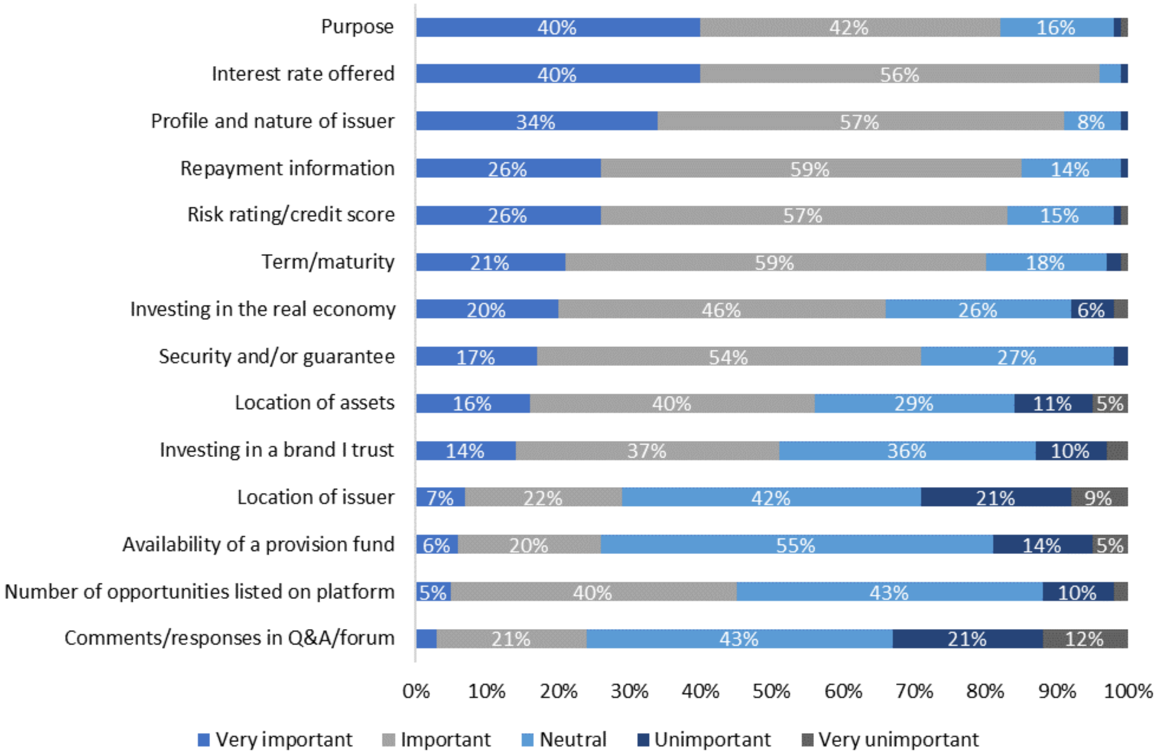
The consulted consumer-facing issuers (e.g. Leon, Lancashire Cricket Club, Vitsoe, Ecotricity) confirm that their investors tended to be people with a pre-existing relationship to the firm, often customers. Some issuers (e.g. John Lewis) offered their mini-bond exclusively to customers and staff (Macalister, 2011). While all stakeholders recognise the importance of both financial return and engagement with the firm, there is no consensus about the relative importance of the two. Some also see the novelty and sense of innovation around mini-bonds as an additional driver of investor interest.

"With the vouchers, plus the % return it works out at 7% return on investment. There is a heritage to the Jockey Club, they have been around for hundreds of years. (Male, 47)

In contrast to consumer-facing businesses, the interviewed investors investing in mini bonds issued by financial services firms like LCF, Harewood Associates and Wellesley & Co were especially enticed by the high interest rates, less so by the product or brand. These investors may not even know who the end companies are that their money is being invested in. In the interviews we found that these types of investors tended to be less experienced investors who had come into money (e.g. pension, inheritance) or had some spare cash, which they wanted to use to generate income. They tended to be older and focused on how to secure finances for their upcoming or recent retirement.

The 2016 CCAF survey confirms the influence of “purpose” in investors’ decision to purchase mini-bonds. While 96% of investors cite “interest rate offered” as an important factor, 82% and 91% also mention “purpose” and “profile and nature of issuer”, respectively. The survey only targeted those who invested through a platform. As a result, it misses most NTDS holders who invested in financial services issuers because those rarely used a platform (see Section 6). The above evidence suggests that those investors would be less likely to consider “purpose” important.

Figure 23 Factors that influence investor demand for unlisted bonds



Base: Investors in platform-mediated unlisted debt securities (N=578)

Zhang et al (2017), chart recreated by London Economics

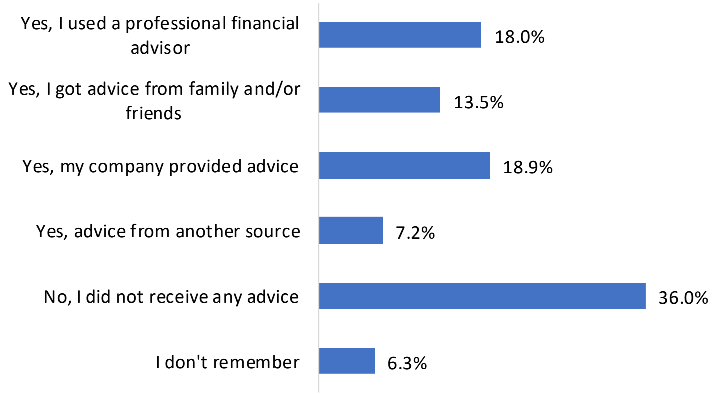
5.3 Investors' experiences with mini-bonds

This sub-section maps the journey of mini-bond investors, from steps taken prior to investing, through the experience with the product to their plans on future investments. The findings are informed primarily by the qualitative consultations with investors, but insights from other research streams are also included where relevant.

5.3.1 Seeking advice before investing

In the investor survey, 18% mini-bond holders said that they used a professional financial advisor before investing in mini-bonds. A further 40% received advice from other sources, such as family, friends or the employer. About one third (36%) of investors did not receive any advice (see Figure 24). The share of respondents that invested in mini-bonds without advice was particularly high among older NTDS investors – 55% of 45-54 year olds and 56% of over 55 year olds.

Figure 24 Advice received prior to taking out mini-bond(s)? (%)



Base: current and past mini-bond holders, N=111

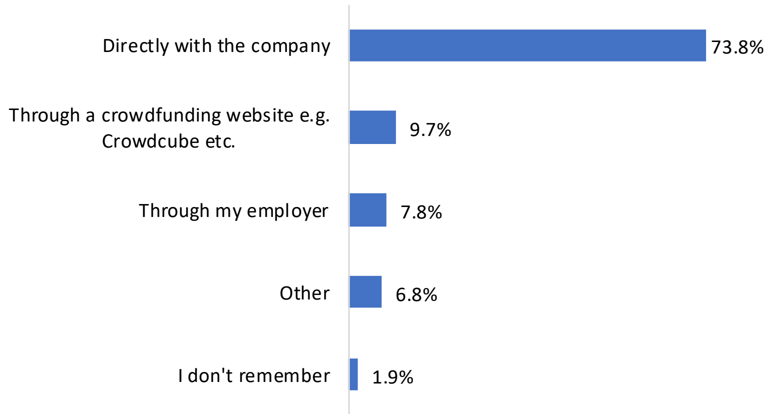
YouGov and LE investor survey

Patrick Connolly of Chase de Vere also believes that IFAs see only "the tip of the iceberg", with most people investing in mini-bonds without professional advice. According to Adrian Lowcock of Willis Owen, most IFAs would be reluctant to get involved because recommending such a product would require substantial due diligence and research. Moreover, Lowcock argues that IFAs have a preference for diversification rather than investing in one company. Several interviewed issuers expressed their frustration at IFAs' reluctance to recommend their mini-bonds.

5.3.2 Purchase

Most investors bought their mini-bonds directly from the issuing company. As Figure 25 shows, almost three quarters of mini-bonds held by respondents in the investor survey were purchased directly. One in ten mini-bonds is accessed through a crowdfunding platform and about 8% were purchased through the investor's employer. Section 6 discusses modes of intermediation in more detail.

Figure 25 Access route to a mini-bond investment



In this question, mini-bond holders reported their answers separately for each the bonds they hold.

Base: individual mini-bonds held by current and past mini-bond holders (N=103).

YouGov and LE investor survey

The investors generally view mini-bonds as an accessible way to invest. Nearly all of the interviewed investors spoke of the journey to purchase being clear and easy. Often, investors who are a customer, employee or shareholder of the company, learn about their mini-bond via a direct email from them. Others find out about the mini-bond from proactively looking for a high interest investment product and coming across the product through their web search, on a financial advice website (e.g. Money Matters, Martin Lewis / Money Expert) or on an investment platform (e.g. Crowdcube) that they are already using.

"These investments [mini-bonds] seem more straightforward – you sign up on the website and away you go." (Female, 34)

A few received cold calls from finance company's trying to sell a mini bond to them. One spoke of receiving a follow-up call from the provider when the online application form said she wasn't eligible for the mini bond; the caller told her to complete the form again and answer in such was as to ensure it accepted her application. She has since lost £80,000 as the company went into administration.

Most bought the mini-bonds directly but some used Crowdcube (either for research or to purchase the mini-bond). Platforms such as Crowdcube are seen to give credibility. They are viewed as a professional site, where you can see what others are investing in and communicate with other investors. Investors spoke of the prospectus information being clear and professional.

Most often information is felt by investors to be clear and communications explicit. Risk warnings are typically repeated and in large text on the initial webpage and/or in investor communications. However, not all noticed the information about regulation. A few experienced what they perceived as misleading communications from LCF and Harewood Associates, where it was not clear that the mini-bond is not regulated because it highlighted that the issuer is regulated.

Most of the interviewed investors did some additional research on the provider before investing – typically they looked at the investor prospectus, the issuer's website, reviews, purchased the product (if relevant) and did a general web search. Some, often more financially savvy investors, did more substantial research – they reviewed the issuer's financial statements, annual accounts and as well as their future business plans.

A few investors did very little research as they felt they knew the provider well enough from being a customer (e.g. seeing how busy BrewDog bars are, have shares in them or as a member of the sports club). A few others who did little research were not overly financially savvy and were new to investing – they either trusted their friends' or family members' recommendation, thought the website looked professional or just accepted that the risk was high but that it was worth it due to potential high return.

Most said that the marketing information received from the provider did not overly sway them to invest if they had serious reservations about the investment. However, most did expect and need the communications to look professional and to be clear in order to invest.

Investors do not expect mini-bond marketing materials to be overly exciting or 'glossy'. They just want them to cover the facts, interest rates, term and risks. They also want to get a good sense of the company and their growth plans. Knowing specifically how the money is going to be used was helpful for many (e.g. a new product, expansion of the sports ground, growth into new markets), especially for those who chose to invest in a company they know and care about.

In the 2016 CCAF survey, 51% of investors in unlisted bonds sold on platforms said that they rely on the platform's due diligence when selecting investment opportunities (Zhang et al, 2017). A slightly larger share (54%) reported that they rely on their own due diligence.[28] Less than one fifth (17%) said that they rely on due diligence performed by other investors.

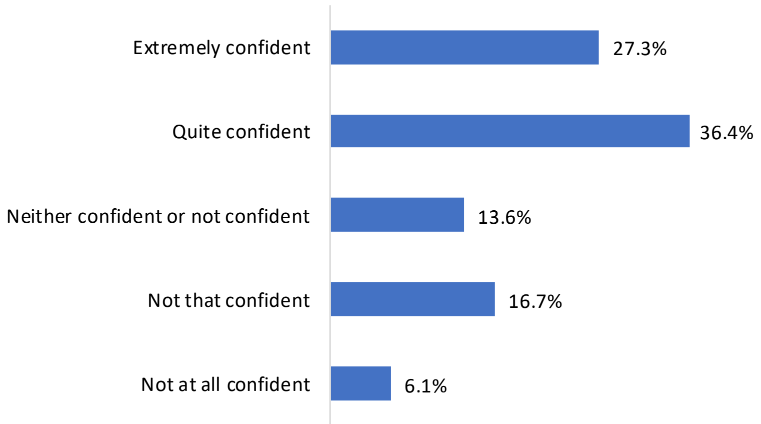
5.3.3 Bond performance (so far)

Most of the interviewed investors do not regularly monitor the performance of the mini-bond or the issuer more than once or twice a year, especially if they are receiving the interest payments. A few spoke of there being no point checking because they are for a fixed term and non-transferable.

In the survey, most investors expressed confidence that they would get their money back when their current mini-bond matures. They were asked to report this for each of the mini-bonds they hold. For about two thirds of the outstanding mini-bonds (64%), investors said that they were either "extremely confident" or "quite confident" of getting their money back. By contrast, investors had low confidence in about 23% of their outstanding mini-bonds (see Figure 26).

The 2016 CCAF survey studied the confidence of investors in unlisted bonds to recover their investments if the issuer fails (Zhang et al, 2017). Only 7% reported being confident of recovering their money in such a situation. This signals awareness of the lack of FSCS protection, but it should be noted that the CCAF survey only targeted the minority of NTDS holders who invested through a platform.

Figure 26 Mini-bond investors' confidence of getting back invested capital



In this question, mini-bond holders reported their answers separately for each the bonds they hold.

Base: individual mini-bonds held by current mini-bond holders (N=66).

YouGov and LE investor survey

A few of the interviewed investors have had negative experiences where they have lost or will probably lose most of their capital (e.g. Taylor St Baristas, LCF and Harewood Associates). One investor who has a mini-bond with LCF was yet to realise that they have gone into administration, and was confident he would get his capital back.

[28] Multiple answers were possible.

There are some broad themes that seem to link these negative experiences:

- Aggressive marketing and cold calling. There are examples where the investors are not sure how the organisation got their details in the first place.
- Marketing which is perceived to be deliberately confusing. For example, the issuer advertising being regulated by the FCA even though this does not apply to products being offered.
- The proposition not being clear. For example, a small number of the interviewed investors found that the investments were not as diversified as they were led to believe.
- The product and provider being hard to research effectively. Information is misleading and a different company may be offering the bond to the one marketing it. This makes it hard for investors to keep track of.
- Feeling hooked in with initial high interest payments. These are initially paid, and are felt to be used to build trust and get people to invest more money in the scheme.
- Small print that gives the company the option not to return the capital at end of investment term and for compulsory roll over to happen. This makes it harder for the investor to get their money back.
- Where investors have been encouraged to invest large amounts (over £10,000) chasing very high returns even by mini-bond standards - e.g. 8%, 10%.
- Investors learning that the mini bond is not performing by an interest payment being missed, and not via any formal communications.
- Poor communication channels when investors become worried about the performance of the mini-bond and the company.

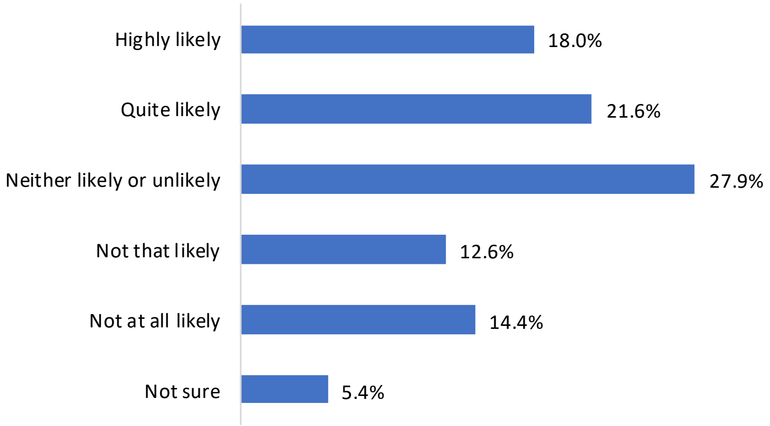
The characteristics of failed issuers are also explored in sub-section 4.3.

5.3.4 Future plans

Some of the consulted investors say that they had rolled over a mini-bond when the term had ended because they have been impressed with the success of the company (e.g. BrewDog, Chilango) or the interest payments received. Several of the interviewed issuers also mention that many of their investors chose to roll over their mini-bond.

About a third (30%) of investors in the survey say that they are likely to invest in mini-bonds in the future. A slightly smaller share (27%) are unlikely, with others undecided (see Figure 27).

Figure 27 Likelihood of investing in mini-bonds in the future



Base: current and past mini-bond holders, N=111

YouGov and LE investor survey

The interviews explore these attitudes in more detail. Most of those who say they would invest again are not actively looking for a mini bond product per se – they are just looking in general for a high interest product and/or an opportunity to invest in something they care about.

Many would not recommend mini-bonds to friends or family members unless they knew they had spare money and would not 'get greedy' and invest too much. They are aware that the product is risky and would be worried to recommend them to others who are not experienced in investing and are not financially stable. They would recommend investing money from their savings accounts or previous bonds, and not their pensions.

5.4 Understanding of risk and regulatory protection

This sub-section first integrates theoretical insights and stakeholders' views to outline the potential sources of harm investors may experience in the mini-bond market. This is followed by an overview of the empirical evidence from the investor survey and in-depth interviews.

The key finding is that although investors understand that they could lose money, they may be unable to competently evaluate the risk or compare it with other investments. While this concern is not unique to mini-bonds, some of their features make them particularly complex for retail investors. The regulatory protections are also not well understood.

5.4.1 Potential sources of harm

Until recently, bonds of individual companies were not accessible to retail investors. When the London Stock Exchange opened its trading facility for listed retail bonds in 2010, it argued that "[m]any investors currently gain exposure to fixed income markets by buying units in managed bond funds, but a growing number of private investors are becoming increasingly knowledgeable about debt securities and are seeking to take a more active role in managing their assets." (LSE, 2011). However, accessing the new retail bonds still required a broker, which meant that listed bonds were unlikely (and still are) to become mainstream investments among retail investors.

By contrast, unlisted bonds made it easy for all retail investors to lend to an individual company, often unadvised and relying only on one's own due diligence. The lack of investors' experience in fixed income investing could give rise to concerns about their understanding of risk. In particular, a number of stakeholders worry that:

- The defined coupon of mini-bonds can suggest misleading comparisons with savings products. Even if retail investors previously invested in corporate bonds through managed funds, these do not advertise fixed rate over fixed term. Most investors will be familiar with such structure only in relation to FSCS-protected savings products.
- Investors may fail to appreciate concentration risk.
- Retail investors may not understand the implications of ranking in fixed income investing. Mini-bonds are typically subordinate and unsecured.
- Even when the mini-bond is secured, investors may be unable to assess the quality of the underlying assets.
- Similarly, the security structure may be complex. Retail investors may not understand the role of security trustees and other arrangements in place to protect bondholders' interests and ensure that the raised funds are used in the way the company said they would be.
- Investors may lack the capacity to evaluate financial statements and other documentation attached to the bond offer. Even if they are sophisticated enough to assess the issuer's financial position and performance, the mandatory disclosure requirements for unlisted bonds are minimal.

"Bond analysis is quite a specialist area and most investors are not equipped to ask the sort of questions an expert bond analyst would ask."
Adrian Lowcock, Head of Personal Investing at Willis Owen

Low understanding of the bond fundamentals is likely to be substituted by a general trust in the company and its commercial success. Most stakeholders (including many issuers) do not believe that investors do substantial investigative work – typically, they would look at the interest rate, the issuer's business and sometimes online reviews of the bond.

While some stakeholders including, for example, the IFA Patrick Connolly worry that "too many" investors confuse mini-bonds with conventional savings products, most believe that investors typically perceive mini-bonds as investments rather than savings. As a result, most investors are thought to be aware that they may not get their money back if the company goes bankrupt – because this risk is common to nearly all investments. According to most stakeholders, the problem is rather that retail investors are generally not well-equipped to assess the *likelihood* that they may lose money. They may struggle to distinguish risk levels between different mini-bonds or between mini-bonds and other investments.

The other frequently cited area of concern is the investors' lack of understanding of the regulatory regime around mini-bonds. If investors buy the bond directly with the issuer, typically their only connection to an FCA-authorised entity is the requirement that financial promotion is approved by an authorised firm[29] and restricted only to certain retail investors (see Sub-section 2.4). This position of the market on the regulatory 'periphery' is perceived as a cause for concern because it can confuse retail investors, whose experience is that mainstream investment products are sold by regulated providers. The stakeholders (including some issuers) that commented on the regulatory

[29] Except in the case of the exceptions described above – see Footnotes 2 and 3.

requirement to restrict marketing to certain investors were generally sceptical of its success in preventing harm to unsophisticated consumers.

Several stakeholders argue that investors' understanding of the regulatory protections often depends on how information is presented to them. Specifically,

- Advertisements and price comparison websites that compare the interest rates on unlisted bonds with FSCS-protected fixed-rate 'bonds' may encourage the confusion of the two products.
- Labels such as 'FCA-authorised' may suggest to investors a level of scrutiny by a trusted authority or a degree of protection that in fact does not exist.
- This concern is seen as particularly pronounced with ISA eligibility, which is perceived to grant the investment more legitimacy and give it appearance of being more mainstream. Mini-bonds are not ISA-eligible (although some have been sold as such), however unlisted but legally transferable debt securities may be eligible (provided they meet additional criteria).

Marketing of mini-bonds is further discussed in sub-section 6.3.2.

5.4.2 Empirical evidence

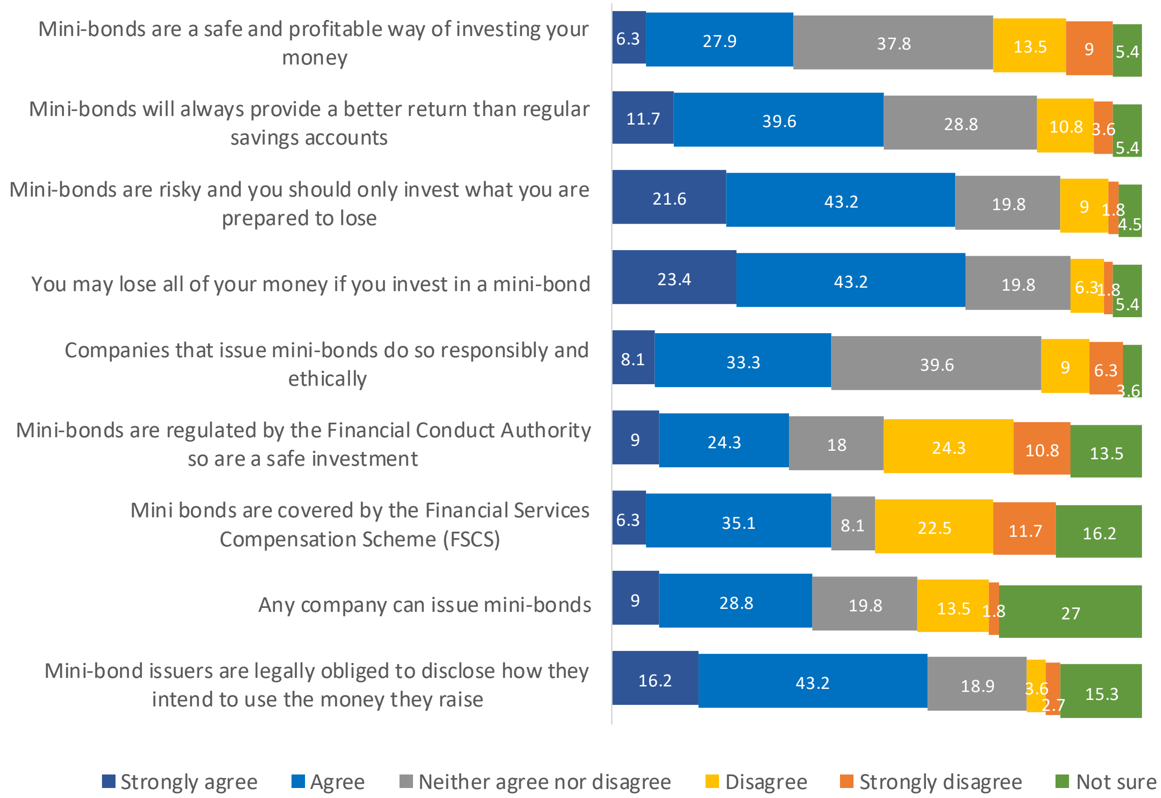
The investor survey confirms that mini-bond holders are generally aware that their NTDS investments are risky, but unclear about regulatory protections. Figure 28 shows that about two thirds of the surveyed mini-bond investors agree with the statement that "mini-bonds are risky and you should only invest what you are prepared to lose". A similar share also agrees that "you may lose all of your money if you invest in a mini-bond". Only around one in ten mini-bond investors disagrees with these statements, while the rest is unsure.

Respondents are more optimistic about the returns that mini-bond investments promise. Just over half think that "mini-bonds will always provide a better return than regular savings accounts", while less than 15% disagree with the statement. Although it is true that the coupon rate of unlisted bonds will always need to be higher than the interest rate on largely risk-free deposits, the investment return could well be lower if the issuer is unable to repay.

The recent cases of failed issuers and fraud allegations have so far not undermined investor trust in the industry. More than two fifths (41%) of NTDS investors contend that "companies that issue mini-bonds do so responsibly and ethically". Only 15% disagree with the claim.

The understanding of the regulatory environment around mini-bonds is potentially the most concerning result of the survey. A third of the respondents (33%) maintain that "mini-bonds are regulated by the Financial Conduct Authority so are a safe investment", while 41% believe that "mini bonds are covered by the Financial Services Compensation Scheme (FSCS)". Only about a third of investors disagree with the two claims. These questions also display high proportions of "not sure" responses, as well as "neither agree nor disagree", suggesting little understanding. Investors are also often unclear about whether *any* company can issue a mini-bond or whether issuers are legally obliged to disclose how they intend to use the money they raise. A significant majority (59%), however, inaccurately believe that issuers *do* have a legal obligation to disclose how the money will be used.

Figure 28 Views of mini-bond holders about risk and investor protections (%)



Base: current and past mini-bond holders, N=111

YouGov and LE investor survey

Interestingly, respondents who are considering investing in mini-bonds are more cautious than those who have already invested. Figure 29 shows that while 34% of current and past mini-bond holders consider it a safe and profitable way of investing money, only 22% of potential investors do. Similarly, potential investors are more sceptical about the high returns, issuers' conduct or FSCS protection. However, investors from both groups are equally confident that mini-bonds are risky and that they could lose money if they invest in them.

Figure 29 Views of potential mini-bond investors (% agree)

Reported percentages are a sum of “agree” and “strongly agree” responses.

Base: current and past mini-bond holders (N=111) and consumers considering investment in mini-bonds (N=188).

YouGov and LE investor survey

These findings are confirmed by in-depth interviews with a subset of the survey respondents. All the interviewees are aware that there are risks with any investment product. Most understand that mini-bonds are riskier than cash ISAs or fixed rate ‘bonds’ offered by banks, and that is why the interest rate is typically higher.

> *“I know they are risky. I have seen in the paperwork that they are not FCA protected. I could lose money if it goes burst. Some companies have gone down… but not that many have gone down. You need to be aware of risk.” (Male, 32)*

Due to the level of risk with mini bonds, most spoke of only investing amounts which they feel they could afford to lose, often because it is ‘spare’ money or new money e.g. from an inheritance. Many spoke of making a judgement based on wanting to invest enough to ensure a reasonable return, but not enough that would seriously impede their lives if they lost it.

Most investors were able to define a mini-bond in a way that was similar to the definition provided in the survey.[30] The most common elements described included: that mini-bonds are aimed at individual investors, are often with start-up / newer companies who wish to grow, are sold directly, have high interest rates and are for a fixed term, often 2-5 years.

[30] This definition is provided in Annex A2.1.

However, not all were aware that mini-bonds are non-transferable. For some this is good; it 'goes into a drawer' and they don't have to think about it. Some, however, are unsure about how this works in practice. For a few who were aware that they are non-transferable, the amount they invested was based on the fact that they cannot access the money in the case of a 'rainy day'.

The interviews confirmed the gaps in knowledge around regulation. Most assume that there is a level of protection with at least the provider, if not necessarily the mini-bond product. A few think they may have even higher regulation as they are aimed directly at consumers, whilst others guess that they are not protected by FSCS.

"I thought they would be even more regulated as more risky than shares. I assume they are protected by the FCA and FSCS. I would be shocked and worried if not…." (Female, 44)

Those who are aware that mini-bond issuance is not regulated by the FCA tend to hope that their money will still be safe as the provider is successful and they trust them. A few are willing to take the risk as the interest rates are high and they haven't invested too much.

Most think that, if the issuer becomes insolvent, they are likely to lose most or all of their money. However, a few had been told that they would be ahead of shareholders in getting their money back in such a case.

6 Intermediation

This section focuses on the intermediaries that helped companies issue NTDSs and market them to investors. It looks at the different roles that intermediaries have played as the market evolved. It also studies the ways mini-bonds were marketed to investors.

6.1 Market structure and trends

There have been a number of different types of intermediary active in the mini-bond market. One sort is FCA-authorised firms who have approved financial promotions for mini-bond issuers. Approving financial promotions is typically not the primary activity of these firms (and because of this, it is difficult to estimate their number); some of the implications of this are discussed further in Section 6.2. Another sort is crowdfunding platforms who have hosted mini-bond issues. During our research we identified three of these. Another sort of intermediary is the law firms who advise on the legal aspects of mini-bond issues; corporate law firm Memery Crystal, for instance, advised on a number of high-profile mini-bond issues (Memery Crystal, undated), especially in the relatively early years of the market. A number of issuers have employed another sort of intermediary in the form of communications consultancies, who advised issuers on how best to market their bonds from a strategic and public relations perspective. Finally, mini-bond issuers used marketing firms to promote their mini-bonds; most notably, Surge Financial Ltd promoted the bonds of LCF and Blackmore Bonds.

We have observed three models of intermediation with respect to financial promotions for mini-bonds. In the first (and most of common) of these, the issuer's issues 'directly' and its financial promotions are approved by an FCA-authorised third party. In the second of these, the issuer issues via a crowdfunding platform. In the third, the issuer issues 'directly' and either 'approves' its own financial promotions (being FCA-authorised) or gets approval for its financial promotions from a related company with FCA authorisation.[31] The differences in the levels of pre-issuance scrutiny and investor protection entailed by these three models are discussed in section 6.2.

In the early days of the mini-bond market, the first model of promotion intermediation was dominant. The second model, involving issuance through a crowdfunding platform, was present in the market from 2014 and was the most common (by number of issuers choosing it) of the three models in 2015. Section 6.1.1 provides more evidence on the prevalence of the second model in the market further. The third model has been a recent innovation in the market.

Intermediaries are now exiting the mini-bond market. This is largely because the high-profile failure of LCF and the losses for investors that it has resulted in have damaged the reputation of the mini-bond market and increased the level of scrutiny from the press and from regulators to which it is subject. This is discussed further in section 7.4, and evidence suggestive of this is displayed in section 6.1.1.

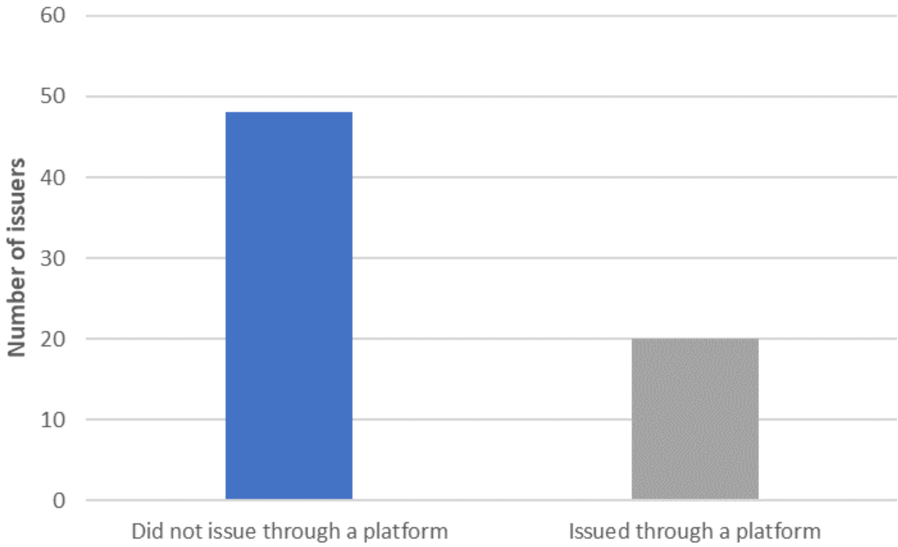
[31] As described in Footnote 2, if an authorised person is merely communicating its own financial promotions then it does not need to 'approve' the promotion; it will only need to 'approve' the promotion if it is to be communicated by another, unauthorised person

6.1.1 Mode of issuance

As mentioned in section 2.1.2, crowdfunding platforms have been active in the mini-bond market, providing platforms for some mini-bond issuances.

48 issuers did not use a crowdfunding platform and 20 issuers did (Figure 30).

Figure 30 Number of issuers who issued through a platform and other than through a platform



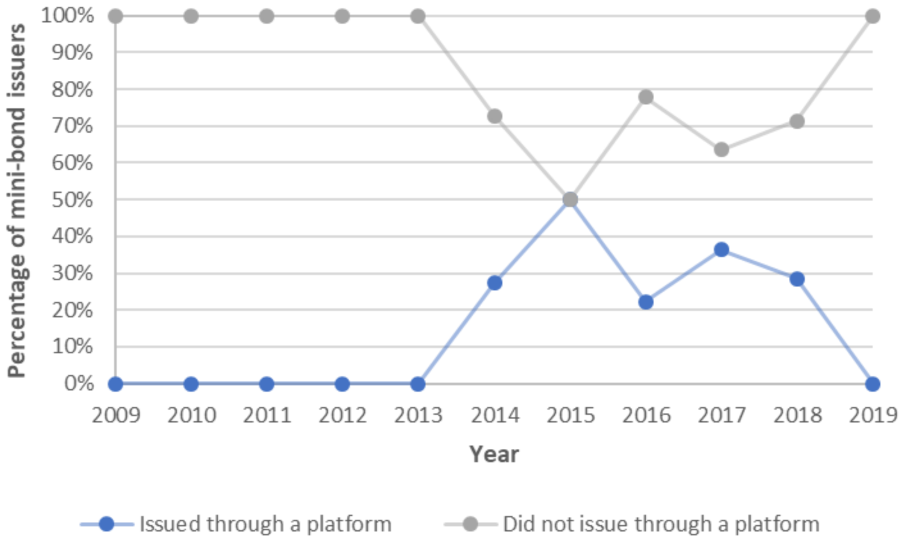
Each issuer is counted only once.

Base: Mini-bond issuers, 2009-2019 (N=68)

LE mini-bond register and FAME data

Notably, though, percentage of issuers choosing to issue through a crowdfunding platform evolved over time (see Figure 31).

Figure 31 Percentage of issuers choosing to issue through a platform over time



Base: Mini-bond issuers in each year 2009-2019 (2009: N=1, 2010: N=2, 2011: N=4, 2012: N=4, 2013: N=10, 2014: N=11, 2015: N=18, 2016: N=18, 2017: N=11, 2018: N=7, 2019: N=4)

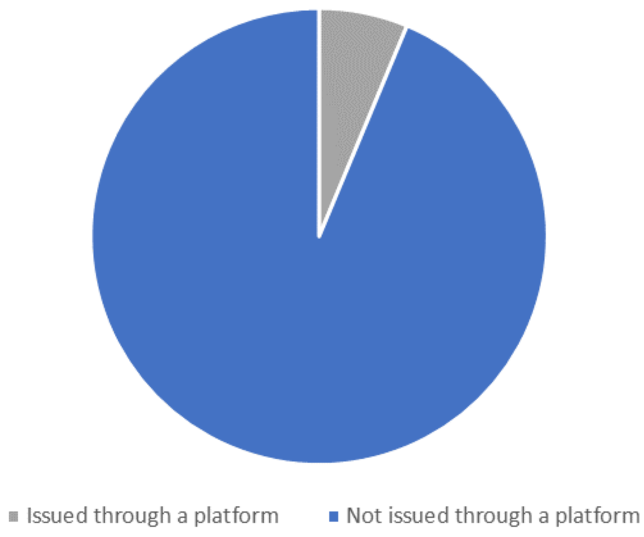
LE mini-bond register and FAME data

The first mini-bond issues through crowdfunding platforms occurred in 2014; these issues were by tourist attraction The Eden Project, Mexican restaurant chain Chilango, and River Cottage Canteens and Delis. In 2015, half of mini-bond issuers (by number) issued through a crowdfunding platform; the percentage of mini-bond issuers issuing through such platforms peaked in 2015 and has been trending downward since then. Two main drivers explain this trend.

- The first of these drivers is the rise of financial services firms in the mini-bond market. These firms have largely eschewed the crowdfunding platforms when issuing their mini-bonds. One reason for this is that financial services firms' mini-bonds issues are often large. Since platforms charge a percentage of the issued amount while direct issues often involve lump sum fees to legal advisers, promotion advisers, registrars and the like, direct issuance is generally cheaper for large issues.
- The second driver is the decline in activity in the mini-bond market by the crowdfunding platforms themselves. The crowdfunding platforms that have been involved in the mini-bond market now primarily focus on equity-based funding; this is likely a consequence of the reputational damage suffered by the mini-bond market as a result of high-profile issuer failures, such as that of LCF.

While, as shown in Figure 30, around 30% of issuers used a crowdfunding platform to issue, issues through a crowdfunding platform account for a small fraction of the mini-bond market by value (Figure 32). Around 6% of the total value of mini-bonds issued throughout the market's lifetime is accounted for by mini-bonds issued through a platform.

Figure 32 Comparison of the value of mini-bonds issued through a crowdfunding platform and those not issued through such a platform

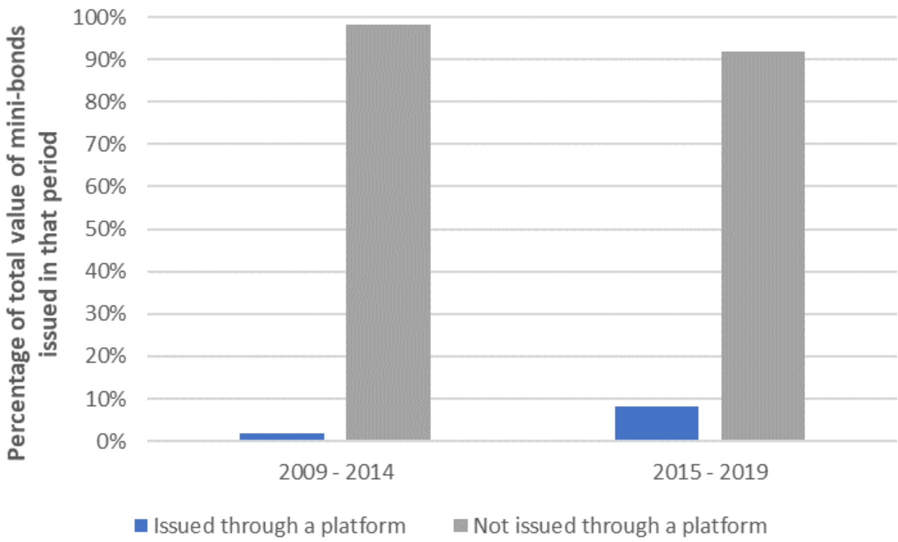


Base: Mini-bonds issued in the UK, 2009-2019 (N=132)

LE mini-bond register and FAME data

The percentage of the value of mini-bonds issued accounted for by mini-bonds issued through platforms has varied significantly over time, as suggested by the variation over time in the percentage of issuers using platforms shown in Figure 31. Before 2015, less than 2% of mini-bonds by value were issued through platforms; this figure reached 8% from 2015 to 2019 (Figure 33).

Figure 33 Comparison of the value of mini-bonds accounted by mini-bonds issued directly and through a platform, before 2015 and from 2015 onwards



Base: Mini-bonds issued in the UK, 2009-2019 (N=132)

LE mini-bond register and FAME data

6.2 Difference in investor protection depending on type of intermediation

This section will discuss the differences in pre-issuance scrutiny and investor protection associated with different forms of intermediation in the mini-bond market.

Investors benefit from different levels of protection depending on whether or not they received regulated advice from an FCA-authorised entity. An investor who believes that they invested in a failed mini-bond after receiving inaccurate or unsuitable advice from an FCA-authorised advisor may have access to the complaint process with the FOS. If the FOS decides that the advice was unsuitable and the investor suffered harm as a result, it has the power to order the regulated advisor to compensate the investor. If the firm that provided the advice is in default or no longer trading, the investor may have an eligible compensation claim with the FSCS. As mentioned in Section 2.4.3 above, one potential route to FSCS compensation for investors in LCF identified by LCF's administrators was "negligent advice" given to investors by LCF (Smith & Williamson, 2019b). Investors, then, generally have greater protection when they have received investment advice from a regulated firm than when they have not.

As described in section 6.1, mini-bond *promotions* have been intermediated in three ways. These three different modes of issuance can entail different levels of pre-issuance scrutiny and investor protection.

It is unclear in principle whether direct issuance or issuance via a platform will involve greater pre-issuance scrutiny. Platforms are authorised by the FCA to undertake the regulated activity of arranging investment deals. This means that they are required to follow a number of rules of conduct. The FCA's (2018a) interpretation of these rules clarifies that the platforms must, for example, undertake basic due diligence or ensure that the investor has enough information to undertake their own due diligence (see sub-section 2.4.1). The platform's failure to meet these standards again opens the avenue for the investor to seek compensation through the FOS or FSCS. The regulatory standards therefore act both as an incentive for the intermediary to undertake checks and due diligence – increasing the level of protection before investing – and facilitate protection after investing through the appropriate compensation scheme.

When an issuer issues directly and has its financial promotions approved by an FCA-authorised third party, this third party may not be influenced by regulatory considerations in the way that platforms are. Approving financial promotions is not itself a regulated activity. The regulatory expectations are therefore more limited than when they are performing a regulated activity. In the case of direct issuance, then, the firm approving the financial promotions does not have the same incentives arising from regulation to perform pre-issuance scrutiny.

However, direct issuance can involve greater pre-issuance scrutiny than issuance via a platform. Approval of financial promotions of mini-bonds is typically not the primary activity of firms who perform it. For instance, BDO LLP approved a number of promotions for mini-bond issues (including that by The Jockey Club, for example); it is the fifth largest professional services firm in the UK. These firms often operate in markets where the required levels of scrutiny are higher and where requirements on firms, including reporting requirements, are generally more onerous than those in the mini-bond market. They may apply these higher levels of scrutiny and higher standards when approving mini-bond promotions simply as a reflection of the environments they are used to operating in. These firms will also be conscious that if they were found to have performed insufficient scrutiny of a mini-bond that failed with significant losses to investors, this would be highly likely to have negative reputational consequences for them more broadly and to thereby impact their other business areas.

In sum, regulatory considerations mean that the guaranteed minimum level of pre-issuance scrutiny is greater for issuance via a platform than for direct issuance. It may, though, be the case that pre-issuance scrutiny is greater for some direct issues. This depends on the nature and behaviour of the company approving the issuer's financial promotion. It is unlikely that investors will be able to understand this, though; they are unlikely even to know the name of the firm approving the issuer's promotions, let alone research its business activities and reputation.

The third route, where the issuer's promotions are approved by itself or by a related company set up just to approve those promotions, will likely entail the least pre-issuance scrutiny because of the lack of involvement of an independent third party. All the stakeholders consulted about this issue in the research for this study agreed that this was the case. Further, there are a number of FCA authorisations corresponding to different activities. The requirements for these FCA authorisations vary in how stringent they are. Having any of these FCA authorisations, though, allows a company to approve mini-bond promotions. The issuer or related company, then, can obtain the FCA authorisation with the least stringent requirements and then approve the issuer's promotions – and may never perform the activities for which it is FCA-authorised. LCF had FCA authorisation for a number of activities it appears never to have performed.[32]

The route, then, by which investors access mini-bonds – whether they are advised before purchase and how the promotion reaches them – affects both the amount of pre-issuance scrutiny the promotions they receive are subject to and the level of protection they receive.

6.3 Financial Promotion

Financial promotion is discussed in the context of intermediation rather than issuance because of the regulatory requirement for financial promotion to be approved by an FCA-authorised entity (see sub-section 2.4). The authorised firm must also ensure that the promotion is only communicated to certain types of retail investors. This section first reviews these regulatory restrictions on financial promotion, before discussing how NTDSs have been marketed in practice.

6.3.1 Restrictions

Since 2014, mini-bond issuers have been subject to restrictions governing to which retail investors they may communicate direct offer financial promotions. A direct offer financial promotion must "contain an offer or invitation and specify the manner of response or include a form by which the response is made" (Fieldfisher, 2015). A mini-bond issuer is generally permitted to make direct offer financial promotions to an investor who is:

- Certified as a 'high net worth investor';
- Certified as a 'sophisticated investor';
- Self-certified as a 'sophisticated investor';
- Certified as a 'restricted investor'; or
- In receipt of regulated investment advice or investment management services from an authorised person.

[32] Interview with LCF administrators and their legal advisor.

Someone is a certified high net worth investor, a certified sophisticated investor or a self-certified if they have signed a statement in the past year stating that they qualify in one of those respective categories (COBS 4.7.9 R).

To qualify as a certified high net worth investor, someone must in the past 12 months have signed a statement affirming that they have an annual income of £100,000 or more, or net assets of £250,000 or more (COBS 4.7.9 R and COBS 4.12.6 R).

To qualify as a certified sophisticated investor, someone must have a written certificate signed within the last 36 months that affirms that the firm considers them to be "sufficiently knowledgeable to understand the risks associated with engaging in investment activity in [non-readily realisable securities]" and must in the past 12 months have signed a statement affirming that they qualify as a sophisticated investor (COBS 4.7.9 R and COBS 4.12.7 R).

To qualify as a self-certified sophisticated investor, someone must in the past 12 months have signed a statement affirming that they are a sophisticated investor because one or more of the following statements is true of them:

"(a) I am a member of a network or syndicate of business angels and have been so for at least the last six months prior to the date below;

(b) I have made more than one investment in an unlisted company in the two years prior to the date below;

(c) I am working, or have worked in the two years prior to the date below, in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises;

(d) I am currently, or have been in the two years prior to the date below, a director of a company with an annual turnover of at least £1 million" (COBS 4.7.9 R and COBS 4.12.8 R).

Someone is a certified restricted investor if they have signed a statement affirming that they have not invested more than 10% of their net assets in non-readily realisable securities in the past 12 months and will not do so in the next 12 months (COBS 4.7.10).

6.3.2 Common features and potential causes for concern

This sub-section will begin by discussing the common features of marketing materials and strategies used in the promotion of mini-bonds, before turning to problematic practices in mini-bond marketing.

Several issuers consulted in our research for this study reported that they targeted their existing customers when marketing their mini-bond, and 11 of the 13 issuers who answered our survey question asking how they marketed their mini-bonds reported that they directly targeted their existing customers. These people are likely to be particularly receptive to investing in a mini-bond as they are more likely to have a liking for or affinity or relationship with the issuer. Many mini-bond issues were also covered in the press, often with comments from the issuer concerned. Social media was another popular marketing channel, with four of the 13 respondents to the relevant survey question citing this as one of the channels they used to market their mini-bond(s) to investors. Section 5.3.2 looks at investors' routes to mini-bonds based on our primary research.

Investors access mini-bonds through invitation documents, which give information on the issuer and the mini-bond it is issuing and give instructions on how to invest in the mini-bond.

Invitation documents for mini-bonds typically have similar features. Most open with a letter to prospective investors from the CEO, usually giving the history of the company and explaining what the funds raised through the mini-bond issue will be used for. The documents give the mini-bond's key features – such as the term, coupon rate and minimum and maximum levels of investment. FAQs sections are a very common feature. The documents also generally contain information on the firm's financial performance in the recent past and more detailed information about the planned use of the finance raised through the mini-bond issue. The documents typically contain a 'risks' section that highlights risk factors, including non-transferability. The documents typically conclude by giving technical and legal information.

The opening letters and team profiles are presumably included in a bid to foster the growth of a relationship between the issuer and prospective investors or to convince investors that they are investing with competent or trustworthy people. The financial performance information and detailed information about the use of funds are presumably meant to allow prospective investors to assess the mini-bond being offered as a financial proposition.

The rest of this sub-section will discuss recurring marketing practices observed in the mini-bond market that can be potentially misleading or unclear for some investors. While they are recurring, they are not pervasive throughout the market.

Sections 5.4.1 and 5.4.2 explained that retail investors are typically not entirely clear on their regulatory protections when investing in mini-bonds and are prone to making mistaken comparisons between mini-bonds and savings products. Worryingly, there are a number of examples of mini-bonds being marketed in ways that appear to exploit and aggravate these failures of understanding by investors.

LCF's marketing of its mini-bonds was criticised by the FCA for a number of elements of its promotion that the FCA deemed "misleading, not fair and not clear" (FCA, 2019a). Two elements related to its regulatory status and the tax status of its mini-bonds. One of these was LCF giving "undue prominence" to the fact that it was an FCA-authorised firm, when the issuing of NTDSs was not an FCA-regulated activity and therefore investors did not have protection under the FSCS (FCA, 2019a). LCF also marketed its bonds in 'Fixed Rate ISAs' and 'Innovative Finance ISAs' even though they were, by virtue of their being non-transferable, not ISA-eligible (FCA, 2019a). Several stakeholders consulted for this study reported that the ISA 'badge' confers a legitimacy on a product in the eyes of investors and gives investors the impression that the product is mainstream (which, presumably, has connotations of safety).

An issuer whose mini-bonds include a number that are currently 'live' also treats FCA authorisation unclearly in its marketing materials. This issuer has a sister company with a very similar name that promotes the bonds of the issuer and arranges the investments in those bonds. This sister company is FCA-authorised, while the issuer itself is not. The issuer's website states in large font "Investing with a regulated firm" and explains below this that the sister company is FCA-regulated. While there is nothing false about this, it may be confusing to retail investors. The "Investing with a regulated firm" line and the fact that the issuing company and its sister company are similarly named appear to invite the thought from investors that the issuing firm is FCA-authorised (which, as stated above, it is not).

This issuer provides an example of a mini-bond issuer that could be conceived as making comparisons with savings products. The issuer offers a mini-bond product called a 'Cash Bond'. The term 'Cash Bond', though, is typically used to refer to fixed-rate ISAs, which – unlike mini-bonds – are FSCS-protected. The same issuer offers another mini-bond product called a 'Pensioner Bond'.

This may be intended to evoke National Savings and Investments' (NS&I's) 65+ Guaranteed Growth Bonds, which were fixed-rate savings accounts backed by HMT. Indeed, the issuer in question produced an advert proclaiming, "Pensioner Bonds Are Back". In both of these cases, the naming of the product may invite comparisons with savings products where guarantees meant that the risk was far lower than that associated with mini-bonds.

Online advertising has also been used to blur the distinction between mini-bonds and similar products on the one hand, and savings products on the other. LCF's mini-bonds was placed on price comparison websites alongside savings products. And a Google search for terms like 'high interest savings account' or 'high interest ISA' returns (at the time of writing) sponsored advertisements for mini-bonds and other, similar products.

Another recurring problematic marketing practice observed in the mini-bond market involves statements that misleadingly downplay the risk associated with the mini-bond in question.

One way in which firms have misrepresented the level of risks associated with their bonds is by placing an emphasis on untroubled past performance without a sufficiently prominent warning that success in the past is not a guarantee of success in the future. This was another of the aspects of LCF's marketing that the FCA criticised in ordering LCF to withdraw its promotional materials.

Another way in which some issuers have given the impression that mini-bonds were less risky than they in fact were is by overstating the level of protection resulting from the bonds' being secured. In a judgement awarding an investor in SEB the right to compensation from IPM (both discussed above in section 4.3) after the latter approved SEB's promotions for its mini-bond, the FOS said that "the Invitation Document also gave the clear impression to potential investors that the Secured Energy Bond was a relatively safe investment in which investors had the protection of additional security measures making the investment less risky than other mini-bonds", but that "The Security system was not fit for purpose. The SEB bonds were no more secure, or less risky, than other non-secured mini-bonds" (FOS, 2018a). The ombudsman concludes that "The Invitation Document was not therefore fair, clear and not misleading. IPM should not have approved it" (FOS, 2018a).

The FCA has taken action in response to how mini-bonds have been promoted. In January 2019, the FCA emphasised through a 'Dear CEO' letter that if a regulated firm refers in its financial promotion to activities that are not regulated, the promotion should make it clear (FCA, 2019d).

In January and again in April 2019, the FCA reminded authorised businesses of their responsibilities when approving financial promotions of mini-bonds, underlining "how seriously [the FCA] treat[s] this issue" (FCA, 2019d and 2019e). The regulator complained that it continued to observe examples where the due diligence carried out on a financial promotion fell "well short" of the expected standard (FCA, 2019e). It also clarified that the FCA expects that the financial promotion of mini-bonds reflects "an appropriate level of due diligence into the risks they bear", acknowledging that complex products like mini-bonds present "an inherent challenge to being promoted in a manner that is fair, clear and not misleading" (ibid.).

7 Economic value of the NTDS market

The total economic value of the NTDS market cannot be quantified using the information available. However, in this section we explain the various channels through which the NTDS market has economic value and disvalue. We provide quantitative estimates of the significance of the individual channels insofar as this is possible.

7.1 Improved access to finance

According to economic theory, a project creates net economic benefits if its net present value (NPV) is positive. The NPV of a project is positive if the total value of its benefits now and in the future exceeds the total value of its costs now and in the future. All projects with a positive NPV should be funded, but in practice not all are.

This sub-section first explains the causes of such inefficiencies in credit markets. It proceeds by outlining the channels through which NTDSs can reduce the frictions and improve access to funding, especially for small and medium-sized enterprises (SMEs) and other credit-constrained businesses. Finally, it reviews the empirical evidence.

7.1.1 Frictions in credit markets

SMEs and other credit-constrained businesses may struggle to find bank finance or pay a premium for such finance, even for projects with positive NPV. There are a number of reasons for this, but the most important include informational asymmetries and transaction costs.

Firstly, when SMEs seek a loan from a bank or other credit institution, the bank may have less access to relevant information about the SMEs seeking finance and the projects for which they intend to use the funds than the SMEs seeking finance do. Informational asymmetries are likely to be larger when an SME seeks a bank loan than when a larger firm seeks such a loan, because there is likely to be more available financial information for larger firms and because larger firms will have more evidence of sustained performance over time (Department for Business, Innovation and Skills, 2016).

Secondly, there are costs associated with assessing SME loans, and these costs are greater than those associated with assessing loans to larger businesses. Assessing the creditworthiness of small businesses and their planned uses for finance tends to be more costly relative to the size of the loan. This same factor reduces the opportunities for selling securitised SME loans on, which further reduces their attractiveness to lenders (Mills, 2014).

SMEs have found it especially difficult and expensive to secure bank finance in the years following the financial crisis; Eurozone data for 2007 to 2013 shows that the spread in average interest rates of bank loans to non-financial companies for loans up to €1 million versus those above €1 million rose throughout that period. In 2013, the finance gap for UK SMEs – the shortfall in the finance offered to these firms compared to the finance they required– was between £10 and £11 billion (Stirling and King, 2017).

7.1.2 NTDSs are associated with lower transaction costs

NTDSs may provide finance for projects that otherwise would not be funded for the following reasons.

In traditional SME lending markets, the presence of intermediaries introduces costs; NTDSs can provide economic value by reducing these costs. For example, NTDS issues avoid some costs associated with intermediation and meeting regulatory requirements. An NTDS issue does not require the production of an FCA-approved prospectus. This avoids the significant costs associated with producing such a prospectus, which a 2018 HMT Impact Assessment estimated at 7 to 12% of the funds raised by the issue (HM Treasury, 2018). NTDS issues also do not carry with them the reporting obligations that issues of listed bonds do, and so an NTDS issue avoids the costs associated with gathering the requisite information and reporting it.

NTDS issuers may also save funds on marketing. Consumer-facing businesses with a large customer base or a strong brand following typically advertised their mini-bonds to their customers, potential customers, shareholders, employees or other investors with a pre-existing connection to the business. According to the consulted issuers, this way of marketing was far cheaper than, for example, advertising through IFAs or the press or other media.

The NTDS issues that were done through crowdfunding platforms such as Crowdcube had lower intermediation costs.

This is, for example, because these newer crowdfunding platforms are not burdened by the same legacy operating costs that banks and other conventional lenders are. Crowdfunding platforms are less likely to have legacy IT infrastructures that are inefficient, costly to maintain and expensive to update. Also, crowdfunding platforms do not have the costs associated with a branch network developed over time (Siciliani, 2016). Finally, crowdfunding platforms are subject to less stringent capital requirements (Siciliani, 2016).

Platform-based issuance could also save on marketing costs because the platform could manage a sizeable group of registered investors. Individual issues are marketed to these investors through the platform. The advertising costs of several projects or issuers are therefore pooled, which is again likely to be cheaper than the less targeted advertising through traditional media or the IFA network.

The reduction in the costs associated with intermediaries means that investors receive higher net returns even from investments with the same risk profile.

7.1.3 NTDSs can reduce information asymmetries

It may also be the case that the informational asymmetries are smaller in the case of some NTDSs than in the case of bank loans to SMEs. Investors in NTDSs are often customers of the issuers, or at least consumers in the market in which the issuers operate. As such, they are likely to be familiar with the businesses in which they are investing and with the projects that the finance raised from the NTDSs are intended to fund. For example, buyers of fine wine are likely to be better informed about the value of the asset than banks. They are therefore in a better position to lend funds to the business and accept the product as collateral.

Indeed, some investors in NTDS are employees of the issuers, who will both have knowledge of the issuer and its projects but will also have a stake in the success of the issuer and its projects. This increased access to information will reduce the amount of adverse selection in the market and reduce the amount of credit rationing.

However, the cases of NTDS issues where retail investors are likely to be better informed than traditional lenders are considerably limited. In most cases, it does not appear that retail investors make more informed decisions than credit institutions or professional investors.

7.1.4 Empirical evidence

Our primary research indicates that NTDSs may indeed broaden access to finance for SMEs. Our stakeholder survey asked issuers what they would have done if they had been unable to issue a NTDS. Six out of 14 issuers responding to this question reported that they would have scaled down or cancelled the activity for which the funding was to be used rather than raising the funds through another instrument (such as a listed retail bond or an equity issue). NTDS issues are overwhelmingly used to raise funds for projects or expansion, rather than to raise working capital.

7.2 Non-financial return to investors

Another way in which NTDSs can provide economic value is through giving investors non-monetary benefits beyond the financial return they receive. Many NTDSs have been issued by passion brands – brands that consumers have an emotional attachment to ("Passion Brands: What are they really?", 2013) – sports clubs and renewable energy projects. Investing in a brand one believes in, in a club one supports or in a project one believes will make the world a better place is likely to have a psychological reward in addition to the financial reward provided by the interest payments. A 2017 report by the Cambridge Centre for Alternative Finance found that investors in debt-based securities, of which NTDSs are a subset, were more likely than investors in other alternative finance methods to say that the money they invested was "money I would use for charitable or social giving" (Zhang et al, 2017).

NTDSs, therefore, may provide investors with utility that they would not otherwise gain. This source of economic value has fallen in importance after 2015, when mini-bond issues by lenders and other finance companies started gaining prominence and issues by consumer-facing companies and 'passion brands' declined.

7.3 Potential misallocation of capital

Although NTDSs may increase the number of projects that are funded, this need not always be a net economic benefit. Projects funded by NTDSs may have negative NPV, but still receive funding because investors are unsophisticated, uninformed, misled or unfairly compensated for the risks they are taking. The lack of regulatory obligations and disintermediation can lead to insufficient scrutiny and due diligence. And because non-transferability means that each retail investor must value the bond individually, there is scope for potential mis-pricing.

All of these factors can lead to misallocation of capital from its optimal use, reducing economic value in social welfare. Simply put, some projects may be funded that – from an economic perspective – should not be.

7.3.1 Uninformed/misled investors accept excessive risk

When consumers take well-informed decisions, it is in the interest of the economy as a whole. When consumers lack the knowledge or ability to make sound purchasing decisions, market forces do not generally allocate resources optimally. Evidently, better consumer choices improve consumer welfare. However, consumer choices also drive competition between sellers, leading to lower prices, improved quality, more product variety and increased innovation.

The retail investment market is no exception. If consumers misjudge the risk and return of various investment options, capital in the economy may be allocated inefficiently. The concern in the NTDS market is that the return may not be proportional to the risks. Sub-section 7.3.3 below explains why mini-bonds may be mispriced.

There are a number of reasons why retail investors could underestimate the risks – they may, for example, lack financial sophistication or specialist knowledge to evaluate bonds of individual companies. They could misunderstand the regulatory protections or be confused by misleading marketing that encourages rather than tempers the investor's misconceptions (see sub-section 6.3.2).

The informational problems of the mini-bond market may also create selection risks, both on the issuer and investor side.

- Among issuers, light regulation, minimal independent third-party due diligence and illiquidity of NTDSs may attract high-risk credit disproportionately. While both creditworthy and uncreditworthy SMEs can find it difficult to obtain enough finance from conventional sources, the uncreditworthy businesses are more likely to struggle – and turn to NTDSs instead. The combination of low transparency and regulation with relatively homogenous, risk-insensitive pricing (see sub-section 7.3.3 below) may discourage the more creditworthy borrowers and attract the riskier ones.
- On the investor side, the evidence shows that retail investors are drawn into NTDS investments from low-risk cash and savings products rather than from traditional investments such as equity or bond funds (see sub-section 5.2.1). Less experienced investors are therefore likely to be disproportionately represented among mini-bond holders. This risk has increased with the advent of financial services issuers since 2015. While the previously dominant consumer-facing issuers attracted investors that had some engagement with or understanding of the issuer and its market, the now-dominant financial issuers attract investors with the simple proposition of higher yield than savings products.

In sum, a key risk to the economic value of NTDSs arises from uninformed decisions.

7.3.2 Disintermediation can lead to insufficient scrutiny before issuance

While the fact that the mini-bond market is disintermediated relative to the markets for alternative sources of business finance reduces or eliminates some costs, disintermediation may be of negative economic value in net terms. This will be the case if intermediation brings economic benefits that are greater than its costs. Intermediation has economic benefits because it can reduce informational asymmetries and the distortions they entail.

The disintermediation in the mini-bond market means that the level of scrutiny performed before mini-bond issues can be very low (as described in section 6.2 above, the level of pre-issuance scrutiny that mini-bonds undergo varies and depends on how they are intermediated). This was true in the case of LCF, which approved its own financial promotions. Scrutiny by a third-party might have prevented it from releasing some of the misleading promotions that it did, and this may have avoided some of the economic losses associated with LCF's having collapsed after attracting more than 11,600 investors.

The reporting and disclosure obligations that are associated with other securities also reduce informational asymmetries. If investors have better information about the companies they are investing in, they are better-placed to assess the risk associated with investing in a mini-bond and, relatedly, whether the interest rate on offer adequately compensates them for the risk they stand to bear.

7.3.3 Potentially mis-priced asset

Mini-bonds may not be priced efficiently. This is because a properly functioning price discovery mechanism is not present in the mini-bond market. Since mini-bonds are non-transferable, they are not traded after the initial purchase and so an equilibrium price cannot be arrived at iteratively through trade. Further, buyers have limited access to information about the product they are purchasing, and they are often unsophisticated investors and are therefore not well-placed to assess a mini-bond's value even if they did have access to perfect information.

Our research indicates that issuers did not choose the interest rate in a way that reflected the risk associated with their respective mini-bonds. Issuers and intermediaries we consulted largely said that interest rates were chosen to be in line with a market standard rather than reflecting the individual characteristics of the mini-bond in question. Early issuers, our stakeholder consultations revealed, generally chose their interest rates such that they were sufficiently above the Bank of England base rate as to make the mini-bond attractive to prospective investors but not so high as to be overly expensive. One issuer described the interest rate selection as "fairly arbitrary".

The stakeholders we interviewed revealed another way in which the price discovery mechanism has failed to operate properly in the mini-bond market. Issuers perceived that a high interest rate would be interpreted by prospective investors as a signal that the mini-bond was risky. This perception, rather than facts about their own mini-bond, its features and its risk profile, influenced their pricing decision and led them to choose a more moderate interest rate.

This phenomenon illustrates the application of Goodhart's law, often phrased as "when a measure becomes a target, it ceases to be a good measure". The interest rate on an investment ceases to be a good proxy for risk when the risk perception itself is targeted by the issuer. The issuers are able to price the asset not according to its fundamentals when the asset is illiquid, the disclosure and documentation requirements are minimal and the investors are unsophisticated.

The empirical evidence suggests at least two reasons to believe that NTDSs may, indeed, have been mis-priced:

- The differences between companies issuing mini-bonds are large, but the range of interest rates is tight (generally 6-9%, see Section 2). NTDS issuers include large, established retailers with tens of thousands of employees, but also micro-firms that are less than a year old, employ less than five people and whose entire business model is based on issuing NTDSs and lending the raised funds. And yet, all of these various companies raise finance at a very similar price that, according to market participants, is simply based on the "market standard".

- The interest rates for listed bonds and NTDSs are similar. LSEG (2014) states that listed bonds typically have a coupon rate of approximately 5%; this is not dissimilar from the 6% - 9% coupon rates associated with NTDSs (see Section 1). Such a lack of a significant difference in interest rates is unlikely to reflect the considerable differences in regulatory standards and market scrutiny in the listed bond market and the mini-bond market, or the extra risk associated with mini-bonds' lack of transferability.

7.4 Risk of undermining trust in financial services

Misleading, deceptive or fraudulent practices – or practices perceived as such by consumers – can undermine trust in financial services providers. LCF's promotional materials were characterised by the FCA as misleading (FCA 2019a), and the Serious Fraud Office has opened an investigation into individuals connected to LCF (Smith & Williamson, 2019a). More generally, investor losses from mini-bond issuer failures may undermine investors' trust in if they perceive that they were led to believe that mini-bonds were safe (whatever the facts of the matter in fact are).

Consumer trust in the finance sector is important for the functioning of markets. Arrow's pioneering and widely-cited work on the subject describes trust as an "important lubricant" of market interactions, the absence of which can create severe inefficiencies or even collapse of the affected markets (Arrow, 1974). Subsequent empirical work has confirmed the beneficial role of trust in a country's economic development (see Putnam, 1993 for an overview). Not only can a negative experience with the financial sector undermine consumers' trust in that industry, it can also have spill-over effects on trust in other economic contexts that can impair other markets and social interactions (Jansen et al, 2013).

Evidence from our investor survey suggests that a loss of trust in mini-bond issuers because of the high-profile failures of mini-bond issuers has yet to materialise. As shown in Figure 28, just 15.3% of current and past mini-bond holders surveyed said that they disagreed or strongly disagreed that mini-bond issuers issue mini-bonds responsibly and ethically; 41.4% either agreed or strongly agreed. However, the risk exists that a loss of trust may still materialise as more information comes to light about issuer failures that have already occurred and as more failures occur.

There is more evidence, however, that the mini-bond market has suffered reputational damage in the eyes of issuers and intermediaries. Issuer activity has declined in recent years, both in terms of value (see section 3.2.1 above) and in terms of the number of issuers undertaking new issues. A number of intermediaries have also exited the mini-bond market because of reputational concerns. For instance, BDO no longer approves mini-bond promotions, while there are no mini-bond issues open on Crowdcube at the time of writing.

Index of Tables, Figures and Boxes

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ANNEXES

Annex 1 References

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Annex 2 Detailed methodology

A2.1 Investor survey

This section of Annex 2 explains in detail the methodology behind our investor survey. Sub-section A2.1.1 gives the script for the questionnaire that was used for the survey. Sub-section A2.1.2 describes the screening sample used in the survey. Sub-section A2.1.3 gives details of the cleaning of the data from the survey. It then describes the econometric methods used to analyse the final data from the survey.

A2.1.1 Scripted questionnaire

#Mini-bonds Brand list used

<1> Asset Life

<2> Big60Million

<3> Blackmore Bonds

<4> Brewdog

<5> Caxton FX

<6> Chilango

<7> Clearwell Capital Group

<8> Diamond Construction and Renewables

<9> Ecotricity

<10> Equfund

<11> Golfbreaks.com

<12> Good Energy

<13> Grind

<14> HAB Land (part of the HAB Group)

<15> Hambledon Vineyard

<16> Harewood Associates

<17> Harlequins (Harlequin F.C.)

<18> Hotel Chocolat

<19> Innis and Gunn

<20> John Lewis

<21> JUST

<22> King of Shaves

<23> Lancashire County Cricket Club

<24> Leon

<25> London Capital and Finance

<26> London Property Bonds

<27> MJS Capital (which changed its name to Colarb Capital)

<28> Mr and Mrs Smith

<29> Naked Wines

<30> Nuffield Health

<31> Ocea

<32> Pocket

<33> pod (pod Food)

<34> POD Point

<35> Providence Financial Investments

<36> Rectory Homes

<37> Regenerate London

<38> Rhino

<39> River Cottage Canteens and Delis

<40> Secured Energy Bonds (whose parent company was CBD Energy)

<41> Shenton International Bonds

<42> Shojin Property Partners

<43> SmartWater Technology

<44> Square Pie

<45> Surrey County Cricket Club

<46> Taylor Street Baristas

<47> The Eden Project

<48> The Jockey Club

<49> Warren Evans

<50> Wellesley & Co

<51> Wind Prospect Group

#Screening

#PDL update ask if not answered within the last three months

[investment_types_new] {multiple columns = 2 varlabel="Types of investment - owned"} Which, if any, of the following INVESTMENTS do you own? Please select all that apply.

<1> Stocks and shares

<2> Company bonds

<3> UK Government bonds

<4> Overseas Government bonds (excl. emerging market)

<5> Emerging market sovereign debt

<6> Options and futures (excl. commodities)

<7> Commodities (e.g. options or futures)

<8> Spread betting account or Contracts for Difference account

<9> Unit trust/OEIC

<10> Absolute return and hedge funds

<11> Exchange traded funds (ETF/Tracker Funds)

<12> Endowment policies, with-profits insurance policies or unit-linked insurance policies

<13> An investment bond with a life insurance company

<14> Other types of investment funds

<15> Investment trust

<16> Real estate investment trusts (REITs)

<17> Property / land / buy to let (excluding your own home)

<18> Employee options / share schemes

<19> Art, wine, jewellery, classic cars / motorbikes

<20 fixed> Other

<95 fixed xor> None of the above ***#SCREEN OUT***

<96 fixed xor> Don't know – my adviser invests it all for me ***#SCREEN OUT***

<99 fixed xor> Prefer not to say ***#SCREEN OUT***

[S2] {single} Have you ever invested in non-transferable debt securities – sometimes known as "mini-bonds"?

These are debt securities issued by companies to borrow money from household investors in exchange for regular interest payments and sometimes additional benefits (vouchers, special discounts, etc.). After a pre-determined period, the capital is repaid to the investor. Unlike retail bonds listed on the London Stock Exchange, mini-bonds are typically sold to investors directly by the issuing company or through online crowdfunding platforms, such as Crowdcube, Crowdstacker or CODE investing, and cannot be sold by the investor to a third party.

If, you are not sure whether or not you hold a mini-bond, you can see a list of mini-bond issuers by clicking on the link below.

<1> Yes, I currently hold one or more mini-bonds

<2> Yes, I invested in mini-bonds in the past but no longer hold any

<3> No, but I am considering investing in mini-bonds in the future

<4> No, I have never invested in mini-bonds and would be unlikely to do so in the future ***#SCREEN OUT***

<5> No, I have never heard of mini-bonds ***#SCREEN OUT***

<5> I'm not sure ***#SCREEN OUT***

{page intro}

Thank you for agreeing to take part in this questionnaire. We would now like to ask you some questions about mini-bonds.

Please note that all your answers are anonymous and will be aggregated accordingly. The survey should take approximately 5 minutes to complete and your YouGov Account will be credited with <>25<> points.

In order to begin please click the arrow below.

{end page intro}

#Section One -This whole section is to be asked to all who currently hold one or more mini-bonds [those who answered code1 at S2]

[Q1] How many mini-bonds do you currently hold?

#[Drop down box of numbers, 1-100]

[Q2] Which, if any of the following mini-bonds do you currently hold? If you have more than 10 please think about the ones you have invested the most money in. ***#Only show the last piece of text if Q1 = More than 10***

Please start typing the mini-bond issuer and it should appear, if not keep typing.

[Q3] {single} Do you have any other mini-bonds that were not listed above?

<1> Yes, please specify

<2> No

<3> Don’t know

[Q4] How much have you invested in each of these mini-bonds?

[Q5] What interest rate and term did you get on each of your mini-bonds?

[Q6] When did you take out each of these mini-bonds?

[Q7] How did you take out these mini-bonds?

#[Grid with each mini-bond listed at Q1 – must answer for each option] #randomize

<1> Directly with the company

<2> Through a crowdfunding website e.g. Crowdcube etc.

<3> Through my employer

<4> Other, please specify #fix

<5> I don't remember #fix

[Q7a] Are any of your mini-bonds included in a tax-wrapper (for example, an Innovate Finance ISA, ISA badge etc.)?

#[Grid with each mini-bond listed at Q1]

<1> Yes

<2> No

<99> Don't know

[Q8] {single} Did you receive any advice prior to taking out your mini-bond(s)? #randomize

<1> Yes, I used a professional financial advisor

<2> Yes, I got advice from family and/or friends

<3> Yes, my company provided advice

<90> Yes, advice from another source #fix

<4> No, I did not receive any advice #fix

<5> I don’t remember #fix

[Q9] How confident are you that you will get back the amount that you have invested in your mini-bonds?

#[Grid with each mini-bond listed at Q1]

<1> Extremely confident

<2> Quite confident

<3> Neither confident or not confident

<4> Not that confident

<5> Not at all confident

<6> Don’t know

[Q10] {single} How likely would you be to take out more mini-bonds in the future?

<1> Not at all likely

<2> Not that likely

<3> Neither likely or unlikely

<4> Quite likely

<5> Highly likely

<6> Not sure

#Section 2 to be asked to all who have invested in mini-bonds in the past but no longer have them [if they answered code2 at S2]

[Q11] How many mini-bonds have you held in the past?

#[Drop down box of numbers, 1-100]

[Q12] Which, if any of the following mini-bonds did you hold? If you had more than 10 please think about the ones you invested the most money in. ***#Only show the last piece of text if Q11 = More than 10***

[Q13] {single} Did you have any other mini-bonds that were not listed above?

<1> Yes, please specify

<2> No

<3> Don't know

[Q14] How much did you invest in each of these mini-bonds?

[Q15] What interest rate and term did you get on each of your mini-bonds?

[Q16] When did you take out each of these mini-bonds?

[Q17] How did you take out these mini-bonds?

#[Grid with each mini-bond listed at Q11]

#randomize

<1> Directly with the company

<2> Through a crowdfunding website e.g. Crowdcube etc.

<3> Through my employer

<4> Other, please specify #fix

<5> I don't remember #fix

[Q17a] Were any of your mini-bonds included in a tax-wrapper (for example, an Innovate Finance ISA, ISA badge etc.)?

#[Grid with each mini-bond listed at Q1]

<1> Yes

<2> No

<99> Don't know

[Q18] {single} Did you receive any advice prior to taking out your mini-bond(s)?

#randomize

<1> Yes, I used a professional financial advisor

<2> Yes, I got advice from family and/or friends

<3> Yes, my company provided advice

<90> Yes, advice from another source #fix

<4> No, I did not receive any advice #fix

<5> I don't remember #fix

[Q19] Did you get what back what you expected for each of the mini-bonds that you held?

#[Grid with each mini-bond listed at Q11]

<1> Yes

<2> No

<3> Don't know

[Q20] {single} How likely would you be to take out more mini-bonds in the future?

<1> Not at all likely

<2> Not that likely

<3> Neither likely or unlikely

<4> Quite likely

<5> Highly likely

<6> Not sure

#Section 3: ask to all who are considering taking out mini-bonds in the future [All who answered code3 at s2]

[Q21] {multiple} Which, if any of the following mini-bonds have you heard of?

[Q22] {multiple} Which, if any of these mini-bonds are you considering taking out?

[Q23] {single} Are there any other mini-bonds that you have reviewed or are considering that were not listed above?

<1> Yes, please specify

<2> No

<3> Don't know

[Q24] {single} How much would you consider investing in mini-bonds?

<1> Up to £500

<2> £500 to £999

<3> £1,000 to £1,999

<4> £2,000 to £2,999

<5> £3,000 to £3,999

<6> £4,000 to £4,999

<7> £5,000 to £9,999

<8> £10,000 to £14,999

<9> £15,000 to £19,999

<10> More than £20,000

<11> Not sure

[Q25] {single} Would you seek advice prior to taking out a mini-bond?

#randomize

<1> Yes, I would use a professional financial advisor

<2> Yes, I would get advice from family and/or friends

<3> Yes, I would get advice from my company

<90> Yes, I would get advice from another source #fix

<4> No, I did not receive any advice #fix

<5> Not sure #fix

#Section 4: Ask all

Randomise statements dyngrid

[Q26] To what extent do you agree or disagree with each of the following statements about mini-bonds?

- Mini-bonds are a safe and profitable way of investing your money

- Mini-bonds will always provide a better return than regular savings accounts

- Mini-bonds are risky and you should only invest what you are prepared to lose

- You may lose all of your money if you invest in a mini-bond

- Companies that issue mini-bonds do so responsibly and ethically

- Mini-bonds are regulated by the Financial Conduct Authority so are a safe investment

- Mini bonds are covered by the Financial Services Compensation Scheme (FSCS)

- Any company can issue mini-bonds

- Mini-bond issuers are legally obliged to disclose how they intend to use the money they raise

<1> Strongly agree

<2> Agree

<3> Neither agree nor disagree

<4> Disagree

<5> Strongly disagree

<6> Not sure

[Qual_available]

{module qual_opt_in}

To follow up on this survey, YouGov is conducting paid **telephone interviews** in order to explore the topics covered in this survey in more depth.

The telephone interviews will last approximately 30 - 45 minutes and to thank you for time and feedback we are pleased to offer you **£30 in Amazon vouchers**.

Interviews will take place between ** _23rd of September_ ** and ** _19th of October_ ** and will be conducted at a time convenient to you (weekdays between 9.15am-7.00pm).

We will record the interview for note taking purposes, and on completion of the research, we will share anonymous insights and the recording with our client. The tape recording will not be made public.

Please note that registering your interest and availability for an interview will not guarantee your selection, however it will ensure that you are shortlisted as a possible participant. If you are selected to take part and are no longer available it is important that you let us know immediately so that we can find a replacement.

[available_qual] {single} **Are you interested and available to take part in a telephone interview on a weekday between _23rd of September_ and _19th of October_ **?

<1> Yes, I'm interested in and available to take part

<2> No, I'm not available

{

if available_qual==2: is_sure_screenout = True

}

{goto page p_thanks if is_sure_screenout}

#screen out if 2

{end module qual_opt_in}

#---

[Dates] Please tell us <>your availability to take part in a telephone interview between the 23rd of September_ and _19th of October (Monday – Friday).<> Please provide a minimum of three times/dates that work for you to help us with scheduling.

[phone_number] {open} Please provide us with the best telephone number(s) to contact you on. Please note that your telephone number will be used for the purposes of this research only and will not be stored for longer than necessary.

[email_address] {open} Please provide us with the best email address(es) to contact you on. Please note that your email address will be used for the purposes of this research only and will not be stored for longer than necessary.

{page p_thanks} ***#Only show if <1> at available_qual***

Thank you for taking the time to fill out these questions. If you are selected to participate in the research, you will be contacted via email with further information.

If you don't hear from us then this will mean that unfortunately you haven't been selected.

{end page p_thanks}

A2.1.2 Screening sample

About 5,800 people on YouGov's panel were screened to identify mini-bond holders. The respondents were not chosen from a nationally representative sample (where the incidence rate of mini-bond holders was expected to be too low). Rather, the sample for screening included UK adults who hold at least one investment product from a pre-defined list. The list is provided in a table below, alongside the number of people on YouGov's panel that hold each of the investment products. The underlying rationale was that people who hold some investment products are most likely to have invested in mini-bonds.

Table 3 Investment products tracked on YouGov's panel

Investment type	Count
Stocks and shares	30210
Unit trust/OEIC	6565
Other types of investment funds	4872
UK Government bonds	4547
Endowment policies, with-profits insurance policies or unit-linked insurance policies	3543
An investment bond with a life insurance company	3256
Investment trust	3109
Employee options / share schemes	3058
Other	3003
Company bonds	2268
Exchange traded funds (ETF/Tracker Funds)	1460
Real estate investment trusts (REITs)	727
Overseas Government bonds (exc. emerging market)	641
Spread betting account or Contracts for Difference account	566
Commodities (e.g. options or futures)	484
Absolute return and hedge funds	447
Emerging market sovereign debt	332
Options and futures (exc. commodities)	283
Total	**69371**

Source: YouGov

A2.1.3 Data cleaning and analysis

Of the 5,800 people targeted, 4,426 responded to the screening question. Of these, 2,525 said that they never heard of mini-bonds. A further 1,566 said they have never invested in mini-bonds and would be unlikely to do so in the future; 188 said that they have not invested in mini-bonds but are considering it in the future. Finally, 100 said that they currently hold a mini-bond and 45 said that they invested in mini-bonds in the past but no longer hold any.

However, the subsequent data cleaning led to the removal of 34 respondents who claimed to have or have had a mini-bond, but whose detailed answers suggested that they did not. When asked to name the provider of the product, they listed companies that never issued mini-bonds but did issue other kinds of bonds or shares. A small number of investors listed the names of banks, suggesting that they confused their fixed rate 'bond' with a mini-bond. In addition, some bond entries had to be excluded from respondents who had invested in mini-bonds, but in their survey responses included also other products. This affected a further 34 bond entries from 10 mini-bond holders.

This led to the final sample of 74 current mini-bond holders and 37 past mini-bond holders. However, even this group can be split into two. Of the 74, only 42 could be 'verified' as mini-bond holders because the products they indicated in the survey were indeed mini-bonds. Among past mini-bond holders, 15 could be verified. The rest includes people who said they have a mini-bond (or had one in the past), but did not provide the name of the mini-bond. These two groups explain why the market sizing from investor perspective is reported as a range between two point estimates.

The econometric analysis of socio-demographic characteristics that predict taking out a mini-bond investment was performed as follows:

- The chosen model specification is a logistic regression model. Instead of the ordinary logistic probability distribution, the Firth method is used (also known as penalised likelihood). This method is chosen to reduce the small-sample bias introduced by the fact that the incidence of mini-bond investors in the investor population is small. Although the total sample size is large (4,426 investors), the small-sample bias is still present because one of the groups in the binary model (mini-bond holders and non-mini-bond holders) is small. The Firth method is generally recommended by the literature for circumstances where logistic regression is used to model rare events.[33]
- The regressors included: social grade, region, age, gender, risk scale and a measure of income/wealth. The latter measure was modelled using personal income, household income or investable assets. In the regression model, only one of these three was included at a time to avoid large multicollinearity.

A2.2 Investor interviews

This annex sub-section first describes (in A2.2.1) the approach with respect to investor interviews that helped to inform this study, including the duration of the interviews, when they took place, and the sample inclusion criteria used. It then provides (in A2.2.2) the interview guide used by the researchers conducting these interviews.

A2.2.1 Approach

- 20 telephone depths were conducted during late September / October 2019 with retail investors who all currently invest in a mini-bond from a total of 17 unique issuers:
    - Asset Life
    - Blackmore Bonds
    - BrewDog
    - Chilango
    - Clearwell Capital Group
    - Ecotricity
    - Harewood Associates
    - Harlequin F.C.
    - Hotel Chocolat
    - The Jockey Club
    - John Lewis
    - LCF

[33] See, for example, https://statisticalhorizons.com/logistic-regression-for-rare-events.

- Mr and Mrs Smith
- Naked Wines
- Surrey County Cricket Club
- Taylor St Baristas
- Wellesley & Co.

- The interviews lasted 30-45 minutes and were moderated by YouGov senior researchers.
- All but one respondent was recruited off the back of the investor survey hosted by YouGov. YouGov has a UK online research panel of 1.6 million people, which are profiled regularly on their demographics and investment products.
- Respondents were incentivised in line with the MRS Code of Conduct – a £40 retail voucher was offered.
- All data has been made anonymous; all names used in the case studies are not respondent's real names.

Sample inclusion criteria:

- All currently invest in at least one mini bond
- Mix of mini bond providers
- Mix of gender, income, working status, age, region and ethnicity – there is a natural skew towards men
- Mix of investing experience.

Sample profile of those who currently have a mini bond:

Table 4 Sample profile of interviewed investors

Respondent	Gender	Age	Region
1	Female	40	London
2	Female	58	South West
3 (non YG sample)	Male	40	London
4	Male	49	Scotland
5	Male	47	North West
6	Male	73	North East
7	Male	62	South East
8	Male	48	London
9	Male	76	London
10	Female	26	Scotland
11	Male	36	West Midlands
12	Female	34	Northern Ireland
13	Male	39	London
14	Female	58	South East
15	Male	65	London

16	Male	43	East of England
17	Male	37	North East
18	Male	71	London
19	Female	58	South East
20	Male	71	Essex

Source: YouGov

A2.2.2 Guide for researchers

Draft discussion guide for 20x tele-depths with consumers who have a mini-bond / recently had a mini-bond

30-45mins

Introductions (3 minutes)

Hello, thanks for agreeing to take part in this telephone discussion. My name is Olivia/Jane.

We will be exploring your perceptions and experiences of investing in non-transferable debt securities, sometimes known as mini-bonds.

Everything you share today is anonymous and will not be attributed to you. Please note that there are no right or wrong answers

Please note that this session will be tape recorded for the purpose of note taking and will only be shared with the research team – YouGov and London Economics.

- Please start by introducing yourself by your first name, age, job role/ working status and region you live in

Investment behaviour and knowledge (8-10mins)

- When did you start investing (in any financial product)? How old were you?

- How experienced would you say you are at investing? What makes you say this?
  - How confident are you in investing? Why do you say this?
  - Would you consider yourself a 'professional investor'? Why / why not?
  - What do you think differentiates a professional investor from a non-professional?

- Where do you get your financial information and knowledge from? *Probe: work, peers, media, financial blogs / websites, FA's, personal experience over time*
  - When making financial decisions, which sources, if any do you consult? *Probe: product provider vs. other research*

- Please give me a brief overview of all of the investment products you hold? *E.g. shares, stocks, bonds, hedge funds, investment trusts, bitcoin etc.*
    - What motivates you to invest (in general)? What do you like about investing?
    - What motivated you to invest in these particular products?
    - Are there any downsides to investing?

<u>Non-transferable debt securities / mini-bonds – customer journeys (15- 20 mins)</u>

- What comes to mind when you think about the term 'mini-bonds'? *Images, words, associations, feelings. Positive or negative?*
    - How did you first learn about mini-bonds? When was this?
    - What were your initial perceptions of mini-bonds when you first heard of? Any initial concerns?
    - How would you describe them to someone who has never heard of one?

- For the purpose of this research here is a definition of mini-bonds:

"These are sold to household investors who receive their money back at the end of a set time period, as well as interim, often high interest payments and sometimes additional benefits (vouchers, special discounts, etc.). Unlike other bonds listed on the London Stock Exchange or marketed only to large investors, mini-bonds are typically sold to investors directly by the issuing company or through online platforms, such as Crowdcube, Crowdstacker or CODE investing, and cannot be sold onwards by the investor."

    - Any surprises? If so, what?

- Just to confirm do you currently have any mini-bonds? Or when did you last have a mini-bond?
    - How many do you <u>currently have</u> and with who?
        - Where did you purchase them from e.g. the company directly or an intermediary e.g. CrowdCube, Crowd stacker, Funding circle, law firm, employer etc?
        - Why did you choose this route to purchase? *Probe: brand loyalty, trust, awareness, recommendations, marketing*
    - How many have you <u>ever had</u> and with who?
        - Where did you purchase them from e.g. the company directly or an intermediary e.g. CrowdCube, Crowd stacker, Funding circle, law firm, employer etc?
        - Why did you choose this route to purchase? *Probe: brand loyalty, trust, awareness, recommendations, marketing*

- **Let's now focus on your current mini-bonds (or your most recent mini-bonds if you do not have any currently):**
    - Per mini-bond – how much have you invested?
    - Can you remember what the interest rate and term is? Are there any other potential rewards e.g. vouchers, consumer products?
    - What were your reasons for investing in this particular mini-bond product(s)?
        - Did you receive any <u>marketing</u> material about? If so, what role did this play? Was it clear and transparent or not?
        - How was it marketed? What were the key things advertised e.g. rates of return, FCA authorisation etc?
        - Where did you see this marketing? E.g. press, internet ad's, social media, companies website etc.
        - *Probe role of trust in company*
    - Did you have any worries / concerns at first?
    - Do you know what the outcome was for this bond(s)?
        - Were you satisfied or not with the outcome (if known yet)? Why do you say this?

- <u>Research conducted</u>: How do you typically go about deciding which mini-bond(s) to invest in?
    - Do/ did you seek advice from anyone? If so, who and why? E.g. FA, peers, investment manager
    - Do /did you do any research? If so, what type? What sources do you use and why?
    - Do/did you understand the business model of the company you are investing in? Why/ why not? E.g. age, start up, status, who owns it, how they will use the money etc
        - Do/did you know if the company was regulated? If so, what does this mean to you?
    - Do/did you study the financial performance of the company you are investing in? Why/ why not? If so, how?
        - Do you still monitor the performance of the company?

- Have you <u>ever had</u> any mini-bonds that have been included in a tax-wrapper (for example, an Innovate Finance ISA, ISA badge)? Which ones, if so?
    - <u>If so,</u> have you benefited from the tax relief?
    - If a tax-wrapper was available, did it affect your decision to invest? Why/ why not? If so, in what way?

- <u>If they have had more than 1 mini bond</u>: How much do you typically invest in a mini-bond? Do you have an upper limit for mini-bonds, if so what?
    - How have you come to this decision / amount? *Probe: views on risk vs potential rewards*

- IF they say at the start that they are a professional investor: When investing in the mini-bond, did you explicitly request to be treated as a professional investor? Why / why not?

Understanding of risk and regulation (7 - 10 mins)

- If you had not invested your money in a mini-bond, what would you have invested in instead, if anything? Why?

- How confident have you been / are you that you will get your money back when investing in mini-bonds? What makes you say this?
    - *Probe: if confidence varies across mini-bond products / providers?*
    - What do you think would happen in the event the issuer defaults? How do you know this?

- What is your understanding of the risk associated with these products?
    - How risky are they generally? What do you mean by this?
    - Are they safe? What do you mean by 'safe'?
    - Thinking about all mini-bonds you have had – did you ever think you might lose capital on your mini-bond investment?
        - How likely do you think this is? What makes you say this? *e.g. advice provided, media stories etc*
        - How does this make you feel?

- What is your understanding of the regulation around mini-bonds?
    - Is your mini-bond(s) investment protected by the Financial Services Compensation Scheme do you know?
    - How do you feel about this?

- Did you know that mini-bonds are non-transferable? What are your views on this?

- If the company that you lent money to goes bust, what happens then? Do you think you're likely to recover any part of your investment?
    - What makes you think this?
    - How does this make you feel?
    - Have you ever experienced this? If so, what happened and what impact did it have on you and your finances?

Conclusions (3 – 5 mins)

- How likely are you to invest in mini-bonds in the future? Why do you say this?

- Would you recommend them to friends? Why / why not?

- What advice would you give anyone thinking of investing in a mini-bond?

- Any other comments on the topic?

Thank you and close

If there are any concerns, point them towards the FCA guidance on mini-bonds: ttps://www.fca.org.uk/consumers/mini-bonds

A2.3 Market sizing

This annex sub-section explains the methodology of our estimates of the size of the market for NTDSs. A2.3.1 explains the methodology for the demand-side estimate, while A2.3.2 explains the methodology for the supply-side estimate.

A2.3.1 Demand-side

The methodology for the market sizing using the data from the investor survey is described in detail in Subsection 3.2.2.

The approach can be summarised with the following equation, where **bold** variables describe sample statistics and un-bolded variables denote population statistics:

$$Value = UK\ pop \times \frac{UK\ investing\ adults}{UK\ pop} \times \frac{\boldsymbol{NTDS\ holders}}{\boldsymbol{UK\ investing\ adults}} \times \frac{\boldsymbol{\#\ of\ NTDSs\ held\ by\ verified\ NTDS\ holders}}{\boldsymbol{Verified\ NTDS\ holders}} \times (\pounds\ \boldsymbol{per\ NTDS})$$

The share of UK investing adults in UK population is retrieved using YouGov's audience analytics and profiling tool, YouGov Profiles that can reveal the natural incidence rate of people that hold one of the investment products listed in Annex A2.1.2.

The number of NTDS holders in the screened sample was 111 and the number of screened investors in total was 4,426 (see Annex A2.1.2). The ratio of these two numbers corresponds to the second fraction in the equation.

The number of mini-bonds ("# of NTDSs held by verified NTDS holders") is the sum of the number of mini-bonds held by all verified mini-bond holders. Dividing this number by the number of verified NTDS holders gives the average number of mini-bonds held.

Finally, the average value of an NTDS investment ("£ per NTDS") is given by first summing the value of all mini-bonds where the verified NTDS holder provides the investment value. This is then divided by the number of such NTDS holders in the sample.

A2.3.2 Supply-side

To calculate the supply-side estimate of the size of the NTDS market over its lifetime, we summed all of the known values of the mini-bond issues in the LE mini-bond register.

To calculate the supply-side estimate of the value of mini-bonds live in 2019, we summed the known values of the mini-bond issues in the LE mini-bond register whose maturity dates, calculated by taking the origination date and adding the bond's term, were in 2019 or later. This means that the value of mini-bonds issued by failed issuers was included in this calculation. This inclusion is justified, since the issuer going into administration does not remove the obligation to bondholders or the claim that bondholders have (even if their coupons are not being paid). Information on origination dates, maturity dates and terms was taken from the LE mini-bond register.

The information in the mini-bond register referred to here was taken from contemporary press articles, blog posts, company accounts and administrators' reports and our primary research. The primary and secondary research were used to cross-check each other where possible.

A2.4 Mini-bond register and FAME data

The LE mini-bond register contains information on 152 mini-bonds issued in the UK between 2009 and 2019 and the 68 companies that issued them. Regarding the mini-bonds it contains, where the data was available, information on the origination date, term, maturation date, coupon rate, level of investment, minimum and maximum target issues, number of investors, minimum and maximum levels of investment per investor and mode of issuance. This information was taken from contemporary press articles and blog posts, platform webpages, issuer websites, company accounts and other records on Companies House, bond invitation documents, administrators' reports and our primary research. The primary and secondary research were used to cross-check each other where possible.

The exports from FAME (a proprietary database published by Bureau van Dijk), where the data was available, the company's name, its date of incorporation, its age at the end of the year in which it issued each of its mini-bonds, its status (whether it is active or dormant, whether it is in administration or not, whether it has been dissolved or not, and whether it is in voluntary arrangements or not), whether or not it is an SME, its assets in the year it issued each of its mini-bonds, its turnover in the year it issued each of its mini-bonds, the number of employees it had in the year it issued each of its mini-bonds or, where that data was unavailable, and the number of employees it had in the next year in which that data was available. LE researchers added to this information the sector in which the companies operated.

A2.4.1 Figures on issuers in sections 4 and 6

The figures on issuers in sections 4 and 6 were constructed using data from the LE mini-bond register.

Several of these figures make comparisons between the mini-bond market from 2009 to 2014 and from 2015 to 2019. These two periods were chosen because each represents around half of the lifetime of the mini-bond market, and a noticeable change is observable in various characteristics of the market between these two periods. 2015 is also the year in which LCF entered the mini-bond market.

To produce Figure 6, the number of issuers classed in each sector was summed. Each company was counted at most once – so while some companies issued multiple mini-bonds, they are counted only once for the purposes of this figure.

For the production of Figure 7, the number of issuers who issued a mini-bond(s) before 2015 that were classed in each sector was summed and this was compared with the number of issuers who issued a mini-bond(s) in 2015 or later that were classed in each sector was summed. Each issuer was counted at most once in each time period, so a company that issued multiple mini-bonds in one of these time periods is counted only once in that period. However, a company that issued a mini-bond(s) in each period is counted in each period.

To produce Figure 8, the total of the known values of the mini-bonds of each issuer in each sector was summed.

To produce Figure 9, the total of the known values of the mini-bonds in the periods 2009 to 2014 and 2015 to 2019 of the issuers in each sector was summed.

To produce Figure 10, we calculated the percentage of issuers that were classed as being in the financial services sector in each year. Each issuer was counted at most once in each year, so that if a company issued multiple mini-bonds in one year then it is counted once in that year. One firm whose sector could not be identified was omitted from the percentage calculations.

To produce Figure 11, Figure 12, Figure 13 and Figure 14, firms with one to nine employees were classified as micro-enterprises, firms with 10 to 49 employees are classified as small businesses, firms with 50 to 249 employees are classified as medium-sized businesses, and firms with 250 employees or more are classified as large businesses. For figures concerning numbers of issuers of different sizes, each issuer is counted once; if an issuer issued mini-bonds in more than one year, its size in the year in which its first mini-bond issue occurred, or the next year after that for which the data is available, is used. For figures concerning the value of mini-bonds issued by issuers of different sizes, the issuer's size in the year of the mini-bond whose value is being considered is used.

Figure 15 compares the ages of mini-bond issuers with those of all UK companies. The data for all UK companies is simply taken from the Companies House Companies Register Activity 2017-18; the effective register is used. Mini-bond issuers' ages were calculated by finding the time from their incorporation date to the end of the year of their first mini-bond issue.

Figure 16 was constructed by summing the known values of mini-bonds issued by companies in each of the age categories shown, with their age being calculated as the number of years between the end of the year of the mini-bond's issue and the issuer's incorporation date. In some cases, the information from the LE mini-bond register was not available at a sufficient level of disaggregation to allow this calculation. For instance, the total value of an issuer's mini-bond issues over two years was known but it was not known how much of this value was accounted for by each year, and the issuer was in different age categories in the two years. In cases like this, the mini-bond issues in question were omitted from this analysis. This problem was not common, though.

Figure 17 and Figure 18 display the percentages of issuers in each age category in the 2009 to 2014 period and the 2015 to 2019 period. As described above, if an issuer issued mini-bonds in more than one year in one of the periods, its age in the year of its earliest issue in that period is used.

To construct Figure 18, the percentages of the total value of mini-bonds issued in the periods 2009 to 2014 and 2015 to 2019 were calculated as follows. First, values of mini-bonds issued by companies in each age category in each of these two time periods was calculated in the same way as for Figure 16. Then the known values of mini-bonds issued in these periods were summed. Percentages were then calculated.

In Figure 30, the number of issuers identified as having made an issue through a platform was counted, and the number of issuers identified as having made an issue other than through a platform counted. Together these two categories were exhaustive. Each issuer could be counted at most once in each category, so that – for instance – an issuer who made two issues through a platform would be counted once under "Issued through a platform". However, an issuer who issued through a platform for a mini-bond issue(s) but other than through a platform for another mini-bond issue(s) would be included in both counts.

Figure 31 was constructed using the percentages of issuers in each year who had issued through a platform and who had issued other than through a platform. Each issuer was counted once in each year.

Figure 32 was constructed by summing the known values of mini-bonds issued through a platform and of mini-bonds issued outside a platform, throughout the lifetime of the market.

Figure 33 was constructed by summing the known values of mini-bond issues before 2015 and from 2015 onwards for issues made through a platform and for issues made not through a platform. The known value of mini-bonds issued in each of these periods was calculated by simple summation. Percentages were then calculated.

A2.5 Stakeholder survey

This sub-section describes the methodology we applied to the stakeholder survey that helped to inform this report. A2.5.1 describes what different stakeholders were asked in the survey, and the rationale behind this. A2.5.2 gives the design of the survey questionnaire. Finally, A2.5.3 describes how we invited participants, and gives the number of respondents as well as a breakdown of the stakeholder categories they fell into.

A2.5.1 Approach

The survey questionnaire, presented below, was designed so that different sorts of stakeholder were asked different questions. This meant that stakeholders were asked only those questions to which they would best be able to respond. The questions were designed to gather information beyond that we were able to obtain through our secondary research, but also to gather basic information that we could use to verify the information obtained from publicly-available sources. The questions asked issuers about the features of their mini-bonds, the success of their mini-bond issues, their decisions around their mini-bond issues and their experience of mini-bond issuance. Platforms were asked about their activity in the mini-bond market, about the differences between debt- and equity-based funding, and about the motivations of firms issuing mini-bonds on their platforms. Other intermediaries were asked about their activity in the mini-bond market, their decision on whether or not to work with an issuer, issuers' motivations for entering the mini-bond market, and mini-bond marketing.

A2.5.2 Survey questionnaire design

London Economics has been commissioned by HM Treasury to develop an economic study of the market for non-transferable debt securities (NTDSs), sometimes known as 'mini-bonds'. NTDSs are unlisted bonds issued by companies for retail investors. Unlike listed bonds, mini-bonds cannot be sold onwards by the investor and must be held to maturity.

You have been invited to participate in this survey because our research suggests that your company has in the past either issued a mini-bond, advised mini-bond issuers or provided a platform for mini-bond issuance.

Your answers will be treated as confidential and London Economics will not share them with anyone, including HM Treasury. Our findings will be reported only in an aggregated format that makes it impossible to identify individual responses.

There are a few questions to which answers are required; these are marked with red asterisks.

CATEGORY ASSIGNMENT

Q0.1: What is your name, the name of your organisation and your position within your organisation? *

FREE RESPONSE

Q0.2: Which of the following best describes your organisation? *

A:

(1) My organisation has in the past issued at least one 'mini-bond'
(2) My organisation has advised or assisted at least one 'mini-bond' issuer
(3) My organisation provides or provided in the past a platform for 'mini-bond' issuance
(4) My organisation was never professionally involved with 'mini-bonds'

ISSUERS [If Q0.2=1]

Q1: How many people, including yourself, are employed by your company?

A: NUMBER or

Don't know.

Q2: What is the annual turnover of your company?

A: More than £50m

More than £10m but less than £50m

More than £2m but less than £10m

Less than £2m

Q3: Does your company have Financial Conduct Authority (FCA)/Prudential Conduct Authority (PRA) authorisation?

A: YES or

NO or

Don't know.

Q4: What industry is your company in? Please choose one; if multiple options apply, please choose the most relevant.

A: Energy

Financial Services

Food & Drink

Healthcare and Health Services

Real Estate

Retail and Consumer Goods

Sport

Technology

Tourism

Other – please specify: ___.

Q5: Have many times have you issued NTDSs ('mini-bonds')? *

A: NUMBER

IF A = 2:

Q5.1: What percentage of investors did you retain from the first issue to the second issue?

A: NUMBER % or

Don't know.

IF A >= 3:

Q5.1 and

Q5.2: What percentage of investors did you retain from the second issue to the third issue?

A: NUMBER % or

Don't know

Q6: What was the total level of funding raised by your company's NTDS issue(s)?

A: NUMBER or

Don't know.

OPTION TO SELECT DIFFERENT ANSWERS FOR EACH ISSUE IF RESPONDENT ANSWERED > 1 TO Q5

Q6.1: How much, by value, of the NTDS(s) your company issued is yet to mature?

A: NUMBER or

Don't know.

Q7: What other funding arrangements does your company have in place or has used in the last 5 years? Please select all that apply.

A: Bank loan – unsecured

Bank loan – secured

Loan from non-bank financial institution – unsecured

Loan from non-bank financial institution – secured

Loan from a peer-to-peer platform

Listed corporate bond (exc. retail bond)

Listed retail bond

Debt-based crowdfunding ("crowd bond")

Equity-based crowdfunding

Other equity (IPO, venture capital, private equity, seed capital etc.)

Other – please specify: ___.

Q8: For which purposes were the funds raised through a NTDS(s) used? Please select all that apply.

A: Working capital

Bridge finance

Investment in productive assets

Investment in financial assets

Investment in staff

Acquisitions

R&D

Refinancing

Putting the balance sheet on a sounder financial basis (for example, changing the debt-to equity ratio, maturity transformation, reducing interest expenses)

Other – please specify: ___.

OPTION TO SELECT DIFFERENT ANSWERS FOR EACH ISSUE IF RESPONDENT ANSWERED > 1 TO Q5

Q9: What would you have done if you had been unable to issue a NTDS?

A: Raise funds through a different instrument (e.g. bank loan, listed retail bond or equity issue)

Scale down or cancel the activity for which the funding was to be used

Other – please specify: ___.

Q10: What were your motivations for issuing a NTDS? Please choose the three most relevant options from the following list.

A: Insufficient finance offered by bank

Insufficient finance offered by other sources

Favourable collateral or guarantee requirements

Favourable interest rate

Lower time/resource requirements

Other terms & conditions

Time for funds to be provided

Reputation/relationship with customers

Flexibility – please clarify: ___.

Financial covenants

Repayment and interest payments schedule

Other – please specify: ___.

Don't know.

Q11: Please rank the three answers you selected in the previous question (Q8) in order of importance, where [1] was the most important and [3] the least.

A: Ranking of selections from previous question from [1] to [3]

Q12: Did investors in your NTDS(s) have the option to choose between receiving interest in cash or in the form of vouchers, loyalty coupons, store credit or similar rewards? *

A: YES, they could select receiving interest payments in cash, rewards or a combination of the two.

YES, they could select receiving interest payments only in cash or only in rewards.

NO, the interest payments were paid only in cash.

NO, the interest payments were paid only in rewards.

NO, the interest payments were only paid in a combination of cash and rewards.

If YES:

Q12.1: What percentage of investors chose the cash option?

A: NUMBER % or

Don't know.

Q12.2: What percentage chose the rewards option?

A: NUMBER % or

Don't know.

OPTION TO SELECT DIFFERENT ANSWERS FOR EACH ISSUE IF RESPONDENT ANSWERED > 1 TO Q5

Q13: How many investors purchased your NTDS(s)?

A: NUMBER or

Don't know.

OPTION TO SELECT DIFFERENT ANSWERS FOR EACH ISSUE IF RESPONDENT ANSWERED > 1 TO Q5

Q13.1. How many of them were professional/institutional investors?

A: NUMBER % or

Don't know

Q14: Did you target a specific type or group of investors when issuing your NTDS(s)?

A: YES

NO

If YES:

Q14.1: What group or type of investors did you target? Why?

FREE RESPONSE

Q15: What was the minimum level of investment allowed in your NTDS(s)?

A: £ NUMBER or

No minimum or

Don't know.

OPTION TO SELECT DIFFERENT ANSWERS FOR EACH ISSUE IF RESPONDENT ANSWERED > 1 TO Q5

Q16: What was the maximum level of investment allowed in your NTDS(s)?

A: £ NUMBER or

No maximum or

Don't know.

OPTION TO SELECT DIFFERENT ANSWERS FOR EACH ISSUE IF RESPONDENT ANSWERED > 1 TO Q5

Q17: Did you offer your investors to include your NTDS(s) within a tax-wrapper (such as an Innovative Finance ISA)?

A: YES

NO

Don't know.

If YES,

Q17.1: Could you provide more details?

A: FREE RESPONSE

OPTION TO SELECT DIFFERENT ANSWERS FOR EACH ISSUE IF RESPONDENT ANSWERED > 1 TO Q5

Q18: Did you use a crowdfunding platform, such as Crowdcube or Crowdstacker, or a broker in issuing your NTDS(s)?

A: YES

NO

If YES:

Q18.1: Why did you choose to use a platform or broker?

A: FREE RESPONSE

Q18.2: What was the name of this platform or broker?

A: FREE RESPONSE

OPTION TO SELECT DIFFERENT ANSWERS FOR EACH ISSUE IF RESPONDENT ANSWERED > 1 TO Q5

Q19: Were you advised on your NTDS issue(s) by a law firm, a professional services firm or similar?

A: YES

NO

If YES:

Q19.1: What was the name of this firm?

A: FREE RESPONSE

and

Q19.2: Why did you seek the advice of this firm for your NTDS issue?

A: FREE RESPONSE

OPTION TO SELECT DIFFERENT ANSWERS FOR EACH ISSUE IF RESPONDENT ANSWERED > 1 TO Q5

Q20: Did you use an FCA-authorised firm to approve your financial promotions relating to your NTDS issue(s)?

A: YES

NO

If YES:

Q20.1: What was the name of the firm?

FREE RESPONSE

Q21: What channels did you use to market your NTDS to investors?

A: Financial advisers or brokers

Direct marketing to customers

Direct marketing to employees

Press advertisement

Online advertisement

Company website

Social media

Crowdfunding platform

Other – please specify: ____.

Q22: Did you encounter any difficulties or obstacles during your NTDS issue(s) or during your preparation for it (them)?

A: YES or

NO or

Don't know.

If YES:

Q22.1: What were they?

A: FREE RESPONSE

Q23: Does your company have any plans to issue any further NTDSs in the future?

A: YES or

NO or

Don’t know.

If NO:

Q23.1 Why not?

A: FREE RESPONSE

PLATFORMS [If Q0.2=3]

Q1: How many NTDSs ('mini-bonds') have been issued through your platform?

A: NUMBER or

Don't know.

Q2: What is the total value of the NTDS issues that have taken place on your platform?

A: £ NUMBER or

Don't know.

Q3: What do you believe is the main motivation for firms issuing NTDSs to choose this form of financing? Please choose the three most relevant options from the following list.

A: Insufficient finance offered by bank

Insufficient finance offered by other sources

Favourable collateral or guarantee requirements

Favourable interest rate

Lower time/resource requirements

Other terms & conditions

Time for funds to be provided

Reputation/relationship with consumers

Flexibility – please clarify: ___.

Financial covenants

Repayment and interest payments schedule

Other – please specify: ___.

Don't know.

Q4: Does your platform host both debt-based and equity-based funding? *

A: YES or

NO or

Don't know.

If YES:

Q4.1: Please briefly compare the firms that engage in these two types of funding and any other points of difference between the two funding types.

A: FREE RESPONSE

Q4.2: What do you think the main criteria are for firms when they decide between debt-based and equity-based funding?

A: FREE RESPONSE

ADVISORS TO FIRMS [If Q0.2=2]

Q1: What services do you offer to firms issuing NTDSs ('mini-bonds')?

A: FREE RESPONSE

Q2: How many issues of NTDSs has your organisation assisted in?

A: NUMBER or

Don't know.

Q3: Has your organisation refused to assist in any issues of NTDSs?

A: YES or

NO or

Don't know.

If YES:

Q3.1: Why?

A: FREE RESPONSE

Q4: What do you believe are the main motivations for firms issuing NTDSs? Please choose the three most relevant options from the following list.

A: Insufficient finance offered by bank

Insufficient finance offered by other sources

Favourable collateral or guarantee requirements

Favourable interest rate

Lower time/resource requirements

Other terms & conditions

Time for funds to be provided

Reputation/relationship with consumers

Flexibility – please clarify: ___.

Financial covenants

Repayment and interest payments schedule

Other – please specify: ___.

Don't know.

Q5: How do investors receive promotions of NTDSs, and what information is given to them in these promotions?

A: FREE RESPONSE

A2.5.3 Invitation and participation

We invited issuers and intermediaries – including platforms, promotion advisers and registrars – to complete the survey online using the secure software SmartSurvey, in which we had encoded the survey design given in A2.5.2. Invitations were sent by email to all the stakeholders in these categories we had identified that were still active and for which any email address could be found. Invitations were generally sent to the CEO, CFO or another senior member of staff. In total, 52 issuers and more than 5 intermediaries were invited to complete the survey.

We sent reminder emails at appropriate intervals to stakeholders who had not responded to our invitation, in order to maximise the response rate.

In total, 17 stakeholders, including 14 issuers and 3 intermediaries, responded to the survey.

A2.6 Stakeholder interviews

This sub-section describes the methodology pertaining to the stakeholder interviews that helped to inform this report. A2.6.1 describes the approach, including the purpose and nature of the interviews as well as their duration and when they were conducted. A2.6.2 gives the interview guide that was used by those conducting these semi-structured interviews. Finally, A2.6.3 gives the number of participants, as well as a breakdown of the categories respondents fell into. The names of those interviewees who gave us permission to acknowledge their contribution to the report are given.

A2.6.1 Approach

In addition to our stakeholder survey, we conducted interviews with a range of stakeholders. These allowed in-depth exploration of the knowledge about and the experience of the mini-bond market that various stakeholders had. In the case of issuers, it allowed us to explore particularly interesting survey answers in more detail. The questions asked were tailored to the type of stakeholder being interviewed. Generally, the interviews asked about stakeholders' experience with mini-bonds, their journey in the mini-bond market (including their motivations for entering the market), their views on the regulation of mini-bonds, and their reasoning for the decisions they made around mini-bonds.

The interviews were conducted by London Economics researchers by telephone and in-person between 3rd October 2019 and 23rd October 2019. They followed a semi-structured format, using an interview guide presented in A2.6.2 but allowing the interviewers to use their discretion to explore areas and insights of particular interest in more detail. The interviews were mostly between 30 and 90 minutes in duration.

A2.6.2 Stakeholder interview guide

Introduction

Thank you for agreeing to participate in this interview.

London Economics has been commissioned by HM Treasury to develop an economic study of the market for non-transferable debt securities (NTDSs), sometimes known as 'mini-bonds'. NTDSs are unlisted bonds issued by companies for retail investors. Unlike listed bonds, mini-bonds cannot be sold onwards by the investor and must be held to maturity.

Explain that the purpose of these interviews is to help us learn more about the characteristics of the market and its participants.

Ask permission to take notes, which can be shared afterwards to verify their accuracy.

Ask permission to acknowledge the contribution of the interviewee/organisation in the final report.

Ask permission to attribute individual quotes to the interviewee/organisation.

Ask permission to make audio recording of the interview.

Check that it is OK for the interview to last for 30-60 minutes.

Interviewee Details

Ask for the interviewee's name, their position, their organisation name, and their organisation type (SME or large cap, sector, etc.).

Ask for a brief description of their or their organisation's involvement with NTDSs (issuer or platform or…, etc.).

General Questions

Ask these questions to all participants.

- What are the main benefits, costs and risks of NTDSs (relative to alternatives) for:
  - Issuers?
  - Investors?
- Do you think that NTDSs can help to meet the needs of issuers and investors?

Stakeholder-Specific Questions

Ask the participant one of the following sets of questions given which type of stakeholder the participant is or represents.

Issuers

- In your answers to the survey emailed to you, I can see that you selected [SURVEY ANSWER]. Could you go into a bit more detail on why you selected these options?
- Questions about the NTDS "journey"
  - How did your company discover that issuing an NTDS was an option for raising finance?

- ☐ Which alternative sources of finance did your company consider, and why did you choose an NTDS over or as well as these sources? What were the pros/cons of these options? Did the regulatory treatment of NTDSs play any role?
- ☐ Did your company encounter any barriers to issuing an NTDS, such as difficulty finding legal advice on the issue?
- ☐ What did your company use the finance it raised from the NTDS issue for?
- ☐ Does your company have any plans to issue an NTDS in the future? Why, or why not?

- Questions about the terms/structure of the NTDS
  - ☐ How did you structure the issue? Did you make use of advisors? If so, how?
  - ☐ Did your company offer the investor to include their NTDS investment in a tax wrapper (i.e. an Innovative Finance ISA)? If so, why? Did you have to take some additional steps to be able to offer this? How do you think this influenced investor's actions?
  - ☐ Did you place any restrictions on the amount a consumer could invest?
- Do you find the existing NTDS regulatory regime clear? If not, what in particular is not clear?
- Do you have any information about the characteristics of your investors?
  - ☐ Do they tend to be retail investors or professional investors?
  - ☐ Do the retail investors tend to be consumers or businesses?
  - ☐ Do they tend to be experienced investors?
  - ☐ Do you have any information about their typical socio-demographic characteristics?
  - ☐ Would you consider your investors 'brand-loyal'?
- Did you develop a specific marketing strategy for your issue of NTDSs? What information did you choose to highlight about the issue in your marketing? (I.e. tax wrapper status/ rate of return/ Financial Conduct Authority (FCA)/ Prudential Regulation Authority (PRA) authorisation etc)

Intermediaries & advisers

- In your answers to the survey emailed to you, I can see that you selected [SURVEY ANSWER]. Could you go into a bit more detail on why you selected these options?
- Questions on investors
  - ☐ Can you describe the types of investors that tend to invest in NTDSs?
    - Do they tend to be retail investors or professional investors?
    - Do the retail investors tend to be consumers or businesses?
    - Do they tend to be experienced investors?
    - Do you have any information about their typical socio-demographic characteristics?
  - ☐ Why do you think investors choose to invest in NTDSs, and how do they become aware of them? How does this compare with other types of securities (i.e. shares)?
  - ☐ How do you identify potential investors?
- Questions on issuers
  - ☐ Can you describe the types of companies that tend to issue NTDSs?

    What size of company tends to issue NTDSs?

How old are the companies that tend to issue NTDSs? Do they tend to be start-ups or more established companies?

What sectors do companies that tend to issue NTDSs operate in?

- □ What do you believe are the most important motivations for companies choosing to issue an NTDS (over alternatives)? Does the regulatory treatment of NTDS play any role?
- □ What barriers do companies seeking to issue an NTDS face?
- □ Are issues of NTDS usually successful (i.e. does the target capital usually get fully raised)?

- ■ Questions on the services they provide to issuers
  - □ What services do you offer to companies issuing NTDSs and to investors looking to buy NTDSs?
  - □ Do you have any requirements for companies seeking your advice on or assistance in an NTDS issue?
  - □ Has your company refused to advise on or assist in the issue of an NTDS? If so, can you elaborate on why your company refused to advise on or assist in that issue or those issues?
  - □ What are the different kinds of NTDSs you helped facilitate / advised on? Do all products marketed as 'mini-bonds' have the same legal structure?
  - □ How does your company describe NTDSs when it markets or promotes them? What information is included in your marketing material for NTDSs?
- ■ Questions relating to regulation
  - □ Are some 'mini-bonds' eligible for inclusion in a tax wrapper (i.e. an Innovative Finance ISA)? Which ones? Do you think this influences investor's actions?
  - □ Do you find the existing NTDS regulatory regime clear? If not, what in particular is not clear?
- ■ How has the NTDS market developed over time? (in terms of NTDS types and characteristics, issuer characteristics, investor characteristics, market size…)
- ■ Do you know of any NTDS issues where the issuing company failed to meet its obligations? What types of NTDS issuers tend to default? What tend to be the reasons for the default?

Platforms

- ■ In your answers to the survey emailed to you, I can see that you selected [SURVEY ANSWER]. Could you go into a bit more detail on why you selected these options?
- ■ Questions about investors
  - □ Can you describe the types of investors that tend to invest in NTDSs?
    - – Do they tend to be retail investors or professional investors?
    - – Do the retail investors tend to be consumers or businesses?
    - – Do they tend to be experienced investors?
    - – Do you have any information about their typical socio-demographic characteristics?

  Why do you think investors choose to invest in NTDSs on your platform?
- ■ Questions about companies
  - □ Can you describe the types of companies that tend to issue NTDSs?

- What size of company tends to issue NTDSs?
- How old are the companies that tend to issue NTDSs? Do they tend to be start-ups or more established companies?
- What sectors do companies that tend to issue NTDSs operate in?
- □ What do you believe are the most important motivations for companies choosing to issue an NTDS (over alternatives)? Does the regulatory treatment of NTDSs play any role?

- Questions about their services
  - □ How are NTDSs typically marketed on your platform? What information is included in marketing material for NTDSs?
  - □ What requirements do you place on companies seeking to issue NTDSs through your platform?
  - □ What legal obligations do you as a platform have to the investors and to the issuers?
  - □ Does your platform host both loan-based and equity-based fundraising? If so, what are the differences between the companies and investors involved in NTDS issues versus those involved in equity-based fundraising?
- How many other platforms hosting NTDS issues are you aware of, and how big are they?
- Are there different types of NTDSs in terms of their legal structure? What is the difference between 'mini-bonds', 'crowd bonds' and potentially other unlisted bonds?
- How has the NTDS market developed over time? (in terms of NTDS types and characteristics, issuer characteristics, investor characteristics, market size…)

Consumer organisations, financial advisors, (public authorities)

- Questions about investors
  - □ Can you describe the types of investors that tend to invest in NTDSs?
    - Do they tend to be retail investors or professional investors?
    - Do the retail investors tend to be consumers or businesses?
    - Do they tend to be experienced investors?
    - Do you have any information about their typical socio-demographic characteristics?
  - □ What do you believe are the main reasons that investors purchase NTDSs?
  - □ Do you believe that investors are aware of the risks associated with NTDS products?
  - □ What proportion of investors in NTDSs do you think have received financial advice on the matter before investing?
- Questions about different sorts of NTDSs
  - □ What different sorts of NTDSs are you aware of?
    - Secured vs. unsecured
    - tax wrapper-eligible (i.e. IF ISA) vs. tax wrapper-ineligible
    - Legally non-transferable vs illiquid
    - Any other distinctions.
  - □ How do the companies that issue different sorts of NTDSs differ from each other?
  - □ How do the investors that invest in different sorts of NTDSs differ from each other?

- Do you know of any NTDS issues where the issuing company failed to meet its obligations? What types of NTDS issuers tend to default? What tend to be the reasons for the default?
- Do you believe that NTDS products are a suitable product for retail investors?
- Questions about regulation
  - Do existing regulations ensure sufficient level of investor protection in the NTDS market?
  - Do you think investors in NTDSs understand how they are regulated? What do you think investors expect when they see a firm is Financial Conduct Authority (FCA)/ Prudential Regulation Authority (PRA) authorised? What do you think investors believe they can access in compensation if the issuer defaults?
- Questions about marketing
  - How are NTDSs typically marketed? What information is usually prominent about the issue in the marketing? (I.e. tax wrapper status/ rate of return/ Financial Conduct Authority (FCA)/ Prudential Regulation Authority (PRA) authorisation etc)
  - Are there any concerns you have about the marketing of NTDSs?
  - What information is included in marketing material for NTDSs?
  - Are you aware of any mis-selling or other complaints? What do you think about them?
  - Are you aware of NTDSs marketed as ISA-eligible, even when they were not? Are you aware of other potentially misleading practices?
  - What other sorts of products have you seen marketed as or referred to as “mini-bonds”?
  - What are the similarities and differences between NTDSs and the other products marketed as or referred to as “mini-bonds”?

Academics and Researchers

- Can you describe the types of investors that tend to invest in NTDSs?
  - Do they tend to be retail investors or professional investors?
  - Do the retail investors tend to be consumers or businesses?
  - Do they tend to be experienced investors?
  - Do you have any information about their typical socio-demographic characteristics?
- What different sorts of NTDSs are you aware of?
  - Secured vs. unsecured
  - tax wrapper-eligible (i.e. IF ISA) vs. tax wrapper-ineligible
  - Legally non-transferable vs illiquid
  - Any other distinctions.
- How do the companies that issue different sorts of NTDSs differ from each other?
- How do the investors that invest in different sorts of NTDSs differ from each other?
- Do you know of any NTDS issues where the issuing company failed to meet its obligations? What types of NTDS issuers tend to default? What tend to be the reasons for the default?
- How has the NTDS market developed over time? (in terms of NTDS types and characteristics, issuer characteristics, investor characteristics, market size…)
- Are you aware of NTDS in other countries – which ones? How does the UK NTDS market compare to any non-UK NTDS markets of which you are aware:
  - in terms of the size (value) of market;

  - □ in terms of the characteristics of investors;
  - □ in terms of the characteristics of issuing companies; and,
  - □ in terms of the role and nature of intermediaries, platforms and advisors?
- What other sorts of products have you seen marketed as or referred to as “mini-bonds”?
- What are the similarities and differences between NTDSs and the other products marketed as or referred to as “mini-bonds”?

End of Interview

Thank the participant for their time.

Ask if the participant is willing to participate in any follow-up work.

Ask for the best method of contacting the participant (e-mail or telephone).

A2.6.3 Participants

22 stakeholders were interviewed, including 11 issuers, 3 intermediaries, 1 crowdfunding platform, 2 IFAs, 3 public authorities, 1 administrator of a failed issuer and 1 academic researcher. The stakeholders were chosen to provide insights from a broad range of perspectives, representing as they do a broad range of stakeholders performing different activities in relation to the mini-bond market. The issuers we interviewed were varied in their ages, sizes, sectors and the nature of their involvement in the mini-bond market (in the number of issues they had made, for instance). As such, they provided a diversity of insights even within the issuer perspective.

Of those we interviewed, the following gave us permission to acknowledge their contribution to the report:

Antony Perring, CFO of Leon;

Ed Marley-Shaw, CEO of Clearwell Capital;

Rupert Lee-Browne, CEO of Caxton FX;

Lee Morgan, Finance Director and Secretary of Lancashire Cricket Club;

Dale Vince, Chief Executive of Ecotricity;

Juliet Davenport, Chief Executive of Good Energy;

Rich Wagner, CEO of APS Financial (trading as Cashplus);

Guy Hadas, Director of Basset & Gold;

Robert Davidson, Finance Director of Rectory Homes;

Chris Searle, Corporate Finance Partner at BDO LLP;

Richard Wheat, Director of MRM;

Nick Paler, Associate Director of MRM;

Jonathan Lea, Managing Director of The Jonathan Lea Network;

Patrick Connolly, Head of Communications at Chase de Vere;

Adrian Lowcock, Head of Personal Investing at Willis Owen;

Guy Wilkes, Partner at Mishcon de Reya;

Finbarr O'Connell, Partner at Smith & Williamson;

Tania Ziegler, Head of Global Benchmarking at the Cambridge Centre for Alternative Finance;

Mark Adams, Managing Director of Vitsoe;

The Financial Conduct Authority;

The Financial Services Compensation Scheme; and

The Financial Ombudsman Service.

Annex 3 Investor case studies

Julia, 58. Full time book keeper, Surrey
Inexperienced investor

Julia has been investing since 2016 but considers herself to be an inexperienced investor. She holds 3 mini-bonds with LCF and 1 with Blackmore, all at 8% interest.

"I don't follow the markets/[finance] in general."

Julia thought mini bonds were FCA-approved and saw them as a low-risk way of securing higher interest payments.

"Just thought it was a bond - that would be safe. I thought I would get my money back."

Julia was motivated to make more of her inheritance when her parents passed away, and looked into higher interest products. Her first port of call for information was the internet – Google and the LCF website.

- High interest rates were a key driver for purchase, and professional-looking websites persuaded Julia to invest.
- She was aware that the bonds were non-transferrable but says she should have 'done her homework' when it came to reading the T&Cs - *"When it went under I saw in T&Cs that it wasn't covered. I should have read it."*
- Julia invested £20k at a time – she was also offered a tax-free ISA linked to her bonds and agreed to this, unaware that it was illegal.
- At first she received payments regularly, however these stopped and when she tried to enquire she was unable to get through to LCF. She then found they had gone into administration, and is now in limbo waiting to hear what, if anything, she will get back from her initial investment.

"I was cautious at first but then put more in. I did get interest payments regularly at first and they were great!...I did my research and it kept saying it was good, but then when it went under...I felt awful. I'd lost my parents' inheritance."

Adam, 32. Security guard, North East.
Moderately experienced investor

Adam has been investing for c.10 years and is a moderately experienced investor. He holds a cash ISA, stocks and shares, and has mini-bonds with Clearwell Property and the Wellesley Group.

"[Interest is] 6.5% compared to 1.4% on bank."

Adam says mini-bonds tend to be with property or start ups who are looking for smaller investments. The return rate is high, but the risk is also higher than for other investments.

"It's a higher return of capital but at a higher risk of getting nothing back."

Adam wanted a higher interest rate than banks offer – his brother already had experience of investing in mini-bonds so was able to advise him with relevant information. He currently has £3k invested in mini-bonds.

"£3k. So a good starting amount but not too bad if lost it."

- Adam chose his Clearwell bonds after researching on the internet, including looking at reviews on social media, and forums such as MoneySavingExpert. He knows less about the Wellesley bond he holds, but says the most important thing is looking carefully at the terms and conditions of the bond itself.
- He has already seen some return from his Clearwell bond, so he feels confident in his investment.
- Adam says he is aware of the risks of investing, especially given the economic instability caused by Brexit – he is clear that mini-bonds are not regulated but regards the risk to be worth it if smaller amounts are invested, as there is less to lose.

"I wish it was [protected by FSCS]. But given the 3-4x times rate of return in comparison to normal savings, it's a risk you have to take."

Robert, 65. Retired accounting professional, London
Experienced investor

Robert has been investing for 45 years, having saved with the post office as a child. He's had ISAs – group bonds on Index and an ISA with a fund manager. Having worked in accounting, he is experienced in investing.
"In areas I am interested in, I'm very confident e.g. bonds, income generating products."

Robert understands a mini bond to be a short/fixed-term loan to an organisation, generating higher interest than would be achieved with a bank. He says that, if the organisation goes 'belly up', holders of mini bonds are more likely to get a pay-out than other shareholders.
"You receive money if they go belly up as a preferred investor."

Robert has invested £10k in a local cricket team at 5.5% interest. The high interest rate was a key motivator, as well as the opportunity to support and 'help out' the team, of which he is a member. So far, he is satisfied with the monthly returns.

- Robert was approached by a cricket team as one of their members – he was invited to a meeting where information about the bonds was presented. Solicitors and the organisation's CEO were present at the meeting, giving a reassuring sense of professionalism - they were clear about the risks involved, and gave attendees opportunity to ask questions.
- Robert also did his own research – primarily looking through the company accounts. While he understands that some mini-bonds can be a risk, his current investment feels safe given what he knows of the company's financial health.

"They are not regulated as such....I would be worried / uncomfortable with this generally, so I studied the accounts myself. Joe Bloggs could get sucked in by the glitz of it but I am used to this – I have 38yrs accountancy experience."

Kim, 58. Works part-time, South West
Inexperienced investor

Kim started saving as a teenager, with unit trusts, premium bonds and also now an ISA. Overall she considers herself to be an inexperienced investor.

"I'm not really experienced in investing - as I know very little. I know I need to do research on it as I have a few thousand pounds of inheritance."

Kim was unaware that the bonds she currently holds were mini-bonds, and assumed they were akin to shares. She would like to understand what the difference is.

"I didn't know it was a mini bond before [this]…Is it different to shares? If so, how?"

Having been disappointed by the return on premium bonds and wanting a higher interest rate, Kim invested £2,000 in a mini-bond with Ecotricity.

"£2,000. Seemed a round sum and not too big [that it would ruin] me if [it] went belly up. Reasonable amount to get a return on it."

- Kim was looking for ways to invest and make her money work for her, and friends had mentioned mini-bonds as higher interest products.
- Her decision to invest was primarily made based on the company. She is a long-term customer of Ecotricity and believes in their ethos, so wanted to support their growth. Reading further about the company on their website helped Kim to feel informed about the investment she was making, including the risks.
- Although it was made clear to Kim that she could lose capital, she feels the risk is low – Ecotricity are an established company, and the amount she has invested is small.

"I saw Ecotricity wanting to build/grow – I liked their idea and ethos. It was about the company rather than the mini-bonds, it just happened to be a mini-bond product. My friend had done it and told me to - a few friends have [mini-bonds] in this company ."

Chris, 62. Retired engineering manager, South East
Inexperienced investor

Chris looked into investments following the sale of his property. He is not interested in finance or investments per se, but wanted to put some of his capital in higher interest accounts.

"I've got savings accounts and a stocks and shares ISA…Poor return for capital in ISAs so I moved away from them."

Mini bonds are a short term investment with the potential for high interest returns. He says some companies advertise being regulated, even though the mini-bonds themselves are not, which makes things unclear.

"There is a grey area with how companies position themselves as being regulated or secure."

Chris invested £50,000 across 4 companies in 2017 - London Capital Finance, Blackmore, Asset Life and Westway Holdings. With LCF he also took out an ISA as part of the mini-bond.

"I took out a fixed-rate ISA as part of the mini-bond – I assumed that this would have been approved by HMRC as a financial product."

- Prior to investing, Chris looked online at the companies websites, at what products they offer, and what they put the bond money into – they advertised themselves as regulated, and interest rates were appealing.
- At first, Chris was getting monthly pay outs from his investments. However, one company extended the mini-bond without warning and without giving Chris any choice in the matter. The company is now in administration and Chris is unsure what he will get back from them.
- Another of the companies Chris invested in is also in administration, and Chris is frustrated at the lack of information he has received.

"At the time I had been getting a 10% pay out each month. After that no more payments. I had £12k invested in them – they're now in administration, with no channels for getting in touch. I'm just waiting now for the administrator."

John, 73. Part time lecturer, North West
Experienced investor

John has been investing for 20 years – he has shares and ISAs.
He gains his financial information from Money Facts website. John doesn't use a FA due to the costs involved. He invested £35,000 in a mini-bond from Harewood Associates (Monmouth Regions).

John learnt about mini bonds 4 years ago when a property investment company cold called him about one.
"I did a considerable amount of research for 6 months. Monmouth wasn't a FCA-regulated organisation but...I was assured that they were backed by a FCA-regulated company".

John was motivated by the high interest (c.10% over a 5yr fixed period). He liked the idea of investing in property due to his background in surveying.
"I anticipated that the company would be run by professionals and would be a safe investment as property based."

- John did a substantial amount of research on the company and their backers (Blackheath Capital). He was aware that the mini bond was not regulated but he thought that the company backing them was and that they would be professional.

"They advertised to customers that the company was FCA regulated and said it was laid out by section 21 of the Marketing Act 2000. There are grey areas if a company is backed by an FCA regulated company."

- He was well aware that the product was riskier than a traditional savings account. "*Another problem is because interest rates are so low, people are incentivised by higher risk products. If interest rates were higher this would be less likely to happen".*
- The company is now in administration and being investigated for fraud. John is not confident that he will get his money back. He has joined a support group to help him through this difficult time.

"Really knocked me back, the interest didn't turn up one month. I rang up and the investment manager informed me of the insolvency and a few days latter a letter came through...Avoid mini-bonds at all costs, they are a very risky product and you can't rely on the advice"

Max, 48. Managing Director, London
Moderately experienced

Max started investing 8 years ago by buying shares in BrewDog. He now has shares with other companies via Crowdcube, Nutmeg and Seedrs investment platforms.
He has a mini-bond with Ecotricity, which he bought directly.
£5,000, 5% interest.

Max only realised that the product he had was a mini bond after taking part in the research project. He doesn't think the product name is very clear.
"I know they are non-transferable, offer interest, not FSCS-protected and often direct with start up companies."

Max was motivated by his belief in the company and their future business plans. As a customer of Ecotricity he got an extra 1% interest, which was appealing. He was also attracted by the higher interest rate compared to what banks offer.

- Max received an email from Ecotricity inviting him to invest – the information and risks were made clear.
- He didn't feel the need to do lots of extra research as he "*understood the model of renewable energy and scaling this – it made sense to me. I was aware of where they are in the market as a customer of theirs".*
- He understands that the product is riskier than a savings account and assumes it is not FSCS-protected, but he is confident enough in the company.
- He was however surprised to learn that mini-bonds are non-transferable and is not sure what would happen if the company went burst – he just assumes they will not.
- Max is open to investing in other mini-bonds and has looked into the BrewDog mini-bond - he would only invest in companies who he knows and trusts.

Annex 4 Issuer sector case studies

Financial Services

The issuers

At least 20 financial services firms issued a mini-bond between 2009 and 2019, including LCF and Wellesley; their prominence in the market grew from 2015

There have been several high-profile failures by issuers in this sector. Most famously, LCF entered administration in January 2019 after issuing mini-bonds worth around £237 million to over 11,600 investors.

Terms

2.95% - 12%

The highest coupon rates were generally from issuers in this sector; coupon rates for mini-bonds issued by financial services issuers ranged between 2.95% and 12%

Coupon rates were typically the driver for investment in these mini-bonds (issuers in this sector did not generally have a loyal, pre-existing customer base they were seeking investment from). This may explain why it is this sector that provided the most varied coupon rates

Platform or direct issuance?

10%

10% of financial services issuers used a platform, compared to 30% of all issuers

The reason why financial services issuers used a platform less than other issuers is likely that their issues were, on average, larger than other firms' issues. Direct issuance tends to be cheaper for large issues

Use of funds

Issuers in this sector typically invested the funds raised through their mini-bonds in the projects of third parties (in contrast to issuers in other sectors)

Some financial services firms used funds for their own operations, but these were smaller issues

Food and Drink

The issuers

At least 15 food and drink businesses issued a mini-bond between 2009 and 2019, including Brewdog, Naked Wines and Leon

"As we have grown we have always sought ways to engage with our loyal and supportive customers and build a business with them at the heart of it. For us, it's really special to now be able to connect directly through the Bond – to share the future and fun together whilst providing a return which we believe is attractive" – Prue Freeman, founder of Daisy Green (Hurst, 2015)

Terms

A number of issuers in this sector paid some or all of the mini-bond coupon in vouchers, loyalty points or free food and drink

"The key thing with crowdfunding is that it's half an exercise in fundraising, and another half in brand building and marketing" – Eric Partaker, co-founder of Chilango, who offered large investors in their mini-bonds a free weekly burrito (Graham, 2019)

Platform or direct issuance?

80%

80% of food and drink issuers used a platform, compared to 30% of all issuers

Issuing a mini-bond through Crowdcube "helps reduce the cost and complexity of raising finance and provides an effective way for more established brands, like River Cottage, to raise growth funding without the banks" – Rob Love, co-founder of River Cottage Canteens and Delis (Crowdcube, 2014)

Use of funds

Issuers in this sector generally used mini-bonds to raise funds for expansion

"pod believes it has created a solid base for expansion and is issuing a mini-bond (the pod mini-bond) to support organic growth, enhance the existing estate and open new sites that adhere to a demanding new site opening model" – pod Food profile on CODE Investing (QSR Media, 2018)

Real Estate

The issuers

At least five businesses in the real estate sector issued a mini-bond between 2009 and 2019, including Pocket Living and HAB Land

"As stakeholders in a triple-bottom line business, our investors will be able to see potential returns through social and environmental means as well as gaining a good financial return…allow me to urge you to hurry and join our community of like-minded investors" – Kevin McCloud, Director of HAB Land (HAB Housing, 2019)

Terms

6.25% - 10%

Identified coupon rates for mini-bonds issued by businesses in this sector ranged between 6.25% and 10%, with most in the typical 6% - 9% range

5 years

The most common maturity for mini-bonds issued by businesses in this sector was five years, which is longer than the market average

Platform or direct issuance?

40%

40% of real estate issuers used a platform, compared to 30% of all issuers

15%

However, only 15% by value of mini-bonds issued by issuers in this sector were issued through a platform

Use of funds

Issuers in this sector generally used mini-bonds to raise funds for planned projects and site purchase

"Last year was a great year for Pocket, we are rapidly expanding to meet a strong demand for affordable housing. This bond is an exciting opportunity to support an alternative to London's middle-market housing crisis and invest in a scheme that offers a return on your capital" – Marc Vlessing, co-founder of Pocket (Burn-Callander, 2015)

Renewable Energy

The issuers

At least seven businesses in the renewable energy sector issued a mini-bond between 2009 and 2019, including Ecotricity and Wind Prospect Group

"When we launched [our first mini-bond], it was a pretty radical idea, with a simple ambition: to give people the opportunity to share in the financial benefits of the Green Energy revolution" - Dale Vince, founder of Ecotricity (Baldwin, 2016)

Terms

4% - 9%

Identified coupon rates for mini-bonds issued by businesses in this sector ranged between 4% and 9%, with most below 7%

Two issuers in this sector offered higher coupon rates for existing customers

Platform or direct issuance?

0%

No renewable energy issuers used a platform, compared to 30% of all issuers

This may be because issuers from this sector were targeting their own customers or particular networks of environmentally-minded people, rather than a mass market

Use of funds

Issuers in this sector generally used mini-bonds to raise funds to invest in renewable energy projects, such as the construction of a solar farm. However, there were examples of firms in this sector not using the funds raised through their mini-bond(s) for the stated purpose

"Mini-bonds allow investors to practise product-led due diligence whereby they invest in products they know, love and believe in" - Juliet Davenport, CEO and Founder of Good Energy

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