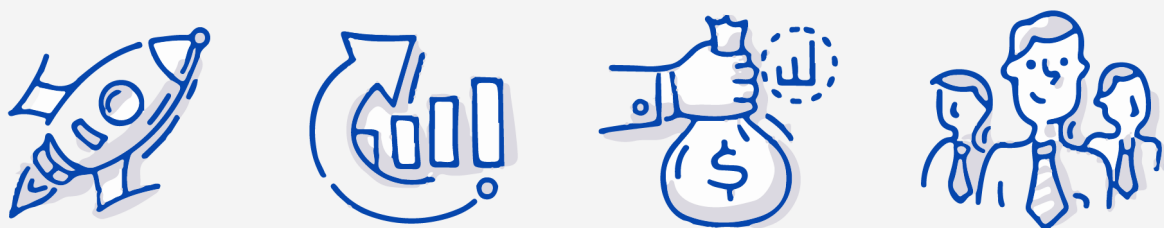


EMPATHY DRIVEN FUNDING

New frontier of financing small businesses



April 2017

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CHAPTER 1 BACKGROUND

➤ 1.1 Introduction

This report describes some innovative financing products for MSMEs and entrepreneurs, with a special focus on Micro Investment Crowdfunding, in Japan. In 2013, the “Japan Revitalization Strategy” was approved by the Cabinet, and the government officially prioritized the promotion of financing to facilitate investment in ventures and MSMEs. One example is FURUSATO Investment (micro investment in hometowns) Initiative, which we will discuss further in Chapter 4.

To accelerate and strengthen this economic growth strategy from the financial perspective, the Financial Services Agency (hereinafter referred to as the “FSA”), the Japanese financial regulator, adopted the “Law on Revising Financial Instruments and Exchange” in 2014, consolidating the plans to improve and enhance the appeal of the Japanese financial and capital markets, including measures that encourage shifting households’ financial assets to capital investments.



In this Law, one of the priorities was a more active use of **Micro-Investment Crowdfunding**. The measures to promote it included the revision of requirements for financial intermediaries (permitting transactions with unlisted shares on crowdfunding platforms), decreasing the minimum capital required for registration, improving anti-fraud regulations, etc. Moreover, the FSA is providing a strong guidance to financial intermediaries to take a forward-looking approach in their credit risk analysis of MSMEs. The financial intermediaries are encouraged to change their risk analysis method from a corporate risk centered one, where the corporate loans are secured with collaterals and guarantees, to a project risk centered one, where the financial institutions focus more on the future cash flow, in line with the “Japan Revitalization Strategy”.

Amid these movements, the unforgettable role of Micro-Investment Crowdfunding in responding to the Great East Japan Earthquake in March 2011 must be highlighted, since it served to quickly supply funds for the damaged local MSMEs.

Shortly after the earthquake, the function of local governments and financial institutions was seriously damaged. Even though the formal **financial intermediaries** agreed on rescheduling debt of the local MSMEs, the damaged local MSMEs just had their equipment seriously damaged by the tsunami and were not able to resume their business operations without investing in their repair. At that difficult time, there was a surge in financial contributions from individuals wishing to reach out to support these disaster struck areas. **Micro Investment Crowdfunding platforms** made a difference by channeling their money in the form of investment (not just as donation) into the local economy rehabilitation and reconstruction.

People say that this **Micro-Investment Crowdfunding** paved the way for FURUSATO investment initiative and established itself nationwide as an innovative financing mechanism to revitalize and develop the areas damaged by disaster, and also as a means of financing the local MSMEs, particularly in local areas.

The main objective of the study is to assess the potential of **innovative financing** mechanism as a financial infrastructure that organically combines the local economic development with a mechanism to supply funds to the local MSMEs and entrepreneurs. In addition, based on the findings of a detailed analysis of those financing mechanisms that address revitalization of the local economy and strengthen the competitiveness of MSMEs in towns or villages with relatively small economies and/or a lack of financial infrastructure compared to metropolitan areas, the report studies the potential for utilizing the innovative financing mechanism in the LAC countries. The report identifies the necessary conditions for making this mechanism effectively work, points the direction for legal framework development, and lists the requirements on each of the stakeholders and the potential obstacles in the LAC region.

➤ 1.2 Background

Despite the widespread political and fiscal decentralization of the recent decades, the LAC region has yet to see the positive impacts of decentralization on the economic and social welfare at the local economy level. Unfortunately, decentralization in the LAC region was rarely accompanied by the necessary policies and programs development for local MSMEs to fully capitalize on the local resources and competitive advantages.

It is equally important to strengthen the competitiveness of the existing local manufacturing sectors and to foster high-growth businesses to ensure self-sufficient and sustainable development of the local economies. To boost value by optimally exploiting the local financial resources, both the existing and the new

businesses often need to install new machinery, acquire and adopt new technologies to introduce new products and services, or launch new lines of business. Due to the lack of formal credit history and assets to be pledged as collateral, however, those MSMEs find it difficult to obtain funding from the formal financial intermediaries.

The same can be said for **MSMEs in Japan**, where financing from the formal financial intermediaries is unavailable to start-ups that lack formal credit history or collateral. Since financing needs vary as businesses grow and evolve, various financial products and/or services should be offered to effectively respond to them and to develop local economies. However, the lack of a secondary market for loans, strict regulations on holding risk assets, and a traditional preference for secured debt have prevented formal financial intermediaries from providing loans, particularly in the local areas. This has resulted in a steep curve – the ‘valley of death’¹ – for many MSMEs.

The **OECD Working Party** on SMEs and **Entrepreneurship** (WPSMEE) also has long recognized the limitation of traditional debt financing for responding to the different financing needs that MSMEs encounter along their life cycle. Financing opportunities are not enough for sustaining most dynamic enterprises.² Most of the MSMEs do not have the security required for conventional collateral-based bank lending, nor high enough returns to attract formal venture capitalists and other risk investors.

In recent years, however, the conventional credit offered by formal financial intermediaries and the subsidized credit provided by governments or state-owned financial entities, was supplemented by innovative financing vehicles such as crowdfunding platforms and alternative investment funding in Japan. Investors in such vehicles are not targeting Initial Public Offerings (IPOs) as the primary exit strategy, while providing growth capital to the local MSMEs under the local business investment initiative announced by the **Government of Japan in 2015**.

In this context, Micro-Investment Crowdfunding, as an innovative financing mechanism for MSMEs, has been attracting high attention both from individual investors and MSMEs including start-ups in Japan.



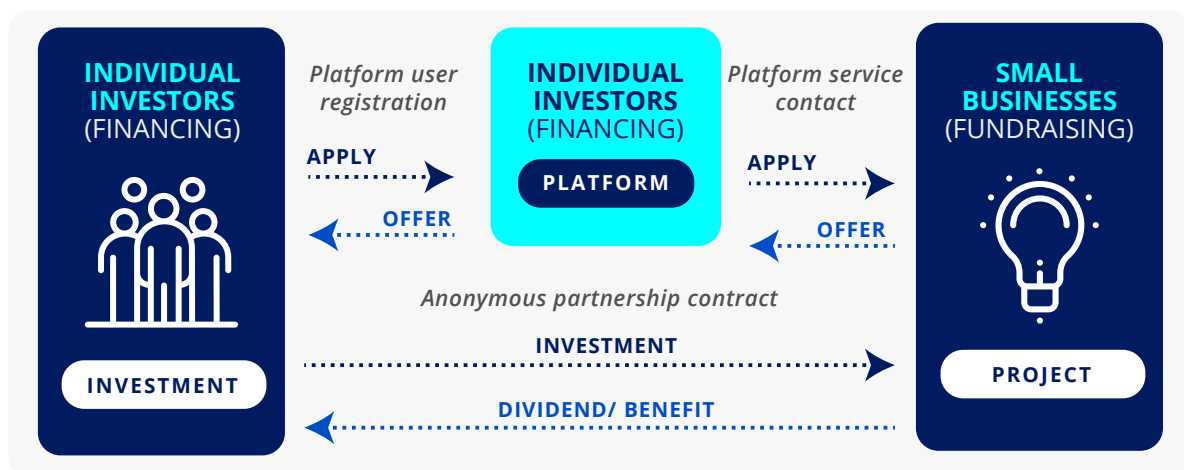
¹ <http://www.investopedia.com/terms/d/death-valley-curve.asp>

² New Approach to SME and Entrepreneurship Financing: Broadening the Range of Instruments (OECD 2015)

➤ 1.3 Overview of new financing mechanism/ Micro-Investment Crowdfunding

Micro Investment Crowdfunding, one type of crowdfunding, is spotlighted for its innovativeness and uniqueness as a financial instrument.

FIGURE 1 STRUCTURE OF MICRO INVESTMENT CROWDFUNDING



The above is the basic structure of **Micro Investment Crowdfunding** in Japan. Micro Investment Crowdfunding is an alternative finance option for MSMEs to raise business capital (funding) from numerous unspecified individuals (crowds) on an internet platform operated by an intermediary.

Micro Investment Crowdfunding is mainly featured by the following characteristics:

- Inviting small online investment from numerous unspecified individual investors
- Intermediated on a platform developed by authorized investment management financial institutions (Type II financial instruments business firms in Japan)
- Funds financed under an anonymous partnership agreement called “Tokumei-Kumiai”.

The anonymous partnership agreement implies that numerous individual investors and small businesses directly conclude a contract while there is no contractual relationship between the platforms and each individual investor (the detail is described in the chapter 5).

More importantly, the main driver of Micro Investment Crowdfunding is individual investors' "empathy" to an MSME and/or the project. This 'empathy' is what makes this new funding mechanism effectively fit the diverse funding needs of MSMEs with individual investors' strong emotional attachment, which cannot be met by the conventional financial instrumen

Micro Investment Crowdfunding, "an empathy-driven funding mechanism", which has been evolving recently in Japan, is expected to play a more significant role for mobilizing individual financial assets to investment capital for MSMEs, obtaining policy support from the Government of Japan and municipalities.

In Japan, **Micro Investment Crowdfunding** is operated by small number of private companies, including Music Securities, Inc. (hereinafter referred to as "MS"), which operates the Internet platform named "Securite". MS, the largest Micro Investment Crowdfunding platform operator in Japan, currently has approx. 70,000 individual investors with membership³ and 380 MSMEs have already raised funds on the platform, with a total amount of approximately JPY 6.5 billion (USD 56.5 million)⁴.

This report will mainly refer to MS and its platform "Securite" as it is the most well-established Micro Investment Crowdfunding platform in Japan, which is operating since 2001.

³ As of June 2016

⁴ As of January 2017 (Exchange rate USD1 = JPY 115)

CHAPTER 2 EMPATHY

New driver for small business financing



➤ 2.1 What is Empathy?

As mentioned in Chapter 1, the Micro Investment Crowdfunding can flexibly fit the wide range of financial needs of small business including startups and satisfy the emerging desire of micro investment among individual investors at the same time. While the platforms adequately make a series of risk assessment with a special focus on project risk, “empathy” is newly highlighted as one of the key factors in their due diligence for the Micro Investment Crowdfunding in Japan.

The word “**empathy**” means, according to a dictionary, ‘the ability to understand and share the feelings of another’⁵. And it is often a vital first step toward compassionate action⁶. Furthermore, “empathy” is also the basis to trust others. When people feel that you care, then you can earn their trust. If people trust you, they will take more risks with you and be more open with you.

While private investors are believed to make an investment decision mainly on risk-return profile, there seems to be a new evolving trend of investment in which individuals invest in a specific small business not because the expected financial return is more attractive than other investment opportunities but they feel “empathy” toward the small business.

Empathy can be described also as “**strong emotional attachment**” to a specific person, region, and firm, product or business project. Empathy can be caused by various types of ‘clues’, depending on individual preference, perspective, etc.

The clue causing empathy varies from person to person as it totally depends on personal belief, thought, preference and experiences. Those individual investors, who feel empathy to a specific small business, are keen to be involved in the business not only as a fund provider but also as a supporter as a whole. The following are typical ‘clues’ of empathy:

⁵ Quote; Oxford living dictionary (<https://en.oxforddictionaries.com/>)

⁶ Greater Good in Action, The science of meaningful Life, University of California Berkeley (<http://greatergood.berkeley.edu/topic/empathy/definition>)

- ✓ **Novelty and Innovation:** New products, processes, services, technologies, or business models that bring added value to a market and/or society gain attention and are sought after. When such novelty and innovation is generated by an MSME, people generally feel empathy and the desire to support it.
- ✓ **Story (History):** Products and/or services that bring an inspiring story and/or history with them often gain people's empathy. These products and/or services have significant value to them.
- ✓ **Challenges:** People are eager to support others who struggle to tackle difficult challenges. An example is how many individuals financially supported those affected by the Great East Japan earthquake in 2011.
- ✓ **Creativity:** Creativity is one of the greatest abilities given to human beings. People are attracted to creative businesses and/or products, whether it to be the final production and/or the process.
- ✓ **Originality:** Goods and/or services with originality are highly valued as they are neither easily available nor replicable.
- ✓ **Contribution to Local Economy:** People generally have a strong attachment to their hometown and/or specific places where they have lived, visited and felt attracted to. They are more motivated to support local small businesses in such places for making contribution to local economy development.

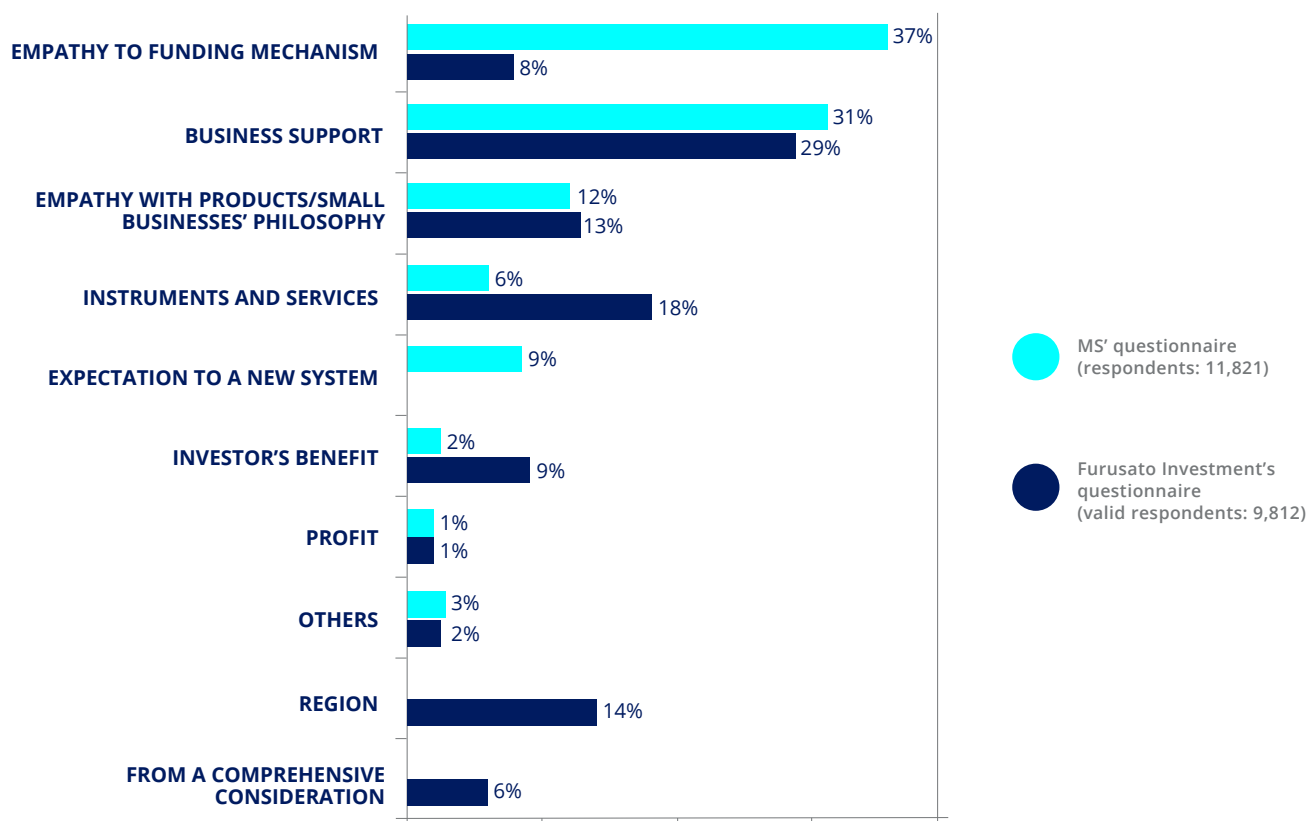
➤ 2.2 What motivates individuals to Micro Investment Crowdfunding?

Micro Investment Crowdfunding is an innovative financing mechanism driven by empathy. Many individual investors in Japan appreciate the innovativeness of this funding mechanism, as shown in the Questionnaire Survey on investors' motivation on MS and FURUSATO Investment⁷ (Figure 2).

The said survey also shows that the **individual investors** are motivated by their empathy for a specific small business, and a sense of emotional attachment to a specific region that makes them feel as if they are community members through micro investment to local small businesses.

⁷ FURUSATO Investment is a new initiative by the Government of Japan for stimulating and revitalizing local economies utilizing Micro Investment Crowdfunding.

FIGURE 2 QUESTIONNAIRE SURVEY ON INVESTORS' MOTIVATION ON MS AND FURUSATO INVESTMENT



(Source: Presentation handout for the symposium on establishment of Furusato Investment Liaison Office (2014) / Explanatory presentation on Nishi-Iburi Crowdfunding dissemination seminar by MS (2016))

By contrast, the attitude survey with private investors, who invest in financial products such as stocks and bonds, (Figure 3) demonstrates that in contrast to individual investors who make an investment decision from different perspectives (as shown in Figure 2), the private investors place the highest priority on the firms' earning forecast which influences the financial returns on the investment. On the other hand, Individual investors in Micro Investment Crowdfunding give less importance to financial returns as their primary objective of investment is to take compassionate action based on the empathy.

As described above, the behavior of **individual investors** who invest in Micro Investment Crowdfunding is totally different from the one of other private investors mainly because the minimum amount (per unit) of investment is normally JPY10,000 to 50,000 (USD87.00 to 435.00), which is smaller than the amount invested in other financial products such as stocks⁸. Those individual investors are psychologically and emotionally motivated to invest in Micro Investment Crowdfunding based on the empathy they feel, taking limited amount of the substantial risks.

⁸ Average minimum amount of investment in the stocks listed in First(1st) Section of Tokyo Stock Exchange is JPY273,999 (JPY2739.99 × 100 shares(minimum units) = JPY273,999, (USD2382.6))

FIGURE 3 ITEMS INVESTORS PLACE IMPORTANCE IN CHOOSING ISSUES FOR INVESTMENT
(NOMURA IR MONITOR: ATTITUDE SURVEY TOWARD INVESTMENT 2013)



TABLE 1 ATTRIBUTES OF MICRO INVESTMENT CROWDFUNDING INVESTORS (IN THE CASE OF MS)

BY AGE GROUP	MS
Under 20s	4%
30s	22%
40s	27%
50s	22%
60s or older	25%
BY GENDER	
Male	65%
Female	35%
BY PREFECTURE	
Tokyo	26%
Kanagawa	11.6%
Saitama	6.5%
Chiba	6.2%
Osaka	6%
Aichi	5.4%
Miyagi	4%
Hyogo	3.9%
Hokkaido	2.3%
Shizuoka	2.2%
Fukouka	2.2%
Kyoto	1.9%
Ibaraki	1.8%
Ehime	1.5%
Hiroshima	1.3%

The tables show the attribute of individual investors who use Micro Investment Crowdfunding platform "Securite" of MS (as of June 2016).

Males account for 65% of the entire investors and mostly live in the Tokyo metropolitan areas. It is notable that all age groups from 30s to 60s equally use Micro Investment Crowdfunding, as this funding mechanism can fit a variety of desires of the individual investors.

In Japan, crowdfunding is known as a tool for **donation** and/or **pre-purchase** on a web site and there is much room left for promoting recognition and acknowledgement of Micro Investment Crowdfunding specialized in investment. It is also important that Micro Investment Crowdfunding is categorized and recognized as an alternative funding mechanism which supplies funds necessary for the small business development.

Micro Investment Crowdfunding makes it easier for individual investors to make investments, given the small amount of risk associated with the small amount of investment. And, their interest has shifted from the risk-return profile to the empathy which they feel for the local small businesses, products, and the impacts that they as investors can make on revitalizing the local economies of Japan. This is also an interesting aspect of how the Micro Investment crowdfunding is being used.

MS currently has approx. 70,000 members of individual investors and it is important for a Micro Investment Crowdfunding platform to list as many investors as possible to respond to a wide range of financial needs of small businesses including startups when needed and to increase recognition and acknowledgement of **Micro Investment Crowdfunding** as a useful funding infrastructure.

➤ 2.3 How the empathy-driven financing works?

Empathy-driven financing is featured by the following functions and characteristics, which are different from conventional financing modalities for MSMEs⁹ such as bank loans and venture capitals.

- ✓ **Autonomy of Management:** The business owner, who raises funds on Micro Investment Crowdfunding, has greater autonomy of management compared to conventional ways of funding from banks and venture capital. The basis of the investment - the feeling of empathy - already gives them a sense of trust and support toward the firm's business plan. This financial mechanism is supported by an anonymous partnership agreement¹⁰. This is a great advantage for business owners who get access to funds without intervention from individual investors of Micro Investment Crowdfunding.
- ✓ **Sense of Participation:** If Individual investors have sense of participation as a supporter to the small business, it makes their attachment stronger and deeper. They are more open to develop personal connections with the small business, and it makes them feel more and more empathy to the small business in which they invest. Micro Investment Crowdfunding serves to build a stronger relationship between a business owner and individual investors than conventional funding modalities by close communication through various channels such as the investors' events organized by the platform. Thus, a sense of participation can be further developed.

⁹ This includes startups.

¹⁰ The detail of an anonymous partnership agreement is shown in Chapter 5.

- ✓ **Risk Tolerance:** Empathy can motive individual investors to take risks and empower small businesses to overcome difficulties. This is very important in times when the small businesses are in a challenging condition because the business owners are strongly encouraged by the psychological and/or emotional support that they feel by the act of investment from individual investors on the platform.
- ✓ **Long-term Relationship:** Empathy can pave a way for the individual investors to build up a long-term relationship with the small business, and this pushes for individual investors to keep supporting in a mid and long-term. This contrasts with venture capital or other capital investors that seek maximum financial returns in a short-term.
- ✓ **Sense of solidarity against challenging situation:** Individual investors tend to feel strong empathy when the small business faces extraordinary predicaments (e.g. large-scale natural disasters, accidents, etc.), barriers and obstacles that pose a challenge to the small business.

As empathy is a subjective driver of the **Micro Investment Crowdfunding** and cannot be easily measured in a quantitative way, it is essential that objective screening mechanisms be built in the process of fundraising. In the case of MS, the platform has established an empathy screening mechanism to check if small businesses can successfully raise the necessary amount of funds by attracting as much empathy as possible from individual investors. (Please find ANNEX 3-2).

Empathy, as a key driver of Micro Investment Crowdfunding, is a hopeful tool for many small businesses to obtain more financing and it encourages individual investors to take more risks with their strong emotional attachment to the small business in Japan.

At the same time, we can say that both empathy and sense of participation could be important key drivers to promote inclusive, sustainable, and resilient small business development in LAC region as well, because LAC people are culturally featured to place more importance on personal connections and emotional attachment than in Japan.

CHAPTER 3

MORE THAN CONVENTIONAL FINANCING TO SMALL BUSINESSES



Looking at the individual investors, it is a global trend that millennials find it more attractive to invest their private assets in the financial products with added-value rather than just saving them in a bank account. As a matter of fact, statistics¹¹ indicate that 33 % of the millennial generation in the U.S. believes they won't need a bank at all. At the same time, it has been learnt through this study that the MSMEs are also hoping for non-financial services beyond just loan transactions.

In other words, financial institutions might not be able to continue its business by just providing conventional financial services such as security backed credits only to traditional customers. They must precisely understand how to respond to contemporary expectations their customers are embracing, and what to offer as beneficial products and/or services for both investors and small businesses. In reality, the small businesses in Japan we have interviewed in this study actually appreciate evolving Micro Investment Crowdfunding that integrates new functions which are really useful for their business growth.

This chapter describes what function of the Micro Investment Crowdfunding is appreciated by small businesses other than financial one, which serves to differentiate Micro Investment Crowdfunding from the conventional financial institutions' instruments.

➤ 3.1 Marketing function

For small businesses, advertising their business and reaching market access is one of the biggest challenges, especially for those in local areas. Micro Investment Crowdfunding is operated on an internet platform where the small businesses can effectively advertise their business and reach out to new potential customers of the platform membership.

Specifically, Micro **Investment Crowdfunding** has its own platform website where small businesses can appeal to potential individual investors and is allowed to directly reach out to them once they are offered an investor list by the platforms. It is thanks to empathy, the key driver of the Micro Investment Crowdfunding, that individual investors tend to become loyal customers and even word-of-mouth

¹¹ Source: THE Millennial Disruption Index
(http://www.millennialdisruptionindex.com/wpcontent/uploads/2014/02/MDI_Final.pdf)

advertiser to others at the same time. In this context, MS, the largest platform operator of Micro Investment Crowdfunding in Japan, says that the mechanism helps small businesses to obtain a “big fan” of long-standing relationship as well as mobilize valuable financial resources to small businesses. In fact, many small businesses testified that they had been able to open up a new market of their products and/or services with fundraising through Micro Investment Crowdfunding Platforms.

From the individual investors’ perspective, the small businesses and their products and/or services appear on the internet platform, which allows “visible investment” with empathy. Individual investors are able to check to what type of business and to whose business their money is channeled. Apparently, the platforms serve to promote marketing in addition to fundraising by nature.

As described in the **previous chapter**, Micro Investment Crowdfunding may fit financial needs under extraordinary situations, as more people are likely to feel stronger empathy after its occurrences like natural disasters.

In the case of K City Support Fund (Case study: Chapter 1), the Micro Investment Crowdfunding offered the marketing opportunities and made a magnificent advertising effect for a small local business. A local business A (fundraiser) planned to develop a new showcase product which is mainly made of local food ingredients for further business expansion and, therefore, needed funding to make it happen. However, a local financial institution implicitly turned down the small business’s request for a new loan because the financial conditions did not seem as stable as expected at that time while the sales turnover had steadily scaled up every year. Moreover, the purpose of funding was also the financial institution’s concern because the fund was not for investment in machinery and equipment but for a new showcase product development.

Under the situation, the business A (fundraiser) decided to raise funds by publishing a business plan on Micro Investment Platform. This challenge was sufficiently supported by individual **investors feeling empathy** for expected impact on the local value chain from view point of the local economy development. In addition, the business A made a choice to tie up with a first-class designer who was introduced to design the new showcase product by the platform. Consequently, the new design also impacted to increase empathy for attractiveness of the new showcase product and successfully gained high profile on mass media.

From marketing point of view, we add that the small business landed contracts with some major retailers and department stores because of advertising effect to this challenging fundraising on the Micro Investment Crowdfunding. In fact, the small business would not have been able to develop the new market if the business A had not challenged this fundraising on the Micro Investment

Crowdfunding Platform. The uplifted brand of small business led to make positive impact even on relations with local financial institutions. In this way, Micro Investment Crowdfunding is creating a leveraging effect in terms of marketing as well.

➤ 3.2 Advisory services to improving a business plan

Micro Investment Crowdfunding is open to all the MSMEs including startups that need funding, regardless of its scale, sector and region.

After a small business owner's application for fundraising is submitted, the platforms conduct due diligence on the business plan in order to assess credit risks and project risks. Then, the platforms decide financial terms and conditions of the fund in coordination with small businesses.

Micro Investment Crowdfunding Platform operators observe the inspections manual for financial instrument business firms compiled by the Securities and Exchange Surveillance Commission of Japan, which serves as a referential guide to risk management system developed for the purpose of investor protection. (The manual does not provide detailed risk assessment methods).

Under this circumstance, the Micro Investment Crowdfunding Platform operators make an assessment based on their own criteria. For example, the MS's assessment procedure and the approximate timeline are as follows.

TABLE 2 STEPS IN THE COURSE OF MS'S DUE DILIGENCE

ESTIMATED TIME REQUIRED (CUMULATIVE)	STEPS
0 week	Application is sent from an MSME to the platform operator (attachment) (directly or via financial institution cooperating with the platform)
1 week (1 week)	Initial Meeting (1st stage screening by MS)
1 week (2 week)	Interview on site
4 week (8 week)	Signing on service agreement and submission of required documents (attachment)
3 week (11 week)	Preparation of contract and offering document (interview, photography), Producing the web page
3 week (14 week)	Submission of small business confirmation sheet, entry of article of greetings (fund news) --> beginning of offering

(Source: documents disclosed by MS on the website of Sobetsucho, Utsunomiya-gun, Hokkaido)

MSMEs are required to submit the following documents for their application to MS.

TABLE 3 DOCUMENTS TO BE SUBMITTED FOR APPLICATION

1	Corporate brochure and other documents to outline the small business
2	Financial documents with detailed statements for the last 3 fiscal years
3	Corporate tax returns record for the last 12 months (Corporate Tax attachments 1,2,4,5,7, corporate tax summary, explanatory material)
4	Trial balance for the latest month
5	Contract and repayment schedule of each borrowing from financial institutions
6	C.V. for CEO
7	Last financial statements of affiliate companies if any
8	Statement of cash flow
9	Business plan (entire company and business for which fund is raised)
10	Certified copy of register
11	(Copy of bank book as needed: as of the last closing day and last day of the last month)

Under the Financial Instruments and Exchange Act, as well as the self-regulation of Type II Financial Instruments Business Association, the Micro Investment Crowdfunding platforms are required to properly assess business plans.

The business plan assessment is strictly made in order to analyze business risks, which are essential in order to check out the feasibility and to decide the financial terms and conditions of the funds. In the course of business plan assessment, the technical and financial feasibility are carefully examined in the platform's due diligence because the funds have no guarantee of principal for individual investors and the platform also takes reputation risk in the market.

The platform is not a business advisory services provider such as management consulting firms, business accelerators and incubators. However, the process of assessing and discussing the business plans in its due diligence could turn out to be a valuable business advisory service. The due diligence process allows small businesses to clarify their objectives and targets and lets them to review whether the business plan is sound and feasible. This due diligence process also helps to shape business preparation more effectively and efficiently. For those small businesses which often do not have the access to business development services, the advisory to improve the business plan built in the due diligence process could be very valuable.

In this sense, we conclude that the platform's assessment is certainly contributing to brush up the business plans as if that was advisory services to the small businesses in the course of business plan development.

➤ 3.3 Profound Investors Relationship

This section will closely look at the added-value of the platform's funding mechanism from the investors' point of view.

Conventionally, bank loans and investment funds were indirectly financed through financial intermediaries. Thus, investors (depositors) who invest their money cannot decide to whom their money is channeled and they do not feel the sense of participation as a result. Whereas in Micro Investment Crowdfunding, individual investors can choose small businesses to which they feel empathy because Micro Investment Crowdfunding is a kind of direct investments.

As written in **Chapter 2**, there is difference between conventional financial products and Micro Investment Crowdfunding in terms of investors' motivation. In other words, empathy is the major driver of Micro Investment Crowdfunding, while risk return profile is a key to conventional financial products.

On the top of that, a sense of participation is certainly developed amongst the individual investors of the Micro Investment Crowdfunding. They seem to be satisfied with non-financial returns such as the delivery of the small business products, site study tours, and having a sense that the money they invested is making a difference.

In the case of the N Village Common Forest Fund (Case study: Chapter 2), individual investors, though most of them live in urban areas, visit N village, to see how the invested money is making a difference. It seems like a majority of individual investors did not seek for high financial return, rather they place importance on being part of revitalizing the village through the project funded on Micro Investment Crowdfunding.

In the case of K City Support Fund (Case study: Chapter 1), the individual investors can feel a sense of satisfaction, when the new products finally make their way into the markets across the country. At a trial tasting event of the new products exclusively for the individual investors of the platform, many affirmed that they had surely invested because they enjoyed being part of the new product development, and not only for the financial returns.

As has been described above, Micro Investment Crowdfunding can meet the expectation of individual investors, which conventional funding mechanisms cannot.

Individual investments driven by empathy nourish the sense of participation in the investment projects. In this way, they can have a sense of solidarity with the small business owners, which may be an important part of added-value to individual investors.

In this chapter, we discussed the useful functions of Micro Investment Crowdfunding which differentiate it from conventional financial instruments. Micro Investment Crowdfunding can satisfy the emerging needs of small businesses by bringing new value-added services. Consequently, some financial institutions have already decided to collaborate with the platform operators for such value-added services in the new competitive market trend.



CHAPTER 4

PUBLIC SECTOR MATTERS

➤ 4.1 How the public sector collaborates with the platform?

✓ Local governments' support to the platforms

Amongst the various financial instruments, Micro Investment Crowdfunding is spotlighted for its innovativeness and uniqueness. From local governments' perspective, Micro Investment Crowdfunding has potential to mobilize more financing to local small businesses from individual investors on the platforms. By taking this opportunity, some of them started to collaborate with the platforms in various ways and offer multidirectional support to MSMEs. The platforms, on the other hand, can also benefit from cooperation with local governments to efficiently disseminate the mechanism, reach-out to potential local small businesses, and to negotiate subsidy support to initial fund arrangement fees, etc. In this chapter, we provide with an overview of the collaboration between local governments and the platforms, which outlines the benefits for both parties.

After the Great East Japan Earthquake in 2011, innovative financial instruments like Micro Investment Crowdfunding, which enables the mobilization of small-amount investment from individuals, are stressed as an important part of the financial diversification to extend private sector finance in the Japan Revitalization Strategy (2012) announced by the Government of Japan.

One outstanding example is the “Furusato Investment Initiative”, announced by the Government of Japan in April 2014, which aimed to channel more money to local small businesses for promoting stimulation and revitalization of local economies in Japan. It allows individuals to invest small-amount money in local projects in their hometowns and/or in any local cities of their choice, for example, to support the productive use of unique local items. This gives the local areas a brand and promotes the revitalization of local economies and communities.

Along with the promotion of “Furusato Investment Initiative”, Micro Investment Crowdfunding gained more popularity as an innovative financing instrument to local small businesses in prefectural and municipal governments around 2014. Many local governments encouraged the local small businesses to use the platforms, subsidizing the initial fund arrangement fees which are charged to small businesses by the platforms.

✓ Necessity of subsidy support

The platforms offer various operational services like advertising, contract arrangement, audit, investor relations and small businesses' payment of dividends, etc. Shortly after small businesses submit a filled application form, they are requested to pay initial fund arrangement fees to the platforms, which cover costs for due diligence, promotion to investors, and preparation of the contract and explanatory materials for investors amongst others. During the business operation stage after successful fundraising on the platforms, the small businesses are charged further fees specified in the table below.

TABLE 4 DETAILED FEE BREAKDOWN OF MICRO INVESTMENT CROWDFUNDING IN THE CASE OF MS ¹²

FREES	DUTIES	CONTENTS	AMOUNT
FUND ARRANGEMENT FEES	Assess and calculate the fund amount, Prepare contract document.	<ul style="list-style-type: none"> Carry out due diligence Formulate fund conditions. Prepare contract and explanatory materials for investors. Confirm with lawyers and certified needed). 	900,000 yen [USD 7,826]800,000 yen [USD 6,957] without photography and data banner production as they are optional
	Promotion to investors.	<ul style="list-style-type: none"> Design web page for fund offering. Notice to media when offering starts Notice to company members (approx. 70,000) on newsletters etc. Photography and data banner production!*" 	
OPERATION AND AUDIT FEES	Manage Investor Relations (IR)	<p>Operation</p> <ul style="list-style-type: none"> Respond to inquiries about fund operation. Assist business report to investors. Individual money transfer of dividend to investors <p>Auditing</p> <ul style="list-style-type: none"> Audit how fund is spent and track salesTravel expenses are additionally billed to the MSMEs when onauditing is required. Prepare detailed di 	<p>Operation fees: 2%/yearAuditing gees: 150,000 yen [USD 1,304] in the first year and 100,000 yen [USD 870] from the second year</p>
SUCCESS FEES	Assist small businesses in sales increase	<ul style="list-style-type: none"> Assist marketing in collaboration with investors. Investor survey and sampling Create fan community (plan and organize tour and briefing sessions). 	Sales of funded business several percent*portion beyond breakeven point of investors

¹² MS an excerpt from the explanatory materials for Nishi Iburi Crowdfunding Market Channel Expansion Project of Sobetsucho, Hokkaido

As for fees, the platforms can flexibly set in consideration to the projects' characteristics, fund amount, size of sales turnover, current financial status of the MSMEs, etc.

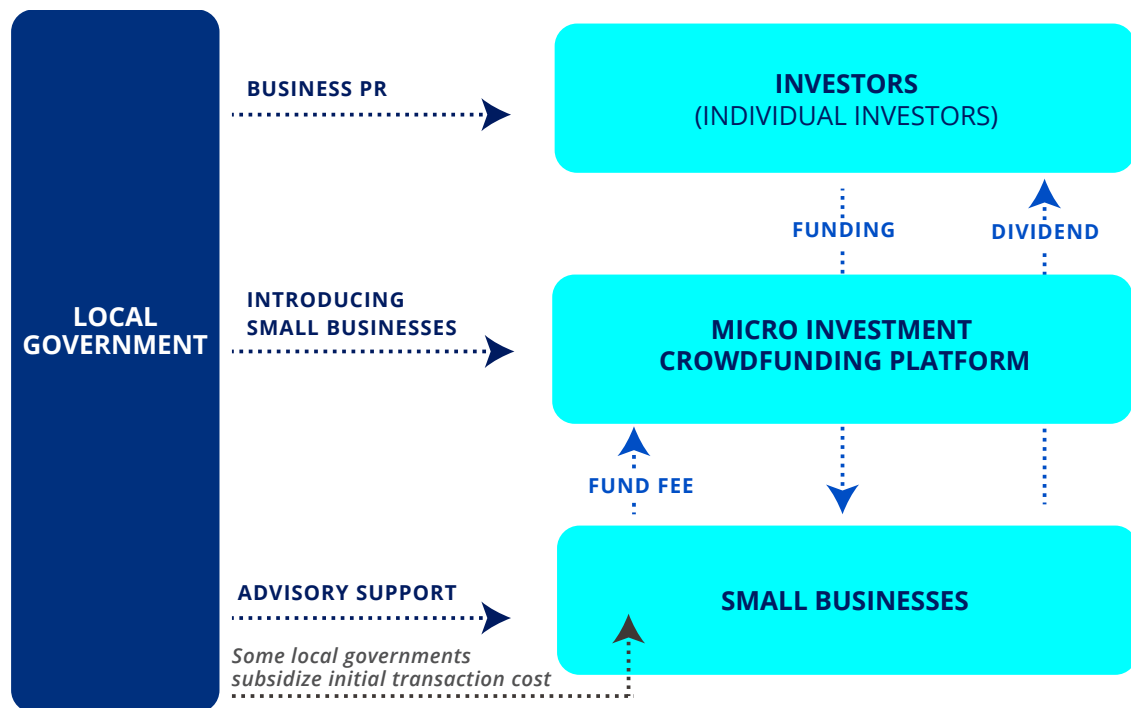
The Annexes and the **Case Study section** of this report show deeper analysis of the financial cost of Micro Investment Crowdfunding. In any case, the ratio of financial cost to utilize Micro Investment Crowdfunding considerably varies from the fund amount and size of sales turnover. In other words, the ratio of financial cost per year naturally gets higher if the fund amount is smaller, while the total financial cost may get even higher if sales turnover marks higher than the expectation described in the business plan because of larger amount of dividend to individual investors.

There are no private firms which are able to determine their exact annual sales turnover in advance. Compared to the business size of MSMEs, it is understandable that a majority of small businesses recognize the initial fund arrangement fee as expensive. Thus, under the Furusato Investment initiative, some local governments subsidize small businesses for such initial fee payment so that they are more encouraged to use Micro Investment Crowdfunding.

Generally, local industries are on a declining trend due to urbanization and sales reduction in Japan. The outflow of population to the prefectural capitals and metropolitan areas negatively impacts these industries, together with the general downturn of the local economy. Under those circumstances, some cities are desperate to enable self-sustained growth and make a new strategic city management plan by necessity.

For example, K city in Hokkaido, the northern island of Japan, led to launch the Micro Investment Crowdfunding program called "**K City Support Fund**", in March 2015. Once the projects/small businesses are qualified to try fundraising on the platforms, the municipal government provides a subsidy to cover 90% of the initial fund arrangement fee amounting JPY 900,000 [USD 7,826] so that selected small businesses just pay 10% equivalent to JPY 100,000 [USD 870]. The municipal government allocated JPY 5 million [USD 43,478] to finance up to five projects in FY2016ⁱ to secure support to K City Support Fund and intends to continue this subsidy support on a continuous basis to stimulate local economy.

FIGURE 4 COOPERATIVE STRUCTURE WITH LOCAL GOVERNMENTS



In the start-up stage, small businesses always have difficulties in borrowing loans from financial institutions due to lack of their credit record. As it is well known as a “Death valley”, it must be extremely important for small businesses to keep growing to get access to the financial market. In this regard, local governments can play a significant role to facilitate small businesses to obtain necessary funds in various ways, which subsequently leads to the local economy revitalization.

Apart from the above-mentioned, local governments can benefit from cooperation with the platforms through more appropriate screening of potential small businesses in the dynamic market mechanism of the platforms. Potential small businesses are strictly assessed by individual investors and small businesses cannot successfully raise sufficient funds without strong support with empathy from individual investors.

➤ 4.2 Smart use of public funds

In 2011, the same year of the Great East Japan Earthquake, the Ordinance for Enforcement of the Local Autonomy Act was revised in Japan and that allowed local governments to entrust the collection of donations to third parties. As a result, when local governments raise funds on donation-based crowdfunding platforms, they can legally make it without any restriction. In reality, K City in the Kanagawa Prefecture, a historic city which is located

close to Tokyo, entrusted the collection of donations to a general incorporated foundation called “Japan Giving”. K City was mobilizing donations for the purpose of reinstalling street signs in hopes to revitalize the city’s tourism industry.

The revised Ordinance also aims to encourage local governments to leverage public funds to support small business development in line with policy objectives of local governments, which include the promotion and revitalization of local industries. Additionally, local governments can benefit from cooperation with the platforms because they have a large investor base, to whom local governments can market their local brands efficiently.

Local governments actually have a wide range of direct subsidies as a principle means of supporting small businesses, and the local governments have a particular target of channeling subsidies in many cases. However, some of them may not always work well for small business development. The table below compares Micro Investment Crowdfunding with conventional public subsidy supports to small businesses.

TABLE 5 COMPARISON BETWEEN CONVENTIONAL PUBLIC SUBSIDY SUPPORT AND MICRO INVESTMENT CROWDFUNDING FROM THE SMALL BUSINESSES PERSPECTIVE

ITEMS	CONVENTIONAL PUBLIC SUBSIDY SUPPORT	MICRO INVESTMENT CROWDFUNDING
REPAYMENT OF FUND	NO	YES
FEES	NO	YES
TIMING	Fixed	Flexible
FUND AMOUNT	1/2 to 2/3 of the necessary amount at most. 100% is rarely provided. The upper limit is set because of the budgetary constraints	Variable (the marketoriented mechanism)
CONTINUITY	Not available every year.	Dependent on (market-oriented mechanism)
FINANCE TARGET	Variable (decided by the public sector)	Flexible

As shown above, Micro Investment Crowdfunding Platforms can be utilized in a more flexible manner from the view point of small businesses. Nonetheless, the Micro Investment Crowdfunding mechanism is not yet sufficiently understood by small businesses and by individual investors.

Active promotion is needed to increase the inflow of small business financings with support from the public sector.

In the case of K City Support fund, a total amount of JPY 11.9 million [USD 103,480] was raised in FY2015, while the Municipal government subsidized JPY 1.6 million [USD 13,913] (JPY 800,000 [USD 6,957] x 2 funds) of it. This shows that the public subsidy support successfully leveraged to mobilize roughly eight times more investment on the platform.

Therefore, it can be concluded that public subsidy support covering the initial fund arrangement fees can result in larger financial impact to small businesses, encouraging them to try fundraising with a small enough financial burden. At the same time, the public sector can count on the dynamic market-oriented mechanism of the platforms to screen potential small businesses because the target amount of fund cannot be raised without individual investors' strong empathy.

➤ 4.3 Engagement of stakeholders and dissemination

✓ Acknowledgement to Micro Investment Crowdfunding

Micro Investment Crowdfunding still needs more recognition and acknowledgement amongst the small businesses, ensuring a better understanding of this useful innovative financial mechanism. It must be particularly important for the platform to reach out to the small businesses that cannot access a corporate loan from the local financial institutions even though they have a solid business plan. To endorse the use of this financial instrument, some of local governments takes a lead to organize seminars to raise awareness and promote better understanding of its scheme amongst local small businesses because certain level of financial literacy is required for small businesses to understand how the Micro Investment Crowdfunding work.

In the seminar, the platforms should make a detailed explanation about the fees including the initial fund arrangement fee for which some local governments have a program to offer subsidy support. Additionally, the platform can describe another function of marketing on the Micro Investment Crowdfunding platform, that is to say small business can directly reach out to individual investors who can be converted into big supporters or fans of their products and/or services thanks to their strong emotional attachment.

At the same time, we stress that the fees can be reduced with the internal process and operating system standardized and/or improved by automating/digitalizing (assessment, web meetings etc.) and out-sourcing.

✓ Engagement of stakeholders

It is important to note that suburban and local areas tend to have closed and conservative cultures. In such communities, the prefectural and municipal governments are the reliable organization having a close connection with the local people, and so it is important for outsiders like crowdfunding platforms to take advantage of the municipalities' local network, and engage local stakeholders with reliable information offered through these municipalities.

In the case of Kumamoto prefecture, which was hit by a large earthquake in 2016, the prefectural government took a strong initiative to get stakeholders work in coordination, even in the chaotic situation shortly after the earthquake, to set up an enabling ecosystem to speed up small business recovery. The local governments played a key role in engaging local stakeholders in local small businesses recovery.

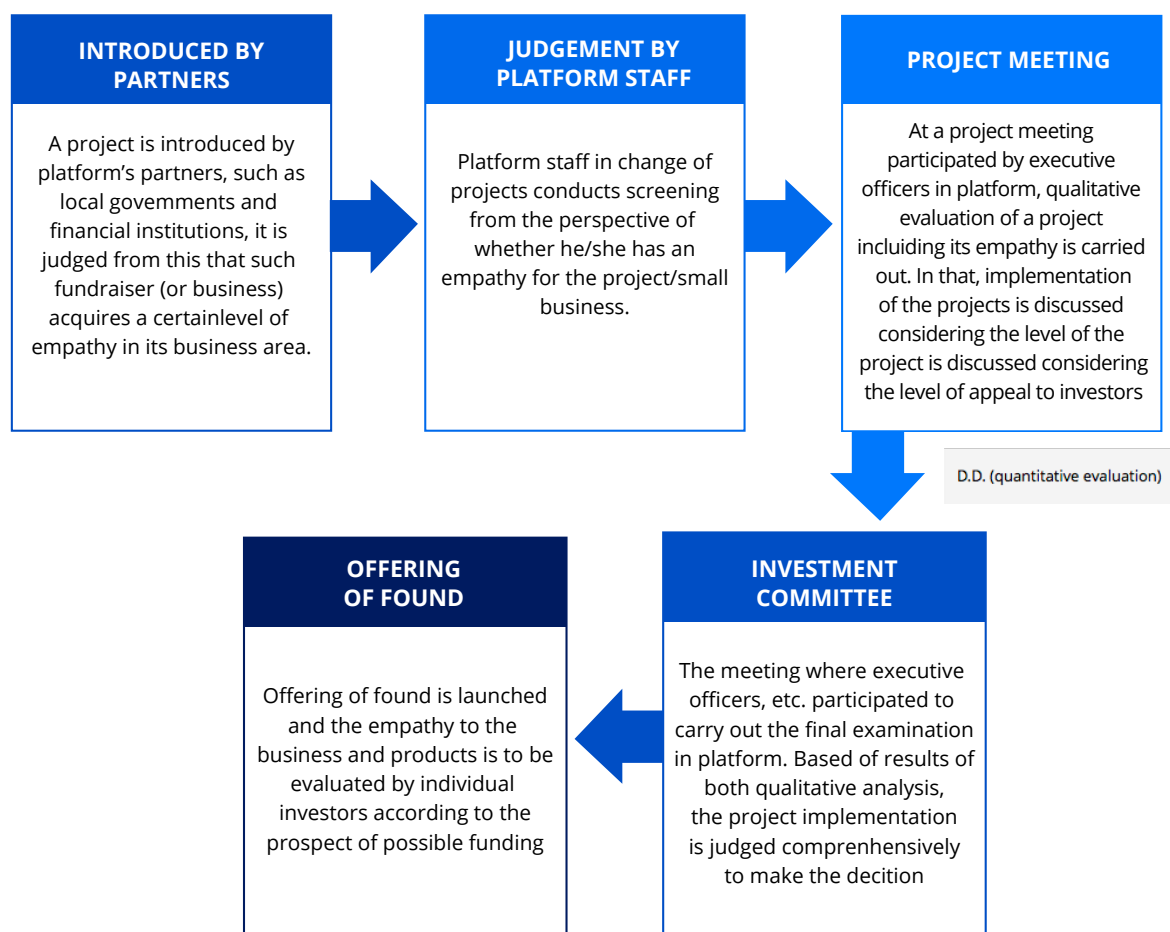
The prefectural government launched “**Kumamoto Earthquake Support Fund**” to be managed by a steering committee of local stakeholders like the Chamber of Commerce, Industry of Kumamoto, and Kumamoto University. This is to subsidize initial fund arrangement fees which are charged to local small businesses damaged by the earthquake when they challenge fundraising on the platform. In this case, the platform designed a special hybrid fund consisting of half investment and half donation to cut off the financial burden even more on local small businesses so that they are financially and empathically empowered to make every effort to have their businesses recovered as soon as possible.

✓ Giving endorsement to the funds

The local governments take a lead to disseminate the active use of Micro Investment Crowdfunding and give endorsement to the funds in case they subsidize the initial fund arrangement fees for local small businesses. As described earlier, the platforms have their own criteria to assess both credit and project risk. We can say that empathy is a crucial criteria in the qualitative assessment in their process of due diligence.

In collaboration with the local governments, the platform is able to deepen such risk assessment with abundant information shared by them. On empathy, the local governments judge it at first based on the local reputation amongst the local stakeholders and communities, market characteristics and competitiveness of business in the region, etc. That is to say, small businesses are graded first by the local governments in terms of empathy.

FIGURE 5 BUILT-IN EMPATHY QUALIFICATION MECHANISM



For instance, K City sets the criteria to qualify the candidate small businesses as follows; the project i) must have some unique local features (25 points), ii) must resonate with people (15 points), iii) must be highly attached to K City somehow (culturally, economically, historically, etc.: 10 points), and iv) must be economically feasible (50 points). After this qualification, candidate small businesses are brought to K City Public University's Research Center for Regional Economies who provides advice at the selection stage.

The small businesses released on the Micro Investment Crowdfunding platform in collaboration with local governments are qualified and regarded as "certified" by them. It works to mitigate the risk tolerance in Japan when the individuals determine investment.



The use of the Micro Investment Crowdfunding platform matches the potential monetary supply from individuals to small businesses' financial demand. It can also make potential financial demand of local small businesses visible on the

platforms and mobilize more financing from individual investors living in the metropolitan areas to local small businesses of Japan.

Both financial and non-financial support from the public sector must be a crucial element that makes the Micro Investment Crowdfunding mechanism gain more acknowledgement and spread further for the local small business development in Japan.

At the same time, the enabling ecosystem is also fundamental. The platform cannot effectively and efficiently work without well-structured cooperation amongst the local stakeholders and the multidirectional support from local governments as well as appropriate regulatory frameworks. In this context, local governments can effectively and efficiently push local small businesses development by supporting access to finance via Micro Investment Crowdfunding and bridge small businesses from the start-up stage to the expansion stage so that they can become self-sufficient in terms of their credit.

In conclusion, seed money from local governments serves to promote the local small business development in the dynamic market-oriented mechanism of the platform and to have local products and/or services acknowledged more to open a new market through the platform. It must be a smart use of public money that can leverage to mobilize more investment from the private sector and to make multiple impacts from view point of publicity. Thus, there seems to be room left for the local governments to benefit more, if they plan to smartly use the Micro Investment Crowdfunding and restructure their public expenditure to local MSME development and public relations activities instead.

From the local economy development perspective, Micro Investment Crowdfunding can contribute to make a positive impact on small businesses in case the platform works with local governments in harmony. According to this give-and-take of interaction, Micro Investment Crowdfunding is utilized by small businesses as one of a valuable channel of financing, and gradually recognized as an innovative investment product that doesn't focus on high financial returns but on individual investors' empathy.



CHAPTER 5 POLICY IMPLICATION

It is essential that a proper regulatory framework must be developed to promote new financial products such as Micro Investment Crowdfunding, so that individual investors can increasingly invest in them. Legal framework revisions and voluntary regulations related to Micro Investment Crowdfunding (as of December 2016) are detailed in ANNEX 3-1-5.

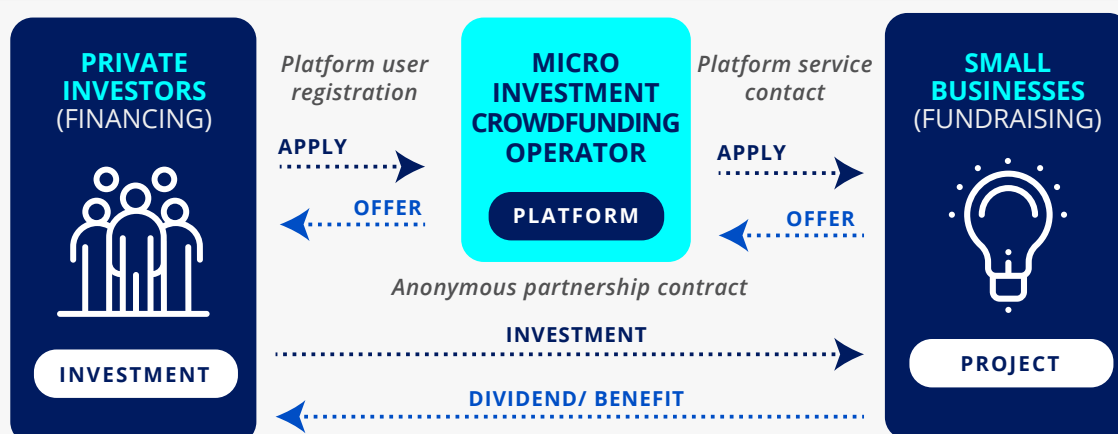
Followings are the principal measures taken for promoting Micro Investment Crowdfunding in Japan:

- 1 regulation by the platform operator association, in addition to a regulatory law, is enforced for protecting individual investors.
- 2 Rules to utilize the new financial mechanism for enhancing MSMEs' equity capital are introduced.
- 3 Simplified taxation and accounting rules are developed to attract individual investors.
- 4 Appropriate disclosure policy to make the screening and monitoring process transparent so that individual investors can trust in the crowdfunding platforms.

BOX- 1 "TOKUMEI KUMIAI AGREEMENT" (ANONYMOUS PARTNERSHIP AGREEMENT)

One of the most significant features of Micro Investment Crowdfunding as a financial instrument is the "Tokumei Kumiai Agreement" (anonymous partnership agreement). Under this agreement, numerous individual investors and small businesses directly enter into a contract. This contract is supported by a platform operator in concluding the agreement, but there is no contractual relationship between the platforms and each individual investor.

FIGURE 6 STRUCTURE OF MICRO INVESTMENT CROWDFUNDING



The relationship between the **individual investors** and the **MSMEs** under this anonymous partnership agreement is unique in having intermediate hybrid characteristic between equity and debt from a financial perspective. For instance, while profits and losses of a small business are basically shared in proportion to the invested amount and it is similar to the nature of stocks and shareholders, individual investors cannot intervene directly in any decision makings over business management. In this sense, the nature is more like a lender. In other words, the investors can receive dividends, but they do not ‘own’ the small business in any way.

One of the reasons for this distinctive financial instrument development with a high profile in recent years is because of the unsatisfied financial demand of MSMEs including startups that are in a certain business phase, called the “**death valley**”. In practice, the MSMEs with an insufficient track record of transactions are regarded as high-risk businesses in credit screening by financial institutions. For start-ups in particular, a considerable period of time is necessary to earn profits, and retain a certain amount of money for affording repayment. Conversely, a financial demand for small business continuation generally increases while their actual capital at hand rapidly decreases. Micro Investment Crowdfunding is recognized for being able to satisfy the financial requirements of small businesses in that stage, which cannot be handled by conventional financial institutions due to their constraints.

➤ 5.1 Regulatory framework of Micro Investment Crowdfunding

Some regulatory framework development is necessary to protect individual investors of Micro Investment Crowdfunding. In Japan, this improvement is

done under the Financial Instruments and Exchange Act. Individual investors of Micro Investment Crowdfunding are not institutional investors. In consideration to this, voluntary regulations are enforced by the Type II Financial Instruments Firms Association in addition to the Act in order to ensure healthy transaction for individual investors.

TABLE 6 SUMMARY OF VOLUNTARY REGULATIONS ENFORCED BY TYPE II FINANCIAL INSTRUMENTS FIRMS ASSOCIATION

1	Fund amount should be below 100 million yen [USD 869,565] per year that can be raised by the Type II financial instruments firm.
2	Soliciting investment through home visit and/or phone is prohibited
3	Raised funds must be managed separately from the MSME's own assets.
4	<p>Providing necessary information for individual investors. MSMEs offer the following information to individual investors after the completion of each fiscal year under an anonymous partnership agreement (in practice, it is posted on the customer's "My page" of Type II financial instruments firm's (platform) website:</p> <ul style="list-style-type: none"> ✓ Overview of target business, spending of funds, and business sales of the fiscal year ✓ Presence or absence of returns and redemption money of the fiscal year. If yes, a total amount and the amount per share to be paid. ✓ Confirmation is done for the accounting book of target business sales and received money. (must be certified by accountants, tax accounts)

➤ 5.2 Advantages of Hybrid of debt and Equity Financing in a new policy framework

It is worthwhile to highlight that debt-borrowing through anonymous partnership agreement can be recognized as equity (capital) in MSMEs financial statement although "debt" is treated as liability under common accounting practice. On November 22, 2011, the Financial Services Agency (hereinafter referred to as the "FSA") that supervises financial institutions announced "Active Use of 'Equity-Capital-Like-Debt-Borrowings (ECLDB)'" to promote economic recovery from the Great East Japan Earthquake occurred in the same year, based on which the FSA aggressively supports the MSMEs in the afflicted areas to improve their balance sheets and to access to financing.

After the earthquake in 2011, a large number of MSMEs suffered from erosion of their capital base, and the Japanese yen's sharp appreciation followed. Thus, the FSA aims to promote active use of ECLDB to improve balance sheets of those small businesses with low liquidity but having the potential for revitalization or improvement of their business management. "Active use of ECLDB" specifically means to clarify the terms and conditions that allow financial institutions to

consider “**borrowing recognized as sufficiently having the nature of capital**” as “capital”.

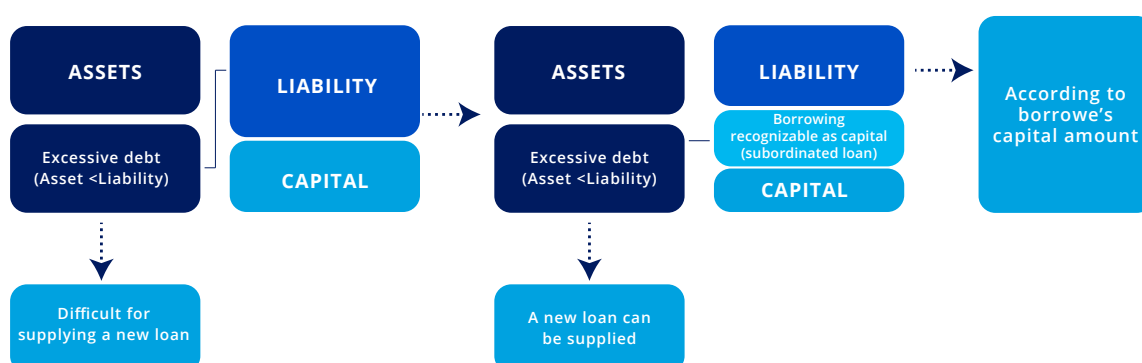
To qualify as “sufficiently having the nature of capital”, certain terms and conditions of the fund must be ensured based on the nature of capital (conditions of amortization, setting of interest rate and subordination). According to “FAQ about the Financial Inspections Manual”, such funding conditions include the followings are considered.

TABLE 7 CONDITIONS FOR ECLDB ¹³

CONDITION	
AMORTIZATION	It must be more than five years.
INTEREST RATE	In principle, the interest rate is set according to the earnings available for dividend.
SUBORDINATION	In principle, the funding is subordinated in case of legal bankruptcy

If financial institutions agree to recognize the ECLDB as a capital in line with the FSA's guidance, the corresponding debt is treated as equity in company's balance sheet and makes it easier for MSMEs to obtain new loans from them. At the same time, financial institutions can benefit from the ECLDB which allows to upgrade the internal credit rating of small businesses thanks to their capital increase and to offer additional corporate loans to them so that MSMEs' can minimize the default risk deriving from temporary aggravation of their financial condition which is unfavorable for financial institutions. Moreover, “borrowing recognized as sufficiently having the nature of capital” is basically redeemed on a lump-sum basis and its term is longer than 5 years. It provides the small businesses enough time for consolidating new business line as well as recovery from temporary downturn due to an unpredictable event such as natural disasters.

FIGURE 7 ADVANTAGEOUS UTILIZATION OF ECLDB.



¹³ Source: Website of the Finance Services Agency (<http://www.fsa.go.jp/news/23/ginkou/20111122-4/01.pdf>)

BOX-2 HYBRID OF DEBT AND EQUITY FINANCING FOR MSMES

The following table shows summarized characteristics of “Tokumei Kumiai Agreement” (anonymous partnership agreement, the legal modality of Micro Investment Crowdfunding), comparing to the characteristics of common shares and loans, the most basic and functional option to raise money for startups and/or growing small businesses.

TABLE 8 COMPARISON OF CHARACTERISTICS OF FINANCIAL TOOLS

	DUTIES	CONTENTS	LOAN
RELATIONSHIP BETWEEN FUND PROVIDER AND FUNDRAISER	Fundraiser is company owner and fund provider entrusts management to the management	Anonymous partner (fund provider) and small businesses are contracting parties	Lender is creditor
CORPORATE (SMALL BUSINESSES”) ASSETS	Attributable to small businesses (indirectly owned by stakeholders)	Attributable to small businesses	Attributable to small businesses (collateral, etc; is set up)
RETURN	Dividend (on a per-share basis)	Performance-bases dividend in proportion to the invested amount	Interest (calculated as a percentage of an outstanding loan balance)
INVOLVEMENT IN BUSINESS OPERATION	Yes (shareholders’ meeting)	No	Yes (instruction on management improvement)

	DUTIES	CONTENTS	LOAN
TRANSFER OF RIGHTS	Yes	No	Yes
FUND RECOVERY PERIOD	Until liquidation and retirement of shares (listed shares can be sold in the market)	Period provided in agreement	Period provided in agreement
REPAYMENT PRIORITY IN BANKRUPTCY	Subordinated to creditors	Equals to creditors (subordinated loan clause could be included)	Prior to stockholders
ACCOUNTING CATEGORIZATION IN SMALL BUSINESSES FINANCIAL STATEMENT	Capital	Debt (could be recognizable as equity in credit screening by financial institutions)	Debt

As shown above, the anonymous partnership agreement used for Micro Investment Crowdfunding is quite similar to common share in terms of water fall in the profits and residual assets. The general characteristics in its financial aspects are summarized below.

[For MSMEs] Business management autonomy

All funded assets belong to the MSMEs while individual investors receive dividend or incur principal loss in accordance with the small businesses sales turnover defined in the anonymous partnership agreement. As a result, small businesses have the right to run their own businesses without any interference from individual investors because they have no right of ownership or disposal right of the assets they have invested in.

[For Individual Investors] Limited risk

While the principal is not guaranteed, individual investors have limited liabilities regarding their investment amount under an anonymous partnership agreement. Therefore, their loss never exceeds their investment amount

✓ **[For Individual Investor and MSMEs] Flexibility of determination of return**

The amount of financial returns can be determined by the small businesses' sales turnover in accordance with the agreement between the MSMEs and the individual investors. Obviously, individual investors take risks that fall below the principal when the small businesses cannot mark the target amount of sales turnover.

✓ **[For Individual Investors] Low liquidity**

Anonymous partners cannot transfer any of their rights or obligations to a third party under the agreement.

➤ **5.3 Simplification of taxation and accounting**

Mobilization of individual financial assets by promoting innovative funding mechanisms is a key for stimulating the Japanese economy, especially in local areas. The Japanese individual financial assets are estimated over JPY 1,000 trillion (approx. USD 8.7 trillion), thus there is still huge potential capital to be channeled to investment. We can say most individual financial assets in Japan are cash or bank deposits accounting for nearly 50% of the total financial assets. There are also pension savings and insurance, while the corporate equity or stocks account for only 13.6% (as of September 2016).

One of the influential factors that impact investment behaviors of the households, hindering it from investing in risk assets, is the taxation system. These are some of its current problems, particularly related to finance and securities:

- ① Income classification and tax rates are complicated, including interest income, income from returns, profits and dividend, temporary income and other income.
- ② Tax collection methods differ by financial products.
- ③ Limits on profit and loss carryover.

Investing through Micro Investment Crowdfunding is not covered by the securities taxation system. The income or loss caused by the **Micro Investment Crowdfunding** cannot be offset with the income or loss from other financial products and are not tax-deductible. Therefore, the Funds to support disaster-affected areas including those applied as special donations are also not eligible for tax deductions. The income generated by Micro Investments Crowdfunding is categorized as “other income” and subject to a 20.42% tax rate in the current taxation system of Japan. “**Other income**” needs to be reported in the income tax return, and losses on these investments cannot be offset against the taxable incomes, such as employment income, dividend income, etc.

Thus, the Government of Japan is envisioned to update taxation on personal income to respond to the above-mentioned situation, while it is still under discussion. In any case, the Government has a strong intention to promote effective utilization of households’ financial assets and to strategically enhance the shift “**from savings to investment**” even more.¹⁴

Along with making changes in the taxation system, it is also important to generate attractive investment products/small businesses which motivate individual investors to expand the investments for financing. Individual investors, unlike institutional investors, definitely value simplicity and facility and they find it difficult to purchase financial products when they do not understand the complex terms, structures, and regulations that apply.

In addition to the unattractive taxation regime, it is one of the main features of Micro Investment Crowdfunding that individual investors are not allowed to withdraw or sell the partnership under an anonymous partnership agreement. These circumstances may discourage some of individual investors to make a micro investment with long period of maturity. In conclusion, there exists certain room for more activation of this innovative financial instrument.

➤ 5.4 Disclosure to individual investors

The individual investors using Micro Investment Crowdfunding platforms do not seek the financial returns alone, making investment decisions from different angles: empathy for the small businesses, social value of the product and/or services, attractive rewards, and sense of participation in the business, etc.

Whether such individual investors repeatedly use Micro Investment Crowdfunding or not principally depend on the sense of satisfaction with their own empathy

¹⁴ Report of finance subcommittee of Government Tax Commission (June 2004)

clues. In this way, individual investors are having greater trust in platforms which lead to bring more potential investments with empathy to the platform itself.

Platform operators always maintain a certain quality of funds at the selection that directly relates to the empathy of potential individual investors. In this context, platform operators are highly requested to put together a set of objective assessment/selection criteria and disclose to individual investors with transparency as much as possible so that a platform is considered as credible.

For example, in the case of conventional financial institutions, it is possible to monitor the borrowers' cash flow and business conditions on a real-time basis through the loan payments and deposit transactions to manage their credit risks. On the other hand, MSMEs that raised funds on the platforms, the report on their business operation to individual investors is disclosed on the platforms. However, there is no standard or obligation for the reporting methodology, the frequency and the contents, and the information that individual investors can access and a quantity of information differs by each MSMEs. Thus, it is also important to develop rules and/or standards to offer information periodically which is disclosed by MSMEs on Micro Investment Crowdfunding Platforms.

In general, the Micro Investment Crowdfunding works with empathy which may be caused by a wide range of clues. Thus, if the platform provides more information periodically, it helps to spread empathy wider and deeper amongst individual investors.



In any case, Micro Investment Crowdfunding is still in the process of becoming a major funding option for small businesses and there is room for improvement as discussed in this chapter. These challenges indicate that Micro Investment Crowdfunding still has a lot of potential to be utilized widely.

CHAPTER 6

CHALLENGES TO USE NEW FINANCING MECHANISM/ MICRO INVESTMENT CROWDFUNDING IN LAC REGION



➤ 6.1 Potentiality of empathy driven financing

There seems to be a new evolving trend of micro investment in a small business through crowdfunding. That is to say that a large number of individuals invest small amount of money in a specific small business each of them choose on the Micro Investment Crowdfunding Platforms. In Japan, this innovative financial mechanism is being spotlighted to promote local economy revitalization with the fund raised from individuals living in urban areas to local small businesses on the platforms.

In the mechanism of Micro Investment Crowdfunding, ‘**empathy**’ is regarded as a key driver for successful fundraising on the platforms. In other words, individual investors tend to place more priority on emotional attachment rather than risk-return profile, which is the crucial for conventional private investors, in their investment decision making process. Individual investors are encouraged to take more risks regardless of financial returns, in case they feel empathy caused by some clues which really vary one another.

At the same time, the small businesses can also benefit from Micro Investment Crowdfunding because the fund money is recognized as the ‘Equity-Capital-Like-Debt-Borrowings (ECLDB)’ under anonymous partnership contract between small businesses and individual investors. Specifically, the ECLDB can support for small businesses to obtain access to financing through deemed increase in capital with their management autonomy completely maintained. Thus, the platforms stress flexibility of the Micro Investment Crowdfunding featured mainly as follows; (i) forward-looking assessment focusing on the business plan, (ii) flexible design of financial returns anchored with annual sales turnover, and (iii) no intervention of investors in small business operation.

Financial access in LAC region is at even lower levels to that in Japan. CGAP shows that 39.2% of adults (age 15+) in Latin America has an account at a formal financial institution, with 20.3% of the adult population using these accounts to receive wages, and 10.4% to receive government payments, both of which are seen as potential channels to increase access to financial products and financial inclusion in the region. Credit is more commonly taken from family or friends (27.2%) than from a formal financial institution (8.6%), while 40% of the adult population has

saved money in the past year, nearly three-quarters of them doing so at a formal financial institution.

On the other hand, we need to remind middle class growth in the LAC region, which must be foundation to make the Micro Investment Crowdfunding mechanism boost with the increasing number of individual investors. During the last decade, the middle class of LAC region nearly doubled in size and now includes 186 million people, according to IDBⁱⁱ. Between 2002 and 2008 - the years of highest growth of per capita GDP - the size of the middle class expanded by 35% more than during the period of slower growth after 2008.

Thus, there is huge demand to push up financing to small businesses in LAC region as well. It is obviously indispensable to support the financial sector development for this purpose. Then, it is worthwhile utilizing Micro Investment Crowdfunding mechanism to expand and diversify the channeling of money to small businesses especially in the local area because they have tremendous difficulty in access to existing direct and indirect financing market. In such a case, we offer that empathy can help mobilize more money to small businesses when they challenge to raise small amount of investment money from a large number of individuals. Moreover, empathy works even better in the LAC culture where people give more importance to personal connection and emotional attachment than in Japan.

We remind that the technological advancement is serving to increase connectivity and, for example, there are a large number of individuals having them connected on social media in LAC region as well. This change is often revealing potential demands like the collective financial mechanism development for small businesses amongst others. In this regard, we think that the Micro Investment Crowdfunding can evolve to mobilize more money from more individuals with the new driver to push local small business development in LAC region.

➤ 6.2 Expectations for new value added financial services of local business development

In the course of this study, we confirmed that the small businesses are hoping for non-financial value-added services as well as funding for their successful business operation. In this sense, the small businesses appreciate non-financial services of Micro Investment Crowdfunding like marketing function and advisory services, which greatly differentiate the platforms from other conventional financial instruments.

One of the biggest challenges amongst small businesses is to advertise their business and to reach market access, especially for those in local areas. In this context, the small businesses appreciate the marketing function of Micro

Investment Crowdfunding platforms where they can effectively be connected potential customers of their products and/or services in an efficient way. Moreover, the small businesses are allowed to utilize the list of individual investors for their direct marketing once fund is raised on the platforms.

In addition, the small businesses appreciate advisory services as well, while the platforms do not provide direct support to the preparation of business plans at present. In the process of the business plan assessment by the platforms, the business plans are very much improved. The process allows small businesses to clarify their businesses' motives and targets, and to make them recheck whether their business plan is directly linked to the practical target-set. This process also helps effective and efficient business preparation and fit the small businesses' demand in the preparation stage.

In conclusion, the Micro Investment Crowdfunding is featured to offer non-financial value-added services as well as financial services of fundraising. From the small business perspective in LAC region, the marketing function very much fits their demand to advertise their products and/or services in an efficient and effective way. LAC countries have the same cultural background and do not have language barrier very much. Thus, this marketing function must be even more useful for the small businesses to open up a new market across the LAC region.

➤ 6.3 Potential cooperation with the public sector

First of all, the enabling ecosystem is fundamental to promote the Micro Investment Crowdfunding and the platforms have to cooperate with the public sector for building up better ecosystem. In reality, the platforms cannot effectively and efficiently work without well-structured framework where the local stakeholders actively cooperate one another with the multidirectional support from local governments, as well as the regulations and norms for the public sector to appropriately supervise the innovative financial services.

Secondly, Micro Investment Crowdfunding still needs more recognition and acknowledgement amongst the small businesses, ensuring their better understanding of how this innovative financial mechanism works. In this sense, the platforms benefit from cooperation with the public sector to jointly reach out further to the small businesses. Actually, both non-financial and financial supports from the public sector seem very helpful to the small businesses.

As for non-financial supports, we offer that the joint promotional activities with local governments must be helpful to raise awareness and promote better understanding of how it works amongst local small businesses. This is because

suburban and local areas tend to have closed and conservative cultures. In such communities, the local governments are often the reliable organizations having a close connection with the local people, and so it is important for outsiders like the platforms to take advantage of their local networks.

Regarding financial supports, we stress that local government is strongly expected to give endorsement to the Micro Investment Crowdfunding, subsidizing the initial fund arrangement fees to encourage the local small businesses to challenge fundraising on the Micro Investment Crowdfunding Platforms because the fees are apparently certain financial burden especially to the small businesses. From local governments' perspective, the subsidy (seed money) can be cost-effective, that is to say, the public financial support can mobilize more money to be channeled to the local small business development which very much matters to the local government. In fact, there are many cases in which the local small businesses could successfully raise the fund amounting several times more than public subsidy amount with it effectively leveraged on the platforms.

Finally, we would conclude that the above-mentioned cooperation is a sort of public-private partnership model to effectively promote the local small businesses and it can be utilized in LAC region as well. The Micro Investment Crowdfunding Platforms (the private sector) serve to mobilize money from individual investors (the private sector) for local economy development which very much matters to local governments (the public sector). In this model, we point out that the Micro Investment Crowdfunding does not work without non-financial and financial support from the public sector and local governments (the public sector) can also benefit from the dynamic market-oriented mechanism to screen potential local small businesses on the platforms in a very efficient manner.

➤ 6.4 Policy implication of Micro Investment Crowdfunding

It is worthwhile pointing out that anonymous partnership agreement is a key factor which makes the Micro Investment crowdfunding valuable as an innovative financial instrument to small businesses. Thus, it is important to arrange the enabling ecosystem securing the following financial characteristics like anonymous partnership agreement or a similar one in LAC region.

1 Business management autonomy of small businesses

Small businesses have the right to run their own businesses without any interference from individual investors having no right of ownership or disposal of assets they have invested in. Individual investors just have the

right to receive dividend and assets that remain when the project is terminated.

2 Limited risk of individual investors

Individual investors have limited liabilities regarding their investment amount and their loss never exceeds it.

3 Flexibility of determination of return

Individual investors take risks that dividend may be lower than their expectation when the small businesses cannot mark the target annual sales turnover.

4 Low liquidity

Any of individual investors' rights or obligation cannot be transferred to a third party.

Moreover, an innovative financial instrument like Micro Investment Crowdfunding needs to be promoted in combination with some strategic policy. For example in Japan, the Financial Services Agency announced "Active Use of Equity-Capital-Like Debt-Borrowings (ECLDB)" and encourages financial institutions to offer an innovative financial solution from which small business can benefit to improve their balance sheets and to access to financing. The Micro Investment Crowdfunding is challenging to evolve in line with the same concept.

It has been a long-standing discussion point how to strategically promote local small business development in LAC region. We found that the FSA's guidance influences on financial institutions' risk take and impacts the potentiality of the Micro Investment Crowdfunding in Japan. There seems to be some implications to find some strategic approaches for further local small business development in LAC region.

In any case, disclosure is fundamental to gain trust to an innovative financial instrument in LAC region as well. It is necessary to develop rules and/or standards of disclosure to individual investors on the platforms. As for Micro Investment Crowdfunding, the platforms can also benefit from disclosure to raise more funds because disclosure can probably serve to increase chances to hook empathy, the key driver to move individual.



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