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Australian Government

Corporations and Markets Advisory Committee

Crowd sourced equity funding

Discussion Paper

September 2013

Corporations and Markets **Advisory Committee**

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1 Introduction

This chapter explains the CAMAC review of crowd sourced equity funding (CSEF), summarises the review process and invites submissions on any aspect of the review.

1.1 CAMAC review

In *Advancing Australia as a Digital Economy: An Update to the National Digital Economy Strategy* (June 2013), reference was made to holding an independent review of the regulation of crowd sourced equity funding (CSEF). CAMAC was asked to conduct that review.

CSEF is a relatively new and evolving form of capital raising. Broadly, it refers to schemes through which a business seeks to raise funding, particularly early-stage funding, through offering debt or equity interests in the business to investors online. Businesses seeking to raise capital through CSEF typically advertise online through a crowd funding platform website, which serves as an intermediary between investors and the business.

1.2 Scope of the CAMAC review

Given the borderless nature of the Internet and social media, CSEF could involve offers of equity in issuers incorporated in any country, mediated through websites established and operated in any country, and open to investors in any country.

This review does not seek to review CSEF in such a generic sense. Rather, this paper focuses on the issues that would arise in the following corporate fundraising situation, as it applies to the three principal classes of participants:

- **issuers:** corporate entities that are registered as companies under the Corporations Act and are seeking to raise capital through offers of their shares or other securities (equity), and
- **intermediaries:** the equity will be offered through online portals of Internet website operators that come within the jurisdiction of Australian regulators, and
- **investors:** those online offers, which may involve small contributions from many investors, will be open to Australian residents and/or other persons.

This form of online fundraising is already theoretically available, subject to compliance by the issuer and the intermediary with fundraising, licensing and other requirements under the Corporations Act. This paper will examine the nature of those requirements and raise for consideration and comment, taking into account approaches in other jurisdictions, whether they should be adjusted in some manner for CSEF or whether a specific regulatory and facilitative framework should be designed in Australia for CSEF.

The paper does not cover other CSEF situations that may arise, such as equity offers to Australian investors by overseas incorporated issuers and which are intermediated on overseas-based websites. The Australian legislation already provides for an extended

jurisdiction in this regard.[1] These situations also involve matters concerning the international reach and coordination of corporate fundraising regulation in various jurisdictions, which are outside the scope of this review.

1.3 The review process

CAMAC has formed a sub-committee for this review, comprising Greg Vickery (chair), Teresa Handicott, Ian Ramsay, Brian Salter and Maan Beydoun (ASIC), in conjunction with the CAMAC Executive.

Given the developing nature of CSEF regulation in various jurisdictions, CAMAC intends periodically to update the discussion paper online. These updates will be posted on the CAMAC website: www.camac.gov.au

CAMAC is seeking written submissions on the matters raised in this discussion paper by the end of November 2013. CAMAC will consider these submissions and also hold roundtable consultation with respondents in the first quarter of 2014 before settling its report.

1.4 Invitation for submissions

CAMAC invites submissions on any aspect of this review, including the series of questions raised in Chapter 7 of this paper.

Please email your submission, **in Word format** (not pdf), to:

john.kluver@camac.gov.au

with a cc to:

camac@camac.gov.au

Word format is requested, as part of the internal CAMAC process for considering submissions involves their collation under topic headings.

All submissions, unless marked confidential, will be published at **www.camac.gov.au**. Submissions will be published in pdf format.

Please forward your submissions by the evening of **Friday 29 November 2013.**

If you have any queries, you can call (02) 9911 2950.

1.5 Advisory Committee

CAMAC is constituted under the *Australian Securities and Investments Commission Act 2001*. Its functions include, on its own initiative or when requested by the Minister, to provide advice to the Minister about corporations and financial services law and practice.

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[1] Subsection 700(4) of the Corporations Act provides that 'This Chapter [Chapter 6D – Fundraising] applies to offers of securities that are received in this jurisdiction, regardless of where any resulting issue, sale or transfer occurs.'

The members of CAMAC are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their knowledge of, or experience in, business, the administration of companies, financial markets, financial products and financial services, law, economics or accounting.

The members of CAMAC are:

- Joanne Rees (Convenor)—Chief Executive Officer, Allygroup, Sydney
- David Gomez—Chief Financial Officer, Land Development Corporation, Darwin
- Teresa Handicott (Brisbane)—Partner, Corrs Chambers Westgarth
- Alice McCleary—Company Director, Adelaide
- Denise McComish—Partner, KPMG, Perth
- Michael Murray—Legal Director, Insolvency Practitioners Association, Sydney
- Geoffrey Nicoll—Co-Director, National Centre for Corporate Law and Policy Research, University of Canberra
- John Price—Commissioner, Australian Securities and Investments Commission (nominee of the ASIC Chairman)
- Ian Ramsay—Professor of Law, University of Melbourne
- Brian Salter—General Counsel, AMP, Sydney
- Greg Vickery AO—Special Counsel, Norton Rose Australia, Brisbane.

The Executive comprises:

- John Kluver—Executive Director
- Vincent Jewell—Deputy Director
- Thaumani Parrino—Office Manager.

2 Online fundraising

This chapter discusses CSEF within the broader context of crowd sourced funding, and identifies the implications of this form of corporate fundraising for the key participants.

2.1 Crowd sourced funding generally

2.1.1 CSEF as one form of crowd sourced funding

CSEF is just one form of what is commonly known as 'crowd sourced funding' (or alternatively as 'crowdfunding' or 'crowdsourcing').

From one perspective, crowd sourced funding in its various forms - soliciting small financial contributions from a large number of people - is not new.[2] Charitable bodies, for instance, have been doing this for many years, in various ways. However, during the last decade the Internet and social media have created or enhanced the means by which individuals and entities can draw their requests, ideas or proposals to the attention of large numbers of persons who may have some funds they are prepared to donate or invest.

2.1.2 Types of crowd sourced funding

Crowd sourced funding is a means of raising money for a creative project (for instance, music, film, book publication), a benevolent or public-interest cause (for instance, a community based social or co-operative initiative) or a business venture, through small financial contributions from persons who may number in the hundreds or thousands. Those contributions are sought through an online crowdfunding platform, while the offer may also be promoted through social media.

Individuals may be invited to contribute to a project, cause, or venture (project):

- for its intrinsic social, artistic, philanthropic or other worth, not in exchange for anything of tangible value: **donation funding**[3]

- in exchange for some existing or future tangible reward (such as an existing or future consumer product or a membership rewards scheme): **reward or pre-payment funding**[4]

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2 An early example of what might now be described as crowd sourced funding was a campaign in 1884, led by newspaper proprietor Joseph Pulitzer, to help fund the installation of the pedestal for the Statue of Liberty in New York harbour. Through that campaign, more than $100,000 was raised in six months from 125,000 people, with most donations being $1 or less.

3 Those contributing money are motivated by an affinity with the idea or goal, rather than by any reward they might receive.

4 See, for instance, www.pozible.com
In the US, *Kickstarter* began as a way for creative individuals—musicians, filmmakers, writers—to fund their work, often with the only return being an advance copy or limited edition of a DVD or other art work, concert tickets, or simply a signed thank-you note. An example in an educational context is a crowdfunded micro-satellite aboard the International Space Station, which contributors can use to conduct their own space experiments.

- in exchange for a future financial reward (such as a share of profits resulting from the sale of a good/service, the production/delivery of which the funding enabled): **investment funding**[5]

- in return for profit on funds lent through one-to-one lending arrangements: **peer-to-peer (P2P) funding**.[6] These can range from person-to-person loans, to arrangements that look in many respects like standard business lending except that a financial institution is not involved

- in exchange for equity or other securities in a company or other entity (if permitted): **equity funding**. This is what is referred to as CSEF.

The various forms of crowd sourced funding are continuing to evolve. As noted in one commentary:

> In a relatively short time, crowdfunding has become a new method of raising capital for a broad range of purposes using the internet. To date, it has mainly been used by people seeking to raise money for a specific project and does not generally involve the issuance of securities. However, in some jurisdictions, crowdfunding is emerging as a way for businesses, particularly start-ups and small and medium-sized enterprises, to raise capital by issuing securities.[7]

In Australia, crowd sourced funding has been typically donation funding and pre-payment funding.

2.1.3 How crowd sourced funding works

The various forms of contemporary crowd sourced funding, including CSEF, have the same basic elements.

A person (the promoter) may have a project but insufficient funds to bring it to fruition. The promoter may decide to raise some or all funds through an intermediary crowdfunding platform which (for a fee) creates a page on its website for the promoter. The promoter may also create a video or other promotional material on the website page, explaining the project and asking for funds in exchange for an immediate or future product or other reward. People interested in contributing may be able to engage with the promoter and with each other, on a chat room or chat board provided by the website platform. The project and its fundraising are also typically promoted via social media, email to friends and associates and other websites with a web-link to the fundraising page.

Crowd funding platforms may require a specified target amount to be reached before contributions are passed to the promoter ('all or nothing' funding), or have those funds passed on without any target threshold ('keep it all' funding).

The operators of a crowdfunding platform may engage in vetting of projects to be included on their website, to maintain the reputation of the website. However, this due diligence

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5 An example in the US is www.appbackr.com Through this website funders 'buy' phone applications wholesale and when the apps are sold retail via the Apple Store, for example, profits are distributed back to the funders.

6 Peer-to-peer lending is developing in a number of jurisdictions. For instance, a report by the Open Data Institute in July 2013 found that between October 2010 and May 2013 some 49,000 investors in the UK funded peer-to-peer loans worth more than £378m. Some intermediaries arrange loans between individuals, other intermediaries pool funds which are then lent to small and medium-sized businesses. In Australia, this form of financing is noted in the Australian Centre for Financial Studies *Funding Australia's future* project.

7 Ontario Securities Commission Consultation Paper 45-712 *Progress report on review of prospectus exemptions to facilitate capital raising* (August 2013) at 5.

may be well short of taking any legal responsibility for the accuracy of the information provided by promoters of projects or for the proper use by promoters of the contributed funds.

2.1.4 Risks of crowd sourced funding

Crowd sourced funding, in any form, carries risks for persons providing funds through this medium. While risks may be present in any capital raising process, the central role of the Internet means that the number of persons potentially affected can be significantly greater than for more traditional means of fundraising. Also, the scale of risk involved can be accentuated by the generally reduced level of scrutiny of these offerings.

Fraud

This can take various forms.

There is the possibility of misappropriation, either by the project promoter or the website operator, of all or some of the funds invested or donated. This risk is more likely to arise where fund providers are not to receive any immediate financial or other benefit.

Also, as crowd funding is largely an online-based activity, there is the risk of false websites being established simply to entice individuals to provide credit card details.

Furthermore, there is the possibility of genuine websites being used by fraudsters claiming to be promoters of projects, perhaps projects similar to ones that were successful in the past in raising a large amount of funds.

Failure

This is the risk that projects, even if properly funded and administered, will not be successfully completed and investors will not receive the financial or other rewards promised, or the return of the funds invested.[8]

This risk, while clearly not confined to crowd sourced funding, is potentially made more significant because it is often the case in crowd sourced funding that the projects that are in fact funded are those that provide the participants with some psychological reward, such as the feeling that the contribution is helping fund a worthwhile cause or is assisting someone in bringing their creative idea to fruition. As these projects are not funded according to their business and financial merits, this increases the risk of failure as they may not have been viable in the first place. Also, as disclosure may be limited, participants may not be able to properly assess the financial and practical merits of particular projects.

2.1.5 Potential impact of crowd sourced funding

The factors most likely to influence the future use and direction of crowd sourced funding, in its various forms, include:

- **promoter opportunity**: the extent to which promoters of projects find it an attractive and workable means to raise finance**.** Promoters may also use online-based funding to gauge community interest in a project and improve community awareness of that project

[8] See, for instance, ASIC *12-196MR ASIC guidance on crowd funding* (August 2012).

- **intermediary opportunity**: the extent to which persons facilitating the activity on their websites find it a viable and profitable business. This is likely to depend on the demand for funding by project promoters and the amount of fees/commission intermediaries collect through the crowdfunding process

- **investor opportunity and protection**: the extent to which investors are willing to fund projects, for altruistic, profit-related or other reasons, taking into account the extent to which they accept the financial risks of the projects on offer, and perceive how the risk of fraud is dealt with

- **regulatory involvement:** the level and type of regulatory involvement. It is possible that regulatory responses in different jurisdictions may develop through a number of stages, and in different forms for the various types of crowd sourced funding, as experience with this form of fundraising increases.

2.2 Crowd sourced equity funding

The CAMAC review is aconfined to CSEF, being one aspect of crowd sourced funding.

2.2.1 Key elements

Concept of CSEF

CSEF could be considered a new form of corporate fundraising to the extent that it utilises the Internet to raise funds from a large number of small investors.

In essence, the concept of CSEF involves the sale of typically small capital interests ('equity') in companies ('issuers') through online websites ('intermediaries'), to potentially numerous individuals or entities ('investors'). CSEF is aimed principally at early stage capital-raising (sometimes referred to as 'seed capital') by start-up companies. However, there are no commercial restrictions on established businesses using CSEF to raise additional funds.

The interest in CSEF seems in part to be driven by what is seen as its potential to improve access to risk capital for innovative knowledge-based 'start-up' companies. Additionally, CSEF may offer new financing opportunities for companies operating in the not-for-profit, community interest and philanthropic sectors.

Internationally, CSEF is receiving increasing attention as an alternative form of corporate fundraising for start-up or other small to medium companies. To date, some jurisdictions, notably the United States, Italy and New Zealand, have enacted legislation dealing with CSEF (though the US and New Zealand legislation is not yet in force), while some other jurisdictions, such as Canada, France and the United Kingdom, are giving consideration to this form of fundraising.

Concept of equity

Strictly speaking, the term 'equity' refers to shareholding in a company. However, CSEF broadly covers any means of raising capital through offering debt or equity interests in the business. The concept of securities in the Australian legislation, in its broadest application, covers financial investment in the form of shares or debentures[9] in a company or interests

[9] A complication for issuing debentures rather than shares is that debentures require a trust deed and trustee. See generally Chapter 2L of the Corporations Act, which regulates debentures.

in a managed investment scheme.[10] For ease of reference, this paper will use the term 'equity', but with this wider application to securities generally.

New type of fundraising market

The concept of CSEF, like other forms of crowd sourced funding, is a product of the Internet and social media, which give potential investors access to investment opportunities of which they would not previously have been aware, and gives issuers access to investors that they would not previously have been able to reach. If regulatory concerns can be addressed, it is argued, CSEF is another channel by which to harness the interest of individuals in new projects and products, combined with the scale and momentum of the crowd.

A key element in the CSEF concept is that the funding process takes place through a regulated online platform or other intermediary. This enables the intermediary to control what capital raising opportunities are made available to issuers and what investment opportunities are made available to investors. In consequence, the CSEF concept could be described as a new form of public fundraising, of limited amounts for particular types of companies, with each intermediary acting as a form of 'exchange' and having the equivalent of 'listing' requirements for issuers, pursuant to any CSEF regulatory requirements.

Financing considerations

There is considerable interest globally in the potential for CSEF, seen as a new form of finance, to promote economic activity. There is a view that CSEF may help fill the demand for financing that banks and other financial institutions in various jurisdictions are no longer meeting, due to tighter credit requirements since the global financial crisis. By meeting this demand, it is argued, the additional funds that CSEF provides will assist in encouraging or increasing economic growth.

The counter view is that the tighter credit requirements that have been introduced are appropriate and should not be circumvented by riskier projects through CSEF, taking into account that investors in CSEF may not have the skills and experience, or access to information, properly to assess these risks.

2.2.2 Impact of CSEF on the traditional business model

A start-up enterprise utilising CSEF (when and where permitted) as a funding mechanism may develop in a manner quite different from a business utilising traditional funding arrangements.

Traditionally, a business may begin by creating and promoting a product or service, funded through private investment (from, for instance, 'angel' investors or other private equity) and/or loan arrangements with a financial institution, often backed by personal guarantees. Any offering of public equity involvement usually takes place only after there has been some indication that the product or service is, or will be, commercially viable.

By contrast, a business seeking to use CSEF may begin by advertising its product or service through the Internet or social media, either as an idea only, or as a concept that has been established or proven to a certain stage but nevertheless requires development and scale-up. The controllers of the business will wait to see if that idea or concept is

[10] Definition of securities in s 92 of the Corporations Act.

sufficiently well-received that sufficient investors are prepared to fund the target amount to create and market the product or service.[11]

On one view, CSEF reflects a new business model that is developing with the digital economy. This model helps address structural early failure that can arise under application of the traditional business model for businesses that lack either tangible initial capital or significant early revenue-flow. For this reason, it is argued, there is interest in CSEF as a potential additional mechanism to bring together early stage issuers and investors, to broaden the range of investment options, and to deepen the funding markets for these types of businesses. In turn, it is argued, this departure from the traditional business model may spur entrepreneurship and the types of high growth businesses that can make a positive contribution to employment and productivity growth.

Another view is that this reversal of the traditional business cycle, where public funding may be sought on the basis of future possibilities only, rather than on clear evidence of a viable business model in operation, increases the risk of failure and loss to equity investors through CSEF. The risk of failure is further increased by the fact that the funding is potentially by participants who do not have the skills and experience that private equity providers, banks or other financial institutions normally bring to bear when considering whether to provide funding to businesses under the traditional business model.

These issues concerning the application of the traditional business model may have less application for 'social enterprises' or other not-for- profit entities with public interest rather than commercial goals.

2.2.3 The CSEF participants

Consideration of the position of the three classes of participants in CSEF, namely:

- issuers
- intermediaries
- investors

raises general questions about the means of achieving a proper balance, in any future legislative or other initiative, between facilitation and regulation of this form of fundraising.

In considering the role of each of these participants, it is also necessary to be mindful that the regulator have sufficient powers to ensure the proper functioning of this form of fundraising.

Issuers

There are various reasons why issuers may seek to utilise CSEF.

For instance, CSEF, if facilitated, may provide a viable alternative source of capital for start-up or small companies that either have limited access to capital (without the expense of preparing a prospectus or other disclosure document) or have exhausted other available sources of capital. CSEF may be far less expensive than raising capital through private

[11] See T Wong, 'Crowd funding: Regulating the new phenomenon' (2013) 31 *Companies and Securities Law Journal* 89 at 91.

equity or debt arrangements, including 'angel investors', or pursuant to a public offering, accompanied by a prospectus.

CSEF may also be a means by which incorporated not-for-profit entities or 'social enterprises' can raise necessary capital for their co-operative, community benefit and other public interest projects, with investors focusing more on altruistic reasons or general benefits for providing funding, rather than any expectation of financial return to them.

CSEF, however, may not be appropriate for all issuers. Depending upon the type of corporate structure utilised, it is possible that CSEF may result in an issuer having a large number of shareholders, most with relatively small amounts of capital. This equity profile may impede or complicate any further financing options for the issuer. It may also result in increased regulatory compliance costs for the issuer (including information disclosure requirements to shareholders) and the potential for disputes between shareholders, as well as between shareholders and the issuer. On the other hand, having a large pool of small equity investors may facilitate a later substantive equity investor acquiring effective shareholder control at relatively low cost, which may or may not be in the interests of the other shareholders.[12]

A managerial challenge that issuers may face is how to most effectively utilise the funds raised through CSEF to implement their business plans. While this challenge is not peculiar to CSEF, lack of this managerial skill may be accentuated in some instances by the variance from the traditional business model. In consequence, even where funds raised through CSEF seem adequate to finance an otherwise worthwhile and potentially profitable venture, poor managerial decisions may undermine its viability and result in loss to investors.[13]

Intermediaries

In essence, CSEF intermediaries provide online platforms as a means by which issuers and potential investors may connect. Depending upon their own business models and how they are regulated, these platforms might be confined to merely matching services by providing a place where investors may 'meet' promising companies, whereas others might seek to be more active in promoting that interaction.

Regulatory regimes in some jurisdictions might treat a platform's activities as amounting to the operation of organized trading facilities or a financial market that may only be undertaken by authorised or registered/licensed entities, whereas other regimes may not.

There may also be some differentiation between platform providers as to how funds to be directed to issuers are to be held. For instance, some online platforms might arrange for direct involvement by investors in issuing companies, with each investor receiving and holding shares in that person's own name. However, offering equity directly to large numbers of investors can result in logistical challenges, as well as fundamentally increasing the number of small shareholders of a company. An alternative could be the 'club' investment model, whereby investments are pooled, with a collective vehicle, being the platform itself or some other party, holding the issuer's equity in its name, on behalf of the investors. In the Australian context, that club arrangement would constitute a managed investment scheme.

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12 In Australia, the shareholder protections in Chapter 6 of the Corporations Act, dealing with change of shareholder control transactions, are aimed at public companies, not proprietary companies: s 606.

13 See, for instance, in the context of crowd sourced funding generally, M Milian, 'Kickstarter's funded projects see some stumbles', *Bloomberg* 22 August 2012.

Another potential issue concerns the process of collecting and holding funds from investors. Regulatory possibilities range from the intermediary holding funds provided by investors on 'trust' until a target contribution level is reached, to intermediaries being obliged to pass all the money-handling functions to, say, independent agents licensed under appropriate legislation. An alternative is that investors only contribute once the target investment level is pledged, with funds then passing directly from the investors to the issuer, or to a designated third party, with no involvement by the intermediary.

To meet the obligations that may be associated with CSEF, as its manner of regulation develops, it is likely that each website operator facilitating CSEF would need to be an entity of substance. It is likely that each website operator would need to have adequate capital, human and technological resources to operate the website in a complying manner, including in regard to ensuring proper record keeping concerning each CSEF offer on its website.

Also, depending upon the applicable regulatory regime that is adopted for intermediaries, some of the risks that platform providers may face in facilitating CSEF could include:

- *reputational risk*: in the event of issuers using the website to defraud investors, or too many start-ups promoted on the website having defective business models leading to investment losses

- *regulatory risk*: due to non-compliance by the website operator with any applicable law

- *legal risk:* due to litigation by investors arguing that the website operator did not carry out reasonable due diligence on start-ups that failed or did not prevent its website from being used to carry out fraud.

Imposing an obligation on platform providers to make some basic background checks on issuers before including them on their websites could help guard against fraud.[14] Intermediaries could also be under an obligation to warn investors of the inherent risks involved in CSEF. Intermediaries could also be required to test investor understanding of investment risks before allowing transactions to proceed.

There is also the issue of conflicts of interest to consider. In some instances, the intermediary's business model may simply link the return to the intermediary to the number of issuers that are posted on its website platform and/or the amount of investor funds that are raised. An intermediary may therefore be conflicted when assessing which issuers or projects should be allowed to raise funds through its website.

An alternative business model, with has less potential for conflict, may be one where the intermediary does detailed due diligence on applicant issuers, hosts only a relatively small number of these issuers on its website platform, and links its income to the longer-term commercial success of those issuers.[15]

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[14] While outside the scope of this review, intermediaries may be required to identify particular matters to AUSTRAC.

[15] See, for instance, www.thecrowdcafe.com/due-diligence-dilemma.

Investors

While CSEF investment opportunities may be open to all investors, the most likely investor target group would be retail investors, who may have only limited discretionary funds available for investment.

Benefits

CSEF, if regulated appropriately, could enable investors to make relatively modest investments across a range of opportunities with relatively low transaction costs. This could be seen as the preferred investment approach in the corporate start-up market, given its high risk/high reward nature, whereby maintaining a portfolio of investments can address the risk of an individual investment failing.

In this way, CSEF may enhance the opportunities for investors to obtain equity positions in particular start-up or other companies that eventually prove to be successful and profitable. Without CSEF, these companies may never have provided investment opportunities to investors generally, at least at the initial phase before any later move for their equity to be listed.

Risk of fraud

There are, however, significant investor protection concerns associated with the concept of CSEF. They include the risk of fraudulent misuse by issuers of the funds received from investors, even where intermediaries operating online CSEF platforms undertake due diligence of issuers, particularly if issuers are not made fully accountable for the use of those funds.

There are similar fraud concerns in relation to the platform providers themselves, including the method of accounting for investor funds if intermediaries are permitted to collect and hold contributions before they are passed on to the issuer.

The problem of detecting fraud may be accentuated by the relatively low loss that might be suffered by many investors, individually, who may prefer to ‘write off’ the loss, rather than seek to have the conduct of the issuer or intermediary investigated. In this sense, there may be less self-policing of crowd sourced equity funded companies than of other companies, yet the potential for fraud may be the same.

A further obstacle to the detection of fraud would be any lack of transparency and reporting obligations on issuers in respect of the use of funds raised. It would make it harder for investors in these circumstances to determine whether the failure of the enterprise was due to a poor business model or the misuse of funds by the issuer.

The risk of fraud also raises questions concerning the recovery rights that investors should have, and against whom, in the event that investors lose money through misappropriation.

Other risks

Apart from fraud, there are concerns that investors may not fully understand the risks associated with their CSEF investment.

There is normal business risk, namely that a project may fail because of an unsuitable business model or through an unanticipated change of external circumstances that undermines the viability of the project.

Other risks also apply, particularly in the context of CSEF. They include that:

- CSEF investments are likely to be offered by issuers who have found it difficult to raise capital through more traditional means, such as loans from financial institutions or from 'angel' investors. This difficulty may often be due to the high-risk nature of the business model and/or poor creditworthiness of the issuer. This means that CSEF investments may be inherently riskier than investments in start-ups generally, which are already a high-risk form of investment. Investors therefore could lose all or most of their investment, even if the issuer is acting in complete good faith and in compliance with all disclosure and other legal requirements, given the high failure rate of start-up businesses generally and the possible variance from the traditional business model under CSEF

- depending upon the applicable laws, CSEF offerings may not have to undergo the same level of due diligence, and disclosure, as that involved in, say, a full prospectus-backed offering. These lower standards may also limit the rights of recourse by investors against the issuer or the Internet intermediary

- equity in small start-ups funded through CSEF are quite likely to be very illiquid, with little or no secondary market in which to sell them, at least in the short/medium term. Investors may therefore find that they are unable to withdraw from the enterprise and recover even a part of their capital investment. Share-based investments may also generate no dividends for a long period of time, if at all

- in addition to the lack of liquidity, equity acquired through CSEF may be very difficult to value. The early stage of the businesses, the significant portion of the value being in intangible, the lack of equivalent transparency of public companies and the lack of any secondary market, present major difficulties to properly valuing that equity. In this type of opaque and illiquid environment it may also be extremely difficult to determine whether the use of funds raised has been in the best interests of investors

- if further equity is issued by the issuer after a CSEF exercise is completed, any returns to existing investors may be materially diluted.

The financial risks in CSEF may be accentuated for investors with relatively little capital wealth and lower incomes, who may therefore be particularly affected by having their investments in illiquid assets. It is likely, for instance, that younger investors may get drawn to CSEF simply because of its link to social media and the Internet. These investors typically have less discretionary funds that they could afford to lose and less experience in assessing the viability of investments. This is especially so if they see CSEF as a substitute for more traditional liquid investments, such as exchange-traded securities.

There is also the problem that uninformed and commercially unsophisticated investors may act with a 'herd mentality' and, seeing that other people have invested, possibly reach the false conclusion that some reliable independent assessment of the viability of the issuer offering CSEF has been undertaken and that the investment is good value for money.

A well-run intermediary that exercises due diligence before hosting issuers on its online platform could, through this sifting process, provide some comfort to investors who may otherwise lack the confidence and depth of knowledge to invest. However, no amount of due diligence can provide any form of guarantee of the commercial success of an issuer.

2.2.4 Public funding but private control

It is likely that the promoter of a start-up or other enterprise seeking capital for a project through CSEF will nevertheless seek to remain in control of the enterprise (on the

argument that the promoter is the party with the 'vision' and the skills to make it successful) and may want to receive a 'premium' from any profits generated (on the argument that this reflects the 'financial value' of the project idea, over and above the capital contributed from the public).

This outcome can be achieved through various means. For instance, in the Australian context, a promoter may establish a proprietary or public unlisted company as the issuer, with various classes of equity. The promoter may hold one class of equity in the issuer, with CSEF investors being offered interests in a different class of equity in the issuer.[16] The class of equity held by the promoter may have voting, dividend and/or other rights which are not available to the class of equity held by CSEF investors.[17] There is no equivalent in this situation of the one share one vote principle that applies to listed public companies.[18] The promoter may also set up favourable remuneration arrangements for managing the company, and entrenching those benefits through the class voting rights.[19]

This form of favourable arrangement for the promoter may not be possible where a promoter seeks capital from 'angel' or other private investors. In that situation, private investors may require that they (not the promoter) receive preferential share rights as a condition of providing the funds, including that they control remuneration arrangements for the promoter (and other corporate officers) of the issuer.

There is no equivalent in CSEF of this negotiation process between issuers and private investors. Public investors may simply be offered an investment in a particular class of equity in the issuer. There is no obvious mechanism by which potential CSEF investors could collectively bargain with the promoter in the same way as private investors.

This difference between private and public fundraising raises the question of achieving the proper balance in the CSEF context between rewarding the promoter of the project and rewarding the capital contributors. There is the possibility that a promoter, by holding a certain class of equity, as well as remaining in full control of the issuer, may also receive much of the funds contributed by CSEF investors (by way of the remuneration arrangements for managing the company) and be entitled to a disproportionate amount of any profit on the project. It is possible that public investors, with a different class of equity, may in some cases receive little tangible return, even when the project is commercially successful. Such an outcome may also reduce the value of the class of equity held by the public investors.

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16 This includes the situation where investors hold a beneficial interest in the class of equity in consequence of a managed investment scheme being interposed between the issuer and the investor: see Section 2.2.4 of this paper.

17 The rights attached to the class of equity held by the promoter would be supported by the legislative controls under Part 2F.2 of the Corporations Act concerning variation of class rights.

18 ASX Listing Rule 6.9.

19 In regard to the process for establishing remuneration arrangements, see further Section 2.2.1 of the CAMAC report *Executive remuneration* (April 2011).

3 Australia

This chapter outlines the current regulatory structure as it would apply to fundraising through CSEF, and raises some general policy options, for further consideration in Chapter 7.

3.1 The Australian market

The potential for CSEF in Australia is not yet clear.

On the one hand, CSEF could become a significant financing source for innovative projects, using online and other broadband means of communication with investors. CSEF, if facilitated, may provide the necessary seed capital for particular start-up or other companies that eventually prove to be successful. While CSEF may only ever be applicable to a small part of the Australian corporate sector, it may have some material impact on promoting overall economic performance, should it become a viable sustainable alternative to more traditional corporate fund raising avenues.

As yet, however, there has been no discernible general move by start-up or other companies registered in Australia to seek capital through CSEF. In part, this may be due to acceptance of the fact that capital for innovative start-up businesses is scarce, with the financing needs of promising new enterprises being met to some extent by more traditional funding channels, such as through financial institutions, 'angel' investors and private equity funds. Other factors may be the newness of the CSEF concept, and that the current regulatory arrangements in Australia for corporate fundraising are not particularly tailored to CSEF. Some start-up companies may also be discouraged by the prospect of having to deal with many small investors.

However, those attitudes may change as the CSEF concept becomes more widely known, and its potential as a source of finance becomes more fully understood, particularly as it develops in the USA and other jurisdictions.

In some other jurisdictions, interest in CSEF appears to be driven in part by what is seen as its broader economic potential. For instance, there appears to be a notion, particularly in the USA, that CSEF may help drive overall economic recovery from the global financial crisis (GFC) by being part of the small business engine for the creation of many new jobs.[20]

Australia's economy has fared reasonably well post the GFC in comparison with the USA and Europe and therefore it is less certain that CSEF will ever have an equivalent influence in Australia. Also, the potential CSEF market in Australia may be relatively small, at least measured by the number of potential Australian investors and the amount they might discretionally invest (noting that individuals will generally be required to have superannuation). What remains unknown would be the level of overseas investor interest that promising Australian companies could attract through online-based CSEF.

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[20] S Hanks, 'Online capital-raising by small companies in the USA after the JOBS Act compared to the same process in the European Union' *Capital Markets Law Journal* Vol 8, No. 3, (2013) 261 at 265.

It is likely that, as with new projects generally, many corporate start-ups will fail to return investors any of the funds they have provided, let alone any profit on that investment. A high level of adverse investor experience and publicity, particularly if investors are given false expectations of what CSEF can achieve for them, may affect the willingness of retail as well as other investors to contribute, with implications for the viability of CSEF as a possible form of corporate fundraising in Australia.

Taking these factors into account, it may be challenging, in any move to give particular regulatory attention to CSEF in Australia, to strike an appropriate policy balance between:

- facilitating CSEF in a manner that would be viable in providing benefits to issuers, intermediaries, and investors, and at the same time, and
- ensuring that CSEF does not encourage investors to fund particularly risky and highly illiquid investments without a full understanding of what is involved, or lead to investor funds being fraudulently misappropriated.

3.2 Issuers

3.2.1 Overview

The promoter of a particular project could set up a proprietary or public company[21] (the issuer) for that purpose, and with a view to investment opportunities in that project being publicised through one or more online intermediaries.

Investors could be offered equity in the issuer itself. However, as explained in this section, difficulties can arise if a CSEF mechanism is to be used for that purpose, including that the ability of a proprietary company to conduct any form of fundraising involving the public is very restricted.

An alternative approach would be to establish a managed investment scheme as an interposed legal structure between the issuer and the investor, with investors acquiring interests in the scheme rather than equity in the issuer, and their funds being channelled to the issuer under the terms of the scheme.

3.2.2 The proprietary company structure

The benefit to the promoter of choosing to operate as a proprietary company is that, in general, this corporate structure is easier to administer, and involves significantly less compliance time and costs, than a public company.

For instance, a small proprietary company[22] has to prepare and distribute reports to shareholders only in limited circumstances, including at the direction of a threshold of its members.[23] A large proprietary company[24] has somewhat greater reporting requirements to shareholders.[25] However, neither form of proprietary company is subject to the same level

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21 Any company other than a proprietary company must be a public company See definition of 'public company' in s 9. This paper does not deal with whether further specific corporate forms should be introduced in some situations, such as the UK 'community interest company', designed for social enterprises seeking to use their profits and assets for the public good, or the comparable US 'benefit corporation.'

22 s 45A(2). This is a combined revenue/assets/ number of employees test.

23 ss 292(2), (3), 293-294B.

24 s 45A(3)-(6). This is a combined revenue/assets/number of employees test.

25 s 292(1)(c).

of ongoing disclosure, financial control, reporting and other compliance requirements that apply to public companies (see below).

The legislative 'trade-off' for reduced compliance requirements are restrictions to ensure that the proprietary company structure is essentially used for private or 'closely held' shareholder arrangements, not involving public participation. The two principal restrictions to achieve this are:

- ***the shareholder cap****:* a proprietary company may have no more than 50 non-employee shareholders[26]

- ***the prohibition on public offers****:* a proprietary company is generally prohibited from engaging in any public offer of its equity or other securities.[27]

There are various exemptions from the prohibition on public offers, including the small scale personal offers exemption (whereby an issuer may make a personal equity investment offer to investors, provided that no more than $2 million is raised in any 12 month period from no more than 20 investors[28]), though there is a ban on advertising small scale personal offers.[29] Some relaxation of those constraints has been provided.[30] There are also exemptions for offers to sophisticated, experienced or professional investors[31] and for large offers[32] (applicable to proprietary as well as public companies). However, none of these exemptions accommodate the type of fundraising involving potentially many investors which is contemplated by CSEF.

The consequence is that the shareholder cap and the prohibition on public offers curtail the capacity of issuers incorporated as proprietary companies to offer equity in their companies through online-based CSEF.

3.2.3 The public company structure

The benefit to the promoter of choosing to operate as a public company is that there is no equivalent of the shareholder cap and prohibition on making public offers that apply to proprietary companies.

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26 s 113(1).

27 Under s 113(3), proprietary companies are prohibited from any activity that would require a prospectus or other disclosure to investors under Chapter 6D (Fundraising) of the Corporations Act. There are exceptions for an offer of shares to existing shareholders and employees of the company or to a subsidiary.

28 s 708(1)-(7). A personal offer is one that may only be accepted by the person to whom it is made, and is made to a person who is likely to be interested in the offer, having regard to a previous personal, professional or other relationship or a statement made that the person receiving the offer would be interested in an offer of that kind.

29 s 734(1).

30 ASIC Class Order 02/273 *Business Introduction and Matching Services* permits up to $5m to be raised in some circumstances, with the restrictions on advertising a small-scale offer also being relaxed. However the ceiling of 20 investors in any 12 month period remains.

31 The exemption applies to offers to a sophisticated investor (being an individual with net assets of at least $2.5 million or with a gross income for each of the last two financial years of at least $250,000: Corporations Regulations reg 6D.2.03), to offers through a financial services intermediary to an experienced investor, to a professional investor, or to a senior manager of the company: s 708(8)-(12).

32 The exemption applies where the minimum amount payable on the securities by the person to whom the offer is made is at least $500,000: s 708(8)(a)(b).

However, use of the unlisted[33] public company corporate structure is subject to:

- ***disclosure requirements****:* an obligation to provide a prospectus or offer information statement (OIS) when seeking funding through public offers of equity in the company, with the various exemptions (small scale personal offers, offers to sophisticated investors and large offers) not sufficing for the size and type of target audience typically contemplated under CSEF

- ***compliance requirements****:* the ongoing corporate governance and financial reporting requirements for public companies, extend well beyond those applicable to proprietary companies.

Disclosure requirements

An unlisted public company could offer its equity through CSEF by publication of an OIS if the amount of capital to be raised by issuing the equity, when added to all amounts previously raised by the body or other related bodies, does not exceed $10 million.[34] The prescribed content of an OIS, while significantly less than for a prospectus (see below), includes a requirement for an audited, up to date financial report, which may be a principal reason for the limited use of OISs.[35]

In other circumstances, an unlisted public company could offer its equity through CSEF by publication of a prospectus.

A prospectus is a disclosure document, to be prepared by the equity issuer,[36] and setting out detailed information about the issuer and the equity being issued. The rationale behind the requirement for a prospectus, or OIS, is that shares, have no inherent value but are dependent on their capital, dividend and other rights, which in turn are dependent on the value and viability of the company.

The disclosure requirements for a full or short-form prospectus[37] include information that investors reasonably require to make an investment decision, on the basis of an informed assessment about:

- the rights and liabilities attaching to the securities offered, and

- the assets, liabilities, financial position and performance, profits and losses and prospects of the company issuing the securities.[38]

This information is required to the extent that ‘a person whose knowledge is relevant’ either knew the information or in the circumstances ought reasonably to have obtained the information by making enquiries.[39]

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33 Listed public companies are not the types of entities that are likely to utilize CSEF, given that they are already sufficiently established to satisfy the listing requirements and their other options to raise funds (including through new or pro-rata rights issues, employee share purchase and dividend reinvestment plans and securities placements to institutional or sophisticated investors). Listed public companies will not be further considered in this paper.

34 s 709(4).

35 s 715.

36 ss 700(2),(3).

37 ss 710-713.

38 s 710(1).

This general disclosure test is in broad, non-prescriptive terms. In consequence, larger entities with complex, established businesses will generally need to provide quite extensive information. However, the test has the benefit of being flexible. A start-up entity with a simple business model may have less information to disclose and could prepare a prospectus relatively easily and inexpensively.

ASIC may also approve the use of a profile statement, provided it states that the recipient of the statement is entitled to a copy of the prospectus.[40] In practice, profile statements are rarely used.

To better ensure the reliability of the information in a prospectus or OIS document, various parties may be subject to civil or criminal liability if that document contains a materially misleading statement or omission.[41] A number of defences apply, including due diligence in preparing a prospectus.[42] An issuer is also obliged to give prospective investors additional disclosure if the original document was misleading or a new circumstance arises that would have required disclosure at the time of the original disclosure document.[43] Various parties also have an ongoing obligation during the offer period to notify the company making the offer if they become aware that the disclosure is defective.[44]

The operator of a CSEF website acting only as an intermediary would be subject to liability for a defective disclosure document only if it was involved in the contravention.

The disclosure document, whether a prospectus or a product disclosure statement, can be provided electronically in compliance with the Corporations Act. Electronic disclosure through the Internet or other electronic distribution channels of disclosure documents would be appropriate for CSEF.[45]

Compliance requirements

A range of general compliance obligations apply to public companies, given that they may involve public participation. These obligations cover various matters, including:

- mandatory opening hours for the registered office of the company[46]
- related party transactions[47]
- annual general meetings[48]
- financial and other reporting[49]

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39 The concept of 'a person whose knowledge is relevant' includes: the person making the offer, the directors of the offeror, any underwriter named in the disclosure document, any persons named in the prospectus with their consent as having performed a particular professional or advisory function and any person named in the prospectus as a financial services licensee involved in the offer: s 710(3).

40 ss 709(2), (3), 714.

41 ss 728, 729.

42 s 731. Other defences are found in ss 732, 733.

43 s 724(1)(c)(d). If a misstatement or omission is material, the company must generally give investors corrective disclosure and 1 month to request a refund: s 724(2).

44 s 730.

45 ASIC Consultation Paper CP211 - *Facilitating electronic offers of securities: Update to RG 107- Electronic Prospectus and RG 211 – Facilitating online financial services disclosure*.

46 s 145.

47 s 207.

48 s 250N.

- appointment of an auditor[50]
- continuous disclosure for a public company that is a disclosing entity[51]
- change of shareholder control situations.[52]

3.2.4 The managed investment scheme structure

Possible arrangements

As an alternative to investors being offered the opportunity to acquire equity in their issuer in own name, they could be invited to buy interests[53] in a managed investment scheme, which would acquire those securities. The scheme, in effect, would be an interposed legal arrangement between the issuer and the investor.

Under one approach, the responsible entity (RE) of the scheme would use the funds raised from the investors to acquire either equity in a particular issuer, with the acquired equity being scheme property and therefore being held by the RE on trust for the investors who are scheme members.[54] Under a loan arrangement, the issuer would pay interest (and capital repayments) to the RE, for distribution to the investors. Under a share arrangement, the issuer would pay dividends to the RE, for distribution to the investors.

Under another approach, a scheme could be structured so that investors can elect which from a number of projects they want to support. They would then acquire a specific class of interests in the scheme for each project or enterprise chosen. Again, all equity acquired would be held by the RE, on trust for the investors who are scheme members.

A benefit to an issuer of CSEF under a managed investment scheme arrangement is that an issuer incorporated as a proprietary company could receive investor funds, but without the shareholder cap problem that would arise if investors themselves could acquire equity in the company in their own name. Also, as the scheme (not the proprietary company) would be making offers to investors of interests in the scheme, the prohibition on proprietary companies making public offers of their own securities would not apply.

Likewise, this arrangement would allow an issuer that is a public company to have fewer shareholders, given that all equity acquired under the investor pooling arrangement would be held by the RE.

Whether a managed investment scheme arrangement would be attractive to investors is another matter, given its interposition between themselves and the issuer. It is unlikely to give investors the same philanthropic or proprietary sense they may have from holding equity in the issuer in their own right. It may also not suit investors who wish to play a more active role through the exercise of shareholding rights.

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49 Under Part 2M.3 of the Corporations Act, various types of public companies are subject to periodic reporting obligations, including to prepare and lodge audited financial statements.

50 s 327A.

51 Unlisted companies that have raised funds from at least 100 persons using a disclosure document lodged with ASIC under Chapter 6D of the Corporations Act are disclosing entities: ss 111AC(1), 111AF. These disclosing entities have continuous disclosure obligations, concerning information that reasonably would have a material effect on the price or value of the company's securities. These entities must lodge their continuous disclosure announcements with ASIC: s 675. There are no equivalent disclosure obligations for proprietary companies.

52 By virtue of s 606(1)(a)(ii), an unlisted company with more than 50 members comes within the application of Chapter 6 (Takeovers) of the Corporations Act.

53 See s 9 definition of 'interest' in a managed investment scheme.

54 s 601FC(2).

Licensing requirements

A managed investment scheme that requires registration (such as one which has many public investors through the operation of CSEF) cannot operate without an RE, which must be a public company that holds an Australian Financial Services Licence permitting it to operate the scheme.[55] Obligations are imposed on REs through this licensing system, including that an RE has available adequate financial, human and technical resources, adequate risk management systems and an internal dispute resolution process, is a member of an external dispute resolution scheme (e.g. Financial Ombudsman Services) and has professional indemnity insurance to provide the financial services covered by their licence.[56]

Disclosure requirements

In principle, CSEF investors should be given accurate and reliable information about the issuer in which they will have an economic interest. This principle should apply whether the investor is to hold legal title to equity in an issuer that is a public company or alternatively is to hold a beneficial interest through a managed investment scheme arrangement that pools investor funds to acquire that equity.

As indicated above, any prospectus or OIS that investors would receive if they directly acquired equity in a public company would have to be prepared by the issuer, with liability for misstatements attaching to the issuer and others referred to in those documents.

However, under a managed investment scheme arrangement, it is the RE of the scheme (or other operator if the scheme is not a registered scheme, for example because it comes within an exemption), not the issuer, that has the legal obligation to prepare a Product Disclosure Statement (PDS) for investors.[57] That difference has the potential to reduce the level of disclosure, and therefore the protections, for investors.

A PDS prepared by an RE must contain any information of which the RE is aware that might reasonably be expected to have a material influence on the decision of a reasonable retail client whether to acquire the interest in the scheme, assuming that the scheme is not a simple managed investment scheme.[58] An RE that refers in its PDS to particular equity as an investment that it will make would have to know some information about that equity, in light of the RE's general duty of care and diligence, which would apply when making investments.[59] However, this may not equate to having as much knowledge as the issuer would have.

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55 s 601FA. The general obligations of licensees are set out in s 912A.

56 See ASIC Regulatory Guide 166 *Licensing: Financial requirements*, Pro Forma 209 *Australian financial services licence conditions* (PF 209) and CO 11/1140 *Financial requirements for responsible entities*. The aim is to ensure that REs have adequate resources to meet operating costs and there is an appropriate alignment with the interests of scheme members.

57 By virtue of s 700(1), which refers to the definition of security in s 761A, an interest in a managed investment scheme would not be a security for the purpose of attracting Chapter 6D, and therefore offers of such interests would not attract the prospectus/OIS obligations in this Chapter that apply to offers of securities in public companies. Instead, by virtue of s 764A(1)(b), an interest in a managed investment scheme is a 'financial product' for the purposes of Chapter 7 of the Corporations Act, with the disclosure requirements to be provided in the form of a Product Disclosure Statement (PDS) pursuant to Part 7.9 of the Corporations Act. The obligation on the RE to issue a PDS is set out in s 1012B.

58 ss 1013D, 1013E.

59 s 601FC.

Where the arrangement between the investor and the RE is that the investor is, or is entitled, to give an instruction that a particular financial product, or a financial product of a particular kind, is to be acquired, a PDS requirement on the part of the RE also applies.[60]

Compliance requirements

Under any managed investment scheme arrangement, the RE would be subject to initial and ongoing compliance requirements in operating the scheme.[61] The RE may charge costs for managing the scheme. The RE will also be responsible for the ongoing monitoring of the scheme's investments in the equities of an issuer. The RE could take action as a substantial shareholder in the issuer if the RE considers that the management of the issuer is not properly considering the interests of the shareholders.

3.3 Intermediaries

Operators of CSEF websites may need to be licensed in order to provide platforms for this form of fundraising. There are also various other legal implications that may arise.

3.3.1 Australian Market Licence

The operator of a website where CSEF offers or invitations to acquire financial products (a share or debt security or an interest in a scheme[62]) are regularly made may come within the concept of conducting a financial market,[63] and thereby may require an Australian market licence (AML), issued by the Minister on the advice of ASIC.[64]

Generally, to obtain an AML, the website operator would need to demonstrate that it has sufficient resources (including financial, technological and human resources) and adequate other arrangements (including arrangements for handling of conflicts of interest involving the licensee) to ensure that, to the extent that it is reasonably practicable to do so, the market a fair, orderly and transparent.[65]

If an AML was required, it would need to be appropriately tailored and flexible to suit the nature of the market being operated. Under the current regime, domestic market licensees are subject to a range of material regulatory costs and requirements that include ASIC Market Integrity Rules, ASIC supervision and a cost recovery regime, annual assessments and Ministerial disallowance on operating rule changes.

The holder of an AML is also subject to the to the consumer protection provisions in Part 2 Division 2 of the ASIC Act,[66] including in regard to advertising.[67]

3.3.2 Australian Financial Services Licence

But even where an AML is not required, due to the intermediary arranging its business in such a way that it is not a facility through which offers or invitations are regularly made,

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60 s 10121A.
61 Principally found in the Chapter 5C of the Corporations Act.
62 s 764A.
63 s 767A.
64 s 791A.
65 ss 792A, See also ss792B-792F, 792I. See also, ASIC Regulatory Guide 172 'Australian Market Licences - Australia Operators'.
66 Operating a financial market is treated as a financial service: s 12BAB(1)(f) of the ASIC Act.
67 ASIC Regulatory Guide 234 *Advertising financial products and advice services (including credit): Good practice guidance.*

then it is more likely than not that an intermediary would be carrying on a financial services business[68] and thereby need an Australian Financial Services Licence (AFSL), issued by ASIC.[69] Conversely, an intermediary that is the holder of an AML would not also need an AFSL.[70]

Generally, to obtain an AFSL, the website operator would need to demonstrate that it has adequate capital, human and technological resources as well as an adequate risk management system to provide the financial services in a compliant manner.[71] Human and technological resources include demonstrating competency, relevant skills and experience required to provide the relevant financial services.[72]

The holder of an AFSL is subject to various licensing obligations, including, to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly.[73]

An AFSL licensee operating a CSEF website would also have to provide retail clients with a Financial Services Guide explaining its role and how it is remunerated by the equity fund raisers.[74] The guide sets out generally information about the licensee's services, how the licensee is remunerated and key relationships with other entities that may influence the licensee in providing its services.

The licensee is also subject to the consumer protection provisions in Part 2 Division 2 of the ASIC Act, including in regard to advertising.[75] The licensee will also need to have an internal dispute resolution process and be a member of an external resolution body, such as the Financial Ombudsman Service, to deal with any complaints about activities undertaken as a licensee.[76]

3.3.3 Acting as a promoter

In some circumstances, the Australian operator of a CSEF website might come within the definition of a 'promoter'[77] of a company seeking equity funding through that website. This has various consequences, including a requirement that any prospectus for the company set out details of any benefits to that promoter.[78]

3.3.4 Restrictions on advertising

There are also restrictions on advertising equity offers that require a disclosure document. For instance, a person must not advertise an offer that needs a disclosure document or publish a statement that directly or indirectly refers to that offer or is reasonably likely to

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68 A financial services business is defined in S 761A to mean the business of providing financial services. The various ways in which a person provides a financial service are defined in s 766A.
69 s 911A.
70 s 911A(2)(d).
71 ss 912A(1)(d), (h), 913B.
72 ASIC Regulatory Guide 105 – *Licensing - Organisational competence*. See also ASIC Regulatory Guide 104 *Licensing: Meeting the general obligations* at RG 104.84-RG 104.96, AFS Licensing Kits 1, 2 and 3.
73 s 912A(1)(a).
74 Part 7.7 Div 2.
75 ASIC Regulatory Guide 234 *Advertising financial products and advice services (including credit): Good practice guidance*.
76 ASIC Regulatory Guide 165 *Licensing: Internal and external dispute resolution*.
77 ss 711(2)-(4). ASIC Regulatory Guide 228 *Prospectuses: Effective disclosure for retail investors* (at RG 228.122) provides some guidance on the concept of 'promoter' of a company.
78 s 711(3), (4).

induce people to apply for the securities.[79] Once a disclosure document has been lodged, however, the restriction is relaxed if the advertisement contains certain information about the disclosure document and application process.[80]

These restrictions on advertising would apply to a CSEF website.

3.4 Investors

There is the potential under CSEF for investors to be offered a range of 'equity' interests in issuers, with differing sets of rights.

3.4.1 Differences between share and debt securities

As previously indicated, while, for ease of reference, the term 'equity' is generally used in this paper, CSEF can cover acquiring share or debt securities in a company.

There are some key differences between these two types of securities in a company:

- ***participation in the company***: shareholders and creditors have different voting rights, with shareholders, but not creditors, being able to vote on various corporate governance matters, while creditors, but not shareholders, have voting rights in various forms of external administration

- ***return on the investment:*** creditors will typically have contractual rights to interest on the debt and repayment of capital, whereas there are restrictions on the circumstances where shareholders may receive dividends on shares[81]

- ***repayment of the capital*****:** creditors have priority over shareholders in the event of the liquidation of a company, though if a company in liquidation is solvent, shareholders will receive any surplus residual funds after all capital has been repaid. Prior to any liquidation, shareholders may receive back some or all of their capital in only limited situations.[82]

3.4.2 Legal and beneficial interest in shares

Investors who acquire an interest in the shares of a company may do so in either of two forms:

- ***legal interest in shares*****:** where investors are registered as the shareholders

- ***beneficial interest in shares*** where the funds of investors are pooled in a managed investment scheme to acquire shares in a company, with the shares becoming scheme property and held by the responsible entity of the scheme on trust for the investors.[83]

Investors with a legal interest in shares may have corporate governance and other rights as shareholders, including participation and voting rights on resolutions at company

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79 s 734(2).
80 s 734(6).
81 s 254T.
82 Apart from selling shares to any available purchaser, a shareholder may receive back all or some of the capital contributed in limited situations, such as through any corporate reduction of capital or buy-back (Chapter 2J of the Corporations Act) or shareholder scheme of arrangement (Part 5.1 of the Corporations Act).
83 s 601FC(2).

meetings. By contrast, investors with a beneficial interest in shares would have rights pursuant to the provisions governing managed investment schemes[84] and the constitutions of those schemes.

3.4.3 Classes of shares

As previously indicated (Section 2.2.4), an issuer may have a number of classes of shares, with different voting, dividend and other rights attached to each class. In some cases the offer to CSEF investors may involve a class of shares with inferior rights to a class of shares held, say, by the promoter of the project.

On one view, potential CSEF investors should be provided with full disclosure of any share class arrangements of an issuer, and their legal and financial implications, in simple clear language, and in a format enabling comparisons between issuers. This disclosure approach is adopted, for instance, in the US JOBS Act and the Canadian proposals.[85]

Beyond that, the question remains whether disclosure alone, combined with various shareholder remedies,[86] would suffice, thereafter leaving it to the 'market' to evaluate the possible consequences of the equity arrangements of issuers and their implication for investing in those issuers.

3.5 Possible ways forward

There are various approaches that could be taken in Australia to CSEF, taking into account issues of market integrity and investor protection as well as facilitating funding opportunities for start-up enterprises and investment opportunities for investors.

These approaches range from:

- no regulatory change
- liberalising the small scale personal offers exemption from the fundraising provisions
- confining CSEF exemptions to offers to sophisticated, experienced or professional investors
- making targeted amendments to the existing regulatory structure for CSEF open to all investors
- creating a self-contained statutory and compliance structure for CSEF open to all investors.

In considering these options, the matters raised in this chapter concerning the current Australian provisions as they impact on CSEF, as well as initiatives or proposals in other jurisdictions (set out in Chapters 4–6 of this paper), would need to be taken into account.

These matters are further discussed in Chapter 7 of this paper, which sets out a series of questions for public consultation.

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84 Principally, Chapter 5C of the Corporations Act.

85 See *Disclosure by the issuer to investors* in Sections 4.2.1 and 4.2.2 of this paper.

86 In the Australian context, see, for instance the oppression remedy and the derivative action remedy, set out in Part 2F.1 and Part 2F.1A of the Corporations Act. See also R Turner, 'Directors' fiduciary duties and oppression in closely-held corporations' (2013) 31 *Company & Securities Law Journal* 278.

4 United States and Canada

This chapter outlines the approach taken in the USA to CSEF, and the proposals currently under consideration in Canada.

4.1 Overview

4.1.1 United States

Crowd sourced funding is rapidly developing in the USA. However, until recently this method of fundraising has not included any form of CSEF, given the legislative restrictions and controls that applied to offering corporate equity to the public.

The Jumpstart our Business Start-ups (JOBS) Act, enacted in April 2012, is intended to encourage economic growth in the US by various means, including greater access to equity funding for emerging and other companies. The Act has a number of chapters or parts ('Titles'), two of which are relevant to CSEF.

Title II of the JOBS Act: Access to capital for job creators

Title II of the JOBS Act deals with equity offers to wealthier investors. Pursuant to SEC Rules under that Title, published in July 2013 and in effect from September 2013, US entrepreneurs may publicly advertise and market their company's investment opportunity, of whatever size, to 'accredited investors' (in effect, individuals with over $1 million in liquid net worth or annual incomes over $200,000[87]), including through the Internet or social media, as well as through print, radio or television. Previously, there was a ban on 'general solicitation' or 'general advertising', of investment in securities, other than a prospectus-based offer, with offers to particular investors being done in private.

The July 2013 SEC Rules pursuant to Title II permit general solicitation in offerings made to accredited investors, provided that issuers of these securities 'take reasonable steps to verify' that all purchasers of the offered securities are accredited. The rules specify both a principles-based approach to satisfy the verification requirement, and a non-exclusive list of methods that issuers may use to satisfy the verification requirement as it applies to natural persons.

The coming into force of Title II of the JOBS Act is therefore a limited form of CSEF, in that more potential investors who satisfy the tests of being 'accredited' may become aware of investment opportunities through online and other means, and issuers may therefore have access to a greater range of funding sources.

Title III of the JOBS Act: Crowdfunding

Title III of the JOBS Act deals with CSEF offers to investors generally. It is intended to allow start-up and other companies to use online intermediaries to obtain modest amounts of capital. It applies to all investors, including investors of modest means (as well as

[87] Accredited investors include natural persons with individual net worth, or joint net worth with their spouse, that exceeds $1m; or natural persons with income exceeding $200,000 in each of the two most recent years, or joint income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year.

accredited investors), thereby giving smaller investors a greater range of investment options.

CSEF under Title III of the JOBS Act is subject to:

- the provisions in the Act (which amends relevant provisions of the US Securities Act of 1933)
- SEC Rules, including in relation to website intermediaries and disclosure, which are still being formulated. CSEF under Title III of the JOBS Act will only be permitted once these rules are published and come into force.

The elements of Title III, as they apply to issuers, intermediaries and investors, are set out in the following sections of this chapter.

Those sections of the CAMAC paper will be updated online once the SEC Rules are published.

4.1.2 Canada

The Ontario Securities Commission Consultation Paper 45-710 *Considerations for new capital raising prospectus exemptions* (December 2012) included (in Appendix A) the elements of a possible CSEF exemption from the prospectus provisions, to facilitate capital raising for business enterprises.

The elements in the Consultation Paper, as they apply to issuers, intermediaries and investors, are set out in the following sections of this chapter. Each element is set out under *Proposal*. The Consultation Paper observations on each element are set out under *Commentary*. Each element can be compared with relevant provisions in Title III of the US JOBS Act.

The Consultation Paper made clear that its proposals had been put forward for discussion only, and did not necessarily mean that a CSEF exemption would be introduced in that, or any other, form.

In August 2013, the Ontario Securities Commission released the follow-up Consultation Paper 45-712 *Progress report on review of prospectus exemptions to facilitate capital raising* (the August 2013 Paper), which included further consideration of the CSEF proposals in its December 2012 Consultation Paper.

The August 2013 Paper indicated that work on a possible CSEF regulatory framework for Canada is continuing. In that context, the Paper stated:

> We are mindful of stakeholder concerns that if the costs associated with investor protection are excessive, crowdfunding may not be a cost-effective capital raising method. At the same time, the Investor Survey suggests that investors would be concerned about the risks of crowdfunding and might not be prepared to invest through crowdfunding if they do not think there are adequate protections in place.[88]

[88] at 29.

4.2 Issuers

The US and Canadian approaches can be compared on a series of elements applicable to issuers:

- types of issuer
- types of permitted securities
- maximum funds that an issuer may raise
- disclosure by the issuer to investors
- controls on advertising by issuers
- liability of issuers
- ban on a secondary market.

4.2.1 United States

Types of issuer

The enabling crowdfunding provisions of the JOBS Act apply only to US incorporated issuers. The provisions in the JOBS Act pre-empt regulation of these issuers by the laws of the various States of the USA. This means that that the small online offerings promoted by the JOBS Act are effectively only subject to the SEC insofar as disclosure, due diligence and review of issuers are concerned.[89]

Also, the JOBS Act excludes investment fund companies utilizing CSEF to distribute their securities.

Types of permitted securities

The JOBS Act provisions apply to equity or debt securities of the issuer.

Maximum funds that an issuer may raise

A company may raise no more than to $1 million in a 12-month period through CSEF.[90]

Disclosure by the issuer to investors

Issuers will be required to file with the SEC, and provide to investors,[91] through the intermediary, information such as:

- a description of the business and its anticipated business plan
- a description of its financial condition (including financial statements: see below)
- the names of officers and directors and persons with a shareholding of more than 20%
- the stated purpose and intended use of proceeds

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89 S Hanks, 'Online capital-raising by small companies in the USA after the JOBS Act compared to the same process in the European Union' *Capital Markets Law Journal* Vol 8, No. 3, (2013) 261 at 266-267.

90 s 4(6)(A) of the Securities Act of 1933.

91 s4A(a)(6).

- the specified target offering amount and deadline to reach that target
- the price of the securities
- a description of the ownership and capital structure, and
- such other information as the SEC prescribes by rule.[92]

The issuer must provide financial statements, certified by an officer of the issuer if the specified target offering amount is $100,000 or less, reviewed by an accountant if that amount is up to $500,000 and audited if that amount is over $500,000. Companies could avoid audit costs by limiting the size of their offerings.[93]

Issuers will be required to provide annual reports to investors on the results of operations and financial statements, containing such information as the SEC shall determine by rule, with such reports to be filed with the SEC.[94]

Issuers will be required to comply with such other requirements as the SEC may, by rule, prescribe.[95]

Controls on advertising by issuers

Issuers are prohibited from:

- advertising the terms of the offering, except for providing a notice that directs investors to the intermediary,[96] or
- compensating any promoter of the securities, unless such compensation is fully disclosed in accordance with the rules that are currently being written by the SEC.[97]

Liability of issuers

Issuers (and 'control persons' of the company including directors and principal officers) will be subject to liability for any misstatements they make. If the issuer:

- makes an untrue statement of a material fact or omits to state a material fact necessary to make its statements, in light of the circumstances in which they were made, not misleading, and
- cannot sustain the burden of proof that it did not know, and in the exercise of reasonable care, could not have known, of such untruth or omission

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92 s 4A(b)(1).

93 In more detail:
(i) for offerings that, together with all other CSEF offerings of the issuer within the preceding 12 months, total $100,000 or less, the issuer must provide:
a) the income tax returns filed by the issuer for the most recently completed year, if any; and
b) financial statements of the issuer, which must be certified by the principal executive officer of the issuer to be true and complete in all material respects (but which do not need to be audited);
(ii) for offerings that, together with all other CSEF offerings by the issuer within the preceding 12 months, total more than $100,000 but less than $500,000, the issuer must provide financial statements reviewed (but not audited) by a public accountant who is independent of the issuer; or
(iii) for offerings that, together with all other CSEF offerings by the issuer within the preceding 12 months, total more than $500,000, audited financial statements are required.

94 s 4A(b)(4).

95 s 4A(b)(5).

96 s 4A(b)(2).

97 s 4A(b)(3).

it must reimburse the purchase price of securities plus interest.[98]

Also, the SEC may ban persons from utilizing CSEF to fund their projects on certain grounds, including fraudulent, manipulative or deceptive conduct.

Ban on a secondary market

The JOBS Act applies to distributions by an issuer of its own securities. It is not available as a means for existing security holders to on-sell their securities of an issuer.

4.2.2 Canada

Type of issuer

Proposal: The issuer of the security, its parent (if applicable) and its principal operating subsidiary (if applicable) must be incorporated or organized under Canadian federal laws or the legislation of a Canadian jurisdiction, and the issuer must have its head office in Canada.

Also, the CSEF exemption is not to be available to investment funds as a means to distribute their securities.

Commentary: The JOBS Act has similarly limited the availability of the CSEF provisions to domestic US issuers. Also, the JOBS Act excludes investment fund companies from using the CSEF exemption.

Types of permitted securities

Proposal: The only securities that can be distributed by the issuer under the CSEF exemption are:

- common shares
- non-convertible preferred shares
- non-convertible debt securities that are linked only to a fixed or floating interest rate
- securities convertible into common shares or non-convertible preferred shares.

Commentary: Given that this exemption is intended to facilitate capital raising by small to medium enterprises (SMEs), it is not necessary or appropriate to allow certain complex products, such as derivatives and securitized products, to be distributed under this exemption.

Maximum funds that an issuer may raise

Proposal: An issuer cannot raise more than $1.5 million in a 12 month period under this exemption.

Commentary: Some commentators have expressed concern that the JOBS Act limit (an issuer can raise up to $1 million in a 12-month period) is too low for the exemption to be a useful capital raising tool. Not all SMEs' capital requirements are the same. Issuers in different industry sectors may require different capital needs at different stages of growth.

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98 s 4A(c)(1), (2).

Disclosure by the issuer to investors

This involves:

- an initial information statement to potential investors, and
- the provision of ongoing information to existing investors.

(1) Information statement

Proposal: A potential investor must be provided with an information statement from the issuer, which must include:

(a) Financing facts

(b) Issuer facts

(c) Registrant facts.

The management of the issuer would be required to certify the disclosures, thereby taking responsibility for the content of the information statement.

Commentary: Purchasers and any registrants advising them require a minimum level of disclosure on which to base an investment decision or recommendation. The key items of disclosure are substantially derived from the requirements for the summary of a long-form prospectus, and the disclosure requirements set out in the CSEF exemption in the JOBS Act.

(a) Financing facts

Financing facts (i.e. basic information about the offering) include:

- the type/nature of the securities being offered
- the price of the securities
- the rights attached to the securities (including the impact on those rights if the issuer's operations and/or assets are located outside Canada)
- whether there is a minimum and maximum subscription and, if so, the deadline to reach the minimum subscription
- the use of the proceeds from the offering (including whether any directors, officers, promoters or related parties of the issuer will receive any of the proceeds)
- resale restrictions
- statutory rights in the event of a misrepresentation, including a right of withdrawal (see under **Liability of issuers,** below).

(b) Issuer facts

Issuer facts (i.e. basic information about the issuer) include:

- a description of the issuer's business or proposed business, and its anticipated business plan
- one year of annual financial statements, if any (see further *Commentary* below)

- a description of the directors, officers and control persons of the issuer
- limited executive compensation disclosure
- principal risks of the issuer's business (see further *Commentary* below).

Commentary on financial statements disclosure: This concept idea requires one year of audited annual financial statements of the issuer if the issuer has been in business for at least that period. The CSEF exemption in the JOBS Act has adopted a scaled approach to financial disclosure. Under the JOBS Act exemption, if the aggregate offering proceeds within a 12-month period are:

- $100,000 or less: the issuer must file income tax statements for the most recently completed year and have its financial statements certified by the principal executive officer to be true and complete in all material respects
- more than $100,000 but not more than $500,000: the issuer must file financial statements reviewed by an independent public accountant, using professional standards and procedures for such review or standards and procedures established by the SEC
- more than $500,000: the issuer must file audited financial statements.

The Canadian proposal is for a similarly scaled approach:

- If the proceeds of the offering are proposed to be at least $500,000 or if the issuer is a reporting issuer, then audited annual financial statements must be included in the information statement.
- If the proceeds of the offering are proposed to be less than $500,000 and if the issuer is not a reporting issuer, then only management-certified financial statements need to be included.

Commentary on risk factor disclosure: The summary of a long-form prospectus requires disclosure of risk factors. Similarly, the CSEF exemption in the JOBS Act contemplates some level of risk factor disclosure. We are similarly suggesting that the information statement include a discussion of the principal risks facing the issuer's business. We have heard from stakeholders that risk factor disclosure is often not helpful as the issuer and its advisors include a lengthy list of risk factors, many of which are boilerplate. Some stakeholders have argued that having those risk factors protects the issuer from liability.

(c) Registrant (intermediary) facts

Proposal: The issuer must provide basic information about the CSEF intermediary, include (where applicable):

- the name of the funding portal
- the name of any other intermediary involved and the relationship between that intermediary and the issuer, if any.

(2) Ongoing information available to investors

Proposal: The issuer must provide its security holders with annual financial statements within 120 days from its fiscal year end. The issuer must also maintain books and records

that are available for inspection by purchasers and the Commission. The books and records must contain, at a minimum:

- the securities issued by the issuer as well as the distribution price and date
- the names of all security holders and the size of their holdings
- the use of funds raised under this exemption.

Commentary on periodic financial statements: Issuers who raise money under this exemption should provide ongoing financial statement disclosure to investors. For start-up issuers, in particular, the financial statements provided at the time of an offering may be of little value to investors if the issuer is in an early stage of development with little in the way of assets or earnings. In addition, requiring annual financial statements may reduce the risk of fraud. Under the terms of the CSEF exemption in the JOBS Act, issuers will be required to file with the SEC and provide to investors on an annual basis reports of the issuer's results of operations and financial statements, with the details to be determined by SEC rulemaking.

Commentary on books and records: Requiring the issuer to maintain books and records provides another measure of investor protection. This would enable security holders to assess whether the issuer has used the proceeds from the offering in the manner indicated in the information statement.

Controls on advertising by issuers

Proposal: Apart from the disclosures provided by the issuer in the information statement (see above), no other marketing materials may be provided by the issuer to potential investors.

In addition, no advertising by an issuer would be permitted except through the funding portal or the issuer's website. However, the issuer would be able to use social media to direct investors to the funding portal or the issuer's website.

Liability of issuers

Proposal: The CSEF exemption would specify that the information statement (see above) falls within the definition of an offering memorandum set out in the Securities Act. In consequence, the statutory rights in the event of misrepresentation in an offering memorandum, set out in s 130.1 of the Securities Act, would apply.

Commentary: The damages or rescission (withdrawal) rights under s 130.1 of the Securities Act provide an important element of investor protection.

Ban on a secondary market

Proposal: The CSEF exemption be limited to distributions by an issuer of securities issued by itself. It should not be available as a means for existing security holders to on-sell their securities in an issuer.

Commentary: The CSEF proposal is intended to facilitate capital raising for business enterprises, not the resale of securities. Selling security holders are not necessarily as well positioned to provide the disclosure and other investor protection measures that should apply to CSEF.

4.3 Intermediaries

4.3.1 United States

Title III of the JOBS Act creates an entirely new type of regulated entity in the USA, the 'funding portal', and permits CSEF only through a funding portal or a registered broker–dealer.

The essential purpose of this channelling through the intermediary approach is twofold:

- **information:** to ensure that all potential investors have access to the same information, and in one location
- **risks:** to impose on intermediaries an obligation to conduct background checks of issuers to help guard against fraud and otherwise reduce risks to investors by ensuring that they are properly informed about the risks of CSEF and do not exceed investment limits.

Permitted types of intermediary

CSEF offerings must be conducted through an 'intermediary' that is registered with the SEC either as a broker-dealer or as a 'funding portal'.[99]

Intermediaries must collect and transmit CSEF transaction data to the SEC for administration and data analysis.[100]

Matters related to issuers

Intermediaries must take such measures to reduce the risk of fraud as will be established by the SEC, including background and regulatory checks on directors, officers and significant shareholders of issuers.[101]

While intermediaries may receive compensation, if fully disclosed,[102] officers of intermediaries are prohibited from having any financial interest in any issuer using its services.[103]

Intermediaries must prevent the issuer having access to CSEF proceeds until a designated funds target for that company is reached and allow all investors to cancel their commitments to invest as determined by SEC Rules.[104]

Matters related to investors

Intermediaries must make available to the SEC and potential investors, not later than 21 days prior to the first day on which securities are sold to any investor, the issuer disclosures.[105]

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99 ss 4(6)(C), 4A(a)(1). An intermediary must also register with FINRA, the securities industry's self-regulatory organisation.
100 s 4A(a)(6), (9).
101 s 4A(a)(5).
102 s 4A(b)(3).
103 s 4A(a)(11).
104 s 4A(a)(7).
105 s 4A(a)(6).

Intermediaries are prohibited from compensating promoters, finders or lead generators for providing the intermediary with personal identifying information of any potential investor.[106]

Intermediaries must:

- provide general disclosures to investors related to the inherent risks involved in CSEF (including the speculative nature of start-up companies and the illiquid nature of their securities) and such other investor education materials as the SEC deems appropriate,[107] and ensuring that investors review such disclosures, affirm the risk of loss and answer various questions[108]

- make such efforts as the SEC determines appropriate to ensure that no investor in a 12-month period exceeds the CSEF investment limits.[109] In this context, intermediaries must also take such steps as required by SEC Rules to protect the privacy of information collected from investors.[110]

Funding portals (but not broker-dealers) cannot:

- offer investment advice or make recommendations to investors. The concept of investment advice could, for instance, include any promotion of a particular offering, such as a funding portal pointing out that the offering is attracting a number of investors

- solicit transactions for securities offered or displayed on its portal, or compensating employees or agents for doing so

- hold or manage any investor funds or securities.[111]

One commentary, in supporting the approach in the JOBS Act that intermediaries provide to investors general disclosures related to the inherent risks involved in CSEF, observed that:

> Since the risks of crowd funding are universally very high, it makes sense to warn investors of this in the broader terms of an investment in the risky *market of crowd funding,* rather than in the narrower terms of an investment in a *particular crowd funding scheme*. In other words, a standard warning could be provided to investors, like this example from the United States, rather than requiring crowd funding schemes to expend significant resources and time to produce a 'bespoke' disclosure document, even before the scheme is allowed to advertise and test the marketability of its idea.[112]

One area in which SEC guidance may be necessary concerns intermediaries providing chat room, chat board or other facilities for investors to communicate with issuers and with each other. These means of communication provide opportunities to share information and views on the merits of particular investments, and may in some cases alert participants to possible fraud. If a funding portal were, say, to moderate chat boards, an issue may arise as

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106 s 4A(a)(10).
107 s 4A(a)(3).
108 s 4A(a)(4).
109 s4A(a)(8).
110 s4A(a)(9).
111 s 304(b)(80).
112 T Wong, 'Crowd funding: Regulating the new phenomenon' (2013) 31 *Companies and Securities Law Journal* 89 at 104.

to how much discretion it would have to remove comments without coming close to giving investment advice.

4.3.2 Canada

The Ontario Securities Commission Consultation Paper 45-710 *Considerations for new capital raising prospectus exemptions* (December 2012) includes proposals for the regulation of intermediaries under any CSEF exemption from the prospectus provisions, and the channelling of CSEF through the intermediary.

The August 2013 Paper raised various questions concerning intermediaries, for further consideration.

Permitted types of intermediary

Proposal: It should be a condition of any CCSEF prospectus exemption that investments be made only through a registered funding portal.

Commentary: A registration requirement for CSEF intermediaries is an important investor protection measure necessary to address, among other things, integrity, proficiency and solvency requirements applicable to funding portals and the persons operating them. The registration requirement would also be designed to help address concerns relating to possible conflicts of interest and self-dealing by intermediaries and provide some assurance that funding portals will not be established or used to facilitate fraudulent offerings of securities to investors through the Internet.

Matters related to issuers

The December 2012 Paper observed that the funding portal must play a 'gatekeeper' role and take reasonable measures to reduce the risk of fraud. That would include obtaining background and securities enforcement regulatory history checks on the issuer and each officer, director and significant shareholder of the issuer.

The August 2013 Paper identified several issuer-related questions that the Commission would expect a funding portal to address in any application to become registered. These matters would be relevant in determining both the threshold question of whether registration to be an intermediary should be granted, as well as appropriate terms and conditions of registration.

Question 1: What due diligence does the portal conduct on issuers and their management?

Commentary: One of the major concerns with permitting crowdfunding as a method of capital raising is that it may become easier to perpetrate investment frauds on investors We would want to ensure appropriate background checks are made by the portal on the issuer, its directors and key executives.

Question 2: What due diligence does the portal conduct on the business?

Commentary: Funding portals may attract issuers that have been unable to access funds elsewhere and that have inexperienced management. We would want to understand the steps a funding portal would take to assess the viability of the issuer's business. For example, one equity crowdfunding portal requires a comprehensive business plan, historical financial information and financial forecasts that are reviewed by an accountant.

Matters related to investors

The August 2013 Paper identified several investor-related questions that the Commission would expect a funding portal to address in any application to become registered. These matters would be relevant in determining both the threshold question of whether registration to be an intermediary should be granted, as well as appropriate terms and conditions of registration.

Question 1: Does the portal conduct any type of investor screening?

Commentary: We have concerns that there may be a significant percentage of retail or non-accredited investors who will not fully understand the risks associated with crowdfunding and investing in a SME. We would want to know whether the portal conducts any screening or vetting of investors before they invest (in addition to the risk acknowledgement that was referred to in the crowdfunding concept idea). For example, one equity crowdfunding portal requires that each potential retail investor answer a questionnaire to demonstrate that the investor understands the key risks associated with investing in a SME, including dilution, illiquidity and risk of loss. If they fail to answer the requisite number of questions correctly, the investor is not permitted to invest unless he or she successfully completes a tutorial.

Question 2: Does the portal offer additional services to issuers and investors, particularly services that may enhance investor protection?

Commentary: Some portals may provide additional services to issuers and investors. For example, the portal could:

- offer a service that enables an issuer to create an investor relations page hosted on the portal, where current and prospective investors could find out more information about the issuer and its business on an ongoing basis,
- provide share register and other record keeping services, or
- provide issuer or other notifications to shareholders.

We would be particularly interested to know if the portal offer any services that could enhance investor protection, e.g., if the portal requires model, standardized term sheets and other legal documents that address typical deal structure issues such as anti-dilution protection, tag-along rights and pre-emptive rights. Another investor protection feature would be a process to hold funds in escrow through an appropriate third party custodian until any minimum amount is raised.

4.4 Investors

Under both the US and Canadian approaches, investors must be provided with certain information by issuers, and have remedies against issuers for any misinformation provided.[113]

The US and Canadian approaches can also be compared on a series of elements applicable to investors:

[113] See further **Disclosure by the issuer to investors** and **Liability of issuers** in Section 4.2 of this paper.

- permitted types of investor
- maximum funds that each investor can tribute
- risk acknowledgement by the investor
- cooling off rights
- resale restrictions.

In particular, placing monetary limits on the size of investments that may be made by investors, either by reference to their financial position (USA), or generally (Canada), is designed to limit the adverse impact on investors of poor investment decisions. To some extent this represents a quantitative rather than qualitative approach to investor protection.

4.4.1 United States

Permitted types of investor

There are no limitations on the purchaser of the security.

Maximum funds that each investor can contribute

There are various approaches (alone or in combination) that could be taken to the funds that investors could put into CSEF if the intention is to limit the possible losses to retail investors through CSEF. They include:

Issuer linked caps

- *first approach*: limiting the number of CSEF issuers in which an investor may invest in one year
- *second approach*: limiting the monetary amount that an investor may invest in each CSEF issuer in one year
- *third approach*: limiting the monetary amount that an investor may invest in each CSEF issuer in total (not per year).

Investor linked caps

- *fourth approach*: limiting the total monetary amount that an investor may invest in all CSEF issuers in one year, irrespective of that person's income or net worth
- *fifth approach*: limiting the total monetary amount that an investor may invest in all CSEF issuers in one year according to that person's income or net worth

The JOBS Act has adopted the fifth approach, with a series of thresholds:

- *lower threshold:* for an investor with an annual income or net worth below $100,000, the investor's annual aggregate investment in CSEF securities is capped at the greater of $2,000 or 5% of the investor's annual income or net worth

- *higher threshold:* for a non-accredited investor with an annual income or net worth of at least $100,000, the investor's annual aggregate investment in CSEF securities is capped at 10% of the investor's annual income or net worth, not to exceed $100,000[114]

- *no threshold:* an accredited investor may invest without any restriction on the total monetary amount to invest in CSEF issuers.

Risk acknowledgement by the investor

The investor must positively affirm an understanding that the entire investment is at risk ad that the investor could bear such a loss.[115] The investor must also answer various questions demonstrating an understanding of various risks.[116]

Cooling-off rights

This will be a matter for the SEC Rules.

Resale restrictions

The securities purchased under the CSEF provisions are subject to certain resale restrictions for one year.[117]

4.4.2 Canada

Permitted types of investor

Proposal: There are no limitations on the purchaser of the security.

Commentary: This exemption would permit the sale of securities under CSEF to any investor, regardless of his/her income, net worth or investment sophistication. As a result, various other conditions are proposed to provide greater investor protection, as outlined below. This exemption would be consistent with Title III of the JOBS Act, where there are no restrictions on who can invest.

Maximum funds that each investor can contribute

As previously indicated, there are various approaches (alone or in combination) that could be taken to the funds that investors could put into CSEF, if the intention is to limit the possible losses to retail investors through CSEF. They include:

Issuer linked caps

- *first approach:* limiting the number of CSEF issuers in which an investor may invest in one year

- *second approach:* limiting the monetary amount that an investor may invest in each CSEF issuer in one year

- *third approach*: limiting the monetary amount that an investor may invest in each CSEF issuer in total (not per year).

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114 s 4(6)(B).
115 s 4A(a)(4)(B).
116 s 4A(a)(4)(C).
117 s 4A(e).

Investor linked caps

- *fourth approach:* limiting the total monetary amount that an investor may invest in all CSEF issuers in one year, irrespective of that person's income or net worth

- *fifth approach:* limiting the total monetary amount that an investor may invest in all CSEF issuers in one year according to that person's income or net worth

While the US JOBS Act has adopted the fifth approach, the Canadian proposal has adopted a combination of the third and fourth approach.

Proposal: A purchaser's investment in securities of a particular issuer cannot exceed $2,500 in total (third approach). In addition, a purchaser's total investment under this CSEF exemption during a calendar year cannot exceed $10,000 (fourth approach).

Commentary: Investment limits are an important element of investor protection, by limiting an investor's exposure. However, an investment limit presents difficulties with compliance. A centralised system where funding portals are required to confirm the size of an investor's investment in its own and other registered portals has been suggested. Another alternative proposal would be to require the investor to self-certify that he/she is within the investment limits and has not exceeded the annual threshold.

There is also a concern that investors under the JOBS Act approach, with investment limits based on annual income or net worth, may not wish to share their tax returns with issuers or registrants to establish that they are investing within the prescribed limits. As a result, a uniform monetary cap (the fourth approach) may be easier to administer than an approach that requires calculations of an investor's net income or net worth (the fifth approach).

Risk acknowledgement by the investor

Proposal: An investor must sign a stand-alone risk acknowledgement form in which that person confirms that he/she:

- falls within the investment limitations

- understands the risk of loss of the entire investment

- can bear the loss of the entire investment

- understands the illiquid nature of the investment.

Commentary: Requiring the purchaser to sign a risk acknowledgement form provides another element of investor protection. It puts the investor on notice that he/she may lose all of his/her investment. Similarly, the CSEF exemption in the JOBS Act contemplates a form of risk acknowledgement.

Cooling-off rights

Proposal: The investor must be provided with an unrestricted right of withdrawal that is to remain exercisable for two business days after the distribution.

Commentary: A right of withdrawal within a 'cooling off' period allows the investor further to consider the disclosure provided and reflect on the investment decision. A two-business day cooling off period in which to exercise the right is suggested, in order to be

consistent with the right of withdrawal period applicable in prospectus offerings under Canadian law.

Resale restrictions

Proposal: Securities distributed under this exemption are subject to a restricted resale period.

Commentary: This resale treatment is consistent with the resale treatment of securities distributed under other capital raising exemptions. It is designed to forestall 'pump and dump' transactions.

5 Europe

This chapter outlines developments in CSEF in the European Union, including the provisions in Italy, being the first EU member to introduce CSEF laws.

5.1 Overview

In Europe, the *Bielsko Biała Declaration* (November 2011), called for a pan-European response for investment crowdfunding, by EU Member States. Since then, CSEF initiatives, or consideration of them, are underway in various EU Member States, including Italy, the United Kingdom and France.

5.2 Italy

In late 2012, the Italian Parliament passed a decree which included the recognition and legalisation of equity-based crowdfunding.[118] In July 2013 the Italian securities regulator (Commissione Nazionale per le Società e la Borsa) (CONSOB) issued regulatory provisions necessary for their implementation,[119] thus making Italy the first country in Europe to operate CSEF laws.

In various respects, as explained below, the Italian approach, as it applies to issuers, intermediaries and investors, differs from that in the USA or Canada.

5.2.1 Issuers

Types of issuer

CSEF in Italy is limited to 'innovative start-ups'. To be 'innovative', a firm must be recognised as such by the Chamber of Commerce, because, for example, it has invested in R&D activities or employs researchers.[120] To be a 'start-up', the firm can be no more than 48 months in existence.

There is no equivalent requirement in the US legislation or the Canadian proposals.

Maximum funds that an issuer may raise

The maximum funds raised by an eligible start-up through CSEF cannot exceed €5 million per year.

5.2.2 Intermediaries

Permitted types of intermediary

CSEF investments must be arranged through 'permitted managers', covering broker-dealers/financial institutions and other persons who match requirements of professionalism

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118 Article 30 of *Decreto Crescita* (Growth Decree), *Raccolta diffusa di capitali di rischio tramite portali online* (widespread collection of venture capital through online portals).

119 CONSOB, Regolamento (delibera n. 18592 del 26 giugno 2013) in materia di *'Raccolta di capitali di rischio da parte di imprese start-up innovative tramite portali on-line'* (equity crowdfunding).

120 The company purpose should expressly include the 'development and commercialisation of high-tech value products or services'.

and trustworthiness, to comply with anti-laundering laws and the EU *Markets in Financial Instruments Directive* (MiFID).

Matters related to issuers

Intermediaries are responsible to verify that the start-ups have all the necessary requirements to register on the portal.

Matters related to investors

The EU MiFID includes obligations on 'permitted managers' concerning matching an investor's profile to investment risk. However, there will be an exemption from MiFID for small investments (investments not exceeding €500 from each investor, and €1,000 total per year in CSEF for each investor) provided the investors, when contributing through a crowdfunding platform, take a test to demonstrate that they are aware of the risks they are taking when investing, and that they can afford the possible loss of the amount invested.

5.2.3 Investors

Threshold sophisticated investor involvement

Professional investors[121] and/or CONSOB-registered institutions must own at least 5% of the equity of a crowdfunded firm after the crowdfunding exercise, for that method of fundraising to be valid. The apparent intention is to give some form of comfort to small investors that the investment is worthwhile, given that one or more sophisticated investors has chosen to invest.

There is no equivalent requirement in the US legislation or the Canadian proposals.

Cooling off rights

Investors can withdraw their commitment at any moment until when the crowdfunding campaign is closed.

Subsequent withdrawal rights

Start-ups using CSEF must insert a clause in their constitution which guarantees investors the right to withdraw from the investment and to sell their shares back to the firm, in case the major shareholder sells its stake to a third party ('tag along' right).

There is no equivalent right in the US legislation or the Canadian proposals.

5.2.4 Future assessment

It is proposed that in mid-2014, CONSOB will evaluate the impact of the regulation on the Italian crowdfunding market and decide whether it is necessary to modify the law in some respect.

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[121] In Europe, professional investors are defined by the EU *Markets in Financial Instruments Directive* (MiFID) Schedule 2, as individuals or organizations who possess the experience, knowledge and expertise to make investment decisions and properly assess risks. That classification can be satisfied if the investor meets at least two of the following criteria:

- having carried out market transactions of at least €50,000 at an average of 10 transactions per quarter for a year
- having a financial instrument portfolio worth more than €500,000
- having worked in a professional position relevant to the transactions envisaged, and in the financial sector.

5.3 United Kingdom

In August 2012, the FCA published a consumer information bulletin called *Crowdfunding: is your investment protected?* The bulletin warned investors that many crowdfunding opportunities are high risk and complex and are suited to sophisticated investors only. The document also pointed out that these types of investments are generally illiquid and that investors should be careful about investing over the Internet because of the risk of fraud. The FCA also expressed concern that some firms involved in crowdfunding may be acting without FCA permission or authorisation.

The FCA bulletin also stated that:

> We believe most crowdfunding should be targeted at sophisticated investors who know how to value a start-up business, understand the risks involved and that investors could lose all their money.

The FCA has since authorised some intermediaries which it considers have the necessary skills and expertise to conduct limited CSEF (which would be an exemption from the UK prospectus provisions).[122] This form of CSEF is confined to a relatively small group of investors, namely those persons who self-certify that they come within prescribed tests of being high net worth or sophisticated investors. This restriction, in turn, reduces the level of regulation of issuers and intermediaries, compared with jurisdictions that permit, or are contemplating, CSEF offers to all investors.

Intermediaries are required, pursuant to their authorisations, to provide clear and not misleading information on the inherent risks of CSEF. As explained on one authorised website:

> Investing in start-ups involves risks, including **loss of capital**, **illiquidity**, **lack of dividends** and **dilution**, and it should be done only as part of a **diversified portfolio**. Seedrs is targeted solely at investors who are sufficiently sophisticated to understand these risks and make their own investment decisions.[123]

Apart from conducting some basic checks, for instance, that an issuer is in fact incorporated and the persons acting on behalf of the issuer are in fact corporate officers, intermediaries are not obliged to exercise due diligence checks of issuers on their websites.

Investors may hold the securities in their own name or may choose to have them held by the intermediary as their nominee, in a 'pooling' type arrangement.[124] As explained on one intermediary website:

> The nominee structure allows us to manage the investment for you while still giving you the full economic interest in the business. If you held the shares directly, you would have to deal with the various obligations and hassles of being a legal shareholder, and the start-up would have to manage the administrative complexities of having a large number of shareholders. By using a nominee structure, you get the benefits of being a shareholder - financial returns as well keeping informed about the business's progress - and the start-ups gets the benefits of your investment without either of you having to face the burdens of a direct shareholding.

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122 See, for instance, Crowdcube, Seedrs Limited.

123 Seedrs Limited website.

124 Investors would hold units in an unregistered collective investment scheme, given that only high net worth or sophisticated investors are involved. In the Australian context, that arrangement would constitute a managed investment scheme. All such schemes must be registered, unless exempted pursuant to the tests in s 601ED.

> That said, if you would like to hold your shares directly, and the company agrees, you are more than welcome to do so.[125]

To avoid complex compliance requirements for intermediaries that would otherwise be applicable, those entities do not hold investor funds. The practice is that funds are not provided from investors until a stipulated target amount has been reached, whereupon they are transferred directly from the investors to the issuer. Investors are given a seven day period after they are notified that the target amount has been reached to decline to continue with their investment.

The UK limited CSEF approach, based essentially on risk disclosure and limiting those who can be investors, appears to provide no specific CSEF protections for sophisticated investors, beyond any remedies they may have in consequence of any breach of the general risk disclosure obligations resting on the intermediaries and general corporate and common law as it may apply to any misstatement or misrepresentations by an issuer.

The FCA is likely to publish a paper on CSEF in the latter part of 2013. The CAMAC discussion paper will be updated online to outline that paper, once published.

5.4 France

In April 2013, the French Government announced that it would establish a legal framework for crowdfunding in France.

The Government is aiming to develop specific proposals for this purpose by September 2013. The CAMAC discussion paper will be updated online to outline these proposals, once published.

[125] Seedrs Limited website.

6 New Zealand

This chapter outlines developments in New Zealand, where recently enacted legislation provides for CSEF.

6.1 Overview

The recently enacted Financial Markets Conduct Act (the Act) contains provisions designed to facilitate CSEF.[126] These provisions will, in the CSEF context, substitute for the regulatory regime otherwise pertaining to equity-raising by corporate entities.

In implementing this initiative, the New Zealand Government stated:

> The Government's updated securities legislation provides explicit mechanisms for regulating new forms of intermediated capital raising, such as 'peer-to-peer lending' and 'crowd funding'. These enable funds for small businesses and individuals to be raised in internet-based market places, potentially more efficiently than through traditional public or private offerings.[127]

Also:

> Enabling crowd-funding was highlighted in the Government's Business Growth Agenda as an initiative to support early-stage and growth companies to access the risk-capital they need to grow. ... Permitting crowd-funding platforms will open up significant new opportunities for small businesses to raise growth capital.[128]

Part 6 of the Act provides for applications to be made to the Financial Markets Authority (FMA) to be licensed as a 'prescribed intermediary service' for the purposes of CSEF. Issuers making CSEF offers through licensed CSEF intermediaries will be exempt from the normal requirement to register a Product Disclosure Statement.

The general principles in the Act, and high level Government decisions relevant to CSEF, are set out in Section 6.2 of this paper. Draft regulations to support the Act will be released for consultation later in 2013. The intention is that the draft regulations concerning CSEF will reflect and develop the high level decisions of the Government in this area.[129] The announced timing is that the provisions of the Act dealing with CSEF will come into operation in April 2014.

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126 Minister of Commerce C Foss *Financial Markets Conduct Bill passes third reading* (28 August 2013). In regard to CSEF, see Ministry of Business, Innovation and Employment, Ministerial Statement 'New regulations for financial markets' 27 June 2013; *Financial Markets Conduct Regulations Regulatory Impact Statement* (June 2013) paragraphs 281-300, Brief Counsel 'Crowd funding and peer-to-peer lending' Chapman Tripp 5 August 2013.

127 See the New Zealand Government *Building Capital Markets* report of its *Business Growth Agenda.* (http://www.mbie.govt.nz/pdf-library/what-we-do/business-growth-agenda/bga-reports/Capital-Markets-report.pdf)

128 The Regulations Cabinet Paper from the Minister of Commerce.

129 See further, http://www.med.govt.nz/business/business-law/pdf-docs-library/current-business-law-work/securities-law-review/fmc-regulations-decisions/Paper-4-licensing.pdf)

New Zealand CSEF offers would not qualify for mutual recognition in Australia.[130]

6.2 Issuers

6.2.1 Maximum funds that an issuer may raise

Issuers may only raise a total of $2 million (aggregated with any fundraising through the New Zealand equivalent of the small scale personal offers 20/12 exception[131]) in each 12-month period through CSEF.

6.2.2 Liability of issuers

Issuers using CSEF will be subject to liability for pecuniary penalties for any misstatements or unsubstantiated representations they make (unless they can prove a defence, for instance that the contravention was due to a cause beyond its control and it took reasonable precautions and exercised due diligence to avoid it).

6.2.3 Other matters

Various other matters concerning issuers that have been included in the US JOBS Act, and have been raised for consideration in the Canadian Consultation papers, have not yet been clarified. They include:

- disclosure by the issuer to investors
- controls on advertising by issuers
- ban on a secondary market.[132]

6.3 Intermediaries

6.3.1 Permitted types of intermediary

License applicants will be subject to various background and other checks, including an assessment of their ability to effectively perform the service.

In that context, the FMA must be satisfied that applicants:

- will conduct open online platforms accessible to all eligible investors
- will act as neutral brokers between issuers and investors
- will have key processes involved in the platform that are fair, orderly and transparent, including:
  - the processes for issuers and investors to access the service

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130 Chapter 8 of the Corporations Act provides a general mechanism for mutual recognition of securities offers by entities registered in other jurisdictions. New Zealand is a recognised jurisdictions: definition of 'recognised jurisdiction' in s 1200(1), Corp Reg 8.1.03. However, only offers for which a prospectus is required are recognised.

131 See Section 3.2.2 of this paper for this exemption in the Australian law.

132 See Section 4.2 of this paper.

- the processes for matching of issuers and investors by the service
- where applicable, the processes for handling of investment funds and payments to investors.

6.3.2 Matters related to issuers

Licensed intermediaries will be required to conduct checks to exclude offers by issuers on their websites where there is evidence that directors, senior managers or controlling owners of the issuer are not of good character and reputation.

6.3.3 Matters related to investors

Intermediaries must provide facilities on their online platform for investors to receive information sufficient to make an informed decision about whether or not to invest in issuers on the platform.

The FMA must be satisfied with the way in which information about the service and the risks involved is disclosed to prospective investors.

Intermediaries will also be required to provide a 'service disclosure statement' to investors and enter into written client agreements with them, dealing adequately with:

- how the platform's investment processes operate
- the mechanisms to deal with interactions between issuers and investors
- any ongoing monitoring of issuers that the platform proposes to perform
- how any investor money is handled by the intermediary
- the fees and charges that will apply to investors
- how investors can make complaints.

6.4 Investors

6.4.1 Permitted types of investor

There are no limitations on who may invest through CSEF.

6.4.2 Maximum funds that each investor can contribute

As previously indicated, there are various approaches (alone or in combination) that could be taken to the funds that investors could put into CSEF, if the intention is to limit the possible losses to retail investors through CSEF. They include:

Issuer linked caps

- *first approach:* limiting the number of CSEF issuers in which an investor may invest in one year
- *second approach:* limiting the monetary amount that an investor may invest in each CSEF issuer in one year

- *third approach:* limiting the monetary amount that an investor may invest in each CSEF issuer in total (not per year)

Investor linked caps

- *fourth approach:* limiting the total monetary amount that an investor may invest in all CSEF issuers in one year, irrespective of that person's income or net worth

- *fifth approach:* limiting the total monetary amount that an investor may invest in all CSEF issuers in one year according to that person's income or net worth.

While the US JOBS Act has adopted the fifth approach, the Canadian proposal has adopted a combination of the third and fourth approach.

In New Zealand, no limits have been proposed so far, though a number of options for caps on retail investment in CSEF will be set out in the forthcoming draft regulations, for comment, such as:

- *third approach:* limiting the amount that an investor may invest in each issuer to $15,000 (the Canadian proposal under the third approach has a cap of $2,500 that an investor may invest in each issuer)

- *fourth approach:* a fixed per investor cap of $50,000 each year (the Canadian proposal under the fourth approach has a per investor cap of $10,000 each year

- *fifth approach:* a per investor cap each year that varies with the income and net worth of the investor (comparable to the US JOBS Act approach).

6.4.3 Risk acknowledgement by the investor

Investors will be required to affirm to the intermediary that they understand the risks involved, such as the risk of loss of their entire investment and that they could bear such a loss.

6.4.4 Cooling of rights

This matter has not yet been clarified.

6.4.5 Resale restrictions

This matter has not yet been clarified.

7 Matters for consideration

This chapter raises for consideration, and invites submissions, by interested parties on whether there should be regulatory arrangements in Australia specifically designed for CSEF and, if so, what should be the elements of those arrangements.

7.1 Overview

In considering what, if any, regulatory response might be made in Australia to CSEF, a range of policy options are available, including:

- **Option 1**: no regulatory change
- **Option 2**: liberalising the small scale personal offers exemption from the fundraising provisions
- **Option 3**: confining CSEF exemptions to offers to sophisticated, experienced or professional investors
- **Option 4:** making targeted amendments to the existing regulatory structure for CSEF open to all investors
- **Option 5**: creating a self-contained statutory and compliance structure for CSEF open to all investors.

Options 1, 2 and 3 are discussed in Section 7.2.

In regard to Options 4 and 5, Section 7.3 sets out a series of questions applicable to issuers, intermediaries and investors for CSEF open to all investors, taking into account matters particularly arising under Australian law and those in other jurisdictions.

7.2 Can a regulatory initiative be justified

CSEF is a form of public offering of securities in an enterprise. The threshold question is whether this form of fundraising should be regulated in any different respect than any other form of corporate fundraising or, alternatively, whether any form of regulatory accommodation for CSEF should be limited to specific situations, falling well short of general public offers, open to all investors.

7.2.1 Option 1

Option 1 proposes no specific adjustment for CSEF in the Australian legislation, on the view that existing requirements and protections (as described in Chapter 3 of this paper) should not be reduced in their application simply to accommodate attempts to use the Internet or a social media forum to sell small parcels of equity to large numbers of online users. Arguably, that form of public market in securities should not be exempt from the controls that otherwise would apply. On this view, persons seeking to obtain capital from investors should be subject to the same requirements, regardless of the medium used to promote their offers.

Further, it could be argued, the risks to investors, including fraud, the extremely high likelihood of loss of capital, lack of liquidity and inability to assign value easily to equity issued through CSEF, make CSEF, in general, an unsuitable form of investment to offer publicly. Also, the investor groups likely to be attracted to CSEF may include persons who will be significantly affected by a loss on an investment (e.g. young people with small amounts of capital). This argument against legal change could be further supported by the fact that the risks identified in this paper may not be able to be adequately managed and that merely disclosing these risks to investors may not suffice.

A contrary view is that under the current law, any attempt at a widespread offer of equity through a crowd funding online portal would likely attract highly significant compliance obligations and costs for issuers and intermediaries. Without some regulatory adjustment to facilitate CSEF, it is argued, Australian start-up enterprises may be disadvantaged in raising necessary capital, compared with overseas start-ups in jurisdictions that have legislative provisions specifically designed for CSEF. It may lead to some Australian promoters moving their operations to overseas jurisdictions that they consider are more facilitative of CSEF.

7.2.2 Option 2

Option 2 would involve some liberalisation of the current small scale personal offers exemption from the Chapter 6D fundraising requirements, whereby an issuer may make a personal equity investment offer to investors provided that no more than $2 million is raised in any 12 month period from no more than 20 investors.[133]

One possibility might be to increase the number of investors (say, to 100), with or without some form of ceiling on the amount of funds (in total or per year) that each person could invest in a particular issuer That could be combined with some adjustment to the ceiling on the total funds that each issuer can raise per year.

This approach would give some increased flexibility to issuers in fundraising, though falling short of the size of the target investor group that is usually envisaged with CSEF. Also, it does not deal with the ceiling on the number of shareholders of a proprietary company (being 50 non-employee shareholders).

7.2.3 Option 3

Option 3 has been adopted in the UK, at this point. There has been some regulatory accommodation for CSEF in that jurisdiction, but only to the extent that it applies to high net worth or other sophisticated investors, and the offer and acceptance process takes place through intermediaries that have been authorised by the regulator.[134]

If a similar approach to the UK was to be taken in Australia, an issue would arise whether the current tests of sophisticated, experienced, or professional investors[135] are appropriate. In particular, they may be a question whether the test of sophisticated investors may be too narrow and thereby unduly restrict the funds that could be raised through this limited form of CSEF. Currently, sophisticated investors are:

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133 s 708(1)-(7). A personal offer is one that may only be accepted by the person to whom it is made, and is made to a person who is likely to be interested in the offer, having regard to a previous personal, professional or other relationship or a statement made that the person receiving the offer would be interested in an offer of that kind.

134 See further Section 5.3 of this paper.

135 s 708(8)-(11).

- individuals with net assets of at least $2.5 million, or
- individuals with a gross income for each of the last two financial years of at least $250,000.[136]

The question of drawing an appropriate distinction between sophisticated and retail investors has already been raised in another context.[137]

Question 1 In principle, should any provision be made in the corporations legislation to accommodate or facilitate CSEF. if so, why, if not, why?

Question 2 Should any such provision:

(i) take the form of some variation of the small scale offering exemption and/or

(ii) confine CSEF to sophisticated, experienced and professional investors? If so, what, if any, change should be made to the test of a sophisticated investor in this context, or

(iii) adopt some other approach (such as discussed in Section 7.3, below).

7.3 Possible content of a general regulatory initiative

In considering Options 4 and 5, it is necessary to take into account matters that particularly arise within the Australian corporate law context, as well as more general matters of principle that have arisen in other jurisdictions, as they affect issuers, intermediaries and investors, respectively.

Option 4 would involve 'cherry picking' approaches in some of these matters, but within the context of otherwise maintaining the existing regulatory structure.

Option 5 would involve creating a new Chapter or Part in the Corporations Act to regulate the process of CSEF, in the manner, say, that Title III of the JOBS Act is intended to exhaustively regulate CSEF in the United States.

The matters that would arise under either Option, as they affect issuers, intermediaries and investors are set out below.

7.3.1 Issuers

Specific matters affecting issuers under Australian law

Consideration would need to be given to whether the current regulatory requirements for proprietary companies, public companies and managed investment schemes should be adjusted in some manner in the CSEF context.

Proprietary companies

On one view, CSEF in the form of investors acquiring equity in their own names in proprietary company issuers could be facilitated by:

- increasing or abolishing the shareholder cap and

[136] Corporations Regulations 6D.2.03.

[137] Australian Government Options Paper Wholesale and Retail Clients: Future of Financial Advice (January 2011).

- revising the prohibition on public offers.[138]

Without those changes, it could be argued, the proprietary company structure would remain ill-suited for start-up or other enterprises seeking to utilise this form of CSEF.

A reservation with this approach is that such changes could, in effect, turn these companies into quasi-public companies, raising general questions about how they should be regulated, compared with public companies, given this enhanced level of public participation.

For instance, the current reduced level of regulation of proprietary companies, compared with public companies, reflects the essentially private or 'close' nature of proprietary companies, and the ability of shareholders to 'self-police' management. Any 'super sizing' of permissible shareholder numbers for proprietary companies could raise issues of public involvement, investor protection and market integrity, calling for a more general review of the regulation of such companies.

By way of example, CSEF shareholders, each, say, with a low financial commitment to a company, may have little incentive to monitor its management and may simply 'write off' a failed investment without further action, even where the total funds collected for the company through CSEF may be substantial and may have been misappropriated. Greater reliance may need to be placed on external supervision of such companies than is usually the case with proprietary companies, to minimize the opportunities for fraudulent conduct affecting large numbers of investors.

On one view, any permitted use by proprietary companies of CSEF should be accompanied by greater on-going corporate governance obligations on those companies, in line with the regulation of public companies, including obligations to prepare audited financial reports and to comply with continuous disclosure obligations. Beyond a certain point of increased regulation, however, there may be little point in using the proprietary, rather than the public, company structure in the CSEF context.

Public companies

On one view, public companies could more easily raise funds through CSEF if, in that context:

- the disclosure requirements and
- the compliance requirements[139]

were reduced or relaxed in some manner.

However any such proposal would have to be considered in the broader context of the public participation, investor protection and market integrity rationale of these provisions.

Managed investment schemes

An alternative approach is for investors' funds to be pooled in a managed investment scheme, with the RE of the scheme acquiring securities in the issuer.[140]

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138 See Section 3.2.2 of this paper.
139 See Section 3.2.3 of this paper.
140 See Section 3.2.4 of this paper.

The question this raises is whether any adjustment to the current regulatory structure for a scheme should be made in the context of CSEF. In particular, would investors be disadvantaged by receiving a PDS prepared by the RE of the scheme, rather than a disclosure document prepared by the issuer? On one view, CSEF investors should receive the same information from an issuer, whether they are to hold a legal or beneficial interest in the equity of that issuer.

Question 3 In the CSEF context, what changes, if any, should be made, and for what reasons, to the regulation of:

(i) proprietary companies

(ii) public companies

(iii) managed investment schemes. In considering (c), should the disclosure obligations of issuers to investors differ, in principle, if investors are investing directly (as equity holders in the issuer) or indirectly (through acquiring an interest in a managed investment scheme) and if so, how and why?

General matters affecting issuers

Various general matters concerning CSEF issuers, which have been raised in other jurisdictions, would also need to be considered in the Australian context.

Please note: In regard to each part of Question 4 below, see Section 4.2, Section 5.2.1 and Section 6.2 of this paper, which set out how those matters have been considered in other jurisdictions.

Question 4 What provision, if any, should be made for each of the following matters as they concern CSEF issuers:

(i) **types of issuer:** should there be restrictions on the classes of issuers permitted to employ CSEF (for instance, investment companies are excluded from the CSEF provisions of the US JOBS Act. In Italy, CSEF is confined to designated 'innovative start-ups')

(ii) **types of permitted securities:** what classes of securities of the issuer should be able to be offered through CSEF

(iii) **maximum funds that an issuer may raise:** should there be a ceiling, and if so what, on the funds that can be raised by each issuer in a particular period through CSEF. Should that ceiling include any funds raised under the small scale personal offers exemption

(iv) **disclosure by the issuer to investors:** what disclosures should issuers have to provide to investors

(v) **controls on advertising by the issuer:** what controls, if any, should there be on advertising by an issuer

(vi) **liability of issuers:** in what circumstances should the directors or controllers of the issuer have liability in relation to CSEF. What defences to liability should apply

(vii) **ban on a secondary market:** should CSEF be limited to new issues, excluding on-selling of existing securities

(viii) **any other matter?**

7.3.2 Intermediaries

Specific matters affecting intermediaries under Australian law

Depending upon the circumstances, a CSEF intermediary operating in Australia may be required to hold an Australian Market Licence or an Australian Financial Services Licence.[141]

A view has been expressed that any requirement that the operator of an Australian-based CSEF intermediary be licensed may diminish a key benefit of CSEF, namely quick and low-cost access to funding for small business and start-up companies.[142]

An alternative view is that, as an addition, or alternative, to legislative prescription of intermediaries, the current licensing requirements would enable ASIC to tailor the terms of licences specifically for CSEF intermediaries. For instance, in addition to various risk disclosure requirements, the terms of these licences could deal with any requirements for intermediaries to perform initial background and/or viability checks on issuers before including them on their website, as well as any ongoing checks on issuers already on their website. The licences could also regulate how each intermediary website is to operate and how funds provided by investors are to be held prior to their being passed to the issuer. Some of these specific matters have also been considered in other jurisdictions: see Question 6, below.

In any case, the intermediary plays a critical role in ensuring that any CSEF market operates well and investors and issuers remain confident of its credibility. Therefore, under any approach, it can be argued, an intermediary must be an organisation of substance and be sufficiently capitalised and resourced to carry out its vital role.

Question 5 In the CSEF context, what changes, if any, should be made, and for what reasons, to the current licensing requirements applicable to intermediaries?

General matters affecting intermediaries

The most developed set of requirements for CSEF intermediaries is found in the US JOBS Act, covering:

- permitted types of intermediary
- matters related to issuers
- matters related to investors.[143]

Canada is also considering these matters, including in the form of questions that parties might be asked to address in any move towards registration of CSEF intermediaries.[144] Likewise, New Zealand is developing criteria affecting intermediaries.

One commentary has argued that the JOBS Act approach of channelling the majority of generic CSEF compliance requirements to the intermediary has the benefit of limiting the compliance requirements for issuers to the elements unique to each of them.[145]

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141 See Sections 3.3.1 and 3.3.2 of this paper.
142 T Wong, 'Crowd funding: Regulating the new phenomenon' (2013) 31 *Companies and Securities Law Journal* 89 at 98.
143 Section 4.3.1 of this paper.
144 Section 4.3.2 of this paper.

Please note: In regard to each part of Question 6, below, see Section 4.3, Section 5.2.2 and Section 6.3 of this paper, which set out how those matters have been considered in other jurisdictions.

Question 6 What provision, if any, should be made for each of the following matters as they concern CSEF intermediaries:

(i) **permitted types of intermediary** (also relevant to Question 5):

- (a) should CSEF intermediaries be required to be registered/licensed in some manner
- (b) what financial, human, technology and risk management capabilities should an intermediary have for carrying out its role
- (c) what fair, orderly and transparent processes must the intermediary be required to have for its online platform
- (d) should an intermediary be required to have an internal dispute resolution and be a member of an external dispute body, such as the Financial Services Ombudsman

(ii) **intermediary matters related to issuers:** these matters include:

- (a) what, if any, projects and/or issuers should intermediaries not permit to raise funds through CSEF
- (b) what preliminary/ongoing due diligence checks should intermediaries be required to conduct on issuers and their management
- (c) what preliminary/ongoing due diligence checks should intermediaries be required to conduct on the business conducted by issuers
- (d) to what extent should intermediaries be held liable for investor losses resulting from misleading statements from issuers made on their websites
- (e) to what extent should intermediaries be held liable for investor losses resulting from their websites being used to defraud investors
- (f) what possible conflict of interest/self-dealing situations may arise between issuers and intermediaries (including intermediaries having a financial interest in an issuer or being remunerated according to the amount of funds raised for issuers through their funding portal), and how these situations might best be dealt with
- (g) what controls should be placed on issuers having access to funds raised through a CSEF portal

(iii) **intermediary matters related to investors:** these matters include:

- (a) what, if any, screening or vetting should intermediaries conduct on investors
- (b) what risk and other disclosures should intermediaries be required to make to investors

[145] T Wong, 'Crowd funding: Regulating the new phenomenon' (2013) 31 *Companies and Securities Law Journal* 89 at 104-105.

(c) what measures should intermediaries be required to make to ensure that any investment limits are not breached

(d) what controls should be placed on intermediaries offering investment advice to investors

(e) should controls be placed on intermediaries soliciting transactions on their websites

(f) what controls should there be on intermediaries holding or managing investor funds

(g) what facilities should intermediaries be required to provide to allow investors to communicate with issuers and with each other

(h) what disclosure should be made to investors about being able to make complaints against the intermediary, and the intermediary's liability insurance in respect of the role as an intermediary

(i) what disclosure should be made about the commission and other fees that intermediaries may collect from funds raised

(j) what, if any, additional services should intermediaries provide to enhance investor protection

(iv) **any other matter?**

7.3.3 Investors

Specific matters affecting investors under Australian law

Issues that could arise include whether investors should be made aware of:

- the key differences between share and debt securities[146] that might be available through CSEF
- in regard to shares, the differences between legal and beneficial interest in shares[147] and how this could impact on their capacity to participate in, or influence, the company in which they have invested their funds, and
- the existence of any classes of shares with differing rights,[148] and whether disclosure of this information is enough.

Question 7 In the CSEF context, what provision, if any, should be made for investors to be made aware of:

(i) the differences between share and debt securities

(ii) the difference between legal and beneficial interests in shares

(iii) any classes of shares in the issuer and its implications for investors. A related question is whether disclosure, alone, would suffice.

146 See Section 3.4.1 of this paper.
147 See Section 3.4.2 of this paper.
148 See Section 2.2.4 and Section 3.4.3 of this paper.

General matters affecting investors

Various general matters concerning investors, which have been raised in other jurisdictions, would also need to be considered in the Australian context.

Please note: In regard to each part of Question 8, below, see Section 4.4, Section 5.2.3 and Section 6.4 of this paper, which set out how those matters have been considered in other jurisdictions.

Question 8 What provision, if any, should be made for each of the following matters as they concern CSEF investors:

(i) **permitted types of investor:** should there be any limitations on who may be a CSEF investor

(ii) **threshold sophisticated investor involvement (Italy only):** should there be a requirement that sophisticated investors hold at least a certain threshold interest in an enterprise before it can make CSEF offers to other investors

(iii) **maximum funds that each investor can contribute:** should there be some form of cap on the funds that an investor can invest**.** In this context, there are a number of possible approaches under *Issuer linked caps* and under *Investor linked caps*

(iv) **risk acknowledgement by the investor:** should an investor be required to acknowledge the risks involved in CSEF

(v) **cooling off rights:** should an investor have some right of withdrawal after accepting a CSEF offer

(vi) **subsequent withdrawal rights (Italy only):** should an investor have some further withdrawal right subsequent to the offer

(vii) **resale restrictions:** should there be restrictions for some period on the on-sale of securities acquired through CSEF

(viii) **reporting:** what ongoing reporting should be made by the intermediary and/or issuers to investors in regards to their investment

(ix) **losses:** what recourse should investors have in relation to losses resulting from inadequate disclosure

(x) **remedies:** what remedies should investor have in relation to losses results from poor management of the enterprise they invest in

(xi) **any other matter?**

7.3.4 Incremental approach or stand-alone regulation

Depending upon the approach taken to the previous questions in this chapter, the issue may arise of whether any legislative accommodation for CSEF should be in the form of incremental adjustments to the existing regulatory structure or be in the form of new and self-contained provisions in the Corporations Act.

Question 9 Should any accommodation for CSEF in the Corporations Act be in the form of incremental adjustments to the existing provisions, or be in the form of a self-contained regulatory regime for CSEF?

7.3.5 Other matters

Question 10 What, if any, other matters which come within the scope of this review might be considered?