SUBMISSION IN RESPONSE TO CAMAC DISCUSSION PAPER ON CROWD-FUNDING

We at Capital Potential are delighted to forward this submission and hope it contributes usefully to overall discussion on this important topic. We strongly believe that crowd funding and appropriate regulation thereof will be a key enabling component of Australia's overall national development strategy. We believe that our nation's future prosperity directly depends on how effectively we can both become a digital economy, and position ourselves to embrace the enormous opportunities brought about by economic transformation in Asia. We believe these two factors are interlinked and that crowd funding is a central component of the supportive and nurturing incubatory environment which Australian small and medium sized business requires to thrive. We applaud this timely initiative by CAMAC and welcome the opportunity to contribute further.

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1. The benefits and risks of online fundraising: response to CAMAC discussion.

We recognise that the CAMAC discussion paper needed to present a balanced outline of the pros and cons of crowd-funding. However, we believe there is a strong case for the potential economic utility of crowd-funding, and also that there are good reasons why crowd-funding appears especially applicable to the Australian economy and its financial system. In our view, these robust principles underlying the concept of crowd-funding were not always prominent in the CAMAC discussion.

In addition, the authors believe that some of the risks of crowd-funding cited in the CAMAC paper are not in fact borne-out by study of crowd-funding's actual practice in other economies.

In this section we attempt to articulate the broad economic case for the potential benefits crowd-funding can bring to the existing financial system.

1.1 Distinction between crowd-sourced equity and crowd-sourced debt funding.

The CAMAC paper makes clear that it is using the term "Crowd sourced equity funding (CSEF)" as a broad term to include both equity and debt (loan) capital raising. Whilst we understand the reasons for this generalisation, we believe that in practice it is useful to distinguish between crowd sourced debt funding (or crowd-lending) and crowd sourced equity funding (which we will refer to as crowd-investing).

The importance of the distinction lies in the very different risk profile for the investor. As the UK's FCA notes in its own discussion of crowd-funding, the failure rate amongst (UK) new business start-ups is between 50% and 70%. This inherent risk profile of equity investment in new business start-ups does suggest that crowd-investing may be appropriate only for relatively sophisticated and/or high net worth individuals, able to make such investments in the context of a larger overall portfolio.

In contrast, crowd-sourced *lending* to small or medium sized businesses looking for loan capital to finance investment or business expansion should in principle represent an investment with a far more manageable risk profile. A competent crowd-lending site, through a combination of some filtering for credit risk and a mechanism for allowing its investors to be diversified across multiple individual loans, should be able to ensure that the return its investors receive is relatively stable. Indeed, with the addition of some form of internal credit insurance or provision fund, a crowd-lending site should be able to deliver a product to its investors which resembles a bank deposit in terms of outcome (albeit not backed by deposit protection as a bank deposit would be). In the UK, crowd-lending is developing rapidly and has proved able to deliver a deposit-like outcome for its investors.

We therefore suggest that crowd-lending and crowd-investing represent very different offerings to investors, and will have different (if related) functions within the financial system and the broader economy. In the UK at least, successful sites to date have tended to focus on one or the other (either crowd lending or crowd-investing). At present in the UK, crowd-lending is a substantially larger phenomenon than crowd-investing: in 2012, loans made via crowd-lending amounted to £350m, whilst equity raised via crowd-investing was just £10m.

We believe that both crowd-lending and crowd-investing will have important roles to play in the Australian financial system. In the following sections we look separately at the case for crowd-investing (equity) and crowd-lending. We will use the term crowd-funding to refer collectively to crowd-lending and crowd-investing.

1.2 The economic case for Crowd-Sourced Equity Investing

In the existing financial system, equity funding for relatively small-scale new business start-ups often has to be found from 'friends and family'. Crowd-sourced equity funding is essentially just a means of broadening the network of "friends and family", by offering a service which matches potential investors with entrepeneurs or users of capital.

The potential economic role of such a service is very clear. Individual investors may already have appetite for investing a portion of their savings in start-up ventures, but may not currently have in their circle of "friends and family" any entrepeneurs looking for equity capital. Access to institutionalised venture capital funds is in practice restricted to ultra-high-net-worth individuals, a tiny segment of the population and a limited segment of the savings pool. It therefore seems likely that the existing financial system is failing to unlock a portion of the risk appetite latent in the savings pool.

Equally, it seems likely that the existing financial system may be failing to deliver sufficient equity-funding for viable but relatively small-scale new business ventures. The banks' role is to provide debt capital to established businesses, whilst venture capital firms are obliged to seek relatively large-scale investment opportunities.

By seeking to match potential individual investors with new businesses seeking equity funding, crowd-investing can deliver an improvement in the matching of supply and demand for risk capital in the economy – an improvement over what the current financial system is able to deliver. In principle, any improvement in the matching of supply and demand for risk capital ought to allow for higher business investment, with all the consequent broader benefits for the economy, employment etc.

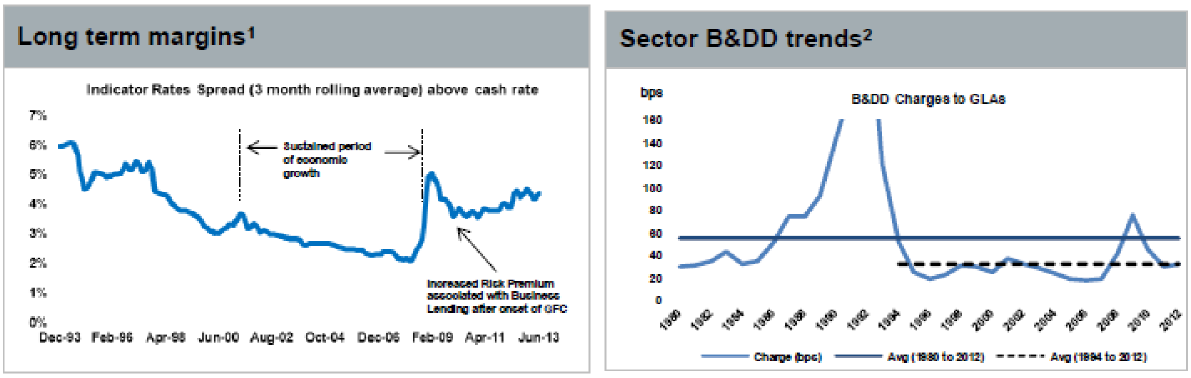
1.3 The economic case for Crowd-Sourced Lending to Businesses

Recycling of domestic savings into loan capital for business is supposed to be a primary function of the banking system. However, post the GFC, the banking systems of many developed economies stand accused of unduly restricting the supply of credit to business. There are a host of economic, regulatory and behavioural reasons why this accusation might be well founded, though it is one which is hard to prove.

We do not have anything specific to add to the debate on whether or not the Australian banking system is unnecessarily restricting the volume of credit supplied to the business sector. However, we believe it *is* possible to make direct observations about the Australian banks' *pricing* of credit and the interest spreads which the banks' are currently extracting from the household and business sectors. On a number of occasions the Australian banks have been accused of failing to pass on RBA rate cuts to borrowers, an accusation which it is easy to quantify and for which there is a wealth of evidence.

As just one example, we would like to cite the charts below taken from a June 2013 presentation by NAB, Australia's largest business lender, to a UBS conference. The chart on the left shows the asset spread which NAB has historically earned on business lending (ie the spread of the average lending rate over the RBA cash rate). Asset spreads are currently close to the historic highs seen in the aftermath of the early 1990's recession and during the GFC. Conversely, the chart on the right hand side shows bad and doubtful debts (ie credit losses) experienced by NAB on the same business lending over the same period. Clearly, credit losses are currently extremely benign, in fact close to the lowest levels seen during periods of sustained economic growth.

Lending spreads paid by Australian business borrowers vs loss rates experienced



Source: NAB

The fact that Australia's largest business lender is currently extracting historically high lending margins, despite an historically benign credit experience, is strong evidence of a market failure. The interest spread should in principle be mainly determined by the credit experience (low credit risk = low interest rate etc). It appears that the banks are extracting unwarranted supernormal profits (or economic rent) from the business sector. This represents a significant inefficiency in the functioning of the economy.

Crowd-lending is highly relevant to this inefficiency (which is not unique to Australia). In the US and especially in the UK, crowd-lending is starting to function as an effective disintermediary of the supernormal interest spreads which currently exist in the banking systems. Simply by directly matching savers (ie lenders), with business (or individual consumer) borrowers, crowd-lending sites have been able to deliver both a higher rate of interest for savers and a lower interest rate for borrowers. This process will reduce the economic rent extracted from the household and business sectors by oligopolistic banking systems. Lowering the cost of credit to business should in principle help to raise business investment, with all the consequent benefits to the economy, employment etc.

It is perhaps worth noting that the UK Government takes this point sufficiently seriously that it has provided government funds to directly aid the development of the crowd-lending sector in the UK[1].

[1] At the time of writing, the UK Government has provided £20m to Funding Circle and £10m to Zopa, to be used in financing loans to business.

2. Comments on some of the risk factors in crowd-funding raised in the CAMAC discussion.

We believe the above gives an outline case for the positive role in the economy that will be played by the growth of crowd-funding. In addition, in this section we would like to respond to some parts of the CAMAC discussion on the risks of crowd-funding.

2.1 There is little evidence that crowd-funding will deliver investments with a higher failure rate.

In section 2.1.4, "Risks of crowd sourced funding, Failure" (p.7), the CAMAC paper discusses whether the risk of an investment project's failure may be greater in the case of crowd funding than in the case of traditional forms of finance, because "in crowd sourced funding….the projects that are in fact funded are those that provide the participants with some psychological reward…..these projects are not funded according to their business and financial merits".

Whilst we understand why the authors of the report might consider this view, we think there is little evidence to support it. In fact there is some evidence for the *opposite* view, namely that the success rate of crowd-funded loans or equity investments may prove to be *better* than those achieved in the traditional financial system. For example, the longest-running crowd-lending site in the UK is Zopa, which was established in 2005. Though it is now expanding into SME lending, Zopa initially crowd-funded unsecured consumer loans (sometimes known as peer-to-peer lending). Since 2005, including the period through the GFC, the credit experience on consumer loans funded by Zopa has in fact been substantially *better* than that achieved by the major UK banks on their own consumer loan portfolios. Bad debts on Zopa's consumer loans have run at just 0.25% for the last three years[2]. This is quite remarkable, as received wisdom would say that a new entrant into a consumer loan market should typically suffer a credit experience *worse* than that of established players.

It is possible that the explanation for Zopa's excellent credit experience may partially lie in its initial screening process for borrowers – perhaps its loan portfolio is focused only on the better credit risks, whilst those of the major UK banks comprise a broader cross-section of consumer borrowers. Still, Zopa is only using publicly available credit data (Experian) to select borrowers – it did not start with the accumulated proprietary data which the banks have claimed gives them an underwriting advantage.

Another possible explanation for the excellent credit experience on Zopa's lending may simply be that of "moral suasion". Borrowers know that they are borrowing directly from peers rather than from a large financial institution. This may improve behavioural influence on default rates.

Crowd-funded lending to business is a more recent phenomenon in the UK and so its track record is too short to be statistically reliable. Nonetheless, the initial credit experience has been good, and certainly not worse than that experienced by the major UK banks.

Crowd sourced equity funding is still too small and recent a phenomenon in the UK to provide a meaningful comparison of success rates with those for institutionally financed ventures. However, our own survey of projects which have been successfully financed in the UK via crowd-investing does *not* suggest an investor base unwilling or unable to apply rational investment judgement.

In conclusion, at present there is some hard evidence that the crowd-funding process is capable of achieving an investment selection with a *better* success rate than that achieved by traditional financing methods. This is especially true with respect to crowd-lending.

[2] Source: Interview with Zopa CEO Giles Andrews, published in UK's Guardian newspaper, August 12th 2013.

2.2 Impact of crowd-investing on the traditional business model

In section 2.2.2 "Impact of CSEF on the traditional business model" (pp 9-10), the CAMAC paper describes CSEF as involving a "reversal of the traditional business cycle… (in which) public funding may be sought on the basis of future possibilities only, rather than on clear evidence of a viable business model in operation". The discussion then suggests that this "reversal" of the traditional business model "increases the risk of failure and loss to equity investors through CSEF".

In fact, current institutional forms of financing for new businesses, such as venture capital firms, very often finance new ventures before there is any demonstrable business model. Many well known and successful internet ventures have gone through several rounds of VC financing before any revenue has been generated.

Crowd-funding does not in fact "reverse" the traditional model for financing investment. What it does is simply provide a new mechanism for matching supply of with demand for capital (either debt or equity capital).

2.3 Crowd-investing participants: quality of issuers

In section 2.2.3 "The CSEF Participants, Issuers" (pp. 11), the CAMAC discussion suggests that the risk of "lack of managerial skill" on the part of issuers (and consequent increased risk of business failure) may be accentuated in the case of crowd due to its business model.

In fact, our own survey of the leading crowd-investment sites in the UK suggests a high degree of professionalism amongst issuers successfully raising finance. For example, Nicola Horlick, a well-known fund manager and entrepeneur in the UK, has successfully used crowd-investment to fund projects which would have also been likely to attract funding from more traditional sources.

We believe the evidence from the UK at least is that both crowd-investing and crowd-lending (to business) are in fact attracting a high quality of investment projects which are seeking to lower their cost of capital via use of crowd-funding. As argued in Section 1 above, lowering the cost of capital for business investment should be viewed as a primary economic benefit of crowd-funding.

2.4 Applicability of crowd funding in the Australian context

In section 3.1 (pp 17), the CAMAC paper discusses the potential for crowd funding in Australia. One line of argument made is that crowd funding in other jurisdictions (especially the US) is seen as a means of driving economic recovery from the GFC. CAMAC notes that "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."

However, we have argued (Section 1 of this paper) that the real benefits of crowd funding lie in its potential to fundamentally improve the efficiency with which capital is recycled from household savings into business investment. This benefit is applicable to any economy, not just those which have suffered most in the aftermath of the GFC.

Moreover, we believe there are several aspects of the Australian financial system which suggest crowd-funding may be especially relevant. We discuss some of these below.

2.4.1 Potential for crowd-lending to disintermediate the banks' supernormal interest spreads

Firstly, as we argued in section 1, there is good evidence that Australia is among the number of developed economies (the UK is another example) in which an oligopolistic banking system appears to be extracting undue "economic rent" (high interest spreads) from the household and business sectors. Wherever this is the case, the potential benefits of crowd-lending are highly pertinent, as is already being demonstrated in the UK.

2.4.2 Potential role of Superannuation assets in supplying investor capital to crowd-funding sector

Secondly, the Superannuation system has created a relatively large and sophisticated retail investor base in comparison to many other developed economies[3], along with a large pool of readily investable assets. Superannuation assets amounted to $1.6tr as of June 2013, this amount is expected to grow to around $3.4tr over the next 10 years, driven by the increase in contribution rate from 9% to 12%.

Within this asset base, the fastest growing segment is self-managed superannuation funds (SMSF): assets in SMSF now amount to some $500bn[4]. The profile of SMSF members suggests a relatively sophisticated investor: SMSF members are older (76% over 50), with significantly higher average incomes and much larger super fund balances (average SMSF fund size $480k)[5].

Interestingly, SMSF funds currently have a very high allocation to cash (bank deposits): approximately 30%, or $150bn[6]. Given relatively low interest rates, it is difficult to see the investment rationale for such a high allocation to cash. There is potentially a powerful motivation for SMSF members (a relatively sophisticated investor group) to reallocate a portion of the cash in their super funds into crowd-lending directly to business. To quantify the obvious, each 1% of just that portion of SMSF funds currently dormant in cash represents a potential A$1.5bn supply of capital to the crowd funding sector.

2.4.2 Potential demand for capital through crowd funding

Borrowings by Australian business currently amount to around A$800bn, within which lending to small and medium-sized businesses is some A$240bn. A shift of just 4% of SME loans onto crowd-lending platforms would equate to roughly A$10bn of demand for capital.

In conclusion, we believe there are strong arguments suggesting that the economic benefits of crowd funding are especially applicable in the Australian context.

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[3] See for example the discussion in "Funding Australia's Future: The Future Demand and Supply of Finance", published by the Australian Centre for Financial Studies.
[4] Source: RBA
[5] Source: RBA
[6] Source: RBA

3. Regulatory responses to crowd-funding in other jurisdictions – comment on broad principle

Among other countries, the US, Canada and Italy are developing a regulatory framework for crowd-funding which has many new provisions specific to the sector – for example specific limits on the amounts issuers may raise via crowd-funding or on the amounts individuals may invest. In contrast, the UK approach largely incorporates crowd funding into the existing regulatory framework for the financial system, with relatively minimal new regulation specific to crowd funding.

As we have argued through this paper, we believe that crowd funding's use of a website intermediary to match savers with users of capital should not alter the underlying principles of raising equity or debt capital. We believe this simple point should inform the regulatory approach to crowd-funding as far as possible, whilst of course respecting the need to protect consumers and to ensure stability of the financial system as a whole.

Specifically, we believe that restrictions on crowd funding relating to the business model of the issuer (as in Italy), or to amounts issuers may raise or individuals may invest (as in the US), or requirements on financial reporting which are specific to crowd-funded issuers (US) are all liable to create un-intended consequences or market distortions. In principle, existing laws relating to corporations and financial fraud will apply to crowd-funded activities as to other financial transactions, and these existing laws and regulations ought to be sufficient.

On this basis we believe that, amongst regulatory approaches taken in other jurisdictions to date, the UK approach offers the best broad model for Australia.

4. Responses to selected questions posed by CAMAC in Section 7 of its discussion paper

Hopefully, the broad principles outlined above, along with the case for the benefits of crowd funding argued previously, should themselves generate answers to many of the specific questions raised by the CAMAC discussion in its section 7.

In this section we offer our responses to some of these specific questions raised by CAMAC.

4.1 Overview

In considering what, if any, regulatory response might be made in Australia to crowd funding, the CAMAC discussion suggests a range of policy options (Section 7.1, pp 53):

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.

The view of the authors of this submission amounts to a combination of options 2,3 and 4. Specifically, we would suggest the following outlines:

- That both crowd-lending and crowd-investing activities are deemed to fall under the regulatory jurisdiction of ASIC;
- That in order to facilitate proprietary companies being able to raise equity via crowd-investing, the current fund-raising restrictions on proprietary companies be liberalised (see further discussion in 4.1.1 below);
- That ASIC consider restricting the crowd-investing (equity) form of crowd-funding to sophisticated, experienced or professional investors;
- Conversely, we believe that the crowd-lending format (ie crowd-funded loans to business or consumer borrowers) should remain open to all retail investors; and
- Beyond the liberalisation of current restrictions on fund-raising, we do not believe there should be any new rules on financial reporting or any other new requirements specific to issuers raising capital via crowd-investing or crowd-lending. We believe that existing regulation surrounding proprietary companies is adequate in this respect.

4.1.1 Liberalisation of fundraising restrictions on proprietary companies – relevance to CSEF

We would envisage that Australian issuers potentially seeking to access crowd-invested equity capital would be proprietary rather than public companies. In both the US and the UK, the $ amounts of equity being raised on crowd-investing platforms by individual issuers are still extremely small in relation to the amounts raised by public companies on the public stock markets. In the UK, looking across the two largest crowd-investment sites (Seedrs and Crowdcube), the largest single capital raise to date appears to have been £600,000. Even in the US, the largest single crowd funded equity-raise to which we can find reference is one for US$10m, a still tiny amount in relation to a typical public market equity raise. In the UK, crowd-investment sites typically require that their issuers be registered as 'private' rather than 'public' companies. 'Private' companies as defined by UK corporate law are the near equivalent to 'proprietary' companies as defined under Australian corporate law.

In order that proprietary companies in Australia be able to access crowd-invested equity capital, we believe there will need to be some liberalisation of the current restrictions on proprietary companies ability to raise equity funds. Specifically, we believe that:

- the shareholder cap (restriction on total number of shareholders) should be removed; and that
- current restrictions on the size of equity offerings by proprietary companies should also be removed.

With regard to the shareholder cap, we note that in the UK, the Companies Act 1980 removed the limit on the number of shareholders in a private company.

4.2 Responses to specific questions raised by CAMAC discussion paper

Below we offer responses to the specific questions raised by CAMAC in Section 7 of its discussion paper.

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

Only insofar as the restrictions on fund-raising by proprietary companies should be liberalised, for the reasons argued above. We do not believe crowd funding requires any amendments to corporation law in other areas.

> **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).

(i) Yes, we believe the small-scale offering exemption should be further liberalised, as argued above.

(ii) We would suggest that crowd funding of *equity* investments in new business ventures (ie crowd-investing as we have narrowly used the term in this document) could be restricted to sophisticated, experienced or professional investors. However, we believe that crowd-*lending* to both business and consumer borrowers should remain open to all retail investors.

With regard to any potential change in the definition of sophisticated investor, we have no specific proposal. However, we would note that:

(a) the definition of sophisticated investor is somewhat more onerous (in terms of the absolute level of wealth) in Australia than it is in the UK ($2.5 million net worth or $250,000 gross annual income in Australia vs £250,000 net worth or £100,000 gross annual income in the UK); and (b) in its latest consultation paper the FCA is proposing to also open CSEF to retail investors who are not sophisticated or high net worth but self-certify that they are either receiving investment advice on the CSEF investment from a regulated financial advisor or that their investment will be less than 10% of their investable assets. In the US, a leading crowd lending site, Lending Club, self-imposes a requirement that investors must have an annual gross income of at least $70,000 and a net worth of at least $70,000, or just a net worth of more than $250,000.

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?

(i) We believe that the funding restrictions on proprietary companies should be liberalised for the reasons argued in 4.1.1 above. We do not believe crowd funding requires any other amendments to the regulation of proprietary companies.

(ii) We do not believe any change is necessary in respect of public companies. We would not envisage public companies to access crowd-funding in the medium term, and even if they did, we do not see that this would require any change to their regulation.

(iii) No, we do not believe any variation in disclosure obligations of issuers to investors is warranted by difference in the structure by which investors invest.

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?**

(i) No, we do not believe there should be any restriction on types of issuer permitted to employ crowd funding. Such restrictions seem to us unnecessarily proscriptive. We have argued that the benefit of crowd-funding lies in its potential to improve the efficiency with which capital is recycled from household savings into business investment. If this view is correct, then there is no need for regulators to take any view on the types of investment to which crowd-funding should allocate capital.

(ii) A restriction to straightforward equity or debt (loan) instruments is worth considering. This would help to ensure the crowd-funding sector remains an appropriate place for household savings.

(iii) We do not believe any maximum on the amount an issuer may raise is necessary. To date, sums raised by individual issuers through crowd-investing sites are still extremely small in the context of broader capital markets. There is no evidence that a limit is required or relevant.

(iv) We do not think there should be any additional disclosure requirements for issuers beyond those enshrined in existing law for proprietary companies. Note that some of the UK crowd-investing sites (eg Seedrs) set their own requirements which go beyond those of UK company law. However, this represents the websites acting as 'investor relations' managers for their issuers, and is not a regulatory requirement.

(v)

(vi) We do not believe that the use of crowd-funding should create any specific liability for issuers' directors or controllers beyond those already existing under current corporation legislation.

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?

Crowd funding intermediaries should be licensed as intermediaries by ASIC. We believe that current licensing requirements would in principle enable ASIC to tailor the terms of licences specifically for crowd funnding intermediaries. ASIC should be able to do this in such a way that the crowd-funding sector is able to flourish. Licences for crowd-funding intermediaries could for example include some specification as to how funds from investors are to be held prior to being passed on to issuers.

We believe that bringing crowd-funding within the authority of ASIC can help the sector to gain the confidence of the public.

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
- (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?**

(i) We believe crowd-funding intermediaries should be licensed by ASIC. The specific requirements for these licences would be a matter for ASIC, but we believe that ASIC should attempt to minimise the initial regulatory burden on the sector. ASIC could consider adopting a phasing-in of regulatory requirements (for example capital requirements) over a number of years, in order to give the sector a chance to achieve critical mass.

(ii) The requirements on intermediaries with respect to due diligence on issuers should be kept to a minimum. The principle of crowd-funding is a simple matching of investors with issuers. Resulting transactions are made directly between the investor and the issuer, at least in terms of the economic relationship. Therefore the intermediary cannot be held responsible for losses resulting in any way from investments made via its website.

This however, does not preclude intermediaries taking it upon themselves to make specific undertakings for investors. For example, an intermediary could undertake to ascertain that all issuers on their site are indeed correctly registered proprietary companies. In practice, existing crowd-funding sites in the US and UK do make such commitments, presumably in order to ensure that their platform is attractive to investors. Clearly, where intermediaries make specific commitments to investors, then they should be held to these commitments.

(iii) If the regulator chooses to restrict crowd-investing in equity to sophisticated, experienced or professional investors, then we believe that intermediary websites should only be required to have investors self-certify themselves as sophisticated investors.

Beyond this, we believe that simple risk disclosures, as outlined in response to Question 7 below, are a sufficient requirement.

We do not believe crowd-funding sites would want to offer investment advice as this would seem to run contrary to the spirit of the business model, and would presumably require separate licensing by ASIC for the provision of investment advice. ASIC might wish to specifically bar crowd-funding intermediaries from also providing advice, though this could also be left implicit in the rules (ie provision of advice would simply require a separate license). However, we believe there is scope to provide access to insurance products which may be used to enhance protections for investors.

With regard to client funds, we believe it would be fair to make crowd-funding intermediaries subject to the same rules for holding or managing client funds as apply to other forms of financial intermediary in Australia.

Provision of facilities for communication between investors and issuers should be left up to intermediaries – no regulatory view is necessary on this point.

Crowd-funding intermediaries should be subject to the same requirements on fee disclosure as apply to other financial intermediaries in Australia.

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.

In principle we believe that crowd-funding sites should be under obligation to provide on their websites clear warnings as to the inherently risky nature of equity investment in start up-ventures. In the case of crowd-lending, we believe that it should be made clear to investors that their investments do not attract the same level of protection as applies to a bank deposit.

We believe these disclosures are sufficient.

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?**

(i) As argued previously, we believe there may be a case for restricting crowd funded *equity* issuance to sophisticated, experienced or professional investors. However, we believe crowd-funded *lending* should be open to all investors

(ii) No.

(iii) We do not believe that there should be any limit on the amount investors may invest via crowd-funding.

(iv) Yes, investors should be required to acknowledge the risks inherent in crowd funding. This can easily be done by ensuring that investors have to acknowledge the warnings we referred to in our response to Question 7.

(v) A standard “cooling-off” period for investments may be warranted, at least in the case of equity investments. These should tie-in with any existing “cooling off” periods applying elsewhere in financial services regulations.

(vi) No.

(vii) No, there should not be any resale restrictions. In the case of crowd-lending, the capacity for investors to re-sell chunks of loan agreement is being very effectively used by the leading UK sites to replicate some of the liquidity provided by a bank deposit.

(viii) No, we do not believe there should be any new reporting requirements specific to issuers raising capital via crowd-funding.

(ix) There should be no recourse available to investors other than those that would already be available in the case of fraud or where a company breaks existing rules on financial reporting.

(x) There should be no new remedies made available to investors accessing crowd-funding beyond what would already be available to such investors under existing corporation legislation.

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?

As argued above, we believe that crowd funding can be accommodated through incremental adjustment to the existing provisions in the Corporations Act (primarily a liberalisation of fundraising restrictions for proprietary companies). We do not believe that a fully self-contained regulatory regime for crowd funding is necessary.