Submission to the Corporations and Markets Advisory Committee regarding Crowd Sourced Equity Funding

This submission is made by CrowdfundUP Pty Limited (CFU) in response to CAMAC's discussion paper regarding Crowd Sourced Equity Funding (CSEF).

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Introduction

CFU welcomes the CAMAC review of crowd sourced equity funding, and strongly supports the guiding principle that project promoters and intermediaries should be subject to appropriate legislation and regulation in order to protect the interests of all parties involved in CSEF, in particular funders.

Within that context, CFU also believes that the current legislative and regulatory framework is not well suited to this fast growing and evolving activity. An inappropriate, inflexible or overly prescriptive regulatory framework has the potential to stifle an exciting new avenue for Australian startups and Small to Medium Enterprises (SMEs) to efficiently source equity capital, potentially harming Australia's competitiveness, employment and reputation for innovation.

There have been many recent examples of high growth Australian companies (eg Atlassian, 99Designs, OzForex) being forced to source capital offshore, ultimately resulting in the majority of economic benefits flowing to offshore parties.

CFU has provided its responses to the specific questions raised in the discussion paper below.

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

Amendments to the Corporations Act 2001

Current Australian corporations legislation imposes rigorous licensing, compliance and disclosure requirements that would cause CSEF in Australia to be at least unwieldy, or potentially unfeasible altogether.

Law reform should be undertaken to enable CSEF as a feasible alternative to traditional sources of equity capital, thereby encouraging entrepreneurs and business owners to advance innovation in the Australian economy, and to keep pace with international peers and competitors.

Of particular importance in this context are:

- the broad definition of "dealing" in a financial product, defined in s766C of the Act, and the consequent AFSL licensing obligations in Part7.6 of the Act;
- the fundraising disclosure requirements in Chapter 6D of the Act;
- the definition and compliance obligations of Managed Investment Schemes under Part 5C of the Act (assuming there are more than 20 funders); and
- the broad definition of “financial market” in s767A of the Act.

Advantages for the Australian economy

In the context of SME financing, we believe that CSEF has the potential to provide a viable alternative to bank debt, venture capital or initial public offering (IPO) financing. CSEF could effectively contribute to bridging the "finance gap" that currently exists for small firms and innovative projects between personal sources of finance, and institutional funds. Improved access to finance for small businesses would in our view promote entrepreneurship and ultimately contribute to economic growth. [1]

Ultimately CSEF creates opportunities for those who otherwise would not have access to traditional forms of finance to engage in entrepreneurial activity.

Advantages for Project Owners

CSEF brings many further advantages to project owners in addition to access to funding. These include early market testing and market validation, reduced product development and marketing costs, and broad reach to consumers. Project owners further benefit from feedback, advice or other resources from the "crowd". [2]

Advantages for Contributors

CSEF offers the opportunity for individual investors to participate in emerging and entrepreneurial ventures, which is currently restricted to a small population of professional and institutional investors and venture capitalists.

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. The small scale offering exemption should be varied to allow for up to 100 purchasers or investors.

(ii) No. CSEF should be made available all legally capable prospective purchasers.

(iii) To enhance investor protections, we recommend consideration be given to a cap on the amount that may be invested by those not considered to be

[1] European Commission, Directorate General Internal Market and Services , Consultation Document, "Crowdfunding in the EU – Exploring the added value of potential EU action" (3 October 2013) - http://ec.europa.eu/internal_market/consultations/2013/crowdfunding/docs/consultation-document_en.pdf

[2] Ibid.

sophisticated investors of, for example, 2 investments totalling no more than $10,000 per annum.

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) The current proprietary company shareholder limit under s113(1) of the Act should be amended to allow up to a minimum 100 non employee shareholders, to allow a viable level of CSEF to be conducted.

While this amendment would allow an additional number of shareholders, it would also allow the CSEF provider to set a lower individual funding requirement, thus limiting financial risk for individual funders.

(ii) We do not believe any changes are required to the regulation of public companies.

(iii) Due to the differing characteristics of MIS, the following additional disclosures should be required;

- the identity of the Manager
- fees and expenses charged by the Manager
- available mechanisms to remove / change the Manager

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) Restrictions should not be put in place on the type of company which may issue shares through CSEF. In practice any restrictions would be subject to difficult issues of interpretation and compliance.

(ii) Only ordinary shares and preference shares should be offered through CSEF. The rights and obligations of shares issued through CSEF should be identical to shares already on issue.

We oppose special classes of shares being created for CSEF purposes, potentially with restricted rights. We believe this may allow sponsors to issue shares at an economic disadvantage to existing shareholders.

(iii) Yes, we believe the ceiling should be $5 million within a 12 month period. The ceiling should be inclusive of all funds raised by whatever means.

We note that median CSEF equity raised is increasing quickly in all markets, and in Australia ASSOB has already conducted an equity fund raising of $3.5m.
For that reason we recommend an increased limit of $5m to accommodate expected ongoing growth and to allow larger enterprises to utilise CSEF.

(iv) The disclosure regime should mirror that of the Offer Information Statement contained in the Corporations Act 2001 s715, excluding ss6 which would be irrelevant.

"An offer information statement for the issue of a body's securities must:

(1) identify the body and the nature of the securities;
(2) describe the body's business;
(3) describe what the funds raised by the offers are to be used for;
(4) state the nature of the risks involved in investing in the securities;
(5) give details of all amounts payable in respect of the securities, including any amounts by way of fee, commission or charge;
(6) state that a copy of the statement has been lodged with the Australian Securities and Investments Commission ('ASIC') and that ASIC takes no responsibility for the content of the offer information statement;
(7) state that the offer information statement is not a prospectus and that it has a lower standard of disclosure than a prospectus;
(8) state that investors should obtain professional investment advice before accepting the offer;
(9) include a copy of a financial report for the body; *see note below
(10) include any other information required by regulations"

* While we support the requirement for financial reporting under s715, we believe the requirements of s715(2) in the case of startups and SMEs are overly prescriptive, costly and burdensome. We recommend an abridged form of financial report be allowed for CSEF purposes.

(v) Typically a crowdfunding campaign will rely on the issuer to generate at least 90% of traffic and investment from their existing networks.

"The truth is, you need to drive the bulk of the traffic to your campaign page yourself. Platforms do a good job of promoting interesting projects but even then, the majority of the views and dollars (usually 80-90 percent) come from other channels and promotional efforts outside of the platforms."
Clay Herbert

We therefore believe that an issuer should be allowed to advertise freely, however such advertising:

- must not be misleading or deceptive;
- must not make financial forecasts which are unreasonable or unrealistic;
- must not contain a recommendation to invest; and
- must not solicit funds directly.

However while advertising should be freely allowed, the provision of investment related information, and the collection / management of funds should be restricted to the CFP. This prevents the potential solicitation and handling of funds outside the regulated (CFP) environment.

(vi) Section 728(1) of the Corporations Act already provides a sufficient issuer liability regime:

"Offering securities under deficient disclosure document. A person must not offer securities under a disclosure document if:[3]

1) there is a misleading or deceptive statement in the disclosure document, in any application form that accompanies the disclosure document or in any document that contains the offer if the offer is not in the disclosure document or the application form;
(2) there is an omission of information required to be included in the disclosure document; or
(3) a new circumstance has arisen since the disclosure document was lodged and the new circumstance would have been required to be included in the disclosure document if it had arisen before the disclosure document was lodged.

The person who offers the securities, a person who is involved in the contravention and other specified persons may be liable to compensate a person who suffers loss due to the contravention.[4]

(vii) We believe CSEF intermediaries should be able to facilitate both issues of new securities, and the sale of existing securities. In the case of new securities, we recommend that new securities only be permitted to be "traded" after a period of 12 months - in order to promote an orderly market for both issuers and investors.

(viii) No further comments.

[3] Corporations Act 2001 s 728(1)
[4] Corporations Act 2001 s 728(3)

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?

The Australian Market Licence (AML) regime is in our view overly restrictive, and onerous, to facilitate the viable use of CSEF by intermediaries.

We believe that a modified form of AFSL licensing is appropriate. We favour the principles of the recently enacted Financial Markets Conduct Act in New Zealand.

"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
  - the processes for matching of issuers and investors by the service
  - where applicable, the processes for handling of investment funds and payments to investors."[5]

[5] CAMAC Discussion Paper (September 2013), section 6.3.1.

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

(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

(i) (a) Yes, using a modified AFSL license

(i) (b) As for an AFSL

(i) (c) A platform must have the following minimum information platform available on its site:

Background information of executives and key personnel
"About us" section
Terms and Conditions
Copyright Policy
Privacy Policy
Contact details
AFSL / MIS or equivalent registration number
Section to explain how the platform works and the risks involved
Where the funds are kept until paid out to the fundraiser
Detailed schedule of fees
Stated policy for handling disputes

(i) (d) Yes, intermediaries should be required to have a stated internal dispute resolution process.

Yes, intermediaries should be members of an approved external dispute body.

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

(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

(ii) (a) We recommend that projects should not be allowed by any persons who have been declared bankrupt, banned from being a Director of a company and have any previous fraud convictions. Additionally we will not allow "inappropriate" projects such as those related to pornography or gambling.

(ii) (b) We recommend that a compulsory National police check be carried out.

(ii) (c) Intermediaries should conduct pre listing due diligence for CSEF projects. As a minimum, intermediaries should conduct reviews to ensure;

- the company is properly incorporated
- the company has the authority to conduct a fundraising
- financial forecasts are not unrealistic or unreasonable, and are based on reasonable assumptions
- appropriate risk disclosures are made

We do not believe it is the responsibility of intermediaries to conduct ongoing due diligence. In our view this would place an unreasonable cost and resource burden on intermediaries.

(ii) (d) We do not believe intermediaries should bear any liability for statements made by issuers, in particular if appropriate due diligence has been conducted.

If however an intermediary becomes aware that a project is acting illegally, without taking timely action (such as delisting the project) the intermediary could be held liable to a limited degree.

(ii) (e) Intermediaries should not be held accountable for investor losses, in particular if appropriate due diligence has been conducted.

(ii) (f) Intermediaries should not be permitted to hold, or buy shares in any company raising funds by way of CSEF. This prohibition may be lifted after 12 months after the completion of the project.

While we acknowledge the potential for a conflict of interest arising from the intermediary's remuneration and a project fund raising target, we believe that this risk is negligible.

(ii) (g) Funds raised during a project should be held on Trust in a segregated account until the completion of fundraising. Funds should only be released to the issuer when legally binding share ownership documentation has been provided to funders.

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

(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

(iii) (a) We do not believe any form of screening or vetting is necessary. The platform however should state clearly that funders must be legally capable of owning shares.

(iii) (b) The intermediary should be required to provide a general risk warning regarding investment risk.

(iii) (c) Intermediaries platforms should automatically monitor limits for;

- overall project funding limit
- funders individual limit

(iii) (d) Intermediaries should be prohibited from providing any investment advice.

(iii) (e) Intermediaries should be allowed to promote their service, and solicit business in accordance with relevant laws. However intermediaries should not be permitted to promote their service on the basis of projected or forecast project projected returns.

(iii) (f) All investor funds should be held in Trust, in segregated client accounts. Funds should be disbursed to project sponsors only when appropriate share ownership documentation has been provided to investors.

(iii) (g) Intermediaries should provide a messaging facility to allow for direct communication between issuers and investors.

(iii) (h) Intermediaries should be required to provide a clear, prominent and up-to-date avenue to refer complaints both for internal resolution, and to an external dispute resolution service.

(iii) (i) Intermediary fees or commissions should be clearly and fully disclosed.

(iii) (j) No further comment

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

(iv) any other matter?

(iv) We strongly believe that tax relief measures be considered in relation to CSEF to encourage the growth of small to medium enterprises. We believe measures similar to those of the UK's Enterprise Investment Scheme (EIS) should be considered.