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**By Email:** john.kluver@camac.gov.au (cc: camac@camac.gov.au)

Dear Sir

**Submission in relation to CAMAC's Discussion Paper on Crowd Sourced Equity Funding (September 2013)**

I refer to the Corporations and Markets Advisory Committee (**CAMAC**)'s discussion paper on crowd sourced equity funding (**CSEF**) dated September 2013 (**Discussion Paper**).

**Introduction**

1. "Crowd sourced funding" has received extensive media coverage as a new, fashionable, cheap and easy method of raising funds for various causes and projects. However CSEFs should not be mistaken with other forms of crowd sourced funding such as, crowd sourced donation funding.
2. A recently publicised example of a crowd sourced funding platform which is not CSEF is kickstarter.com which featured in an article in The Australian Financial Review on 16 October 2013. The primary participants in Kickstarter are: the entity looking for funding who pitches their project on the Kickstarter platform (**Project Operator**); the person who invests into various projects (**Investor**); and Kickstarter which manages the platform and interaction between the Investor and the Project Operator. The Project Operator may provide the Investor with a (non-financial product) gift if their project is successful - no equity is issued or transferred to the investor.
3. The main participants in a CSEF are: the issuer of the equities or promoter of the scheme requiring funds (**Issuer**); the CSEF platform provider/operator (**Intermediary**); and the potential Investors.
4. The Discussion Paper identifies various approaches in relation to the Issuers, Intermediaries and Investors that have been or are being considered in various jurisdictions to protect the integrity of equity markets and retail Investors<sup>1</sup> by imposing various restrictions and obligations the main participants in CSEFs.

**My Submissions**

5. While Australia does not have specific CSEF regulation, the current Australian financial products and fundraising regulatory framework (**Australian Framework**) contains restraints which apply to activities such as CSEF which are similar to the restraints which the United States of America, Canada, Italy the United Kingdom and/or New Zealand are implementing or propose to implement in their respective jurisdictions.

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<sup>1</sup> The test for whether an Investor is deemed a retail Investor varies from country to country. In Australia, broadly speaking, a **retail Investor** is an Investor who is not a **wholesale Investor**, that is, an Investor: (a) in relation to equity offers, where the minimum investment of \$500,000; (b) whose investment is in relation to a business that has 20 or more employees or if it is in manufacturing 100 or more employees; (c) is certified by an accountant has having net assets of at least \$2.5 million or gross income for each of the last 2 financial years of at least \$250,000; (d) is a professional Investor (eg. has an AFS licence, is regulated by the Australian Prudential Regulation Authority, has or controls at least \$10 million worth of assets; is a trustee of a superannuation fund with at least \$10million of assets or is a listed entity); or (e) is a sophisticated Investor (ie. there are reasonable grounds to believe that the Investor has relevant experience in, knowledge and understanding of offers and investments of the kind contemplated and the Investor has provided the Issuer a certificate prior to the issue of equity of the same).

6. Investor restraints:

- (a) The Australian Framework includes a cap on the value of investment per Issuer per year by way of its exemption from:
- (i) managed investment scheme<sup>2</sup> (**MIS**) registration; and
  - (ii) the requirement to issue prescribed regulated disclosure documents, (such as prospectuses and product disclosure statements) for public offers of equity to retail Investors (**Current Regulated Disclosure**),

where the offer is a Small Scale Offer (this is, in summary, an offer to raise no more than \$2 million and from no more than 20 retail Investors in any 12 month period). This limits the quantity of Investors which may be affected by a failed or fraudulent CSEF activity to \$2 million and 20 retail Investors.

- (b) The Discussion Paper suggests that the Small Scale Offer exemption may need to be reviewed and modified as a method of dealing with CSEF.
- (i) The existence and implementation of the Small Scale Offer exception since 2001 suggests that the Australian financial industry and Parliament alike have agreed that public offers of equity to a limited number of retail Investors should be allowed without:
    - (A) regulated disclosure documents; or
    - (B) the Issuer being a public company or registered MIS (and therefore not subject to the reporting and other obligations imposed on public companies or registered MISs).
  - (ii) Furthermore, proprietary companies (which may, depending on its size, not be subject to the reporting and other obligations imposed on public company or registered MISs) are allowed to raise funds through the (non-public) issue of equity to up to 50 non-employee shareholders.
  - (iii) Given the above, increasing the cap on Investors through a Small Scale Offer from 20 retail Investors to, say, 50 retail Investors (together with other Investor protection measures and a reduction of red tape and compliance costs to Intermediaries) would be in line with the principles embodied in the Australian Framework and a step in the right direction for capital markets.
- (c) The Australian Framework also includes a cap on the value of investment in all Issuers by Investors based on the Investor's wealth in the form of the exemption from Current Regulated Disclosure for offers to wholesale Investors.
- (i) This wholesale Investor exemption is intended to ensure that those who may invest alternate funding arrangements such as CSEF (outside of Current Regulated Disclosure) have the experience, skill and/or wealth to engage advisors to properly assess their investments and/or sufficient wealth to be able to bear potential losses.
  - (ii) However satisfying the wholesale Investor test (eg earning more than \$250,000 per annum in each of the last two financial years or agreeing to invest a minimum of \$500,000 in any one Issuer) is a poor indicator of the individual's understanding or investment skills. It is my view that a knowledge based test (in particular regarding risk) would be a better

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<sup>2</sup> A 'managed investment scheme' (**MIS**) is defined in the Corporations Act as a scheme whereby people contribute to acquire interest in (actual, prospective or contingent) benefits produced by the scheme, the contributions are pooled to produce benefits for the people and the members of the scheme do not have day to day control of the operation of the scheme or a time-sharing scheme. The Corporations Act also provides limited exceptions to this definition. Under the Act, unless certain conditions are satisfied, a MIS must be registered.

indicator of an Investor's ability to assess CSEF investment offers and a more egalitarian approach to who is given access to potential investments.

- (iii) I suggest the following as additional or supplementary requirements for exemption from the Current Regulated Disclosure:
- (A) Investors in CSEF must pass a CSEF investment risk knowledge test (as in the USA and Canada) in addition to satisfying the order conditions of the Small Scale Offer exemption; or
  - (B) as an entirely new exemption category from Current Regulated Disclosure, the Investor must pass (every 24 months that the Investor invests through the CSEF platform):
    - (I) a comprehensive online CSEF general knowledge test (generated by the Intermediary and audited by the Australian Securities Investment Commission (**ASIC**)) in order to be granted access to CSEF offers; and
    - (II) a CSEF offer specific online test based on the investment facts and other terms of the relevant CSEF offer generated by the Intermediary from input by the Issuer; and
  - (C) Investors must hold the CSEF equity for a minimum period to discourage speculative investment.

7. Issuer restraints:

- (a) Under the Australian Framework if an Issuer offers to more than 20 retail Investors (that is offers to wholesale Investors and those not exempt under the Small Scale Offers exemption) the Issuer:
- (i) must be a registered MIS or public company and thereby regulated and monitored by ASIC as such.
  - (ii) must provide detailed prescribed disclosure documents to potential Investors which sets out important information and relevant information in relation to offer.
- Furthermore, the Issuer, as a public company or a registered MIS, would be required to prepare and lodge audited financial reports annually with ASIC.
- (b) Under the Australian Framework regardless of what facility or technology is employed to raise equity:
- (i) an Issuer will be liable for any misstatements or fraud it was responsible for;
  - (ii) Investors will be entitled to pursue remedy for damages against the Issuer in relation to such misstatements or fraud; and
  - (iii) ASIC may take action against the Issuer and/or its directors for any breaches of the Corporations Act (eg fraud, negligence of the directors or breach of other obligations, such as reporting obligations, under the *Corporations Act 2001* (Cth)).
- (c) Given the public nature of CSEF offers, the Issuer should also be required to disclose online:
- (i) in a short form disclosure statement (similar to the simple managed investment scheme's 8 page Short Form Product Disclosure Statement),

- prescribed information about: its finances; its business plan; its equity structure; the target and deadline to achieve the financials; its ownership structure; and its management at the time of listing on the CSEF platform;
- (ii) any changes to occurrence to any circumstances salient to the information contained the Information Memorandum; and
  - (iii) updates and annual reports on the matters contained in the Information Memorandum.
8. Intermediary restraints:
- (a) Under the Australian Framework any financial product market operator, regardless of the facility in which the market is operated or to whom the market is targeted to, will require licensing in Australia.
  - (b) Given the broad definitions under the Corporations Act with respect to the Australian Market Licence (**AML**), an Intermediary will need to apply for and hold an AML to operate the CSEF. There is no need to create a new registration or authorisation regime for Intermediaries as ASIC may impose CSEF specific conditions n the AML licensees who intend to operate CSEF.
  - (c) Given the rigorous pre-requisites to be issued with an AML, there is no need to restrict Intermediaries of CSEFs to financial institutions as required in Italy.
9. The UK's approach of CSEF funds being held by a custodian and released to the Issuer only if the target has been reached (within the deadline) should be followed in Australia.

## Conclusion

10. In order for Australian entities to benefit from CSEF as a low cost alternate funding method for start up businesses in Australia:
- (a) the existing effective crowd cap of 20 retail Investors should be expanded by a knowledge based test exemption together with or standing alone from an expanded Small Scale Offer exemption;
  - (b) Intermediaries should still be required to be licensed as market operators but the process, prerequisites and licence conditions should be made quicker, cheaper and more relaxed so as to lower barriers to listing on the Intermediary's platform and funding for the Issuer; and
  - (c) certain CSEF industry specific safeguards should be put in place to protect Investors (such as, short form disclosure requirements for Issuers and the requirement on Investors to hold CSEF investments for at least one year).
11. My above suggestions attempts to balance retail Investor protections against the encouragement of small/medium businesses and the CSEF industry. These suggestions should, to the extent possible, be incorporated in:
- (a) the existing provisions of the Corporations Act and existing regulations and exemptions; and/or
  - (b) new class orders,
- as this would likely be cheaper and more easily understood by the existing financial and private equity industry and stakeholders.
12. However even if no change is made to the existing Australian Framework, non-equity based crowd funding may still be utilised as a method of raising funds for innovation and

new business start ups (like Kickstarter.com) and traditional methods is likely to continue to dominate as the preferred method of raising larger funds.

13. For example, non-equity based crowd funding would allow Issuers to obtain funds from a wider crowd (it would not be limited by any restriction on numbers of shareholders or investors under equity fund raising provisions of the Corporations Act). Crowd sourced debt funding (as opposed to equity) would provide the Investors with priority to the proceeds of the business before distribution to equity holders and avoid any impediment or delays in the business operations that may otherwise arise from a diverse and diluted equity holding.
14. Given the:
  - (a) high risk nature of retail Investors investing in new start up business without a prospectus, product disclosure statement or audited financials, and
  - (b) more intrusive nature of raising funds through issuing equity,

it may be more suitable for such business projects to raise funds through non-financial product means until they grow to a sufficient commercial standing that it can raise funds the more traditional way (i.e., through banks, private equity, angel Investors or through the existing regulated public offers regime).

If you have any queries about this personal submission please do not hesitate to contact me.

Yours faithfully,

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