Submission to

Corporations and Markets Advisory Committee

On

Crowd Sourced Equity Funding

Gerard Shea

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About Me

NAME: Gerard SHEA
EMAIL: gpshea@bigpond.com
MOBILE: 0409 598 915
AGE: 45

EDUCATION:

Graduate Diploma of Legal Practice - Australian National University - exp 2014
Bachelor of Laws - Southern Cross University - exp 2013
Diploma of Financial Services (Financial Planning) - Tribeca Learning - 2005
Diploma of Financial Planning - IAFP/Deakin University - 1990

I also have partial qualifications in Accounting and Information Technology.

RELEVANT EMPLOYMENT:

I have four years experience as a Purchasing Officer with the Department of Defence, five years as an Investigator with the Australian Securities Commission (now ASIC), nine years working with the Health Insurance Commission and eight years within the financial services industry with exposure to financial planning and compliance. I have been a Justice of the Peace for 23 years.

OTHER MATTERS:

I have a strong personal interest in peer-to-peer and crowdsourced funding.

I am currently a director of P2P Financial Services Pty Ltd through which was established with the objective of developing and offering P2P/CSEF facilities. This company is currently dormant and has not yet traded.

Background

Throughout this submission the internet and the world wide web will be collectively referred to as "the internet". Similarly, unless otherwise specifically referenced, Peer to Peer (or P2P) funding and Crowdsourced funding will be collectively referred to as "CSEF" although it is acknowledged that CSEF is more commonly used for equity funding and P2P for debt financing.

The *raison d'être* of CSEF is to facilitate the provision of finance to and from sources that would otherwise not be engaged in the financial system. It serves to complement existing conventional financial services, leveraging off the ability of the internet to overcome the two biggest impediments faced by traditional markets - the 'tyranny of distance' and the 'coincidence of wants'.

CSEF has also arisen due to dissatisfaction with traditional financial intermediaries and a perception that modern technology is rendering the role of the traditional intermediary obsolete. This was envisioned as far back as 1997, "…an emerging view that technological developments and financial innovation have stripped banks of their pivotal position in the financial system.[1]"

The fundamental principles underlying CSEF are simplicity, utility and equity/fairness. Any facilitation and/or regulation of CSEF must bear these principles in mind.

[1] Warren P Hogan and Ian G Sharpe, 'Prudential Regulation of the Financial System: A Functional Approach' (1997) 4 *Agenda* 15.

As CSEF is still in its infancy any regulatory scheme needs to be tailored accordingly. Once CSEF proves its viability within the financial system a more complex and extensive regime of regulation may be implemented.

Any regulatory scheme needs to avoid stifling CSEF or prematurely incurring an unnecessary level of expense for CSEF participants or regulatory agencies.

Questions and Answers

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

In principle, yes. The use of CSEF is intimately linked with the growth of the internet. The internet is already facilitating conventional financial services functions through the provision of online banking and the ability to make purchases online. This level of involvement can only increase over time, in both it's current and any evolved form. It would be irresponsible to ignore the growing impact the internet will have on the provision of financial services in the near and distant future especially if Australia is to remain globally competitive in the provision and utilisation of financial services.

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?

Any regulatory scheme should manifest as a variation to the existing small scale offering exemptions as this would serve to minimise necessary legislative enactments and also bring CSEF within the general fold of fundraising provisions. This would have the collateral advantage of giving credibility to the CSEF industry which may deter infiltration by less savoury participants.

Confining CSEF to sophisticated or professional investors would defeat the fundamental purpose of CSEF in both a practical and ideological sense.

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?

Proprietary companies should be permitted to participate in CSEF. It is unlikely that public companies would need to utilise CSEF, due primarily to scale, but if they were to be permitted to participate such participation should be restricted to raising funds for a specific need or project and not general fundraising. This would be in accordance with the general philosophy and structure of CSEF. In considering economic efficiency, it is also likely that permitting larger entities to utilise CSEF would drain the limited amount of funds available, making them less accessible to those entities that could benefit most from them.

The use of Managed Investment Schemes ("MIS") adds an additional level of complexity that is not really attuned with the philosophy and/or practicality of CSEF. A dual level of disclosure would be required by an MIS relating to both the operations of the MIS and the underlying companies within the fund/s it managed. If MIS's are permitted to participate in CSEF it may be best limit the MIS to

holding the securities of one underlying entity as an MIS holding a diverse portfolio of securities may best be regulated under the existing MIS regime.

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?**

The philosophy and methodology of CSEF would best serve the needs of small proprietary companies or small businesses. As per the US JOBS Act, investment companies should not be permitted to directly participate in CSEF, however they should be permitted to participate in any official or pseudo secondary markets of CSEF securities (discussed elsewhere).

The approach adopted by Italy, whilst commendable in principle, may prove to be difficult to administer given that much legal debate could be engendered on the definition of 'innovative start-up'. Such a term would best be left to the individual investor to define.

In order to maintain simplicity in the operation of any CSEF service and to reduce the intellectual burden on investors, issuers should only be permitted to offer a single class of security - preferably an ordinary share for companies or a single class of unit for an MIS. Issuers wishing to offer diverse or complex financial instruments should utilise more sophisticated marketplaces in the interest of both themselves and potential investors.

From both a legal and operational perspective, there is no fundamental difference between the existing small scale offer provisions and the use of CSEF. Both seek to raise funds directly from investors without the issue of any formal disclosure documentation. It would be appropriate therefore to include any amount raised in the existing small scale offering ceiling.

The 'Crowd' element of CSEF places a focus on obtaining funds from a large number of investors, usually with a commensurately smaller individual *per capita* contribution. In order to achieve this, the existing 20 investor limit for small scale offerings would be manifestly inadequate. Separate provision should be made to allow a greater number of investors if CSEF is utilised, whilst retaining the 20 investor ceiling for any non-CSEF investors. This has two collateral advantages. First, it spreads the risk across a greater number of investors. Secondly, by using a CSEF intermediary a base level of disclosure and scrutiny is present. This could generally provide more protection to investors than what is available under direct approach to individuals, through the aforementioned disclosure and scrutiny but also through the ability of CSEF participants to provide commentary and exchange information on CSEF websites regarding potential investments.

It should also be possible for issuers to engage in 'hybrid' fundraising whereby equity can be raised simultaneously with other non-equity funds, such as donated money, providing the relevant ceilings are not breached for the equity component.

Any disclosure requirements should be significantly less onerous than existing Product Disclosure Statement ("PDS") requirements. They should fall within an amended small offer exemptions regime. If only a single class of shares and/or units are offered, as suggested elsewhere herein, only generic information relating to the nature of the security need be disclosed. Combined with information relating to the purpose of the fundraising and some background on the issuer this may suffice. Known or perceived risks to the project and projected income/returns may also prove useful where these can be ascertained with a degree of accuracy.

Advertising should only take the form of the information displayed on the CSEF website or on a central register held by an independent body specifically to list CSEF projects that has links back to the CSEF website.

Investors obtaining securities via CSEF should have no greater or lesser advantages than any other investor. This would require a limit on how shares held in proprietary companies could be disposed of. Having said that, given the greater number of participants likely to have smaller holdings of securities, it is in the interests of economic efficiency to facilitate disposal. This may best be achieved via a CSEF provider acting as intermediary for the exchange of securities originally offered through that same CSEF provider or via a requirement that issuers offer the ability to exchange securities using their in-house share registry. It would also be theoretically possible for an issuer to utilise a CSEF intermediary to securitise existing issues (primarily for P2P loans) or offer their own securities in exchange for other issued securities. Whilst this effectively creates an investment company, the aforementioned single share/unit class restriction would retain the CSEF nature of such an undertaking whilst facilitating liquidity in CSEF markets.

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

CSEF intermediaries can take two forms. First they can act as a pure intermediary by merely listing securities and facilitating the matching of issuer and investor. Secondly, they can be actively involved in the transaction. This distinction is more pronounced in the P2P lending markets where some intermediaries act as pseudo banks by holding and consolidating investor funds and dispensing them to the relevant issuers - the 'pooling and divisibility' function of the financial system[2]. This active participation adds an additional level of risk for investors, particularly of a professional indemnity nature. Intermediaries should be discouraged from actively participating in transactions and maintain their role primarily as an exchange, akin to the ASX.

Any licencing regime should serve to act primarily as a formal registration system. Intermediaries not actively involved in transactions should be registered and listed on a central registry held by ASIC. To qualify for listing such intermediaries would need to include certain content on their websites (discussed elsewhere). Intermediaries who do take an active part in CSEF transactions should require a higher level of licencing akin to those required by other 'dealers' in financial services and products.

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

[2] Hogan and Sharpe, above n 1, 21.

(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

As previously mentioned intermediaries should be registered rather than licenced (this refers only to those not actively participating in transactions). Registration allows for sanctions to be imposed via de-registration. There should be no statutory requirements vis-à-vis financial/human/technology resources as these will manifest themselves on the relevant CSEF exchange and any failures will soon result in the demise of underperforming intermediaries, which should have minimal impact on investors and issuers if the intermediary has not played an active role in any transactions.

The principal risk management functions that an intermediary can undertake are to screen investors and issuers prior to allowing participation. The exact form such screening takes would best be left to the individual intermediaries but should be explained on their respective websites.

(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

CSEF should be available to raise funds for any project except those that have an illegal purpose. Some projects, e.g. mining operations, will be excluded from raising funds via CSEF purely due to the relevant ceiling imposed on fundraising.

Due to the start-up nature of most issuers using CSEF, there is little that due diligence by an intermediary could offer as an added level of protection to investors. It would be inappropriate and administratively difficult for both the participants and regulator to impose statutory due diligence requirements on intermediaries. In addition, the assumption of due-diligence requirements by intermediaries exposes them to potential litigation for any errors and/or omissions which are inevitable given the aforementioned start-up nature of most issuers and the limited resources available to intermediaries. Any due diligence undertaken would need to be optional and voluntary. Notwithstanding the aforementioned considerations, it is preferable for CSEF intermediaries to act as pure intermediaries and this minimises both the need and obligation for undertaking due diligence checks whilst not absolving the intermediary from requiring certain levels of disclosure by issuers. This is akin to the role of the ASX which holds itself out to be "…a regulated entity with some supervisory functions…[3]".

[3] Australian Securities Exchange, 'ASX's Role in Australia's Financial Regulatory Framework' (2008) *ASX Position Paper* 3.

Full disclosure by issuers would be the most effective way to address this issue. An important check that would be required is proof of identity for both issuers and investors. Online services often do not require such proof and this should not be permitted in the CSEF industry.

Intermediaries who act as pure intermediaries should not be held responsible for any errors/omissions/misleading statements made by issuers unless the accuracy and/or authenticity of those statements can be readily verified. This should not prevent intermediaries from establishing their own fidelity-type funds to compensate for losses on a voluntary basis. The same can be said for liability for fraudulent activities undertaken on an intermediary's website.

Self-dealing should be discouraged on CSEF platforms but if this is unavoidable it should be clearly disclosed in a prominent location and/or the relevant issuer listing clearly flagged to bring the attention of investors to a potential conflict of interest.

Funding models relating to remuneration should be fully disclosed.

Intermediaries should be discouraged from holding investor funds. If such a service is to be offered it would be best if they were held by an independent trustee. Such trustees could be entities registered as such by an appropriate body.

(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?**

Given that CSEF, both philosophically and mechanically, is intended to be used primarily by lay individuals it is imperative that participants have at least a basic understanding of the nature of the transactions they are entering and the implications thereof. This would best be achieved through some sort of educational function. One option would be an online quiz on the intermediary's website that needs to be completed before an investor can utilise the site. Another option would be to have an external entity offer an educational service that provides certification that can be used to access intermediary websites.

Intermediaries should only be required to disclose generic risks to investors as they may not be qualified to offer detailed risk analysis and doing so could render them subject to legal liability issues. Offering comprehensive risk assessments may also constitute offering investment advice which should not be permitted by intermediaries.

Assuming that it is expedient to impose a limit on investors, intermediaries could prevent breaches of any statutory or voluntary investment limits by having a central registry that maintains running totals of amounts invested by individual investors. This could be accessed automatically by individual

intermediaries before processing any application by an investor. If a transaction would breach the relevant limit it would not be permitted to proceed and the investor notified accordingly.

Issuers should be required to include contact details in their listings on intermediary websites. There should be no requirement to have any 'bulletin board' or 'forum' facility on the websites for this purpose as it could constitute breaches of privacy and/or confidentiality and act to deter open communication between investors and issuers. However, intermediaries should offer such facilities for communication between investors and/or the public as this would facilitate the dissemination of information among investors that may not otherwise be available.

Pure intermediaries should only be responsible for addressing issues directly related to the listing of projects by issuers on their websites and the behaviour of issuers and investors on those websites. To facilitate the handling of more complex and serious complaints, intermediaries should be required to pass on such complaints to the relevant authorities and include links and/or contact details for such bodies on their websites. These should be placed in an obvious location such as a separate webpage clearly titled 'complaints'. Intermediaries who actively participate in transactions would need to address any complaints that arise from those activities and the permutations thereof are too numerous to address herein.

As previously outlined, disclosure of fees and commissions should be total.

Assuming it would be financially viable, it may be appropriate to restrict intermediaries to listing either projects or equity raisings but not both. This would serve to clearly differentiate between the two in the minds of the investor/donor. If it would not prove financially viable, then the two categories of issuer listings should be clearly identified and listed separately so that they do not appear together in any list on the intermediary's website.

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.

These matters can best be addressed through the use of the aforementioned online quiz and/or external education certification. If only one class of share (preferably ordinary) and/or unit is permitted to be offered the problems associated with differentiation between share and unit classes does not arise. Whilst this may limit the ability of an issuer to tailor their fundraising accordingly, they must be aware that CSEF operates in a financially unsophisticated environment.

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?**

There should be no real limits on who can be a CSEF investor, subject to normal contract law provisions. As previously mentioned, it may be beneficial to require some sort of basic educational foundation prior to permitting an investor to transact on an intermediary website. This should be consistent for both professional and 'amateur' investors. Whilst professional or sophisticated investors may resent the need to 'prove themselves' in this manner, this is countered by their obvious advantage in having sufficient knowledge to easily complete the educational assessment. In addition, the educational content will address the peer-to-peer and crowdsource nature of the facility which is not addressed in traditional investment education.

No sophisticated investor threshold requirements should be implemented as this runs counterintuitive to the philosophy of CSEF. It also opens up potential avenues for the exertion of bias and control over issuers that may be detrimental to investors in general.

There is no compelling ethical or moral reason to implement investor or issuer linked caps. Investors should be free to invest as they see fit. However, from an operational perspective it may be prudent to limit individual investors to a cap on the total amount of investment they may make in a given period and/or hold at any point in time. This also adheres to the 'crowd' aspect of CSEF which aims to gather small amounts from a larger body of investors. This would be self-regulatory if a statutory obligation was imposed requiring issuers and/or intermediaries to evenly distribute securities to those who have applied. This is best summed up in a table as follows:

Project: $20,000 to be raised by issuing 20,000 shares @ $1 each.		
Investor:	**Equity Sought:**	**Equity Issued:**
A	$5,000	$5,000
B	$1,000	$1,000
C	$10,000	$5,000
D	$5,000	$5,000
E	$4,000	$4,000
Total:	$20,000	$20,000

No individual investor would be able to invest a inordinately large amount of money into a single venture and any investment would be subject to the potential cross-checking against any central registry in operation as previously outlined.

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?

A minimalist approach should be adopted with CSEF fitted into the existing regime.

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

No further issues to raise.