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Submission – Crowd Sourced Equity Funding – Minter Ellison Lawyers

Minter Ellison Lawyers appreciates the opportunity to comment on the discussion paper Crowd Sourced Equity Funding issued by the Corporations and Markets Advisory Committee (CAMAC) in September 2013 and updated in October 2013 (the **Paper**).

Introduction

Crowd funding has undergone rapid global growth in the past couple of years and this looks set to continue.

Crowd sourced equity funding (**CSEF**) is a key component of the broader crowd funding picture. Entrepreneurs are increasingly seeking to offer crowd funding investors an equity interest in the underlying business as an incentive to attract funding and remain competitive in the global crowd funding market.

Overseas crowd funding projects are open, not only to local investors in that overseas jurisdiction, but also to Australian investors. This is because crowd funding traverses geographic and jurisdictional borders as it essentially exists entirely within the internet. Australia's crowd funding entrepreneurs are at a competitive disadvantage to their overseas counterparts because a key component, CSEF, is not readily accommodated under Australian law.

Crowd funding is undergoing rapid evolution. Other countries (including the United States) have responded quickly to update their laws to accommodate CSEF. In the current uncertain global economic environment, Australia should act promptly to accommodate CSEF and not fall too far behind the rest of the world.

This submission discusses each of the five options for reform contained in the Paper and suggests that the fifth option may be the best choice. Those five options are:

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

Which option is best?

The first option, no regulatory change, is potentially problematic. The current Australian framework is simply not designed to accommodate crowd funding and, therefore, is not a suitable long-term solution. If crowd funding continues to evolve in Australia, the regulatory framework will need to be substantially updated and refined to accommodate this new form of capital raising.

The second option involves increasing the 20 investor ceiling. This would facilitate CSEF if the 20 investor ceiling were raised significantly. However, because CSEF involves small investments from as little as A\$1 from each participant, the 20 investor ceiling would need to be raised significantly to allow for a meaningful level of capital to be raised. Raising the 20 investor ceiling to specifically accommodate CSEF may also distort a rule that has been in place for more than 20 years.

The third option involves restricting CSEF investment to sophisticated, experienced or professional investors. Although the third option is attractive from an investor protection perspective, it has the limitation that it will not allow CSEF fundraisers in Australia to attract 'small' contributions from ordinary internet users. This is a significant limitation because most crowd funding schemes rely on several small contributions (eg between A\$1 and A\$100) and the restricted pool of sophisticated, experienced or professional investors is unlikely to allow for a meaningful level of capital to be raised.

The fourth option involves maintaining the existing regulatory structure while 'cherry picking' CSEF regulatory initiatives from other jurisdictions. This option may lead to specific provisions to better facilitate CSEF within the existing regulatory framework by targeting areas of current Australian law that create difficulties for CSEF, including the following areas:

- fundraising by proprietary companies;
- compliance requirements for public companies that fundraise;
- managed investment schemes; and
- financial services licensing.

However, targeted amendments to our current framework may not be the most effective mechanism to facilitate CSEF and may consequentially cause difficulties for the regulation of other financial products and securities within an already complex framework.

Fifth option may be best

The fifth option involves creating a new, possibly standalone regime for the regulation of CSEF. This regime could be constructed to provide benefits for CSEF in Australia including:

- a definition of CSEF that essentially covers CSEF issuers that are granted a license by a specialist regulator (licenses could be granted according to fluid guidelines designed to capture the currently evolving nature of crowd funding);
- an exemption to existing fundraising disclosure and compliance requirements that covers all CSEF issuers that are licensed;

- clarity in the laws and regulations that apply specifically to CSEF (ie those laws drafted by the specialist regulator and enforced on licensed CSEF issuers);
- the ability to make future specific regulatory changes to CSEF laws that avoid any adverse impacts on the existing legal framework that applies to other regulated financial products and securities;
- the ability to specifically control the activities of Australian CSEF investors, issuers and intermediaries and determine investor protection measures to be implemented between these parties; and
- the ability to collect data on CSEF in Australia and allow for data analysis to measure risk, sector growth and to allow for more thoroughly informed and targeted law reform in this rapidly changing area.

This standalone regime would also be best placed to incorporate regulatory features specific to CSEF, as considered for incorporation into overseas CSEF regulatory regimes, including:

- allowing for flexibility in the event that a CSEF issue is oversubscribed (if oversubscription is dealt with under general Australian securities law, this may lead to less than optimal outcomes for CSEF issuers and investors (eg additional disclosure requirements if certain thresholds are breached));
- allowing for non-CSEF investors wishing to invest significant funds, into a business that has already obtained CSEF fundraising, to sit outside the CSEF regulatory regime (while not allowing the completed CSEF fundraising to distort the application of Australian securities laws to non-CSEF investors);
- establishing and maintaining a forum to encourage communication amongst the ‘crowd’ (this would allow greater investor protection by tapping into the key beneficial feature of CSEF, ‘the wisdom of the crowd,’ to ensure optimum investor analysis is available to all CSEF investors); and
- allowing insignificant non-compliance to be dealt with in a flexible and efficient manner that does not unnecessarily penalise small businesses for errors that are of little consequence for investor protection (and that does not require small businesses to obtain expensive and complex legal advice before commencing CSEF for relatively simple business ventures).

Incorporating these features directly into general securities law in Australia could introduce further distortions into existing laws that may be inconsistent with their original design, potentially adding further uncertainty to an already complex framework. A new, standalone regime for the regulation of CSEF could keep these features separate from general securities law in Australia avoiding these potential difficulties.

Conclusion

The key to effective crowd funding regulation is recognising that all crowd funding investors are subject to a higher risk of issuer default because crowd funding issuers are generally not well established. Limiting the risk exposure for participants in CSEF is rightly a key priority. However, CSEF should be governed by different investor protection mechanisms compared to other regulated financial products and securities. A key priority should also be to cultivate CSEF as a vehicle for economic growth and innovation, with appropriate protection for investors, while

minimising compliance obligations, legal complexity and uncertainty and liability risks for issuers.

Yours faithfully

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