

Submission to CAMAC: Crowd sourced equity funding

1 This submission

- 1.1 This is a submission to the Australian Government Corporations and Markets Advisory Committee (**CAMAC**) on their *Crowd Sourced Equity Funding Discussion Paper* dated October 2013 (**Discussion Paper**).
- 1.2 The views expressed in this submission are those of the authors and do not represent the views of Norton Rose Fulbright.

2 Introduction

- 2.1 As noted in the Discussion Paper, crowd sourced equity funding (**CSEF**) is a form of capital raising, typically characterised by small financial contributions made by a large number of investors. CSEF can be used to fund a wide range of activities including, for the purposes of this submission, start-ups.
- 2.2 Although relatively new, CSEF has become a well-established form of capital raising for start-ups and is now regulated (or proposed to be regulated) in a number of key financial markets. In the United States, CSEF is regulated by the Jumpstart Our Business Startups Act (**JOBS Act**). It is also proposed to be regulated in New Zealand.
- 2.3 Many Australian start-ups struggle due to a lack of access to capital. In some cases, they resort to foreign capital, or capital provided by friends and family (which is effectively unregulated). CSEF has the potential to provide that capital.
- 2.4 In our view, the Australian Government should follow the lead of the United States and New Zealand and establish a framework for the regulation of CSEF in Australia.
- 2.5 Supporting start-ups by facilitating their access to capital will have considerable benefits for Australia. In particular, it will lead to increased economic activity and employment opportunities. It will also assist in developing an entrepreneurial and innovative culture.

2.6 Regulatory framework

- 2.7 Given the unique characteristics and regulatory challenges posed by crowd funding, and consistent with the approach adopted in the United States, in our view a self-contained regulatory structure should be established to regulate CSEF in Australia.
- 2.8 Changes should only be made to the existing framework for raising capital under the *Corporations Act 2001* (Cth) (**Corporations Act**) to the extent that the Act is inconsistent with the CSEF regulatory structure.
- 2.9 Any regulation of CSEF should cover each of the main participants in CSEF, ie. issuers, intermediaries, and investors.
- 2.10 Given the small amounts of capital involved, and the lack of sophistication of all the main participants in CSEF, any regulation should be kept to the minimum necessary. Detailed regulation will impose a cost burden on issuers and reduce the attractiveness of CSEF and the likelihood of compliance.

3 Issuers

- 3.1 There are three key features of issuers (and capital raisings under CSEF) relevant to any proposed regulation of CSEF:

- (1) Issuers are generally small, unsophisticated enterprises.
 - (2) The amount sought to be raised is generally low (ie. less than \$10 million).
 - (3) The amount sought to be raised from each individual investor is low (ie. less than \$5,000) and as a result there are often hundreds, possibly thousands, of investors.
- 3.2 In our view, taking these considerations into account, and consistent with the approach adopted in the United States and proposed to be adopted in New Zealand, any regulation of CSEF should:
- (1) Limit the amount that an issuer may raise in any 12 month period. Any such amount should be low (eg. \$2 million) and should include any amounts raised under the fundraising provisions in the Corporation Act. The limit of 20 personal offerings in any 12 month period under the Corporations Act should not apply.
 - (2) Remove the shareholder cap of no more than 50 non-employee shareholders for issuers. The takeovers provisions of the Corporations Code should only apply if the CSEF funded company has more than, eg 500 shareholders or a certain level of revenue.
 - (3) Remove the sophisticated investor exception for investors in CSEF companies. In our view, CSEF should be limited to small investments only.
- 3.3 Issuers should be prohibited from advertising the offer except through notices directing investors to intermediaries. The content of any such notices should be limited to basic information about the issuer and its product that is available on the intermediary's website.
- 3.4 Funding should be kept as simple as possible. Issuers should only be able to issue debt and ordinary shares. There should be no preferred or convertible shares.
- 3.5 Issuers should not be able to access CSEF proceeds until a designated funds target for that CSEF company is reached, thereby ensuring that investors can cancel their contributions for a limited period.
- 3.6 There should also be a ban on a secondary market for two years after the designated funds target is realised. The purpose of CSEF is to raise capital, not to facilitate a market for the sale of securities in CSEF companies.
- 3.7 Issuers should be required to make certain basic disclosures to intermediaries, including filing a business plan and providing basic corporate information, accounts to show financial standing, a description of the ownership and the capital structure of the issuer. Issuers should also specify the target offering amount, the deadline to reach that target and provide regular updates on progress of the issuer in meeting the target amount. These disclosures should include enough information so that investors can make an informed decision.
- 3.8 There should be no requirement for a disclosure document as currently required under the Corporations Act for funding of the type contemplated by CSEF.
- 3.9 Also, in our view, certain products should not be able to be crowd funded eg weapons, drugs, cigarettes and pharmaceuticals. CSEF should also not be able to be used to fund investment companies.

4 **Intermediaries**

- 4.1 Intermediaries play a key role in CSEF, being the portal through which investors can invest in issuers. A number of intermediaries, such as Kickstarter, have recently set up an Australian presence.
- 4.2 In our view, all CSEF should operate through appropriately registered and licensed intermediaries.
- 4.3 Currently, an intermediary must register with the Australian Securities and Investments Commission (**ASIC**) and hold an Australian Financial Services Licence (**AFSL**). ASIC has stated that intermediaries may be considered as the person arranging for the issue of a financial product. In our view, these requirements should continue, subject to some minor amendments to the AFSL conditions to take into account the different disclosure requirements for intermediaries.
- 4.4 Intermediaries should be required to disclose the risks of CSEF when an investor registers with their website. The disclosure information should set out that crowd funded projects are speculative ventures with no guarantee of profit or that the product or idea will even be executed.
- 4.5 When registering with an intermediary an issuer should be required to:
- (1) Undergo basic regulatory checks on directors, officers and any significant shareholders, such as checks on insolvency, banned register and conflicts of interest.
 - (2) Ensure that basic corporate information is available to investors and issuers.
- 4.6 Intermediaries must receive assurances from investors that they:
- (1) Are over 18 years old.
 - (2) Are not from countries with trade embargos, UN sanctions or any other similar political issues.
 - (3) Have not exceeded the CSEF investment limits within the financial year (see below).
- 4.7 In order to avoid any potential conflicts intermediaries should not have any interest in issuers unless that interest is disclosed upfront.

5 Investors

- 5.1 In our view, it is important that investors understand the general risks of CSEF. Investors should be required to confirm they are aware of the risks of CSEF when they sign up to an intermediary.
- 5.2 Information should be readily available on the intermediary's website about CSEF, how it works and the reality that many start-ups will not reach their designated funds target.
- 5.3 There should be investor caps that limit the total amount an investor may invest in issuers for a financial year. The limit on investment in issuers should be in proportion to that person's annual income or net wealth. Under the JOBS Act the cap is the higher of \$5,000 or 5% of annual income for investors that earn less than \$100,000 a year and \$10,000 or 10% of annual income for investors that earn more than \$100,000 a year.
- 5.4 There should be a limit an investor can invest in any issuer in a financial year.

5.5 Also, investors should be able to cancel an investment commitment at any time prior to 48 hours before the designated funds target deadline. This period provides an opportunity for investors to reconsider their investment decision.

6 **Conclusion**

6.1 In our view, the Australian Government should take steps to regulate CSEF in Australia.

6.2 Consistent with the approach taken in the United States, the Australian Government should establish a self-contained statutory and compliance structure to regulate CSEF in Australia. Changes to the Corporations Act should only be made where necessary to be consistent with the CSEF regulatory framework.

6.3 Any regulation of CSEF should cover each of the main participants in CSEF, ie. issuers, intermediaries, and investors.

6.4 Given the nature of the participants, and the amount of funds proposed to be raised, any CSEF regulations should be kept to a minimum.

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