



Submissions to CAMAC Discussion Paper: Crowd sourced equity funding

Thank you for the opportunity to provide a submission on the Crowd Sourced Equity Funding Discussion Paper (**CSEF paper**), released by the Corporations and Markets Advisory Committee on 10 September 2013.

1. Squareknot's business

- 1.1 Squareknot aims to provide an industry leading platform for registered investors to make investments in viable investment opportunities. This will be achieved through facilitating the funding of specific projects and business start-ups, the expansion of existing businesses, providing additional working capital funding, or the finance required for acquisition, and at the same time providing exciting and rewarding investment opportunities to individuals or advisors who have cash funds that they are seeking to invest. Squareknot will also assist with the provision of essential management support to businesses to help them grow and prosper, through a panel of independent specialists.

Square knot provides its comments on the paper and brief response to certain questions below.

2. Response

- 2.1 At a high level, SquareKnot understands that the CSEF paper suggests that crowd sourced equity funding (**CSEF**) mechanisms have not previously been contemplated by lawmakers in the development of Australian law. Consequently, the CSEF paper invites a response on whether the regulatory environment inhibits the development of CSEF in Australia and negates the main advantages of CSEF, namely the ability to efficiently raise funds through soliciting small financial contributions from a large number of people - a source of funding that may not otherwise have been accessible.
- 2.2 In summary, Squareknot submits that the current regulatory environment is, to a large extent, suitable for the growth of CSEF in Australia. CSEF is regulated by the relevant securities-related laws generally, predominantly the *Corporations Act 2001 (Cth)*, and will be subject to relevant licensing, disclosure and conduct obligations. SquareKnot submits that these obligations should not be relaxed given that, as the CSEF paper notes, 'the number of persons potentially affected can be significantly greater than for more traditional means of fundraising' because of the central role of the internet.
- 2.3 The class of persons potentially affected will predominantly be retail investors who, as a class of investors, are afforded a greater degree of protection by relevant financial services laws given that they are more likely to misunderstand or be misled about the risks of financial products.¹ SquareKnot further submits that reducing investor protection

¹ Australian Financial System Inquiry, Parliament of Australia, *Financial System Inquiry Final Report* (1997), 188.

also increases the reputational risk to the CSEF industry as a result of rogue operators or even retail investors who do not properly understand the risks of a financial product.

2.4 In view of the above, regulatory responses to CSEF should be incremental and be based upon characteristics peculiar to CSEF. Commentary such as Baxt, Black and Hanrahan's text 'Securities and Financial Services Law'² has suggested three broad principles guiding modern securities regulation including:

- » the interlocking goals of investor protection, market efficiency and systemic stability
- » that these goals are likely to be realised when participants in markets act with integrity and there is adequate disclosure facilitating informed judgments by the market, and
- » market integrity and adequate disclosure would not otherwise be achieved without regulatory intervention (for reasons of market failure).³

Our submissions have been made in the context of these guiding principles.

2.5 In summary, Squareknot's submissions recommend:

- » liberalising the small scale exemption offer
- » maintaining the current Australian financial services licensing regime for CSEF intermediaries
- » that CSEF intermediaries should be required to conduct limited due diligence on financial product issuers looking to raise funds (issuers) but, after this due diligence has been conducted, will not be held accountable for misrepresentations, misleading statements or fraudulent statements made by issuers
- » a disclosure approach to the responsibilities of CSEF intermediaries is appropriate, and
- » a cooling off period is not appropriate for CSEF but CSEF intermediaries should be required to disclose the absence of a cooling off period to potential investors.

3. Question 1 - accommodation/facilitation of CSEF in corporations laws

3.1 As previously stated, any further introduction of laws specifically regulating current regulation of securities issuing should be introduced incrementally. Further, attempts to update the law specifically to cater for CSEF should consider the impact of, and avoid,

² Robert Baxt, Ashley Black and Pamela Hanrahan, *Securities and Financial Services Law* (LexisNexis, 8th ed, 2012).

³ Robert Baxt, Ashley Black and Pamela Hanrahan, *Securities and Financial Services Law* (LexisNexis, 8th ed, 2012), 9.

undesirable regulatory arbitrage and inconsistencies that financial services reform has been attempting to remove over the past decade.⁴ One way in which CSEF can be facilitated without producing apparent regulatory inconsistencies is through liberalising the exemption for small scale personal offers ("Option 2", paragraph 7.2.2 CSEF paper). Increasing the limit on small scale offerings better facilitates access to funds without significantly removing investor protection - it merely expands on an available exemption.

4. Question 5 and 6 - CSEF intermediary obligations

- 4.1 As noted in the CSEF paper, it is likely that CSEF intermediaries will need to at least obtain an Australian Financial Services Licence (**AFSL**) if not an Australian Market Licence which generally requires that the conditions in Question 6(i)(b) - (d) are met. We suggest that most CSEF intermediaries will structure their business so as to avoid obtaining an Australian Market Licence given that it is of a different nature from other Australian Market Licence holders. Squareknot considers that, contrary to the commentary referred to in the CSEF paper,⁵ obtaining an AFSL does not prevent quick and low-cost access to funding for issuers. However, given the Further, an aim of the licensing regime is to enhance investor confidence in the operation of financial markets and to protect investors (in particular, retail investors) from unscrupulous and incompetent operators.⁶ A reduction in licensing requirements, disclosure or conduct standards relative to securities issued by other means invites issuers and intermediaries looking to exploit regulatory arbitrage and may tarnish the CSEF industry's reputation. Further, the requirement to have adequate resources to carry out its role, transparent processes and membership of an external dispute resolution scheme appears to be an appropriate threshold requirement for any CSEF intermediary.
- 4.2 In relation to Question 6(ii) (intermediary matters related to issuers), Squareknot considers that a requirement on CSEF intermediaries to conduct limited due diligence checks on issuers as not being overly onerous and providing a suitable level of investor protection. However, once a CSEF intermediary has met its due diligence requirement, a CSEF intermediary should not be held accountable or responsible for investor losses result from misleading statements made by issuers or fraudulent issuers. To place the responsibility on an intermediary greatly increases the risk exposure (and costs) of CSEF intermediaries who are not always exposed to the gains of a successful business. Further, the requirement on a CSEF intermediary to vet every statement made by an issuer on its CSEF platform greatly increases resourcing requirements on an intermediary.
- 4.3 In relation to Question 6(iii)(b) (intermediary matters related to investors), Squareknot submits that CSEF intermediaries should make disclosures to investors of its responsibilities and, importantly, the limit of its responsibilities. For example, disclosures

⁴ See, for example, Australian Financial System Inquiry, Parliament of Australia, *Financial System Inquiry Final Report* (1997), 235.

⁵ Terence W Wong, 'Crowd funding: Regulating the new phenomenon' (2013) 31 *Companies and Securities Law Journal* 89, 98.

⁶ Australian Financial System Inquiry, Parliament of Australia, *Financial System Inquiry Final Report* (1997), 243.

should be made about whether a CSEF intermediary conducts any due diligence on product issuers, the kinds of due diligence it performs and the circumstances in which a CSEF intermediary will take responsibility for investor losses (if in any circumstances). This is consistent with an approach of ensuring that investors receive adequate disclosure in order to make informed judgments without unnecessarily placing obligations on CSEF intermediaries.

- 4.4 In relation to Question 6(iii)(f) (controls on intermediaries holding or managing investor funds), SquareKnot supports broad legislative requirements on intermediaries controls holding or managing investor funds in a manner such that an issuer will not have access to funds raised until a specified target amount is reached (if the 'all or nothing' funding model is used).
- 4.5 Squareknot does not consider that a prescriptive approach to other matters in Question 6 significantly furthers investor protection goals.

5. Question 8 - cooling off period

- 5.1 In relation to Question 8(v), giving investors access to cooling off rights disproportionately increases the complexity of CSEF without greatly increasing investor protection. For example, the standard 'all or nothing' CSEF fundraising method involves irrevocably pledging to contribute or contributing an amount of funds until a target amount is reached before a securities issue is successful. Introducing a cooling off period means that it is not clear whether the threshold amount has been reached until the cooling off period has expired for the final contribution required to reach the threshold amount. Further, a disclosure approach that investors do not have access to a cooling off period better strikes the balance between investor protection and market efficiency.

6. Question 9 - incremental or self-contained regulatory approach

- 6.1 As previously stated, regulation of CSEF should be in the form of incremental adjustments rather than a self-contained regulatory regime that adds more regulatory requirements and introduces further barriers to entry.

Please do not hesitate to contact Patrick Schilling on 0408 399 989 if you have any questions or require clarification on Squareknot's submissions.

Kind regards

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