# Crowd sourced equity funding

## Background information

Crowd sourced equity funding (CSEF) involves the sale of typically small capital interests in companies set up by promoters, through Internet websites (intermediaries), to potentially numerous investors. CSEF is aimed principally at early stage capital-raising or seed capitalby start-up companies.

The interest in CSEF is in part driven by what is seen as its potential to improve access to capital for innovative knowledge-based 'start-up' companies. The recent International Organisation of Securities Commissions (IOSCO) Staff Working Paper *Crowd-funding: An Infant Industry Growing Fast* (February 2014) lists the following benefits and risks (pages 4-5):

***Benefits***

- abilityfor entrepreneurs to raise capital, in most cases without giving up large parcels of equity interest.
- spreads risk – the majority of investors are individuals with small investments
- lower cost of capital – CSEF provides low cost capital raising
- can help economic recovery by financing small and medium enterprises (SMEs) which are a key engine of economic growth. Helping SMEs more efficiently access capital for their development and expansion can contribute to job creation and economic recovery.

***Risks***

- risk of default – CSEF is high risk
- risk of intermediary (or funding portal) failure
- risk of fraud
- risk of illiquidity - investors cannot sell their investment where no secondary market exists
- lack of transparency and disclosure of risks.

There is significant interest in CSEF in Australia and other countries. Under the current Australian regulatory structure there are restrictions on capital raising from the public and some types of capital raising may be classified as managed investment schemes with the associated regulatory obligations that apply to such schemes: see ASIC media release of 14 August 2012 *ASIC guidance on crowd funding.* These restrictions, together with the perceived benefits of CSEF, led the then Minister for Financial Services and Superannuation, the Hon Bill Shorten MP, in June 2013 to refer to the Corporations and Markets Advisory Committee (CAMAC – the federal government's independent corporate law reform advisory body) for consideration and advice, the regulation of CSEF and the identification of a best practice regulatory framework for CSEF in Australia.

In September 2013, CAMAC published a discussion paper on CSEF: *Crowd Sourced Equity Funding: Discussion Paper*. In the paper, CAMAC identified several approaches that could be taken in Australia to CSEF, taking into account issues of market integrity and investor protection as well as facilitating funding opportunities for start-up enterprises and investment opportunities for investors.These approaches range from:

- no regulatory change
- confining CSEF to sophisticated investors
- making incremental amendments to the existing regulatory structure
- creating a self-contained statutory and compliance structure for CSEF.

In May 2014 CAMAC published a report on this topic. The report contains a series of recommendations to facilitate crowd sourced equity funding in Australia. It is proposed in the report that an eligible issuer may seek crowd sourced equity funding by offering its equity through a licensed online intermediary, provided:

- the offer does not exceed the issuer cap of $2 million in any 12 month period
- the offer disclosure requirements are complied with
- the controls on advertising are complied with
- the issuer does not lend to crowd investors to acquire its shares
- any material adverse change concerning the issuer is notified.

In relation to investors:

- any person of legal capacity can be a crowd investor
- a crowd investor be limited to investing $2,500 per issuer, and $10,000 for all issuers, in any 12 month period
- crowd investors must acknowledge the risk disclosure statement before investing
- crowd investors have cooling-off and other withdrawal rights
- share resale restrictions apply only to persons associated with the issuer.

In addition to Australian developments, there are many international developments. These include:

- USA - The Jumpstart our Business Start-ups (JOBS) Act, enacted in April 2012, is intended to encourage economic growth in the US by various means, including greater access to equity funding for emerging and other companies. The US Securities and Exchange Commission has yet to finalise rules under the JOBS Act for CSEF
- Canada- proposals for CSEF were published by the Ontario Securities Commission on 20 March 2014
- Asia – it has been reported that regulators in a number of Asian countries are investigating the appropriate regulatory framework for CSEF. For example, it was reported in CaixinOnline that the China Securities Regulatory Commission said on 28 March 2014 it was researching specific regulations for crowdfunding and would announce rules soon.
- New Zealand has enacted legislation for CSEF which is effective 1 April 2014
- Europe – a number of European countries have either enacted or are considering legislation to facilitate CSEF – including the UK, Italy and France.

A review of international developments indicates that key issues for resolution in identifying an appropriate regulatory framework for CSEF include:

**Issuers**

- are there limits on the types of entities that can engage in CSEF (eg CSEF in Italy is limited to 'innovative start ups')
- are there limits on funds that an issuer can raise (eg under the JOBS Act, a company may raise no more than US$1 million in a 12-month period through CSEF; in Italy the maximum funds raised by an eligible start up through CSEF cannot exceed €5 million per year)
- what disclosure by issuers is required (short of full prospectus disclosure)
- what liability for misleading disclosure should be imposed on issuers (should this be full prospectus liability or something less)
- what ongoing disclosure should be made by issuers to investors.

**Intermediaries (or funding portals)**

- what restrictions are imposed on intermediaries (eg in terms of licensing requirements and requirements to conduct some due diligence on the issuer)
- what disclosure should intermediaries make to potential investors.

**Investors**

- are there limits on who can be an investor
- are there limits on the maximum funds that each investor can contribute. Possible approaches outlined in the CAMAC discussion paper include:
    - limiting the number of CSEF issuers in which an investor may invest in one year
    - limiting the monetary amount that the investor may invest in each CSEF issuer in one year
    - limiting the monetary amount that the investor may invest in each CSEF issuer in total (not per year).
    - limiting the monetary amount that an investor may invest in all CSEF issuers in one year.

  The JOBS Act has adopted the fourth approach, with aggregate limits varying, depending upon the income or net worth of the investor. Canada has adopted a different approach.

- should there be a requirement of risk acknowledgement by the investor (for example, under the JOBS Act, the investor must positively affirm an understanding that the entire investment is at risk and that the investor could bear such a loss. The investor must also answer various questions demonstrating an understanding of various risks.
- should the investor have cooling-off rights (in Italy, investors can withdraw their commitment at any moment until when the crowdfunding campaign is closed).

**Relevance to our project**

The key objective of our project is to investigate whether greater Asian regional cooperation on financial regulation is desirable and politically plausible, and if so what form it should take. In relation to capital markets regulation, our research questions include:

- what are the weaknesses of the existing frameworks and bodies in terms of supporting regional cooperation and achieving agreement on initiatives?
- what risks need to be taken into account and mitigated (eg risks in connection with hedge fund activity and shadow banking)?
- can different national approaches to capital markets regulation be coordinated via harmonisation or mutual recognition agreements?

It is stated in the IOSCO Staff Working Paper *Crowd-funding: An Infant Industry Growing Fast* (February 2014) that CSEF does not currently constitute a systemic concern but that "if allowed to grow without proper management, and if the interconnectedness with other industries (for example, through its shadow banking activities…) continues, then there is a possibility of it becoming an important issue, in a systemic context, in the future." (page 51)

In addition the paper states that the next evolution of CSEF will be to develop cross border: "However, basic minimum standards are needed if this is to occur successfully and without causing cross-border contagion to other international markets" (page 42) and that "there might be a need for the international harmonisation of regulatory requirements given the possible cross-border nature of the FR [financial return] crowd-funding market." (page 7)

The paper concludes with the following observations:

"There are still some clear questions on the future of the industry, both in terms of how the benefits of this type of market-based finance can be best directed to the real economy, and how the risks of this infant industry can be controlled. Given the access to retail investors, are there sufficient protections in place as this investment choice becomes more mainstream? Additionally, discussions with industry highlighted the next evolution of this industry is in the global nature of funding sources, thereby opening up cross-jurisdictional implications for contractual and legal harmonisation, dispute settlement and resolution issues. With the rapid evolution of this predominately online industry, however; future challenges may arise around enhanced cross-jurisdictional harmonisation and the quality and comparability of soft information. Finally, continued research focus on this topic would aid regulators in monitoring the development of the industry. Much of the impact factor assessment is qualitative in nature and further research towards developing indicators for those areas lacking hard data; as such the development of quantitative indicators, can help with this assessment." (page 51)

Some research questions, arising from the IOSCO paper, include:

- what are the minimum regulatory standards that should apply to CSEF?
- what are the prospects for international harmonisation of regulatory requirements for CSEF in Asia given potential cross border growth?