

CROWD-SOURCED EQUITY FUNDING - WHAT SHOULD AUSTRALIA DO?

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Legal Briefings - By **Mark Currell**

IN BRIEF

- In December 2015, the Federal Government tabled a bill which proposed a legislative regime to regulate crowd-sourced equity funding in Australia. This bill lapsed upon the dissolution of the Senate in May 2016.
- The Federal Government's legislative regime intended to enable retail investors to invest in small and start-up business while protecting those investors from the risks associated with business failure and fraud.
- A number of high profile overseas jurisdictions have taken different legislative approaches to crowd-sourced equity funding to that proposed in Australia.
- With the legislative process for adoption of Australian crowd-sourced equity funding paused for the current elections, there is an opportunity for Australian stakeholders to ask again what form of crowd-sourced equity funding regime should be adopted in Australia.

SUMMARY

Crowd-sourced equity funding (**CSEF**) is a form of corporate finance that allows businesses to obtain capital from a variety of investors who contribute money in return for equity in the business.

CSEF is championed as a way to encourage broad-based small scale retail investment in innovative and new business ideas. In Australia and other jurisdictions that as a policy objective want to encourage start-ups and innovation, the current securities and financial laws can operate as a barrier to wide-scale CSEF. As such, in Australia and other jurisdictions, Governments have implemented, or are considering implementing, changes to their legal and regulatory regimes to facilitate CSEF while maintaining appropriate retail investor protections.

The CSEF legislative regime proposed by the Coalition Government in December 2015 was based on recommendations made by the Corporations and Markets Advisory Committee (which has since been abolished) in a report in 2014. It aimed to reduce the securities and financial regulatory barriers to invest in small and start-up businesses. The regime was criticised as it imposed, by comparison to some other countries that have adopted CSEF regimes, restrictive rules on the type of company that could raise funds, the amount that could be raised and the amount investors could contribute.

The proposed legislation was not passed by both houses of parliament and lapsed upon the dissolution of the Senate on 9 May 2016.

AUSTRALIA'S LEGISLATIVE REGIME

The proposed CSEF legislative regime was tabled in the *Corporations Amendment (Crowd-sourced Funding) Bill 2015* (Cth) (the **Bill**). The Bill intended to introduce a CSEF regime with the following key features:

- unlisted public companies with less than A\$5 million in assets and less than A\$5 million in annual revenue would be allowed to raise up to A\$5 million per annum through CSEF,
- companies using CSEF would be 'exempt public companies' and would be provided temporary relief from reporting and corporate governance requirements (including continuous disclosure, AGMs, audited financial reports and half-yearly reporting) for a period of three to five years
- investors would be limited to investing A\$10,000 per issuer per 12 month period and would be required to complete a risk acknowledgement statement. Investors would not be limited in how much they invest overall across all issuers,
- CSEF intermediaries would be required to hold an Australian Financial Services Licence, undertake due diligence and provide generic risk warnings to investors (these intermediaries effectively perform the same functions as the platform providers in the US, UK and NZ (see below)), and
- regulatory relief would provide greater flexibility in the Australian market licence and

clearing and settlement facility licensing regimes particularly to enable secondary trading markets for CSEF securities.

RECENT OVERSEAS DEVELOPMENTS

The US, New Zealand and the UK have been the pioneers in the area of CSEF. Each jurisdiction has taken a slightly different approach to each other and Australia. Singapore has also recently signalled a quite radical and different approach. The recent developments for each jurisdiction are outlined below.

United States of America

The USA legislated a CSEF model in 2016 through the Jumpstart Our Business Startups Act 2016 (USA) (**JOBS Act**). The new provisions allow early-stage businesses to offer and sell securities to retail investors through CSEF portals. The regulations mainly relate to regulating these portals. The Financial Industry Regulatory Authority (**FINRA**) oversees the registration of CSEF portals and ensures that they comply with securities laws and FINRA rules.

The JOBS Act imposed the following limitations on an investor:

- Investment limits are determined by income/net assets:
 - if either the investor's annual income or their net worth is less than \$100,000, then during any 12-month period, they can invest up to the greater of either \$2,000 or five percent of the lesser of their annual income or net worth,
 - if both the investor's annual income and their net worth are equal to or more than \$100,000 then, during any 12-month period, they can invest up to 10 percent of their annual income or net worth, whichever is less, but investment must not exceed \$100,000, and
 - the investor can only invest in an offering through an online platform of a broker-dealer or a CSEF portal, a new type of intermediary that was created by the JOBS

Act. This portal must be registered with the Securities and Exchange Commission and be a member of FINRA.

United Kingdom

The United Kingdom's Financial Conduct Authority (**FCA**) introduced CSEF rules in April 2014, supplementing existing regulations which covered CSEF as a 'regulated activity'. These rules will be reviewed in 2016.

Under the UK CSEF rules, crowd-funding platforms are required to be authorised by the FCA, a process which can take around six months. As at 2015, 14 were crowd-funding platforms authorised in the UK.

Rather than implementing new legislation, as in the US, to effect the 2014 changes the FCA amended its rules for businesses, which are contained in the Conduct of Business Sourcebook section in the 'FCA Handbook of rules and guidance'.

Those rules provide that a platform offering CSEF investments must consider the investment to be appropriate for its client(s), based on factors including the investor's knowledge of and involvement in, investments, their investing experience and their education or professional background. The appropriateness test can be managed by the platforms as part of their registration or sign-up process on websites offering CSEF products.

In practice, this means that a platform offering equities to an investor must consider the product suitable for an investor based on their answers to scripted questions and/or other facts or circumstances, and must reasonably believe the investors understand the platform's advice, unless a specific exemption applies. Key exemptions include:

- the investor is a high net worth investor (self-certified as having >£100,000 income p/a or >£250,000 net assets),
- the investor is a sophisticated investor (certified by a qualified 3rd party as knowledgeable enough to understand the risks or self-certified by virtue of their other investments, having had 2 years' private equity or 6 months' business angel experience or being a director of a company with a turnover of £1m or more), or
- the investor is a restricted investor (certified as not having invested, or intending to invest, more than 10% of their net assets in unlisted securities in any 12 month period).

While the above requirements appear restrictive, in reality it is likely that an investor will satisfy one of the above – most commonly as a restricted investor – with certification at the point of investment. Companies raising less than £5m are also exempt from the requirement to produce a prospectus.

New Zealand

New Zealand was an early adopter of CSEF with regulation in place for almost 2 years. New Zealand's system is relatively similar to the USA's regulatory regime for CSEF portals. Unlike Australia, New Zealand allows private companies to legally advertise its share offerings not only to wholesale investors but also retail investors. CSEF portal providers have a licence from the Financial Markets Authority (**FMA**). The FMA checks the provider and the provider must follow rules around helping investors obtain information before investing. These providers have ongoing obligations to continue to comply with the standards they met when first licensed. Start-ups can raise through CSEF up to \$2 million in any 12 month period.

Singapore

The Singaporean Government have recently announced a 'regulatory sandbox' for Fintech companies. It appears that what is proposed is that entrepreneurs can start and run fintech companies in an unregulated environment until the companies reach a certain size and scale. It is anticipated that more detailed information will be provided by the Singaporean Government but this is a significant potential development for CSEF and the regulation of business.

AUSTRALIA'S CSEF CHOICES

The approach to CSEF taken in the USA, UK, NZ and Singapore highlight opportunities and choices available to Australia in formulating its CSEF rules.

Key amongst these opportunities and choices are:

- Eligibility constraints – Australia's proposed legislation limited CSEF eligibility to companies with assets and revenue of less than A\$5 million. These thresholds would naturally restrict the number of companies that may utilise CSEF. Some commentators have argued for higher thresholds on the basis that the proposed thresholds are unnecessarily restrictive and that, as a matter of policy, the thresholds should be abolished or increased in order to permit more widespread use of CSEF. One potential comparison for threshold guidance is the 'Small Proprietary Company' test under the Act (which qualifies companies for lesser financial reporting requirements) where the relevant thresholds are revenue of less than \$25 million and assets of less than \$12.5 million.

- Investment cap – Australia’s proposed legislation capped retail investment in an eligible CSEF company to A\$10,000 in a 12 month period. Again, some commentators have criticised this cap as unnecessarily restrictive and conservative. From an investor protection perspective, it is interesting to compare the proposed CSEF cap to the regulation of retail investment through online brokers where, for example, retail investors can potentially invest unlimited amounts in speculative ASX listed entities.
- Exempt public companies or all companies – Australia’s proposed legislation provided for CSEF participation to be limited to a new form of unlisted public company. While the 50 shareholder ceiling that applies to Australian proprietary companies raises an obvious limitation to participation of private companies in broad-based CSEF under the current rules, consideration could be given to why CSEF should not be available to proprietary companies with appropriate amendments and reliefs to the current regulatory framework.
- Regulatory concession or reform – As noted above, the UK has implemented a CSEF regime with somewhat more flexible regulatory requirements. This approach has resulted in comments in the US about the apparent leap the UK has taken over the US on funding of innovative business because of the relatively regulatory light nature of the UK’s framework. A key question in Australia is about what level of CSEF regulation is appropriate to encourage broad-based investment in innovative business while ensuring appropriate safeguards for retail investors.
- Silver bullet or multi-faceted solution – CSEF is not the only regulatory lever available for Government to encourage investment in small and start-up business. For example, New Zealand is proposing a range of tax incentives for investment in start-up and small businesses. Also, in the US there has been discussion of providing venture capital firms with incentives to commit to seed funding new businesses with the objective that VC investment would act as a catalyst for crowdfunders to invest alongside the venture capital firm.

CONCLUSION

If the new Federal Government pursues a policy objective of seeking to encourage participation and investment in start-up and innovative business, it will have the opportunity to consider what regulatory framework best supports this objective while maintaining appropriate investor protections. While CSEF is a relatively new area of corporate finance, the approaches to CSEF taken in overseas jurisdictions should provide valuable guidance and lessons in formulating Australia’s CSEF regime.

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MORE INFORMATION

For information regarding possible implications for your business, contact [Mark Currell](#).

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