

Manager
Financial System Assessment Unit
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Submission to Discussion Paper: *Crowd-sourced Equity Funding (CSEF)*

Tim Ancev¹

Professor Dimity Kingsford Smith²

1. Introduction

Policy action is clearly required if CSEF is to develop in Australia. This submission considers, in turn, the current practical and regulatory impediments to CSEF that justify policy action, the broad principles that should guide regulatory reform, and specific reforms that are based on those principles. This submission argues that the CAMAC model, with some modifications, can be adopted as an appropriate regulatory response to CSEF. However, adopting this model in its entirety in statutory form may not be conducive to the initial development of CSEF. Rather, a slightly simplified version of the CAMAC model, primarily realised through ‘soft law’ instruments, would be more appropriate during the early stages of CSEF’s development in Australia. In this way, an appropriate balance between facilitation and protection for investors can be struck.

2. Current regulatory impediments to CSEF

The most fundamental barriers to the development of CSEF in Australia are the existing company structure, public company governance and prospectus disclosure laws. However, the current lack of a clear regulatory structure for CSEF in Australia further compounds the problem by introducing uncertainty as to the full set of additional laws and regulations that may apply in this context. There are a number of aspects of the securities and financial services regulatory regime that may act as barriers to the development of CSEF in this way, in addition to the regulations identified by Treasury. Some examples of these include:

- Australian Financial Services Licence (**AFSL**) regime: An AFSL would almost certainly be required for CSEF platforms under the current regulatory regime, as the activities of a platform could likely be characterised as ‘dealing in a financial product’.³ The meaning of ‘dealing’ under the Act includes arranging for the issue or sale of securities,⁴ which is exactly the role played by the platform.

¹ B Com LLB (UNSW). Tipstaff to the Honourable Justice Ball, Supreme Court of New South Wales. The views expressed in this submission are the authors’ own and not those of the Supreme Court of New South Wales or any of its judicial officers.

² B Arts LLB (Sydney) LLM (LSE). Professor, University of New South Wales Faculty of Law.

³ *Corporations Act 2001* (Cth) s 766A(1)(b).

⁴ *Ibid* s 766C(2).

- Financial advice disclosure provisions: The activities of a CSEF platform may amount to providing financial product advice,⁵ given that most platforms undertake at least some basic level of due diligence or ‘vetting’ of investment opportunities. The relevant question is whether the listing of investment opportunities amounts to a recommendation or statement of opinion intended to influence the decision of a potential investor as to whether to invest in those businesses.⁶ Generally, the platform takes an active role in selecting the investment opportunities that are available to investors, rather than merely providing for ‘dissemination of communications’⁷ of others. This tends to suggest that a ‘recommendation or statement of opinion’ on behalf of the platform does indeed take place. This would be unlikely to constitute ‘personal advice’, but rather is likely to be considered ‘general advice’. The result, however, is that a CSEF platform would be required to provide a Financial Services Guide to each client,⁸ and additional disclosure related to the provision of general financial advice.⁹
- Managed Investment Scheme (**MIS**) provisions: The “nominee” model of CSEF, where investors only receive a beneficial interest in shares held on trust for them by the platform would be very likely to fit the definition of a MIS under the *Corporations Act* (‘the Act’).¹⁰ While a beneficial interest in a company’s shares ‘is likely to be treated as a security in its own right’,¹¹ the collective nature of the trust in the nominee model would tend to favour the view that it represents an interest in a managed investment scheme.¹² Accordingly, it might be necessary to seek relief or to bring about legislative changes, to relieve CSEF from the regulatory requirements accompanying an MIS.
- Australian Market License (**AML**) provisions: A financial market is defined in the Act as a facility through which ‘offers to acquire or dispose of financial products are regularly made or accepted’.¹³ Unless specifically exempted by Ministerial action, an AML is required to operate a financial market. Clearly, this definition captures the arrangements under which equity crowd funding platforms operate, meaning the AML regime will apply to these platforms, along with its wide range of compliance requirements (most of which would be prohibitively costly for CSEF platforms). This regime is patently inappropriate in the CSEF context in its current form, where platforms do not ordinarily provide a secondary market for crowd-funded securities.

The problem posed by these regulatory measures is not necessarily that they are inappropriate for CSEF, but more so that it is often unclear which of them applies and exactly to what activities and arrangements. Further, where these protections do apply, participants may not have a clear

⁵ Ibid s 766A(1)(a).

⁶ Ibid s 766B.

⁷ Dimity Kingsford Smith, ‘The Same Yet Different: Australian and United States Online Investing Regulation’ (2006) 37 *University of Toledo Law Review* 461, 484.

⁸ *Corporations Act 2001* (Cth) s 941A.

⁹ *Corporations Act 2001* (Cth) s 949A.

¹⁰ As recognised by the CAMAC report, at 22.

¹¹ Robert Baxt, Ashley Black and Pamela Hanrahan, *Securities and Financial Services Law* (LexisNexis Butterworths, 8th ed, 2012), 107.

¹² Ibid, 108.

¹³ *Corporations Act 2001* (Cth) s 767A(1)(a).

understanding of what compliance with them would require in the CSEF context. This underscores the need for a clearer regulatory framework to provide some degree of certainty to prospective participants in the industry.

3. The rationale for an experimental approach to regulating CSEF

Treasury has aptly identified that the primary challenge for regulators with regard to CSEF is to strike an appropriate balance between facilitation of equity crowd funding and protection for investors. However, for a number of reasons striking this balance is a challenging policy exercise. CSEF as an investing activity is affected by a number of potentially significant risks including the highly speculative nature and illiquidity of investments, the risk of investors falling prey to fraud and deception, and the potential for issues of securities on unfair or predatory terms. In light of the risks involved, equity crowd funding presents policymakers with a problem: namely, whether after mandating the level of protection that is required to safeguard retail investors from losses, CSEF would be commercially viable at all. Even if so, the question remains whether CSEF is likely to ever reach a level of broad acceptance that would make facilitation of the industry desirable or necessary. There are both sceptical and optimistic viewpoints regarding the ultimate commercial viability of CSEF. However, in the view of this submission, these questions need not necessarily be answered at this stage (and perhaps cannot be answered without initially allowing CSEF to develop over a period of time), due to their highly complex and essentially speculative nature.

Rather than seeking to form a settled view on the merits or demerits of CSEF as a form of fundraising and investing, an 'experimental' approach to regulation would provide an opportunity for CSEF to develop initially. This would provide policymakers a means of ascertaining the true costs, benefits and ultimate potential of equity crowd funding in order to develop more appropriate regulation in the longer term. An experimental regulatory framework in this context would involve the adoption of predominantly light-touch regulation, accompanied by measures to limit and contain any potential damage arising from the risks involved in CSEF, as well as regulatory measures that foster investor engagement and education. Therefore, this would arguably be the best way of achieving the balance between protection and facilitation with regard to CSEF in the initial stages of this industry's development.

The CAMAC model

The regulatory model espoused by the final CAMAC report embodies this philosophy to some extent but arguably has some tendency toward legalism and over-regulation, due to its comprehensive and complex regulatory proposal. The proposed experimental approach to regulation would place greater emphasis on simplicity in the regulation of CSEF in its earlier stages. For participants (particularly issuers and intermediaries) to understand their obligations under the law and be able to comply with them with relative ease would significantly aid the facilitation of CSEF.

The UK's Financial Conduct Authority (**FCA**) has adopted an approach that is arguably simpler and more 'light-touch' than what is recommended by the CAMAC report¹⁴ and appears to have been fairly successful in fostering the development of a CSEF industry in that jurisdiction. The FCA has achieved this in the absence of a comprehensive regulatory framework grounded in statute. We argue it is not necessary to develop a fully-fledged statutory framework for CSEF from the very outset, before more is known about the potential for CSEF in Australia and the characteristics of the industry that might ultimately emerge. Therefore, a regulatory approach based primarily on 'soft law' instruments would be preferable in the early stages of CSEF's development. A past example of this in Australia is the regulation of Internet discussion sites under ASIC's Regulatory Guide 162: *Internet Discussion Sites*, providing a good model of 'soft law' regulation in an experimental context. A soft-law focussed approach could potentially pave the way for a more formal statutory framework in the future if CSEF becomes more established as a fundraising and investing activity, and such regulation is necessary for consumer protection and market integrity.

Choice of jurisdiction

Perhaps the primary concern in regulating CSEF security offerings is investor protection. However, a significant challenge for the goal of investor protection arises from the nature of CSEF as a cross-border activity. This is a 'choice of jurisdiction' problem, whereby investors are generally not constrained from investing in foreign jurisdictions. Thus, too great a focus on investor protection in Australia may both inhibit the development of CSEF in Australia and fail to have the desired protective effect, with Australian investors able to circumvent domestic protection measures by choosing to invest in other, more loosely regulated jurisdictions.¹⁵ This problem also highlights the importance of regulatory measures that would help to educate investors and build an appropriate investment culture.

4. Reform proposals in an experimental framework

Investor Limits and Certification

The concept of investor limits proposed by CAMAC and adopted in other jurisdictions is certainly sensible and is in accord with an experimental approach to regulation, acting to limit the potential impact of CSEF-related risks. However, there are a number of unresolved issues with regard to investor limits. One issue is whether the specific numbers proposed by the CAMAC report are appropriate (either too low or too high). Another issue is whether they would apply in an undiscriminating fashion and thereby unnecessarily block out investment by investors for whom a lesser degree of protection would suffice (for example, sophisticated or professional investors). Another issue is the 'choice of jurisdiction' problem referred to above, which potentially renders investor limits ineffective in the pursuit of their protective purpose.

¹⁴ Financial Conduct Authority, *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media*, Policy Statement 14/4 (2014).

¹⁵ Dimity Kingsford Smith, 'Decentred Regulation in Online Investing' (2001) 19 *Company and Securities Law Journal* 532.

Due to the shortcomings of investor limits, investor self-certification can play a greater role than what is suggested by the CAMAC report, especially to allow sophisticated or high-net-worth investors to participate beyond the stipulated limits. If implemented in a sufficiently sophisticated way, such as through the use of well-designed questionnaires, self-certification could be a way of partly addressing the ‘choice of jurisdiction’ problem because it would necessitate the engagement of investors and could be used as an informational and educational tool.

Company Structure, Disclosure and Fundraising Limits

As foreshadowed earlier in this submission, the fundamental regulatory barriers to CSEF include, on the one hand, the 50 member ceiling and public fundraising prohibition for proprietary companies, and on the other hand, the governance requirements for public companies. The ‘exempt public company’ proposal put forward by CAMAC is a reasonable answer to these issues.

The CAMAC model’s recommendation to adopt a disclosure template specifically tailored for CSEF offers is also quite reasonable. As the report acknowledged, this is best achieved through ‘soft law’ instruments, such as ASIC guidance outlining the information expected to be disclosed by issuers and the form in which disclosure would be appropriate.

The proposed issuer cap is another sensible recommendation that plays two important functions. Firstly, it acts as an additional form of ‘damage control’ and is therefore an important part of an experimental regulatory framework. Secondly, it is a partial protection against regulatory arbitrage, in ensuring that only companies seeking relatively small amounts of funding are able to utilise the more lightly regulated CSEF regime.

Intermediary Licensing and Other Obligations

As recommended by the CAMAC report, the AFSL regime is appropriate and should be retained for CSEF intermediaries. This is justified and consistent with an experimental regulatory framework for CSEF, as intermediaries are arguably the parties most capable of bearing the burdens of regulation. Even so, excessive regulation of intermediaries may have negative consequences, particularly where it has the effect of unduly stifling competition. This in turn may lead to undesirable outcomes such as the removal of competitive incentives to adopt sound business practices and uphold a reputation for careful due diligence. However, we argue that the AFSL regime does not raise concerns of this kind, as the standard obligations of an AFSL holder are not so burdensome that a sufficiently capable and resourced platform would have difficulty in complying with them. The AFSL regime also allows for additional obligations, which may be justified to address CSEF-specific concerns, to be prescribed through regulations.¹⁶ Potential additional obligations may include the display of risk warnings for investors, enforcement of issuer and investor caps, and minimum levels of due diligence by intermediaries.

¹⁶ *Corporations Act 2001* (Cth) s 912A(1)(j)

5. Preferable elements of the New Zealand model

Some of the proposals under the New Zealand model are preferable to the recommendations of CAMAC and could be integrated into a framework based on the CAMAC model. Notably, the ideas that could be thus incorporated are:

- a. **Unrestricted fee structures for intermediaries** - The CAMAC report suggests that platforms should be prohibited from charging fees as a percentage of funds raised. By implication, this would necessitate a 'fee for service' model. While well-intentioned, a mandated 'fee for service' model may have significantly negative impacts on both platforms' ability to operate commercially and issuers' ability to participate in equity crowd funding. This is arguably a potential conflict that can be managed by other means, for example, through prohibitions on offering investment advice, soliciting for investment in equity offers hosted by the platform, and lending to investors for purposes of investment, all of which were also recommended by the report.
- b. **Allowing intermediaries to invest in issuers** – Platforms should be able to invest a nominal or small amount (for example, taking up no more than 5% of any particular issue) in order to remain involved in the relationship between an issuer and its investors and retain some degree of oversight over that relationship.

6. Conclusion

The regulatory status quo is not conducive to the development of CSEF and policy action is clearly necessary if the industry is to develop further. An experimental regulatory framework would be an effective bridge to that stage because it would establish conditions to allow the industry to develop, and allow policymakers to formulate appropriate regulation in the longer term, when more is known about the industry and its potential.

Ultimately however, an experimental regulatory framework is not a 'set-and-forget' solution. It is appropriate for an industry in its infancy, but not appropriate for the long term, where the industry becomes established and enters the financial mainstream. In that sense, this submission argues for a gradual escalation of regulation with respect to CSEF, as opposed to the introduction of a comprehensive and rigid regulatory framework based in statute at the outset, before there is any significant CSEF activity in Australia. The approach advocated by this submission would involve lighter regulation in the beginning stages of CSEF's development in Australia, and stronger, more concrete regulation in the longer term.