Introduction

This submission addresses the release of the CAMAC Discussion Paper on Crowd Sourced Equity Funding (September 2013). The aim of this submission is to provide an informed debate on the critical issues raised by the discussion paper.

If any of the responses require further explanations, please contact Dr Marina Nehme at the University of Western Sydney, School of Law at m.nehme@uws.edu.au.
**General Observations:**

The observations made in this submission can be summarised in the following manner:

- Deregulation of crowd sourced equity funding (CSEF) is not desired;
- Provisions clarifying the rules that would apply to crowdfunding should be introduced in the legislation;
- Australian crowdfunding platforms should have a financial market licence; and
- Under the current regime, investors do not need further education about investments when investing in CSEF. The only additional information that may need to be provided is the additional risk that is involved in participating in crowdfunding.

**Question 1- In principle, should any provision be made in the corporations legislation to accommodate or facilitate CSEF. If so, why, if not, why?**

It is important for Australia to remain economically competitive with the rest of the world. However, this should not be done at the expense of sensible regulation. In the context of CSEF, deregulation may negatively affect the three key objectives of securities regulation:

- Protecting investors;
- Ensuring market fairness, efficiency and transparency; and
- Reducing systematic risk.

These objectives are not only enshrined in the *Australian Securities and Investments Act 2001* (Cth)\(^1\) and the *Corporations Act 2001* (Cth)\(^2\) but they are also promoted by the International Organization of Securities Commissions as being the three key objectives of securities regulation.

While CSEF has great potential in providing finance for start-up companies, it also is problematic as crowdfunding involves higher than normal risks for equity investors:

- Fraud and scams: As noted in the discussion paper in para 2.1.4, crowdfunding opens the door wide for fraud. Certain crowdfunding platform providers have dismissed this risk by noting that the ‘wisdom of the crowd’ would help discover potential fraudulent projects. As such, certain platform providers only check whether the entrepreneur behind the project has a profile on social media. No other check about the veracity of their claim is done. \(^3\) This would, of course, raise the risk of potential scams. Additionally, the flexible funding models that certain platform providers have makes them more vulnerable to scams. For instance, Indiegogo, an international crowdfunding platform, allows entrepreneurs to collect funds as soon as they are contributed by investors. As a result, a number of scams have already occurred on

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\(^1\) *Australian Securities and Investments Act 2001* (Cth), s 1(2).

\(^2\) *Corporations Act 2001* (Cth), s 760A.

\(^3\) Claire Ingram and Robin Teigland, *Crowdfunding among IT Entrepreneurs in Sweden: Qualitative Study of the Funding Ecosystem and IT Entrepreneurs’ Adoption of Crowdfunding* (June 2013) 33.
that platform. Even though the scams were discovered before the end of the campaign, the fraudsters escaped with the funds that had already been collected.\textsuperscript{4}

- Failure: New data highlights that three-quarters of venture backed firms in the United States fail.\textsuperscript{5} This number will increase as a result of crowdfunding where entrepreneurs do not have a business model but are selling an idea. A case in point is the example of Mr Frankovich and Mr Pettler. They had a goal to raise $47,500 through the crowdfunding platform Kickstarter to fund an idea, and they ended up raising $215,000. While crowdfunding provided them with access to liquidity, it also meant that they had to implement their idea. This came at a higher cost that both entrepreneurs expected: they had to quit their job, borrow more money from an institutional investor to supplement the crowdfunding money they received and they had to set up the business from scratch. Mr Frankovich stated that:\textsuperscript{6}

> We had to use [Kickstarter] money to not only get our patents done, but our incorporate... manufacturing, tooling, design... all that stuff had to fit into that $215,000'.

The lack of a business model in most enterprises promoted through crowdfunding platforms may lead to a higher rate of failure for these ventures leaving investors in a vulnerable position.

- Selling ideas: As noted before through crowdfunding, the entrepreneurs are selling ideas that may or may not be successful in the future. For example, it is difficult if not impossible, to assess the quality of the final product until the project not only completed its funding but also established its business model.\textsuperscript{7}

In addition to this, the promotion and support of this new source of equity in different national jurisdictions by entrepreneurs and investors will depend on the investing culture and equity needs of that country. Here are a few examples:

- United States and Italy: these two countries have suffered major financial losses during the financial crisis. Crowdfunding may be viewed as a method to spur small business growth to solve the economic woes these countries have suffered. As a

\begin{itemize}
\item See for example: DC Denison, ‘Crowdfunding confusion: Scammer attempt to Rip Off Successful Campaigns Using Indiegogo’ \textit{Make} (08/02/2013) <http://makezine.com/2013/08/02/crowdfunding-confusion/>.
\item Chris Ward and Vandana Ramachandran, ‘Crowdfunding the next Hit: Microfunding Online Experience Goods’ (Paper Presented at Computational Social Science and the Wisdom of Crowds, Whitter, Canada, 10 December 2010), 1.
\end{itemize}
result, crowdfunding exemptions have been introduced. This new type of funding is deemed as a supplement to capital from venture capitalists, angel investors and bank loans.

- Sweden: While two crowdfunding platforms have been established in Sweden, there is a perceived cultural barrier that has prevented entrepreneurs from embracing crowdfunding. There is a perception that Swedes are not known for ‘confidence or risk taking’ investments. As such, unlike the United States and Italy, crowdfunding is considered as complementary rather than supplementary to the search for larger investors. Consequently, crowdfunding in Sweden is lagging behind other countries.

- Egypt: Two crowdfunding platforms, Shekra and Yomken, have recently been established in Egypt. However, to adapt to the culture in Egypt, these two platforms have been advertising themselves as Sharia compliant. This is reminder of the importance that culture plays in investments.

- Australia: To determine whether crowdfunding will be popular in Australia, it is important to assess the Australian investment culture. As a result, studies have to be conducted to highlight Australia’s attraction/ or lack of attraction to crowdfunding as a source of equity. Further, Australia is not facing the economic woes of the United States and Italy, and so the imperative to raise funds this way is lacking.

In view of all this, the law in Australia does not need to be changed to establish a crowdfunding exemption. CSEF provides a risk for consumers/investors who may have low financial literacy or who may be carried away with an exciting idea. Further, the fact that they are investing small amounts of money does not justify deregulation. When a scam occurs, confidence in the system is shaken and regulators will be at the front of the firing line. Additionally, honest entrepreneurs will be negatively impacted.

**Question 2- Should any such provision:**

- i take the form of some variation of the small scale offering exemption and/or
- ii confine CSEF to sophisticated, experienced and professional investors?
- iii adopt some other approach

As mentioned previously, this submission does not support the introduction of a crowdfunding exemption. The fundraising provisions currently in place are effective and provide the necessary protection to investors. Start-up companies and small and medium

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8 Jumpstart our business Start-ups Act (US), Title III – Crowdfunding; Decreto Crescita, Raccolta Diffusa di Capitali di Rischio Tramite Portali Online, Article 30.

9 Claire Ingram and Robin Teigland, Crowdfunding among IT Enterpreneurs in Sweden: Qualitative Study of the Funding Ecosystem and IT Entrepreneurs’ Adoption of Crowdfunding (June 2013) 38.


enterprises may be involved in crowdfunding but they will need to issue an offer information statement (instead of a prospectus as long as these entities are raising no more than $10 million from the issue of securities). An offer information statement is a simplified, less costly disclosure document than a prospectus. It will also provide the investors with the information they may need to invest in the company. Further, the exemption regime under Chapter 6D (including the sophisticated, experienced and professional investors’ exemption) does not need to be modified. Modification of these exemption categories should only be considered when a broader review of Chapter 6D is conducted.

This submission proposes that the Corporations Act 2001 (Cth) provides clarification of when it will apply to crowdfunding. Currently, ASIC’s guidance regarding crowdfunding is minimalistic. ASIC’s commissioner, Mr Tanzer, has noted that: ‘Crowd funding, as a discreet activity, is not prohibited in Australia nor is it generally regulated by ASIC.’

This statement needs to be clarified as a number of enterprises that are seeking to raise money through crowdfunding may be classified as financial products. CSEF would fall under the fundraising provision in the Corporations Act 2001 (Cth). Further, reward or prepayment funding is more likely to fall under Chapter 5C of the Corporations Act 2001 (Cth) as these types of arrangements may be classified as managed investment schemes and as such the regulation of managed investments schemes will apply.

While the application of chapters 5C and 6D to crowdfunding may make it more expensive and complex to run the enterprise, they would provide the entrepreneur with time to reflect on the business model they would like to implement and as such they will not just be promoting ideas but also a viable business model. This will enhance the chances of success of the venture and the regulation in place will also provide the public with more confidence in the system.

The lack of awareness of the legislation that may apply to entrepreneurs and crowdfunding platforms in Australia may lead to confusion regarding the way the venture should be structured. For example, Pozible is an Australian crowdfunding platform which may fall under the definition of financial market (s 767A). However it does not currently have a financial market licence. Accordingly, the current legislation needs to be amended to clarify whether there is a need for such platform to apply for a financial market licence.

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13 Corporations Act 2001 (Cth), Ch 6D.
Question 3- In the CSEF context, what changes, if any, should be made, and for what reasons, to the regulation of:

i proprietary companies
ii public companies
iii Managed investment schemes

No changes are needed.

Question 4- What provision is any, should be made for each of the matters as they concern CSEF issuers?

No changes are needed.

Question 5- In the CSEF context, what changes, if any, should be made, and for what reasons, to the current licensing requirements applicable to intermediaries?

Clarification is needed regarding the role of intermediaries. As noted previously, crowdfunding platforms can be classified as financial markets and as such they need to be licensed. The existing licensing regime should specifically include CSEF as being covered by the current licensing regime. This will provide investors with the necessary confidence to invest in the market as compensation arrangement would also be available. Through regulation, crowdfunding will become a legitimate way of raising equity and not just a fad.

Question 6- What provision, if any, should be made for each of the following matters as they concern CSEF intermediaries

No comments.

Question 7- In the CSEF context, what provision, if any, should be made for investors to be made aware of:

i the difference between share and debt securities;
ii the difference between legal and beneficial interests in shares;
iii any classes of shares in the issuer and its implications for investors.

One of the issues that arises when the ‘crowd’ is investing in a product is the following: each investor has different levels of financial literacy. However, with the current protection available to the investors and the information available through ASIC’s MoneySmart, no further education about investments in general is needed. However, education regarding the dangers that may surround crowdfunding may be needed.

15 Corporations Act 2001 (Cth), Part 7.5.
Question 8- What provisions, if any, should be made for the following matters as they concern CSEF investors

No comment.

Question 9- Should any accommodation for CSEF in the Corporations Act be in the form of incremental adjustments to the existing provisions, or be in the form of a self-contained regulatory regime for CSEF?

No. the only proposal is for the legislation to clarify that it does apply to crowdfunding.

Conclusion

History is filled with situations where people have been the subject of scams and fraudulent activities. It is important that we learn from past experiences. While crowdfunding solicits small financial contributions from a large number of investors, it still needs to be regulated to ensure the protection of the public and to promote confidence in this type of equity funding. Lastly, the International Organization of Securities Commissions is currently analysing the crowdfunding regime in different countries to develop guidance on the regulation of this new form of funding.\(^\text{16}\) It will be good policy to observe the standards that will be set at the international level before finalising the changes to the Australian regulatory regime.

Dr Marina Nehme

29 November 2013