Australian Government
Corporations and Markets
Advisory Committee

Crowd sourced equity funding

Report

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Australian Government

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21 May 2014

Senator the Hon. Mathias Cormann
Minister for Finance
Acting Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Senator Cormann

I am pleased to present CAMAC's report on crowd sourced equity funding (CSEF).

The report recognises the key role that CSEF may play in the development of innovative start-up and other small enterprise companies.

CAMAC has put forward proposals for a balanced legislative framework for CSEF that seeks to promote this sector of the Australian economy.

Yours sincerely

Joanne Rees
Convenor

Contents

1 The CAMAC review

This chapter provides background information on the nature and scope of the CAMAC review, and the review process.

1.1 Reference to CAMAC

In *Advancing Australia as a Digital Economy: An Update to the National Digital Economy Strategy* (June 2013), reference was made to holding an independent review of the regulation of crowd sourced equity funding (CSEF). CAMAC was asked to conduct that review.

CSEF (alternatively described as 'equity crowdfunding' or 'investment-based crowdfunding') is a new and still evolving concept of corporate capital raising. Broadly, it contemplates a company (the issuer) seeking funds, particularly initial ('seed') or early-stage capital, by offering its equity to internet users (the crowd) in return for cash. Issuers would publish their equity offers through a website (sometimes referred to as an 'online portal' or a 'funding portal'), the operator of which would serve as the intermediary between the crowd investors and the issuer, for the purpose of the equity transactions.

1.2 Scope of the review

Given the borderless nature of the internet, CSEF could involve offers of equity in issuers that are incorporated in any country, mediated through websites being operated from any country, and open to investors in any country.

This report focuses on the regulatory questions that would arise in facilitating CSEF where:

- **an issuer** that is registered as a company under the Corporations Act wishes to offer its equity through
- **an online intermediary** that would come within the jurisdiction of the Australian Securities and Investments Commission (ASIC), with the equity offer to be made on the intermediary's website to
- **crowd investors**, whether resident in Australia or elsewhere. In this respect, the global reach of the internet means that this review has an application which is broader than Chapter 6D (Fundraising) of the Corporations Act, which applies only to investors in this jurisdiction.

This report deals with equity offers in the form of shares in a company. Debt securities involve different investor expectations and have some important differences in regulatory arrangements, which would add further layers of complexity in the Australian context.

CSEF is just one form of online fundraising. A general discussion of crowdfunding is found in Appendix 1, which also discusses the particular features of CSEF.

The report notes, but does not seek to review, some obligations on issuers, intermediaries and investors that may be imposed by Australian laws other than the Corporations Act, such as the anti-money laundering and counter-terrorism financing legislation, as well as privacy legislation.

The regulation of CSEF may involve various trans-jurisdictional issues, including access by Australian investors to equity offers made by overseas incorporated issuers and intermediated on overseas-based websites. While the Australian legislation has an extended jurisdiction in this regard, these situations primarily involve matters concerning the international recognition and coordination of corporate fundraising regulation in various jurisdictions. The development of a regulatory framework for CSEF in Australia and the development of international standards by the International Organization of Securities Commissions (IOSCO) may provide scope for the mutual recognition of CSEF offers by foreign jurisdictions and Australia.

1.3 The review process

CAMAC formed a subcommittee, comprising Greg Vickery (chair), Teresa Handicott, Ian Ramsay, Brian Salter and Maan Beydoun (ASIC), in conjunction with the CAMAC Executive. CAMAC acknowledges, with appreciation, the contribution of each of those persons to the outcome of this review.

CAMAC published a discussion paper in September 2013, and also published online updates to the discussion paper in October 2013 and December 2013.

CAMAC invited submissions on any aspect of this review, including the questions raised in the discussion paper. A list of respondents is set out in Appendix 6. The submissions received have been published on the CAMAC website. CAMAC was greatly assisted in its consideration of the issues related to CSEF by the information and views provided by respondents. The Committee thanks all who participated in this way in the review process.

1.4 International context

The CAMAC review took place in the context of considerable, and continuing, developments concerning CSEF in a number of overseas jurisdictions.

In the interests of manageability, CAMAC reviewed developments in some only of these jurisdictions, being the United Kingdom (UK), the USA (US), New Zealand and Canada, while also including developments at the European Union level and with IOSCO. The information on each of these jurisdictions is set out in full in Appendices 3 to 5, while a full analysis of the current Australian position is set out in Appendix 2.

Throughout this report, CAMAC sets out relevant approaches in each of these jurisdictions to the CSEF issues that were raised for consideration. Reference can be made to the same (but fully footnoted) information in the Appendices.

Of the jurisdictions reviewed, the UK and New Zealand implemented their positions on CSEF in April 2014, Canada is still at the proposals stage and CSEF will not begin in the US until the Securities and Exchange Commission (SEC) has settled its rules.

1.5 CAMAC position

This report proposes a way forward for the introduction of CSEF in Australia.

Chapter 2 sets out the CAMAC position on the broad policy issues in this review, centred on whether CSEF should be facilitated in Australia, and possible methods of implementation.

Chapters 3 to 6 deal with the specific implementation issues that would arise if CSEF is to be facilitated in Australia.

The implementation proposals in this report are deregulatory in that they seek to overcome current legal impediments to the use of CSEF in Australia. However, for this form of corporate fundraising to operate in the best interests of all involved parties, a regulatory structure specifically designed for CSEF needs to be developed. The elements of this proposed structure are set out in this report.

Various proposals in this report involve monetary maximums or caps. For instance, CAMAC proposes limits on how much an issuer may raise, or a crowd investor may expend, through CSEF in any 12 month period. The specified figures have been chosen from the perspective of CSEF being principally designed for, and to be utilised by, the innovative start-up and other small-scale enterprise sector of the Australian economy. However, any monetary cap can be arbitrary in some respect, and there is always room for discussion on where caps should be set. Also, caps could be adjusted in light of experience with CSEF, if introduced.

1.6 CAMAC

CAMAC was established in 1989 and is currently constituted under Part 9 of the *Australian Securities and Investments Commission Act 2001*. Its functions include, on its own initiative or when requested by the Minister, to provide advice to the Minister, and make such recommendations as it thinks fit, about corporations and financial services law and practice.

The members of CAMAC are selected by the Minister, following consultation with the States and Territories, in their personal capacity on the basis of their knowledge of, or experience in, business, the administration of companies, financial markets, financial products and financial services, law, economics or accounting.

The members of CAMAC are:

- Joanne Rees (Convenor)—Chief Executive Officer, Allygroup, Sydney
- David Gomez—Chief Financial Officer, Land Development Corporation, Darwin
- Teresa Handicott (Brisbane)—Partner, Corrs Chambers Westgarth
- Alice McCleary—Company Director, Adelaide
- Denise McComish—Partner, KPMG, Perth
- Michael Murray—Legal Director, Australian Restructuring Insolvency & Turnaround Association (ARITA) (formerly the Insolvency Practitioners Association), Sydney
- Geoffrey Nicoll—Co-Director, National Centre for Corporate Law and Policy Research, University of Canberra
- John Price—Commissioner, Australian Securities and Investments Commission (nominee of the ASIC Chairman)
- Ian Ramsay—Professor of Law, University of Melbourne
- Brian Salter—General Counsel, AMP, Sydney

- Greg Vickery AO—Special Counsel, Norton Rose Australia, Brisbane.

The Executive comprises:

- John Kluver—Executive Director
- Vincent Jewell—Deputy Director
- Thaumani Parrino—Office Manager.

2 Looking ahead

This chapter discusses the key questions concerning crowd sourced equity funding in the Australian context and outlines the CAMAC proposals for its facilitation.

2.1 Introduction

The exponential and continuing growth of the internet, with its global reach, provides new opportunities for persons to seek funds from the crowd, with websites, chat rooms, bulletin boards, blogs and other social media being available to communicate with internet users in ways previously unforeseen.

Crowd sourced equity funding (CSEF) is one such method of online fundraising, pitched principally at small investors and offering them a shareholding in a company in return for providing cash to the company.

The potential of CSEF, its likely benefits and risks, whether it should be facilitated in Australia, and, if so, how, are the subject matter of this report.

2.1.1 Concept of CSEF

There is no legal definition of CSEF. However, in practice, the concept refers to a form of corporate fundraising that envisages start-up or other smaller companies (issuers) obtaining seed or other capital through small equity investments from relatively large numbers of investors, with online portals (intermediaries) publicising and facilitating these equity offers to online users (the crowd).

Typically, the amount of equity capital to be sought by an issuer in a particular period through CSEF would be relatively modest. CSEF does not cover large-scale public offers by larger corporations.

The terms of the equity offer may permit acceptances by potentially hundreds of investors, or more, who may have the choice of contributing very small amounts in return for equity.

Further details on the concept of CSEF, within the broader context of online fundraising, its elements, potential benefits and range of risks, are set out in Appendix 1 of this report.

2.1.2 The economic context

Amongst the ongoing challenges facing the Australian economy is how to encourage and facilitate worthwhile innovation, with its significance for productivity, competitiveness and growth.

Innovation that deserves to succeed may take many forms, including start-ups or other early-stage enterprises with creative ideas, expertise and energy but in need of the money to bring these projects to fruition.

Some worthwhile start-ups do succeed, on the strength of their vision and commitment, access to a range of funds (such as personal savings and credit cards, loans or donations from families and friends and contributions from ‘angel investors’, venture capital, or other forms of external finance) and the productive use of advice and other forms of mentoring and assistance from entities known as 'incubators' or 'accelerators'.

Some other worthwhile start-ups do not make this transition to growth, despite the quality of their ideas and the dedication of their promoters, resulting in unfulfilled ideas being either lost or taken up by others, whether in Australia or elsewhere. Part of the reason for this failure may be what is referred to as the 'capital gap', where an enterprise is in need of finance to continue to its next stage of development, but cannot attract further funding from traditional financing sources and is not yet able to conduct an initial public offer of its securities.

Other start-ups fail because they are flawed in some respect, either with the project idea or how it is managed, or suffer from unforeseen external factors, such as the emergence of a better competitor. Some start-ups fail for reasons outside their control or despite their best endeavours. Others, in hindsight, may not have warranted the funds, and trust, given to them by their investors.

While the evidence in Australia (as in other countries) indicates a high failure rate of start-ups, it is difficult to differentiate between those that failed but nevertheless deserved to succeed in the interests of innovation and productivity, and those that did not.

CSEF offers the potential to bridge the capital gap for some start-ups and other small-scale enterprises, and also help them move up the 'funding escalator' as their projects, and future prospects, strengthen. To that extent, crowd investors, collectively, have the potential to play an important, sometimes decisive, role in financing an enterprise at its crucial early stage, which may promote productivity and economic growth and foster employment, while, ideally, returning financial or other benefits to the crowd.

The potential impact of this form of capital mobilisation on competition between capital providers also needs to be considered. On one view, the availability of CSEF as a financing option could increase competition among suppliers of capital to start-up and other small enterprises, resulting in a potentially lower cost of capital for these corporate issuers, including those not utilising CSEF. This might also help reduce the capital gap within this corporate sector. Whether, however, a competitive funding environment of this nature develops remains to be seen, being dependant on the strength and sustainability of CSEF as an alternative source of funding for issuers.

The possible negative impact of CSEF on productivity must also be acknowledged. The fact that this form of funding may bridge the capital gap for some successful innovative start-ups needs to be weighed against the possibility that it may also divert funding from other worthwhile economic ventures and savings towards a large number of start-ups that eventually fail. This diversion of funds, if it occurs, represents potentially a high opportunity cost for the capital bridge CSEF seeks to build, and could reduce or eliminate any net benefits CSEF may have on the economy overall. At this stage, however, in the absence of experience with CSEF in Australia, there is no evidence to determine any such effect.

CSEF also carries potential financial risk for crowd investors, given that in many instances they, in effect, are being asked to finance innovative projects that do not have the level of maturity that traditional financial market sources require. It may involve retail investors, including those with low financial literacy or capacity, making investments in companies, many of which may fail, leading to the total loss of the funds invested. Even for ongoing projects, any return on an equity investment may be well into the future or never eventuate, and there may be no practical means in the meantime to realise the investment. Such an outcome, if it becomes commonplace, may not only harm individual investors but also undermine the confidence of crowd investors, collectively, in this form of investment. Without their participation, CSEF cannot succeed as a source of corporate funding.

2.1.3 The CAMAC review

In considering the role and possible regulation of CSEF in Australia within this economic context, CAMAC has considered the following questions:

- in principle, should CSEF be facilitated in Australia?
- (if so) does the existing law facilitate CSEF?
- (if not) what policy option to facilitate CSEF should be adopted?
- what issues arise in implementing the recommended policy option?

In this chapter, CAMAC sets out its positions in regard to the first three questions, which in summary are:

- CSEF should be facilitated in Australia
- the existing law does not facilitate CSEF
- the preferred policy option is to introduce a regulatory regime specifically designed for CSEF.

This chapter also makes a number of general observations on the fourth question, and provides an overview of the specific implementation issues, which are dealt with in detail in Chapters 3 to 6 of this report.

2.2 In principle, should CSEF be facilitated in Australia?

2.2.1 Summary of the CAMAC position

For the reasons set out below, CAMAC is of the view that CSEF should be facilitated in Australia, though there are arguments against, as well as in favour of, this course and many of the arguments put forward either way can only be speculative at this stage.

2.2.2 Other jurisdictions

In considering this question, CAMAC has reviewed the approaches in various overseas jurisdictions that have moved, or are moving, to facilitate CSEF in some form.

New Zealand

The Financial Markets Conduct Act 2013 (the Act) and the Financial Markets Conduct (Phase 1) Regulations 2014 contain provisions that are designed to facilitate CSEF. They came into force in April 2014. These provisions, in the CSEF context, substitute for the regulatory regime otherwise pertaining to equity-raising by corporate entities.

In implementing this initiative, the New Zealand Government stated that new forms of intermediated fundraising such as CSEF:

> enable funds for small businesses and individuals to be raised in internet-based market places, potentially more efficiently than through traditional public or private offerings.

Also:

> Enabling crowd-funding was highlighted in the Government's Business Growth Agenda as an initiative to support early-stage and growth companies to access the risk-capital they need to grow … Permitting crowd-funding platforms will open up significant new opportunities for small businesses to raise growth capital.

Part 6 of the Act and the associated Regulations provide for applications to be made to the Financial Markets Authority (FMA) to be licensed to provide a 'crowd funding service' for the purposes of CSEF. For this purpose, the FMA has published *Crowd funding Part B1: Your guide to applying for a market service licence* (April 2014) (FMA Crowd funding guide).

Issuers making CSEF offers through licensed CSEF intermediaries will be exempt from the normal requirement to register a Product Disclosure Statement.

New Zealand CSEF offers would not qualify for mutual recognition in Australia, and therefore some adjustment to these arrangements may be necessary.

USA

The Jumpstart our Business Startups (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.

Title III of the JOBS Act deals with CSEF offers to investors generally. It is intended to allow a start-up or other company to raise modest amounts of equity capital by offers to investors through an online intermediary. Under Title III, qualifying CSEF transactions will be exempt from the registration and prospectus delivery requirements of the US Securities Act. Title III applies to all investors, including persons of modest means, thereby giving them a greater range of investment options.

As stated by the SEC:

> To the extent that crowdfunding rules are successfully utilized, the crowdfunding provisions of the JOBS Act should provide startups and small businesses with the means to raise relatively modest amounts of capital, from a broad cross section of potential investors, through securities offerings that are exempt from registration under the Securities Act. They also should permit small investors to participate in a wider range of securities offerings than may be available currently.

The SEC published proposed rules in October 2013, with requests for comment. In putting forward these proposed rules, the SEC observed that:

> Rules that are unduly burdensome could discourage participation in crowdfunding. Rules that are too permissive, however, may increase the risks for individual investors, thereby undermining the facilitation of capital raising for startups and small businesses.

In the same vein, the SEC has commented that:

> for crowdfunding to have a positive impact on the small business funding problem, it must work for both issuers and investors. In particular, it is vitally important that investors have confidence in the crowdfunding process - or they will stay away.

Also:

> [Any] problems that arise from the actions of crowdfunding issuers or [intermediary] portals could generally affect investor confidence in the capital markets and have an adverse effect on capital formation.

Settlement of the SEC Rules (expected during 2014) is a prerequisite to permitting CSEF under Title III.

Canada

The Ontario Securities Commission (OSC) Staff Consultation Paper 45-710 *Considerations for new capital raising prospectus exemptions* (December 2012) included the elements of a possible CSEF exemption from the prospectus provisions to facilitate capital-raising for smaller business enterprises.

In August 2013, the OSC released OSC Notice 45-712 *Progress report on review of prospectus exemptions to facilitate capital raising*, which included further development of its earlier CSEF proposals.

The August 2013 Paper indicated that work on a possible CSEF regulatory framework for Canada was continuing. In that context, the Paper stated:

> We are mindful of stakeholder concerns that if the costs associated with investor protection are excessive, crowdfunding may not be a cost-effective capital raising method. At the same time, the Investor Survey suggests that investors would be concerned about the risks of crowdfunding and might not be prepared to invest through crowdfunding if they do not think there are adequate protections in place.

In March 2014, the OSC published draft proposals for CSEF, which would provide an exemption from the prospectus requirements. The proposals have a 90-day public comment period (as required by law). They would, subject to certain conditions, allow issuers to raise money from the crowd by offering securities through online portals (intermediaries). The proposals include draft provisions.

The OSC commented that:

> In a relatively short period of time, crowdfunding has become an important new method of raising capital through the internet for a broad range of purposes. To date, it has been used to raise money for a specific project and does not generally involve the issuance of securities. However, in some foreign jurisdictions, crowdfunding is emerging as a way for businesses, particularly start-ups and SMEs, to raise capital through the issuance of securities.
>
> We think that crowdfunding through an appropriately regulated crowdfunding portal can be a viable method for start-ups and SMEs to raise capital.

European Union

The European Union (EU) approach to crowdfunding generally, including CSEF, has been influenced to a considerable degree by the global financial crisis, which reduced the lending activities of banks in Europe, making access to finance by European businesses more difficult.

For instance, the stated aim of the *Entrepreneurship 2020 Action Plan - Reigniting the entrepreneurial spirit in Europe* (2013) is to increase the level of employment through reinforcing entrepreneurship across Europe. It invites EU Member States to:

> assess the need of amending current national financial legislation with the aim of facilitating new, alternative forms of financing for start-ups and SMEs [small to medium enterprises] in general, in particular as regards platforms for crowd funding.

The European Commission Consultation Paper *Crowdfunding in the EU–Exploring the added value of potential EU action* (October 2013) pointed out that:

> European SMEs largely depend on bank financing, but since the financial crisis banks are much more restrictive in their lending.

In consequence:

> In the context of SME's finance ecosystem, it appears that crowdfunding may respond to the needs of many small start-ups that do not manage to access bank finance, venture capital or reach the stage of initial public offering (IPO). Crowdfunding could thus contribute to bridging the finance gap for small firms and innovative projects. It could complement other sources of finance. Better access to finance for small businesses would promote entrepreneurship and ultimately contribute to growth and job creation.
>
> Crowdfunding creates opportunities to turn larger groups of people, who otherwise would not have access to traditional channels of finance, into small-scale entrepreneurs.

The Consultation Paper identified a range of opportunities, risks and challenges with crowdfunding.

In a communication *Unleashing the potential of Crowdfunding in the European Union* (27 March 2014), which refers to various types of crowdfunding, including CSEF, the European Commission proposed various steps to support the growth of crowdfunding in the EU, including the formation of an Expert Group and Stakeholder Forum to provide advice and expertise to the Commission in this area. The Commission also noted that as crowdfunding is a global activity, the Commission will closely follow international developments and will support efforts to promote regulatory convergence of approaches at the international level.

The European Commission intends to report on progress with these matters in 2015.

UK

In August 2012, the Financial Conduct Authority (FCA) published a consumer information bulletin called *Crowdfunding: is your investment protected?* The bulletin warned investors that many crowdfunding opportunities are high-risk and complex and are suited to sophisticated investors only. The document also pointed out that these types of investments are generally illiquid and that investors should be careful about investing over the internet because of the risk of fraud.

The FCA bulletin also stated that:

> We believe most crowdfunding should be targeted at sophisticated investors who know how to value a startup business, understand the risks involved and that investors could lose all of their money.

Subsequently, the FCA authorised some intermediaries, which it considered had the necessary skills and expertise, to conduct limited CSEF. This form of CSEF was confined to a relatively small group of investors, namely those persons who self-certified that they came within prescribed tests of being high net worth or sophisticated investors (sophisticated investors).

The FCA published a Consultation Paper, *The FCA's regulatory approach to crowdfunding (and similar activities)* (October 2013) (the Consultation Paper), dealing, among other things, with the future regulation of CSEF.

The FCA subsequently issued a Policy Statement PS14/4 *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (March 2014) (PS14/4), which confirmed and outlined its approach to the regulation of CSEF in the UK.

The relevant rules to implement PS14/4 commenced in April 2014.

IOSCO

IOSCO has begun consideration of CSEF, with the publication of an information paper *Crowd-funding: An Infant Industry Growing Fast* in February 2014.

2.2.3 Submissions

Respondents to the CAMAC discussion paper overwhelmingly supported the facilitation of CSEF in Australia, in some form at least. However, it must be noted that none of the respondents described themselves as potential crowd investors, but predominantly (but not in all instances) were more associated with the perspective of issuers or intermediaries.

Many respondents envisaged CSEF as a vehicle for stimulating economic growth and innovation in the Australian economy by helping to bridge what they considered was the capital gap for innovative and other start-up or small-scale projects between the amount required to continue the project and the funds available. It was pointed out, for instance, that traditional finance products often manage risk by requiring a 'track record' of similar activity, making it very difficult for innovative projects and organizations to obtain funding.

If successful, it was argued, CSEF (together with other policies to encourage innovation) may facilitate a vibrant and thriving Australian innovation and technology sector, with flow-on longer term economic benefits. The creation of new avenues for funding these innovative industries, which often have relatively modest capital needs, offers the prospect of facilitating a range of emerging technologies, while keeping pace with international peers and competitors.

Within this context, the view was expressed that the current capital raising provisions of the Corporations Act were designed for more substantive capital raising activities and that the compliance costs associated with those requirements may be prohibitive for very small capital raisings through crowdfunding portals.

It was argued that the problem that many innovative start-up and other small businesses face is the lack of access to equity or debt capital to develop their businesses at a critical early stage. One respondent referred to Australian Bureau of Statistics data (ABS Catalogue 8167.0 - *Selected Characteristics of Australian Business, 2011-12*) suggesting that lack of access to finance is the primary barrier to innovation for Australian businesses.

Another respondent described the financing problems for these enterprises in terms of the 'valley of death':

> The valley of death represents the stage in the growth cycle of an early stage business at which those early stage businesses have, on balance, not yet matured in their networks and risk profile to identify and attract sufficient capital from external sources to enable them to commercialise their products and services to a level at which the risk profile is sufficiently improved to enable sophisticated investors and professional investors to risk their capital in such companies.

CSEF, it was argued, could be one means for dealing with what was claimed to be this systemic market failure to fund early stage companies by widening the investor base to include the retail crowd. Also, a successful initial fundraising campaign through CSEF may assist in any subsequent further financing from more traditional sources, such as venture capital or business angel investing, if this is necessary. Furthermore, if this initial funding yields positive results, then the companies that gain traction in the market may eventually graduate to listing their securities on public exchange markets to raise more substantial sums of capital.

The point was made in submissions that the full extent of this potential to successfully fund and develop innovative start-ups and other enterprises will only become clearer over time as the market develops and responds to the new investment opportunities.

Another argument was that, by engaging with the crowd via social media, CSEF may provide early market testing of whether a product or idea has a mass appeal, judged by the number of persons who respond positively and the number of crowd investors who are sufficiently attracted to the project to commit their funds. Market validation in this manner may also assist in attracting investors in any subsequent round of CSEF or other funding.

In a similar vein, it was argued that the collective ‘wisdom of the crowd’ would be a means for investors to identify the more viable business ventures that should be supported.

A number of submissions also made the observation that overseas CSEF projects may be open to Australian investors, given that crowdfunding transcends geographic and jurisdictional borders, as it essentially exists through the internet. To inhibit CSEF in Australia, while other jurisdictions are moving to facilitate it, may result in Australian crowd investors putting their funds into offshore concerns, rather than supporting Australian-based enterprises. Likewise, without suitable CSEF provisions in Australia, local innovators and other entrepreneurs may need to set up in other jurisdictions to gain access to the crowd to finance their businesses.

A dissenting view was that the risks involved for crowd investors outweighed the possible benefits of facilitating CSEF. It was argued that CSEF provides a substantial monetary risk for persons who may have low financial literacy or who may be carried away with what appears to be an exciting idea. Further, the fact that they are investing small amounts of money does not justify deregulation. If a scam occurs, it was argued, confidence in the system will be shaken and honest entrepreneurs will be adversely affected.

2.2.4 CAMAC position

As a preliminary point, CAMAC considers that a rationale for CSEF often put forward in other jurisdictions, namely that this form of fundraising may help overcome some of the damage to their economies caused by the global financial crisis of a few years ago, does not carry equal weight in Australia, which fared reasonably well by comparison.

In regard to whether CSEF should, in principle, be facilitated, CAMAC sees the potential for CSEF to encourage the Australian start-up entrepreneurial sector, especially in the crucial early stages of project and product development. Also, enterprises that are funded through CSEF and prove to be commercially successful may provide meaningful returns to their crowd investors, as well as creating employment and other consequential economic benefits.

CSEF also has the potential to finance other corporate entities, such as social enterprises or creative, cultural or philanthropic projects, that otherwise may have difficulties in obtaining sufficient finance to develop or continue.

CAMAC is also aware of the possible economic detriment that may arise if CSEF is facilitated in other jurisdictions (which is increasingly the case), but not in Australia. Lack of a supportive local regulatory environment may result in worthwhile Australian entrepreneurs incorporating in other countries, or moving their businesses offshore, to enable their ideas or projects to be funded by the crowd.

CAMAC recognises, however, that statements about the possible economic consequences if CSEF is, or is not, facilitated in Australia, and the likely impact of CSEF on capital allocation in the Australian economy, can only be speculative at this stage. For instance, there is a possibility that CSEF may lead to some level of misallocation of resources in the economy, with significant investor funds being directed towards high-risk and eventually unsustainable ventures. This may have a negative effect on the allocation of capital to other forms of productive and sustainable development. Also, losses to crowd investors could reduce confidence in corporate investment more generally, particularly if those losses are commonplace.

CAMAC also notes that as CSEF is still in its infancy world-wide, comparative information on the economic significance of this form of fundraising does not yet exist. It is not possible at this stage to obtain any meaningful comparison in any jurisdiction between the success rates of enterprises seed-funded through CSEF and ventures utilising more traditional funding models.

Furthermore, the likely level of investor participation in CSEF, being the key element on which the success of this form of fundraising for issuers depends, cannot yet be gauged, though if CSEF is facilitated in Australia, crowd investors will not necessarily be limited to Australian residents. To date, the interest in CSEF in Australia appears to be largely supply-driven, as evidenced by most respondents to the CAMAC discussion paper being potential issuers or intermediaries, or parties supporting the role of issuers, with no submissions from potential crowd investors. It is unclear how much demand, or interest, there will be from crowd investors for this form of fundraising, if facilitated, and whether any initial enthusiasm will be sustained over time, particularly given the losses of invested capital likely to be experienced by many crowd investors.

CAMAC is also aware of the potential financial and other risks to crowd investors posed by CSEF and the possibility of fraud by some fundraisers. For instance, the so-called 'wisdom of the crowd', a concept often referred to in support of CSEF, has not been independently verified. In addition, there is the possibility of a 'herding effect' with unsophisticated crowd investors, who may be inclined to invest in a project simply because other crowd investors have already done so, and without any considered understanding or assessment of the fundamentals of the project. The fact that CSEF relies heavily on the internet and its associated forms of social media may accentuate that herding effect, compared with traditional securities markets.

CAMAC considers that the extent to which genuine investor concerns might be addressed would partly depend on the nature of any regulatory structure employed for this form of fundraising, if facilitated, including appropriate investor safeguards. CAMAC has carefully considered these matters in subsequent chapters of this report.

2.3 Does the existing law facilitate CSEF?

2.3.1 Summary of the CAMAC position

For the reasons set out below, CAMAC is of the view that the current law presents fundamental difficulties for the use of CSEF by proprietary or public companies. Changes would have to be made to the Corporations Act if CSEF is to be facilitated in Australia.

2.3.2 Proprietary companies

Current barriers

As explained in detail in Appendix 2 of this report, the current barriers to the use of CSEF by proprietary companies are:

- the shareholder cap (such companies may have no more than 50 non-employee shareholders), and
- the prohibition on public offers of equity in these companies (with limited exceptions).

The limited exceptions from the offer restrictions include the small-scale personal offers exemption and offers to sophisticated investors (including very large minimum subscription offers). However, such offers do not come within the general concept of CSEF, as they lack the necessary element of offers to the crowd.

Some of the barriers to the use of CSEF by proprietary companies could be alleviated by interposing a managed investment scheme between the company and its crowd investors, though this would also attract compliance requirements for the scheme. There is also the question whether offering units in a scheme, even though linked to an issuer, would be sufficiently attractive for crowd investors in lieu of acquiring shares in the issuer itself.

Submissions

Many respondents saw the proprietary company structure as the most suitable for the type of start-up or other small-scale enterprise that could benefit from CSEF. However, the general view was that CSEF, which may involve small equity contributions from many investors (potentially hundreds or more), could not be satisfactorily accommodated within the current regulatory framework for proprietary companies.

The predominant view in submissions was that using a managed investment scheme as an interposed entity between a proprietary company issuer and the investor would generally be unattractive to crowd investors and would not be commercially feasible in many instances, given the possible administrative complexity and compliance costs in operating the scheme (even where one scheme was the interposed entity for a number of issuers). Having to utilise this arrangement could deter many start-up or other proprietary companies from seeking funds through CSEF.

CAMAC position

At present, proprietary companies would not be able to engage in CSEF to any significant degree, given the shareholder cap of no more than 50 non-employee shareholders and the prohibition on proprietary companies making public equity offers (with limited exceptions).

Any start-up enterprise using a proprietary company to seek funds from the crowd would be limited to utilising the small-scale personal offers exemption (no more than 20 investors in 12 months contributing no more than $2 million, or $5 million in some circumstances) or the exemptions for offers to sophisticated, experienced, professional or overseas investors. These options, however, are still subject to the shareholder cap and would not permit the scope of fundraising contemplated by CSEF.

In theory, these regulatory obstacles could be overcome by interposing a managed investment scheme between a start-up proprietary company and its crowd investors. Under this approach, investors would buy units in the scheme, with the funds raised being used to acquire shares in the proprietary company, which would be scheme property. However, CAMAC is of the view that this approach may involve a complex exercise, including compliance with the disclosure obligations that would attach to the offers made to crowd investors in relation to the scheme. Also, this indirect form of equity ownership may be unattractive to many crowd investors.

2.3.3 Public companies

Current barriers

As explained in more detail in Appendix 2, the current barriers to the use of CSEF by public companies are the compliance requirements for such companies and the fundraising disclosure requirements in Chapter 6D of the Corporations Act.

Submissions

Respondents strongly argued that the current public company structure was not a suitable vehicle for start-up and other small enterprises seeking funds through crowd sourcing. There was a general view that the current compliance obligations for public companies would deter most start-up and other small-scale enterprises from incorporating as this type of company. In addition, the public fundraising disclosure obligations for public companies under Chapter 6D of the Corporations Act were unsuitable for CSEF.

CAMAC position

Under the current legislation, it is open to entrepreneurs to incorporate as a public company and make offers to the crowd pursuant to the prospectus or offer information statement (OIS) requirements for such companies in Chapter 6D of the Corporations Act. Issuers could employ online intermediaries to publicise their offers, subject to those intermediaries complying with applicable licensing and other legal requirements. Disclosure documents, including prospectuses or OISs, can be made available electronically, including via the internet.

On one view, a start-up or other entity with a simple business model could prepare a prospectus or an OIS relatively easily and inexpensively, depending on the type of start-up activity involved. Also, while the additional costs of ongoing compliance as a public company may be greater for the issuer, the stricter corporate governance requirements for a public company provide a check and balance that could assist in protecting crowd investors, who would most likely be minority retail investors.

CAMAC is equally mindful, however, that the public company structure involves compliance requirements that may discourage many start-up or other small-scale enterprises from using that corporate form, whether or not they are contemplating raising funds through CSEF. Also, the set-up and ongoing compliance costs of a public company could absorb a significant proportion of any funds raised from the crowd. Those costs would be in addition to the costs involved in an issuer making offers to the crowd through an online intermediary.

2.4 What policy option to facilitate CSEF should be adopted?

The alternative policy options to facilitate CSEF considered by CAMAC are:

Option 1 adjust the regulatory structure for proprietary companies

Option 2 confine CSEF offers to a limited classes of investors

Option 3 amend the fundraising provisions for public companies

Option 4 introduce a regulatory regime specifically designed for CSEF.

2.4.1 Summary of the CAMAC position

For the reasons set out below, CAMAC supports Option 4 as the best means to facilitate CSEF in Australia.

2.4.2 Other jurisdictions

New Zealand, USA and Canada

These jurisdictions have adopted Option 4, though the New Zealand 'light touch' regulatory regime focuses on the licensing of intermediaries, and does not fully deal with the range of issues concerning issuers, intermediaries and investors under consideration in the USA and Canada.

UK

The UK has adopted Option 2**,** namely to confine CSEF to sophisticated investors and limited classes of retail investors, being:

- retail clients who are certified or self-certify as sophisticated investors
- retail clients who are certified as high net worth investors
- retail clients who confirm before a promotion is made that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorised person, or
- retail clients who certify that they will not invest more than 10% of their net investible portfolio (i.e. excluding their primary residence, pensions and life cover) in unlisted shares or unlisted debt securities.

The relevant rules commenced operation in April 2014.

2.4.3 Policy Option 1—Adjust the regulatory structure for proprietary companies

This would involve substantially liberalising the small-scale offers exemption for public offers by proprietary companies, as well as substantially increasing the number of permitted shareholders of a proprietary company, currently capped at 50 non-employee shareholders, or dispensing with that cap altogether.

Submissions

There was support in a number of submissions for liberalising the small-scale offers exemption on public offers by proprietary companies. However, it was recognised that the number of permitted offers would have to be increased substantially, possibly into the hundreds or more, to permit an issuer to raise sufficient seed equity from the crowd, particularly where investors could make small investments (a few hundred dollars or less).

Various respondents proposed a material increase in the 50 non-employee shareholder ceiling for proprietary companies, or removal of the shareholder ceiling altogether, to permit proprietary companies to engage fully in CSEF. It was argued that liberalising the small-scale offers exemption, but without changing the shareholder cap, may result in proprietary companies being able to choose from within the pool of willing crowd investors, but still not being able to aggregate sufficient amounts of capital.

CAMAC position

To accommodate CSEF under this policy option, the number of permitted offers under the small-scale offer exemption would have to be uncapped to allow for a meaningful level of capital to be raised through this process. However, any such change would not be effective without substantially increasing the 50 non-employee shareholder cap for proprietary companies, or dispensing with the cap altogether.

CAMAC is mindful that a consequence of such changes, if applicable to all proprietary companies, would be to move away from the concept of proprietary companies being closely-held entities, not generally open to public participation. This change may call into question the current reduced level of regulation of proprietary companies, compared with public companies. CAMAC does not consider it workable to divide proprietary companies according to whether or not they intend to engage in CSEF, and apply a different regulatory structure on this basis.

2.4.4 Policy Option 2—Confine CSEF to a limited classes of investors

Submissions

There was considerable opposition by respondents to adopting this option, with some arguing, for example, that it would not enable CSEF in the manner envisaged in other jurisdictions. It was also argued that restricting the pool of potential investors to, say, sophisticated, experienced or professional investors may not allow for a meaningful level of capital to be raised and would continue to exclude the majority of Australians from investment opportunities in Australian start-ups or other small-scale issuers. The comment was also made that restrictions of this nature would severely limit the possibility of a community supporting a local social enterprise.

Some submissions supported changes to the sophisticated investor test, to make it essentially a self-certification system more in line with the FCA approach in the UK, thereby avoiding any obligation on issuers or intermediaries to check the eligibility of those investors. However, there was no support for limiting CSEF investors to sophisticated investors.

CAMAC position

While limiting the class of permitted investors, as under the UK approach, may protect many retail investors from some of the possible risks of CSEF, it would not facilitate CSEF in the true sense but 'will deliver crowd funding without the crowd'. It is also arguable that restricting the pool of potential investors in this manner may not allow for a meaningful level of capital to be raised through CSEF in many instances.

2.4.5 Policy Option 3—Amend the fundraising provisions for public companies

Submissions

Many respondents were of the view that the unlisted public company structure is inappropriate for the types of start-up and other small enterprises that would seek to raise capital through CSEF, given the current governance and compliance requirements for such companies. In consequence, the policy option of adjusting the fundraising provisions would be irrelevant without substantial changes to the compliance requirements on public companies to accommodate such enterprises.

CAMAC position

Granting some relief from the fundraising provisions for public companies seeking to raise capital through CSEF may not suffice without also making some adjustment to the compliance requirements for those companies. These matters are considered under Policy Option 4, below.

CAMAC's proposal to create a new category of 'exempt public company' to accommodate CSEF is discussed more fully in Chapter 3 of this report.

2.4.6 Policy option 4—Introduce a new regulatory regime for CSEF

Submissions

A number of respondents supported a self-contained regulatory structure for CSEF, which may involve creating a new type of corporate entity as well as designing specific regulatory arrangements for the fundraising process.

One concern raised was that a self-contained regulatory structure should not create discrepancies in the regulatory environment for capital raising that could be exploited to the detriment of what is arguably a successful equity offer disclosure regime under Chapter 6D of the Corporations Act in its application to more developed businesses.

CAMAC position

CAMAC's recommended approach is to create a specific regulatory structure for CSEF, involving two key elements:

- **corporate form**: the creation of a new category of public company, to be known as an 'exempt public company', which could be adopted for a limited period by entities wishing to raise equity finance from the crowd. In developing its approach, CAMAC was aware of the need to make the corporate form sufficiently workable for issuers, while also suitably protecting the position of crowd shareholders.

  This matter is further outlined in Section 2.6.2, below, and is fully discussed in Chapter 3 of this report.

- **fundraising:** the regulation of the offer process to the crowd through specifically tailored provisions applicable to issuers, intermediaries and crowd investors. In developing its approach, CAMAC recognised the need to ensure that a regulatory structure for online fundraising does not create discrepancies in the Australian regulatory environment for corporate capital raising that could be exploited to the detriment of investors generally or other issuers.

  These matters are further outlined in Sections 2.6.3 to 2.6.5, below, and are fully discussed in Chapters 4 to 6 of this report.

This policy approach provides the necessary flexibility to design a specific structure for CSEF without the shortcomings of the other policy options discussed above.

2.5 What issues arise in implementing the recommended policy option?

In considering this question, CAMAC has taken into account two overarching factors that have a direct significance in the context of CSEF:

- achieving a proper regulatory balance that accommodates the legitimate interests of issuers, intermediaries and crowd investors
- achieving a suitable level of regulatory harmonization with approaches in other jurisdictions, given the borderless nature of CSEF.

2.5.1 Regulatory balance

The productivity and competitiveness of start-ups and other small-scale enterprises may be assisted to the extent that they can utilise CSEF under a regulatory structure that encourages, or at least does not create unnecessary barriers to, its use.

From one perspective, this may call for a generally light regulatory touch, taking into account that many start-up issuers may be discouraged by any legal complexity associated with fundraising. Also, for projects to stand a reasonable chance of success, and to reward their crowd (and other) investors, promoters and controllers should principally focus on using their time and skills to develop the project, not disproportionately on legal compliance. Any new regulatory regime for CSEF will not be effective if the compliance costs for issuers or intermediaries are prohibitive.

However, the success of CSEF for issuers rests on one key factor, which is outside their control or the control of advocates of CSEF or of intermediaries, namely, the level of take-up of equity offers by crowd investors. Sustainable growth, productivity and competitiveness through CSEF are only possible if investors have confidence in investing through that process.

In the context of investor confidence, crowd investors are not entitled to any guarantee of financial success through their CSEF investments and it is highly unlikely that many of them would have such an expectation. However, if crowd investors gain little or no return from their investments, see their investments being lost or unable to be liquidated, or witness benefits from the financial success of enterprises going exclusively, or disproportionately, to others within the company, they may become disenchanted. CSEF may thus develop a bad reputation within the crowd. As can be seen in other contexts, social media may be used to criticise as well as to praise.

In effect, the collective 'wisdom of the crowd', a concept so often employed by supporters of CSEF, may become the adverse 'judgment of the crowd' and turn against this form of fundraising. This may act to the detriment of bona fide and potentially viable small enterprises, which could have benefited from the financial support of the crowd and could have returned real benefits to those who otherwise may have invested.

In the view of CAMAC, productivity and competitiveness are best promoted through a regulatory balance that takes into account the legitimate perspectives of issuers, crowd investors and intermediaries. A good understanding by all these parties of how CSEF works, what it is intended to achieve and what risks are involved would be essential in establishing mutual trust.

On some matters a firmer touch of regulation may benefit all parties in the CSEF process. For instance, a structured regulatory approach to the content of an equity offer document would better guide issuers in preparing their disclosure material, increase the confidence of intermediaries that the offers they publish on their websites provide the necessary information to internet users, and also assist potential crowd investors by allowing them more easily to compare different offers.

Moreover, it is in the interests of bona fide issuers for intermediaries to conduct some limited due diligence checks on applicant issuers seeking to access their websites, to help avoid a loss of investor confidence if CSEF is seen as being employed by less reputable entrepreneurs.

Conversely, issuers may be wary of this form of fundraising if they have no external dispute resolution body to which they can turn in the event of disagreement with the intermediary. Likewise, crowd investors may be deterred from investing, despite the merits of an issuer's offer, if they do not have confidence in the professional and neutral role of the intermediary conducting that offer.

CAMAC does not consider that a lighter regulatory regime for CSEF is justified simply because only small amounts of funds from each crowd investor may be involved. These investors are entitled to some level of protection whatever their level of contribution, and the accumulated amount of funds raised from the crowd may be substantial. Furthermore, it is essential to have appropriate safeguards to mitigate attempted fraud, which is unacceptable in principle, as well as discouraging crowd investors. Also, an appropriate regulatory regime is more likely to give crowd investors greater confidence to invest, which will increase the likelihood of the success of CSEF as an additional method of fundraising.

In summary, the regulation of CSEF must engender a level of consumer confidence and trust in its use, as well as avoid stymieing the development of this form of corporate fundraising in Australia.

CAMAC would also caution against an overly precipitous 'rush to judgment' on whether CSEF, if introduced, enhances productivity. It may well be that as CSEF gets under way, there may be a surge of initial interest. However, this may be influenced to some extent by the 'novelty' effect of this internet-based means of becoming a shareholder without undue cost to the individual. Equally, however, some early failures by issuers may quickly erode investor interest and confidence in CSEF. The process of CSEF would need some time to develop before any firmer conclusions on this matter can be reached.

2.5.2 Harmonization with other jurisdictions

CSEF is a world-wide phenomenon, given the global reach of the internet and the capacity of issuers to make offers to crowd investors wherever located. How various jurisdictions have chosen to respond to, and regulate, this activity is therefore directly relevant to any consideration of its regulation in Australia.

In considering the specific elements of a regulatory structure for CSEF in Australia, CAMAC takes the view that there is value in endeavouring to have a degree of regulatory consistency with other jurisdictions concerning this form of fundraising. This may better ensure that the crowd has a comparable level of protection for all internet-based equity offers, wherever the issuer is located, while avoiding undue jurisdiction-shopping by issuers seeking to use CSEF online platforms to secure funds for their ventures.

For these reasons, CAMAC has closely reviewed the implemented or proposed regulatory approaches to CSEF in the UK, the USA, Canada and New Zealand, while also noting developments in Italy, at the European Union level, and with IOSCO.

At the time of completion of this report, the UK and New Zealand have implemented their approaches to CSEF, while the positions in Canada, the USA and the EU are not yet settled. A summary of the approach in each jurisdiction is set out in Appendices 3 to 5 of this report.

Nonetheless, while CAMAC acknowledges the merits of harmonization, each jurisdiction, including Australia, is entitled to forge its own regulatory path. Also, it is not possible to achieve complete harmonization as, on various key matters (as outlined in Section 2.6.1, below), the jurisdictions reviewed materially differ in their approaches. There appears no real prospect of a 'one template' worldwide regulatory approach to CSEF. However, there is still a strong benefit in seeking broad cross-jurisdictional regulatory guidelines, to which Australia can make a useful contribution.

2.6 Overview of the proposed regulatory structure

2.6.1 Comparison with other jurisdictions

In formulating its advice to the Government, CAMAC has carefully considered the key features of the regulatory structures for CSEF adopted or proposed in the overseas jurisdictions reviewed.

Of these jurisdictions, the basic approach taken in New Zealand, Canada and the United States is to establish a regulatory structure permitting start-up and other small-scale issuers to make offers of their equity to the crowd, using online intermediaries for this purpose.

Some key common regulatory features in these jurisdictions are:

- the offers are exempt from the prospectus provisions
- the offers can be made to anyone in the crowd
- the offers can only be made through online licensed intermediaries
- there are caps (relatively low) on the funds that an issuer can raise from the crowd in a 12 month period.

The UK comes from a different regulatory direction. Whereas the other jurisdictions treat the possible lack of a secondary market in equity being offered to the crowd as a risk to be disclosed, the UK treats this as its regulatory starting point.

The UK seeks to regulate the process of making offers, through intermediaries, of any securities that lack a secondary market ('non-readily realisable securities'). In contrast to the other jurisdictions:

- the offers are subject to the prospectus provisions
- the offers are limited to part of the crowd (being sophisticated investors and some classes of retail investors)

- the offers can be made through either online or offline licensed intermediaries
- (subject to compliance with the prospectus provisions) there are no caps on the funds an issuer can raise from eligible members of the crowd in any time period.

CAMAC acknowledges the breadth of the regulatory approach adopted in the UK, which involves 'media-neutral' regulation of the sale of all securities, in companies of any nature or size, that lack a secondary market. The shares that typically would be offered to the crowd by the types of issuers contemplated in the other jurisdictions would, almost always, lack a secondary market. The UK approach would therefore cover what is generally considered to be CSEF, but within a broader regulatory framework.

One difficulty CAMAC has with the application of the UK approach to Australia concerns the retention of the prospectus provisions. The UK prospectus provisions have exemptions from their operation which have no equivalent in Australia. As previously indicated (Section 2.3.3), the Australian prospectus provisions have been identified as one of the factors inhibiting the facilitation of CSEF in Australia. Requiring all issuers to comply with them would likely discourage the growth of CSEF in this jurisdiction.

Italy has also introduced CSEF provisions, though they are particularly tailored to that jurisdiction. For instance, that jurisdiction requires an issuer to obtain prior approval by the Chamber of Commerce before it can engage in CSEF. There is no equivalent comparable body in Australia.

The regulatory structure proposed by CAMAC is, at a general level, consistent with the New Zealand provisions and the Canadian and US proposals, though there are some very significant differences between these jurisdictions, and with the CAMAC proposals, on various policy issues.

For instance, in three key respects, the CAMAC proposals differ from the approach taken in New Zealand:

- **issuers: *offer disclosure***. New Zealand has adopted a partial ambulatory approach to the offer disclosure requirements of issuers, whereas CAMAC proposes a standard template disclosure structure, intended to benefit issuers as well as investors (Section 4.7)
- **intermediaries: *conflict of interest***. New Zealand permits an intermediary to invest in an offer conducted on its website, or otherwise have an interest in that offer, provided that the interest is disclosed, whereas CAMAC considers that any such interest may create conflicts of interest and should be prohibited (Section 5.12)
- **investors: *investor caps*.** New Zealand has no investor cap, whereas CAMAC proposes caps on the funds a crowd investor can invest with each issuer, and issuers collectively, in a 12 month period (Section 6.4). Without any cap, crowd investors could place much of their net worth in high financial risk ventures, many of which may fail.

Information on relevant approaches proposed or adopted in these other jurisdictions is included, under the heading **Other jurisdictions,** in each of the regulatory matters considered in the subsequent chapters of this report. In the interests of simplicity, footnote details related to the information contained under this heading have not been included. However, they are included in the same material in the relevant Appendix.

2.6.2 The corporate form

For a start-up or other small-scale enterprise to raise funds through CSEF, CAMAC is of the view that it should be required to be a public company, given that it will be making offers to the public, in the form of the online crowd.

However, to overcome the current disincentives on promoters of these enterprises to form a public company, a new classification of 'exempt public company' should be created.

A company seeking to engage in CSEF could:

- be incorporated as an exempt public company, or
- change from being a proprietary or public company to an exempt public company in some circumstances, or
- be incorporated as a public company without this exempt status.

Some of the key implications of these proposed options include:

- an issuer that is an exempt public company should be relieved from some of the initial and ongoing compliance requirements for public companies for the limited period that it is so classified
- for all issuers (whether exempt or non-exempt public companies), there should be enhanced disclosure requirements about the rights that will attach to the shares offered to crowd investors
- the exempt public company status should automatically be removed in certain circumstances or otherwise at the expiration of a prescribed period. Thereafter, the issuer will be regulated as a public company.

These, and other, matters affecting the public company status of an issuer are discussed in Chapter 3.

2.6.3 Issuers

The essential purpose of CSEF is to enable start-up and other small-scale enterprises to receive funding from small investors to assist in the development of their projects. Given that issuers, in effect, are asking crowd investors for their cash in return for some interest in the company, they should be obliged to provide the crowd with appropriate information about themselves and their projects and should be prohibited from seeking to unduly influence the crowd in their investment decisions.

Some of the key implications of these proposed requirements for issuers include:

- this form of fundraising should focus on start-ups and other small enterprises, excluding commercially or financially complex corporate entities, listed entities or companies that have already engaged in a formal offer to the public
- in offering its shares to the crowd, an issuer should provide information through one online intermediary and pursuant to a standard offer disclosure template
- an issuer should be subject to restrictions on promoting its offer otherwise than through the offer disclosure document

- an issuer should be prohibited from raising more than $2 million through CSEF in any 12 month period
- an issuer should be subject to conflict of interest prohibitions, including a ban on lending funds to a crowd investor to take up an equity interest in the issuer.

These, and other, matters affecting issuers are discussed in Chapter 4.

2.6.4 Intermediaries

Online intermediaries play the central role in bringing together issuers and crowd investors. It is fundamental to the continued confidence of these parties in the CSEF process that intermediaries act at all times in a professional manner and are free of any possible conflict of interest that may call into question their neutral role. CAMAC also believes that intermediaries are the parties best placed to undertake some vetting of issuers, while ensuring that crowd investors are made aware of the risks associated with CSEF and of the monetary caps that should apply to crowd investors in this form of corporate fundraising.

The regulatory implications of these proposed requirements for intermediaries can be divided into:

- obligations
- prohibitions
- liabilities.

Obligations

These include:

- an intermediary must be licensed by ASIC to operate an online CSEF portal and must comply with the terms of the licence
- an intermediary must conduct some limited due diligence checks on an issuer and its management before publishing the issuer's equity offer on its portal
- an intermediary must provide a generic CSEF risk warning to crowd investors, with a risk acknowledgement specifically provided by each investor, before any share acquisition by that investor through the intermediary portal can take place
- an intermediary must receive self-certification from each crowd investor that the investor has not breached any investment cap, before any share acquisition by the investor through the intermediary portal can take place
- an intermediary should be required to provide means to allow crowd investors to communicate with each other and with an issuer during such time as the issuer is utilising its website.

Prohibitions

These include:

- an intermediary should be subject to various prohibitions to avoid a conflict of interest, including a general prohibition on having a financial interest in any issuer whose offer is published on its portal, including accepting equity in an issuer as payment by the issuer of its fees

- an intermediary should be prohibited from offering investment advice to a crowd investor, or soliciting transactions on its website
- an intermediary should be prohibited from lending funds to a crowd investor to take up an equity interest in an issuer whose offer is published on its website.

Liabilities

An intermediary should be liable for investor losses only where it had actual knowledge of, or was party to, some fraud or other wrongdoing by the issuer.

These, and other, matters affecting intermediaries, including some controls on holding the funds of crowd investors, are discussed in Chapter 5.

2.6.5 Crowd investors

Crowd investors are the linchpin of CSEF, both as a mechanism for funding particular issuers and as a means of achieving some of the broader economic consequences that may flow from this form of corporate financing. Unless sufficient persons in the crowd are willing to provide their money to a sufficient number of suitable issuers, CSEF will largely fail as a productive corporate funding mechanism.

Some of the key implications of CAMAC's proposals for crowd investors include:

- to protect against undue financial exposure and ensure some level of diversification, a crowd investor may not invest more than $2,500 in any particular CSEF issuer in any 12 month period, and may not invest more than $10,000, in total, in all CSEF issuers in that period
- a crowd investor must sign an acknowledgement of risk, and also certify that he or she is within the investor caps, before being permitted to acquire shares through the CSEF process
- a crowd investor should have some cooling off and other withdrawal rights after entering into an acquisition agreement.

These, and other, matters affecting crowd investors are discussed in Chapter 6.

2.7 Public interest enterprises

Various commentators have observed that CSEF may offer new financing opportunities for corporate entities operating in the not-for-profit, community interest and philanthropic sectors.

The question that follows is whether the regulatory structure for CSEF, outlined in Section 2.6 (and further discussed in the remaining chapters of this report), should be adjusted in some manner for public interest enterprises in seeking equity investments from the crowd.

2.7.1 Charities

Crowdfunding for charitable investment purposes can be conducted under the exemptions in ASIC Class Order 02/184 *Charitable investment schemes – fundraising* if the following conditions are met:

- the organization seeking the funds is a 'charity' as defined in ASIC *Regulatory Guide 87: Charities*
- investment in the organization is designed for investors who wish to promote the charitable purposes of the organization and for whom the consideration of profit is not the primary consideration in the investment decision
- the organization fundraises by the issue of debentures or interests in a managed investment scheme
- the offer documents satisfy certain disclosure requirements, including containing a statement to the effect that the normal fundraising protections under the Corporations Act do not here apply
- the organization meets other stipulated requirements, including in relation to lodgement of financial information.

Organizations that meet these criteria are conditionally exempt from certain fundraising, managed investment, debenture and licensing provisions of the Corporations Act. Broadly, this means they are not required to issue a product disclosure statement or prospectus in order to fundraise, to have certain governance structures, or to have an AFSL. Intermediaries arranging this type of investment, say for example a crowdfunding website, will also be exempt from requiring an AFSL to carry out this activity.

CAMAC notes that these requirements are currently under review in ASIC Consultation Paper 207 *Charitable Investment Fundraisers*, which may result in some adjustment to this regulatory structure.

2.7.2 Social enterprises

Submissions

A number of submissions described CSEF as offering opportunities for individuals, by taking up 'community share offers', to provide a valuable source of capital for social enterprises, including community-owned businesses, working for the communal or broader public benefit. For instance, CSEF was described as presenting:

> an opportunity to strengthen community participation in local development by enabling shared ownership, strengthening social capital, and ensuring a stronger link between investment and local priorities.

It was submitted that a specifically designed 'light touch' regulatory regime should be adopted in regard to CSEF for social enterprises, on the basis that any regulatory regime should not have the unintended consequence of discouraging participation in these entities.

In support of this approach, respondents argued, for instance, that:

- the social purpose of community share offers, including their role in building social capital and community well-being, needs to be highlighted. These matters are not specifically dealt with in the regulation of fundraising under the Corporations Act

- there should be no restrictions on 'community share offers' other than perhaps a minimum 'community benefits test'
- the most significant focus of community share investors may not be on any prospect of a financial return on their investment but on its social return, in terms of ensuring that a social good is generated or maintained. In these circumstances, it was argued, most 'community investors' are likely to be 'buy and hold' shareholders and the evidence from 'community share offers' overseas is that most people involved wish any 'dividends' to be re-invested in the community business
- the net effect of 'dense social relations' in social enterprises 'potentially substitutes in community-benefit CSEF for any need to generate a legal response to many of the risks associated with general CSEF'. Rather, it was argued, investment in social enterprises is typically low risk/low return and often facilitates cheaper and better services for investors who are also consumers of the product generated by the social enterprise. Stated another way, community share offers are usually kept 'honest' through the operation of neighbourhood scrutiny and 'knowledge networks'
- there should be no restrictions on intermediaries advertising in general terms what are the benefits to investors, as well as the community, of particular social enterprise offers
- in certain conditions, the regulatory regime should allow the crowd investors to buy out the issuer's remaining stake in the CSEF-derived community business or other social enterprise. This might be particularly appealing to local infrastructure businesses where the community wants literally and metaphorically to own the project, resulting in gradual transfer of equity in a CSEF-derived business from the issuer to the investors.

The view was also expressed in submissions that CSEF for cooperatives in Australia should be encouraged:

> Cooperatives adhere to the international cooperative principles … which require them to be open to any person who is able to use their services and to work towards the sustainable development of their communities. These principles make cooperatives a good fit for crowd sourced or community equity funding models that look to the broad community for small investments and offer either small returns in kind or to satisfy desires to help develop new or community enterprises.

A concern was expressed that any move to introduce a less regulatory regime for CSEF under the Corporations Act, without recognition of the existing funding restrictions on cooperatives (which are one form of social enterprise and are currently regulated under State laws), may result in significantly increased competitive disadvantages for cooperatives in gaining equity funding from the crowd.

CAMAC position

There are competing considerations to take into account. On the one hand, the public interest goals of various social enterprises, both for persons directly involved and for society generally, may be particularly commendable and should not be discouraged. On the other hand, consumer protection issues still remain, given that CSEF involves an investment-based approach to crowd participation, as opposed to seeking capital through donation-based crowdfunding or rewards-based crowdfunding.

CAMAC notes that the UK Financial Conduct Authority, in Policy Statement (PS14/4) *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (March 2014), expressed reservations about providing lesser regulatory arrangements for social enterprises that come within its regulatory regime:

> Several respondents suggested that it was not appropriate to restrict promotions for ‘social investments’ that raise money for a good cause in the same way as promotions for other investments. They noted that applying restrictions could act as a disincentive and limit growth in this sector. They also argued that social investors are not primarily focused on monetary profit and are more willing to accept the risk of capital loss.
>
> [Our response] At present, if an investment activity falls within FCA scope, our rules apply to firms carrying on regulated activities or communicating promotions in relation to investments labelled as ‘social investments’, ‘ethical investments’ and ‘environmental investments’, just as they would in relation to any other designated investment. We do not consider an investment’s social or other non-financial objective to be a reason to reduce consumer protection when the same risks of potential capital losses and illiquidity can apply. … We consider it possible for social investments to be promoted and sold to retail investors in ways that comply with our conduct of business rules.

CAMAC considers that any adjustment to the regulation of CSEF for social enterprises incorporated under the Corporations Act, and its interaction with the regulation of cooperatives under State laws, could be considered after any general regulatory framework for CSEF is settled.

3 The corporate form to facilitate CSEF

This chapter sets out the elements of the proposed 'exempt public company' structure that issuers could adopt to undertake equity offers to the crowd.

3.1 Overview

The concept of CSEF is aimed principally at facilitating fundraising by start-up and other small-scale enterprises. Typically, such enterprises would in the past have been incorporated as proprietary, rather than public, companies. Nevertheless, for a start-up or other small-scale enterprise to raise funds through CSEF, CAMAC considers that it should be incorporated as a public company, given that it will be making an offer to the public, in the form of the online crowd, and will have those members of the public who accept the offer as its shareholders. However, to overcome the current disincentives on promoters to form a public company, a new classification of 'exempt public company' should be created.

This classification should apply only for a limited period, to provide an issuer with the opportunity to raise funds from the crowd in the early stages of its development, free of the usual governance and other obligations of a public company.

During this limited period, an exempt public company should be relieved from some of the compliance provisions otherwise applicable to public companies. It could engage in CSEF under the terms of the provisions regulating this form of fundraising (as discussed in Chapters 4 to 6 of this report), in lieu of having to comply with the public fundraising disclosure provisions in Chapter 6D of the Corporations Act.

An issuer that chooses to be a public company without this exempt status, or after that status has expired, could also seek to raise funds from the crowd under the CSEF provisions in lieu of the Chapter 6D public fundraising requirements, provided the issuer is eligible to do so (Section 4.2).

The key regulatory implications of the approach proposed by CAMAC are:

- **becoming an exempt public company:** an intending CSEF issuer could be incorporated as an exempt public company, or an existing proprietary or public company could change to an exempt public company in some circumstances

- **compliance exemptions:** an exempt public company would be relieved from some of the compliance requirements for public companies during the period of exemption

- **shareholder rights:** every CSEF issuer (whether an exempt or non-exempt public company) would be subject to specific disclosure requirements concerning the rights that it will attach to the shares offered to the crowd and how those rights compare or contrast with the rights attached to any other shares that the company has issued or can issue

- **expiration of the exempt status:** the exempt public company status should automatically expire in certain circumstances or at the expiration of a prescribed maximum period (with a limited exception), after which the issuer would become a public company, subject to all the compliance obligations of that type of company.

Each of these matters is further considered in this chapter.

3.2 Becoming an exempt public company

The purpose of becoming an exempt public company would be to seek public investment through the CSEF process. An enterprise that intends to rely only on private forms of fundraising (including the s 708 exceptions) may be better placed, in terms of relative compliance obligations, to incorporate as a proprietary company and retain that status.

3.2.1 Incorporation

New companies

Provision should be made for the incorporation of an entity as an 'exempt public company', subject to compliance with the statutory registration requirements for being a public company.[1]

Existing companies

An existing proprietary or public company should be entitled to change to an exempt public company if:

- it comes within the capital and turnover caps for being an exempt public company (Section 3.5), and
- it is eligible to conduct a CSEF offer (Section 4.2). This requirement overcomes the possibility of an existing company that is ineligible to conduct a CSEF offer seeking to reduce its compliance obligations, albeit temporarily, simply by changing to an exempt public company.

Some existing 'small proprietary companies'[2] and some small public companies may satisfy both criteria, and could change their corporate status accordingly.

By contrast, a 'large proprietary company' would not be entitled to change to an exempt public company, given that the current revenue/assets thresholds for such a proprietary company[3] exceed the proposed capital and turnover caps of an exempt public company. Likewise, a public company that has already made a regulated public offer under Chapter 6D of the Corporations Act, and hence would be a disclosing entity, could not change to an exempt public company, as it would be ineligible to conduct a CSEF offer (Section 4.2.3).

A listed company could not become an exempt public company, as listed entities cannot engage in CSEF (Section 4.2.3). Likewise, an exempt public company should not be entitled to be listed.

Directors

Currently, a public company must have at least three directors, two of whom must ordinarily reside in Australia.[4]

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1 s 117(2), (3). The requirement in s 117(2)(h) for designated opening hours would be excluded: see further Section 3.3.1 of this report.

2 s 45A(2). The financial ceilings in this provision are higher than the proposed capital and turnover caps for exempt public companies. Accordingly, only some small proprietary companies would be eligible to change to an exempt public company.

3 s 45A(3).

4 s 201A(2).

ASIC should have the discretion to adjust this requirement in some manner for an exempt public company where an applicant has provided good reasons for so doing.

3.2.2 Linked or phoenix companies

Unless CSEF is properly regulated, its facilitation might encourage some individuals to attempt to obtain substantial funds from the crowd through equity offers by a series of issuers, each ostensibly independent and developing different projects, but in reality, and unknown to the investing public, linked to one person or group of persons.

Alternatively, some individuals may seek funds from the crowd through a series of issuers over time, without disclosure of their history in this regard, including their involvement in any past failed CSEF issuers.

Either way, an individual may seek to raise substantial funds from the crowd far in excess of the cap on what any individual issuer could otherwise raise.

Exempt public companies

To reduce the possibility of individuals attempting to use multiple issuers in this way, simultaneously or sequentially, the application form for incorporation[5] as an exempt public company should require:

- the disclosure of any previous or current exempt public company, or any public company that has engaged in a CSEF offer, in which any intending director (including a person who would satisfy the test of being a ‘shadow director’[6]), officer, shareholder or associate of those persons has, or had, a direct or indirect financial interest of any nature, and
- the provision of full details in that regard.

Information on any current applicable company is directly relevant to the amount of funds that can be sought from the crowd in any 12 month period, given that the issuer cap takes into account the ‘issuer group’(Section 4.5.4).

Information on any past applicable company may be relevant to the possible disqualification of a person from managing a company.[7]

Failure to disclose this information, as well as being an offence, should be a ground for ASIC to deregister the company.[8]

Non-exempt public companies

To counter the possibility of individuals seeking to use a series of non-exempt public companies in an inappropriate way, the procedure for incorporation of this form of public company should require the disclosure of the same type of information, set out above, that applies to an exempt public company, and with the same consequences.

5 The contents of an application for registration are contained in s 117.
6 Pursuant to the definition of a ‘director’ in s 9, a shadow director is any person in accordance with whose instructions or wishes the directors of the company are accustomed to act.
7 See Part 2D.6 of the Corporations Act.
8 ASIC’s deregistration power is in s 601AB.

CAMAC acknowledges that this additional disclosure obligation would need to apply with all applications to register a public company. However, it would only impose an additional disclosure burden to the extent that a relevant person is, or has been, involved in CSEF.

Other checks

CAMAC elsewhere proposes that the issuer cap apply to an 'issuer group' (Section 4.5.4). This is designed to overcome the possibility of one or more parties setting up a series of related issuers, each seeking to raise funds from the crowd up to the issuer cap.

The proposed due diligence checks by intermediaries on issuers (Sections 5.8 and 5.9) are also designed to help counter attempts by individuals to manipulate the CSEF process.

In addition, issuers will be required to disclose in their offer disclosure documents information about linked or past companies that have engaged in CSEF (Section 4.7.3).

3.2.3 Eligibility to be a director

Any adult who is not disqualified from managing a company can be a director of a public company.[9]

Some submissions argued that an individual, as a precondition to being a director of an exempt public company, should establish that he or she is sufficiently knowledgeable in the legal duties that arise in being a company director.

One respondent commented that, from past experience, many controllers of start-up or other small-scale enterprises are likely to be unaware of the applicable principles of corporate governance, and their duties to crowd shareholders, in conducting the business:

> Too many times have we seen investors disregarded by issuers due to lack of education of the role of director or an inability for the business to perform resulting in directors withholding important information, which runs the risk of ultimately eroding investor confidence in new business or the share market generally. Unless education is embraced as a prerequisite to CSEF, the issues we have witnessed and many more, will continue.

Another respondent argued that:

> all directors of an issuer should be accredited (via formal training) to ensure they understand their fiduciary and other duties towards their shareholders.

This raises competing considerations. On the one hand, CSEF may involve equity offers being made through the internet to many persons who are legally and financially unsophisticated, and who therefore are dependent upon the controllers of the enterprise to fulfil their legal duties, which may directly impact on their interests as shareholders.

On the other hand, there is currently no knowledge or other prerequisite test that individuals must pass to be a director of a proprietary or public company, whether listed or unlisted. Such a requirement in the context of CSEF would be the sole exception.

Given this, CAMAC considers that there does not appear to be a compelling reason to impose an obligation in the context of CSEF which does not arise in other situations where the public may be involved as shareholders of a company.

9 s 201B.

An intermediary that has concerns about the ability of one or more individuals to fulfil the role of director could choose to decline to include the issuer on its website. In some instances, an intermediary may decide to do so to preserve its commercial reputation concerning the issuers it is prepared to list.

3.2.4 Other forms of fundraising

CAMAC considers that an exempt public company should be permitted to raise equity under the exemptions in s 708 in addition to any fundraising it might undertake pursuant to the CSEF mechanism.

To confine an exempt public company to CSEF may unduly restrict its scope for raising development funds, which might be to the detriment of those members of the crowd who have already invested in the enterprise.

The one qualification on this right of alternative fundraising is that funds raised under the small-scale personal offers exemption in s 708 should be included in the issuer cap under the CSEF proposals, for reasons given elsewhere (Section 4.5.4).

However, an exempt public company should not be permitted to raise funds through the prospectus and other public offer processes under Chapter 6D of the Corporations Act. This avoids the possibility of a company being incorporated as an exempt public company with the intention of making a regulated public offer under Chapter 6D of the Corporations Act but without the other compliance obligations that attach to public companies making such offers. An exempt public company that wished to raise capital under a Chapter 6D public offer could convert to a non-exempt public company for that purpose.

3.3 Compliance exemptions

Public companies are subject to a range of compliance obligations, many of which stem from the fact that the public may have invested in them.

CAMAC proposes that an exempt public company should be relieved of some of these compliance obligations during the limited period that it holds this status. However, the full public company compliance requirements should apply to a CSEF issuer that chooses not to be an exempt public company or from such time as its status as an exempt public company expires (see further Section 3.5 of this report).

Without seeking to be exhaustive, CAMAC has identified various current compliance obligations for public companies where the question of possible exemptions might arise. In considering each of these matters, CAMAC has taken into account that the purpose of any exemption is to reduce the compliance task for start-ups and other small enterprise companies in their early growth stages and that any exemption granted is temporary only. The exemptions discussed below are also set out in the table at the end of this section.

3.3.1 Registered office requirements

A public company has a series of obligations regarding its registered office and place of business.[10]

[10] Part 2B.5 of the Corporations Act.

In the view of CAMAC, an exempt public company could be relieved of some of these obligations, in particular:

- the obligation to display the company name[11]
- the obligation for mandatory office opening hours.[12]

However, the other registered office obligations on public companies, including information on how to contact the company,[13] would remain.

3.3.2 Appointment of an auditor

A public company must appoint an independent auditor of the company within one month of its registration,[14] to be confirmed at the first annual general meeting (AGM) of the company.[15] The business of the AGM may include the appointment of the auditor and the fixing of the auditor's remuneration, even if those matters are not referred to in the notice of meeting.[16] There is a general obligation for companies to have their financial reports audited,[17] though small proprietary companies only have to prepare a financial report and have it audited in certain circumstances.[18]

CAMAC proposes suspending the need for an exempt public company to appoint an auditor, and have its annual financial report audited (see further below), until such time as it has raised $1,000,000 through CSEF or any other prospectus exemption (the income threshold) and, in addition, has expended $500,000 (the expenditure threshold). The purpose of the two-fold test is to require an audit once a company has raised a significant amount of capital and has dissipated a significant proportion of that capital. Canada has a comparable approach.

However, any suspension from the auditing requirements should not be seen as reducing the financial accountability obligations of exempt public companies. Rather, there should be a mandatory full audit of the company's financial affairs when it converts to a public company, covering any period when its financial affairs were not audited.

Directors of exempt public companies should be required during the exemption period to maintain all relevant financial and other records,[19] both for the purposes of the subsequent audit and to know when the income and expenditure thresholds have been reached (thereby necessitating the appointment of an auditor). That auditor would then act and report in the same manner as all other public company auditors, including by the preparation of an annual auditor's report (see further below).

In the event that an exempt public company goes into liquidation while still without an auditor, the liquidator would have access to the company's financial statements and other records, even though those statements are not audited.

11 s 144.
12 s 145.
13 s 146A.
14 s 327A.
15 ss 327A(2), 327B.
16 s 250R(1)(c), (d).
17 s 301(1).
18 ss 292(2), 301(2).
19 s 286.

Where it is necessary that an auditor be appointed to an exempt public company, the directors of the company should be responsible for appointing and fixing the remuneration of that person, given the proposal (below) that the AGM be dispensed with. In so doing, the directors of the company would be subject to the statutory duties to act with due care and diligence and in good faith.[20]

3.3.3 Disclosing entity requirements

Unlisted companies that have raised funds from at least 100 persons using a disclosure document lodged with ASIC under Chapter 6D of the Corporations Act are disclosing entities.[21]

Any company that is a 'disclosing entity' under this test would be ineligible to be an exempt public company (see Section 3.2.1, supra). CAMAC considers that, in principle also, the preferred position is that an exempt public company should not be a disclosing entity. Some of the consequential implications are set out below.

3.3.4 Annual reporting requirements

All public companies must provide annually:

- a financial report
- a directors' report
- an auditor's report.[22]

These reports are provided to company shareholders in electronic form, except for those shareholders who have opted to receive them in hard copy,[23] or have elected not to be sent the information.[24] These reports must be provided to shareholders within certain time frames[25] and must be lodged with ASIC and thereby accessible to the public.[26]

The reports must be laid before the annual general meeting (AGM).[27] Shareholders at that meeting may give 'consideration' to these reports, but do not have a right to pass a resolution on whether to adopt them (except in regard to the remuneration report of listed public companies).[28]

CAMAC elsewhere recommends that the obligation to appoint an auditor be suspended in some circumstances (Section 3.3.2, above). Also, CAMAC elsewhere proposes that the obligation to hold an AGM be suspended during the period that an issuer is an exempt public company (Section 3.3.5, post).

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20 ss 180, 181.
21 ss 111AC(1), 111AF.
22 ss 292 ff, 314(1)(a). A company may choose to provide this information in the form of a concise report: s 314(2), (3).
23 s 314.
24 s 316.
25 s 315.
26 s 319.
27 s 317.
28 s 250R.

Given this, questions arise as to:

- whether the obligation to provide a financial report and a directors' report should remain for an exempt public company
- if so, how should shareholders be informed, and
- what rights should shareholders have in consequence of receiving this information.

Financial report

The content of the annual financial report is prescribed by legislation, including various declarations by directors and others concerning solvency and compliance with accounting standards.[29]

CAMAC considers that these obligations should remain for an exempt public company, subject to relief from the statutory obligation that the report be audited[30] in some circumstances (as described in Section 3.3.2, above). This will involve accounting costs for all exempt public companies, but not additional auditing costs.

As an exempt public company should not be a disclosing entity, it would have no obligation to prepare a half-year financial report.[31]

Directors' report

The directors' report for any public company must include general information about the operation of the company, including its principal activities and outcomes during the year, and some forward-looking information.[32] There is an exemption from disclosure of any matter the publication of which would result in 'unreasonable prejudice' to the company.[33] The report must also contain information about the corporate structure and any dividend distributions.[34]

CAMAC considers that all shareholders, including crowd investors, have a legitimate interest in being informed annually about all these matters. Also, the obligation to provide information on the corporate structure would only impose an administrative burden on the company to the extent that it created a complex structure in the first place.

There are additional reporting requirements for a listed public company or other disclosing entity.[35] CAMAC considers that these additional requirements would be unduly burdensome for an exempt public company.

Position of shareholders

In the interests of simplicity and cost-saving, an exempt public company should be entitled to publish the financial report, the directors' report and the auditor's report (if applicable) online only, with no need to notify shareholders electronically on each occasion, and no option for shareholders to receive a hard copy.

29 ss 295–297. The requirements in s 295A apply only to listed public companies.
30 s 301.
31 The half-year financial reporting requirements for disclosing entities are set out in Part 2M.3 Div 2 of the Corporations Act.
32 ss 298, 299.
33 s 299(3).
34 s 300.
35 ss 299A (applicable to listed entities), 300A (applicable to disclosing entities).

The template CSEF offer disclosure document should include standard information to crowd investors on the periodic reports that an exempt public company must provide in electronic format, with the company inserting details of the website where the reports will be published and generally when this will occur.

In regard to what rights shareholders should have in consequence of accessing these reports, CAMAC notes that, currently, shareholders of an unlisted public company have no rights at an AGM of that company to pass a resolution on whether to adopt the reports. However, concerned shareholders could seek to call another general meeting for the purpose of considering a resolution which is within the power of shareholders to pass.

The same rights to call a general meeting for the purpose of considering a suitable resolution should apply in the context of exempt public companies.

3.3.5 Meetings of shareholders

Annual general meetings

All public companies must hold an AGM at least once in each calendar year and within five months after the end of their financial year (unless ASIC grants an extension or exemption).[36] The AGM is the only shareholder meeting that public companies are obliged to hold.[37]

The AGM serves various purposes in the general engagement process between companies and their shareholders and is a mechanism for accountability of those in control of the company. The AGM is a forum for:

- *reporting:* to inform shareholders about various financial and other matters concerning the company, principally through consideration of the annual financial report, directors' report and auditor's report[38]
- *questioning:* to provide an opportunity for shareholders to ask questions or make comments on various matters, including the management of the company, the remuneration of directors and other senior corporate officers and the conduct of the company's audit[39]
- *deliberating*: to provide an opportunity for shareholders to discuss the matters on which they will be called to vote at the meeting
- *decision making*: to enable shareholders to vote (through binding or non-binding resolutions) on a limited range of matters at the AGM.

The decision-making function of the AGM includes:

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36 ss 250N, 250P, 250PAA, 250PAB, ASIC Regulatory Guide 44 *Annual general meeting -- extension of time*.

37 Other general meetings of shareholders may be called by the company for various reasons, including to obtain shareholder approval for certain transactions (for instance, related party transactions, members' schemes of arrangement or share acquisitions that otherwise would breach the takeover provisions). Shareholders who satisfy the stipulated threshold can also requisition or call a general meeting: ss 249D-249F. The court may also order a shareholders' meeting if it is impracticable to call the meeting in any other way: s 249G (see, for instance, *Beck v Tuckey Pty Ltd* [2004] NSWSC 357).

38 ss 250R(1)(a), 317.

39 ss 250PA-250T.

- (for listed public companies only) the remuneration report (which constitutes part of the directors' report)[40]
- the election of directors[41]
- the appointment of the auditor and the fixing of the auditor's remuneration[42]
- other permissible resolutions concerning the company that may also conveniently be considered at the AGM, such as resolutions to amend the company's constitution,[43] adjust the share capital in some manner,[44] or remove one or more directors.[45]

While not seeking to reduce the significance of the AGM as a forum for discussion and accountability, CAMAC sees some significant practical difficulties, and costs, that CSEF issuers would face if they were obliged to hold an AGM during the period that they are an exempt public company.

For instance, copies of the AGM notice and all the accompanying information must be sent by post to shareholders, except for those persons who have elected to receive this information electronically.[46] This could be an expensive exercise in the early stages of a start-up enterprise, particularly if it has crowd investors. Also, the AGM must be held at 'a reasonable time and place'.[47] Companies may use technology to hold an AGM at more than one venue,[48] but the enabling provision makes no reference to shareholders participating through the internet, nor to an AGM being held only online. Holding an AGM would also require a company to establish a structure (or contract a third party for this purpose) for the administrative tasks involved in holding an AGM, including the proxy voting process.

On balance, CAMAC considers that, in the specific circumstances of the types of start-up and other small-scale companies for which the category of exempt public company is designed, and taking into account that this is a temporary status only, there is a good case for dispensing with an obligation on these companies to hold an AGM while they are so classified.

One consequence would be to dispense with the need to pass shareholder resolutions on the matters which currently must be voted on by shareholders at an AGM of a public unlisted company. However, CAMAC has earlier recommended that exempt public companies not be required to appoint an auditor in some circumstances, and has placed the responsibility for auditor appointment and remuneration with the directors in other circumstances (see Section 3.3.2). Also, the provision concerning shareholder approval of persons appointed by the board to fill a casual vacancy is a replaceable rule, and therefore can be dealt with in the constitution of the company.

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40 s 250R(2), (3).

41 s 250R(1)(b). A person appointed to fill a casual vacancy on the board of a public company can remain as a director only with the approval of shareholders at the company's next AGM: s 201H(3) (a replaceable rule).

42 s 250R(1)(c), (d).

43 s 136.

44 Chapter 2J of the Corporations Act.

45 Shareholders of a public company may at any time, including at the AGM, by ordinary resolution, remove one or more directors: s 203D. A company's constitution may be amended by special resolution of shareholders: s 136(2). The CAMAC report *Diversity on boards of directors* (March 2009) footnote 12 explains other means by which shareholders can pass resolutions at the AGM, or at other general meetings, to influence the future direction of the company.

46 s 249J.

47 s 249R.

48 s 249S.

The directors of an exempt public company may, of course, choose to hold a formal AGM or hold an informal physical or electronic 'town hall' meeting of shareholders, to update them on the company's progress and allow for discussion. This form of engagement may be one means to maintain a positive reputation of the company with the crowd and engender continuing investor support for any further CSEF or other equity offers to the public.

Other general meetings

The statutory procedures for other shareholder meetings,[49] as well as the special rules for resolutions for the appointment of public company directors,[50] should apply to exempt public companies.

3.3.6 Executive remuneration

The procedure for settling the remuneration of executive and non-executive directors of a public company is a matter for each company. The directors of public companies that choose to be governed by the replaceable rules contained in the Corporations Act[51] are paid the remuneration determined by ordinary resolution of shareholders.[52] However, these companies may make alternative arrangements in their constitutions for determining the remuneration of directors, for instance, leaving this matter for decision by the board.

Remuneration provided by a public company to a director is a 'related party' transaction.[53] It is prohibited unless it is 'reasonable' or is approved by shareholders.[54] What constitutes reasonable remuneration is determined by reference to the circumstances of the company and the responsibilities involved in the office. Shareholders numbering at least 100 members who are entitled to vote at a shareholder meeting or collectively hold at least 5% of the votes that may be cast at a general meeting can, at any time, obtain information about the remuneration paid to directors.[55]

CAMAC considers that these requirements should also apply to an exempt public company, though crowd investors may or may not have voting rights in regard to executive remuneration matters.

However, the additional complex remuneration reporting requirements,[56] which apply only to disclosing entities,[57] and the 'two-strikes' rule, which applies only to listed public companies,[58] should not apply to exempt public companies.

3.3.7 Executive termination

Termination benefits for directors, senior executives and other key management personnel of public companies that exceed one year's average base salary are subject to shareholder approval.[59] In relation to change of control transactions, a takeover bid cannot lawfully include a condition that depends on approval of compensation to an officer or employee of the target (or any related body corporate of the target) in connection with the loss of, or

49 Part 2G.2 of the Corporations Act.
50 s 201E.
51 See further s 135 on the concept of replaceable rules.
52 s 202A(1).
53 ss 228–229.
54 ss 208, 211.
55 s 202B.
56 s 300A.
57 s 300A(2).
58 s 250R(2), (3), Part 2G.2 Div 9 of the Corporations Act.
59 Part 2D.2 Div 2 of the Corporations Act.

retirement from, office in consequence of the bid.[60] Also, the court may void agreements between a target company and its directors to give them termination benefits linked to a successful takeover bid for the company ('golden parachutes'), except where the benefits have been approved by ordinary resolution of shareholders.[61]

CAMAC does not see any clear rationale for adjusting any of these provisions for exempt public companies, given the importance of placing some controls on executive termination arrangements in the interests of all members of the company. However, crowd investors may or may not have voting rights in regard to executive termination arrangements.[62]

3.3.8 Related party transactions

The stated purpose of the related party transaction requirements is 'to protect the interests of a public company's members as a whole, by requiring member approval for giving financial benefits to related parties that could endanger those interests'.[63]

CAMAC sees no reason why exempt public companies should be permitted to provide financial benefits to related parties without compliance with the relevant provisions.[64] However, the Committee notes that the role that crowd investors will have in determining whether to permit related party transactions will depend upon whether they hold shares with voting rights in this regard.

3.3.9 Continuous disclosure requirements

A public company that is a disclosing entity must comply with the continuous disclosure requirements in Chapter 6CA of the Corporations Act.

The general purpose of the continuous disclosure requirements is to ensure that members of the public can keep themselves fully and promptly informed of all information that would reasonably be expected to have a material effect on the price or value of the company's securities.

From one perspective, an exempt public company should be made subject to the continuous disclosure obligations in the same way as other bodies that raise funds from the public. Offsetting considerations are the possible compliance burden that this obligation may place on a small entity during its initial or early growth stages and the limitation on the amount of funds that can be raised under CSEF.

CAMAC considers that, on balance, and taking into account that an exempt public company will be subject to specific disclosure requirements in making any equity offer to the crowd (Section 4.7), and that the exempt public company status is temporary only, such a company should not be made subject to the continuous disclosure obligations.

However, an issuer that is no longer, or never was, an exempt public company, would, and in principle, should, be subject to the continuous disclosure requirements if and when it satisfies the criteria for being a 'disclosing entity'.

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60 s 628.
61 s 1325C.
62 s 200E.
63 s 207.
64 The relevant provisions are set out in Chapter 2E of the Corporations Act.

3.3.10 Change of shareholder control

An unlisted public company with more than 50 shareholders is subject to the takeover provisions in Chapter 6 (Takeovers) of the Corporations Act.[65]

The purposes of these procedural provisions include ensuring that all affected shareholders are adequately informed, are treated equally, and are given a reasonable time to consider any proposed change of shareholder control in the company.[66] While the requirements of a formal takeover offer are complex, there are exemptions that provide for alternative equity acquisition arrangements in some instances, including through shareholder approval.[67]

CAMAC does not consider that there are any compelling reasons for dispensing with these requirements for exempt public companies, given that they are designed to protect the interests of shareholders, while allowing for changes in control where this is supported by a sufficient number of shareholders.

Applicability of some key provisions to exempt public companies

Obligation	Corporations Act reference	Whether applicable
Continuous disclosure (being a disclosing entity)	ss 111AC(1), 111AF, Chapter 6CA	No
Application for registration	s 117	Yes (with modifications for exempt public companies)
Display company name	s 144	No
Mandatory office opening hours	s 145	No
Information on how to contact the company	s 146A	Yes
Duties to act with due care and diligence and in good faith	ss 180, 181	Yes
Controls on termination benefits	Part 2D.2 Div 2	Yes
Minimum number of directors	s 201A(2)	Yes (but with ASIC power to adjust)
Rules for resolutions for appointment of public company directors	s 201E	Yes
Shareholders' right to obtain information about directors' remuneration	s 202B	Yes
Related party transactions	Part 2E.1	Yes
Statutory procedures for shareholder meetings (other than AGM)	Part 2G.2	Yes
Hold AGM	s 250N	No
Two-strikes rule	s 250R(2), (3), Part 2G.2 Div 9	No
Keep financial records	s 286	Yes
Financial report	s 292	Yes

65 s 606(1)(a)(ii).
66 s 602.
67 s 611.

Obligation	Corporations Act reference	Whether applicable
Directors' report	ss 292, 298, 299	Yes (unlisted company obligations only)
Remuneration reporting requirements	s 300A	No
Shareholder entitlement to report	s 314	Modified: online only
Appoint an independent auditor	s 327A	No (unless certain thresholds met)
Have financial report audited	s 301	No (unless certain thresholds met)
Half-year financial report	Part 2M.3 Div 2	No
Takeover provisions	Chapter 6	Yes

3.4 Shareholder rights

This discussion of shareholder rights applies to all CSEF issuers, whether exempt or non-exempt public companies.

3.4.1 Crowd expectations

In considering the rights of crowd shareholders, it should be recognised that these investors may differ considerably amongst themselves in what they expect in return for their investment.

For instance, some crowd investors may see their role essentially as assisting a particular socially worthwhile project. Although they acquire shares, they may have little interest in exercising any rights attached to their shares or in receiving any dividend from them. Rather, their expectation of intangible benefits, in terms of helping to advance the goals of the project, may suffice.

Other, possibly most, crowd investors may place their money with an enterprise in expectation of some financial return, at least in the longer term. Some of them may also be attracted to the notion of being part 'owners' of a company through their shareholding, which they see as giving them some participation role in its affairs and a direct interest in its future.

For the various types of crowd investors, there is the risk that without sufficient information they may simply assume that the shares being offered to them necessarily carry rights that fulfil their expectations and that these rights are guaranteed indefinitely. In practice, this may be far from the case.

3.4.2 Other jurisdictions

The USA and Canada do not seek to prescribe shareholder rights, but rely principally on a full disclosure approach.

USA

Consistent with a requirement under the JOBS Act, the proposed SEC rules would require an issuer to provide a description of its ownership and capital structure. This disclosure would include:

- the terms of the securities being offered and each other class of security of the issuer, including the number of securities being offered and/or outstanding, whether or not such securities have voting rights, any limitations on any such voting rights, how the terms of the securities being offered may be modified and a summary of the differences between such securities and each other class of security of the issuer, and how the rights of the securities being offered may be materially limited, diluted or qualified by the rights of any other class of security of the issuer
- a description of how the exercise of the rights held by the principal shareholders of the issuer could affect the purchasers of the securities
- the name and ownership level of persons who are 20% or more owners
- how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions
- the risks to purchasers of the securities relating to minority ownership in the issuer and the risks associated with corporate actions including additional issuances of securities, issuer repurchases of securities, a sale of the issuer or of assets of the issuer or transactions with related parties, and
- a description of the restrictions on the transfer of the securities.

Canada

It is not proposed to require that crowd investors be provided with shareholder rights.

Rather, an issuer must disclose the specific risks to crowd investors if specified rights are not provided and that the absence of such rights affects the value of the securities.

In regard to possible dilution, it is proposed that the offer document must contain the following statement:

> The rights of purchasers of the securities under this offering may be diluted or negatively affected as a result of a number of factors, including the rights and characteristics of other securities already issued by the issuer, future issuances of securities by the issuer, and potential changes to the capital structure and/or control of the issuer.

3.4.3 Determining crowd investor rights

Policy options

One possible policy response to deal with crowd expectations is to provide that only non-voting shares can be offered under CSEF. This has the benefits of simplicity and certainty. However, it may unduly restrict issuers, who otherwise may be willing to offer shares with voting and other rights in return for financial support from the crowd. It may also unduly discourage those crowd investors who expect more than just a passive role in the company.

Another possible response to crowd expectations is to prescribe a set of rights for all shares offered to the crowd, which either cannot be varied, or can be varied only with the consent of the crowd investors themselves (by ordinary or special resolution). Such a prescriptive approach, while providing certainty, would raise the broader question of how to achieve a satisfactory balance between crowd investors having too much power in an issuer and their having too little power. The former outcome may deter entrepreneurs from seeking funds through CSEF, while the latter outcome may be unduly out of alignment with the expectations of many crowd investors.

Another approach would be a requirement that any share offer that occurs at the same time as an offer to the crowd (such as a private placement under s 708) must have the same terms and conditions, including price, as the crowdfunding offer. While this approach is intended to achieve a level of fairness and equality of treatment between crowd and other offerees, it only covers the offer period. It does not resolve the broader issue of a company having a complex equity structure, with differential rights between different groups of shareholders.

CAMAC considers that a preferable approach to deal with the range of crowd expectations is to allow each issuer to design its own equity structure and determine what shares it will offer through CSEF (as permitted under current law, discussed below), provided that the rights that attach to these shares, and how those rights compare and contrast with the rights attached to any other shares that the company has issued, or can[68] issue, are fully disclosed to the crowd in the offer disclosure documents in a clear, comprehensive and transparent manner. That comparison must include rights that are attached to any other shares in the company but that are not available to the shares offered to the crowd.

CAMAC observes that compliance by an issuer with the proposed disclosure requirements would not impose an administrative burden on the issuer except to the extent that it chooses to adopt a complex equity structure in the first place. Also, each issuer may need carefully to consider whether the equity structure it has adopted, and the respective rights that attach to each class of its shares, will satisfactorily align with the expectations of its target group of crowd investors.

Implementing the proposed policy option

Under current Australian law, a public company, by its constitution or the terms of issue of its shares, may determine the terms on which its shares are issued, and the rights and restrictions attaching to them vis-à-vis other shares in the company.[69] As summed up in one legal commentary:

> shares may be issued on terms … that provide for different rights than the rights upon which other shares are held. The differential rights may relate to participation in dividends, return of capital, distribution of surplus assets on winding up, voting, or other matters … . Memberships may be created with different rights from the rights of existing members.[70]

In consequence, in regard to governance and other matters, including the appointment and removal of directors[71] and corporate reconstructions, classes of shares may be issued with preferential, abbreviated, or no, voting or other rights on some or all of those matters.

CAMAC does not seek to disturb the right of exempt or non-exempt public company issuers to issue classes of shares with differential rights. For instance, in the context of start-ups and other small enterprises, there may be good reasons for creating a separate class of 'founder' shares, with voting, dividend and other rights that permit these shareholders to remain in control of the enterprise (on the argument that they are the persons with the 'vision' and the skills to make the enterprise successful) and to receive a 'premium' return from any profits

68 The concept of shares that a company 'can' issue is intended to cover shares of a specific designation or description that are referred to in the company's constitution but that have not yet been issued.
69 s 254B(1).
70 Austin & Black's *Annotations to the Corporations Act* [2F.246B].
71 ss 201E, 203D.

generated (on the argument that this premium reflects the 'financial value' of their ideas, over and above the capital contributed from the crowd).

Having said this, CAMAC also observes that some investors (such as 'angel', venture capital or other institutional fund providers) are in a position to negotiate arrangements with the issuer that protect their interests. This can involve these investors taking up a class of equity with preferential voting, dividend and other rights attached. There is no equivalent representative to negotiate shareholder rights for crowd investors, even where, collectively, they may be making a substantial, if not the largest, financial contribution to an enterprise, at least in its crucial early development stage.

Given this, CAMAC considers that issuers should be obliged clearly to set out the comparative rights of shares they are offering to the crowd. For this purpose, the offer disclosure document should oblige issuers to provide the following information:

- **summary of equity structure:** what is the existing equity structure of the issuer, including whether there are existing and/or anticipated classes of shares (in name or in fact[72]) or any securities convertible to shares[73]
- **simple equity structure:** if there is only one class of equity, the issuer should confirm that crowd investors will have the same voting, dividend, capital reconstruction, takeover, return of capital and other rights as all other holders of equity, proportionate to the number of shares held
- **complex equity structure:** if there are existing or anticipated classes of equity, which class of shares is to be offered to crowd investors, what are the rights attached to this class, and in what respects do these rights differ from the rights attached to any other class of equity (including any rights given only to one or more other classes of shares)
- **variation of equity rights:** what is the procedure by which any rights attached to equity generally, or to any class of equity, can be varied or cancelled.[74]

Requiring all issuers to provide this information, in a standard template format, would assist the crowd to compare the shareholder rights being offered by different issuers, for the purpose of making investment decisions. Crowd investors may, of course, take other factors into account in deciding whether to acquire shares in a particular issuer (such as the public interest or community advancement goals of that issuer). What is important, however, is that the crowd not be misled in their expectations of the rights they will receive if they choose to become shareholders.

3.4.4 Later dilution of crowd investor rights

Submissions

It was argued that market practice would suggest that any capital-raising from sophisticated investors following the raising of funds through CSEF may require the issue of preference shares, with superior rights to the share capital previously offered to the crowd. In consequence, appropriate disclosure should be made to CSEF investors about the risks

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72 The relevant case law provides that if the shares of a company can be divided in terms of their relative rights, benefits, or disabilities, then the share capital of the company will be deemed to be divided into classes of shares according to those distinctions, whether or not the shares are so described.

73 This disclosure obligation would be consistent with the existing requirement that an application for registration as a public company must include information concerning the share capital and any classes of shares: s 117(2)(k).

74 In regard to the procedure for varying class rights, see also Part 2F.2 (Class rights) of the Corporations Act.

associated with future capital raisings causing dilution or a potential impact on the rights attached to their shares.

CAMAC position

The CSEF issuer cap of $2 million in any 12 month period, proposed elsewhere in this report (Section 4.5), means that in many instances the issuer may need to raise equity capital from the crowd on a number of occasions, or from a range of sources, including sophisticated investors. Given this, the chance of dilution of various rights of shares taken up by crowd investors in an early fundraising exercise through later share issues could be very high, and needs to be taken into account.

Subsequent share issues in the same class

An issuer may engage in a number of CSEF offers of shares in the same class (subject to compliance with the issuer cap: see Section 4.5). Any subsequent successful offer will proportionately dilute the percentage of the issued shares held by earlier-accepting crowd investors. At the same time, of course, there will be more equity capital available to the issuer.

CAMAC notes that this dilution effect applies to share issues generally, whether or not through CSEF. However, it may be important to draw this effect to the attention of crowd investors in the generic risk disclosure warning (Section 5.15), given that some of them may lack this understanding of the effect of any subsequent CSEF offer.

Subsequent share classes

The disclosures proposed under **Determining crowd investor rights**, above, do not cover the situation where, subsequent to an offer to the crowd, an issuer decides to create and offer a new class of shares, say, to particular sophisticated or other investors who are now willing to invest on the apparent strength of the enterprise. In some cases, the earlier financial contribution by crowd investors may have been a decisive factor in attracting later equity providers. However, those subsequent providers may require preferential shareholder rights over crowd investors as a condition of funding the company at this point.

The outcome could be that the original crowd investors receive little return on their investment, and their shares may have no material resale value, even when the enterprise to which they have provided the original seed capital eventually proves to be successful.

While acknowledging this problem, CAMAC considers that it is not possible, given the many possible circumstances, to create a regulatory regime for this post-offer situation in the particular context of CSEF.

There are already some legal constraints on what issuers may do, and some existing remedies are available for crowd investors. For instance, directors of a company, pursuant to their statutory duty to act in good faith in the best interests of the company, can only issue new shares for a proper purpose.[75] Also, crowd shareholders aggrieved by any new equity issue may seek oppression remedies,[76] individually or through a class action. It is also open to crowd investors, as members of the company, to take proceedings on behalf of the company, with the leave of the court, in appropriate circumstances, against an alleged wrongdoer, who could be a director or other officer of the company.[77] Of course, individual crowd investors may or may not be motivated to act, and the cost of doing so, even

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75 s 181. In this context, see the summary of relevant case law principles concerning share issues in Austin & Black's *Annotations to the Corporations Act* [2D.181].

76 Part 2F.1 of the Corporations Act.

77 Part 2F.1A of the Corporations Act.

collectively, may for many of them well exceed the funds they have already invested in the company.

Given these constraints and remedies, albeit limited, and the fact that new classes of shares may be created during the lifetime of any company (whether or not through CSEF), it is not considered appropriate to impose specific constraints on share class issues in the specific context of CSEF. Rather, CAMAC considers that the preferable course is to draw the possibility of subsequent share class issues, and their dilution effects, to the attention of crowd investors in the generic risk disclosure statement (Section 5.15).

3.4.5 Crowd investors communicating with each other

The possibility of crowd investors, individually or collectively, seeking remedies in appropriate circumstances might be strengthened if they can directly communicate with each other for this purpose (see further Section 4.15).

3.5 Expiration of the exempt status

The exempt public company status proposed by CAMAC is specifically designed to facilitate CSEF by start-up and other small-scale enterprises in the early stages of their growth. However, during such time as an issuer is an exempt public company, crowd investors will not have the benefit of the full corporate governance, and other, requirements for a public company, which provide some level of check and balance and which could assist in protecting persons who will most likely be minority retail investors.

For these reasons, an issuer should not have the benefit of an exempt status indefinitely. That status should lapse when the basis for the exemption no longer exists or after a prescribed time period has elapsed, with the issuer thereafter automatically becoming a public company for all purposes.

CAMAC therefore proposes that the exempt public company status automatically lapse when any of the following occur:

- the capital of the enterprise reaches a certain stipulated threshold, say, $5 million (for a certain continuous period of, say, 6 months)
- the turnover of the enterprise meets a predetermined minimum, say, $5 million per annum
- the company has been incorporated as an exempt public company for a certain period, say, three years, subject to a limited extension (see below).

The issuer itself, by notice to ASIC, should have the power at any time to remove its status of being an exempt public company, thereby becoming a public company. Also, the shareholders of the company, by special resolution, or the court, on application, should also have the power to alter its status in this way. What, if any, voting rights crowd investors would have on any such resolution would be a matter for each company.

To provide some flexibility in particular circumstances, and if shareholders agree by special resolution (with crowd investors voting as a separate class for this purpose), an exempt public company that has not yet satisfied the capital or turnover criteria could continue as this type of company for a further 12 months after the prescribed time period has expired. That extension could be renewed annually by shareholder vote, for, say, a maximum of two years after the expiration of the three year maximum period that otherwise applies. The reason for giving crowd investors class voting rights in this particular context is that they could be directly affected by continuation of the compliance exemptions that otherwise would no longer apply to the company.

4 The crowdfunding process: issuers

This chapter sets out the proposals to permit issuers to offer their equity to the crowd.

4.1 Overview

It is proposed that an exempt or non-exempt public company (discussed in Chapter 3) may seek funds from the crowd by offering its equity through a licensed online intermediary (discussed in Chapter 5) provided:

- it is an eligible issuer (Section 4.2)
- it is offering shares in the company (Section 4.3)
- the offer is a primary offer (Section 4.4)
- the offer does not exceed the issuer cap (Section 4.5)
- the offer disclosure requirements are complied with (Section 4.7)
- the controls on advertising are complied with (Section 4.8)
- it does not lend to crowd investors to acquire its shares (Section 4.10)
- any material adverse change concerning the issuer is notified (Section 4.11)
- no transfer of funds or shares takes place until the CSEF offer is completed (Section 4.12)
- the controls on fee payments are complied with (Section 4.13).

An issuer could also:

- offer other equity during the CSEF offer period (Section 4.6)
- accept oversubscriptions (Section 4.9).

However:

- the issuer will be liable for certain breaches (Section 4.14).

There is also a discussion on whether an issuer should provide a means for its crowd and other shareholders to communicate with each other (Section 4.15).

CAMAC considers that these proposals achieve a proper and workable balance between facilitating the CSEF process for bona fide issuers, and providing safeguards against possible abuse.

4.2 Permitted issuers

Issue: should there be restrictions on the types of issuers permitted to employ CSEF?

4.2.1 Other jurisdictions

USA

The enabling crowdfunding provisions of the JOBS Act apply to US incorporated issuers. The provisions in the JOBS Act pre-empt regulation of these issuers by the laws of the various States of the USA in relation to the fundraising process.

Also, the JOBS Act excludes investment fund companies utilising CSEF to distribute their securities.

The SEC has also proposed to exclude a company that has no specific business plan or has indicated that its business plan is simply to engage in a merger or acquisition with an unidentified entity or entities:

> crowdfunding is a new and evolving method to raise money that serves as an alternative source of capital to support a wide range of ideas and ventures. We believe that the exemption under [Title III of the JOBS Act] is intended to provide an issuer with an early stage project, idea or business an opportunity to share it publicly with a wider range of potential investors. Those potential investors may then share information with each other about the early stage proposal and use that information to decide whether or not to provide funding based on the "wisdom of the crowd." Under such circumstances, this mechanism requires the public to have sufficient information about the issuer's proposal to discuss its merit and flaws.
>
> At the same time, an early stage proposal may not allow the crowdfunding mechanism to work appropriately if the issuer does not describe a specific project, idea, or business, or is seeking funding for unspecified corporate transactions. In such cases, individuals reviewing the proposal may not have sufficient information to formulate a considered view of the proposal, or the proposal may be less likely to attract enough perspectives to inform a crowd decision.

Italy

CSEF in Italy is limited to 'innovative start-ups'. To be 'innovative', a firm must be recognised as such by the Chamber of Commerce, because, for example, it has invested in R&D activities or employs researchers. The company purpose should expressly include the 'development and commercialisation of high-tech value products or services'. To be a 'start-up', the firm can be no more than 48 months in existence.

There is no equivalent requirement in the US legislation or the Canadian proposals.

UK

CSEF in the UK is effectively limited to issuers that are public companies.

Although there is no maximum number of shareholders of a UK private company (in contrast with the Australian 50 non-employee shareholder cap), the prohibition on public offers of private company shares remains in the UK context (as indicated in FCA Policy Statement PS14/4).

Canada

Under the proposals, eligible issuers must be incorporated or organized in Canada, with their head offices situated in Canada, and the majority of their directors must be Canadian residents. Both reporting issuers and non-reporting issuers are eligible to raise funds through CSEF, though some issuers are excluded, principally investment funds or issuers involved in 'blind pools' (see below).

In applying CSEF opportunities to reporting as well as non-reporting issuers, the OSC commented that:

> As the overall goal of our crowdfunding initiative is to facilitate capital raising for start-ups and small and medium-sized enterprises (SMEs), we think the exemption should be available to both reporting issuers and non-reporting issuers.
>
> We have been advised that reporting issuers may wish to raise capital through crowdfunding, particularly venture issuers that may be experiencing difficulties in raising capital through more traditional means in the current economic environment.
>
> We support allowing reporting issuers to raise capital through crowdfunding as reporting issuers should not have fewer capital raising options than non-reporting issuers, particularly since reporting issuers have a continuous disclosure record and are subject to regulatory oversight.

Situations that involve a 'blind pool' include where:

- an issuer does not have a written business plan setting out its business or proposed business, its goals or milestones and a plan for reaching those goals or milestones
- the proceeds of a distribution will be used primarily by the issuer to invest in, merge with or acquire another unspecified business.

4.2.2 Submissions

There were a range of approaches by respondents on whether to confine CSEF to particular entities.

One view was that CSEF be confined to 'genuine start-ups'. Other respondents referred to the legal difficulties that may arise in applying any definition of an 'innovative start-up' or a 'genuine start-up', noting that in Italy the classification of an 'innovative' start-up was determined by a particular body, not pursuant to a legislative definition. It was also argued that confining CSEF to 'innovative start-ups' (even if satisfactorily defined) may unnecessarily rule out many potential projects that are based on proven approaches, but which have a new emphasis or capital need.

Another approach in submissions was to permit all enterprises, whether or not technology or other start-ups, to raise funds through CSEF, except for all or some of the following types of entities:

- investment companies (referred to by a number of respondents)
- companies without a specific business plan or a plan which is simply to engage in a merger or acquisition with an unidentified entity
- companies with more than one business operation
- pooled investment or private equity funds

- banks or other financial institutions
- any other AFSL holder or entity acting as an ADI, custodian or depository service.

Some submissions opposed restrictions on the classes of entities permitted to employ CSEF, with the following range of reasons being put forward by various respondents:

- Australian companies should have access to the broadest range of sources of capital and markets
- firms outside any specified category may nevertheless have the capacity to generate innovation, employment and economic growth
- the goal of improving the efficiency with which capital is recycled from household savings into business investment does not require regulators to take any view on the types of investment for which crowdfunding should be used to allocate capital.

4.2.3 CAMAC position

The CAMAC review is limited to Australian incorporated issuers, which, as proposed in Chapter 3 of this report, must be public companies, whether or not they come within the proposed new category of ‘exempt public company’.

While there is merit in the view put forward in submissions that the range of entities eligible to seek funds through CSEF not be unduly confined, various restrictions should nevertheless apply.

Complex institutions. As the proposed regulatory structure for CSEF is aimed at facilitating start-up and other small enterprises, it should not be available for more commercially or financially complex structures, such as investment or financial institutions, nor for ‘cash box’ arrangements. These more commercially sophisticated entities have the capacity to seek funds from the public through the processes under Chapter 6D (Fundraising) of the Corporations Act.

Listed companies. The proposed CSEF procedure should not be available, directly or indirectly (say, through subsidiaries or associates), to a listed public company. Such a company may well be beyond the start-up or small-scale phase of its development. Also, the company can offer its securities, and the crowd can transact in its shares, through the exchange mechanism.

Companies that have made regulated public offers. A company that has made a public offer of its equity under Chapter 6D of the Corporations Act (other than under the s 708 exemptions) should not be permitted to raise further funds through CSEF. That company would already have complied with the disclosure and due diligence requirements in the Chapter 6D provisions. It could make further regulated offers to the public pursuant to that Chapter without undue additional expense in preparing the offer documentation. The offer disclosure document can be provided electronically (ASIC Regulatory Guide 107).

Blind pool. CAMAC supports the exclusion of ‘blind pools’ as that term is used in the Canadian proposals, to avoid crowd investors putting their funds into an enterprise without a business plan or in circumstances where the funds invested in the issuer will, in effect, be made available to another enterprise.

Companies with substantial capital. Consideration should be given to excluding companies with substantial capital, say, more than $10 million, from raising funds through CSEF, given that they would no longer be start-ups or small-scale enterprises, and would normally have the financial capacity to make regulated public offers under Chapter 6D if they wished to raise additional capital.

CAMAC does not support the further step of limiting CSEF to issuers classified as ‘innovative start-ups’. While the CSEF process is intended to assist worthwhile innovative projects, imposing some classification of this nature as a precondition to offering equity to the crowd would add an unnecessarily complex level of regulation.

The mutual recognition rules between Australia and New Zealand include the prospectus regime, allowing New Zealand companies to raise funds in Australia through compliance with the New Zealand prospectus requirements (and vice versa). The current provisions do not extend to capital-raising through CSEF. Consideration may need to be given to the extension of the mutual recognition rules to cover this form of corporate fundraising.

However, any mutual recognition may have to take into account some material differences between the New Zealand approach and what is proposed by CAMAC for Australia, in particular different issuer disclosure regimes and different approaches to whether there should be a cap on the total funds that an investor can invest through CSEF in a particular period.

4.3 Permitted securities

Issue: what types of securities of the issuer should be able to be offered through CSEF?

4.3.1 Other jurisdictions

New Zealand

CSEF is limited to shares in companies, excluding options and convertible securities.

USA

The JOBS Act provisions apply to equity or debt securities of the issuer.

Canada

Securities

Limited types of securities of the issuer can be offered under CSEF, principally:

- common shares
- non-convertible preference shares
- securities convertible into common shares or non-convertible preference shares
- non-convertible debt securities linked to a fixed or floating interest rate.

All of the securities offered in a crowdfunding distribution must have the same price, terms and conditions.

The OSC commented that:

> As the overall goal of our crowdfunding initiative is to facilitate capital raising by start-ups and SMEs, we do not think it is necessary or appropriate to allow complex

> securities, such as derivatives and securitized products, to be offered under the [CSEF provisions].

Other rewards

An issuer can combine securities and non-securities rewards (including ‘perks’) in a crowdfunding offer, provided the offer document describes any non-securities rewards that are being offered and on what terms. The OSC considered that this would enable the issuer to derive the benefits of both securities-based and non-securities-based crowdfunding:

Non-securities-based crowdfunding has been cited as contributing to consumer and investor loyalty, product development, and marketing. As a result, combining securities and non-securities rewards and perks in a crowdfunding offer may result in a better investment opportunity for investors without detracting from investor protection.

UK

The FCA regulatory structure for what it terms ‘investment-based crowdfunding’ covers the processes by which licensed intermediaries may market ‘direct offers’ to various classes of investors to acquire ‘non-readily realisable securities’ in issuers.

The concept of ‘non-readily realisable securities’ is designed to cover equity or debt securities of small and medium enterprises for which there is no, or only a limited, secondary market, and which, therefore, would pose a liquidity risk for investors. The concept therefore excludes from the FCA regulatory provisions for investment-based crowdfunding those securities which are ‘readily realisable’, meaning securities that are admitted or about to be admitted to an official listing; or traded, or soon to be traded, on a recognised investment exchange or designated investment exchange. However, a secondary market does not cover an online bulletin board on which people can list securities they wish to sell.

4.3.2 Submissions

One view in submissions was that to maintain simplicity in the operation of any CSEF exercise, and to reduce the intellectual burden on crowd investors and the compliance burden on issuers, CSEF offers should be limited to a single class of security - preferably an ordinary share. Issuers wishing to offer more diverse or complex financial instruments should utilise more sophisticated marketplaces in the interest of both themselves and potential investors.

Some other respondents considered that issuers should be permitted to issue the types of securities contemplated under the Canadian approach.

Another position in submissions was that issuers should be permitted to offer all forms of equity and equity-like instruments (such as ordinary shares, preferred shares and convertible notes) and debt-like instruments (such as debentures and secured interests in income streams). It was argued that these are all proven instruments used by the venture capital investor community.

A further view was that issuers should be entitled to offer different classes of shares, with investors determining through their own assessment (taking into account the mandatory disclosures by issuers) which, if any, class of shares offered by an issuer fits with their expectations and investment needs.

There was a general view that complex financial instruments, such as derivatives, would be too complicated for retail investors and unnecessary for most CSEF issuers, and the associated investment risks would not be properly appreciated.

4.3.3 CAMAC position

CAMAC supports the New Zealand approach of limiting CSEF to one class of shares, excluding options and convertible securities, together with the requirement that all the shares in a particular offer to the crowd must have the same price, terms and conditions.

Also, there should be a prohibition on offering partly-paid shares, given the possibility that crowd investors may not understand that they could be subject to calls in the future for all or part of the unpaid portion of those shares.

Consideration could be given, in the future, to extending the permitted categories of fully-paid equity that can be offered through the CSEF process to a broader class of securities, depending upon experience with any such regime in Australia.

CAMAC agrees with the view in submissions that issuers wishing to offer more diverse or complex financial products, including derivatives, should utilise more sophisticated marketplaces in the interest of both themselves and potential investors. Retail crowd investors may not fully understand the nature of these more complex financial products, or some potential liabilities that may come with them.

Limiting CSEF to one class of shares will not overcome the possibility of the shares acquired by crowd investors being diluted in various ways, including through subsequent equity issues to holders of shares in other classes. It is not the intention of CAMAC to constrain an entity, especially a start-up, from raising further equity through other means. Issues concerning possible dilution of shares held by the crowd are discussed elsewhere in this report (Section 3.4.4).

CAMAC sees no objection, in principle, to permitting the inclusion of other rewards (‘perks’) in a share offer to the crowd, provided these rewards are equally available to all crowd investors and do not involve any further financial obligation on their part.

CAMAC notes that the UK concept of ‘non-readily realisable securities’ is part of a different regulatory approach that has been adopted in that jurisdiction.

4.4 New equity

Issue: should CSEF be limited to new equity issues?

4.4.1 Other jurisdictions

USA

The JOBS Act applies to distributions by an issuer of its own securities. It is not available as a means for existing security holders to on-sell their securities in an issuer.

Canada

Under the proposals, crowdfunding arrangements are limited to primary offers by an issuer of its own securities. It is not available as a means for existing security holders to on-sell their shares.

An intermediary acting in connection with CSEF offers of a particular issuer cannot also act as an intermediary in any secondary transactions in those securities, such as clearing or settling any trades in an issuer’s securities.

The OSC commented that the CSEF provisions are intended to facilitate capital raising by issuers and not the resale of securities.

The OSC pointed out that these limitations apply only to activities in connection with a distribution of securities through the CSEF process. An intermediary may engage in other types of crowdfunding activities that do not involve a distribution of securities, such as donation funding, reward funding or pre-purchase funding

4.4.2 Submissions

A number of respondents supported CSEF being confined to new equity offers, arguing that the primary purpose of CSEF should be to improve access to start-up capital for small companies, not to facilitate a market for the further sale by shareholders of existing securities.

A contrary view in submissions was that intermediaries should be able to facilitate both issues of new securities, and the sale of existing securities, to the crowd. It was argued that it is in the interests of economic efficiency, including creating liquidity in the CSEF market, to facilitate the exchange of existing securities through the crowd mechanism, which may best be achieved via the original CSEF intermediary.

A middle position in submissions was that while the CSEF process should be limited to primary offers by issuers, intermediaries should be able to operate a securities 'match-making' service to match buyers and sellers of existing equity of issuers during such time as those issuers are listed on that particular CSEF platform for the purpose of making CSEF offers.

4.4.3 CAMAC position

Fundraising through CSEF should be limited to primary offers, meaning offers by issuers to crowd investors to take up previously unissued shares in their companies.

This limitation is not intended to restrict the development of a secondary market in shares issued through CSEF. Indeed, as observed in a number of submissions, any secondary market may be in the interests of economic efficiency by creating some liquidity in these shares, to the benefit of crowd shareholders. These shareholders could then cash in their equity investment if other investors are willing to buy the shares, and at a price determined by that market.

A CSEF intermediary that sought to operate a secondary market in shares previously issued through the CSEF process would need to be appropriately licensed under the Corporations Act and comply with the terms of the licence requirements in conducting that market.

One limitation CAMAC would place, to avoid a possible conflict of interest between the issuer and the intermediary, is that an intermediary may not conduct a CSEF primary offer of a particular class of shares of an issuer simultaneously with conducting a secondary market in that class of previously issued shares of the issuer. The issuer could utilise another eligible intermediary to conduct the CSEF primary offer or the intermediary could decide to suspend the secondary market on its website.

4.5 Issuer cap

Issue: should there be a cap, and if so what amount, on the funds that an issuer can raise in a particular period through CSEF? Should that issuer cap include any funds raised under the small-scale personal offers exemption or the sophisticated investors' exemption?

4.5.1 Different types of caps

There are two types of cap to consider in the context of CSEF:

- **issuer caps:** being limits on the amount of funds an issuer can raise through CSEF (usually per year). The purpose of these caps is to restrict the amount an issuer can raise from the crowd without having to comply with the usual offer disclosure obligations, in the form of a prospectus or similar document.

- **investor caps**: being limits on what an individual investor can invest through CSEF (usually per year). This may take the form of a cap on the funds that an individual investor may place with a particular issuer in a certain period and/or a cap on the funds that an individual investor may place with issuers (combined) in a certain period. The purpose of these caps is to limit an individual investor's exposure to these high-risk investments.

Caps directly impact on the funds that issuers can raise through CSEF and how many investors they will need to attract to achieve their funding goal. Investor and issuer caps are interrelated in that the lower a cap on the amount of funds any crowd investor can place with each issuer, the more crowd investors each issuer may need to attract to reach its funding target.

This Section deals with issuer caps. Investor caps are dealt with in Section 6.4.

4.5.2 Other jurisdictions

UK

There is no prescribed issuer cap. However, depending upon the amount sought, an issuer may have to publish a prospectus or other disclosure document.

New Zealand

Issuers may raise a total of $2 million in each 12 month period through a combination of CSEF to retail investors and any fundraising through the New Zealand equivalent of the small-scale personal offers exception (in s 708(1) of the Australian legislation). However, investments from wholesale investors will not count in determining whether the fundraising is within the cap:

> This means that issuers will be able to raise more than $2 million per year (sometimes much more) through crowd funding services if some of the investors are wholesale investors under the FMC Act.

Intermediaries must ensure that issuers do not exceed fundraising limits. For this purpose, intermediaries must maintain adequate systems and procedures to ensure that issuers do not exceed the issuer cap of $2 million in any 12 month period that the issuer uses the intermediary's service.

USA

A company may raise no more than $1 million in a 12 month period through CSEF (that amount to be periodically adjusted based on the consumer price index).

The SEC noted that:

> The limitation on the amount that may be raised could benefit investors by reducing the potential for dilution or fraud. However, we recognize that the cap on the maximum amount that may be sold … also could prevent certain issuers from raising all the capital they need to make their businesses viable.

Canada

Through CSEF

Under the proposals, there is of $1.5 million limit on what any 'issuer group' may raise in any 12 month period. An issuer group includes the issuer, any affiliate of the issuer, and any other issuer that is engaged in a common enterprise with the issuer or with an affiliate of the issuer.

As explained by the OSC:

> As the exemption is focused on financing for start-ups and SMEs, we think a distribution limit of $1.5 million is appropriate.
>
> The imposition of the offering limit on the aggregate proceeds raised by the issuer group, rather than only by the issuer, is intended to prevent the $1.5 million offering limit from being circumvented.

Through other means

It is proposed that during a CSEF offer period, an issuer can raise other funds under any other permissible exemptions from the Canadian prospectus requirements, such as the accredited (sophisticated) investor exemption. These funds can be additional to the $1.5 million CSEF limit.

Italy

The maximum funds raised by an eligible start-up through CSEF cannot exceed €5 million per year.

4.5.3 Submissions

The caps on the amount that an issuer may raise in any 12 month period proposed in submissions ranged from $½ million to $10 million, with most respondents supporting either a $2 million annual cap (based on the small-scale offer exemption cap in s 708) or a $5 million annual cap (based on ASIC Class Order 02/273). It was argued, for instance, that a cap in the order of $2 million would be consistent with the seed capital requirements of many start-ups and would be pitched at a level which is able to help to bridge the gap between founders and angel finance and formal venture capital. That cap would suffice for the majority of start-ups to prove their concept on a small scale and attract further capital, through traditional means, for further product development. It would also be suitable to meet the capital requirements of a broader range of small businesses which may wish to raise capital via a crowdfunding platform.

One respondent proposed a tiered system for different business models, particularly in the areas of innovative 'local infrastructure' and 'clean-technology', whereby the cap is different for certain types of projects according to varying criteria to be assessed with reference to costs associated with proving the concept and the time and cost likely to be involved in breaking even and generating a profit.

There was some support in submissions for the New Zealand approach, which would permit issuers to make some small-scale personal offers alongside CSEF offers to retail clients, provided the aggregate funds raised are within a cap stipulated by legislation, as well as being able to make additional uncapped offers to sophisticated investors. One suggestion, however, was that the total amount that an issuer could raise within 12 months by these combined methods be identified in the offer document to crowd investors, to avoid CSEF and small-scale personal offer investors unknowingly having their proportion of equity in the company watered down by the size of the equity investment by sophisticated investors.

One view was that there should be no ceiling on the amount an issuer may raise, given that maximum amounts likely to be raised by issuers through CSEF would generally be very small in the context of broader capital markets.

It was also argued that issuers should be entitled to accept over-subscriptions, in the manner proposed by the SEC, and for the reasons it put forward. The issuer policy concerning oversubscriptions should be outlined in the issuer offer document.

4.5.4 CAMAC position

Issuer cap

There should be a restriction on the maximum funds allowed to be raised by an issuer in a given period through CSEF, taking into account that CSEF is aimed at start-ups and other small enterprises and that the full regulatory structure in Chapter 6D of the Corporations Act will not apply to this form of offer to the public.

The jurisdictions reviewed generally set caps in the $1 million to $2 million range for a 12 month period. CAMAC considers that the New Zealand cap, whereby an issuer may raise up to $2 million in any 12 month period, would also be appropriate in Australia, at least at the outset. CAMAC agrees with the comment in submissions that a cap of this amount would suffice for the majority of start-ups to prove their concept on a small scale and attract further capital, through traditional means, for further product development. A start-up which, say, reached its issuer cap with strong public interest in its equity offer still remaining could consider moving to a regulated public offer in the form of a prospectus or an offer information statement, which could be provided online.

However, any figure chosen is arbitrary to some extent and this cap could be adjusted at some future time in light of experience with CSEF.

CAMAC does not support the suggestion in some submissions of creating a tiered system of caps for different business models. Such an approach may be administratively costly and cumbersome, while creating arbitrary differences in caps which may be difficult to justify in particular circumstances and could lead to perverse effects.

The UK has no issuer cap. However, that reflects a different regulatory approach in that jurisdiction, which deals with the direct sale of any form of security of any issuer, of whatever size, where that security does not have a secondary market.

Sophisticated investors' exemption

The proposed issuer cap should not include any funds raised under the sophisticated investors' exemption in s 708 (which includes very large minimum subscription offers). A similar approach is taken in New Zealand and Canada. It would not be in the interests of issuers, or their crowd investors, to limit funding from this source.

Small-scale personal offers exemption

The New Zealand issuer cap includes any funds raised by the issuer under the equivalent of the Australian small-scale personal offers exemption in s 708 of the Corporations Act.

In the Australian context, there are competing considerations to take into account.

In some instances, issuers currently may raise up to $5 million under the small-scale personal offers exemption (taking into account ASIC Class Order 02/273). To require any funds raised in this manner to be taken into account for the CSEF issuer cap of $2 million may constrain some issuers that have attracted funding from no more than 20 investors from making an equity offer to the crowd within the 12 month period.

A competing view is that funds raised under the small-scale personal offers exemption may involve retail investors similar to crowd investors generally, given that there is already another exemption for sophisticated investors (including large offers) (s 708(8)). An issuer should not have the opportunity, in effect, to raise funds from the crowd, in excess of the issuer cap, through using both mechanisms.

On balance, CAMAC considers that funds raised under the small-scale personal offers exemption should be taken into account for the purposes of the CSEF issuer cap. In consequence:

- an issuer that raised the maximum possible through CSEF in any 12 month period under the issuer cap, being $2 million, could not raise additional funds in that period under the small-scale personal offers exemption
- an issuer that raised less than the $2 million through CSEF during that period could raise additional funds from retail shareholders under the small-scale personal offers exemption, provided that the combined amount did not exceed the $2 million in that period
- an issuer that raised in excess of $2 million under the small-scale personal offers exemption (given that up to $5 million may in some circumstances be raised in this manner) would not be permitted to engage in CSEF within the relevant 12 month period.

Issuer group

CAMAC elsewhere discusses the possibility of one or more parties seeking to circumvent an issuer cap by setting up a series of issuers, each seeking to raise funds from the crowd up to the issuer cap (Section 3.2.2).

To help counter this possibility, CAMAC proposes that the issuer cap of $2 million in any 12 month period apply to any 'issuer group'. That concept should be broadly defined to include any issuer with which the directors, senior management, or other related party associates have an involvement. The definition of 'senior manager' in s 9 of the Corporations Act and the concept of 'related parties' in s 228 may be a useful guide for this purpose.

In consequence, the maximum funds a particular issuer may raise in any 12 month period through CSEF will be reduced below the $2 million issuer cap by any funds that any entity in the issuer group has raised in that period through CSEF (including under the small-scale personal offers exemption).

This approach will require an issuer to monitor any CSEF activities of any other entity in its issuer group. That will be an ongoing task only to the extent that a complex issuer group has been established in the first place and more than one entity in the group has sought to utilise the CSEF process.

Enforcement

CAMAC agrees with the New Zealand approach that intermediaries must ensure that issuers do not exceed fundraising limits. For this purpose, intermediaries must maintain adequate systems and procedures to ensure that issuers do not exceed the issuer cap of $2 million in any 12 month period that the issuer uses the intermediary's service.

For this purpose, intermediaries could employ a software system which automatically closes off acceptances once an issuer cap is reached.

Other matters referred to in submissions

The matter of disclosure of other equity offers is dealt with under **complex equity structure** in Section 3.4.3.

The matter of oversubscription is dealt with in Section 4.9.

4.6 Other equity issues

Issue: should there be controls on other equity issues by the issuer during the CSEF offer period?

4.6.1 Other jurisdictions

Canada

It is proposed that that shares offered or issued during the period of a CSEF offer or shortly thereafter, but independently of that offer, must be on the same terms and conditions, including price, as the offer to the crowd.

More specifically, if an issuer distributes securities under other prospectus exemptions (such as the sophisticated investor exemption) during the period beginning at the commencement of the crowdfunding offer period and ending one month after the distribution date under that offer (the prescribed period), the securities sold under the other exemptions must have the same price, terms and conditions as those distributed under the crowdfunding offer.

According to the OSC, this requirement:

> is intended to promote fairness to investors by prohibiting an issuer from offering securities during the prescribed period at different prices, or with different terms and conditions, than those being distributed under the [CSEF offer]. Limiting the prescribed period to one month following the distribution date is appropriate because once an issuer receives the funds, the value of the issuer or its operations could quickly change, thus justifying offering securities at different prices or with different terms and conditions than those that were distributed under the crowdfunding [offer].

The intermediary conducting the CSEF offer cannot also act as the intermediary for these additional transactions, which must also be disclosed in the issuer's marketing materials to investors in the CSEF offer.

4.6.2 CAMAC position

While recognising that the Canadian approach seeks to promote fairness and equality of treatment between different shareholders, CAMAC is concerned that it may create inflexibilities in some instances, given that elsewhere in this report CAMAC confirms that an issuer may have various classes of shares (Section 3.4).

A more pragmatic approach would be an obligation on an issuer, in the CSEF offer disclosure document, fully to disclose the price, terms and conditions of any non-CSEF equity offer or placement that the issuer will make, or intends to make, during the CSEF offer period. A previously published offer disclosure document would have to be amended if this intention is formed, or a previously unannounced equity offer or placement eventuates, during the CSEF offer period.

CAMAC also elsewhere recommends that crowd investors who have accepted equity offers have rights of withdrawal where there is a subsequent material adverse change in the position of the issuer (Section 4.11). An issuer would need to consider whether a previously unannounced equity offer or placement outside CSEF that takes place during that CSEF offer period should be treated as a material adverse change for that purpose.

4.7 Disclosures in the offer documents

Issue: what disclosures should issuers provide to investors in making their offer to the crowd?

4.7.1 Other jurisdictions

UK

Issuers are subject to the prospectus provisions, though UK corporate law contains some exemptions for promotions of small securities issues.

Coming within an exemption from the prospectus requirements still imposes some disclosure requirements on an issuer. According to one commentary on UK corporate law:

> If a prospectus is not required, the offer document (or information memorandum or other marketing material) would not have to comply with any regulatory criteria. The only constraints would be under the common law, and subscribers could have remedies against the directors for negligent misstatement and/or deceit if incomplete or misleading information is provided. It would therefore be prudent for the contents of the offer document to follow the prospectus requirements as far as possible, as well as including appropriate 'health warnings', even if these are not mandatory (e.g. that the value of the shares may fall, and that the investor may not get back all the money he/she paid for them). In this regard it would be appropriate to undertake due diligence and verification of the offer document to ensure that the contents are factually correct.

An issuer is also subject to various general application disclosure rules in the FCA Handbook depending upon the nature of the offer and the nature of the investor, including:

- FMA Conduct of Business Sourcebook (COBS) 2.2.1R: information disclosure before providing services

- COBS 4.7.1R: information to be disclosed in direct offer financial promotions
- COBS 6.1: information concerning various charges and remuneration.

USA

Issuers will be required to file with the SEC, and provide to investors, through the intermediary, information such as:

- the name, legal status, physical address and website address of the issuer
- a description of the business and its anticipated business plan
- a description of the issuer's financial condition (including financial statements: see below)
- the names of officers and directors and persons with a shareholding of more than 20%. The SEC is proposing to require disclosure of the business experience of directors and officers of the issuer during the past three years
- the stated purpose and intended use of proceeds
- the specified target offer amount and deadline to reach that target
- the price of the securities. The SEC proposes to permit issuers to alter the offer price during the course of the offer ('dynamic pricing'), given the cancellation rights of investors (see Section 6.6)
- a description of the ownership and capital structure (which has a particular significance for the ongoing position of the CSEF investors in the company: see further Section 3.4), and
- such other information as the SEC prescribes by rule. The SEC is proposing to require disclosure by the issuer of various matters, including the amount of compensation paid by the issuer to the intermediary for conducting the offer, any material factors that make an investment in the issuer speculative or risky and certain related-party transactions.

The issuer must provide financial statements, certified by an officer of the issuer if the specified target offer amount is $100,000 or less, reviewed by an accountant if that amount is up to $500,000 and audited if that amount is over $500,000. Companies could avoid audit costs by limiting the size of their offers. The SEC is proposing that each issuer also provide a narrative discussion of its financial position.

Intermediaries must make the issuer disclosures available to the SEC and potential investors not later than 21 days before the first day on which securities are sold to any investor. According to the SEC:

> The issuer disclosure requirements should benefit investors by enabling them to better evaluate the issuer and the offering. Requiring intermediaries to make the issuer information publicly available and easily accessible on their platforms would reduce information asymmetries between issuers and investors and would enhance both transparency and efficiency of the market.

An intermediary would be prohibited from requiring any person to establish an account with the intermediary in order to access this information.

Issuers will be required to comply with such other requirements as the SEC may, by rule, prescribe, such as disclosure of the indebtedness of the issuer and any prior CSEF undertaken by the issuer:

> [the SEC is] proposing to require disclosure of any indebtedness of the issuer because we believe that servicing debt could place additional pressures on a company in the early stages of development and this information would be important to investors. The proposed rules also would require disclosure of any prior securities-based crowdfunding or other exempt offerings conducted within the past three years. In some cases, an issuer might have previously engaged in crowdfunding in reliance on [the Title III CSEF regulatory provisions] and may be returning for additional funding. We believe that it would be important to investors to know whether the prior securities-based crowdfunding or other offerings of securities were successful, and if so, the amount raised in these prior offerings.

The SEC considered that the issuer disclosure requirements are necessary to ensure that investors are sufficiently informed:

> Small private businesses typically do not disclose information as frequently or as extensively as public companies, if at all. Moreover, unlike public companies, small private businesses are not required to hire an independent third party to validate the information disclosed. When information about a company is difficult to obtain or the quality of the information is uncertain, investors are at risk of making poorly-informed investment decisions regarding that company.
>
> Such information asymmetries might be especially acute in the securities-based crowdfunding market because the market includes startups and small businesses that have significant risk factors and that might have characteristics that have led them to be rejected by other potential funding sources, including banks, [venture capitalists], and angel investors. In addition, the securities-based crowdfunding market may attract unsophisticated retail investors who may not have the resources necessary to effectively monitor issuers.

While supportive of disclosure, the SEC also noted that it could benefit competitors of an issuer:

> disclosure might have indirect costs to the extent that information disclosed by issuers relying on [the Title III CSEF provisions] could be used by their competitors. Requiring significant levels of disclosure at an early stage of an issuer's lifecycle might affect an issuer's competitive position and might limit the use of the [CSEF provisions] by issuers who are especially concerned with confidentiality.

Ongoing disclosure

Issuers will be required to provide annual reports to investors on the results of operations and financial statements, containing such information as the SEC shall determine by rule, with such reports to be filed with the SEC. The SEC proposes that issuers post the annual reports on their websites.

New Zealand

The details of the information in the offer to provide to investors are determined by the intermediary in conjunction with the issuer, with guidance provided by the regulator (the FMA), as set out below.

Intermediaries must have adequate disclosure arrangements with issuers to give investors, or to enable investors readily to obtain, timely and understandable information to assist investors to decide whether to acquire particular shares on offer on the intermediary's website (for example, through initial disclosure, or question and answer forums, or other information that is made available).

In considering whether the disclosure arrangements are adequate, the FMA must have regard to:

- the limits (if any) on the amount that retail investors may invest in an issuer; and
- the amount that issuers may raise through the CSEF process.

Minimum disclosure arrangements

The minimum disclosure arrangements include:

- a dedicated webpage on the intermediary facility for each offer, which is simple to access and navigate and available to all investors
- disclosure of a description of the issuer business and the purpose of the fundraising
- disclosure of the terms of the offer, including:

price

minimum funding sought

duration of the offer

amounts raised (updated regularly)

investor caps (if any)

rights attaching to the shares (and details of any other securities of the issuer)

- information about how shares can be sold, including about any available secondary markets
- the names and positions of the issuer's directors and senior managers (intermediaries could also consider requiring disclosure of their education, skills and experience)
- arrangements with issuers to supply required information.

An intermediary's disclosure arrangements should also cover how the intermediary will review the information issuers' supply to check that it is understandable and timely (when disclosed) or state how the intermediary will rely on the issuer to do this.

Discretionary disclosure arrangements

Intermediaries may also consider including:

- a Q&A function on their websites
- information from the Companies Office about issuers, or links to the Companies Office 'Company Summary' webpages for issuers.

Level of disclosure linked to any investor cap

The FMA has indicated that if voluntary investor caps are not imposed, or they are high, or the issuer is trying to raise significant amounts of capital, the FMA would usually expect that the arrangements for disclosure to the crowd include extra disclosure such as providing a business plan, details of how funds will be used, key risks and key financial information, such as financial statements.

Canada

The OSC has observed that:

> For crowdfunding to be a viable method of raising capital, investors must be provided with appropriate information to make informed investment decisions without imposing excessive costs on issuers.

The intention is that the disclosures in an issuer's 'crowdfunding offering document' should be streamlined and focus on material information that is relevant to the issuer's business and an investment in the securities offered.

An issuer must make this document available to an investor through the intermediary portal before the investor enters into an agreement to purchase the security. The issuer must also obtain a signed risk acknowledgement from the investor before entering into the agreement (see further Section 6.5). The issuer must also provide a copy of the offer document to the regulator.

The offer document must comprise 5 items, together with a certificate from the issuer that the offer document does not contain a misrepresentation.

Item 1: Required statements

This involves:

- the risk warning to investors.

Item 2: Financing facts

This involves:

- offering summary
- description of securities offered and relevant rights
- ability to resell securities
- right of action for misrepresentation and right of withdrawal
- concurrent offerings
- use of proceeds
- ability to achieve next milestone or business plan
- other crowdfunding offerings
- persons promoting and marketing the offering.

Item 3: Issuer facts

This involves:

- business of the issuer
- principal risks facing the business
- financial information
- ongoing information
- mining issuer disclosure [relevant only to Canada]
- capital structure
- executive officers, directors and other principals

- management compensation
- related party transactions
- other relevant information.

Item 4: Registrant facts

This involves:

- registered funding portal.

Item 5: Contact information

This involves:

- contact information for the issuer
- contact information for the registered funding portal.

Certificate

This involves:

- statement of no misrepresentation.

Various aspects of these proposed disclosure requirements are outlined below.

Offer size

An issuer's offer document for a crowdfunding distribution must disclose the minimum number or principal amount of securities being offered, and whether there is a maximum number or principal amount of securities being offered.

Length of time an offer can remain open

An issuer's offer document must disclose how long the offer will remain open, which cannot exceed 90 days. If an issuer cannot complete a crowdfunding offer within 90 days, it must withdraw it.

The OSC has taken the view that a 90 day limit on the length of time an offer can remain open will help to ensure that the information in the offer document does not become stale.

The issuer can commence a new crowdfunding offer after the 90 day period.

This right of an issuer to commence a new offer every three months is particularly significant for the investor caps discussed in Section 6.4, given that the Canadian proposal is to impose a $2,500 investment ceiling per offer, within a total $10,000 ceiling on all CSEF investments by an investor per year. In effect, an investor in one year could place the whole $10,000 with one issuer, if that issuer published a new offer each three months.

Securities holdings by principals in an issuer

The principals of an issuer seeking to raise capital through CSEF are not required to invest their own money in the venture before making an offer to the public. However, an issuer must disclose:

- whether or not the principals own securities of the issuer
- if so, the number and type of the securities
- how much the principals paid for them

- whether or not the securities are subject to an escrow or hold period, and, if so, details of the escrow or hold period.

The OSC considered that while there is a benefit in principals of a business investing their own money in the issuer, as this would align their interests with those of other investors in the issuer, this should not be a mandatory requirement:

> One of the principal purposes of [permitting CSEF] is to enable an entrepreneur to finance a start-up where he or she does not have the personal financial resources to do so.

Rather, according to the OSC, disclosure would suffice:

> However, requiring an issuer to disclose whether or not the principals own securities of the issuer, the number and type of the securities, how much the principals paid for the securities, whether or not the securities are subject to an escrow or hold period and details of any escrow or hold period will help investors make informed investment decisions.

Risk warning by issuers to crowd investors

Issuers must include a general risk warning obligation in their ‘crowdfunding offering document’ as well as risk warning obligations on intermediaries.

The issuer must provide a risk warning to investors, at the top of its crowdfunding offer document, indicating that:

- many start-ups and small businesses fail
- investors may not be able to resell their securities
- investors may receive limited ongoing information about the issuer’s performance
- no securities regulatory authority has reviewed the CSEF offer.

Business plan

An issuer must disclose the nature of its existing or proposed business, its business plan, and the use of the proceeds of the distribution in furtherance of the business plan.

Previous CSEF offers

An issuer making a CSEF offer must disclose all current, previously closed, and failed CSEF distributions by each issuer comprised in the issuer group.

Intended use of CSEF proceeds

The issuer must state in the offer document how it intends to spend the net proceeds to be raised from a CSEF offer, including the principal purposes to which proceeds will be allocated, for both of the following circumstances:

(a) if the issuer raises the minimum funds to be raised in this offering, and

(b) if the issuer raises more than the minimum funds.

The issuer must also disclose if any of the following persons will receive any proceeds from the funds received through CSEF directly or indirectly and, if so, the amount each person will receive:

(a) any of executive officers, directors or founders of the issuer,

(b) any person promoting or marketing the CSEF offer,

(c) any person who owns 20% or more of the issuer's voting securities, or

(d) any other person that is a related party to the issuer.

One respondent to the CAMAC Paper proposed that directors of issuers be obliged to sign and publish a declaration that no funds raised through CSEF shall be used by directors or their related parties in a personal capacity.

4.7.2 Submissions

A general comment in submissions was that, in designing issuer disclosure requirements, a balance needs to be struck between the need to provide reliable and useful information to the crowd investor and the need to ensure that the disclosure obligations are not so burdensome as to discourage bona fide start-up and other enterprises from seeking equity funds through CSEF. Issuers should not be subject to the prospectus obligations that currently apply to public equity offers under the Corporations Act. Also, it was submitted, the use of investor and issuer financial caps and the facilitation of information sharing through online communication channels are important features of CSEF which ought to enable regulation with less costly disclosure compliance burdens on the issuer.

One suggested approach was to introduce only a generic disclosure requirement, for instance:

> An issuer must disclose everything that is material for the reasonable investor to know in making a decision whether to invest in the issuer.

Another approach was to adopt the offer information statement (OIS) requirements in s 715 of the Corporations Act, with modifications to exclude the audit requirement in s 715(2) to avoid the financial reporting requirements for start-up and other small enterprises being overly burdensome. Rather, an abridged and graded form of financial report (possibly based on the proposed US graded approach) should be allowed for CSEF purposes.

In this context, one approach in submissions was to require a disclosure document for issuers making crowd-based equity offers, drawing on s 715, but being more specifically designed for this form of fundraising. The disclosures should include:

- a description of the issuer's business and business plan and the principal risks facing the issuer
- current financial statements (adopting, for instance the US stepped approach)
- the company's management structure, involving details of directors, officers and any other key personnel (including any shareholders with at least 20% of the current issued shares), including relevant skills and experience of these persons (the US is proposing disclosure of relevant experience during at least the last three years) and their remuneration arrangements
- the capital structure of the issuer, including any classes of shares and their particular rights
- the target offer amount
- the purpose for which the funds raised will be used

- details of all amounts payable by the issuer in respect of the equity to be raised from the crowd, including any amounts by way of fee, commission or charge
- any minimum subscription to activate the investor acceptances
- the expiry date of the offer
- the offer price of the shares, supported by a valuation, as well as details of how the valuation was reached
- any related party transactions
- any future equity or debt fundraising that is anticipated and its potential dilution or other implications for the shareholding of crowd investors.

One respondent took the view that in the context of early stage start-up enterprises, crowd investors would also benefit from more detailed information on key aspects of the intended project. While it is not proposed that disclosure of all these matters be mandated, they could be treated as useful guidance. They could include:

- an explanation of the intended product, process or service (project) and a basic description of any technology on which it depends for its functionality
- what is the edge or competitive advantage over what is currently available in the market that will make the project successful
- what are any risks associated with any technology for the project
- any estimates prepared of the size of market for the project
- the milestones and path to market for the project
- the roles of the key personnel in the project development, including the continued involvement of the inventor of any relevant technology
- how any intellectual property is protected and whether the issuer is aware of any disputes concerning it or challenges to the validity of any associated patents or other forms of intellectual property protection.

The observation was also made in submissions that a key to any successful CSEF project is for the issuer to create engagement with the public. This is normally achieved via whatever means are appropriate to the project – additional information provided on a website, informative videos, social media updates etc. Failure to provide this promotional content may result in a failed project/capital raising. This type of material should not be banned, though it does not form part of the mandatory offer document. Its content should be subject to general law principles to cover any misleading or deceptive content.

One note of reservation expressed in submissions was that the disclosure of the key aspects of an intended project could lead to intellectual property theft, premature exposure to market competition, and copycat activities by other entities.

4.7.3 CAMAC position

Approach to disclosure

CAMAC has considered a number of possible approaches to how issuers should disclose information about themselves, and the offer, to the crowd, taking into account the observation in submissions that a balance needs to be struck between the need to provide reliable and useful information to the crowd investor and the need to ensure that the disclosure obligations are not unduly burdensome for issuers.

One approach is an offer disclosure document for CSEF modelled on the offer information statement (OIS) disclosure requirements under s 715 of the Corporations Act, possibly excluding the requirement that the financial reports be audited. There already exists some useful guidance on current disclosure requirements, which could be of assistance to intending issuers (for instance, ASIC Regulatory Guide 228 *Prospectuses: Effective disclosure for retail investors*).

New Zealand has adopted another approach, which contemplates the issuer and the intermediary determining to some extent the content of the disclosure within the context of general guidance provided by the Financial Markets Authority. The New Zealand approach also contemplates the level of disclosure being partially ambulatory, depending on the amount of funds sought and whether the issuer proposes to place a cap (and if so, the amount) on the funds that each crowd investor can invest in that issuer through a particular CSEF offer (see further Section 6.4 concerning investor caps).

A third approach, which CAMAC considers is preferable in the context of CSEF, is an issuer disclosure template specifically tailored for this form of corporate fundraising. A useful starting point is the Canadian proposed ‘crowdfunding offer document’, which provides clear and structured direction to issuers on what needs to be disclosed, using a standard template to be completed by issuers.

The Canadian template format has a number of advantages:

- *guidance*: the template provides clear structured guidance to issuers on what they need to disclose to the crowd about themselves and the terms of their offer, as well as the format of that disclosure. This can be particularly helpful to start-ups, given that their controllers may have had little or no experience with fundraising from the public and may have little idea of what is expected of them in this regard

- *comparison:* it would assist crowd investors to compare offers from different issuers more easily, given that all offers would have to follow the same disclosure template and format.

In the view of CAMAC, this is an instance where greater (but not undue) disclosure prescription may be in the interests of all involved parties.

The disclosure obligation, and liabilities for breach, should rest primarily on the issuer. An intermediary provided by an issuer with a fully completed offer document would be entitled to publish the offer, short of actual knowledge of some material misrepresentation or omission or of issuer fraud (Section 5.10 and Section 5.11).

CAMAC suggests that the specific elements of a disclosure template might best be developed by ASIC and contained, say, in an ASIC policy document. The Commission could take into account the Canadian precedent, the US approach (particularly its requirements concerning financial statements) and some of the very useful suggestions put forward in the submissions, outlined above.

This template approach would also provide flexibility by enabling ASIC to adjust the disclosure requirements over time, in light of experience with the CSEF process. Such an approach may have a more deregulatory outcome than a prescriptive legislative or regulation-based formulation of the disclosure requirements.

From the perspective of the best use of public funds, CSEF offer documents should not be required to be lodged with ASIC, nor should ASIC otherwise be required to review such documents, before their publication on the intermediary's website, given that, unlike prospectus or OIS offers, CSEF offers might only be for very small amounts, with a low cap on the total funds that an issuer can raise in a 12 month period. Rather, ASIC should be granted stop order powers, to be employed where warranted.

CAMAC proposes a number of elements that should be included in the disclosure regime for CSEF offers, and how they may best be regulated, as set out below.

Offer size

An issuer's offer document should disclose:

- the minimum number or value of shares being offered in the online offer, and
- whether there is a maximum number or value of shares being offered (within the proposed $2 million cap).

Pricing of shares

The price per share of the equity offered to the crowd should be at the discretion of the issuer. However, an issuer should be obliged to indicate how the price per share is arrived at, and how it compares with the price per share of any other class of shares in the issuer, as well as who are the holders of any other class of shares.

An entrepreneur would be entitled to have differential pricing between classes of shares (for instance, giving an advantage to the class of 'founder shares' over the class of 'crowd shares'), provided that this information is fully disclosed to the crowd in the offer disclosure document.

Length of time an offer can remain open

An issuer's offer document should disclose how long the offer will remain open. That period should be no more than, say, three months, thereby helping to ensure that the information in the offer document does not become stale.

Securities holdings by principals in an issuer

The principals of an issuer seeking to raise capital through CSEF may themselves have little or no financial resources to place into the project. It may undermine some of the productivity potential of CSEF if an equity offer to the crowd cannot proceed unless and until these persons have invested a substantial amount of their own capital in the project.

However, in the view of CAMAC, information on what funds, if any, principals have contributed to the project is material to crowd investors in making informed investment decisions. Some members of the crowd may place considerable importance on this matter.

Accordingly, an issuer offer document should be required to disclose:

- whether each of the principals owns shares or other securities of the issuer, or has otherwise invested funds in the issuer
- if so, details of the amounts invested, shares or other securities owned or other relevant arrangements entered into, and how much the principals paid in such transactions
- whether or not the shares or other securities are subject to an escrow or hold period and, if so, details of the escrow or hold period.

Risk warning by issuers to crowd investors

Elsewhere in this report CAMAC proposes that intermediaries be obliged to provide a generic warning to crowd investors about the risks of investing in shares offered through CSEF (Section 5.15) and that these warnings must be acknowledged by these investors before they can invest in a particular equity offer through the intermediary's website (Section 6.5).

Canada is proposing that issuers also be obliged to provide a generic risk warning in their equity offer document. CAMAC supports this approach, noting that it would constitute a passive risk warning, as investors would not need to acknowledge it before investing. The Canadian proposals have useful suggestions concerning the content of this generic risk warning.

CAMAC considers that generic risk warnings of this nature, being given to crowd investors both by issuers and by intermediaries, are a vital component of investor protection with CSEF.

Dilution

One of the ongoing risks that crowd investors may face, even if the project in which they have invested is successful, is the possible dilution of the dividend, voting or any other rights attached to their shares through share issues to other parties. This matter is further discussed in Section 3.4.

However, each offer disclosure document should contain a clear explanation of the nature of any such risk for crowd investors who accept shares under the offer.

Business plan

An issuer should be obliged to disclose in its offer document the nature of its existing or proposed business, its business plan, and how the proceeds of the CSEF offer will be used in furtherance of the business plan.

Having said this, CAMAC recognises the need to have some commercial-confidentiality exemption, analogous to that applicable in the context of continuous disclosure, to avoid mandating disclosures that could lead to intellectual property theft, premature exposure to market competition, or copycat activities by other entities.

As earlier indicated, CAMAC supports a prohibition on issuers making offers in 'blind pools', which include arrangements where an issuer does not have a written business plan.

Previous CSEF offers by the issuer

An issuer should be required to disclose the outcome of all past CSEF offers by the issuer at any time, including any failed or withdrawn offers.

Other relevant issuers

An issuer should be required to disclose information about linked or relevant past companies that have engaged in CSEF at any time. This information should involve the association details (see Section 3.2.2) and the nature and outcome of all CSEF offers, and any other offers to the public, by those companies, including any failed or withdrawn offers.

Intended use of CSEF proceeds

The issuer should be obliged to state in the offer document how it intends to spend the proceeds to be raised from a CSEF offer, including the principal purposes to which proceeds will be allocated and how the proceeds will be used in furtherance of the issuer's business plan.

One submission proposed that directors of issuers should be obliged to sign and publish a declaration that no funds raised through CSEF shall be used by them, or their related parties, in a personal capacity. CAMAC considers that such an obligation, in principle, may help ensure that investor funds are used directly to advance the issuer's project. However, this raises a number of implementation issues, including whether funds raised through CSEF could be used to cover reasonable remuneration of the principals of the issuer.

An alternative approach is to require an issuer to disclose in the offer document if any of the following persons, directly or indirectly, will receive any proceeds from the funds received through CSEF and, if so, the amount each person will receive:

(a) any of the executive officers, directors or founders of the issuer

(b) any person promoting or marketing the CSEF offer

(c) any person who owns 20% or more of the issuer's voting securities, or

(d) any other person that is a related party of the issuer.

CAMAC supports this alternative disclosure approach. It avoids the need to resolve complex problems surrounding the circumstances when proceeds from a CSEF offer could legitimately be used to reasonably remunerate promoters in developing the project.

The Committee considers that a disclosure obligation may also help alert the crowd to possible excessive or questionable payments from funds to be raised to persons associated with the project, and thereby reduce the attractiveness of that offer as an investment option.

Implications of an adverse material change

The template would explain the opt-out option for investors who accept an offer before disclosure of any material adverse information concerning the offer (see Section 4.11).

Ongoing reporting obligations

The template should state that an exempt public company is entitled to publish its annual financial report, the directors' report and the auditor's report (if applicable) online only, with no need to notify shareholders electronically on each occasion, and no option for shareholders to receive a hard copy (see further Section 3.3.4).

An exempt public company issuer should insert details of the website where the reports will be published.

4.8 Controls on advertising

Issue: what controls should there be on advertising by an issuer?

4.8.1 Other jurisdictions

USA

Issuers are prohibited from two forms of advertising or promotion of their offers:

- advertising the terms of the offer, except for providing a notice that directs investors to the intermediary platform for that information. The SEC commented that this limitation:

> is intended to direct investors to the intermediary's platform and to make investment decisions with access to the disclosures necessary for them to make informed investment decisions.

- compensating any promoter of the securities, unless such compensation is fully disclosed in accordance with SEC Rules. The SEC commented that:

> Although the requirement [on issuers] to take steps to ensure disclosure of compensation paid to persons promoting the offering would impose compliance costs for issuers, we believe that investors would benefit from knowing if the investment they are considering and discussing with other potential investors is being touted by a promoter who is compensated by the issuer.

Canada

It is proposed that the only materials that may be made available to potential investors in connection with a crowdfunding offer, in addition to the mandatory offer document, are:

- any document that is described in the offer document, such as the issuer's business plan or shareholders' agreements, and

- any term sheet or other summary, including a video, of the information that is included in the offer document.

All offer materials must be made available to potential investors through the intermediary's website. The issuer must also provide a copy of these offer material to the regulator.

An issuer (as well as an intermediary and any other person involved with a CSEF offer) may not advertise the offer or solicit potential investors. However an issuer (as well as an intermediary and any other person involved with a CSEF offer) may advise potential investors that the issuer is proposing to make the offer and refer the potential investors to the website of the intermediary through which the offer is made. This advice may be provided in paper format or through social media.

4.8.2 Submissions

A number of respondents supported the principle of issuers being able to advertise their offers in some manner other than merely through the offer on the intermediary website. A total ban on other forms of advertising, it was argued, could negate the purpose of CSEF to bring the offer to the attention of a broad range of potential investors.

Within this context, one approach was that there be no restrictions on advertising by an issuer, other than pursuant to existing consumer protection provisions against false and misleading or deceptive statements (which, for instance, could apply to financial forecasts which are unreasonable or unrealistic) and a prohibition on an issuer accepting equity funds other than pursuant to the offer on the intermediary online platform.

Another approach was that any advertising by an issuer other than through the offer on the intermediary website should be limited to basic information identifying the name and business of the issuer and the investment opportunity, and directing potential investors to the intermediary where they can obtain the offer information and relevant documents. One suggestion was that in describing the investment opportunity in any form of advertising there should be an express ban on an issuer engaging in financial forecasting, including any statement concerning potential earnings or future distributions.

Another view was that any form of advertising by issuers other than through the offer on the intermediary website should be banned. It was argued that if advertising by issuers is permitted in the mainstream media, crowd investors could form unrealistic first impressions or expectations in relation to the potential rewards of such investments, even though they could only accept the offer through the intermediated process.

4.8.3 CAMAC position

CAMAC considers that controls need to be placed on advertising (other than what is set out in the offer documents) by an issuer making a CSEF offer.

Such controls are necessary, over and above reliance on general law remedies for false and misleading or deceptive statements, in the interests of investor protection. As summed up in one submission:

> if advertising by issuers is permitted in the mainstream media, investors could form unrealistic first impressions or expectations in relation to the potential rewards of such investments, even though they could only accept the offer through the intermediated process.

There may also be a temptation for issuers, or persons associated with them, to try to generate interest in an offer by, for instance, planting fake positive comments in social media. CSEF, being internet based, may accentuate this problem. While it may not be possible to curtail this practice, it is still in the interests of investor protection to formally indicate that such practices are unacceptable.

CAMAC sees the general approach in s 734 of the Corporations Act as a possible model in the context of CSEF. That provision regulates advertising and publicity of currently permitted securities offers, before and after the disclosure document is lodged.

The US and Canadian approaches, and the views of those respondents in submissions who favoured controls on advertising by issuers, also constitute a range of useful suggestions about the form, and purpose, of such controls in the specific context of CSEF.

4.9 Oversubscription

Issue: should issuers be permitted to raise more funds than referred to in the original offer?

4.9.1 Other jurisdictions

Canada

It is proposed that an issuer be permitted to offer more than the number of securities initially proposed to be offered in its offer document if it has disclosed the maximum number of securities that could be offered under CSEF and the use of the additional proceeds that would be raised. However, the $1.5 million limit on the aggregate amount that can be raised under CSEF by the issuer group in a specified time period must be complied with.

According to the OSC:

> This approach will allow an issuer to raise additional funds to allocate to the advancement of its business plan if there is strong investor interest in the offering, subject to the overall distribution limit of $1.5 million.

USA

In the US, the SEC also favours an issuer being able to accept investments in excess of any target amount in an offer document, subject to the $1 million in 12 months limitation and certain conditions:

> We believe that permitting oversubscriptions would provide flexibility to issuers so that they can raise the amount of capital they deem necessary to finance their businesses. For example, permitting oversubscriptions would allow an issuer to raise more funds, while lowering compliance costs, if the issuer discovers during the offering process that there is greater investor interest in the offering than initially anticipated or if the cost of capital is lower than initially anticipated.

4.9.2 CAMAC position

An issuer should be permitted to offer to the crowd more than the number of shares previously referred to in its offer document, provided that it discloses the adjusted maximum number of shares on offer under CSEF (within the $2 million cap) and the use of the additional proceeds that would be raised.

This will give some flexibility to issuers to raise funds in excess of an initial target where there is a stronger than anticipated level of crowd interest in the offer.

4.10 Lending to crowd investors

Issue: should there be controls on lending to investors to acquire shares offered through the CSEF process?

4.10.1 Other jurisdictions

Canada

It is proposed that restrictions apply to the ability of crowd investors to borrow money to finance the purchase of securities through CSEF.

Under this approach, issuers (as well as intermediaries: see Section 5.19) and their respective directors and executive officers, must not lend or finance, or arrange lending or financing (for instance, from an affiliate), for an investor to purchase securities of the issuer through CSEF.

This approach was seen as helping to address concerns associated with retail investors using leverage to invest through crowdfunding, though a possible further step of prohibiting a potential investor outright from borrowing money to finance the purchase of securities through CSEF was seen as overly intrusive and difficult to enforce.

4.10.2 CAMAC position

CAMAC agrees with the Canadian approach that to avoid conflicts of interest, issuers (as well as intermediaries) and their respective directors and executive officers should be prohibited from financing, or arranging financing for, a crowd investor to purchase shares of the issuer through CSEF. This prohibition would address some concerns associated with retail investors using leverage to invest through CSEF.

However, in the view of CAMAC, going the further step of prohibiting outright a potential crowd investor from independently borrowing money to finance the purchase of shares through CSEF would be an overly intrusive form of regulation, and would be very difficult to enforce.

An independent, though related, question concerns the status of any shares acquired in breach of this prohibition. Given that the circumstances surrounding loan transactions may differ, the better course may be to give discretionary powers to the court to unwind, or otherwise adjust, such transactions.

4.11 Material adverse change concerning the issuer

Issue: what should be the consequences of a 'material adverse change' concerning the issuer during the offer period?

4.11.1 Other jurisdictions

Canada

Where a material change in the offer occurs, committed investors must be notified of the change, and reconfirm their commitment, within five business days. If reconfirmation is not received within that time, the investment must be automatically cancelled and the funds returned.

4.11.2 CAMAC position

Where, following the publication of an offer to the crowd, an issuer becomes aware of a 'material adverse change' concerning itself, the issuer should be required to amend the offer documentation accordingly and advise the intermediary of the corrected information, for publication on the intermediary's website.

A material adverse change concerning the issuer would be any matter:

- involving a misleading or deceptive statement in the offer disclosure documentation, or

- a material omission from the information required in the offer disclosure documentation, or
- a new circumstance that has arisen since the offer was published, and

which is materially adverse from the point of view of the crowd investor (cf s 719(1)).

The obligation should rest on the issuer to identify any adverse material change.

An intermediary that has been notified by the issuer of a material adverse change should be required to notify that change to all investors who have previously accepted the offer. This would not be a burdensome task, as the intermediary would have contact details for these crowd investors. The intermediary would only have to pass on the information, and would not be required to make any assessment of it. The intermediary should be entitled to charge the issuer for that notification service.

Once notified by the intermediary, affected investors should be given certain rights to withdraw their earlier acceptance of the offer. In this regard, CAMAC has considered two policy approaches:

- *opt-out rights*: placing the onus on each investor, once informed of the material adverse change, to notify the intermediary, within a prescribed period, of any intention to cancel the acquisition of all or some of the shares previously purchased under the offer
- *opt-in rights:* automatically cancelling the previous share transactions of each investor under the offer, other than those of any investor who, once informed of the material adverse change, notifies the intermediary within a prescribed period that the investor wishes to continue with the acquisition for all or some of the affected shares.

Both policy options would be equally workable for those crowd investors who chose to make an election within the prescribed period. However, the opt-out policy option would be detrimental to the interest of those crowd investors who did not respond in the stipulated period (which could be for any number of reasons). From their perspective, the opt-in policy option would be preferable.

The opt-out policy option is adopted in the Corporations Act in regard to regulated offers to the public (s 724). The opt-in policy option has been proposed in the Canadian approach.

CAMAC considers that, on balance, the opt-out policy option should be adopted, for the following reasons:

- it is workable for those investors who turn their mind to whether to exercise the election to withdraw from the share transaction
- the opt-in policy option could see the collapse of a CSEF offer by default, through the non-response, including through apathy, of a sufficient number of crowd investors who have previously accepted the offer
- an opt-out approach in the context of CSEF would create a consistent approach with other regulated forms of public equity fundraising.

CAMAC considers that to draw the attention of crowd investors to the operation of the opt-out mechanism, and the implications of their not responding, they should be made aware of this mechanism:

- by the issuer, in the offer disclosure document itself
- by the intermediary, when giving notice of any adverse material change to the investor, at which time the opt-out right arises.

In the interests of all parties, a template explanation of the opt-out process, in both contexts, could be designed for this purpose.

In addition to opt-out rights, investors may have remedies under the general law, including damages, where fraud or some other form of misrepresentation is involved (Section 6.10).

4.12 Completing the offer

Issue: what should be the preconditions to completing a CSEF offer?

4.12.1 Other jurisdictions

Canada

It is proposed that a CSEF offer cannot be completed unless:

- the minimum amount of funds to be raised, as disclosed in the crowdfunding offer document has been subscribed for, and
- at the time of completion of the offer, the issuer has financial resources (which may include funds raised other than through CSEF) that are sufficient to achieve the next milestone set out in its written business plan, or if the issuer does not have any milestones set out in its written business plan, to carry out the activities set out in its written business plan.

The OSC considered that these requirements:

> will provide an element of investor protection, as an investor will know the minimum amount of proceeds that will be raised under the offering and will have some assurance that, on completion of the offering, the issuer will have financial resources sufficient to achieve the next milestone set out in its written business plan or to carry out the activities set out in its written business plan.

An intermediary must ensure that a CSEF offer is not completed until these conditions have been satisfied.

An issuer that distributes securities under a completed CSEF offer must file a report to the regulator within 10 days of completion of the distribution.

4.12.2 Submissions

There was a view in submissions that whether it is an ‘all or nothing’ or ‘keep it all’ CSEF campaign, issuers should only gain access to investor funds when:

- the CSEF offer period has ended, and
- any minimum subscription/designated funds target set by the issuer has been met, and
- any other preconditions in the offer have been satisfied
- any cooling off period for investors has expired, and

- legally binding share ownership documentation has been provided to investors.

4.12.3 CAMAC position

CAMAC agrees with the approach in submissions as to what constitutes completing a CSEF offer. Until the offer is completed, there should be a ban on the transfer of any crowd investor funds to the issuer and the transfer of any shares to those investors.

An offer cannot proceed to completion unless the subscription threshold, being the minimum amount of funds to be raised, as disclosed in the crowdfunding offer document, has been reached. However, whether that threshold has been achieved may be influenced by:

- any material adverse change during the offer period and, if so, the number of investors who thereupon withdraw their acceptances (Section 4.11).
- the cooling-off rights of crowd investors (Section 6.6).

In consequence, a CSEF offer cannot be treated as being completed until the expiration of these investor rights.

Canada has proposed that a second condition apply, namely that at the intended time of completion, the issuer has financial resources (taking into account the funds raised through the CSEF offer) that are sufficient to achieve the next stage in its written business plan, or otherwise to carry out the activities set out in that plan.

CAMAC notes that this proposed *sufficient funds condition* is intended to give crowd investors some assurance (before the share transactions are completed) that the issuer will have sufficient financial resources to continue the project.

The type of circumstance sought to be covered by the *sufficient funds condition*, such as a material deterioration in the financial position of the issuer during the offer period, would, under the CAMAC approach, constitute a material adverse change that would allow the investor to rescind the share acquisition contract (Section 4.11). Given this, an additional layer of investor protection through a *sufficient funds condition* may be unnecessary.

4.13 Fees paid by issuers

Issue: what controls should apply to fees paid by issuers?

4.13.1 Other jurisdictions

Canada

An issuer will be prohibited from, directly or indirectly, paying a commission, finder's fee, referral fee or similar payment to any person in connection with any CSEF offer other than to the intermediary through which the offers are made. According to the OSC, this prohibition does not apply to payments by issuers to persons as compensation for their services to an issuer in preparing materials in connection with a CSEF offer, such as accounting or legal fees.

In the view of the OSC, these fee restrictions will mitigate potential conflicts of interest.

4.13.2 CAMAC position

CAMAC considers that fee restrictions should apply, to mitigate conflicts of interest, including hidden promotions or endorsements by persons who, unknown to the crowd, will benefit from the take-up of certain CSEF offers.

Consistent with the approach in Canada, an issuer should be prohibited from, directly or indirectly, paying a commission, finder's fee, referral fee or similar payment to any person in connection with any CSEF offer, other than fees to the intermediary directly referable to conducting that offer on its website.

However, this prohibition should not apply to payments by an issuer to persons as compensation for their services to that issuer in preparing materials directly in connection with a CSEF offer, including payment of accounting or legal fees in preparing an offer disclosure document.

CAMAC elsewhere discusses the disclosure of fees charged by intermediaries (Section 5.23).

4.14 Liability

Issue: in what circumstances should issuers and their controllers be liable for the content of CSEF offer documents? What defences should apply?

4.14.1 Other jurisdictions

New Zealand

An issuer using CSEF will be subject to liability for pecuniary penalties for any misstatements or unsubstantiated representations it makes (unless it can prove a defence, for instance that the contravention was due to a cause beyond its control and it took reasonable precautions and exercised due diligence to avoid the contravention).

USA

Misstatements

Issuers, and 'control persons' of the company, including directors and principal officers, will be subject to liability for any misstatements they make. If the issuer:

- makes an untrue statement of a material fact or omits to state a material fact necessary to make its statements, in light of the circumstances in which they were made, not misleading, and
- cannot sustain the burden of proof that it did not know and, in the exercise of reasonable care, could not have known, of such untruth or omission

it must reimburse the purchase price of securities plus interest.

Investment limits

There are limits on the amount of funds that each investor can contribute annually through CSEF (see Section 6.4).

The SEC has proposed allowing an issuer to rely on efforts that an intermediary takes to determine that an investor does not exceed the investor limits (see Section 6.4.2), provided that the issuer does not have knowledge that the investor had exceeded, or would exceed, the investor limits as a result of accepting the offer of the issuer.

Banning and safe harbour

The SEC may ban persons from utilising CSEF to fund their projects on certain grounds, including non-compliance with regulatory requirements or fraudulent, manipulative or deceptive conduct.

The SEC is proposing to provide a safe harbour for issuers for certain insignificant deviations from regulatory requirements under the CSEF provisions, provided:

- the failure to comply was insignificant with respect to the offer as a whole
- the issuer made a good faith and reasonable attempt to comply with all applicable terms, conditions and other regulatory requirements, and
- the issuer did not know of the failure to comply, where that failure was the result of the failure of the intermediary.

Canada

Certificate

It is proposed that a crowdfunding offer document must contain a certificate, signed by the issuer, stating that the offer document does not contain a misrepresentation, and that investors have rights of action and withdrawal in the case of a misrepresentation.

This requirement is intended to make management and directors of the issuer accountable for the disclosure, while making investors aware of their rights of action.

Also, if a certificate ceases to be true after it has been made available to a potential investor, the issuer is prohibited from accepting any offer from that investor to acquire securities until:

- an amended offer and certificate is published on the intermediary website and made available to the investor, and
- the investor reconfirms its offer to acquire securities, or does not withdraw its offer, to purchase the securities during the offer period.

Liability for misrepresentation

The OSC considered it important for market confidence that investors have a contractual right to sue for misrepresentation. For this purpose, the issuer must provide a contractual right of action for rescission or damages to each investor and security holder in the event of a misrepresentation, subject to a due diligence defence and a defence that the investor knew of the misrepresentation.

4.14.2 Submissions

Various respondents considered that the principles in ss 728-733 of the Corporations Act (dealing with liability for misstatements in, or omission from, a disclosure document) should also apply to disclosures by an issuer in the context of CSEF.

However, one respondent considered that some adjustments to the available defences under those provisions would be needed, arguing that the costs of full verification, required with the current defences to misleading and deceptive statements for public company offers, could be prohibitive and negate the viability of CSEF. Rather, there should be a specific defence in the CSEF context for those directors of issuers who have acted honestly and reasonably, without requiring that this involve full verification.

In regard to directors' duties and liability when a company is insolvent, the general view was that directors of entities employing CSEF should be in the same legal position as directors of other companies.

4.14.3 CAMAC position

There is a strong case for making any liability and defence regime for the content of all issuer disclosures to the crowd generally consistent with the approach adopted in ss 728-733 of the Corporations Act in regard to offer and other disclosure documents under Chapter 6D of the Corporations Act. However, as suggested in submissions, there may be merit in the context of CSEF in having a defence of acting honestly and reasonably, without the requirement of full verification.

There may also be merit in the Canadian proposal for a signed certificate by the issuer, as part of the offer document to the crowd, stating that there is no misrepresentation in that document, together with the consequences if the certificate is untrue or ceases to be true after its publication.

This certification requirement would draw to the attention of both issuers and crowd investors the disclosure obligations of issuers in making equity offers to the crowd and that directors or other controllers of issuers may be subject to civil liability for misrepresentations or material omissions.

Also, ASIC should be granted a banning power, to be used where issuers have seriously, or repeatedly, breached their obligations under the CSEF provisions.

CAMAC also agrees with respondents that directors of entities employing CSEF should be in the same legal position as directors of other companies in relation to directors' duties and liability when a company is insolvent.

4.15 Communication between crowd investors

Issue: what, if any, obligation should issuers have to provide a means for its crowd and other investors to communicate with each other?

4.15.1 CAMAC position

CAMAC elsewhere proposes that intermediaries be required to provide facilities for crowd investors to communicate with each other and with the issuer. However, this obligation on the intermediary should only apply during such time as the issuer is utilising the intermediary's website (Section 5.21).

Following the completion of an offer, crowd and other shareholders may wish to communicate with each other for various purposes, including to consider possible responses to the conduct of company directors or other officers (see Section 3.4). This could be facilitated if shareholders had a ready ongoing means of online contact, say, through the issuer's website or through a social media site (with, for instance, shareholders having password access to the online site).

Such an initiative by issuers may be one means of more effective engagement of shareholders with each other and with the company. Beyond that, however, the question is whether this should be a statutory obligation.

An argument for a mandatory approach is that an issuer that is experiencing difficulties may choose to close down the electronic communication portal at the very time that it may most be needed by shareholders.

A contrary position is that without a general statutory requirement applicable to all public companies, the consequence would be that only those issuers that had raised funds through CSEF would have this obligation. CAMAC considers that this matter should be considered in this broader context, and not be introduced for CSEF issuers alone.

5 The crowdfunding process: intermediaries

This chapter sets out the proposals for intermediaries to conduct equity offers to the crowd through their websites.

5.1 Overview

Intermediaries play the central role in bringing together issuers and crowd investors. How they perform that role is fundamental to the integrity of the CSEF process.

It is proposed that each equity offer to the crowd be conducted through one intermediary only, operating online only (Section 5.2). The issuer would choose the intermediary, subject to the intermediary agreeing to host the issuer on its website.

The CAMAC proposals concerning intermediaries seek to engender issuer and investor confidence in the CSEF process by requiring intermediaries to take a fully professional approach to their role. Also, intermediaries would benefit from significant economies of scale as more issuers are hosted on their platforms, thereby reducing their compliance costs.

5.1.1 Obligations

To conduct any CSEF offer, an intermediary should be appropriately licensed and comply with the various obligations attached to that licence (Section 5.3 to Section 5.6).

It is also proposed that intermediaries must:

- conduct limited due diligence checks on issuers (Section 5.8 and Section 5.9)
- provide a generic risk disclosure statement to crowd investors (Section 5.15)
- check compliance with investor caps in some instances (Section 5.16)
- provide communication facilities between issuers and investors (Section 5.21)
- have, and disclose information about, dispute resolution procedures and indemnity insurance (Section 5.22)
- disclose the fees they charge (Section 5.23).

Intermediaries must also notify accepting investors of material adverse changes (Section 4.11).

Intermediaries should not be obliged to screen crowd investors (Section 5.14). However, they should be required to receive investor acknowledgements of risk disclosure statements before permitting them to acquire shares through CSEF (Section 6.5).

5.1.2 Prohibitions

It is proposed that intermediaries cannot:

- publish offers of ineligible issuers (Section 5.7)

- engage in conflict of interest situations (Section 5.12)
- provide investment advice to crowd investors (Section 5.17)
- solicit crowd investors to accept CSEF offers on their websites (Section 5.18)
- lend to crowd investors to acquire shares offered on their websites (Section 5.19).

5.1.3 Liabilities

It is proposed that intermediaries be liable only where they have *actual* knowledge of:

- materially misleading issuer information (Section 5.10)
- issuer fraud (Section 5.11).

5.1.4 Administration

Administrative matters which intermediaries will need to perform as part of an effective CSEF process deal with:

- holding crowd investor funds (Section 5.20)
- monitoring the issuer cap (Section 4.5.4)
- issuer access to crowd investor funds (Section 5.13)
- cancelled offers (Section 5.24)
- the privacy of information about crowd investors (Section 5.25).

A Permitted types of intermediary

5.2 Sole-intermediary and online-only requirement

Issue: should there be a sole-intermediary and online-only requirement for each CSEF offer?

5.2.1 Other jurisdictions

USA

A key underlying principle in the SEC approach to CSEF under Title III of the JOBS Act is that any offer to investors to take up securities in an issuer utilising these provisions must be conducted exclusively through a sole intermediary, operating online-only:

> a central tenet of the concept of crowdfunding is presenting members of the crowd with an idea or business so members of the crowd can share information and evaluate the idea or business. Allowing an issuer to conduct a single offering or simultaneous offerings in reliance on [Title III of the JOBS Act] through more than one intermediary would diminish the ability of the members of the crowd to effectively share information, because essentially, there would be multiple ‘crowds.’

Also:

> an "online-only" requirement enables the public to access offering information and share information publicly in a way that will allow members of the crowd to decide whether or not to participate in the offering and fund the business or idea … Offerings made by other means would not be widely accessible by the public, which would defeat the benefit of the collective wisdom of the members of the crowd.

The proposed rules would require that a registered intermediary execute CSEF transactions only through its online platform. An intermediary or its associated persons would be prohibited from accepting an investment commitment until the investor has opened an account with the intermediary and the intermediary has obtained the investor's consent to electronic delivery of materials:

> This requirement would help ensure that certain basic information about the investor is on file with the intermediary and that all investors are on notice of the primary method of delivery for communications from the intermediary.

The online platform requirement is intended to benefit both issuers and investors:

> This requirement should help issuers gain exposure to a wide range of potential investors, who also may benefit from having numerous investment opportunities aggregated in one place, resulting in lower search costs or burdens related to identifying suitable investment opportunities.

Canada

An issuer will only be permitted to offer its securities to the crowd through one intermediary during the distribution period established by the issuer. An offer document cannot be posted on any other website.

The OSC argued that:

> All relevant information should be included in one place (i.e., the portal's website) for ease of investor reference and to facilitate the exchange of information and views that is conducive to eliciting the 'wisdom of the crowd'. It will also make it easier to monitor both the distribution and investment limits.

UK

The FCA regulation is designed to be 'media-neutral' in that it applies to all intermediaries marketing offers, for 'non-readily realisable securities' whether using online platforms or other media:

> This was done with [the FCA's] competition objective in mind and in order to provide appropriate protection for all investors however they invest … In our view, the same protection should apply to investors whether they engage with firms online or offline as a result of direct marketing or through telephone-selling of investments.

5.2.2 Submissions

The view was expressed in submissions that any CSEF regime should require that an offer by an issuer to the crowd to take up securities should be conducted through a sole intermediary, operating online only, consistent with the proposed crowdfunding rules published by the US SEC. This approach, it was argued, supports transparency and a level playing field by ensuring that all crowd investors have access to the same information in a single location. The sharing of knowledge and information among investors will help to disseminate information that will form the reputations of issuers, intermediaries and other actors, which is critical given the division of labour in the market assessment process.

5.2.3 CAMAC position

CAMAC has considered whether, in relation to each CSEF offer, that offer can be conducted only through one intermediary (sole-intermediary) and that intermediary can make the offer and process the acceptances only through its online website (online-only). An issuer could approach any intermediary to conduct a particular offer.

The principal argument for these requirements, as reflected in the US and Canadian approaches, and in submissions, is to ensure that all relevant information provided to the crowd concerning an issuer and its equity offer is available at one, readily accessible, internet location.

Possible concerns about this requirement are that it might reduce productive competition between intermediaries (as the intermediary that is conducting a particular offer would have a monopoly in that regard), and could in some instances encourage a 'herd mentality' amongst crowd investors, as they see other internet participants take up an offer from a particular issuer.

On balance, CAMAC considers that the benefits to the crowd of a single internet location for all relevant information concerning a CSEF offer outweigh the possible anti-competitive drawbacks with this approach.

The UK 'media-neutral' approach reflects a different regulatory structure that includes, but is not confined to, CSEF offers.

5.3 Licensing

Issue: should CSEF intermediaries be required to be licensed or registered in some manner?

Typically, in the Australian context, licensing requirements are more onerous for applicants than registration-only requirements, given that licensing involves closer vetting by the regulator of the suitability of applicants as well as the ability of the regulator to impose tailored conditions on any licence granted.

5.3.1 Other jurisdictions

UK

Intermediaries must be authorised by the FCA before being permitted to market non-readily realisable securities to eligible investors, whether through the internet or otherwise.

New Zealand

Part 6 of the Financial Markets Conduct Act 2013 and the associated Regulations provide for applications to be made to the Financial Markets Authority (FMA) to be licensed for the purposes of providing a 'crowd funding service'.

A person provides a crowd funding service if:

- it provides a facility by means of which offers of shares in a company are made; and
- the principal purpose of the facility is to facilitate the matching of companies who wish to raise funds with many investors who are seeking to invest relatively small amounts

To be licensed, an intermediary must:

- have fair, orderly, and transparent systems and procedures for providing the service.
- satisfy capability standards.

In addition, the directors and senior managers of the intermediary must be fit and proper persons to hold their respective positions. The FMA has laid down minimum standards in this regard.

A number of other licensing requirements apply, including in relation to the internal governance, financial resources, indemnity insurance, and information technology arrangements of intermediaries, and a plan to protect the interests of relevant issuers or investors if the intermediary services are terminated.

USA

CSEF offers must be conducted through an 'intermediary' that is registered with the SEC either as a broker-dealer or as a 'funding portal'.

A funding portal will be required to have written policies and procedures reasonably designed to achieve compliance with its CSEF statutory obligations and SEC Rules, as well as complying with anti-money laundering requirements. A funding portal must also maintain fidelity bond coverage, as some protection to CSEF investors from potential loss through fraud. Non-resident funding portals will be permitted provided that certain conditions are met.

As explained by the SEC:

> The use of a registered intermediary to match issuers and investors would require that they incur certain transactions costs necessary to support the intermediation activity, but also would provide centralized venues for crowdfunding activities that should lower investor and issuer search costs.

Issuers and investors may also benefit from competition between registered intermediaries:

> It also is likely that there will be significant developments in the types and ranges of crowdfunding products and services offered to potential issuers and investors, particularly as competitors learn from their experiences.

Intermediaries must collect and transmit CSEF transaction data to the SEC for administration and data analysis. They must also maintain and preserve certain records relating to their business, including all records related to persons that use the communication services provided by a funding portal to promote an issuer's securities or to communicate with potential investors, as well as records of all CSEF agreements:

> We [the SEC] believe that it is important for funding portals to be subject to a recordkeeping requirement in order to create a meaningful audit trail of the crowdfunding transactions and communications.

Canada

CSEF offers must be conducted through an online intermediary registered as a restricted dealer.

The OSC described this licensing requirement for intermediaries as a key investor protection element in CSEF:

> Registration is necessary to address, among other things, potential integrity, proficiency and solvency concerns that may apply to funding portals and the persons operating them, as well as potential concerns relating to conflicts of interest and self-dealing. The registration requirement is also intended to serve as a safeguard against funding portals being used to facilitate fraudulent offerings of securities through the internet.

Intermediaries must comply with general registrant requirements, including account opening, reporting, record-keeping and record-retention requirements, but with certain adjustments to other licensing requirements to take into account the CSEF provisions applicable to them.

Intermediaries will also be subject to a minimum net capital requirement of $50,000 and a fidelity bond insurance obligation providing for coverage of at least $50,000 (to help insure against the loss of investor funds that may occur if, for example, an intermediary or any of its officers or directors breaches the prohibitions on holding, managing, possessing or otherwise handling investor funds or securities).

Similar to other registrants, the intermediary will be required to act honestly, fairly and in good faith.

An intermediary must provide quarterly reports to the regulator on various aspects of the CSEF activities on its website. Issuers will have obligations to provide some of this information, but the obligation could be delegated to the intermediary. The regulator may also request other information or information on a more frequent basis.

Also, changes in control of the intermediary will require regulatory approval.

The regulator has exemption powers in regard to the obligations applicable to CSEF intermediaries.

Italy

CSEF investments must be arranged through 'permitted managers', covering broker-dealers/financial institutions and other persons who match requirements of professionalism and trustworthiness, to comply with anti-laundering laws and the EU *Markets in Financial Instruments Directive* (MiFID).

5.3.2 Submissions

Respondents differed between those who supported:

- licensing of CSEF intermediaries
- registration of these intermediaries
- neither licensing nor registration of these intermediaries.

One approach in submissions was that whether licensing or registration, or neither, was appropriate should turn on the level of active involvement in the CSEF process expected of intermediaries. Licensing may not be appropriate if the only statutory roles of intermediaries are to provide an online platform where issuers may advertise their offers and to administer the offer and acceptance process. In that case, according to some respondents, registration may still be necessary to avoid 'fly-by-night' intermediaries who fail to perform even these functions. Conversely, licensing may be appropriate if intermediaries are obliged to play an active role in scrutinising issuers and otherwise safeguarding the interests of crowd investors and deterring fraud.

Some respondents considered that intermediaries should, at most, only have to be registered (with an industry-based code of conduct) if they are prohibited from giving financial advice to potential investors and are also prohibited from holding investors' funds or securities. It was also argued that any further regulation through licensing in these circumstances may be too onerous and costly for intermediaries, who would ultimately pass such costs on to the issuer, thus defeating the purpose of CSEF as a low cost option for small business.

Another view was that intermediaries that provide an online platform between the issuers and the investors should be subject to an appropriate licensing arrangement to provide some minimum standard of protection to those issuers and investors participating in the marketplace. The role the operators play in the intermediation of investors and issuers should determine what type of licence they have and the regulatory obligations the operator should meet.

Within this context, the view was expressed that intermediaries should not be required to hold an Australian Market Licence (AML) to operate a CSEF online platform, as this would place an undue pecuniary and compliance burden on them, the cost of which would ultimately be passed on to issuers and investors. It was also argued that the balance sheet resources required for an AML would almost certainly be beyond the capacity of candidates to operate as CSEF intermediaries. However, to build investor confidence that these intermediaries have the appropriate expertise and resources to carry out their role and can be held accountable, they should hold an Australian Financial Services Licence (AFSL), tailored specifically for CSEF intermediaries, possibly in the manner being adopted in New Zealand. It was pointed out that a capital or security bond requirement for the licensing of intermediaries may help ensure that only appropriately funded businesses act as intermediaries, while also offering some financial protection to affected parties in the event that an intermediary acts dishonestly.

It was also argued that a reduction in licensing requirements, including conduct standards, relative to securities issued by other means could invite issuers and intermediaries looking to exploit regulatory arbitrage and may tarnish the CSEF industry's reputation.

5.3.3 CAMAC position

Given the central role of intermediaries in the CSEF process, including to conduct some due diligence vetting of applicant issuers (Section 5.8 and Section 5.9), and the need for them to act at all times in a professional manner, free of conflicts of interest, they should be required to be licensed by ASIC as a precondition to conducting CSEF offers on their websites.

Mere registration of intermediaries and reliance on industry-based voluntary codes of conduct would not necessarily suffice to ensure the continuing confidence of issuers and crowd investors in the impartial role of intermediaries. Also, the licensing of suitable intermediaries would not be overly onerous, costly or time-consuming.

An intermediary that intends to conduct a secondary market in shares issued through the CSEF process would also need to be appropriately licensed.

CAMAC notes that, depending upon the interpretation of key legislative concepts, including what constitutes operating a financial market, a question may arise whether an Australian Financial Services Licence (AFSL) or an Australian Market Licence (AML) would be necessary under the current law.

CAMAC does not seek to resolve matters of statutory interpretation. It notes that Treasury is presently considering the interrelationship between these two licences. CAMAC considers that the appropriate course in the context of CSEF is a tailored licensing regime for intermediaries, which covers the relevant matters for those parties set out elsewhere in this report.

5.4 Capacity to conduct role

Issue: what financial, human, technology and risk management capabilities should an intermediary have for carrying out its role?

5.4.1 Other jurisdictions

New Zealand

To operate a crowd funding service, an intermediary must satisfy various standards identified by the FMA concerning:

- fit and proper
- capability
- operational infrastructure
- financial resources
- governance.

See further the summary in Section 5.3.1.

UK

Authorised intermediaries, and their representatives, must comply with the FCA Handbook requirements.

5.4.2 Submissions

It was suggested in submissions that intermediaries, as well as having high integrity, must display the technical capacity and competence to conduct a fully secure and functioning online portal, including:

- to facilitate communications between investors as well as between investors and issuers
- to ensure secure online payments
- to enable investors to log in and view their investment, and
- to guard against online fraud, unauthorised access to investor details, and money laundering.

Also, depending upon their role, and potential liabilities, with issuers and investors, intermediaries may need some legal competence and financial literacy (or access to such) to detect misrepresentations by issuers in marketing materials, including the CSEF offer document.

The view was also expressed that intermediaries should have the capacity to guide issuers as to the equity fundraising process, given that seldom do start-up or early stage companies have the knowledge and expertise to raise funds.

Another comment was that intermediaries specialising in early stage technology companies could build their reputation in the CSEF market by choosing to conduct significant due diligence assessment of an issuer before hosting it on their platform. For this purpose, their human resources would need to include individuals experienced in early stage investing and/or access to other relevant expertise (for instance 'business incubators' who could undertake a due diligence vetting process). It was argued that intermediaries will build their brand and reputation around the quality of the investment opportunities hosted.

Other respondents expressed the view that intermediaries should not be obliged to have the capability to carry out this form of due diligence assessment of issuers, as this would require involving persons with specialised financial and legal qualifications, with potential high costs to the intermediary. The more efficient and economic option would be to place the disclosure obligations solely on issuers. Rather, each intermediary could be obliged to explain on its website what, if any, screening of issuers it undertakes (or arranges to be undertaken).

5.4.3 CAMAC position

CAMAC considers that the New Zealand licensing requirements for CSEF intermediaries provide a useful precedent for the necessary minimum skills base of an intermediary, which could be blended into the current general licensee requirements in s 912A(1) of the Corporations Act.

CAMAC also supports the observation in submissions that, in addition to any regulatory obligations concerning the capacity of an intermediary to conduct its role, an intermediary could choose to build its brand and reputation around the quality of any additional assessment it chooses to make of issuers before agreeing to host them on its website.

CAMAC elsewhere discusses whether intermediaries should be required to conduct due diligence assessments of applicant issuers, and what this may involve (Section 5.8 and Section 5.9).

5.5 Processes to fulfil role

Issue: what fair, orderly and transparent processes should the intermediary be required to have for its online platform?

5.5.1 Other jurisdictions

UK

Authorised intermediaries, and their representatives, must comply with the FCA Handbook requirements.

New Zealand

The procedures employed by an intermediary for attracting new clients (both issuers and investors) must ensure that they get sufficient information to make informed decisions about the financial services offered, and that these services are not inappropriately marketed.

The intermediary, in making its licence application, will need to describe how it intends to attract clients to its service, such as using advertising or referrals.

The intermediary will also need to demonstrate how its procedures will ensure it meets various obligations, including:

- the requirement for a written client agreement with investors
- fair dealing obligations, including the process to ensure its advertisements are not misleading or deceptive.
- the obligation to provide a disclosure document to investors, with particular attention to disclosure in respect of the nature and extent of due diligence conducted on issuers and the use of the facility by persons associated with associated with the intermediary
- the obligation to provide a warning statement to investors, and to get their confirmation that they have seen the warning.

Intermediaries must provide a service disclosure statement to retail investors and enter into written client agreements with them, dealing adequately with:

- how the platform's investment processes operate
- the mechanisms to deal with interactions between issuers and investors
- any ongoing monitoring of issuers that the platform proposes to perform
- how any investor money is handled by the intermediary
- the fees and charges that will apply to investors
- how investors can make complaints.

The service disclosure statement must also contain the risk warning statement.

5.5.2 Submissions

There was a view in submissions that the principal role of an online intermediary is to host investment opportunities in an efficient and transparent manner for the benefit of both issuers and crowd investors.

A number of respondents considered that the New Zealand proposals provided a useful model (including by requiring intermediaries to disclose the processes by which issuers and investors access the service, their fair matching to a service, their handling of investment funds and processes and checks to avoid price manipulation).

5.5.3 CAMAC position

CAMAC considers that the New Zealand requirements in the CSEF context provide a very useful precedent, which could be blended into the current licensee requirements in s 912A(1) of the Corporations Act.

CAMAC notes that if intermediaries are required to hold an AFSL, they will need to provide a financial services guide to crowd investors that would provide details about the service that is being provided. CAMAC elsewhere in this report makes various recommendations concerning particular matters to be included in that guide (Sections 5.6.3 and 5.22.3).

5.6 Dispute resolution

Issue: should an intermediary be required to have an internal dispute resolution mechanism and be a member of an external dispute resolution body, such as the Financial Services Ombudsman?

5.6.1 Other jurisdictions

UK

Intermediaries are expected to manage any conflicts of interest fairly, both between themselves and their issuer or investor clients, and between the issuer and investor clients.

New Zealand

Intermediaries are expected to have a complaints process, including belonging to a dispute resolution scheme, as required under the Financial Service Providers (Registration and Dispute Resolution) Act 2008. This is one of the requirements of registering to become a financial service provider to retail clients.

5.6.2 Submissions

A number of respondents supported a requirement that an intermediary be required to have an internal mechanism to resolve disputes with issuers or investors and be a member of an external dispute body, such as the Financial Services Ombudsman (FOS). It was also suggested that the FOS could issue guidelines on their role in this CSEF context and how claims by issuers or investors against intermediaries will be assessed. These guidelines could avoid parties seeking dispute resolution in inappropriate circumstances.

In this context, it was argued that any dispute mechanism requirement for intermediaries be limited to the functioning of the intermediary online platform, as it affects issuers or investors, and not cover, for instance, the performance of issuers in which individuals have invested.

A contrary approach was that where investors believe intermediaries have breached any of their obligations or duties (under the terms of any licensing or registration requirements), they will have recourse to ASIC. Given that, it would suffice to encourage intermediaries to include dispute resolution on a voluntary ‘opt-in’ basis, or at least set out their stated policy for handling disputes.

5.6.3 CAMAC position

To promote confidence among issuers and crowd investors, there should be a process by which they can make complaints through internal and external dispute resolution procedures concerning any aspect of the conduct of the intermediary, as it affects them, or their dealings with the intermediary.

CAMAC agrees with the comment in submissions that the performance of issuers in which individuals have invested should lie outside the dispute resolution procedure concerning the conduct of intermediaries.

CAMAC notes that holders of AFSLs must have internal and external dispute resolution procedures where retail clients are involved (s 912A(1)(g), (2)). It considers that the same obligation should apply to a licensed intermediary in the context of CSEF, and be available to issuers as well as crowd investors.

The need for such a requirement is reinforced in the context of CSEF, given that (as proposed elsewhere in this report) the intermediary will have a monopoly on the carriage of a particular offer to the crowd.

In the Australian context, a suitable external dispute resolution body could be the Financial Services Ombudsman.

Information about the internal and external dispute resolution procedures should be disclosed on the intermediary's website, as well as being disclosed in the financial services guide given to crowd investors by intermediaries.

In the event that an intermediary is not placed under an obligation to have an internal or external dispute resolution procedure, each intermediary should be obliged to disclose on its website whether it has any such procedure and, if so, the details.

This matter is further discussed in Section 5.22.

B Intermediary matters related to issuers

5.7 Excluded issuers

Issue: what, if any, projects and/or issuers should intermediaries not permit to raise funds through CSEF?

5.7.1 Other jurisdictions

Canada

An intermediary must not allow an issuer access to the online portal to publish its offer if the intermediary, or any officer, director or significant shareholder of the intermediary or of any affiliate of the intermediary:

(a) has beneficial ownership of, or control or direction over, more than 10% of the issued and outstanding securities of the issuer, or securities convertible into securities of the issuer, or

(b) except as permitted under (a), otherwise has an economic interest in the issuer.

5.7.2 Submissions

Respondents referred to excluding projects which cannot lawfully be pursued.

Other suggestions for possible exclusion included funds management/investment projects and projects for trading in securities or other financial instruments.

5.7.3 CAMAC position

An intermediary should be prohibited from publishing an equity offer of a particular issuer on its website where:

- the issuer is ineligible to utilise the CSEF process (see Section 4.2)
- the intermediary (including any of its controlling persons) has any material interest in the issuer. This differs from the Canadian approach of allowing an equitable interest up to a threshold (see further Section 5.12).

5.8 Due diligence on issuers and their management

Issue: what preliminary and ongoing due diligence checks should intermediaries be required to conduct on issuers and their management?

5.8.1 Other jurisdictions

New Zealand

Intermediaries must have anti-fraud and fair dealing policies that enable them to assess issuers and their management, and if needed, exclude an issuer from using the online facility.

Anti-fraud

Intermediaries are required to conduct checks to exclude offers by issuers on their websites where there is evidence that directors, senior managers or controlling owners of the issuer are not of good character and reputation.

At a minimum, this must involve:

- checking, against publicly available and readily accessible information, the identity of the issuer and information provided by the issuer relating to the identity and character of its directors and senior managers; and
- excluding an issuer from using the service if the provider is not satisfied as to the identity of the issuer or of the issuer's directors and senior managers, has reason to believe that any of the issuer's directors or senior managers are not of good character or has reason to believe that the issuer is not likely to comply with the obligations imposed on it under the service.

The intermediary must have adequate systems and procedures to implement this policy.

The FMA has indicated that the anti-fraud policy must, at a minimum, confirm the identity and character of the issuer's directors and senior managers from publicly available and readily assessable information. This should include searching relevant public registers (such as the Companies Register and Insolvency Register) and the internet (for relevant news articles or other commentary) to identify evidence of:

- bankruptcy or involvement with insolvent companies
- information that may question the identity of directors or senior managers
- convictions for fraud or dishonesty – or involvement in litigation or other disputes.

The intermediary must also identify the criteria to help assess this information and to make decisions about allowing issuers to use the service.

Fair dealing

An intermediary must has an adequate policy for excluding an issuer from using the service if the provider has information (for example, from checks or assessments it carries out (if any)) that gives it reason to believe that the issuer, in relation to any dealing in shares using the service, has:

- engaged in conduct that is misleading or deceptive or likely to mislead or deceive; or
- made a false or misleading representation in contravention of s 22 of the Act; or
- made an unsubstantiated representation in contravention of s 23 of the Act.

The intermediary must have adequate systems and procedures in place to implement this policy.

The FMA has indicated that the fair dealing policy of an intermediary must enable it to exclude an issuer from using the service in certain circumstances. An intermediary's fair dealing policy should set out:

- the steps the intermediary will take if it identifies identify actual or suspected evidence of misconduct of the type set out in Regulation 17(1)(e)(see above)
- the process an intermediary will use to exclude an issuer, and how that exclusion will be given effect to, for example through appropriate provisions in agreements with issuers.

USA

Intermediaries must take such measures to reduce the risk of fraud as will be established by the SEC, including background and regulatory checks on directors, officers and significant shareholders of issuers.

The SEC has taken the view that placing a responsibility on intermediaries to conduct checks of issuers (which might be done by third parties employed by intermediaries for this purpose) solves an issuer assessment problem that would be prohibitively costly if left to individual investors, and that:

> to the extent these checks lessened the likelihood of inappropriate or nefarious activity, they could increase investor willingness to purchase crowdfunding securities, thereby potentially resulting in issuers having greater access to capital.

Under the proposed rules, the SEC would permit an intermediary to rely on an issuer's representations concerning compliance with the various specific regulatory requirements unless the intermediary has reason to question the reliability of the representations:

> The proposed rules would permit intermediaries to reasonably rely on representations of the issuer, absent knowledge or other information or indications that the representations are not true.

However an intermediary would be required to deny access to an issuer if it has a reasonable basis for believing that the issuer or any of its officers, directors (or any person occupying a similar status or performing a similar function) was subject to a disqualification under the proposed rules. Also, the proposed rules would require an intermediary to deny access to its platform if the intermediary believes that the issuer or the offer presents the potential for fraud or otherwise raises concerns regarding investor protection. The power of an intermediary to deny access:

> would further enhance investor protection by giving funding portals the flexibility to deny access to potential bad actors.

The SEC has recognised the limits of these rules in reducing the risk of fraud, but has also identified some counter-veiling considerations:

> We also recognize that permitting an intermediary to rely on an issuer's representations unless the intermediary has reason to question the reliability of the representations could potentially lessen the incentive for an intermediary to thoroughly investigate the issuers and securities to be offered on its platform. Such an outcome could result in a higher levels of fraud compared to a requirement that intermediaries perform a thorough investigation to ensure that the issuer complied with all the requirements. A higher level of fraud would negatively affect both investors in crowdfunding offerings and non-fraudulent issuers … however, we believe it is likely that investors and interested participants would provide relevant adverse information about an issuer or an offering through postings on chat sites, message boards, and other communication channels, including, but not limited to, the communication channels to be provided by the intermediary.

Canada

Intermediaries will be required to conduct background checks on issuers, and their directors, executive officers, promoters and control persons, to verify the qualifications, reputation and track record of the parties involved in the key aspects of the offer. The checks will include identifying criminal and regulatory issues.

The OSC has indicated that, at a minimum, an intermediary should conduct the following checks:

(a) for issuers:

- (i) the existence of the issuer and its business registration, including a review of the issuer's constitutional documents
- (ii) criminal record and securities enforcement history checks
- (iii) bankruptcy/liquidation checks, and
- (iv) court record checks, where available

(b) for directors, executive officers, control persons and promoters of the issuer:

- (i) criminal record and securities enforcement history checks
- (ii) bankruptcy checks, and
- (iii) court record checks, where available.

An intermediary may retain a third party to perform these checks. However, the statutory obligation remains with the intermediary.

An intermediary must deny access to an issuer if, based upon its review of the issuer's application and information obtained through background checks, it believes that the business of the issuer may not be conducted with integrity and in the best interests of security holders because of, among other reasons, the conduct of the issuer, or any of the issuer's executive officers, directors, promoters, or control persons.

UK

See Section 5.9, post.

Italy

Intermediaries are responsible for verifying that the start-ups have satisfied all the necessary requirements to register on the portal.

5.8.2 Submissions

Respondents basically divided between:

- those who supported some level of compulsory due diligence checks by intermediaries,
- those who considered that intermediaries should have no due diligence role and
- those who considered that investors would be protected by market forces, which would provide a satisfactory self-regulatory outcome.

Limited mandatory due diligence

One proposal was that intermediaries be required to conduct preliminary due diligence, with 'know your customer' minimum type checks of issuers (eg an ASIC incorporation extract, any available credit report, checks that directors are not disqualified, that the issuer has provided legal and accountant sign-off for offer documents and financial information respectively, and a statement by directors as to the solvency of the issuer). Directors of the issuer might also be required to provide a statement to the intermediary that there is not any undisclosed information concerning the issuer that would be material to its being listed with the intermediary.

Beyond that, it should be at the discretion of intermediaries whether to conduct ongoing due diligence surveillance of issuers while listed on their online platform, though it may be in the commercial interest of intermediaries to do so. The comment was made that any requirement for an intermediary to vet every statement made by an issuer on its CSEF online platform would greatly increase an intermediary's costs.

No due diligence obligation

The view under this approach was that there should not be any requirement for intermediaries to undertake any particular due diligence of intending issuers. Intermediaries should merely provide a platform for investor-issuer matching (and a process to manage the purely administrative actions relating to an offer). Any due diligence obligation on intermediaries could expose them to litigation for any inevitable errors/omissions by issuers (given the start-up nature of most issuers and the limited resources available to intermediaries).

Self-regulation

It was argued that to build and protect their market position, intermediaries, of their own volition and without any need for a due diligence obligation, will undertake basic enquiries about issuers and their key personnel (eg searches to establish company identity, registered office, financial accounts filings up-to-date, any charges over the company's business and assets, any pending legal actions or judgments, and any director disqualification) before determining whether to list applicant issuers on their websites. This form of self-regulation should be effective, given that intermediaries have a commercial interest in maintaining their reputation.

A variation of this approach was to leave to the discretion of intermediaries what, if any, due diligence to conduct concerning an issuer, but to oblige intermediaries to disclose on their websites whether they had conducted any due diligence on the issuer, and the nature of any such due diligence.

5.8.3 CAMAC position

The problem to be addressed

Unless properly regulated, the CSEF process could become an opportunity for fraud or other abuse.

For instance, individuals may become adept at preparing documentation describing a business idea or plan in a manner designed to attract attention and crowd interest, but without there being any real substance behind it, and without any intention, or capacity, of proceeding with the idea. Any funds raised from the crowd may be used for private purposes, with the businesses being discarded and crowd investors left with shares of no value.

Left to themselves, crowd investors would have little capacity to distinguish between genuine and questionable issuers. While a business or other idea may appear sound, these investors will have no ready means to work out whether the individuals behind the idea have the intention or ability to make the idea succeed or whether they are simply going through the fundraising exercise to obtain money for their personal use.

Though this problem may occur with any form of fundraising, it is exacerbated with CSEF, which will likely involve start-up or other small-scale enterprises that lack a proved business plan or product, and are well short of being developed to the point that they can seek funds from the public through a regulated initial public offer (IPO).

Elsewhere, CAMAC has proposed measures to counter the possibility of individuals seeking to manipulate the CSEF process by using a series of companies for this purpose (Section 3.2.2, dealing with linked and phoenix companies, and Section 4.5.4, which applies the issuer cap to the 'issuer group'). Also relevant is the CAMAC proposal that issuers be required to disclose in their offer disclosure documents information about linked or relevant past companies that have engaged in CSEF (Section 4.7.3).

In the CAMAC response in this Section, and Section 5.9, the crucial role of intermediaries in countering possible abuse by vetting issuers is considered.

Importance of intermediary checks

Limited due diligence checks by intermediaries on issuers and their management should be mandatory, given the important investor protection filtering function that those checks serve. While such due diligence should not be considered as a guarantee of the integrity of the issuer and its management, crowd investors need some confidence in this regard, and it would be unrealistic to expect each of them to conduct such checks themselves. Permitting questionable issuers to obtain cash from the crowd through CSEF without any form of due diligence sifting by intermediaries could undermine the reputation of CSEF with the investing public and reduce its role in assisting worthwhile enterprises to succeed. It could also damage the commercial position of intermediaries.

CAMAC does not support self-regulation in this area, as proposed in some submissions. Leaving it to intermediaries to decide what due diligence checks to undertake, if any, on issuers and their management, provided what they do or don't do is disclosed to investors, may provide little or no protection to investors, particularly if intermediaries take the view that they might more easily attract issuers to their website if they choose not to conduct due diligence. By contrast, requiring all intermediaries to conduct some due diligence (the costs of which would be charged to issuers) overcomes this arbitrage possibility.

Initial checks

CAMAC considers that a template limited due diligence approach ensures that all intermediaries will conduct at least the same minimum due diligence checks on issuers and their management. Intermediaries should not be required to design a due diligence check for each issuer.

The overseas approaches to due diligence obligations, including the New Zealand anti-fraud and fair dealing requirements, and the circumstances in those jurisdictions where intermediaries should deny access by issuers provide useful direction for the content of a template due diligence check by intermediaries. These various approaches could be integrated into a manageable, yet effective, due diligence template in Australia.

In that context, for instance, intermediaries would be able to check for any criminal records of an issuer or its managerial personnel by obtaining authorisations from those parties for police to conduct such searches.

To assist intermediaries in conducting due diligence, CAMAC supports the principles that:

- intermediaries should be entitled to rely on various representations of the issuer pursuant to the template requirements, other than where the intermediary has actual knowledge that the representations are not true

- each issuer should be obliged to certify to the intermediary that there is no undisclosed information concerning the issuer and its management that would be material to a decision by the intermediary whether to include the issuer on the intermediary's website.

Intermediaries could elect to commission other parties to conduct due diligence checks on issuers and their management. While this delegation would not allow intermediaries to contract out of their due diligence responsibilities, it may provide evidence of the means by which they have sought to fulfil these limited responsibilities.

Intermediaries who properly comply with the template requirements should not be liable merely because it later transpires that information concerning an issuer or its management was untrue. CAMAC elsewhere recommends that intermediaries will be liable only where they have actual knowledge of some wrongdoing by the issuer (Sections 5.10 and 5.11). The same test should apply in this context.

Subsequent checks

An issuer should be obliged to notify its intermediary of any material changes to the information previously provided (for instance, a change of director) and provide authorisations for criminal checks to be conducted on any new personnel. In addition, an intermediary should be obliged to conduct a supplementary check if it otherwise has actual knowledge (not merely constructive knowledge) of such a material change or has actual knowledge of a fact that puts into question some matter on which it relied in an earlier background check.

Subject to these requirements, an intermediary should not have an obligation of continuing inquiry, or be expected to provide some guarantee to the crowd concerning the propriety of the issuer and its management.

It would not be appropriate for ASIC to have to conduct due diligence checks on issuers beyond those that currently apply when companies are registered.

5.9 Due diligence on the business of issuers

Issue: what preliminary and ongoing due diligence checks should intermediaries be required to conduct on the business conducted by issuers?

5.9.1 Other jurisdictions

UK

Intermediary checks on issuers

Apart from conducting some basic checks, for instance that an issuer is in fact incorporated and the persons acting on behalf of the issuer are in fact corporate officers, intermediaries are not obliged to conduct due diligence checks of issuers that use their websites. Rather, as indicated in PS14/4, they have disclosure obligations in regard to whether they have conducted due diligence:

> In satisfying the financial promotion rules we expect sufficient detail to be provided to give a balanced indication of the benefits and the risk involved, including whether or not any due diligence has been carried out on [an issuer], the extent of the due diligence, and the outcome of any analysis.

However, the FCA has also indicated that, in line with FCA Principles, firms that operate investment-based crowdfunding platforms are expected to conduct their businesses with integrity and have system and controls to mitigate the risk of offers being made in contravention of applicable legislation.

Intermediary obligations in relation to issuer promotions

Intermediaries that communicate or approve financial promotions concerning crowdfunding offers will need to ensure that they comply with applicable financial promotion rules, particularly the requirement for the promotion to be fair, clear and not misleading.

Also, intermediaries, as well as issuers, must satisfy themselves that issuers are meeting any requirement to publish a prospectus (or satisfy themselves that an exemption applies).

New Zealand

An intermediary must maintain clear and transparent information about what due diligence the intermediary has and has not carried out in this area, so investors can make reasonable judgments about the risks of investing.

More specifically, the intermediary must disclose the nature and extent of the checks, if any, of the risks involved with the shares that are subject to the offer, or disclose that such checks are not part of the intermediary’s service.

Canada

This has a number of elements.

Due diligence on the issuer’s offer

An intermediary must have the proficiency that a reasonable person would consider necessary to perform its role competently, including to understand the structure, features and risks of each security coming within a CSEF offer on its website.

An intermediary is expected to develop this understanding based on a review of the issuer's articles of incorporation, other relevant constitutional documents and other materials included in the issuer's application for access to the intermediary's portal (see *Issuer access agreements*, post). For example, if an issuer proposes to offer securities that contain restrictions on voting, or contain redemption rights that allow the issuer to redeem the shares in certain circumstances, or that insiders or promoters of the issuer hold another class of securities that have multiple votes, the intermediary should understand that it may be misleading to investors if the issuer describes the securities as 'common shares' or does not disclose the existence and material terms of the securities held by the insiders and promoters.

Likewise, if an issuer is part of a corporate group, and the issuer's interest in the business or the assets of the business are owned through one or more subsidiaries, the intermediary should understand the features and risks of the capital structure of the corporate group and assess whether the issuer's disclosure adequately discloses these risks.

Within this framework, an intermediary must review the information intended to be presented by the issuer on the portal's website for the purpose of forming a reasonable belief that the information adequately sets out:

- the general features and structure of the security to be offered
- issuer-specific risks
- parties involved and any inherent conflicts of interest, and
- the intended use of funds raised through the issue.

However, this obligation does not include an obligation to assess:

- the merits or expected returns of an investment to purchasers, or
- the commercial viability of a proposed business or offer.

Also, business plans must be prepared by the issuer's management. Intermediaries will not be required to assess the commercial viability of these plans.

In addition, the intermediary is not obliged to determine whether an issuer's milestones are realistic or achievable or to assess the experience of the directors or executive officers of the issuer.

The OSC was of the view that:

> Many [intermediaries] will realize the importance of conducting due diligence on issuers, especially if the portal expects to maintain its business in what is expected to be a very competitive market.

While an intermediary will not be automatically liable for the accuracy or completeness of the issuer information, it may not include on its website any issuer information or communication that appears to be false, deceptive, misleading or contains a misrepresentation. Likewise, an intermediary must deny access by an issuer to its online portal if the intermediary has reason to believe that the issuer or its offer is fraudulent. The intermediary must terminate any such offer and must also report immediately to the principal regulator if fraud is discovered during the distribution period.

Issuer access agreements

Before an intermediary may permit an issuer to access its online portal, the intermediary must enter into an 'issuer access agreement' with that issuer.

The issuer access agreement must contain various provisions, including a confirmation from the issuer that it will comply with the intermediary's posting policies, including confirmation that the information that the issuer provides to the intermediary or posts on the intermediary's website will:

- comply with applicable securities legislation
- not contain unduly promotional statements or material that cannot be reasonably supported or any misrepresentation
- be presented in a fair and balanced manner, and
- not be misleading.

Assistance to issuers

An intermediary may assist an issuer in the preparation of an offer document, business plan or other permissible document, provided that the service is limited to assisting the issuer to comply with its disclosure obligations and to ensure that the information is presented in a fair, balanced and reasonable manner.

Intermediaries may also assist issuers to meet their disclosure and record-keeping obligations. However, the provision of such assistance is at the discretion of the intermediary and will not be a condition of intermediary registration.

Obligations that intermediaries may place on issuers

As part of its gatekeeping role, an intermediary may, at its discretion, impose upon issuers such other requirements as the portal considers desirable to protect the interests of investors. An intermediary may develop standard form documents for that purpose.

USA

See the response in Section 5.8.1.

5.9.2 Submissions

Some respondents supported a very limited form of initial due diligence by intermediaries of the business of the issuer, for instance, to ensure that the issuer is incorporated in a manner that permits it to issue the shares in the offer document, and, possibly, that any initial forecasts in the offer document are not unrealistic or unreasonable.

Beyond that, it was argued, any further, or ongoing, due diligence obligations would place an unreasonable cost and resource burden on intermediaries. Also, the ongoing business conducted by an issuer is principally a matter between the issuer and its equity investors. There is little that due diligence by intermediaries could offer in these circumstances as an added level of investor protection.

Another view in submissions was that any due diligence or quality control on the business conducted by issuers, if required, should be done by non-platform sponsors (eg investment bankers, accountants or corporate advisers), with issuers being required to obtain their sign-off before intermediaries could publish their offers on their websites.

Another perspective in submissions was that consideration might be given to a means of tracking the performance of companies hosted on online CSEF platforms and making this information publicly available on the website to assist informed decision-making by investors. This disclosure of an intermediary's issuer portfolio performance may also focus the attention of intermediaries on the quality of the companies they host.

5.9.3 CAMAC position

Conducting due diligence on the business of issuers would provide some protection to investors against placing their funds with wholly unsuitable issuers.

CAMAC considers, however, that the task for intermediaries in conducting due diligence on the business of an issuer, including the issuer's offer, could involve a much more complex and technical exercise than conducting due diligence on issuers and their management (Section 5.8).

If due diligence on the business of an issuer is to be introduced, the Canadian approach provides a useful template model of regulation, thereby ensuring that the same key checks are undertaken in all circumstances. Intermediaries could elect to commission other parties to conduct these business checks. While this delegation would not allow intermediaries to contract out of their due diligence responsibilities, it may provide evidence of the means by which they have sought to fulfil these responsibilities.

CAMAC notes the reservations in some submissions about imposing any form of due diligence obligation for intermediaries concerning the business of the issuer, other than for some basic checks. The New Zealand disclosure-only approach, whereby an intermediary indicates the extent to which, if at all, the intermediary has undertaken checks on the business of the issuer, may be more practicable. This may constitute an appropriate compromise position between mandatory checks and no expectation of any checks.

5.10 Liability for misleading issuer information

Issue: to what extent should intermediaries be held liable for investor losses resulting from materially misleading information, or omissions, from issuers made on their websites?

5.10.1 Submissions

By way of legal analysis, one respondent referred to the decision of the High Court in *Google Inc v ACCC* [1913] HCA 1, which held that where a party has no control over the subject matter published on its website, it cannot be held responsible for any misleading statement therein. However, where an intermediary has greater control over the publication of information provided by an issuer, it could be held responsible for the contents: *Clarke v Nationwide News Pty Ltd* (2012) FCA 307. In consequence, it was argued, under the current law unless amended, CSEF intermediaries would potentially be liable for misleading statements made by issuers (pursuant to s 1041H of the Corporations Act).

Various respondents started from the principle that the intermediary role in CSEF is essentially one of a business introduction service, and thus they should not be automatically liable for investor losses resulting from misleading statements from issuers made on the intermediary's websites. It may be in the commercial interests of intermediaries to monitor and curate issuer statements issued on their websites, as best they can, in order to build and retain investor trust. However, it was argued, it would be too burdensome on intermediaries to be under an obligation to vet all issuer statements, with the prospect of personal liability in the event that a statement turns out to be materially misleading in some manner.

One suggestion was that, to help protect investors as well as intermediaries, issuers should be required to sign a declaration that all information provided by them to the intermediary concerning its offer and its business is true and correct and includes all information material to the offer. This declaration would negate intermediary liability for materially misleading statements by issuers published on the intermediary website, except where the intermediary had actual knowledge of the falsehood.

Another view in submissions was that an intermediary should not be liable for misleading statements by an issuer published on the intermediary's website, provided the intermediary exercised reasonable care/due diligence to verify the accuracy of these statements and had no knowledge or reason to suspect that any issuer statement was materially misleading. An alternative suggested formulation was that the intermediary would not be liable where it could not reasonably have known that a statement made by an issuer was misleading. It was also suggested that to avoid any vetting obligation on intermediaries being too burdensome, and to alert investors, intermediaries should post notices on their websites stating when they have not been able to verify material statements and that investors should make their own enquiries.

A distinction was also drawn in submissions between statements made by an issuer and statements by an intermediary. An intermediary should be liable, according to general law principles, for any misleading statements that it might choose to make concerning an issuer, including, for instance, a misleading embellishment by an intermediary of text provided by an issuer.

5.10.2 CAMAC position

Subject to compliance with the limited due diligence obligations (Sections 5.8 and 5.9), an intermediary should be civilly liable for investor losses for materially misleading information, or omissions, concerning an issuer on its website, only where the intermediary had actual knowledge that the information provided by the issuer was misleading or that the issuer had omitted material information, and thereupon failed to act. This would be in addition to issuer liability for this wrongdoing.

In the view of CAMAC, going further and imposing civil liability on the intermediary for constructive knowledge would place too heavy a burden on the intermediary to conduct checks. The intermediary may become liable even where it was not aware of a material misrepresentation or omission, but, in hindsight, it was judged that it should have been so aware. Likewise, including a 'reckless' test of civil liability, as suggested in some submissions, may, in effect, impose a policing role on the intermediary that could be unduly burdensome in some circumstances.

5.11 Liability where fraud involved

Issue: to what extent should intermediaries be held liable for investor losses resulting from their websites being used to defraud investors?

5.11.1 Submissions

The predominant view in submissions was that, over and above any due diligence obligations and liabilities on intermediaries, they should not be under an additional liability for fraud by another party, unless they can be shown to have been a knowing or reckless party to the fraud. As observed by one respondent:

> An intermediary should be a watchdog and not a bloodhound, i.e. if they come across fraudulent activity they should be obliged to report it but they should not be expected to go out and search for fraudulent activity.

Another view was that intermediaries should make reasonable enquiries of issuers (eg receive regular audited financial statements) before permitting them to use their platform to help ensure they are not engaging in fraudulent conduct.

5.11.2 CAMAC position

Consistent with the approach in Section 5.10 and the thrust of views in submissions, an intermediary should be civilly liable for investor losses where fraud is involved only where the intermediary was a party to the fraud, or otherwise had actual knowledge of the fraud and thereupon failed to act. This would be in addition to issuer liability for this wrongdoing.

5.12 Conflict of interest

Issue: what possible conflict of interest or self-dealing situations may arise between issuers and intermediaries and how might these situations best be dealt with?

5.12.1 Other jurisdictions

USA

Payment from issuers

While intermediaries may receive compensation from the issuer, if fully disclosed, officers of intermediaries, or persons performing similar functions, are prohibited from having any financial interest in any issuer using its services. The SEC also proposes that these persons be prohibited from receiving a financial interest in the issuer as compensation for services provided to, or for the benefit of, the issuer, in connection with the offer and sale of its securities.

To avoid a possible conflict of interest, the SEC would extend these prohibitions on having a financial interest, other than compensation, to the intermediary itself:

> Such a prohibition would be beneficial to investors and issuers because if an intermediary were to have a financial interest in one or more issuers that plan to use its services, the intermediary could have an incentive not based solely on merit to promote that issuer's offering, potentially to the detriment of investors and other issuers.

Canada

Payment from issuers

An intermediary must disclose all compensation, including fees, costs and other expenses, that it may charge to, or impose on, an issuer.

In regard to the forms of payment, the OSC noted that if an intermediary has a financial stake in a particular issuer, it may have an incentive to promote that issuer over other issuers on its portal. However, the OSC also noted that that many start-ups and small and medium enterprises may have limited resources to pay intermediary fees. The OSC therefore proposes that issuers be permitted to pay these fees in securities of the issuer (if agreed by the intermediary), provided this compensation is fully disclosed to investors, and the investment would not result in the intermediary owning or controlling more than 10% of the issuer.

Beyond that, an intermediary may not invest in an issuer or underwrite an issuer on its website.

The March 2014 OSC Paper raised the question whether permitting issuers to pay intermediary fees in securities of the issuer is appropriate:

> The [requirements] would allow [intermediary] fees to be paid in securities of the issuer so long as the [intermediary's] investment in the issuer does not exceed 10%. Is the investment threshold appropriate? In light of the potential conflicts of interest from the portal's ownership of an issuer, should [intermediaries] be prohibited from receiving fees in the form of securities?

Conflicts of interest

Intermediaries must identify and appropriately deal with any conflicts of interest that may arise in the activities of the online portals.

New Zealand

An intermediary will be required to identify and deal with conflicts of interest in a fair, orderly and transparent way.

An intermediary must have adequate systems and procedures for handling conflicts between its commercial interests (or of its associated persons) and the need to have fair, orderly, and transparent systems and procedures for providing the service.

For this purpose, an intermediary must clearly and prominently disclose:

- if the intermediary or anyone commercially associated with the intermediary has a direct or indirect interest in any offer made through the intermediary's facility
- the nature and extent of the interest (or intended investment) and any fees the issuer pays the intermediary above the standard disclosed amount.

More specifically, intermediaries will be permitted to invest in offers made on the intermediary's website, provided they provide details of the likely nature and extent of such investment (if known). If an intermediary, or an associated person, wishes to invest in this manner, the intermediary must explain how its systems and procedures for handling conflicts of interest will ensure other investors are not prejudiced. An intermediary must also ensure that potential conflicts are disclosed clearly and prominently on its online facility.

5.12.2 Submissions

Interest in the issuer

Various respondents supported the principle of a crowdfunding platform being a 'neutral portal' in regard to the issuers which it hosts on its website. To ensure this, some submissions proposed that intermediaries and their officers should be prohibited from holding any legal or beneficial interest in the equity of any issuer using its platform, or have any other commercial interest in the issuer, apart from the right of the intermediary to receive remuneration from the issuer.

One suggested qualification was that any prohibition on an intermediary or its officers holding an equity or any other interest in an issuer should be lifted after some period, say 12 months, from the completion of a CSEF project by the issuer on the intermediary's website.

A contrary view was that there should not be a prohibition on an intermediary or its officers having an equity or commercial interest in an issuer on their website, provided any financial association is fully disclosed in the CSEF offer document. It was also suggested that early stage companies may ask the intermediary if they can pay their up-front fees in shares of the issuer in lieu of cash (given that they may have little available capital and the equity offer to the crowd may not be successful). It was also noted that given the limited secondary market, a pecuniary interest of this nature may well be lost or only gain value many years down the track.

5.12.3 CAMAC position

General approach

The approaches in other jurisdictions differ between a general prohibition, with limited exceptions, and permitting potential conflict of interest situations, provided there is full disclosure.

CAMAC supports the general prohibition with exceptions approach. It questions whether an emphasis on disclosure would ensure against an intermediary having a self-interest which could compromise its role as a neutral facilitator of offers on its website. CAMAC is also concerned that disclosure by an intermediary of, say, some interest in an issuer could be a form of, not so subtle, advertising or soliciting (intended or otherwise) for that issuer. For instance, crowd investors could take the view that if an intermediary has an interest in one, but not another, issuer that it is hosting on its website, it must be for a good reason, and therefore may be influenced to place their funds with the former issuer on that basis. Requiring an intermediary to state its reasons for investing in a particular issuer would take it even further from its 'neutral portal' role.

Prohibition on a financial interest

To avoid any possible conflict of interest, and to ensure that an intermediary is, and is seen to be, a neutral facilitator, there should be a general prohibition on an intermediary or its officers having any financial interest, of whatever form, in an issuer, other than the right of the intermediary to be remunerated for the issuer using its website (with some exceptions, discussed below).

As noted above, to permit an intermediary to have an interest in an issuer and rely only on public disclosure of that fact may unduly influence the crowd in favour of that issuer, regardless of the merits of its offer, on the view that the offer must be worthwhile because the intermediary itself has an interest in it.

It was suggested in submissions that any prohibition on an intermediary or its officers holding an equity interest in an issuer should be lifted after some period, say 12 months, from the completion of a CSEF project by the issuer on the intermediary's website. CAMAC considers that the prohibition should remain only while the issuer is hosted on the intermediary's website. An intermediary could acquire a financial interest in an issuer which it has previously hosted, but this issuer could not conduct any subsequent CSEF offer through that intermediary while the intermediary retained that interest.

Remuneration

The right of an intermediary to be remunerated by an issuer should be subject to a number of restrictions to avoid possible conflicts of interest for the intermediary.

Payment according to funds raised

An intermediary should be prohibited from being remunerated according to the amount of funds raised by an issuer through an offer conducted on the intermediary's online portal. To permit this form of payment may encourage an intermediary to promote the offer to maximise its return, thereby compromising its neutral role between issuers and crowd investors.

Payment in shares

CAMAC has also given consideration to the Canadian proposal, likewise referred to in some submissions, to allow an issuer (with the consent of the intermediary) to pay all or part of its fees to the intermediary by providing its securities to the intermediary, provided that, in consequence, the intermediary does not own or control more than 10% of the issuer.

This raises competing considerations. Permitting this form of payment by the issuer may reduce the financial barriers to early-stage enterprises utilising CSEF. However, as with any other interests of an intermediary in an issuer, the disclosure of this arrangement could be seen as a form of endorsement by the intermediary of that issuer, contrary to the role of the intermediary as a 'neutral portal' between issuers and the crowd.

CAMAC notes that permitting intermediaries to accept any securities in the issuer (even within a cap) also raises the further question of whether this type of transaction should disentitle the intermediary from acting in any subsequent CSEF offers by the issuer while it holds those securities of the issuer.

Here, also, there are competing factors to consider.

On the one hand, an intermediary may be reluctant to agree to accept securities of the issuer as payment in the first place if the consequence is that the issuer must conduct any subsequent CSEF exercise through another intermediary while the original intermediary retains those securities.

On the other hand, an intermediary with any interest in securities of an issuer (whether obtained as payment for an earlier CSEF offer or otherwise) could be seen as having a self-interest in any subsequent CSEF offer by the issuer. This could place the intermediary in a position of conflict of interest, contrary to its neutral role. Also, the disclosure of an intermediary's existing interest in securities might act as a form of endorsement by the intermediary of that issuer.

On balance, CAMAC considers that issues of conflict of interest should be paramount in this situation. In consequence, an intermediary should not be permitted to accept any securities, or other interest, in the issuer in payment of its fees for a CSEF offer conducted through its website.

5.13 Access to crowd investor funds

Issue: what controls should intermediaries exercise on issuers having access to funds provided by crowd investors?

5.13.1 Other jurisdictions

USA

Intermediaries must prevent the issuer having access to CSEF proceeds until a designated funds target for that company is reached and allow all investors to cancel their commitments to invest as determined by SEC Rules.

Intermediaries themselves are prohibited from holding or managing any investor funds or securities. The proposed rules would oblige intermediaries to direct investors to transmit the funds directly to an account with a qualified third party bank, which has agreed in writing to hold the funds and to transmit them to the issuer or the investors, depending on whether the offer was completed or was cancelled. Also:

> the requirement that the [bank] account in which funds are deposited be exclusively for the benefit of investors and the issuer would help prevent the intermediary or other parties from claiming or otherwise unlawfully taking funds from that account.

Canada

Intermediaries must arrange for reputable third parties to handle investor funds in a trust or escrow arrangement until the offer minimum has been achieved.

5.13.2 Submissions

There was a view in submissions that until an offer was successfully completed, investor funds should be held by an appropriate independent third party (such as a bank). It was argued that prohibiting intermediaries from holding or managing any investor funds would permit less stringent licensing arrangements for intermediaries while not compromising investor protection.

Some other respondents considered that it would suffice for the funds to be held in a separate trust account of the intermediary.

In the event of failure to meet the funding threshold, contributed funds should be returned to the investors.

5.13.3 CAMAC position

The principles in s 981B of the Corporations Act, together with any relevant terms or conditions of the intermediary licence, should apply to funds provided by investors (see also Section 5.20).

Where intermediaries are authorised to hold crowd investor funds in a trust arrangement, they should ensure that issuers have no access to these funds until the offer has been completed (see Section 4.12).

C Intermediary matters related to investors

5.14 Screening of crowd investors

Issue: what, if any, screening or vetting should intermediaries conduct on crowd investors?

5.14.1 Other jurisdictions

UK

The UK, unlike other jurisdictions, confines CSEF to sophisticated investors and some categories of retail investors.

Intermediaries must ensure that their retail clients come within one of the eligibility criteria before communicating direct offer promotions to them. However, in regard to some of these criteria, the FCA Policy Statement PS14/4 indicates that repeat appropriateness assessments by intermediaries of retail clients who have not received advice will not be required if it is reasonable to consider that an earlier assessment is still current. Also, where retail clients certify that they will not invest more than 10% of their net investible assets in non-readily realisable securities, intermediaries can communicate such offers to that individual for 12 months after the date of the statement without a new certification from that individual. During that period intermediaries do not need to ensure that individuals continue to qualify on an ongoing basis.

Canada

An intermediary will not be subject to 'client-specific' know-your-client and suitability requirements for investors who are taking up issuer offers that are posted on the intermediary's website.

5.14.2 Submissions

Some respondents proposed that intermediaries check that intending investors have complied with any investor accreditation prerequisite that might be imposed (except where any such requirement is on the basis of self-certification by the investor)**.**

There was some support in submissions for the principle of intermediaries undertaking some screening of crowd investors according to the understanding of those investors of the fundamentals of investing in CSEF offers, and the inherent risks and other implications of such investments. Suggestions included investors having to satisfactorily answer an online questionnaire on the intermediary's website before being permitted to accept a CSEF offer. An alternative approach was for an external entity to offer an educational service for investors, such as an accreditation workshop, with certification being a precondition to retail investors accepting CSEF offers on intermediary websites.

Some other respondents favoured any vetting of investors by intermediaries being confined to identity checks of investors and screening for money laundering, in compliance with money laundering regulations.

However, some submissions considered that intermediaries should have no obligation to vet or screen investors, though their online platforms should state clearly that investors must have legal capacity to own shares. Beyond that, it was argued, investors should be responsible for informing themselves about the merits of making an investment through

CSEF. Any requirement that investors provide an acknowledgement of the risks involved in CSEF should suffice.

5.14.3 CAMAC position

Given that CSEF offers could be accepted by crowd investors wherever located, there should not be any initial investor screening or vetting obligation on intermediaries (such as a 'know your client' or an investor suitability rule).

CAMAC notes the terms of the anti-money laundering and counter-terrorism financing legislation (AML/CTF Act). In the event that the service provided by an intermediary to crowd investors meets the definition of a 'designated service', the intermediary will have various obligations under the AML/CTF Act in relation to its investors, including 'know your customer' obligations and ongoing due diligence and suspicious matter reporting. The AML/CTF Act has a number of exemptions that apply in different contexts, based on the size of the transaction. Similar exemptions could be considered in relation to CSEF, if the Government considers it appropriate.

Whether there should be some form of risk appreciation test to be a crowd investor is discussed in Section 5.15, below.

5.15 Risk disclosure

Issue: what risk disclosures should intermediaries be required to make to crowd investors and should these investors be required to complete a risk appreciation test?

5.15.1 Other jurisdictions

New Zealand

An intermediary must ensure that a warning statement is prominently displayed on the home page of its online site; and on a page on the site, immediately before the investor uses the site to apply for, or otherwise acquire, equity.

The warning statement must be in the following form:

> Equity crowd funding is risky.
>
> Issuers using this facility include new or rapidly growing ventures. Investment in these types of businesses is very speculative and carries high risks. [Omit these sentences if the facility is confined to issuers for whom the sentences would be inapplicable]
>
> You may lose your entire investment, and must be in a position to bear this risk without undue hardship.
>
> New Zealand law normally requires people who offer financial products to give information to investors before they invest. This requires those offering financial products to have disclosed information that is important for investors to make an informed decision.
>
> The usual rules do not apply to offers by issuers using this facility. As a result, you may not be given all the information usually required. You will also have fewer other legal protections for this investment.
>
> Ask questions, read all information given carefully, and seek independent financial advice before committing yourself.

USA

Investment risk disclosure

Intermediaries must provide general disclosures to investors related to the inherent risks involved in CSEF (including the speculative nature of start-up companies and the illiquid nature of their securities) and such other investor education materials as the SEC deems appropriate, and ensure that investors review such disclosures, affirm the risk of loss and answer various questions.

In this context, the SEC has indicated that the intermediary would be required to undertake this exercise each time an investor seeks to make an investment commitment. Also, the questionnaire required under the proposed rules would help address concerns that nothing more is required of an investor than a mere self-certification.

The required educational materials would be set out in the SEC Rules. In regard to their utility, the SEC has observed that:

> the effectiveness of the educational materials to enhance investor protection would vary depending upon the education and experience of retail investors. In addition, a presentation that highlights the risks of securities-based crowdfunding could discourage investor participation.

Italy

The EU MiFID includes obligations on 'permitted managers' concerning matching an investor's profile to investment risk. However, there will be an exemption from MiFID for small investments (investments not exceeding €500 from each investor, and €1,000 total per year in CSEF for each investor) provided the investors, when contributing through a crowdfunding platform, take a test to demonstrate that they are aware of the risks they are taking when investing, and that they can afford the possible loss of the amount invested.

UK

The FCA noted in PS14/4 that investors face significant inherent risks when buying non-readily realisable securities. These include:

- the risk of capital loss (which is exacerbated if the price paid for a security is based on an over-valuation of the business)
- the risk of dilution of shareholder value
- the risk that dividends will not be declared, and
- illiquidity risk (the lack of a secondary market).

The FCA indicated that intermediaries are obliged to provide fair, clear and prominent risk warnings. However, boiler-plate standard warnings may not suffice:

> As the risks involved when investing in different non-readily realisable securities vary greatly, depending on the nature of the investment offered, it may not always be meaningful or helpful to present consumers with a single, uniform FCA-approved risk warning. Different warnings will be needed in differing circumstances, for different investments and audiences.

Canada

Risk warnings to investors must be set out at the top of the issuer offer.

In addition, an intermediary must prominently state on its online portal that:

- no securities regulatory authority or regulator has approved or expressed an opinion about the securities offered on the portal
- 'A crowdfunding investment is highly risky. You may lose all your investment and you may not be able to sell any securities you purchase'.

Also, an intermediary must take reasonable steps to ensure that investors understand the risks of a crowdfunding investment. In that respect:

> [an intermediary] should not rely solely on the risk acknowledgement form signed by an investor.

Without being prescriptive, the OSC has indicated that for the purpose of ensuring that investors understand the risks of a crowdfunding investment, an intermediary might require investors to:

- correctly answer questions in an interactive questionnaire conducted at the time of the account opening that demonstrates that the investor understands the level of risk generally applicable to investments in start-ups, emerging businesses, and small issuers and the risk of illiquidity, and
- correctly answer questions in an interactive questionnaire conducted annually thereafter.

5.15.2 Submissions

There was strong support in submissions for intermediaries being required to provide investors with a generic risk statement covering the inherent risks of investing though CSEF, with that risk statement being prominently situated on the online platform, together with an accompanying indication that the generic risk statement does not constitute the giving of financial advice in any way. Investors should be obliged to acknowledge that they have read or are aware of the generic risk statement before being permitted to accept any CSEF offer on the intermediary website.

Respondents made a range of suggestions as to the content of a generic risk statement.

For instance, one suggestion was that this statement should indicate that CSEF projects are typically speculative ventures, with no guarantee of profit and a high risk of loss of capital and that the product/idea being promoted may not ever come to fruition.

Another suggestion was that the generic risk statement be in the form of short warnings (as they may be more likely to be read by investors), which would then direct investors to more detailed information setting out the risks linked to such matters as:

- feasibility/technology risk associated with a start-up idea
- market risk
- intellectual property risk
- the risk of competing products
- the risk of dilution of initial shareholding by later fundraisings
- the illiquid nature of investments in start-ups

- the potential impact of preferential shareholder rights on returns to crowd shareholders; and
- the usual lack of dividends in the early stages.

A number of respondents also suggested that the risk disclosure statement should recommend to prospective investors that they obtain legal and financial advice before investing in CSEF offers or making any serious financial decisions in that regard.

5.15.3 CAMAC position

Risk disclosure statement

In the interests of all involved parties, issuers and intermediaries as well as investors, there should be a clear formal enunciation of the inherent risks for crowd investors in placing their funds through the CSEF process. No regulatory structure for this form of corporate fundraising can overcome these risks, and investors should not be misled into thinking that issuers or intermediaries are promising or guaranteeing any form of financial return for their investment, or return of the capital invested.

Given the importance of risk disclosure, CAMAC proposes that there be a risk disclosure template, containing clear and direct warnings to crowd investors about the risks associated with CSEF investments.

In regard to the contents of the template, CAMAC notes the useful ideas and text in the New Zealand, the UK and the Canadian approaches, as well as in the submissions.

The template could point out, for instance, that:

- most start-ups fail
- even if a project is successful, any return on the investment could be reduced through share dilution or occur only after a long period during which there may be little or no means to sell the shares
- even though investors may have remedies for issuer misconduct, the chances of actual monetary recovery from the issuer or involved individuals may be low.

These, and other, matters could be distilled into one standard document, to be provided by all intermediaries to crowd investors.

Any draft risk disclosure statement should be consumer tested before it is adopted, to ensure that crowd investors can readily understand and absorb the content of the disclosure.

An intermediary should be required to provide the risk disclosure statement to a crowd investor, and receive acknowledgement by that investor of having read and understood the statement, before that investor makes each CSEF investment (see further Section 6.5 in regard to investor acknowledgement). The process of providing the statement could be automated (for instance, a software generated standard email and attachment response to an inquiry from a crowd investor), thereby avoiding any material regulatory burden on the intermediary.

Imposing this requirement before each investment, not just before the first CSEF investment by that investor through an intermediary's website, would continue to draw to the attention of the investor the risks associated with CSEF, with the automated process (referred to above) minimising any cost.

Risk appreciation test

CAMAC has also given consideration to whether, in addition to the risk disclosure statement and the risk acknowledgement by the crowd investor, there should be some form of risk appreciation test for a crowd investor before being permitted to accept CSEF offers.

This raises competing considerations.

On the one hand, CAMAC notes that risk appreciation initiatives have been undertaken with complex derivatives and other financial products (see ASIC Regulatory Guide 227, which provides industry direction). While the financial risks associated with investing in derivatives differ from the financial risks in investing through CSEF, introduction of a risk appreciation assessment for crowd investors may go some way toward improving their understanding that CSEF is not a direct substitute for more traditional, liquid and lower risk equity investments offered to the public.

On the other hand, it may be unduly burdensome to oblige intermediaries to conduct such tests before a crowd investor is permitted to enter into a CSEF transaction for the first time through that intermediary, given the number of crowd investors that may be involved.

CAMAC has elsewhere proposed that crowd investors must acknowledge each of the risks set out in the risk disclosure statement (Section 6.5). This is designed to encourage crowd investors to turn their minds to each of these risks, thereby acting as a form of risk appreciation, albeit without any ‘test’ element. On balance, CAMAC considers that this may suffice.

5.16 Compliance with investor caps

Issue: what measures should intermediaries be required to take to ensure that any crowd investor caps are not breached?

The various types of investor caps are further discussed in Section 6.4. The question here concerns the role of the intermediary in monitoring compliance with investor caps.

5.16.1 Other jurisdictions

As indicated in Section 6.4, the USA and Canada have proposed investor caps for CSEF transactions, while New Zealand has no mandatory investor cap. The UK has a different form of investor cap. The jurisdictions take various approaches in regard to the role of the intermediary in policing these caps.

USA

Intermediaries must make such efforts as the SEC determines appropriate to ensure that no investor in a 12 month period exceeds the investor caps.

UK

PS14/4 indicates that repeat appropriateness assessments of retail clients who have not received advice will not be required if it is reasonable to consider that an earlier assessment is still current.

Also, where retail clients certify that they will not invest more than 10% of their net investible assets in non-readily realisable securities, intermediaries can communicate such offers to that individual for 12 months after the date of the statement without a new certification from that individual. During that period intermediaries do not need to ensure that individuals continue to qualify on an ongoing basis.

Canada

Intermediaries must obtain a written certification from investors that they are complying with the annual investment limit. Also, further, cumulative investments made by the same investor on the intermediary's platform must be monitored by the intermediary to ensure that the annual investment limit is not exceeded.

New Zealand

There are no investment limits on investors, except if imposed by the issuer.

5.16.2 Submissions

The predominant view of respondents was that investors themselves should be responsible for complying with any investment limits, which are for their benefit. At most, investors should be required to self-certify to the intermediary, when acquiring equity offered on the intermediary's online platform, that they are complying with any applicable investment limits. To impose an independent obligation on intermediaries to verify compliance would be onerous.

A contrary view was that intermediaries could monitor compliance by investors with any investment limits through the creation of a central registry (of amounts invested to date by individual investors). Intermediaries could consult this registry before processing investor applications. Alternatively, intermediaries providing the crowdfunding platform could design software that prevents further subscription after the investor ceiling is reached.

5.16.3 CAMAC position

In any consideration of what, if any, monitoring role intermediaries reasonably should be expected to play, it is necessary to distinguish between two types of investor cap for crowd investors (as proposed in Section 6.4):

- ***investor cap on all issuers:*** a cap on the total amount that a crowd investor can invest in all CSEF offers in any 12 month period
- ***investor cap per issuer:*** a cap on the total amount that a crowd investor can invest in a particular issuer in any 12 month period.

Investor cap on all issuers

During any 12 month period, a crowd investor could accept a series of CSEF offers, from different issuers using different intermediary websites. Therefore, short of some central registry of equity interests of all crowd investors, it may be impossible for anyone, apart from the investor, to know how much the investor has invested collectively in CSEF offers in a particular period.

CAMAC does not support the idea of a central registry for various reasons, including privacy concerns about access to the complete CSEF trading history of crowd investors.

In the absence of a central registry, CAMAC supports only a self-certification requirement for crowd investors in regard to compliance with the *investor cap on all issuers*. That certification should be provided by the investor to the relevant intermediary each time the investor seeks to accept a CSEF offer. That certification will draw the attention of crowd investors to this cap, intended to protect them from over-exposure to this type of investment.

Investor cap per issuer

An intermediary has a capacity to monitor the *investor cap per issuer* in one of two situations.

Each offer: Given that an intermediary would have to keep a record of all acceptances by crowd investors concerning a particular offer (which as recommended by CAMAC can only take place through one intermediary), the intermediary could easily impose an automatic 'transaction-stop' if the cap on an investment in one issuer would otherwise be breached by a crowd investor. This monitoring task for intermediaries, which would not be administratively burdensome, could be made a condition of their licence.

Offers on various websites: The situation that cannot be monitored by an intermediary is where an issuer makes a number of offers within a 12 month period (within its cap), using, say, a different intermediary for each of these offers, and the investor takes up offers in that issuer on more than one website. Each intermediary would be unaware of the investments by an investor in the issuer through another website, and could not be expected to seek out that information.

In all situations concerning the *investor cap per issuer,* in addition to the intermediary having a limited monitoring role (as described above), crowd investors should be obliged to self-certify in regard to this cap before each CSEF transaction. This certification should be provided by the investor to the intermediary each time the investor seeks to accept a CSEF offer. This would help draw the attention of crowd investors to the *investor cap per issuer,* which is designed, in the interests of investor protection, to limit their exposure to a particular issuer.

Identifying a crowd investor

Investors, for various reasons, may operate through a series of legal entities, including family or other trusts or companies, rather than, or in addition to, transacting in their own name.

For the purpose of its limited monitoring role of *the investor cap per issuer,* an intermediary should be entitled to treat each entity, including a trust, as a separate investor, unless otherwise directed. The intermediary should not be obliged to treat a number of parties as one investor simply because they had, say, beneficial entitlements in each other, unless those parties so directed the intermediary. If an investor creates multiple legal entities, which, in combination, exceed either or both of the investor caps, that investor has intentionally denied itself the investor protections that these caps provide.

5.17 Investment advice

Issue: what controls should be placed on intermediaries offering investment advice to crowd investors?

5.17.1 Other jurisdictions

USA

Intermediaries are prohibited from offering investment advice or making recommendations to investors. The concept of investment advice could, for instance, include any promotion of a particular offer, such as a funding portal pointing out that the offer is attracting a number of investors.

To avoid limiting the utility of funding portals, the SEC is considering introducing a conditional safe harbour that would permit funding portals to engage in a range of activities without breaching this prohibition:

> We anticipate that some funding portals may wish to limit, to some extent, the scope of their businesses by, for example, specializing in offerings by issuers in certain industries or geographic locations. In some circumstances, these limitations could be viewed as providing investment advice. To accommodate reasonable limitations, the proposed safe harbor would permit a funding portal to apply objective criteria to limit the offerings on its platform, without being deemed to be providing investment advice. Those criteria would be required to be reasonably designed to result in a broad selection of issuers offering securities through the funding portal's platform and be applied consistently to all potential issuers and offerings, so as not to recommend or implicitly endorse one issuer or offering over others. The criteria also would be required to be clearly displayed on the funding portal's platform.

In the view of the SEC, this approach should help investors better appreciate any niche focus of a particular funding portal and the scope of the offers available on that funding portal's platform.

Canada

General prohibition

An intermediary is prohibited from providing recommendations or advice to investors about specific securities. It cannot recommend or endorse a particular issuer or offer on its website.

For instance, commenting to investors on the merits of, or expected returns from, an issuer offer on its website would constitute a recommendation or advice. Also, highlighting, showcasing or spotlighting a particular issuer on its website could be considered as a form of express or implied recommendation, endorsement or advice to investors.

Exemptions

An intermediary may perform various actions which otherwise might be seen as coming within the general prohibition on providing advice to investors, provided that those actions would not be viewed by a reasonable person as an assessment of the quality or commercial viability of a crowdfunding offer, namely to:

- present or display information about an issuer or a crowdfunding offer on its website, if the information is presented or displayed in a fair, balanced and reasonable manner

- use objective criteria to limit the CSEF offers on its platform, provided the criteria are disclosed on the website, are applied consistently, and would not be viewed by a reasonable person as a recommendation or endorsement
- prohibit crowdfunding offers on its website based on a good faith determination that an issuer is not complying with securities law
- assist an issuer in the preparation of an offer document, business plan or other permissible document, provided that the service is limited to assisting the issuer to comply with its disclosure obligations and to ensure the information is presented in a fair, balanced and reasonable manner
- provide general information and educational materials to potential purchasers about crowdfunding offers, provided that the information and materials are presented in a fair, balanced and reasonable manner
- provide on its website search functions or other tools for potential purchasers to search, sort or categorise crowdfunding offers available on the funding portal's website according to objective criteria, and
- provide communication channels or discussion boards to enable potential purchasers pursuant to a crowdfunding offers, to communicate with one another and with representatives of the issuer about a crowdfunding offer displayed on the intermediary's website provided that communication by a person can be traced back to its author.

5.17.2 Submissions

The overwhelming view in submissions was that intermediaries should not be permitted to give investment advice, including to recommend or to endorse particular investment opportunities, though some respondents suggested an exemption for intermediaries that are licensed as investment advisers (in which case they could provide advice pursuant to the terms of the licence).

There was some support for the broad approach adopted in the USA of what might amount to giving investment advice, including a statement by an intermediary that a particular offer is attracting investors.

It was suggested that the prohibition on giving advice be prominently displayed by intermediaries to ensure investors are aware that no such advice can be given and that they should seek independent advice.

It was suggested in submissions that what constitutes the giving of investment advice by intermediaries, or soliciting transactions on their websites could include such things as tabs on their website such as 'Staff picks', 'What's hot', or proactive suggestions, such as 'You might like this…', or 'Your friend liked this; check it out'.

There was some support for safe harbour provisions (along the lines of the US SEC proposals) to enable intermediaries to apply criteria to limit offers on their websites (for instance, to specific industries), without this being deemed to be offering investment advice or soliciting transactions.

5.17.3 CAMAC position

To better ensure that intermediaries act as neutral facilitators between issuers and crowd investors, there should be a general prohibition on an intermediary offering investment advice, directly or indirectly, to these investors in regard to any CSEF offer on its website. Respondents also pointed to examples of the type of advice by intermediaries, through tabs on their websites, that should be prohibited.

CAMAC considers that the ban should apply even where an intermediary is licensed to offer investment advice, given that the provision of any advice would clearly undermine the neutral role of the intermediary between issuers and investors. Such a ban would not be oppressive. If approached by a crowd investor for advice concerning an offer by any issuer on the intermediary's website, the intermediary could refer that person to another, unrelated, investment adviser.

However, to prevent this ban from being over-restrictive by applying to situations where, in effect, investment advice is not being offered, the exemptions proposed in the USA and Canada, including the right of intermediaries to limit the offers on their websites to certain commercial sectors, appear sensible.

5.18 Soliciting share acquisitions

Issue: should controls be placed on intermediaries soliciting crowd investors to accept CSEF offers on their websites?

5.18.1 Other jurisdictions

USA

Soliciting transactions

Intermediaries are prohibited from soliciting transactions for securities offered or displayed on their portals, or compensating employees or agents for doing so.

Identifying information

Intermediaries are prohibited from compensating promoters, finders or lead generators for providing the intermediary with personal identifying information concerning any potential investor.

The SEC noted that this prohibition would help to remove the incentive for high-pressure sales tactics and other abusive practices. The SEC noted, however, that intermediaries may have a legitimate need for referrals to the intermediary's platform. Accordingly:

> It would be acceptable under the proposed rules, therefore, for an intermediary to make payments to advertise its existence, provided that in doing so, it does not pay for the personally identifiable information of investors or potential investors.

Canada

An intermediary will not be able to advertise the offer or solicit transactions of securities offered on its platform, other than through posting an offer (and other permitted documents) on its platform. This prohibition includes an intermediary compensating its employees or agents to solicit the sale of securities on the online platform.

However, an intermediary may advertise its existence, the fact that crowdfunding offers can be made through its online portal, and the fact that information about such offers is posted on its website.

5.18.2 Submissions

There was support in submissions for a prohibition on solicitation by intermediaries. It was argued that the role of intermediaries should be confined to facilitating the introduction of eligible investors to issuers by hosting the issuers on their online platform, and publishing the information that is provided by the issuer (pursuant to relevant CSEF provisions). Solicitation in this context could take the form of an intermediary using its own, not the issuer's, words to market an offer.

Some respondents were concerned that any such ban on solicitation should not inhibit the right of investors to receive relevant information. For instance, it was argued that intermediaries should have the right to outline on their website home pages the name and type of projects (project 'badges'), the funding targets and timeframes of each of these projects, and the amount raised to date on each project, without this being taken as solicitation.

Another view was that there should be no restriction on intermediaries soliciting transactions on their websites. The purpose of such intermediary online sites is to create an effective market place by which investors can find issuers and vice versa. Market forces should be allowed to create the 'winners' of the best such providers. One qualification expressed was that intermediaries should not be permitted to solicit transactions on the basis of projected or forecast returns to investors.

Another view was that any prohibition on intermediaries soliciting transactions should not prohibit them from advertising their services as a CSEF platform and showcasing investment opportunities for the purpose of demonstrating what they do.

5.18.3 CAMAC position

There should be a general prohibition on direct or indirect solicitation (as that term is usefully described in the Canadian and US approaches) by intermediaries, with the exemptions provided for in those jurisdictions to cover the provision of certain information to investors and with the exemptions proposed in some submissions, namely that:

> intermediaries should have the right to outline on their website home pages the name and type of projects (project 'badges'), the funding targets and timeframes of each of these projects, and the amount raised to date on each project, without this being taken as solicitation.

Information on funds raised to date, while having the potential to create a 'herding' effect amongst crowd investors, can also be vital to an informed investment decision, and should be permitted.

However, 'showcasing' one or more particular offers by issuers, for the purpose of an intermediary demonstrating what it does in practice, should be seen as solicitation or the offering of investment advice concerning those particular offers.

5.19 Lending to crowd investors

Issue: should there be a prohibition on intermediaries lending to crowd investors?

5.19.1 Other jurisdictions

Canada

Intermediaries will be prohibited from lending money, extending credit or providing margin to any investor or recommend that an investor use borrowed money to finance any purchase of a security.

Under this approach, intermediaries (as well as issuers: see Section 4.10) and their respective directors and executive officers, must not lend or finance, or arrange lending or financing (for instance, from an affiliate), for an investor to purchase securities of the issuer through CSEF.

This approach was seen as helping to address concerns associated with retail investors using leverage to invest through crowdfunding. Also, to permit intermediaries to fund investors in crowd-based fundraising 'would create a conflict of interest which cannot be properly managed'.

5.19.2 CAMAC position

An intermediary should be prohibited from lending money (directly or indirectly, including by extending credit) to any crowd investor to acquire shares offered on its website. To permit intermediaries to fund crowd investors in this manner would create a clear conflict of interest, and a potential indirect endorsement of the offer.

Similarly, to avoid a conflict of interest, an intermediary should be prohibited from recommending to any crowd investor that he or she borrow money from any other source to finance any CSEF offer on its website.

CAMAC considers that this approach addresses some (but not all) concerns associated with retail investors using leverage to make high-risk investments through crowdfunding.

5.20 Holding crowd investor funds

Issue: what controls should there be on intermediaries holding or managing crowd investor funds?

5.20.1 Other jurisdictions

USA

Intermediaries are prohibited from holding or managing any investor funds or securities, which must be held by a qualified third party bank.

UK

To avoid complex compliance requirements for intermediaries that would otherwise be applicable, the practice has been that intermediaries do not hold investor funds. Rather, funds are not provided from investors until a stipulated target amount has been reached, whereupon they are transferred directly from the investors to the issuer.

Canada

Intermediaries will not be able to hold, handle, or have access to, investor funds or assets of investors. Indicia of holding or having access to an investor's funds or assets include:

- holding an investor's securities, certificates or cash for any period of time
- having authority (e.g., a power of attorney) to withdraw funds or securities from an investor's account
- accepting funds from an investor directly (e.g., a cheque made payable to the intermediary) or accepting funds on the investor's behalf from a custodian
- acting in the capacity of a trustee for an investor
- having, in any capacity, legal ownership of, or access to, the investor's funds or securities.

Rather, intermediaries must arrange for reputable third parties to handle investor funds. These funds would have to be held externally in a trust or escrow arrangement until the offer minimum has been achieved.

However, to a limited extent, intermediaries may be able to provide directions as to when and to whom client funds may be released. In this context, the intermediary must take reasonable steps to confirm that the minimum offer threshold is achieved before investor funds are transferred to the issuer.

New Zealand

If intermediaries receive, hold, pay or transfer funds from investors to pay for investments, they must comply with the broker obligations in the Financial Advisers Act, meaning that the funds must be held in trust.

An intermediary must also disclose how investor money is received and dealt with.

5.20.2 Submissions

A number of respondents favoured investor funds being held in a segregated trust account for each offer, until such time as the issuer is entitled to have those funds released to it.

One view was that the trust account be established and controlled by a reliable independent third party (such as a trustee company). Another view was that an intermediary itself should be permitted to manage investor funds in this manner, provided it holds an Australian Financial Services Licence authorising it to do so.

5.20.3 CAMAC position

It is important that investors' money not be intermingled with that of an intermediary.

Consistent with the CAMAC approach in Section 5.13.3, there should be a prohibition on intermediaries holding or managing crowd investor funds (using, for instance, the Canadian indicia of what that involves) except where the intermediary is authorised to do so under the terms of its licence (which, at a minimum, should require that funds be held in a separate segregated trust account).

In consequence, the principles in s 981B of the Corporations Act, together with any relevant terms or conditions of the intermediary licence, should apply to the handling of funds provided by crowd investors.

5.21 Communication facilities

Issue: what facilities should intermediaries be required to provide to allow crowd investors to communicate with issuers and with each other?

5.21.1 Other jurisdictions

USA

The proposed rules would require an intermediary to provide channels on its online platform through which investors can communicate with one another and with representatives of the issuer about offers made available on that platform.

As observed by the SEC:

> A premise of crowdfunding is that investors would rely, at least in part, on the collective wisdom of the crowd to make better informed investment decisions

and that:

> individuals decide whether or not to invest after sharing information about the idea or business with, and learning from, other members of the crowd.

The communication channels proposed by the SEC are intended to provide a centralised and transparent means for members of the public that have opened an account with an intermediary to share their views about investment opportunities and to communicate with representatives of the issuer to better assess the issuer and investment opportunity.

Also, though communications between investors could occur outside the intermediary's platform, communications by an investor with a crowdfunding issuer or its representatives about the terms of the offer would be required to occur through this single intermediary online platform through which the offer is conducted. This requirement is designed to provide transparency and accountability, and thereby further the protection of investors.

The proposed rules would also require the intermediary to make the communications on the online channels publicly available for viewing, though only persons who had opened an account with the intermediary could post comments on the online platform.

The SEC also proposes disclosure rules to deal with possible conflicts of interest that could arise in the use of these online communication channels, including the use of hidden promotional material. For instance:

> under the proposed rules, the intermediary must require that any person posting a comment in the communication channels [of the intermediary's online platform] clearly disclose with each posting whether he or she is a founder or an employee of an issuer engaging in promotional activities on behalf of the issuer, or is otherwise compensated, whether in the past or prospectively, to promote the issuer's offering.

Canada

Intermediaries may (but are not obliged) to provide online communication between issuers and investors. If an intermediary chooses to offer a discussion board or other means of communication between investors and/or an issuer and its investors (for example, via chat rooms or a blog), it must ensure that all comments made within such forum can be traced back to their authors.

The intermediary must also monitor postings to confirm that the issuer is not making statements or providing information that are inconsistent with the crowdfunding offer document and may remove any material that it deems inappropriate or raises investor protection concerns.

5.21.2 Submissions

There was support in submissions for the principle of investors being able to discuss projects among themselves and with issuers. It was argued that facilitating these communications has the potential to improve CSEF investment decision making and also act as a means to detect or expose apparent fraud in some instances.

It was suggested that information and opinion sharing could be done, for instance, through online discussion forums set up by the intermediary, with comments and discussion by investors, and questions posed to the issuer and answers provided, accessible to other investors.

There were differences of view among respondents on whether an online communication facility for each CSEF offer should be mandatory, or be left to the discretion of the intermediary or each issuer. There were also differences of view as to whether, or in what circumstances, intermediaries or issuers should have the power to exclude or remove posted material (for instance, on the basis of its being defamatory).

5.21.3 CAMAC position

CAMAC notes the strong support in submissions for the concept of online investor-to-investor and investor-to-issuer communications. However, there were differences of view on whether an intermediary should be obliged to provide this communication facility on its online portal.

CAMAC considers that to ensure a consistent approach for intermediaries, and in the interests of encouraging the exchange of information and views between interested parties, intermediaries should be obliged to provide this facility on their websites (or through a link to another online site) in regard to each issuer it is hosting during such time as the issuer is utilising its website. This requirement would not be technologically difficult for intermediaries or be expensive.

CAMAC is also of the view that only those persons who have an account with the intermediary should be entitled to participate on the website as investors. Account holders could comment online in regard to any offers on the intermediary's website. Without controls of this nature, competitors and other parties who have not registered with the intermediary could seek to influence the crowd perception of an issuer through false postings. A requirement of prior account registration with the intermediary may act as some (albeit incomplete) deterrence in this regard. In the same manner, there should be controls, as proposed in the US, on hidden promotional material.

The intermediary should have power to remove material from its website in limited circumstances (for instance, where material is false, materially misleading or defamatory). Some analogy could here be drawn with the relevant law concerning directors of a company excluding various statements circulated in resolutions on the grounds of defamation.

These recommendations concern postings on the online portal of the intermediary. They do not seek to regulate postings on websites, or through other forms of social media, not controlled by the intermediary.

5.22 Dispute resolution and indemnity insurance disclosure

Issue: what disclosure should be made to crowd investors about being able to make complaints against the intermediary, and the intermediary's liability insurance?

5.22.1 Other jurisdictions

New Zealand

Intermediaries will be required to provide a service disclosure statement to retail investors and enter into written client agreements with them, dealing adequately with various matters, including how investors can make complaints. In this context, intermediaries are expected to have a complaints process, including belonging to a dispute resolution scheme, this being one of the requirements of registering to become a financial service provider to retail clients.

Also, an intermediary must maintain an appropriate level of professional liability indemnity insurance cover for its business.

5.22.2 Submissions

Complaints

A view was expressed that intermediaries should be required to outline a clear, prominent and up-to-date procedure for referring any investor complaints against them to an external dispute resolution service. The obligation of intermediaries in this regard could be imposed as one of the conditions of an Australian Financial Service Licence (assuming that intermediaries were required to hold an AFSL).

It was also suggested that information about the rights of investors to make complaints against intermediaries should be disclosed in the intermediary's financial services guide and should be placed in an obvious location on the intermediary's website, such as on a separate webpage on their online platform clearly titled 'Complaints'.

Liability insurance

One proposal in submissions was that, to protect investors, an intermediary should have liability insurance to cover claims, in total, of up to $2 million annually, assuming that financial caps on CSEF investments would limit investor losses, and therefore any consequential claims that could lawfully be made against the conduct of intermediaries.

Another view was that insurance requirements for intermediaries should be substantially reduced if intermediaries are prohibited by regulation from offering investment advice or soliciting transactions.

5.22.3 CAMAC position

Complaints

CAMAC elsewhere proposes that to promote confidence, there should be a process by which crowd investors and issuers can make complaints through internal and external dispute resolution procedures concerning any aspect of the conduct of the intermediary, as it affects them, or their dealings with the intermediary (Section 5.6).

CAMAC agrees with the view in submissions that information about the rights of investors to make complaints against intermediaries should be disclosed in the intermediary's financial services guide and should be placed in an obvious location on the intermediary's website, such as on a separate webpage on their online platform clearly titled 'Complaints'.

In the event that an intermediary is not placed under an obligation to have an internal or external dispute resolution procedure, each intermediary should be obliged to disclose on its website whether it has any such procedure and, if so, the details.

Liability insurance

CAMAC notes that holders of AFSLs must have compensation arrangements where retail clients are involved (s 912B(2)(a), Corp Reg 7.6.02AAA). It considers that the same obligation should apply to a licensed intermediary in the context of CSEF, and be available to issuers as well as crowd investors, depending upon the nature of the breach by intermediaries.

As with the approach to complaints, information about indemnity insurance should be prominently disclosed on the intermediary's website, as well as being disclosed in the financial services guide given to investors by intermediaries.

In the event that an intermediary is not placed under an obligation to have indemnity insurance, each intermediary should be obliged to disclose on its website whether it has any such insurance and, if so, the details.

5.23 Fees charged by intermediaries

Issue: what disclosure should be made about the fees that intermediaries may receive?

5.23.1 Other jurisdictions

Canada

An intermediary must disclose all compensation, including fees, costs and other expenses, that it may charge to, or impose on, an investor.

New Zealand

An intermediary must clearly and prominently disclose all fees paid by issuers in connection with the offer, whether direct or indirect and however described.

5.23.2 Submissions

There was support in submissions for the full disclosure by intermediaries, to issuers and investors, of all commissions and any other fees that intermediaries are to receive and how those fees are derived. This would include details of any part of an intermediary's remuneration that is linked to the amount of funds raised by the issuer. It was argued that the more transparent the disclosure, the more effective the crowd will be at sourcing the best investments and selecting the most appropriate intermediary.

A qualified view was to encourage this disclosure, but mandate it only to the extent that such information is material for an investor and is not misleading or deceptive in its own right.

There was a general view that, in the interests of transparency, intermediaries should prominently disclose this information on their website.

5.23.3 CAMAC position

This Section deals with the disclosure of fees charged by intermediaries. CAMAC has elsewhere proposed some controls on fees paid by issuers (Section 4.13).

In principle, each intermediary should have a transparent fee structure and accordingly all remuneration arrangements between an issuer and an intermediary, of whatever nature, should be fully disclosed to the crowd.

Consistently with this principle, CAMAC considers that the approach taken in New Zealand is appropriate.

To achieve this, as one of the conditions of its licence, an intermediary should be obliged to disclose this information on its website.

5.24 Cancelled offers

Issue: what should be the consequences of a cancelled offer?

5.24.1 Other jurisdictions

Canada

Intermediaries will be required to notify committed investors within five business days if the offer is cancelled and must take appropriate steps so that investor money is returned.

5.24.2 CAMAC position

Intermediaries should be required to notify committed investors within five business days of cancellation of the offer and take appropriate steps to ensure that the funds provided by investors for the shares are returned to them.

5.25 Privacy

Issue: how should the privacy of information about crowd investors be protected?

5.25.1 Other jurisdictions

USA

Intermediaries must also take such steps as are required by SEC Rules to protect the privacy of information collected from investors. That information may include details of the income and net worth of the investor, given the US approach to the maximum funds that each investor can contribute (see Section 6.4.2).

The SEC has commented that:

requiring a funding portal to comply with privacy obligations would help protect the personally identifiable information of investors and potential investors, consistent with how it is protected by other financial intermediaries.

5.25.2 CAMAC position

CAMAC considers that the Australian Privacy Principles should address this issue (if not applicable already), with the US approach providing some guidance in the CSEF context.

6 The crowdfunding process: investors

This chapter sets out proposals concerning crowd investors.

6.1 Overview

It is proposed that:

- any person of legal capacity can be a crowd investor (Section 6.2)
- there be no sophisticated investor threshold (Section 6.3)
- there be investment caps for crowd investors (Section 6.4)
- crowd investors must acknowledge the risk disclosure statement before investing (Section 6.5)
- crowd investors have cooling-off rights (Section 6.6)
- crowd investors have other withdrawal rights (Section 6.7)
- share resale restrictions apply only to persons associated with the issuer (Section 6.8)
- issuers have ongoing reporting obligations to crowd investors (Section 6.9)
- crowd investors have remedies in certain situations (Sections 6.10).

These proposals seek to protect crowd investors in various ways, while drawing to their attention the inherent risks that remain with this form of investment.

6.2 Eligible crowd investors

Issue: should there be any limitations on who may be a crowd investor?

6.2.1 Other jurisdictions

New Zealand, USA and Canada

No limitations are proposed on who may invest through CSEF.

UK

Unlike other jurisdictions, the classes of investors to which direct offers of non-readily realisable securities can be made are limited to sophisticated investors and some classes of retail investors.

The October 2013 Financial Conduct Authority Consultation Paper proposed that licensed intermediaries, in addition to being able to communicate offers in non-readily realisable securities to sophisticated investors, be permitted to make these offers to the following classes of retail client:

- retail clients who are certified or self-certify as sophisticated investors

- retail clients who are certified as high net worth investors
- retail clients who are venture capital contacts or corporate finance contacts
- retail clients who confirm before a promotion is made that, in relation to the investment promoted, they will receive regulated investment advice or investment management services from an authorised person, or
- retail clients who certify that they will not invest more than 10% of their net investible portfolio (i.e. excluding their primary residence, pensions and life cover) in non-readily realisable securities.

The Consultation Paper proposed that where regulated investment advice is not provided, intermediaries should apply an appropriateness test before sending retail clients direct offer financial promotions for non-readily realisable securities. This would help ensure that only clients who have the knowledge or experience to understand the risks would invest.

The Consultation Paper also commented that:

> Given our consumer protection objective, our aim is to ensure that only those retail investors who can understand and bear the various risks involved are invited to invest in [non-readily realisable securities]. If [intermediaries] target this wider but still restricted audience of retail investors appropriately, this may result in greater access to alternative (non-bank) finance options for businesses seeking finance.

The March 2014 FCA Policy Statement PS14/4 confirmed the approach taken in the Consultation Paper (described above) in regard to the classes of retail investors (in addition to sophisticated investors) to whom offers of non-readily realisable securities could be made through a licensed intermediary. The relevant rules operate from April 2014.

According to an FCA media release accompanying PS14/4:

> The new rules for securities-based crowdfunding keep the crowd in crowdfunding by allowing anyone to invest up to 10 per cent of their available assets.

PS14/4 noted that its approach to permit CSEF offers to be made to various classes of retail investors, under certain conditions:

> [is] aimed to provide ordinary retail investors, who may lack the knowledge, experience and resources to understand and cope with the risks, with both the freedom to invest and proportionate protection when they are invited to invest in non-readily realisable securities that involve potential for significant capital losses.

6.2.2 Submissions

The overwhelming view in submissions was that CSEF should be open to all investors (subject to the current restrictions on who may legally hold shares in a company eg the standard rules of capacity). One observation was that there was a need to broaden the funding base for small or innovative Australian businesses. Likewise, any limitation would unduly restrict the ability of social enterprises to raise funds in their community.

A few respondents suggested that any CSEF investor should have to be ‘accredited’, for instance, by undertaking a free online risk-understanding workshop, or passing an online test to demonstrate a basic understanding of investing in securities. It was not made clear who would operate such online facilities.

6.2.3 CAMAC position

Consistently with the general overseas approaches and the views in submissions, there should be no limitations on a person with legal capacity being a crowd investor.

The UK approach, which has a limited class of eligible retail investors, is part of a more general approach to the regulation of all securities that lack a secondary market, including offers to the crowd.

CAMAC elsewhere has considered whether there should be some risk appreciation test that crowd investors need to satisfy before being permitted to invest through the CSEF process (Section 5.15).

6.3 Sophisticated investor threshold

Issue: should there be a requirement that sophisticated investors hold at least a certain threshold interest in an issuer before it can make CSEF offers to crowd investors?

6.3.1 Other jurisdictions

Italy

Professional investors and/or CONSOB-registered institutions must own at least 5% of the equity of a crowd-funded firm after the CSEF exercise, for that method of fundraising to be valid. The apparent intention is to give some form of comfort to small investors that the investment is worthwhile, given that one or more sophisticated investors has chosen to invest.

There is no equivalent requirement in the US legislation or the Canadian proposals.

6.3.2 Submissions

One view was that a sophisticated investor minimum involvement requirement (for instance, that one or more sophisticated investors must subscribe at least 5-10% of the capital in each offer document to crowd investors) will assist in pricing the security being offered. The price per share paid/to be paid by the sophisticated investor(s) should be disclosed in the offer document to the crowd. Also, to ensure the authenticity of the disclosed price, sophisticated investors should not get any preferential treatment in regard to capital, benefits or additional capital raised, by virtue of that investment.

Another view was that while there should not be a sophisticated investor minimum involvement requirement, an issuer should be able to demonstrate a particular level of equity contribution (or government grant funding) in the target business before being permitted to seek funds through CSEF. It was argued that such a requirement would provide protection to small investors by the issuer committing its own funds at a level that ensures that there is something more than a mere idea that is being funded.

Most submissions, however, opposed a sophisticated investor threshold requirement. Arguments put forward by respondents included:

- the essence of CSEF is that it appeals to the non-sophisticated investor. The requirement would substantially defeat the purpose of CSEF and perpetuate current obstacles to finance affecting large portions of the population

- sophisticated investors are not necessarily suitable investors for all CSEF offers. The requirement would unfairly bias against newer ideas that may not yet have any sophisticated investors such as several small businesses

- sophisticated investors typically do not become involved in most businesses at the very early stages, unless the business has the potential to be very profitable and/or is technology-based. This restriction would therefore result in many businesses not receiving funding.

It was also argued that the requirement would create an undue level of complacency in non-sophisticated investors, and hence become the opposite of a protective measure. The fact that someone meeting the current sophisticated investor definition has invested does not mean they have conducted any significant or effective due diligence on the issuer. Also, it was argued, sophisticated investors may be prepared to take a gamble with a small investment they could more easily write off, which may send false ‘comfort’ signals to the retail investor market.

6.3.3 CAMAC position

CAMAC notes that a threshold sophisticated investor involvement requirement could benefit crowd investors to the extent that it is an assurance to them that the equity offer to the crowd is supported, to some extent at least, by funds already committed to the project. Whether that can also act as an assurance about the fundamentals of the issuer is a separate question, as a sophisticated investor may or may not have conducted a suitable assessment before committing its funds.

However, a sophisticated investor requirement may have various detrimental effects, as indicated in submissions. For instance, it would deny start-up and other small enterprises without this involvement the opportunity to seek funds through CSEF. It would mean that in many instances the ‘capital gap’, which CSEF seeks to address in some respects, would remain in effect, even for worthwhile enterprises.

Given these considerations, CAMAC is of the view that it would be too restrictive to impose a sophisticated investor financial involvement precondition on an issuer in making an online offer. An issuer with such financial support could, of course, point that out in its offer disclosure document to crowd investors.

6.4 Investor caps on crowd investors

Issue: should there be caps on the funds that a crowd investor can invest through CSEF?

This Section deals with investor caps. Issuer caps are discussed in Section 4.5.

6.4.1 Types of investor caps

The purpose of investor caps is to limit an individual investor’s exposure to high-risk investments likely to be associated with CSEF.

Investor caps may take the form of:

- ***investor cap per issuer***. This is a cap on how much an individual crowd investor can invest in a particular CSEF issuer, in a particular period or per offer by the issuer. This cap is designed to limit an investor's financial contribution to a particular issuer, and therefore the exposure of that contribution

- ***investor cap on all issuers***. This is a cap on how much an individual crowd investor can invest in CSEF issuers (combined) in a particular period. This cap is designed to limit an investor's overall financial contribution to all CSEF issuers in that period, and therefore the exposure of that contribution.

6.4.2 Other jurisdictions

There are various caps (alone or in combination) that could be applied to the funds that an investor could put into CSEF, if the intention is to limit the possible losses to retail investors through CSEF:

Investor cap per issuer: different approaches

- ***first approach:*** limiting the number of CSEF issuers in which an investor may invest in one year
- ***second approach:*** limiting the monetary amount that an investor may invest in each CSEF issuer in one year
- ***third approach:*** limiting the monetary amount that an investor may invest in each CSEF issuer in total (not per year)
- ***fourth approach*:** limiting the monetary amount that an investor may invest in each CSEF issuer per offer by that issuer

Investor cap on all issuers: different approaches

- ***fifth approach:*** limiting the total monetary amount that an investor may invest in all CSEF issuers in one year, irrespective of that person's income or net worth
- ***sixth approach:*** limiting the total monetary amount that an investor may invest in all CSEF issuers in one year according to that person's income or net worth
- ***seventh approach:*** limiting the total monetary amount that an investor may invest in all CSEF issuers, regardless of time.

No caps

The **eight approach** is to place no mandatory cap on the funds that an individual investor could put into CSEF.

Summary

In summary, of the jurisdictions analysed in this report:

- Canada has proposed a combined *investor cap per issuer* (the *fourth approach*) with an *investor cap on all issuers* (the *fifth approach*)
- the US has adopted an *investor cap on all issuers* (the *sixth approach*)
- the UK has adopted an *investor cap on all issuers* for some retail investors (the *seventh approach*)

- New Zealand has a voluntary *investor cap per issuer* (at the discretion of the issuer), but unlike the other jurisdictions has no *investor cap on all issuers* (the *eight approach*).

Canada

The Canadian proposal has adopted a combination of the *fourth approach* and the *fifth approach*.

Under the proposals, an investor's investment in securities of a particular issuer through CSEF cannot exceed $2,500 per offer by that issuer (*fourth approach*). In addition, a purchaser's total investment in all CSEF offers during a calendar year cannot exceed $10,000 (*fifth approach*).

In putting forward this combined approach, the OSC argued that having low investment limits minimizes an investor's exposure. Also, specified maximum dollar amounts are easier to administer than the *sixth approach*, as adopted under the US JOBS Act, that requires calculations based on an investor's annual income or net worth. In addition, it avoids the concern, under the *sixth approach*, that investors may be unwilling to share their tax returns or other personal financial information with issuers or portals to establish they are investing within the prescribed limits.

With each investment, the intermediary is responsible for verifying that the investor is not exceeding the caps, more specifically that in any 12 month period:

- the investor is not investing more than $2,500 in a particular offer

- the investor will not have invested more than $10,000 through the portal of that intermediary.

However, an investor will be required to certify that he or she is within the investment limits. The OSC considered that:

> self-certification bolstered by a portal monitoring compliance by the investor with the investment limits based on investments made by the investor through the portal is a reasonable and practical approach.

To reinforce this approach, the purchaser of the CSEF securities must purchase them as the principal.

USA

The JOBS Act has adopted the *sixth approach*, with two caps:

- ***lower cap****:* for an investor with an annual income or net worth below $100,000, the investor's annual aggregate investment in CSEF securities is capped at the greater of $2,000 or 5% of the investor's annual income or net worth

- ***higher cap:*** for an investor with an annual income or net worth of at least $100,000, the investor's annual aggregate investment in CSEF securities is capped at 10% of the investor's annual income or net worth, not to exceed $100,000.

While no additional cap is made for accredited [sophisticated] investors under Title III of the JOBS Act, equity offers can also be made to them, promoted online or through other means, under Title II of the JOBS Act.

These cap amounts are to be periodically adjusted based on the consumer price index.

The SEC noted that the investment caps would limit the potential upside for investors in the CSEF market:

> This might particularly affect the decisions of those with large portfolios who might be able to absorb losses and understand the risks associated with risky investments. For these investors, the $100,000 aggregate cap might limit their incentive to participate in the securities-based crowdfunding market, compared to other types of investments, potentially depriving the securities-based crowdfunding market of more experienced and knowledgeable investors and possibly impeding capital formation. Limiting the participation of such investors would be likely to negatively affect the informational efficiency of the securities-based crowdfunding market because sophisticated investors are better able to accurately price such offerings.

The SEC also noted that the investment caps could limit the ability of investors to diversify within the CSEF market by:

> limit[ing] an investor's ability to choose a sufficiently large number of investments to offset this risk and to recover the due diligence costs of sufficiently investigating individual investments. One potential solution to this diversification problem would be to invest smaller amounts in more ventures. The drawback is that the costs associated with identifying and reviewing investment opportunities are, to a large extent, fixed.

In regard to compliance with the investment caps, the proposed SEC Rule would provide that before permitting an investor to make an investment commitment on its platform, an intermediary must have a reasonable basis to believe that the investor comes within the investment caps. However, the SEC also recognises the difficulties that this may impose on intermediaries. Accordingly, the SEC proposes that, notwithstanding that investors might make inaccurate representations, whether intentionally or not:

> an intermediary may rely on an investor's representations concerning compliance with the investment limits unless the intermediary has reason to question the reliability of the representations.

In regard to reliance on an investor's representations, the SEC also commented that:

> it would not be reasonable for an intermediary to ignore other investments made by an investor in securities sold in reliance on [the CSEF provisions] through an account with that intermediary or other information or facts about an investor within its possession.

UK

Those retail investors who rely on the certification that they will not invest more than 10% of their net investible portfolio (i.e. excluding their primary residence, pensions and life cover) in non-readily realisable securities are limited to that cap, which applies independently of any period (the *seventh approach*).

New Zealand

Unlike the proposals in the USA or Canada, there are no mandatory limits on how much can investor can invest in CSEF. An issuer may choose to impose such a cap for a particular offer.

The FMA has indicated that if voluntary investor caps are not imposed, or they are high, or the issuer is trying to raise significant amounts of capital, the FMA would usually expect that the arrangements for disclosure to the crowd include extra disclosure such as providing a business plan, details of how funds will be used, key risks and key financial information, such as financial statements.

6.4.3 Submissions

Most respondents supported the principle of a cap or caps, for retail investors, though respondents held quite differing views as to what it, or they, should be. One comment was that while, from one perspective, the market realities of risk and reward for all equity investing should not be ameliorated by regulation, from an operational perspective it may be prudent to limit individual investors to a cap on the total amount of investment they may make in a given period and/or hold at any point in time. No individual retail investor should be able to invest a very large amount of money in a single venture.

One comment was that the report should make clear that any caps only applied to retail investors and that the existing tests for exemption from the need for a formal offer document under s 708 of the Corporations Act should apply equally to a CSEF offer. In consequence, there should be no limit on the amount that any individual could invest if they fall within one of those exemptions.

On the issue of enforcement of caps, one view was that as compliance with any caps may be hard to monitor and police in practice, any cap should be self-regulatory, such as investors having to 'self-certify' that they were complying with any applicable caps. Requiring, for instance, certificates from accountants etc as to incomes or net worth under the *sixth approach* would be too cumbersome and costly for both the investor and issuer.

In regard to the various possible caps:

Investor cap per issuer

First approach: limiting the number of CSEF issuers in which an investor may invest in one year

No respondent supported this approach.

Second approach: limiting the monetary amount that an investor may invest in each CSEF issuer in one year

There was some in-principle support for this approach. It was argued that this approach is simpler than the *fifth and sixth approaches*, which may require a centralised intermediary system to monitor the number of issuers an investor had invested in and the amount invested.

Third approach: limiting the monetary amount that an investor may invest in each CSEF issuer in total (not per year)

There was considerable difference between respondents supporting this approach as to what should be a reasonable limit, ranging from $2,500 - $5,000 to $10,000, $20,000 or even $50,000.

Another approach was that if audited financial statements of the issuer are not available, then the issuer should be limited to raising a maximum of $1000 from each investor. This would encourage disclosure, while allowing new entities to participate.

It was argued that it is not appropriate for issuers or intermediaries to have to police whether investors have exceeded the caps. Rather, the risk disclosure document to investors should clearly specify that these are high-risk investments and only suitable for a portion of investable capital.

Fourth approach: limiting the monetary amount that an investor may invest in each CSEF issuer per offer by that issuer

There was considerable difference between respondents supporting this approach as to what should be a reasonable limit, ranging from $2,000-$5,000 per offer to $10,000 or $20,000 per offer.

It was argued that any cap under this approach not be linked to the income or net wealth of the investor, as it would be impractical to monitor.

Investor cap on all issuers

Fifth approach: limiting the total monetary amount that an investor may invest in all CSEF issuers in one year, irrespective of that person's income or net worth

There was some difference between respondents supporting this approach as to what should be a reasonable limit each year for retail investors, ranging generally from $1,000-$5,000 per year, up to $10,000 per year, with the limit of $10,000 suggested for self-managed super funds (SMSFs).

Sixth approach: limiting the total monetary amount that an investor may invest in all CSEF issuers in one year according to that person's income or net worth

There was some in-principle support for the cap being in proportion to the investor's annual income or net wealth in any financial year.

A number of respondents raised concerns that a cap based on a person's income or net worth is too difficult for the issuer or intermediary to verify. On that view, the *sixth approach* is unworkable, unless based on 'self-certification' by the investor, for instance by investors providing a verified statement that their investment does not breach the income/net worth tests.

Seventh approach: limiting the total monetary amount that an investor may invest in all CSEF issuers, regardless of time

There were no submissions on this approach (as the *seventh approach* reflects the March UK position).

No caps

Eight approach: no mandatory investor cap

Some respondents considered that there should be no investor caps on any individual that falls within one of s 708 exemptions of the Corporations Act, in particular sophisticated investors.

Another approach was that offers that come within any of the s 708 exemptions should be separate altogether from the CSEF process, both as to the amounts that an issuer can raise and as to amounts that a person can invest.

6.4.4 CAMAC position

General comments

Consideration of investor caps raises a series of questions that have a particular significance for the overall operation of CSEF.

For instance, the imposition of any form of investor cap, and the amount of that cap, will have a direct bearing on the number of crowd investors an issuer may need to attract to reach a target threshold of equity investment. If investor caps are very low, issuers may struggle in some instances to reach their fundraising targets even where there is a significant level of support from crowd investors.

High investor caps, or no caps, may assist issuers in reaching their investment targets, even where limited numbers of crowd investors are involved. However, this may also increase the potential level of exposure of individual investors to the risks associated with this form of investment.

Of the jurisdictions reviewed, only New Zealand has no mandatory investor cap of any description. In consequence, a crowd investor in a particular period may choose to place a large sum of money with one issuer (unless that issuer has a self-imposed *investor cap per issuer*) or may invest a large amount in a series of issuers, with no limit on the total amount that he or she can invest. In effect, a crowd investor could, at any time, put up to all of their available assets into high-risk start-up ventures through the CSEF process, but without the full protections normally associated with public offers of equity.

One reason New Zealand may have decided against any form of mandatory investor cap is the difficulty that can arise in policing or enforcing a cap, particularly an *investor cap on all issuers*. CAMAC notes that this problem has been recognised in other jurisdictions, which largely favour 'self-certification' by the investor that he or she is complying with an investor cap. CAMAC also favours this approach, with a limited obligation on the intermediary to check compliance with an investor cap where it is easy for it to do so.

CAMAC does not support any sanction being imposed on an investor who breaches an investor cap. Rather, investor caps constitute formal recognition of the financial risks for investors that are inherent with CSEF. Such caps can act as a brake on excessive investment by most crowd investors, even if the cap is inadvertently or intentionally breached by particular investors in some cases. Having investor caps strongly reinforces mandatory risk statements to, and risk acknowledgements by, crowd investors.

Another consequence of no investor cap is that some issuers could be funded through the CSEF process primarily or solely by a few crowd investors and without any significant support from the crowd generally, thereby negating any effect of the supposed 'wisdom of the crowd'.

Within this context of CAMAC support for the introduction of investor caps, a number of situations need to be considered.

Sophisticated investors

Sophisticated and other like investors (as defined under the Corporations Act) should be permitted to invest in any issuer under the s 708 exemption for these types of investor, independently of any CSEF offer by that issuer. There should be no form of investor cap for such investors.

Any equity capital raised from these investors in this manner should not count for the purpose of any *issuer cap* (see Section 4.5.4).

In regard to equity issues to sophisticated investors during a CSEF period, see Section 4.6.2.

Investors under the small-scale personal offers exemption

Issuers considering, or undertaking, a CSEF offer should be entitled also to raise equity from investors under the small-scale personal offers exemption from s 708. There should be no form of investor cap for such investors (in addition to the caps in s 708), though any equity capital raised in this manner should be included in the *issuer cap* (see Section 4.5.4).

Crowd investors in a CSEF offer

CAMAC is of the view that while an *investor cap per issuer* can be an important investor protection mechanism, an *investor cap on all issuers* is even more significant in that regard.

Reliance only on an *investor cap per issuer* could result in a crowd investor investing a large part of that person's available wealth in a series of high-risk CSEF issuers within a short period. The *investor cap on all issuers* seeks to counter this possibility.

Investor cap on all issuers

CAMAC considers that there should be a cap on how much an individual crowd investor can invest in all CSEF issuers (combined) in a particular period. This restriction on freedom of investment by an investor takes into account the high-risk nature of many start-up and other small enterprises that are likely to utilise a CSEF process to raise capital, in circumstances where the full range of investor protections normally associated with offers to the public does not apply. An investor cap on all issuers (depending upon the cap formula) will reduce an individual investor's overall exposure to these high-risk investments during any particular period.

CAMAC recognises that the principal difficulty with an investor cap on all issuers is that of fully policing or enforcing any such cap, without some central registry to record each crowd investor's total investment in CSEF offers within a particular period, given that an investor could take up CSEF offers by different issuers on various intermediary websites.

This problem has been recognised in various jurisdictions, which tend to favour 'self-certification' by the crowd investor that he or she is complying with the *investor cap on all issuers*, without any central registry being established. CAMAC supports this approach, with an intermediary only needing to check that an investor has not exceeded this cap in relation to investments through its portal.

On this basis, crowd investors would have to certify to an intermediary that an intended CSEF share acquisition came within the *investor cap on all issuers* before they could accept the offer by the issuer. At a minimum, this would remind these investors of this cap and the reasons for it. However, an intermediary would not be required to check on the accuracy of that certificate.

There is also the problem of the legal status of investments by a crowd investor which have exceeded the *investor cap on all issuers*. Should a crowd investor be able to undo a share acquisition previously entered into on this ground? Arguably, an individual investor should not be able to benefit from his or her own breach of this investor cap, intentional or inadvertent. Possibly the only instance where a crowd investor should have the right to unwind a share acquisition is where the issuer was a knowing party to the breach (though in some cases that could harm the interests of remaining shareholders).

Canada proposes to impose a cap of $10,000 per year on the funds that each investor can invest, in total, in CSEF offers (the *fifth approach*). In the US, this cap will vary depending upon the annual income or net worth of the investor (the *sixth approach*). CAMAC considers that the Canadian approach is preferable, as it avoids the complications involved in the US approach in determining a cap according to those variables.

CAMAC also considers that a cash cap, of the type proposed in Canada, is preferable to the UK approach that links a cap, for some retail shareholders, to a proportion of their net investible portfolio (the *seventh approach*).

In regard to the cash limit, CAMAC considers that an amount in the order of $10,000 in any 12 month period would be appropriate, at least at the outset. However, any figure chosen is arbitrary to some extent, and this cap could be adjusted at some future time in light of experience with CSEF.

Investor cap per issuer

CAMAC considers that it may be appropriate also to have a cap on how much an individual crowd investor can invest in a particular CSEF issuer (in a particular period). This constitutes a constraint on freedom of investment by an investor, but equally restricts an investor's exposure to each particular CSEF issuer.

The Canadian approach has a cap per issuer of $2,500 per offer by that issuer (the *fourth approach*). CAMAC notes that an issuer in Canada may conduct a series of offers within a twelve month period, which would increase this cap. For instance, if an issuer conducted four offers in a 12 month period, and a crowd investor contributed the maximum of $2,500 per offer, that investor could place its full permitted $10,000 cap on all issuers in that period with one issuer.

CAMAC considers that if, in addition to the *investor cap on all issuers*, an *investor cap per issuer* is to be adopted, a simpler approach for the latter cap would be to limit the amount that a crowd investor may invest in a particular CSEF issuer in one year, rather than per offer (the *second approach*). That amount could be in the order of $2,500, or somewhat higher, given that, unlike Canada, that would be an absolute ceiling per issuer for each 12 month period. However, any figure chosen is arbitrary to some extent and this cap could be adjusted at some future time in light of experience with CSEF.

The effect of an *investor cap per issuer* of $2,500 in any 12 month period would be that a crowd investor seeking to invest funds in CSEF up to the maximum permitted under the *investor cap on all issuers* of $10,000 in any 12 month period would have to diversify these investments to some extent.

CAMAC prefers the *second approach* to simply limiting the number of CSEF issuers in which a crowd investor may invest in one year (the *first approach*) or limiting the monetary amount that such an investor may invest in a particular CSEF issuer in total (the *third approach*). The *first approach* would involve an arbitrary ceiling, which may have little influence on restricting an investor's exposure to a particular issuer. The *third approach* would be equally arbitrary and prohibit an investor from making any further equity investments in an issuer through CSEF, once the investment limit had been reached, even where the issuer was successful and a further investment would be in the interests of the investor. An investment limit per year (the *second approach)* may achieve a proper balance, in most instances, between investor opportunity and investor protection.

Intermediaries should be under a limited duty to check that individual crowd investors do not breach the *investor cap per issuer* (Section 5.16). As with the *investor cap on all issuers*, an investor who breached the *investor cap per issuer* should not have a right of rescission, except possibly where the issuer was knowingly a party to the breach.

New Zealand has a voluntary *investor cap per issuer.* A reason why an issuer in New Zealand may consider imposing an investor cap relates to the level of disclosure requirements in the offer. According to the New Zealand Financial Markets Authority Crowd Funding Guide (April 2014):

> If you don't impose investor caps (or they are high) or the issuer is trying to raise significant amounts of capital, we'd usually expect your arrangements to include extra disclosure such as providing a business plan, details of how funds will be used, key risks and key financial information, such as financial statements.

CAMAC elsewhere proposes a template disclosure approach for all CSEF offers, regardless of the amount of funds sought to be raised by an issuer (Section 4.7). The quoted thinking behind the New Zealand ambulatory approach to offer disclosures would not have any application in that context.

6.5 Risk acknowledgement

Issue: should a crowd investor be required to acknowledge the risks involved in CSEF?

CAMAC elsewhere proposes that an intermediary must provide a generic risk disclosure statement to a crowd investor before each CSEF investment (Section 5.15). The question here concerns the content of the risk acknowledgement by the investor in response to that risk disclosure statement.

6.5.1 Other jurisdictions

New Zealand

Investors will be required to affirm to the intermediary that they understand the risks involved in CSEF. For this purpose, an intermediary must obtain from each crowd investor, a confirmation to the following effect:

- I confirm that I have seen the warning statement about crowd funding; and
- I understand that equity crowd funding is risky and I may lose my entire investment; and
- I confirm that I could bear that loss without suffering undue hardship; and
- I understand that the usual legal protections do not apply to this investment; and
- I understand that I may not be given the same information as is usually required by New Zealand law for investments.

The confirmation must be obtained in writing in a separate document or, if it is obtained by electronic means, through a process by which it is obtained separately from the agreement to use the intermediary service.

The confirmation must be obtained by the intermediary before the investor is authorised to use the intermediary service.

USA

The investor must positively affirm an understanding that the entire investment is at risk and that the investor would be able to bear such a loss. The investor must also answer various questions demonstrating an understanding of various risks.

Canada

Investor will be required positively to affirm that they understand they are making a high-risk investment.

For this purpose, prior to an investor entering into an agreement to purchase securities through the CSEF process, the investor must sign a risk acknowledgement form in which the investor confirms that he or she falls within the investment limits and also acknowledges the risks associated with the investment, including the following:

- it is a very risky investment
- the investor could lose all of the money invested
- the investor may never be able to sell the securities
- the investor will be provided with less disclosure than public companies provide
- the investor will not have the benefit of protections associated with an investment made under a prospectus
- borrowing money increases the risk of an investment
- the intermediary portal will not be responsible if the investor loses all or some of the money invested.

The risk acknowledgement form may be signed by an online signature.

The issuer must retain the signed risk acknowledgement form for eight years after the distribution.

The OSC commentary stated that:

> Requiring that an investor sign a risk acknowledgement form may help to alert the investor to the risks of the investment, including that the investor may lose his or her entire investment.

6.5.2 Submissions

The overwhelming view in submissions was that a risk acknowledgement by the investor should be a necessary part of any investment application process.

Various suggestions concerning the content of a risk acknowledgement statement included:

- investors should sign that they are fully aware there is a high statistical chance they will lose all their money and that they accept this
- investors should acknowledge the risk of the investment and that they may lose all their capital or subsequently find that the capital structure of the company could see their economic interest significantly decrease, notwithstanding a successful business.

Some respondents also suggested that any CSEF offer document encourage investors to get independent professional advice before investing and that, to accept the offer, investors must either indicate that they have either done so or indicate that they have chosen to waive that option and understand this risk.

Another proposal was for an accreditation process whereby, prior to investing, an investor would be required to attend and pass a risk awareness workshop.

6.5.3 CAMAC position

A crowd investor should be obliged to acknowledge (which may be by means of an electronic signature) having read and understood the risk disclosure statement. This should occur before each CSEF offer can be accepted (see Section 5.15.3).

The various jurisdictions, and suggestions in submissions, provide useful draft texts of the content of a template risk acknowledgement by the investor.

Given the range of risks involved, CAMAC considers that a crowd investor should be required separately to acknowledge each of the risks set out in the risk acknowledgement template, rather than simply provide one general acknowledgement.

CAMAC elsewhere has considered whether there should be some risk appreciation test that crowd investors need to satisfy before being permitted to invest through the CSEF process (Section 5.15).

6.6 Cooling-off rights

Issue: should a crowd investor have cooling-off rights after accepting a CSEF offer?

6.6.1 Other jurisdictions

Canada

An issuer that offers securities under the CSEF process must provide an investor with a contractual right to cancel an agreement to purchase the security by delivering a notice to the issuer within at least 48 hours prior to the date of completion of the distribution disclosed in the issuer's offer document.

The OSC considered that a right of withdrawal would provide an investor with a 'cooling off' period to consider the disclosure provided and reflect on his or her investment decision.

An investor also has withdrawal rights in the event of material changes in the offer.

USA

The SEC has proposed that investors have an unconditional right, for any reason, to cancel their acceptances up to 48 hours prior to the end of the offer period:

> Under this approach, an investor could reconsider his or her investment decision with the benefit of the views of the crowd and other information, until the final 48 hours of the offering.

In the view of the SEC:

> the proposed rules strike an appropriate balance between giving investors the continuing benefit of the collective views of the crowd and then, if desired, to cancel their investment commitments, while providing issuers with certainty about their ability to close an offering at the end of the offering period.

The SEC considers that issuers should be entitled to vary the securities offer price ('dynamic pricing') during such time as investors have cancellation rights:

> the investor's ability to cancel his or her investment commitment could mitigate potential concerns that dynamic pricing could be used to provide preferential treatment to certain investors (*e.g.*, when an issuer offers better prices to relatives or insiders). We

> also believe that the proposed cancellation rights would address the concerns about time pressure on the investment decision because investors would have the opportunity to cancel their investment commitments if they decide to do so.

If there is a material change to the terms of an offer, including the offer price, or to the information provided by the issuer regarding the offer, the proposed rules would require the intermediary to give each investor who has made an investment commitment notice of the material change, with the notice also stating that the investor's investment commitment will be automatically cancelled unless the investor reconfirms his or her commitment within five business days of receipt of the notice:

> We believe that when material changes arise during the course of an offering, an investor who had made a prior investment commitment should have a reasonable period during which to review the new information and to decide whether to invest. This notification would be required to be provided by e-mail or other electronic media.

Italy

Investors can withdraw their commitment at any moment until the crowdfunding campaign is closed.

6.6.2 Submissions

There were differing views in submissions as to whether investors should have cooling off rights, or in what circumstances any such withdrawal rights should be exercisable.

Support some right of withdrawal

Some respondents considered that this consumer protection type of measure is appropriate. It was argued that a cooling-off period for CSEF would mirror the current operation of crowdfunding sites outside equity-raising, where investors can cancel a pledge at any time prior to the campaign reaching its threshold target.

Some respondents supported an unconditional withdrawal right for investors, within a stipulated timeframe of the investor accepting the offer to acquire equity. However, suggested withdrawal time-frames ranged widely, from 3 business days to 30 business days, or various times within that period.

Other suggested approaches were for the withdrawal right to apply at any time prior to 48 hours before either the minimum subscription is reached or the time deadline for the offer expires.

Support no right of withdrawal

One view was that giving investor withdrawal rights may undermine the CSEF policy objectives. For instance, introducing a cooling-off period may mean that it is not clear whether any investment threshold has been reached until the cooling-off period for all investors has expired.

Rather, it was argued, a disclosure approach whereby, for instance, CSEF intermediaries should be required to make clear to investors, before entering into a contract, that they do not have access to a cooling-off period, better strikes the balance between investor protection and market efficiency. CSEF investors will typically be more indecisive, less experienced, and therefore a cooling-off right is likely to invite and encourage withdrawals.

6.6.3 CAMAC position

Crowd investors should have an unconditional right to withdraw from an online share acquisition for a limited period (say, five clear working days) after accepting the equity offer. There should be no capacity for crowd investors to waive that cooling-off right. This is consistent with general investor protection approaches in other contexts.

CAMAC considers that a longer cooling-off period, particularly if extending to some period finishing close to the end of the offer period (which could be for some months) could create ongoing uncertainty about the likely success of any CSEF offer.

Details about this general cooling-off right for crowd investors, when it commences, the length of time it operates, and how to exercise it, should be clearly explained on each intermediary website, and should be included, in template form, as part of the acknowledgement by the intermediary to crowd investors at the time they enter into the equity acquisition agreement.

6.7 Other withdrawal rights

Issue: should a crowd investor have some further withdrawal right, during or after the offer period, such as a ‘tag along’ right if certain key persons withdraw their investment in the issuer?

6.7.1 Other jurisdictions

Italy

Start-ups using CSEF must insert a clause in their constitution which guarantees investors the right to withdraw from the investment and to sell their shares back to the firm, in case the major shareholder sells its stake to a third party (‘tag along’ right).

There is no equivalent right in the US legislation or the Canadian proposals.

6.7.2 Submissions

One view in submissions was that a mandatory ‘tag along’ clause would protect retail investors by giving them the same rights as larger shareholders. It would ensure a majority shareholder cannot sell out leaving minorities with no exit strategy.

The predominant view in submissions was that a ‘tag along’ right would unnecessarily create uncertainty for issuers and could be detrimental to remaining shareholders.

6.7.3 CAMAC position

There should not be any ‘tag along’ right for crowd investors, given that it may fundamentally affect the capacity of the issuer to continue, taking into account that the issuer would have to fund any buy-backs by the company. Exercise of such a right may see the collapse of the company, as shareholders seek to exit simply to avoid being left as members of a company drained of its assets as it pays off other shareholders.

However, CAMAC elsewhere proposes that crowd investors have withdrawal rights where there is a material adverse change in the position of the issuer after they have accepted the offer (Section 4.11).

Also, crowd shareholders may have rescission and other remedies under general law principles in instances of fraud, or material misrepresentations or omissions, by the issuer (Section 6.10).

6.8 Resale of shares

Issue: should there be restrictions for some period on the on-sale of shares acquired through CSEF?

6.8.1 Other jurisdictions

USA

Securities purchased under the CSEF provisions are subject to resale restrictions for one year.

The SEC has described this restriction, which it recognises may impede securities price discovery, as nevertheless important for investor protection:

> By restricting the transfer of securities for a one-year period, the proposed rules would give investors in a business a defined period to observe the performance of the business and to potentially obtain more information about the potential success or failure of the business before trading occurs.

Canada

The investor education materials must make it clear to investors that there are significant resale restrictions and the securities cannot be resold through the intermediary portal.

Securities of a non-reporting issuer

Securities of a non-reporting issuer acquired through crowdfunding cannot be resold until the issuer becomes a reporting entity, unless the sale is made under a prospectus exemption other than the crowdfunding exemption (for instance, to a sophisticated investor)

The OSC expressed concern about permitting a sale before an issuer becomes a reporting entity and is therefore subject to the continuous and timely disclosure requirements.

Securities of a reporting issuer

Securities of a reporting issuer acquired through crowdfunding are subject to a four month hold period.

6.8.2 Submissions

There were a range of approaches by respondents.

Some respondents supported a prohibition on resale of equity acquired under CSEF for, say, 12 months from the time of purchase or the end of the offer period during which the purchase took place, subject to some exemptions (for instance, pursuant to a will, under a formal takeover offer or merger arrangement, or under a family law direction; other suggested exemptions included selling to friends and family, selling back to the issuer in the event of a buyback, and selling to a sophisticated investor). The prohibition, it was argued, would prevent the possible manipulation of the equity market price through short-term purchase and sale (‘pump and dump’) activities.

Another view was that equity resales should be restricted only during the CSEF offer period. Secondary markets should be available once the initial capital raising has closed.

Arguments put forward by respondents opposed to any resale restriction included that:

- the interest and financial well-being of retail investors is the primary consideration, hence the possibility of making a capital gain in the short to medium term should not be impeded
- any success of investors in achieving a capital gain through sale of their shares augurs well for the reputation of CSEF
- unimpeded rights of resale allow investors to recoup their investment should they require cash or should they feel that the investment is no longer for them.

Independently of whether there should be resale restrictions on equity acquired through CSEF, a number of respondents proposed a ban on founders and directors of the enterprise selling any of their equity in the enterprise, or more than 10% of their equity holding, within a period (say, 12 months) of a CSEF offer concerning that enterprise. Any such sale, it was argued, could result in crowd investors being left 'high and dry' with an enterprise which has no management or where the expertise of the founders is no longer available. The restriction would also counter the possibility of promoters engaging in a 'pump and dump' exercise.

6.8.3 CAMAC position

There should not be resale restrictions on crowd investors. They should be permitted, at any time, to sell shares acquired through the CSEF process to anyone who is willing to buy them, given that it is unlikely in many instances that there will be any secondary market in the shares. What, if any, on-sale market there is in these shares should not be discouraged.

However, to counter the possibility of crowd investors being the victims of a share 'pump and dump' exercise (a concern raised in a number of submissions), there should be a ban on directors or other persons associated with the issuer selling a significant proportion of their equity holding in the issuer (say, 10% or more) within, say, 12 months of any CSEF offer by that issuer.

6.9 Ongoing reporting

Issue: what ongoing reporting should be made by the intermediary and/or issuers to crowd investors in regard to their investment?

6.9.1 Submissions

The predominant view in submissions was that the primary responsibility for ongoing reporting to CSEF investors should rest on issuers, with intermediaries not having any ongoing duty to provide independent reports on issuers. Instead, any reporting on the intermediary's website should be a matter for the intermediary and its contract with an issuer. For instance, an intermediary may choose to provide an *online issuer update area* on its website, to post information periodically provided by the issuer, but without any obligation on the intermediary to vet that information.

6.9.2 CAMAC position

In principle, as crowd investors would now be shareholders of the issuer, any ongoing reporting obligations should be on the issuer, rather than the intermediary. The ongoing reporting requirements for issuers are discussed in Chapter 3 and Chapter 4 of this report.

Intermediaries should not have ongoing reporting obligations in relation to issuers who raised funds through the intermediary website. However, intermediaries may see a competitive benefit in having an 'issuer update' area on their websites, containing information supplied by, and relating to, issuers who have previously made offers through that website. It may be in the interests of issuers who are contemplating a further CSEF offer to keep website users informed in this way.

This matter is separate from the proposal, discussed elsewhere in this report (Section 5.21), that intermediaries should provide a means on their websites for investor-to-investor and investor-to-issuer communications.

6.10 Remedies

Issue: what remedies should crowd investors have in relation to losses resulting from inadequate disclosure by issuers or poor management by issuers?

6.10.1 Inadequate disclosure

Submissions

Respondents considered that investors should have general law remedies against the directors of the issuer for any material misrepresentation/omission of material information (alternatively, misleading or deceptive conduct) concerning the issuer, as well as against any other person knowingly involved in that misrepresentation or omission. Beyond that, there should be no specific individual recourse to the intermediary for information provided by the issuer.

CAMAC position

The primary recourse of crowd investors should be remedies against the issuer, its relevant officers, and any other persons involved in any inadequate disclosure.

Intermediaries should be liable only to the extent that they had actual knowledge of the misconduct and failed to act (Section 5.10).

6.10.2 Poor management

Submissions

Respondents considered that the same duties and liabilities should apply to directors and other officers of issuers (including the duties of care and diligence and to act in good faith in ss 180-181 of the Corporations Act) as with other companies.

CAMAC position

CAMAC agrees with respondents that the same duties and liabilities should apply to directors and other officers of issuers as with other companies.

Intermediaries should be liable only to the extent that they had actual knowledge of some fraud by the issuer and failed to act (Section 5.11).

6.10.3 Limitations of these remedies

CAMAC position

CAMAC notes that the benefit to crowd investors of any remedies they may have against the issuer and relevant involved persons will depend upon the assets of those persons. It is very unlikely that directors or other officers of start-ups or other small enterprises will have adequate D&O insurance to cover any such claims by crowd investors.

Given this, the generic risk statement to crowd investors, discussed elsewhere in this report (Section 5.15), should point out these possible shortcomings of investor remedies.

Appendix 1 Online fundraising

This Appendix discusses CSEF within the broader context of crowd sourced funding, and identifies the implications of this form of corporate fundraising for the key participants.

A1.1 Crowd sourced funding generally

A1.1.1 CSEF as one form of crowd sourced funding

CSEF is just one form of what is commonly known as 'crowd sourced funding' (alternatively described as 'crowdfunding' or 'crowdsourcing').

From one perspective, crowd sourced funding in its various forms - soliciting small financial contributions from a large number of people - is not new.[78] Charitable bodies, for instance, have been doing this for many years, in various ways. However, during the last decade the internet and social media have created or enhanced the means by which individuals and entities can draw their requests, ideas or proposals to the attention of large numbers of persons who may have some funds they are prepared to donate or invest.

A1.1.2 Types of crowd sourced funding

Crowd sourced funding is a means of raising money for a creative project (for instance, music, film, book publication), a benevolent, humanitarian or public-interest cause (for instance, a community based social or co-operative initiative) or an entrepreneurial or other business venture, through small financial contributions from persons who may number in the hundreds or thousands. Those contributions are sought through an online crowdfunding platform, while the offer may also be promoted through social media.

Individuals may be invited to contribute to a project, cause, or venture (project):

- for its intrinsic social, artistic, philanthropic or other worth, not in exchange for anything of tangible value: **donation funding**[79]

- in exchange for some existing or future tangible reward (such as an existing or future consumer product or a membership rewards scheme): **reward, pledge and reward, pre-payment or pre-sales funding**[80]

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78 An early example of what might now be described as crowd sourced funding was a campaign in 1884, led by newspaper proprietor Joseph Pulitzer, to help fund the installation of the pedestal for the Statue of Liberty in New York harbour. Through that campaign, more than $100,000 was raised in six months from 125,000 people, with most donations being $1 or less.

79 Crowdfunding in Australia for charitable investment purposes, not just outright donations, can be conducted pursuant to the requirements in ASIC Class Order 02/184 *Charitable investment schemes- fundraising.* See also ASIC Consultation Paper 207.

80 See, for instance, www.pozible.com
In the US, *Kickstarter* began as a way for creative individuals—musicians, filmmakers, writers—to fund their work, often with the only return being an advance copy or limited edition of a DVD or other art work, concert tickets, or simply a signed thank-you note. An example in an educational context is a crowdfunded micro-satellite aboard the International Space Station, which contributors can use to conduct their own space experiments.

- in exchange for a future financial reward (such as a share of profits resulting from the sale of a good/service, the production/delivery of which the funding enabled): **investment funding**[81]

- in return for profit on funds lent through one-to-one lending arrangements: **peer-to-peer (P2P) lending**.[82] These can range from person-to-person loans, to arrangements that look in many respects like standard business lending except that a financial institution is not involved

- in exchange for equity or other securities in a company or other entity (if permitted): **equity funding**. This is what is referred to as CSEF.

As summarised in one analysis:

> While donations, rewards and pre-sales models do not entail any financial return to contributors, profit-sharing, lending and investment in securities models involve the prospect of financial return. The first category can be referred to generally as crowd sponsoring, while the latter can be described as crowd lending or crowd investing (including profit sharing). The campaigners collecting funds can include SMEs, startups, micro-entrepreneurs, social entrepreneurs, the self-employed, the cultural and creative sectors, public authorities, innovative or environmental projects, public interest bodies, researchers, consumers or the unemployed.[83]

The various forms of crowd sourced funding are continuing to evolve. As noted in one commentary:

> In a relatively short time, crowdfunding has become a new method of raising capital for a broad range of purposes using the internet. To date, it has mainly been used by people seeking to raise money for a specific project and does not generally involve the issuance of securities. However, in some jurisdictions, crowdfunding is emerging as a way for businesses, particularly start-ups and small and medium-sized enterprises, to raise capital by issuing securities.[84]

Crowd sourced funding has also been presented as a means to assist growth in developing countries.[85]

In Australia, crowd sourced funding has been typically donation funding and pre-payment funding.

A1.1.3 How crowd sourced funding works

The various forms of contemporary crowd sourced funding, including CSEF, have the same basic elements.

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81 An example in the US is www.appbackr.com Through this website funders 'buy' phone applications wholesale and when the apps are sold retail via the Apple Store, for example, profits are distributed back to the funders.

82 Peer-to-peer lending is developing in a number of jurisdictions. For instance, a report by the Open Data Institute in July 2013 found that between October 2010 and May 2013 some 49,000 investors in the UK funded peer-to-peer loans worth more than £378m. Some intermediaries arrange loans between individuals, other intermediaries pool funds which are then lent to small and medium-sized businesses. In Australia, this form of financing is noted in the Australian Centre for Financial Studies *Funding Australia's Future* project. For regulatory developments in the UK see the Financial Conduct Authority Policy Statement PS14/4 *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (March 2014), in particular Chapter 3. For developments in China see X Yang: P2P's unbridled growth *International Financial Law Review*, February 2014, at 23.

83 European Commission, *Unleashing the potential of Crowdfunding in the European Union* (27 March 2014) at 4.

84 Ontario Securities Commission Notice 45-712 *Progress report on review of prospectus exemptions to facilitate capital raising* (August 2013) at 5.

85 See, for instance, The World Bank *Crowdfunding's Potential for the Developing World* (2013).

A person (the promoter) may have a project but insufficient funds to bring it to fruition. The promoter may decide to raise some or all funds through an intermediary crowdfunding platform which (for a fee) creates a page on its website for the promoter. The promoter may also create a video or other promotional material on the website page, explaining the project and asking for funds in exchange for an immediate or future product or other reward. People interested in contributing may be able to engage with the promoter and with each other, on a chat room or chat board provided by the website platform. The project and its fundraising are also typically promoted via social media, email to friends and associates and other websites with a web-link to the fundraising page.

Crowdfunding platforms may require a specified target amount to be reached before contributions are passed to the promoter ('all or nothing' funding), or have those funds passed on without any target threshold ('keep it all' funding).

The operators of a crowdfunding platform may engage in vetting of projects to be included on their website, to maintain the reputation of the website. However, this due diligence may be well short of taking any legal responsibility for the accuracy of the information provided by promoters of projects or for the proper use by promoters of the contributed funds.

A1.1.4 Risks of crowd sourced funding

Crowd sourced funding, in any form, carries risks for persons providing funds through this medium. While risks may be present in any capital raising process, the central role of the internet means that the number of persons potentially affected can be significantly greater than for more traditional means of fundraising. Also, the scale of risk involved can be accentuated by the generally reduced level of scrutiny of these offers.

Fraud

This can take various forms.

There is the possibility of misappropriation, either by the project promoter or the website operator, of all or some of the funds invested or donated. This risk is more likely to arise where fund providers are not to receive any immediate financial or other benefit.

Also, as crowdfunding is largely an online-based activity, there is the risk of false websites being established simply to entice individuals to provide credit card details.

Furthermore, there is the possibility of genuine websites being used by fraudsters claiming to be promoters of projects, perhaps projects similar to ones that were successful in the past in raising a large amount of funds.

Failure

This is the risk that projects, even if properly funded and administered, will not be successfully completed and investors will not receive the financial or other rewards promised, or the return of the funds invested.[86]

This risk, while clearly not confined to crowd sourced funding, is potentially made more significant because it is often the case in crowd sourced funding that the projects that are in fact funded are those that provide the participants with some psychological reward, such as the feeling that the contribution is helping fund a worthwhile cause or is assisting someone in bringing their creative idea to fruition. As these projects are not funded according to their

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86 See, for instance, ASIC *12-196MR ASIC guidance on crowd funding* (August 2012).

business and financial merits, this increases the risk of failure as they may not have been viable in the first place. Also, as disclosure may be limited, participants may not be able to properly assess the financial and practical merits of particular projects.

A1.1.5 Potential impact of crowd sourced funding

The factors most likely to influence the future use and direction of crowd sourced funding, in its various forms, include:

- **promoter opportunity**: the extent to which promoters of projects find it an attractive and workable means to raise finance**.** Promoters may also use online-based funding to gauge community interest in a project and improve community awareness of that project

- **intermediary opportunity**: the extent to which persons facilitating the activity on their websites find it a viable and profitable business. This is likely to depend on the demand for funding by project promoters and the amount of fees/commission intermediaries collect through the crowdfunding process

- **investor opportunity and protection**: the extent to which investors are willing to fund projects, for altruistic, profit-related or other reasons, taking into account the extent to which they accept the financial risks of the projects on offer, and perceive how the risk of fraud is dealt with

- **regulatory involvement:** the level and type of regulatory involvement. It is possible that regulatory responses in different jurisdictions may develop through a number of stages, and in different forms for the various types of crowd sourced funding, as experience with this form of fundraising increases.

A1.2 Crowd sourced equity funding

The CAMAC review is confined to CSEF, being one aspect of crowd sourced funding.

A1.2.1 Key elements

Concept of CSEF

CSEF (alternatively described as ‘equity based crowdfunding’, ‘equity crowdfunding’ or ‘investment-based crowdfunding’) could be considered a new form of corporate fundraising to the extent that it utilises the internet to raise funds from a large number of small investors.

In essence, the concept of CSEF involves the sale of typically small capital interests (‘equity’) in companies (‘issuers’) through online websites (‘intermediaries’), to potentially numerous individuals or entities (‘investors’). CSEF is aimed principally at early stage capital-raising (sometimes referred to as ‘seed capital’) by start-up companies. However, there are no commercial restrictions on established businesses using CSEF to raise additional funds.

The interest in CSEF seems in part to be driven by what is seen as its potential to improve access to risk capital for innovative knowledge-based ‘start-up’ companies. Additionally, CSEF may offer new financing opportunities for companies operating in the not-for-profit, community interest and philanthropic sectors.

Internationally, CSEF is receiving increasing attention as an alternative form of corporate fundraising for start-up or other small to medium companies. To date, some jurisdictions, including the United States, Italy, the UK and New Zealand, have enacted legislation or introduced administrative policy dealing with CSEF (though the US legislation is not yet in force), while some other jurisdictions, including Canada, are giving consideration to this form of fundraising. CSEF regulatory initiatives are also under way in other countries, including, for instance, France, Israel, Japan and Korea,[87] as an alternative to the traditional rules regarding the public offer of securities in start-up or other small enterprises.

Concept of equity

Strictly speaking, the term 'equity' refers to shareholding in a company. However, CSEF broadly covers any means of raising capital through offering debt or equity interests in the business. The concept of securities in the Australian legislation, in its broadest application, covers financial investment in the form of shares or debentures[88] in a company or interests in a managed investment scheme.[89] For ease of reference, this paper will use the term 'equity', but with this wider application to securities generally.

New type of fundraising market

The concept of CSEF, like other forms of crowd sourced funding, is a product of the internet and social media, which give potential investors access to investment opportunities of which they would not previously have been aware, and gives issuers access to investors that they would not previously have been able to reach. If regulatory concerns can be addressed, it is argued, CSEF is another channel by which to harness the interest of individuals in new projects and products, combined with the scale and momentum of the crowd.

A key element in the CSEF concept is that the funding process takes place through a regulated online platform or other intermediary. This enables the intermediary to control what capital raising opportunities are made available to issuers and what investment opportunities are made available to investors. In consequence, the CSEF concept could be described as a new form of public fundraising, of limited amounts for particular types of companies, with each intermediary acting as a form of 'exchange' and having the equivalent of 'listing' requirements for issuers, pursuant to any CSEF regulatory requirements.

Financing considerations

There is considerable interest globally in the potential for CSEF, seen as a new form of finance, to promote economic activity. There is a view that CSEF may help fill the demand for financing that banks and other financial institutions in various jurisdictions are no longer meeting, due to tighter credit requirements since the global financial crisis. By meeting this demand, it is argued, the additional funds that CSEF provides will assist in encouraging or increasing economic growth.

The counter view is that the tighter credit requirements that have been introduced are appropriate and should not be circumvented by riskier projects through CSEF, taking into account that investors in CSEF may not have the skills and experience, or access to information, properly to assess these risks.

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87 See, for instance, Hye-Hwal Seong, *Crowdfunding in Korea* at the University of California Berkeley Global Academic Crowdfunding Symposium (October 2013); IOSCO, *Crowd-funding: An Infant Industry Growing Fast* (February 2014) Annex 1.

88 A complication for issuing debentures rather than shares is that debentures require a trust deed and trustee. See generally Chapter 2L of the Corporations Act, which regulates debentures.

89 Definition of 'securities' in s 92 of the Corporations Act.

A1.2.2 Impact of CSEF on the traditional business model

A start-up enterprise utilising CSEF (when and where permitted) as a funding mechanism may develop in a manner quite different from a business utilising traditional funding arrangements.

Traditionally, a business may begin by creating and promoting a product or service, funded through private investment (from, for instance, 'angel' investors[90] or other private equity) and/or loan arrangements with a financial institution, often backed by personal guarantees. Any offer of public equity involvement usually takes place only after there has been some indication that the product or service is, or will be, commercially viable.

By contrast, a business seeking to use CSEF may begin by advertising its product or service through the internet or social media, either as an idea only, or as a concept that has been established or proven to a certain stage but nevertheless requires development and scale-up. The controllers of the business will wait to see if that idea or concept is sufficiently well-received that sufficient investors are prepared to fund the target amount to create and market the product or service.[91] A possible risk for a business using this approach is that the idea or concept becomes public before the product is developed, thereby creating the opportunity for others to pre-empt the development and marketing of the product (subject to intellectual property rights).

On one view, CSEF reflects a new business model that is developing with the digital economy. This model helps address structural early failure that can arise under application of the traditional business model for businesses that lack either tangible initial capital or significant early revenue-flow. For this reason, it is argued, there is interest in CSEF as a potential additional mechanism to bring together early stage issuers and investors, to broaden the range of investment options, and to deepen the funding markets for these types of businesses. In turn, it is argued, this departure from the traditional business model may spur entrepreneurship and the types of high growth businesses that can make a positive contribution to employment and productivity growth.

Another view is that this reversal of the traditional business cycle, where public funding may be sought on the basis of future possibilities only, rather than on clear evidence of a viable business model in operation, increases the risk of failure and loss to equity investors through CSEF. The risk of failure is further increased by the fact that the funding is potentially by participants who do not have the skills and experience that private equity providers, banks or other financial institutions normally bring to bear when considering whether to provide funding to businesses under the traditional business model.

These issues concerning the application of the traditional business model may have less application for 'social enterprises' or other not-for- profit entities with public interest rather than commercial goals.

A1.2.3 The CSEF participants

Consideration of the position of the three classes of participants in CSEF, namely:

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90 An angel investor is typically an affluent individual who provides capital for start-up or emerging businesses, usually in exchange for equity in that business. In Australia, see, for instance, the Australian Association of Angel Investors.

91 See T Wong, 'Crowd funding: Regulating the new phenomenon' (2013) 31 *Companies and Securities Law Journal* 89 at 91.

- issuers
- intermediaries
- investors

raises general questions about the means of achieving a proper balance, in any future legislative or other initiative, between facilitation and regulation of this form of fundraising.

In considering the role of each of these participants, it is also necessary to be mindful that the regulator have sufficient powers to ensure the proper functioning of this form of fundraising.

Issuers

There are various reasons why issuers may seek to utilise CSEF.

For instance, CSEF, if facilitated, may provide a viable alternative source of capital for start-up or small companies that either have limited access to capital (without the expense of preparing a prospectus or other disclosure document) or have exhausted other available sources of capital. CSEF may be far less expensive than raising capital through private equity or debt arrangements, including ‘angel investors’, or pursuant to a public offer, accompanied by a prospectus.

CSEF may also be a means by which incorporated not-for-profit entities or ‘social enterprises’ can raise necessary capital for their co-operative, community benefit and other public interest projects, with investors focusing more on altruistic reasons or general benefits for providing funding, rather than any expectation of financial return to them.

CSEF, however, may not be appropriate for all issuers. Depending upon the type of corporate structure utilised, it is possible that CSEF may result in an issuer having a large number of shareholders, most with relatively small amounts of capital. This equity profile may impede or complicate any further financing options for the issuer. It may also result in increased regulatory compliance costs for the issuer (including information disclosure requirements to shareholders) and the potential for disputes between shareholders, as well as between shareholders and the issuer. On the other hand, having a large pool of small equity investors may facilitate a later substantive equity investor acquiring effective shareholder control at relatively low cost, which may or may not be in the interests of the other shareholders.[92]

A managerial challenge that issuers may face is how to most effectively utilise the funds raised through CSEF to implement their business plans. While this challenge is not peculiar to CSEF, lack of this managerial skill may be accentuated in some instances by the variance from the traditional business model. In consequence, even where funds raised through CSEF seem adequate to finance an otherwise worthwhile and potentially profitable venture, poor managerial decisions may undermine its viability and result in loss to investors.[93]

Intermediaries

In essence, CSEF intermediaries provide online platforms as a means by which issuers and potential investors may connect. Depending upon their own business models and how they

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92 In Australia, the shareholder protections in Chapter 6 of the Corporations Act, dealing with change of shareholder control transactions, are aimed at public companies, not proprietary companies: s 606.

93 See, for instance, in the context of crowd sourced funding generally, M Milian, ‘Kickstarter’s funded projects see some stumbles’, *Bloomberg* 22 August 2012.

are regulated, these platforms might be confined to merely matching services by providing a place where investors may 'meet' promising companies, whereas others might seek to be more active in promoting that interaction.

Regulatory regimes in some jurisdictions might treat a platform's activities as amounting to the operation of organized trading facilities or a financial market that may only be undertaken by authorised or registered/licensed entities, whereas other regimes may not.

There may also be some differentiation between platform providers as to how funds to be directed to issuers are to be held. For instance, some online platforms might arrange for direct involvement by investors in issuing companies, with each investor receiving and holding shares in that person's own name. However, offering equity directly to large numbers of investors can result in logistical challenges, as well as fundamentally increasing the number of small shareholders of a company. An alternative could be the 'club' investment model, whereby investments are pooled, with a collective vehicle, being the platform itself or some other party, holding the issuer's equity in its name, on behalf of the investors. In the Australian context, that club arrangement would constitute a managed investment scheme.

Another potential issue concerns the process of collecting and holding funds from investors. Regulatory possibilities range from the intermediary holding funds provided by investors on 'trust' until a target contribution level is reached, to intermediaries being obliged to pass all the money-handling functions to, say, independent agents licensed under appropriate legislation. An alternative is that investors only contribute once the target investment level is pledged, with funds then passing directly from the investors to the issuer, or to a designated third party, with no involvement by the intermediary.

To meet the obligations that may be associated with CSEF, as its manner of regulation develops, it is likely that each website operator facilitating CSEF would need to be an entity of substance. It is likely that each website operator would need to have adequate capital, human and technological resources to operate the website in a complying manner, including in regard to ensuring proper record keeping concerning each CSEF offer on its website.

Also, depending upon the applicable regulatory regime that is adopted for intermediaries, some of the risks that platform providers may face in facilitating CSEF could include:

- *reputational risk*: in the event of issuers using the website to defraud investors, or too many start-ups promoted on the website having defective business models leading to investment losses
- *regulatory risk*: due to non-compliance by the website operator with any applicable law
- *legal risk:* due to litigation by investors arguing that the website operator did not carry out reasonable due diligence on start-ups that failed or did not prevent its website from being used to carry out fraud.

Imposing an obligation on platform providers to make some basic background checks on issuers before including them on their websites could help guard against fraud.[94] Intermediaries could also be under an obligation to warn investors of the inherent risks

[94] While outside the scope of this review, intermediaries may be required to identify particular matters to AUSTRAC.

involved in CSEF. Intermediaries could also be required to test investor understanding of investment risks before allowing transactions to proceed.

There is also the issue of conflicts of interest to consider. In some instances, the intermediary's business model may simply link the return to the intermediary to the number of issuers that are posted on its website platform and/or the amount of investor funds that are raised. An intermediary may therefore be conflicted when assessing which issuers or projects should be allowed to raise funds through its website.

An alternative business model, with has less potential for conflict, may be one where the intermediary does detailed due diligence on applicant issuers, hosts only a relatively small number of these issuers on its website platform, and links its income to the longer-term commercial success of those issuers.[95]

Investors

While CSEF investment opportunities may be open to all investors, the most likely investor target group would be retail investors, who may have only limited discretionary funds available for investment.

Benefits

CSEF, if regulated appropriately, could enable investors to make relatively modest investments across a range of opportunities with relatively low transaction costs. This could be seen as the preferred investment approach in the corporate start-up market, given its high-risk/high reward nature, whereby maintaining a portfolio of investments can address the risk of an individual investment failing.

In this way, CSEF may enhance the opportunities for investors to obtain equity positions in particular start-up or other companies that eventually prove to be successful and profitable, with investors in these companies receiving financial returns in the form of dividends and/or capital growth in the value of their shares. Without CSEF, these companies may never have provided investment opportunities to investors generally, at least at the initial phase before any later move for their equity to be listed.

Risk of fraud

There are significant investor protection concerns associated with the concept of CSEF. They include the risk of fraudulent misuse by issuers of the funds received from investors, even where intermediaries operating online CSEF platforms undertake due diligence of issuers, particularly if issuers are not made fully accountable for the use of those funds.

There are similar fraud concerns in relation to the platform providers themselves, including the method of accounting for investor funds if intermediaries are permitted to collect and hold contributions before they are passed on to the issuer.

The problem of detecting fraud may be accentuated by the relatively low loss that might be suffered by many investors, individually, who may prefer to 'write off' the loss, rather than seek to have the conduct of the issuer or intermediary investigated. In this sense, there may be less self-policing of crowd sourced equity funded companies than of other companies, yet the potential for fraud may be the same.

A further obstacle to the detection of fraud would be any lack of transparency and reporting obligations on issuers in respect of the use of funds raised. It would make it harder for

[95] See, for instance, www.thecrowdcafe.com/due-diligence-dilemma.

investors in these circumstances to determine whether the failure of the enterprise was due to a poor business model or the misuse of funds by the issuer.

The risk of fraud also raises questions concerning the recovery rights that investors should have, and against whom, in the event that investors lose money through misappropriation.

Other risks

Apart from fraud, there are concerns that investors may not fully understand the risks associated with their CSEF investment.

There is normal business risk, namely that a project may fail because of an unsuitable business model or through an unanticipated change of external circumstances that undermines the viability of the project. This risk may be accentuated with start-up or small businesses, whether operating in Australia or in other jurisdictions, which are the entities most likely to utilise CSEF, if available. For instance, various studies referred to by the US Securities and Exchange Commission (SEC) have indicated a high failure rate in the USA with such businesses, including a study that indicated that of some 2,000 US companies which received at least $1 million in funding from venture capital in the period from 2004 to 2010, almost three-quarters of them failed. The SEC observed that:

> These failure rates are high, despite the involvement of sophisticated investors like [venture capitalists] that are likely better equipped than the average retail investor to deal with uncertainty and risk associated with investments in startups and that generally specialize in selecting firms with good prospects, have direct access to management, have board representation and have at least some degree of control over operating decisions.[96]

Furthermore, according to the SEC:

> Because we expect that issuers that would engage in offerings made in reliance on [CSEF] would potentially be in an earlier stage of business development than the businesses included in the above studies, we believe that issuers that engage in [CSEF] may have higher failure rates than those in the studies cited above.[97]

Another commentary refers to market intelligence indicating that there is a 50% chance of a start-up folding in the first 5 years of its existence.[98]

Other risks also apply, particularly in the context of CSEF. They include that:

- CSEF investments are likely to be offered by issuers who have found it difficult to raise capital through more traditional means, such as loans from financial institutions or from ‘angel’ investors. This difficulty may often be due to the high-risk nature of the business model and/or poor creditworthiness of the issuer. This means that CSEF investments may be inherently riskier than investments in start-ups generally, which, as indicated above, are already a high-risk form of investment. Investors therefore could lose all or most of their investment, even if the issuer is acting in complete good faith and in compliance with all disclosure and other legal requirements, given the high failure rate of start-up businesses generally and the possible variance from the traditional business model under CSEF

96 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) [17 CFR Parts 200, 227, 232, 239, 240 and 249; Release Nos. 33-9470; 34-70741; File No. S7-09-13, RIN 3235-AL37] at 335.

97 ibid.

98 IOSCO, *Crowd-funding: An Infant Industry Growing Fast* (February 2014) at 10.

- depending upon the applicable laws, CSEF offers may not have to undergo the same level of due diligence, and disclosure, as that involved in, say, a full prospectus-backed offer. These lower standards may also limit the rights of recourse by investors against the issuer or the internet intermediary

- equity in small start-ups funded through CSEF are quite likely to be very illiquid, with little or no secondary market in which to sell them, at least in the short/medium term. Investors may therefore find that they are unable to withdraw from the enterprise and recover even a part of their capital investment. Share-based investments may also generate no dividends for a long period of time, if at all. As observed in an IOSCO paper:

  > Generally, the only realistic chance an investor has of liquidating their holding in a start-up investment is if the company survives until a public float. But the probability to do this is not high given the high attrition rate among start-up companies.[99]

- in addition to the lack of liquidity, equity acquired through CSEF may be very difficult to value. The early stage of the businesses, the significant portion of the value being in intangible, the lack of equivalent transparency of public companies and the lack of any secondary market, present major difficulties to properly valuing that equity. In CSEF arrangements there would be no underwriter to value the offer (compared with prospectus-based offers) and the issuer may not be skilled in valuation. In this type of opaque and illiquid environment it may also be extremely difficult to determine whether the use of funds raised has been in the best interests of investors

- if further equity is issued by the issuer after a CSEF exercise is completed, any returns to existing investors may be materially diluted as well as reducing any market value of the shares.

The financial risks in CSEF may be accentuated for investors with relatively little capital wealth and lower incomes, who may therefore be particularly affected by having their investments in illiquid assets. It is likely, for instance, that younger investors may get drawn to CSEF simply because of its link to social media and the internet. These investors typically have less discretionary funds that they could afford to lose and less experience in assessing the viability of investments. This is especially so if they see CSEF as a substitute for more traditional liquid investments, such as exchange-traded securities.

There is also the problem that uninformed and commercially unsophisticated investors may act with a ‘herd mentality’ and, seeing that other people have invested, possibly reach the false conclusion that some reliable independent assessment of the viability of the issuer offering CSEF has been undertaken and that the investment is good value for money.

A well-run intermediary that exercises due diligence before hosting issuers on its online platform could, through this sifting process, provide some comfort to investors who may otherwise lack the confidence and depth of knowledge to invest. However, no amount of due diligence can provide any form of guarantee of the commercial success of an issuer.

A1.2.4 Public funding but private control

It is likely that the promoter of a start-up or other enterprise seeking capital for a project through CSEF will nevertheless seek to remain in control of the enterprise (on the argument that the promoter is the party with the ‘vision’ and the skills to make it successful) and may

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[99] id at 37.

want to receive a ‘premium’ from any profits generated (on the argument that this reflects the ‘financial value’ of the project idea, over and above the capital contributed from the public).

This outcome can be achieved through various means. For instance, in the Australian context, a promoter may establish a proprietary or public unlisted company as the issuer, with various classes of equity. The promoter may hold one class of equity in the issuer, with CSEF investors being offered interests in a different class of equity in the issuer.[100] The class of equity held by the promoter may have voting, dividend and/or other rights which are not available to the class of equity held by CSEF investors.[101] There is no equivalent in this situation of the one share one vote principle that applies to listed public companies.[102] The promoter may also set up favourable remuneration arrangements for managing the company, and entrenching those benefits through the class voting rights.[103]

This form of favourable arrangement for the promoter may not be possible where a promoter seeks capital from ‘angel’ or other private investors. In that situation, private investors may require that they (not the promoter) receive preferential share rights as a condition of providing the funds, including that they control remuneration arrangements for the promoter (and other corporate officers) of the issuer and can influence or determine the general direction of the business. These private investors may also seek to ensure that their rights cannot be diluted, even where the company seeks further financing.

There is no equivalent in CSEF of this negotiation process between issuers and private investors. Public investors may simply be offered an investment in a particular class of equity in the issuer. There is no obvious mechanism by which potential CSEF investors could collectively bargain with the promoter in the same way as private investors to achieve rights arising from their investment and to protect those rights from any attempted subsequent dilution.

This difference between private and public fundraising raises the question of achieving the proper balance in the CSEF context between rewarding the promoter of the project and rewarding the capital contributors. There is the possibility that a promoter, by holding a certain class of equity, as well as remaining in full control of the issuer, may also receive much of the funds contributed by CSEF investors (by way of the remuneration arrangements for managing the company) and be entitled to a disproportionate amount of any profit on the project. It is possible that public investors, with a different class of equity, may in some cases receive little tangible return, even when the project is commercially successful. Such an outcome may also reduce the value of the class of equity held by the public investors.

A1.2.5 Experience with CSEF

To date, there has been little experience internationally with CSEF. A number of initiatives are underway in some jurisdictions to facilitate CSEF through adjustment to their regulatory structures. However, no reliable data on the overall economic consequences of CSEF in

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100 This includes the situation where investors hold a beneficial interest in the class of equity in consequence of a managed investment scheme being interposed between the issuer and the investor: see Section 2.3.2 and Section A2.1.4 of this report.

101 The rights attached to the class of equity held by the promoter would be supported by the legislative controls under Part 2F.2 of the Corporations Act concerning variation of class rights.

102 ASX Listing Rule 6.9.

103 In regard to the process for establishing remuneration arrangements, see further Section 2.2.1 of the CAMAC report *Executive remuneration* (April 2011).

particular jurisdictions, or the cost/benefits of particular CSEF regulatory models, is as yet available. As observed in an IOSCO paper:

> There are very few equity crowd-funding platforms, with the majority focusing on angel investors or sophisticated investors due to regulatory requirements. There is no data on the overall market size or growth rates relating solely to equity crowd-funding due to so few platforms operating in this area.[104]

Furthermore, the likely level of investor participation in CSEF, being the key element on which the success of this form of fundraising for issuers depends, cannot yet be gauged.

The IOSCO paper concludes that CSEF does not pose an immediate systemic risk, though it does raise significant investor protection issues, particularly in relation to retail investors:

> Equity crowd-funding is a particularly small market. Though the risks posed by this industry are high, they are currently only posed to a few investors, most of whom are sophisticated investors due to the strong regulation surrounding the issuance of this type of equity. These investors should already understand this type of investment, and be able to absorb any losses. Problems could arise as this market opens up to retail investors. Small investors may lack the experience to deal with the problems associated with start-up companies or illiquid investments, creating a high risk of instability and raising investor protection issues. These risks could increase as the industry expands through the use of exemptions. Less disclosure of information by issuers could increase the risk of fraud. Currently the strict regulation surrounding this form of crowd-funding prevents the industry from posing a systemic risk and mitigates some of the investor protection issues. The industry also accounts for a tiny percentage of the overall issuance of equity.[105]

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[104] IOSCO, *Crowd-funding: An Infant Industry Growing Fast* (February 2014) at 36.
[105] id at 45.

Appendix 2 Australia

This Appendix outlines the current corporate fundraising regulatory structure as it applies to issuers, intermediaries and investors.

A2.1 Issuers

A2.1.1 Overview

The promoter of a particular project could set up a proprietary or public company[106] (the issuer) for that purpose, and with a view to investment opportunities in that project being publicised through one or more online intermediaries.

Investors could be offered equity in the issuer itself. However, as explained in this section, difficulties can arise if a CSEF mechanism is to be used for that purpose, including that the ability of a proprietary company to conduct any form of fundraising involving the public is very restricted.

An alternative approach would be to establish a managed investment scheme as an interposed legal structure between the issuer and the investor, with investors acquiring interests in the scheme rather than equity in the issuer, and their funds being channelled to the issuer under the terms of the scheme.

A2.1.2 The proprietary company structure

The benefit to the promoter of choosing to operate as a proprietary company is that, in general, this corporate structure is easier to administer, and involves significantly less compliance time and costs, than a public company.

For instance, a small proprietary company[107] has to prepare and distribute reports to shareholders only in limited circumstances, including at the direction of a threshold of its members.[108] A large proprietary company[109] has somewhat greater reporting requirements to shareholders.[110] However, neither form of proprietary company is subject to the same level of ongoing disclosure, financial control, reporting and other compliance requirements that apply to public companies (see below).

The legislative 'trade-off' for reduced compliance requirements are restrictions to ensure that the proprietary company structure is essentially used for private or 'closely held' shareholder arrangements, not involving public participation. The two principal restrictions to achieve this are:

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106 Any company other than a proprietary company must be a public company: see definition of 'public company' in s 9. This paper does not deal with whether further specific corporate forms should be introduced in some situations, such as the UK 'community interest company', designed for social enterprises seeking to use their profits and assets for the public good, or the comparable US 'benefit corporation'.

107 s 45A(2). This is a combined revenue/assets/number of employees test.

108 ss 292(2), (3), 293-294B.

109 s 45A(3)-(6). This is a combined revenue/assets/number of employees test.

110 s 292(1)(c).

- ***the shareholder cap****:* a proprietary company may have no more than 50 non-employee shareholders[111]
- ***the prohibition on public offers****:* a proprietary company is generally prohibited from engaging in any public offer of its equity or other securities.[112]

There are various exemptions from the prohibition on public offers, including the small-scale personal offers exemption (whereby an issuer may make a personal equity investment offer to investors, provided that no more than $2 million is raised in any 12 month period from no more than 20 Australian resident investors,[113] and any number of offshore investors[114]), though there is a ban on advertising small-scale personal offers.[115] Some relaxation of those constraints has been provided.[116] There are also exemptions for offers to sophisticated, experienced or professional investors,[117] overseas investors[118] and for large offers[119] (applicable to proprietary as well as public companies). However, none of these exemptions accommodate the type of fundraising involving potentially many investors which is contemplated by CSEF.

The consequence is that the shareholder cap and the prohibition on public offers curtail the capacity of issuers incorporated as proprietary companies to offer equity in their companies through online-based CSEF.

A2.1.3 The public company structure

The benefit to the promoter of choosing to operate as a public company is that there is no equivalent of the shareholder cap and prohibition on making public offers that apply to proprietary companies.

However, use of the unlisted[120] public company corporate structure is subject to:

- ***fundraising disclosure requirements****:* an obligation to provide a prospectus or offer information statement (OIS) when seeking funding through public offers of equity in the company, with the various exemptions (small-scale personal offers, offers to

111 s 113(1).
112 Under s 113(3), proprietary companies are prohibited from any activity that would require a prospectus or other disclosure to investors under Chapter 6D (Fundraising) of the Corporations Act. There are exceptions for an offer of shares to existing shareholders and employees of the company or of a subsidiary.
113 s 708(1)-(7). A personal offer is one that may only be accepted by the person to whom it is made, and is made to a person who is likely to be interested in the offer, having regard to a previous personal, professional or other relationship or a statement made that the person receiving the offer would be interested in an offer of that kind.
114 Under s 708(5)(b), in counting the issues and sales for the purposes of the small scale offerings under s 708, it is permitted to disregard offers that are not received in Australia. This means that in addition to the 20 personal offers, an issuer can issue securities to investors located offshore, though the issuer and the intermediary would need to meet the offshore jurisdiction's requirements for making offers in that jurisdiction.
115 s 734(1).
116 ASIC Class Order 02/273 *Business Introduction and Matching Services* permits up to $5m to be raised in some circumstances, with the restrictions on advertising a small-scale offer also being relaxed. However, the ceiling of 20 investors in any 12 month period remains.
117 The exemption applies to offers to a sophisticated investor (being an individual with net assets of at least $2.5 million or with a gross income for each of the last two financial years of at least $250,000: Corporations Regulations reg 6D.2.03), to offers through a financial services intermediary to an experienced investor, to a professional investor, or to a senior manager of the company: s 708(8)-(12).
118 This is the effect of s 708(5)(b).
119 The exemption applies where the minimum amount payable on the securities by the person to whom the offer is made is at least $500,000: s 708(8)(a), (b).
120 Listed public companies are not the types of entities that are likely to utilise CSEF, given that they are already sufficiently established to satisfy the listing requirements and their other options to raise funds (including through new or pro rata rights issues, employee share purchase and dividend reinvestment plans and securities placements to institutional or sophisticated investors). Listed public companies will not be further considered in this paper.

sophisticated investors and large offers) not sufficing for the size and type of target audience typically contemplated under CSEF

- ***compliance requirements****:* the ongoing corporate governance and financial reporting requirements for public companies, extend well beyond those applicable to proprietary companies.

Fundraising disclosure requirements

An unlisted public company could offer its equity through CSEF by publication of an OIS if the amount of capital to be raised by issuing the equity, when added to all amounts previously raised by the body or other related bodies, does not exceed $10 million.[121] The prescribed content of an OIS, while significantly less than for a prospectus (see below), includes a requirement for an audited, up to date financial report, which may be a principal reason for the limited use of OISs.[122]

In other circumstances, an unlisted public company could offer its equity through CSEF by publication of a prospectus.

A prospectus is a disclosure document, to be prepared by the equity issuer,[123] and setting out detailed information about the issuer and the equity being issued. The rationale behind the requirement for a prospectus, or OIS, is that shares, have no inherent value but are dependent on their capital, dividend and other rights, which in turn are dependent on the value and viability of the company.

The disclosure requirements for a full or short-form prospectus[124] include information that investors reasonably require to make an investment decision, on the basis of an informed assessment about:

- the rights and liabilities attaching to the securities offered, and

- the assets, liabilities, financial position and performance, profits and losses and prospects of the company issuing the securities.[125]

This information is required to the extent that 'a person whose knowledge is relevant' either knew the information or in the circumstances ought reasonably to have obtained the information by making enquiries.[126]

This general disclosure test is in broad, non-prescriptive terms. In consequence, larger entities with complex, established businesses will generally need to provide quite extensive information. However, the test has the benefit of being flexible. A start-up entity with a simple business model may have less information to disclose and could prepare a prospectus relatively easily and inexpensively.

121 s 709(4).
122 s 715.
123 s 700(2),(3).
124 ss 710-713.
125 s 710(1).
126 The concept of 'a person whose knowledge is relevant' includes: the person making the offer, the directors of the offeror, any underwriter named in the disclosure document, any persons named in the prospectus with their consent as having performed a particular professional or advisory function and any person named in the prospectus as a financial services licensee involved in the offer: s 710(3).

ASIC may also approve the use of a profile statement, provided it states that the recipient of the statement is entitled to a copy of the prospectus.[127] In practice, profile statements are rarely used.

To better ensure the reliability of the information in a prospectus or OIS document, various parties may be subject to civil or criminal liability if that document contains a materially misleading statement or omission.[128] A number of defences apply, including due diligence in preparing a prospectus.[129] An issuer is also obliged to give prospective investors additional disclosure if the original document was misleading or a new circumstance arises that would have required disclosure at the time of the original disclosure document.[130] Various parties also have an ongoing obligation during the offer period to notify the company making the offer if they become aware that the disclosure is defective.[131]

The operator of a CSEF website acting only as an intermediary would be subject to liability for a defective disclosure document only if it was involved in the contravention.

The disclosure document, whether a prospectus or a product disclosure statement, can be provided electronically in compliance with the Corporations Act. Electronic disclosure through the internet or other electronic distribution channels of disclosure documents would be appropriate for CSEF.[132]

Compliance requirements

A range of general compliance obligations apply to public companies, given that they may involve public participation. These obligations cover various matters, including:

- mandatory opening hours for the registered office of the company[133]
- related party transactions[134]
- annual general meetings[135]
- financial and other reporting[136]
- appointment of an auditor[137]
- continuous disclosure for a public company that is a disclosing entity[138]

127 ss 709(2), (3), 714.
128 ss 728, 729.
129 s 731. Other defences are found in ss 732, 733.
130 s 724(1)(c), (d). If a misstatement or omission is material, the company must generally give investors corrective disclosure and 1 month to request a refund: s 724(2).
131 s 730.
132 ASIC Regulatory Guide 107, *Fundraising: Facilitating electronic offers of securities.*
133 s 145.
134 s 207.
135 s 250N.
136 Under Part 2M.3 of the Corporations Act, various types of public companies are subject to periodic reporting obligations, including to prepare and lodge audited financial statements.
137 s 327A.
138 Unlisted companies that have raised funds from at least 100 persons using a disclosure document lodged with ASIC under Chapter 6D of the Corporations Act are disclosing entities: ss 111AC(1), 111AF. These disclosing entities have continuous disclosure obligations, concerning information that reasonably would have a material effect on the price or value of the company's securities. These entities must lodge their continuous disclosure announcements with ASIC or on their websites: s 675, ASIC Regulatory Guide 198 *Unlisted disclosing entities: Continuous disclosure obligations*. There are no equivalent disclosure obligations for proprietary companies.

- change of shareholder control situations.[139]

A2.1.4 The managed investment scheme structure

Possible arrangements

As an alternative to investors being offered the opportunity to acquire equity in their issuer in own name, they could be invited to buy interests[140] in a managed investment scheme, which would acquire those securities. The scheme, in effect, would be an interposed legal arrangement between the issuer and the investor.

Under one approach, the responsible entity (RE) of the scheme would use the funds raised from the investors to acquire either equity in a particular issuer, with the acquired equity being scheme property and therefore being held by the RE on trust for the investors who are scheme members.[141] Under a loan arrangement, the issuer would pay interest (and capital repayments) to the RE, for distribution to the investors. Under a share arrangement, the issuer would pay dividends to the RE, for distribution to the investors.

Under another approach, a scheme could be structured so that investors can elect which from a number of projects they want to support. They would then acquire a specific class of interests in the scheme for each project or enterprise chosen. Again, all equity acquired would be held by the RE, on trust for the investors who are scheme members.

A benefit to an issuer of CSEF under a managed investment scheme arrangement is that an issuer incorporated as a proprietary company could receive investor funds, but without the shareholder cap problem that would arise if investors themselves could acquire equity in the company in their own name. Also, as the scheme (not the proprietary company) would be making offers to investors of interests in the scheme, the prohibition on proprietary companies making public offers of their own securities would not apply.

Likewise, this arrangement would allow an issuer that is a public company to have fewer shareholders, given that all equity acquired under the investor pooling arrangement would be held by the RE.

Whether a managed investment scheme arrangement would be attractive to investors is another matter, given its interposition between themselves and the issuer. It is unlikely to give investors the same philanthropic or proprietary sense they may have from holding equity in the issuer in their own right. It may also not suit investors who wish to play a more active role through the exercise of shareholding rights.

Licensing requirements

A managed investment scheme that requires registration (such as one which has many public investors through the operation of CSEF) cannot operate without an RE, which must be a public company that holds an Australian Financial Services Licence permitting it to operate the scheme.[142] Obligations are imposed on REs through this licensing system, including that an RE has available adequate financial, human and technical resources, adequate risk management systems and an internal dispute resolution process, is a member of an external

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[139] By virtue of s 606(1)(a)(ii), an unlisted company with more than 50 members comes within the application of Chapter 6 (Takeovers) of the Corporations Act.

[140] See s 9 definition of 'interest' in a managed investment scheme.

[141] s 601FC(2).

[142] s 601FA. The general obligations of licensees are set out in s 912A.

dispute resolution scheme (e.g. Financial Ombudsman Services) and has professional indemnity insurance to provide the financial services covered by their licence.[143]

Disclosure requirements

In principle, CSEF investors should be given accurate and reliable information about the issuer in which they will have an economic interest. This principle should apply whether the investor is to hold legal title to equity in an issuer that is a public company or alternatively is to hold a beneficial interest through a managed investment scheme arrangement that pools investor funds to acquire that equity.

As indicated above, any prospectus or OIS that investors would receive if they directly acquired equity in a public company would have to be prepared by the issuer, with liability for misstatements attaching to the issuer and others referred to in those documents.

However, under a managed investment scheme arrangement, it is the RE of the scheme (or other operator if the scheme is not a registered scheme, for example because it comes within an exemption), not the issuer, that has the legal obligation to prepare a Product Disclosure Statement (PDS) for investors.[144] That difference has the potential to reduce the level of disclosure, and therefore the protections, for investors.

A PDS prepared by an RE must contain any information of which the RE is aware that might reasonably be expected to have a material influence on the decision of a reasonable retail client whether to acquire the interest in the scheme, assuming that the scheme is not a simple managed investment scheme.[145] An RE that refers in its PDS to particular equity as an investment that it will make would have to know some information about that equity, in light of the RE’s general duty of care and diligence, which would apply when making investments.[146] However, this may not equate to having as much knowledge as the issuer would have.

Where the arrangement between the investor and the RE is that the investor is, or is entitled, to give an instruction that a particular financial product, or a financial product of a particular kind, is to be acquired, a PDS requirement on the part of the RE also applies.[147]

Compliance requirements

Under any managed investment scheme arrangement, the RE would be subject to initial and ongoing compliance requirements in operating the scheme.[148] The RE may charge costs for managing the scheme. The RE will also be responsible for the ongoing monitoring of the scheme’s investments in the equities of an issuer. The RE could take action as a substantial

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143 See ASIC Regulatory Guide 166 *Licensing: Financial requirements*, Pro Forma 209 *Australian financial services licence conditions* (PF 209). The aim is to ensure that REs have adequate resources to meet operating costs and there is an appropriate alignment with the interests of scheme members.

144 By virtue of s 700(1), which refers to the definition of security in s 761A, an interest in a managed investment scheme would not be a security for the purpose of attracting Chapter 6D, and therefore offers of such interests would not attract the prospectus/OIS obligations in this Chapter that apply to offers of securities in public companies. Instead, by virtue of s 764A(1)(b), an interest in a managed investment scheme is a ‘financial product’ for the purposes of Chapter 7 of the Corporations Act, with the disclosure requirements to be provided in the form of a Product Disclosure Statement (PDS) pursuant to Part 7.9 of the Corporations Act. The obligation on the RE to issue a PDS is set out in s 1012B.

145 ss 1013D, 1013E.

146 s 601FC.

147 s 1012IA.

148 Principally found in the Chapter 5C of the Corporations Act.

shareholder in the issuer if the RE considers that the management of the issuer is not properly considering the interests of the shareholders.

A2.2 Intermediaries

Operators of CSEF websites may need to be licensed in order to provide platforms for this form of fundraising. There are also various other legal implications that may arise.

A2.2.1 Australian Market Licence

The operator of a website where CSEF offers or invitations to acquire financial products (a share or debt security or an interest in a scheme[149]) are regularly made may come within the concept of conducting a financial market,[150] and thereby may require an Australian market licence (AML), issued by the Minister on the advice of ASIC.[151]

Generally, to obtain an AML, the website operator would need to demonstrate that it has sufficient resources (including financial, technological and human resources) and adequate other arrangements (including arrangements for handling of conflicts of interest involving the licensee) to ensure, to the extent that it is reasonably practicable to do so, that the market it operates is fair, orderly and transparent.[152]

If an AML was required, it would need to be appropriately tailored and flexible to suit the nature of the market being operated. Under the current regime, domestic market licensees are subject to a range of material regulatory costs and requirements that include ASIC Market Integrity Rules, ASIC supervision and a cost recovery regime, annual assessments and Ministerial disallowance on operating rule changes.

The holder of an AML is also subject to the to the consumer protection provisions in Part 2 Division 2 of the ASIC Act,[153] including in regard to advertising.[154]

A2.2.2 Australian Financial Services Licence

But even where an AML is not required, due to the intermediary arranging its business in such a way that it is not a facility through which offers or invitations are regularly made, then it is more likely than not that an intermediary would be carrying on a financial services business[155] and thereby need an Australian Financial Services Licence (AFSL), issued by ASIC.[156] Conversely, an intermediary that is the holder of an AML would not also need an AFSL.[157]

Generally, to obtain an AFSL, the website operator would need to demonstrate that it has adequate capital, human and technological resources as well as an adequate risk

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149 s 764A.
150 s 767A.
151 s 791A.
152 s 792A. See also ss 792B-792F, 792I. See also ASIC Regulatory Guide 172 *Australian market licences: Australian operators*.
153 Operating a financial market is treated as a financial service: s 12BAB(1)(f) of the ASIC Act.
154 ASIC Regulatory Guide 234 *Advertising financial products and services (including credit): Good practice guidance*.
155 A financial services business is defined in s 761A to mean the business of providing financial services. The various ways in which a person provides a financial service are defined in s 766A.
156 s 911A.
157 s 911A(2)(d).

management system to provide the financial services in a compliant manner.[158] Human and technological resources include demonstrating competency, relevant skills and experience required to provide the relevant financial services.[159]

The holder of an AFSL is subject to various licensing obligations, including, to do all things necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly.[160]

An AFSL licensee operating a CSEF website would also have to provide retail clients with a Financial Services Guide explaining its role and how it is remunerated by the equity fundraisers.[161] The guide sets out generally information about the licensee's services, how the licensee is remunerated and key relationships with other entities that may influence the licensee in providing its services.

The licensee is also subject to the consumer protection provisions in Part 2 Division 2 of the ASIC Act, including in regard to advertising.[162] The licensee will also need to have an internal dispute resolution process and be a member of an external resolution body, such as the Financial Ombudsman Service, to deal with any complaints about activities undertaken as a licensee.[163]

A2.2.3 Acting as a promoter

In some circumstances, the Australian operator of a CSEF website might come within the definition of a 'promoter'[164] of a company seeking equity funding through that website. This has various consequences, including a requirement that any prospectus for the company set out details of any benefits to that promoter.[165]

A2.2.4 Restrictions on advertising

There are also restrictions on advertising equity offers that require a disclosure document. For instance, a person must not advertise an offer that needs a disclosure document or publish a statement that directly or indirectly refers to that offer or is reasonably likely to induce people to apply for the securities.[166] Once a disclosure document has been lodged, however, the restriction is relaxed if the advertisement contains certain information about the disclosure document and application process.[167]

These restrictions on advertising would apply to a CSEF website.

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158 ss 912A(1)(d), (h), 913B.

159 ASIC Regulatory Guide 105 *Licensing: Organisational competence*. See also ASIC Regulatory Guide 104 *Licensing: Meeting the general obligations* at RG 104.84-RG 104.96, AFS Licensing Kit Parts 1, 2 and 3 (RG 1-RG 3).

160 s 912A(1)(a).

161 Part 7.7 Div 2.

162 ASIC Regulatory Guide 234 *Advertising financial products and services (including credit): Good practice guidance*.

163 ASIC Regulatory Guide 165 *Licensing: Internal and external dispute resolution*.

164 s 711(2)-(4). ASIC Regulatory Guide 228 *Prospectuses: Effective disclosure for retail investors* (at RG 228.122) provides some guidance on the concept of 'promoter' of a company.

165 s 711(3), (4).

166 s 734(2).

167 s 734(6).

A2.3 Investors

There is the potential under CSEF for investors to be offered a range of 'equity' interests in issuers, with differing sets of rights.

A2.3.1 Differences between share and debt securities

As previously indicated, while, for ease of reference, the term 'equity' is generally used in this paper, CSEF can cover acquiring share or debt securities in a company.

There are some key differences between these two types of securities in a company:

- ***participation in the company***: shareholders and creditors have different voting rights, with shareholders, but not creditors, being able to vote on various corporate governance matters, while creditors, but not shareholders, have voting rights in various forms of external administration

- ***return on the investment:*** creditors will typically have contractual rights to interest on the debt and repayment of capital, whereas there are restrictions on the circumstances where shareholders may receive dividends on shares[168]

- ***repayment of the capital*:** creditors have priority over shareholders in the event of the liquidation of a company, though if a company in liquidation is solvent, shareholders will receive any surplus residual funds after all capital has been repaid. Prior to any liquidation, shareholders may receive back some or all of their capital in only limited situations.[169]

A2.3.2 Legal and beneficial interest in shares

Investors who acquire an interest in the shares of a company may do so in either of two forms:

- ***legal interest in shares*:** where investors are registered as the shareholders

- ***beneficial interest in shares*** where the funds of investors are pooled in a managed investment scheme to acquire shares in a company, with the shares becoming scheme property and held by the responsible entity of the scheme on trust for the investors.[170]

Investors with a legal interest in shares may have corporate governance and other rights as shareholders, including participation and voting rights on resolutions at company meetings. By contrast, investors with a beneficial interest in shares would have rights pursuant to the provisions governing managed investment schemes[171] and the constitutions of those schemes.

A2.3.3 Classes of shares

As previously indicated (Section A1.2.4), an issuer may have a number of classes of shares, with different voting, dividend and other rights attached to each class. In some cases the

168 s 254T.
169 Apart from selling shares to any available purchaser, a shareholder may receive back all or some of the capital contributed in limited situations, such as through any corporate reduction of capital or buy-back (Chapter 2J of the Corporations Act) or shareholder scheme of arrangement (Part 5.1 of the Corporations Act).
170 s 601FC(2).
171 Principally Chapter 5C of the Corporations Act.

offer to CSEF investors may involve a class of shares with inferior rights to a class of shares held, say, by the promoter of the project.

On one view, potential CSEF investors should be provided with full disclosure of any share class arrangements of an issuer, and their legal and financial implications, in simple clear language, and in a format enabling comparisons between issuers.

Beyond that, the question remains whether disclosure alone, combined with various shareholder remedies,[172] would suffice, thereafter leaving it to the 'market' to evaluate the possible consequences of the equity arrangements of issuers and their implication for investing in those issuers.

[172] In the Australian context, see, for instance the oppression remedy and the derivative action remedy, set out in Part 2F.1 and Part 2F.1A of the Corporations Act. See also R Turner, 'Directors' fiduciary duties and oppression in closely-held corporations' (2013) 31 *Company & Securities Law Journal* 278.

Appendix 3 United States and Canada

This Appendix outlines and compares the approaches taken in the USA and Canada to CSEF.

A3.1 Overview

A3.1.1 United States

Crowd sourced funding is rapidly developing in the USA. However, until recently this method of fundraising has not included any form of CSEF, given the legislative restrictions and controls that applied to offering corporate equity to the public.

The Jumpstart our Business Startups (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 Act has a number of chapters or parts ('Titles'), two of which are relevant to CSEF.

Title II of the JOBS Act: Access to capital for job creators

Title II of the JOBS Act deals with equity offers to wealthier investors. Pursuant to Rules under that Title, published by the Securities and Exchange Commission (SEC) in July 2013 and in effect from September 2013, US entrepreneurs may publicly advertise and market their company's investment opportunity, of whatever size, to 'accredited investors' (in effect, individuals with over $1 million in liquid net worth or annual incomes over $200,000[173]), including through the internet or social media, as well as through print, radio or television. Previously, there was a ban on 'general solicitation' or 'general advertising', of investment in securities, other than a prospectus-based offer, with offers to particular investors being done in private.

The July 2013 SEC Rules pursuant to Title II permit general solicitation in offers made to accredited investors, provided that issuers of these securities 'take reasonable steps to verify' that all purchasers of the offered securities are accredited. The rules specify both a principles-based approach to satisfy the verification requirement, and a non-exclusive list of methods that issuers may use to satisfy the verification requirement as it applies to natural persons.

The coming into force of Title II of the JOBS Act is therefore a limited form of CSEF, in that more potential investors who satisfy the tests of being 'accredited' may become aware of investment opportunities through online and other means, and issuers may therefore have access to a greater range of funding sources.

Title III of the JOBS Act: Crowdfunding

Title III of the JOBS Act deals with CSEF offers to investors generally. It is intended to allow a start-up or other company to use an online intermediary as the means to conduct offers to investors to obtain modest amounts of equity capital. Under Title III, qualifying

173 Accredited investors include natural persons with individual net worth, or joint net worth with their spouse, that exceeds $1 million; or natural persons with income exceeding $200,000 in each of the two most recent years, or joint income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year.

CSEF transactions will be exempt from the registration and prospectus delivery requirements of the US Securities Act. Title III applies to all investors, including investors of modest means (as well as accredited investors), thereby giving smaller investors a greater range of investment options. As observed by the SEC:

> To the extent that crowdfunding rules are successfully utilized, the crowdfunding provisions of the JOBS Act should provide startups and small businesses with the means to raise relatively modest amounts of capital, from a broad cross section of potential investors, through securities offerings that are exempt from registration under the Securities Act. They also should permit small investors to participate in a wider range of securities offerings than may be available currently.[174]

Also:

> the availability of securities-based crowdfunding as a financing option could increase competition among suppliers of capital, resulting in a potentially lower cost of capital for all issuers, including those that choose not to use securities-based crowdfunding.[175]

CSEF under Title III of the JOBS Act is subject to:

- the provisions in the Act (which amends relevant provisions of the US Securities Act of 1933)
- the SEC Rules. The SEC published proposed rules in October 2013, with requests for comment. In putting forward these proposed rules, the SEC observed that:

> Rules that are unduly burdensome could discourage participation in crowdfunding. Rules that are too permissive, however, may increase the risks for individual investors, thereby undermining the facilitation of capital raising for startups and small businesses.[176]

In the same vein, the SEC has commented that:

> for crowdfunding to have a positive impact on the small business funding problem, it must work for both issuers and investors. In particular, it is vitally important that investors have confidence in the crowdfunding process—or they will stay away.[177]

Also:

> [Any] problems that arise from the actions of crowdfunding issuers or [intermediary] portals could generally affect investor confidence in the capital markets and have an adverse effect on capital formation.[178]

Settlement of the SEC Rules is a prerequisite to permitting CSEF under Title III.

The elements of Title III, and the proposed SEC Rules, as they apply to issuers, intermediaries and investors, are set out in the following sections of this Appendix.

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174 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) [17 CFR Parts 200, 227, 232, 239, 240 and 249; Release Nos. 33-9470; 34-70741; File No. S7-09-13; RIN 3235-AL37] at 344.

175 id at 347.

176 id at 13.

177 SEC Commissioner LA Aguilar, *Harnessing the Internet to Promote Access to Capital for Small Businesses, While Protecting the Interests of Investors* (Washington, D.C. 23 October 2013).

178 ibid.

A3.1.2 Canada

The Ontario Securities Commission (OSC) Staff Consultation Paper 45-710 *Considerations for new capital raising prospectus exemptions* (December 2012) included (in Appendix A) the elements of a possible CSEF exemption from the prospectus provisions, to facilitate capital raising for business enterprises.

The Consultation Paper made clear that its proposals had been put forward for discussion only, and did not necessarily mean that a CSEF exemption would be introduced in that, or any other, form.

In August 2013, the OSC released the follow-up OSC Notice *Progress report on review of prospectus exemptions to facilitate capital raising* (the August 2013 Paper), which included further consideration of the CSEF proposals in its December 2012 Consultation Paper.

The August 2013 Paper indicated that work on a possible CSEF regulatory framework for Canada is continuing. In that context, the Paper stated:

> We are mindful of stakeholder concerns that if the costs associated with investor protection are excessive, crowdfunding may not be a cost-effective capital raising method. At the same time, the Investor Survey suggests that investors would be concerned about the risks of crowdfunding and might not be prepared to invest through crowdfunding if they do not think there are adequate protections in place.[179]

In December 2013, the OSC announced its intention to publish, in the first quarter of 2014, various new capital raising prospectus exemptions, including a crowdfunding exemption, together with a registration framework for online funding portals.[180]

In March 2014 the OSC published draft proposals for CSEF,[181] which would be an exemption from the prospectus requirements. The proposals have a 90-day public comment period (as required by law). The proposals would, subject to certain conditions, allow reporting issuers[182] and non-reporting issuers to raise money from the crowd by offering securities through online portals (intermediaries).

The proposals include draft provisions.[183]

The OSC commented that:

> In a relatively short period of time, crowdfunding has become an important new method of raising capital through the internet for a broad range of purposes. To date, it has been used to raise money for a specific project and does not generally involve the issuance of securities. However, in some foreign jurisdictions, crowdfunding is emerging as a way for businesses, particularly start-ups and SMEs, to raise capital through the issuance of securities.

179 at 29.

180 OSC News Release *OSC provides update on exempt market review, including its consideration of existing security holder exemption* 4 December 2013.

181 OSC *Introduction of proposed prospectus exemptions and proposed reports of exempt distribution in Ontario* (March 2014) (March 2014 OSC Paper). This document, which is a supplement to the OSC Bulletin (2014) 37 OSCB, deals with a range of prospectus-exemption matters, including CSEF. The details of the CSEF proposals are set out in *Appendix D: Crowdfunding*.

182 A reporting issuer is a company that has issued shares to the public and is subject to continuous disclosure requirements by one or more of the provincial securities commissions. The comparable entity in Australia is the ‘disclosing entity’.

183 The draft CSEF provisions are set out in Annex D-3 of Appendix D, and a Companion Policy is set out in Annex D-6 of Appendix D.

> We think that crowdfunding through an appropriately regulated crowdfunding portal can be a viable method for start-ups and SMEs to raise capital.[184]

The elements in the March 2014 proposals, as they apply to issuers, intermediaries and investors, are set out in the following sections of this Appendix. Each element can be compared with relevant provisions in Title III of the US JOBS Act.

A3.1.3 Comparison of US and Canadian approaches

To assist in comparing the approaches in the USA and Canada, this Appendix analyses the US and Canadian positions on a series of matters concerning:

- issuers (Section A3.2)
- intermediaries (Section A3.3), and
- investors (Section A3.4).

A3.2 Issuers

The US and Canadian approaches can be compared on a series of elements applicable to issuers:

(i) types of issuer

(ii) types of permitted securities

(iii) restriction to primary offers

(iv) maximum funds that an issuer may raise

(v) disclosure by the issuer to investors

(vi) prohibition on lending to investors (Canada only)

(vii) controls on advertising

(viii) conditions to complete the distribution (Canada only)

(ix) fees paid by issuers (Canada only)

(x) liability of issuers.

A3.2.1 United States

Set out below are relevant provisions in the JOBS Act and the draft SEC Rules (October 2013) as they apply to issuers.

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184 March 2014 OSC Paper at 15.

(i) Types of issuer

The enabling crowdfunding provisions of the JOBS Act apply only to US incorporated issuers. The provisions in the JOBS Act pre-empt regulation of these issuers by the laws of the various States of the USA in relation to the fundraising process.[185]

The JOBS Act excludes investment fund companies utilising CSEF to distribute their securities.

The SEC has also proposed to exclude a company that has no specific business plan or has indicated that its business plan is simply to engage in a merger or acquisition with an unidentified entity or entities:

> crowdfunding is a new and evolving method to raise money that serves as an alternative source of capital to support a wide range of ideas and ventures. We believe that the exemption under [Title III of the JOBS Act] is intended to provide an issuer with an early stage project, idea or business an opportunity to share it publicly with a wider range of potential investors. Those potential investors may then share information with each other about the early stage proposal and use that information to decide whether or not to provide funding based on the "wisdom of the crowd." Under such circumstances, this mechanism requires the public to have sufficient information about the issuer's proposal to discuss its merit and flaws. At the same time, an early stage proposal may not allow the crowdfunding mechanism to work appropriately if the issuer does not describe a specific project, idea, or business, or is seeking funding for unspecified corporate transactions. In such cases, individuals reviewing the proposal may not have sufficient information to formulate a considered view of the proposal, or the proposal may be less likely to attract enough perspectives to inform a crowd decision.[186]

(ii) Types of permitted securities

The JOBS Act provisions apply to equity or debt securities of the issuer.

(iii) Restriction to primary offers

The JOBS Act applies to distributions by an issuer of its own securities. It is not available as a means for existing security holders to on-sell their securities of an issuer.

(iv) Maximum funds that an issuer may raise

A company may raise no more than $1 million in a 12 month period through CSEF (that amount to be periodically adjusted based on the consumer price index).[187]

The SEC noted that:

> The limitation on the amount that may be raised could benefit investors by reducing the potential for dilution or fraud. However, we recognize that the cap on the maximum amount that may be sold … also could prevent certain issuers from raising all the capital they need to make their businesses viable.[188]

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185 S Hanks, 'Online capital-raising by small companies in the USA after the JOBS Act compared to the same process in the European Union' *Capital Markets Law Journal* Vol 8, No. 3 (2013) 261 at 266-267.

186 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 37.

187 s 4(6)(A) of the Securities Act of 1933. For periodic adjustment of the allowable maximum, see s 4A(h). Unless otherwise stated, references to US legislative provisions are to the Securities Act of 1933.

188 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 353.

Oversubscription: offering additional securities

The SEC favours an issuer being able to accept investments in excess of any target amount in an offer document, subject to the $1 million in 12 months limitation and certain conditions:

> We believe that permitting oversubscriptions would provide flexibility to issuers so that they can raise the amount of capital they deem necessary to finance their businesses. For example, permitting oversubscriptions would allow an issuer to raise more funds, while lowering compliance costs, if the issuer discovers during the offering process that there is greater investor interest in the offering than initially anticipated or if the cost of capital is lower than initially anticipated.[189]

(v) Disclosure by the issuer to investors

Issuers will be required to file with the SEC, and provide to investors,[190] through the intermediary, information such as:

- the name, legal status, physical address and website address of the issuer
- a description of the business and its anticipated business plan
- a description of the issuer's financial condition (including financial statements: see below)
- the names of officers and directors and persons with a shareholding of more than 20%. The SEC is proposing to require disclosure of the business experience of directors and officers of the issuer during the past three years[191]
- the stated purpose and intended use of proceeds
- the specified target offer amount and deadline to reach that target
- the price of the securities. The SEC proposes to permit issuers to alter the offer price during the course of the offer ('dynamic pricing'), given the cancellation rights of investors[192] (see further ***(iv) Cancellation rights*** in Section A3.4.1)
- a description of the ownership and capital structure of the issuer (which has a particular significance for the ongoing position of the CSEF investors in the company: see further ***(vi) Shareholder rights*** in Section A3.4.1), and
- such other information as the SEC prescribes by rule.[193] The SEC is proposing to require disclosure by the issuer of various matters, including the amount of compensation paid by the issuer to the intermediary for conducting the offer, any material factors that make an investment in the issuer speculative or risky and certain related-party transactions.[194]

The issuer must provide financial statements, certified by an officer of the issuer if the specified target offer amount is $100,000 or less, reviewed by an accountant if that amount is up to $500,000 and audited if that amount is over $500,000.[195] Companies could avoid

189 id at 376.
190 s 4A(a)(6).
191 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 45.
192 id at 119.
193 s 4A(b)(1).
194 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 58-59.
195 In more detail:

audit costs by limiting the size of their offers. The SEC is proposing that each issuer also provide a narrative discussion of its financial position.[196]

Issuers will be required to provide annual reports to investors on the results of operations and financial statements, containing such information as the SEC shall determine by rule, with such reports to be filed with the SEC.[197] The SEC proposes that issuers post the annual reports on their websites.[198]

Issuers will be required to comply with such other requirements as the SEC may, by rule, prescribe,[199] such as disclosure of the indebtedness of the issuer and any prior CSEF undertaken by the issuer:

> [the SEC is] proposing to require disclosure of any indebtedness of the issuer because we believe that servicing debt could place additional pressures on a company in the early stages of development and this information would be important to investors. The proposed rules also would require disclosure of any prior securities-based crowdfunding or other exempt offerings conducted within the past three years. In some cases, an issuer might have previously engaged in crowdfunding in reliance on [the Title III CSEF regulatory provisions] and may be returning for additional funding. We believe that it would be important to investors to know whether the prior securities-based crowdfunding or other offerings of securities were successful, and if so, the amount raised in these prior offerings.[200]

The SEC considered that the issuer disclosure requirements are necessary to ensure that investors are sufficiently informed:

> Small private businesses typically do not disclose information as frequently or as extensively as public companies, if at all. Moreover, unlike public companies, small private businesses are not required to hire an independent third party to validate the information disclosed. When information about a company is difficult to obtain or the quality of the information is uncertain, investors are at risk of making poorly-informed investment decisions regarding that company.
>
> Such information asymmetries might be especially acute in the securities-based crowdfunding market because the market includes startups and small businesses that have significant risk factors and that might have characteristics that have led them to be rejected by other potential funding sources, including banks, [venture capitalists], and angel investors. In addition, the securities-based crowdfunding market may attract unsophisticated retail investors who may not have the resources necessary to effectively monitor issuers.[201]

(i) for offerings that, together with all other CSEF offerings of the issuer within the preceding 12 months, total $100,000 or less, the issuer must provide:
 a) the income tax returns filed by the issuer for the most recently completed year, if any; and
 b) financial statements of the issuer, which must be certified by the principal executive officer of the issuer to be true and complete in all material respects (but which do not need to be audited);

(ii) for offerings that, together with all other CSEF offerings by the issuer within the preceding 12 months, total more than $100,000 but not more than $500,000, the issuer must provide financial statements reviewed (but not audited) by a public accountant who is independent of the issuer; or

(iii) for offerings that, together with all other CSEF offerings by the issuer within the preceding 12 months, total more than $500,000, audited financial statements are required.

196 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 66.
197 s 4A(b)(4).
198 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 94.
199 s 4A(b)(5).
200 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 362.
201 id at 359-360.

While supportive of disclosure, the SEC also noted that it could benefit competitors of an issuer:

> disclosure might have indirect costs to the extent that information disclosed by issuers relying on [the Title III CSEF provisions] could be used by their competitors. Requiring significant levels of disclosure at an early stage of an issuer's lifecycle might affect an issuer's competitive position and might limit the use of the [CSEF provisions] by issuers who are especially concerned with confidentiality.[202]

(vii) Controls on advertising

Issuers are prohibited from two forms of advertising or promotion of their offers:

- advertising the terms of the offer, except for providing a notice that directs investors to the intermediary platform for that information.[203] The SEC commented that this limitation:

  > is intended to direct investors to the intermediary's platform and to make investment decisions with access to the disclosures necessary for them to make informed investment decisions.[204]

- compensating any promoter of the securities, unless such compensation is fully disclosed in accordance with SEC Rules.[205] The SEC commented that:

  > Although the requirement [on issuers] to take steps to ensure disclosure of compensation paid to persons promoting the offering would impose compliance costs for issuers, we believe that investors would benefit from knowing if the investment they are considering and discussing with other potential investors is being touted by a promoter who is compensated by the issuer.[206]

The SEC has also taken the view that intermediaries should take certain steps to ensure that investors are made aware of promotional arrangements. For instance:

> under the proposed rules, the intermediary must require that any person posting a comment in the communication channels [of the intermediary's online platform] clearly disclose with each posting whether he or she is a founder or an employee of an issuer engaging in promotional activities on behalf of the issuer, or is otherwise compensated, whether in the past or prospectively, to promote the issuer's offering.[207]

(x) Liability of issuers

Misstatements

Issuers (and 'control persons' of the company including directors and principal officers) will be subject to liability for any misstatements they make. If the issuer:

- makes an untrue statement of a material fact or omits to state a material fact necessary to make its statements, in light of the circumstances in which they were made, not misleading, and

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202 id at 363.
203 s 4A(b)(2).
204 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 109.
205 s 4A(b)(3).
206 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 376.
207 id at 398.

- cannot sustain the burden of proof that it did not know, and, in the exercise of reasonable care, could not have known, of such untruth or omission

it must reimburse the purchase price of securities plus interest.[208]

Investment limits

There are limits on the amount of funds that each investor can contribute annually through CSEF (see Section A3.4.1).

The SEC has proposed allowing an issuer to rely on efforts that an intermediary takes to determine that an investor does not exceed the investor limits, provided that the issuer does not have knowledge that the investor had exceeded, or would exceed, the investor limits as a result of accepting the offer of the issuer.[209]

Banning and safe harbour

The SEC may ban persons from utilising CSEF to fund their projects on certain grounds, including non-compliance with regulatory requirements or fraudulent, manipulative or deceptive conduct.

The SEC is proposing to provide a safe harbour for issuers for certain insignificant deviations from regulatory requirements under the CSEF provisions, provided:

- the failure to comply was insignificant with respect to the offer as a whole
- the issuer made a good faith and reasonable attempt to comply with all applicable terms, conditions and other regulatory requirements, and
- the issuer did not know of the failure to comply, where that failure was the result of the failure of the intermediary.[210]

A3.2.2 Canada

Set out below are the CSEF proposals in the March 2014 OSC Paper as they apply to issuers.

In setting out a proposed regulatory framework for issuers (see below) the March 2014 OSC Paper also raised for comment the general question whether other requirements should be imposed on issuers to protect the interests of investors.[211]

(i) Types of issuer

Eligible issuers must be incorporated or organized in Canada, with their head offices situated in Canada and the majority of their directors must be Canadian residents. Reporting issuers[212] and non-reporting issuers are eligible to raise funds through CSEF, though some issuers are excluded, principally investment funds or issuers involved in 'blind pools'.[213]

In applying CSEF opportunities to reporting as well as non-reporting issuers, the OSC commented that:

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208 s 4A(c)(1), (2).
209 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 25.
210 id at 412-413.
211 March 2014 OSC Paper at 20.
212 A reporting issuer is a company that has issued shares to the public and is subject to continuous disclosure requirements by one or more of the provincial securities commissions. The comparable entity in Australia is the 'disclosing entity'.
213 Appendix D of the March 2014 OSC Paper at D-3 – D-6 and s 8 of Annex D-3 of Appendix D at D-49.

> As the overall goal of our crowdfunding initiative is to facilitate capital raising for start-ups and small and medium-sized enterprises (SMEs), we think the exemption should be available to both reporting issuers and non-reporting issuers.
>
> We have been advised that reporting issuers may wish to raise capital through crowdfunding, particularly venture issuers that may be experiencing difficulties in raising capital through more traditional means in the current economic environment.
>
> We support allowing reporting issuers to raise capital through crowdfunding as reporting issuers should not have fewer capital raising options than non-reporting issuers, particularly since reporting issuers have a continuous disclosure record and are subject to regulatory oversight.[214]

Situations that involve a 'blind pool' include where:

- an issuer does not have a written business plan setting out its business or proposed business, its goals or milestones and a plan for reaching those goals or milestones
- the proceeds of a distribution will be used primarily by the issuer to invest in, merge with or acquire another unspecified business.[215]

(ii) Types of permitted securities

Securities

Limited types of securities of the issuer can be offered under CSEF, principally:

- common shares
- non-convertible preference shares
- securities convertible into common shares or non-convertible preference shares
- non-convertible debt securities linked to a fixed or floating interest rate.[216]

All of the securities offered in a crowdfunding distribution must have the same price, terms and conditions.[217]

The OSC commented that:

> As the overall goal of our crowdfunding initiative is to facilitate capital raising by start-ups and SMEs, we do not think it is necessary or appropriate to allow complex securities, such as derivatives and securitized products, to be offered under the [CSEF provisions].[218]

Other rewards

An issuer can combine securities and non-securities rewards (including 'perks') in a crowdfunding offer, provided the offer document describes any non-securities rewards that are being offered and on what terms.[219] The OSC considered that this would enable the issuer to derive the benefits of both securities-based and non-securities-based crowdfunding:

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214 Appendix D at D-3.
215 Appendix D at D-5 and s 8(4) of Annex D-3 of Appendix D at D-49.
216 s 1(1) 'eligible securities' of Annex D-3 of Appendix D at D-44.
217 Appendix D at D-6 - D-7 and s 12 of Annex D-3 of Appendix D at D-50.
218 Appendix D at D-6.
219 Appendix D at D-14.

> Non-securities-based crowdfunding has been cited as contributing to consumer and investor loyalty, product development, and marketing. As a result, combining securities and non-securities rewards and perks in a crowdfunding offering may result in a better investment opportunity for investors without detracting from investor protection.[220]

(iii) Restriction to primary offers

Crowdfunding arrangements are limited to primary offers by an issuer of its own securities. They are not available as a means for existing security holders to on-sell their shares.[221]

The OSC commented that the CSEF provisions are intended to facilitate capital-raising by issuers and not the resale of securities.[222]

(iv) Maximum funds that an issuer may raise

Through CSEF

There is of $1.5 million limit on what any 'issuer group' may raise in any 12 month period. An issuer group includes the issuer, any affiliate of the issuer, and any other issuer that is engaged in a common enterprise with the issuer or with an affiliate of the issuer.[223]

As explained by the OSC:

> As the exemption is focused on financing for start-ups and SMEs, we think a distribution limit of $1.5 million is appropriate.[224]
>
> The imposition of the offering limit on the aggregate proceeds raised by the issuer group, rather than only by the issuer, is intended to prevent the $1.5 million offering limit from being circumvented.[225]

Through other means

During a CSEF offer period, an issuer can raise other funds under any other permissible exemptions from the Canadian prospectus requirements, such as the accredited (sophisticated) investor exemption. These funds can be additional to the $1.5 million CSEF limit.[226]

However, if an issuer distributes securities under other exemptions (such as the sophisticated investor exemption) during the period beginning at the commencement of the crowdfunding offer period and ending one month after the distribution date under that offer (the prescribed period), the securities sold under the other exemptions must have the same price, terms and conditions as those distributed under the crowdfunding offer.[227]

According to the OSC, this requirement:

> is intended to promote fairness to investors by prohibiting an issuer from offering securities during the prescribed period at different prices, or with different terms and conditions, than those being distributed under the [CSEF offer]. Limiting the prescribed period to one month following the distribution date is appropriate because once an issuer receives the funds, the value of the issuer or its operations could quickly change,

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220 ibid.
221 Appendix D at D-7.
222 ibid.
223 Appendix D at D-7 and s 7(b) of Annex D-3 of Appendix D at D-48.
224 Appendix D at D-7.
225 Appendix D at D-8.
226 Appendix D at D-13.
227 s 14 of Annex D-3 of Appendix D at D-50.

> thus justifying offering securities at different prices or with different terms and conditions than those that were distributed under the crowdfunding [offer].[228]

The intermediary conducting the CSEF offer cannot also act as the intermediary for these additional transactions, which must also be disclosed in the issuer's marketing materials to investors in the CSEF offer.[229]

(v) Disclosure by the issuer to investors

The OSC has observed that:

> For crowdfunding to be a viable method of raising capital, investors must be provided with appropriate information to make informed investment decisions without imposing excessive costs on issuers.[230]

The intention is that the disclosures in an issuer's 'crowdfunding offering document' should be streamlined and focus on material information that is relevant to the issuer's business and an investment in the securities offered.[231]

An issuer must make this document available to an investor through the intermediary portal before the investor enters into an agreement to purchase the security.[232] The issuer must also obtain a signed risk acknowledgement from the investor before entering into the agreement[233] (see further (iii) of Section A3.4.2 of this paper). The issuer must also provide a copy of the offer document to the regulator.[234]

The offer document must comprise 5 items, together with a certificate from the issuer that the offer document does not contain a misrepresentation.[235]

Item 1: Required statements

This involves:

- the risk warning to investors.[236]

Item 2: Financing facts

This involves:

- offering summary[237]
- description of securities offered and relevant rights[238]
- ability to resell securities[239]
- right of action for misrepresentation and right of withdrawal[240]

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228 Appendix D at D-14.
229 Appendix D at D-86.
230 Appendix D at D-21.
231 ibid.
232 s 7(f)(i) of Annex D-3 of Appendix D at D-48.
233 s 7(f)(ii) of Annex D-3 of Appendix D at D-48.
234 s 17 of Annex D-3 of Appendix D at D-51.
235 Appendix D at D-21 - D-22, s 15(1), (2) of Annex D-3 of Appendix D at D-50 – D-51 and Annex D-4 (D-65 – D- 77) of Appendix D.
236 Appendix D at D-67.
237 Appendix D at D-67 – D-68.
238 Appendix D at D-68 – D-69.
239 Appendix D at D-69. An issuer must disclose whether there is any market for the securities and the impact on an investor's ability to resell the securities.
240 Appendix D at D-69.

- concurrent offerings[241]
- use of proceeds[242]
- ability to achieve next milestone or business plan[243]
- other crowdfunding offerings[244]
- persons promoting and marketing the offering.[245]

Item 3: Issuer facts

This involves:

- business of the issuer[246]
- principal risks facing the business[247]
- financial information[248]
- ongoing information[249]
- mining issuer disclosure [relevant only to Canada][250]
- capital structure[251]
- executive officers, directors and other principals[252]
- management compensation[253]
- related party transactions[254]
- other relevant information.[255]

Item 4: Registrant facts

This involves:

- registered funding portal.[256]

Item 5: Contact information

This involves:

- contact information for the issuer[257]
- contact information for the registered intermediary.[258]

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241 Appendix D at D-70.
242 ibid.
243 ibid.
244 Appendix D at D-71.
245 ibid.
246 ibid.
247 Appendix D at D-71 – D-72.
248 Appendix D at D-72 – D-73.
249 Appendix D at D-73.
250 ibid.
251 ibid.
252 Appendix D at D-73 – D-74.
253 Appendix D at D-75.
254 ibid.
255 ibid.
256 Appendix D at D-76.
257 ibid.
258 Appendix D at D-77.

Certificate

This involves:

- statement of no misrepresentation.[259]

Various aspects of these disclosure requirements are outlined below.

Risk warning to investors

The issuer must provide a risk warning to investors, at the top of its crowdfunding offer document, indicating that:

- many start-ups and small businesses fail
- investors may not be able to resell their securities
- investors may receive limited ongoing information about the issuer's performance
- no securities regulatory authority has reviewed the CSEF offer.[260]

Business plan and risks

An issuer must disclose the nature of its existing or proposed business, its business plan, and the use of the proceeds of the distribution in furtherance of the business plan.[261]

As earlier indicated (see (i) ***Types of issuer***), there will be a prohibition on issuers making offers in 'blind pools', which includes arrangements where an issuer does not have a written business plan.

Offer size

An issuer's offer document for a crowdfunding distribution must disclose the minimum number or principal amount of securities being offered, and whether there is a maximum number or principal amount of securities being offered.[262]

Oversubscription: offering additional securities

An issuer will be permitted to offer more than the number of securities initially proposed to be offered in its offer document if it has disclosed the maximum number of securities that could be offered under CSEF and the use of the additional proceeds that would be raised.[263] However, the $1.5 million limit on the aggregate amount that can be raised under CSEF by the issuer group in a specified time period must be complied with.[264]

According to the OSC:

> This approach will allow an issuer to raise additional funds to allocate to the advancement of its business plan if there is strong investor interest in the offering, subject to the overall distribution limit of $1.5 million.[265]

259 Appendix D at D-77.
260 Appendix D at D-67.
261 Appendix D at D-5.
262 Appendix D at D-8.
263 Appendix D at D-9.
264 Appendix D at D-10.
265 Appendix D at D-9.

Length of time an offer can remain open

An issuer's offer document must disclose how long the offer will remain open, which cannot exceed 90 days.[266] If an issuer cannot complete a crowdfunding offer within 90 days, it must withdraw it.[267]

The OSC has taken the view that a 90 day limit on the length of time an offer can remain open will help to ensure that the information in the offer document does not become stale.[268]

The issuer can commence a new crowdfunding offer after the 90 day period. This right is particularly significant to the maximum funds that each investor can contribute through CSEF, given that the Canadian proposal is to impose a $2,500 investment ceiling for each offer, within a total $10,000 ceiling per year (see further Section A3.4.2).

Previous CSEF offers

An issuer making a CSEF offer must disclose all current, previously closed, and failed CSEF distributions by each issuer comprised in the issuer group.[269]

Securities holdings by principles in an issuer

The principals[270] of an issuer seeking to raise capital through CSEF are not required to invest their own money in the venture before making an offer to the public. However, an issuer must disclose:

- whether or not the principals own securities of the issuer
- if so, the number and type of the securities
- how much the principals paid for them
- whether or not the securities are subject to an escrow or hold period, and, if so, details of the escrow or hold period.[271]

The OSC considered that while there is a benefit in principals of a business investing their own money in the issuer, as this would align their interests with those of other investors in the issuer, this should not be a mandatory requirement:

> One of the principal purposes of [permitting CSEF] is to enable an entrepreneur to finance a start-up where he or she does not have the personal financial resources to do so.[272]

Rather, according to the OSC, disclosure would suffice:

> However, requiring an issuer to disclose whether or not the principals own securities of the issuer, the number and type of the securities, how much the principals paid for the securities, whether or not the securities are subject to an escrow or hold period and details of any escrow or hold period will help investors make informed investment decisions.[273]

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266 Definition of 'distribution period' in s 1(1) of Annex D-3 of Appendix D at D-44, and s 7(d) of Annex D-3 of Appendix D at D-48.

267 Appendix D at D-10.

268 ibid.

269 Appendix D at D-8.

270 Principals include directors and senior officers of the company, some promoters, and shareholders with at least 10% of the voting shares: see further Appendix D, Footnote 1 of D-11.

271 Appendix D at D-10.

272 ibid.

273 Appendix D at D-11.

Intended use of CSEF proceeds

The issuer must state how it intends to spend the net proceeds to be raised from a CSEF offer, including the principal purposes to which proceeds will be allocated, for both of the following circumstances:

(a) if the issuer raises the minimum funds to be raised in this offer, and

(b) if the issuer raises more than the minimum funds.

The issuer must also disclose if any of the following persons will receive any proceeds from the funds received through CSEF directly or indirectly and, if so, the amount each person will receive:

(a) any of executive officers, directors or founders of the issuer

(b) any person promoting or marketing the CSEF offer

(c) any person who owns 20% or more of the issuer's voting securities, or

(d) any other person that is a related party to the issuer.[274]

Ongoing disclosure

Reporting issuers that utilise CSEF must comply with all the ongoing reporting obligations of such entities, including the continuous disclosure obligations under Canadian securities law.

Non-reporting issuers are required to make available to their CSEF investors certain ongoing disclosures, including financial information and notices disclosing the use of CSEF proceeds. Notice of a prescribed event must be given to investors within 10 days of the occurrence of the event. Issuers may choose to make information available to investors in different ways, provided they take reasonable steps to ensure that all their investors receive or can access the documents.[275]

Financial information

An issuer must provide the following financial information:

- *if the issuer has not incurred any expenditures and its only asset is cash*: the amount of the issuer's cash, together with third party confirmation of cash held in a bank account or held in trust
- *if the issuer has incurred expenditures*: annual financial statements, to be audited if the issuer has achieved the financial threshold (see below) or to be reviewed by an independent public accounting firm if the issuer has not achieved the financial threshold.

An issuer achieves the financial threshold if, since its formation, it has raised more than $500,000 through CSEF or any other prospectus exemption and has expended more than $150,000.[276]

As summed up by the OSC:

274 Appendix D at D-70.
275 Appendix D at D-88.
276 March 2014 OSC Paper at 17 and Appendix D at D-28 and s 23 of Annex D-3 of Appendix D at D-53 – D-54.

> The most significant ongoing expenditure for non-reporting issuers would involve preparation of annual financial statements. Issuers would need to provide annual financials at point of sale if they have had incurred any expenditures and would have to provide them on an annual basis to investors. Annual financial statements would need to be reviewed by an independent public accounting firm. However, if the aggregate amount raised under [CSEF] and any other prospectus exemption is over $500,000 since the issuer's formation and the issuer has expended at least $150,000 since that time, then the annual financial statements would need to be audited.[277]

The March 2014 OSC Paper raises the questions whether these financial information reporting requirements (i) provide adequate protection to investors and (ii) are too costly for issuers:

> Would it be appropriate to require that all non-reporting issuers provide financial statements that are either audited or reviewed by an independent public accounting firm? Are financial statements without this level of assurance adequate for investors? Would an audit or review be too costly for non-reporting issuers?
>
> The proposed financial threshold to determine whether financial statements are required to be audited is based on the amount of capital raised by the issuer and the amount it has expended. Are these appropriate parameters on which to base the financial reporting requirements? Is the dollar amount specified for each parameter appropriate?[278]

Other information

Issuers must maintain certain books and records for various purposes, including to generate financial statements and to make various disclosures, including how the gross proceeds from a CSEF exercise have been expended by the issuer.[279]

The OSC observed that:

> it will be a novel approach in Canada to require that a non-reporting issuer provide ongoing disclosure. However, since the [CSEF provisions] will allow issuers to raise money from a large number of retail investors, we think that requiring certain limited ongoing disclosure is appropriate.[280]

(vi) Prohibition on lending to investors

Restrictions apply to an investors' ability to borrow money from or through certain parties to finance the purchase of securities through CSEF.

Under this approach, issuers (as well as intermediaries) and their respective directors and executive officers, must not lend or finance, or arrange lending or financing (for instance, from an affiliate), for an investor to purchase securities of the issuer through CSEF.[281]

This approach was seen as helping to address concerns associated with retail investors using leverage to invest through crowdfunding, though a possible further step of prohibiting a potential investor outright from borrowing money to finance the purchase of securities through CSEF was seen as overly intrusive and difficult to enforce.[282]

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277 March 2014 OSC Paper at 26.
278 at 20.
279 Appendix D at D-25 – D-27 and ss 24-27 of Annex D-3 of Appendix D at D-54 – D55.
280 Appendix D at D-25.
281 ss 10 and 45 of Annex D-3 of Appendix D at D-49 and D-60.
282 Appendix D at D-17.

(vii) Controls on advertising

The only materials that may be made available to potential investors in connection with a CSEF offer, in addition to the mandatory offer document, are:

- any document that is described in the offer document, such as the issuer's business plan or shareholders' agreements, and
- any term sheet or other summary, including a video, of the information that is included in the offer document.[283]

All offer materials must be made available to potential investors through the intermediary's website. The issuer must also provide a copy of these offer material to the regulator.[284]

An issuer (as well as an intermediary and any other person involved with a CSEF offer) may not advertise the offer or solicit potential investors.[285] However an issuer (as well as an intermediary and any other person involved with a CSEF offer) may advise potential investors that the issuer is proposing to make the offer and refer the potential investors to the website of the intermediary through which the offer is made.[286] This advice may be provided in paper format or through social media.[287]

(viii) Conditions to complete the distribution

A CSEF offer cannot be completed unless:

- the minimum amount of funds to be raised, as disclosed in the crowdfunding offer document (see above), has been subscribed for, and
- at the time of completion of the offer, the issuer has financial resources (which may include funds raised other than through CSEF) that are sufficient to achieve the next milestone set out in its written business plan, or if the issuer does not have any milestones set out in its written business plan, to carry out the activities set out in its written business plan.[288]

It is intended that these requirements:

> will provide an element of investor protection, as a purchaser will have some assurance that the issuer will raise a sufficient amount of proceeds to achieve the next milestone or activities set out in its written business plan. In addition, permitting the additional financial resources of the issuer to be included in the determination as to whether this requirement has been satisfied will permit an issuer to satisfy the requirement as quickly as possible.[289]

An intermediary must ensure that a crowdfunding offer is not completed until these conditions have been satisfied, through issuer confirmation.[290]

283 s 16(1) of Annex D-3 of Appendix D at D-51.
284 s 17 of Annex D-3 of Appendix D at D-51.
285 s 18(1) of Annex D-3 of Appendix D at D-51.
286 s 18(2)(b) of Annex D-3 of Appendix D at D-52.
287 Appendix D at D-87.
288 Appendix D at D-8 - D-9 and D-86, s 13(1) and (2) of Annex D-3 of Appendix D at D-50.
289 Appendix D at D-86.
290 Appendix D at D-9 and s 13(3) of Annex D-3 of Appendix D at D-50.

An issuer that distributes securities under a completed CSEF offer must file a report to the regulator within 10 days of completion of the distribution.[291]

(ix) Fees paid by issuers

An issuer will be prohibited from, directly or indirectly, paying a commission, finder's fee, referral fee or similar payment to any person in connection with any CSEF offer other than to the intermediary through which the offers are made.[292] According to the OSC, this prohibition does not apply to payments by issuers to persons as compensation for their services to an issuer in preparing materials in connection with a CSEF offer, such as accounting or legal fees.[293]

In the view of the OSC, these fee restrictions will mitigate potential conflicts of interest.[294]

(x) Liability of issuers

Certificate from the issuer

A crowdfunding offer document must contain a certificate, signed by various persons associated with the issuer, stating that the offer document does not contain a misrepresentation, and that investors have rights of action and withdrawal in the case of a misrepresentation.[295] This requirement is intended to make management and directors of the issuer accountable for the disclosure, while making investors aware of their rights of action.[296]

Also, if a certificate ceases to be true after it has been made available to a potential investor, the issuer is prohibited from accepting any offer from that investor to acquire securities until:

- an amended offer and certificate is published on the intermediary website and made available to the investor, and

- the investor reconfirms its offer to acquire securities, or does not withdraw its offer, to purchase the securities during the offer period.[297]

Liability for misrepresentation

The OSC considered it important for market confidence that investors have a contractual right to sue for misrepresentation. For this purpose, the issuer must provide a contractual right of action for rescission or damages to each investor and security holder in the event of a misrepresentation, subject to a due diligence defence and a defence that the investor knew of the misrepresentation.[298]

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[291] s 47 of Annex D-3 of Appendix D at D-61.
[292] s 19 of Annex D-3 of Appendix D at D-52.
[293] Appendix D at D-12.
[294] ibid.
[295] s 15(1)(b) of Annex D-3 of Appendix D at D-51, Appendix D at D-77. See also D-63 –D-64 concerning who is required to sign the certificate.
[296] Appendix D at D-20.
[297] s 15(3) of Annex D-3 of Appendix D at D-51.
[298] Appendix D at D-20 and s 22 of Annex D-3 of Appendix D at D-52 – D-53.

A3.3 Intermediaries

The US and Canadian approaches can be compared on a series of elements applicable to intermediaries:

(i) sole online only intermediary

(ii) permitted types of intermediary

(iii) matters related to issuers

(iv) matters related to investors.

A3.3.1 United States

Title III of the JOBS Act creates an entirely new type of regulated entity in the USA, the 'funding portal', and permits CSEF only through a funding portal or a registered broker–dealer.

The essential purpose of this channelling through the intermediary approach is twofold:

- **information:** to ensure that all potential investors have access to the same information, and in one location
- **risks:** to impose on intermediaries an obligation to conduct background checks of issuers to help guard against fraud and otherwise reduce risks to investors by ensuring that they are properly informed about the inherent risks of CSEF and do not exceed investment limits.

In that context, as noted by one SEC Commissioner:

> Under the proposed rules, the [CSEF] intermediary is required to keep an eye out for fraud and to have a reasonable basis for believing that the issuer has complied with the requirements of the exemption. The [CSEF] intermediary will also provide a forum for information sharing, with communications by an issuer or paid promoter clearly identified as such.[299]

One commentary, in supporting the approach in the JOBS Act that intermediaries provide to investors general disclosures related to the inherent risks involved in CSEF, observed that:

> Since the risks of crowd funding are universally very high, it makes sense to warn investors of this in the broader terms of an investment in the risky *market of crowd funding*, rather than in the narrower terms of an investment in a *particular crowd funding scheme*. In other words, a standard warning could be provided to investors, like this example from the United States, rather than requiring crowd funding schemes to expend significant resources and time to produce a 'bespoke' disclosure document, even before the scheme is allowed to advertise and test the marketability of its idea.[300]

Set out below are relevant provisions in the JOBS Act and the draft SEF Rules (October 2013) as they apply to intermediaries.

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299 SEC Commissioner LA Aguilar, *Harnessing the Internet to Promote Access to Capital for Small Businesses, While Protecting the Interests of Investors* (Washington, D.C. 23 October 2013).

300 T Wong, 'Crowd funding: Regulating the new phenomenon' (2013) 31 *Companies and Securities Law Journal* 89 at 104.

(i) Sole online only intermediary

A key underlying principle is that any offer to investors to take up securities in an issuer utilising these CSEF provisions must be conducted exclusively through a sole intermediary, operating online-only:

> a central tenet of the concept of crowdfunding is presenting members of the crowd with an idea or business so members of the crowd can share information and evaluate the idea or business. Allowing an issuer to conduct a single offering or simultaneous offerings in reliance on [Title III of the JOBS Act] through more than one intermediary would diminish the ability of the members of the crowd to effectively share information, because essentially, there would be multiple "crowds."[301]

Also:

> an "online-only" requirement enables the public to access offering information and share information publicly in a way that will allow members of the crowd to decide whether or not to participate in the offering and fund the business or idea … Offerings made by other means would not be widely accessible by the public, which would defeat the benefit of the collective wisdom of the members of the crowd.[302]

The proposed rules would require that a registered intermediary execute CSEF transactions only through its online platform. An intermediary or its associated persons would be prohibited from accepting an investment commitment until the investor has opened an account with the intermediary and the intermediary has obtained the investor's consent to electronic delivery of materials:

> This requirement would help ensure that certain basic information about the investor is on file with the intermediary and that all investors are on notice of the primary method of delivery for communications from the intermediary.[303]

The online platform requirement is intended to benefit both issuers and investors:

> This requirement should help issuers gain exposure to a wide range of potential investors, who also may benefit from having numerous investment opportunities aggregated in one place, resulting in lower search costs or burdens related to identifying suitable investment opportunities.[304]

(ii) Permitted types of intermediary

Registration requirement

CSEF offers must be conducted through an 'intermediary' that is registered with the SEC either as a broker-dealer or as a 'funding portal'.[305]

A funding portal will be required to have written policies and procedures reasonably designed to achieve compliance with its CSEF statutory obligations and SEC Rules,[306] as well as complying with anti-money laundering requirements. A funding portal must also maintain fidelity bond coverage, as some protection to CSEF investors from potential loss

301 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 30.
302 id at 31, 33.
303 id at 388.
304 id at 387.
305 ss 4(6)(C), 4A(a)(1). A funding portal must also be a member of a registered national securities association.
306 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 408-409.

through fraud.[307] Non-resident funding portals will be permitted provided that certain conditions are met.[308]

As explained by the SEC:

> The use of a registered intermediary to match issuers and investors would require that they incur certain transactions costs necessary to support the intermediation activity, but also would provide centralized venues for crowdfunding activities that should lower investor and issuer search costs.[309]

Issuers and investors may also benefit from competition between registered intermediaries:

> It also is likely that there will be significant developments in the types and ranges of crowdfunding products and services offered to potential issuers and investors, particularly as competitors learn from their experiences.[310]

Information collection

Intermediaries must collect and transmit CSEF transaction data to the SEC for administration and data analysis.[311] They must also maintain and preserve certain records relating to their business, including all records related to persons that use the communication services provided by a funding portal to promote an issuer's securities or to communicate with potential investors, as well as records of all CSEF agreements:

> We [the SEC] believe that it is important for funding portals to be subject to a recordkeeping requirement in order to create a meaningful audit trail of the crowdfunding transactions and communications.[312]

(iii) Matters related to issuers

Checks on issuers

Intermediaries must take such measures to reduce the risk of fraud as will be established by the SEC, including background and regulatory checks on directors, officers and significant shareholders of issuers.[313]

The SEC has taken the view that placing a responsibility on intermediaries to conduct checks of issuers (which might be done by third parties employed by intermediaries for this purpose) solves an issuer assessment problem that would be prohibitively costly if left to individual investors, and that:

> to the extent these checks lessened the likelihood of inappropriate or nefarious activity, they could increase investor willingness to purchase crowdfunding securities, thereby potentially resulting in issuers having greater access to capital.[314]

Under the proposed rules, the SEC would permit an intermediary to rely on an issuer's representations concerning compliance with the various specific regulatory requirements unless the intermediary has reason to question the reliability of the representations:

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307 id at 404.
308 id at 215-219 and 402-403.
309 id at 378.
310 id at 380.
311 s 4A(a)(6), (9).
312 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 261.
313 s 4A(a)(5).
314 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 395.

> The proposed rules would permit intermediaries to reasonably rely on representations of the issuer, absent knowledge or other information or indications that the representations are not true.[315]

However an intermediary would be required to deny access to an issuer if it has a reasonable basis for believing that the issuer or any of its officers, directors (or any person occupying a similar status or performing a similar function) was subject to a disqualification under the proposed rules. Also, the proposed rules would require an intermediary to deny access to its platform if the intermediary believes that the issuer or the offer presents the potential for fraud or otherwise raises concerns regarding investor protection.[316] The power of an intermediary to deny access:

> would further enhance investor protection by giving funding portals the flexibility to deny access to potential bad actors.[317]

The SEC has recognised the limits of these rules in reducing the risk of fraud, but has also identified some counter-veiling considerations:

> We also recognize that permitting an intermediary to rely on an issuer's representations unless the intermediary has reason to question the reliability of the representations could potentially lessen the incentive for an intermediary to thoroughly investigate the issuers and securities to be offered on its platform. Such an outcome could result in a higher levels of fraud compared to a requirement that intermediaries perform a thorough investigation to ensure that the issuer complied with all the requirements. A higher level of fraud would negatively affect both investors in crowdfunding offerings and non-fraudulent issuers … however, we believe it is likely that investors and interested participants would provide relevant adverse information about an issuer or an offering through postings on chat sites, message boards, and other communication channels, including, but not limited to, the communication channels to be provided by the intermediary.[318]

Payment from issuers

While intermediaries may receive compensation from the issuer, if fully disclosed,[319] officers of intermediaries, or persons performing similar functions, are prohibited from having any financial interest in any issuer using its services.[320] The SEC also proposes that these persons be prohibited from receiving a financial interest in the issuer as compensation for services provided to, or for the benefit of, the issuer, in connection with the offer and sale of its securities.[321]

To avoid a possible conflict of interest, the SEC would extend these prohibitions on having a financial interest, other than compensation, to the intermediary itself:

> Such a prohibition would be beneficial to investors and issuers because if an intermediary were to have a financial interest in one or more issuers that plan to use its services, the intermediary could have an incentive not based solely on merit to promote that issuer's offering, potentially to the detriment of investors and other issuers.[322]

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315 id at 137.
316 id at 141-144 and 394-395.
317 id at 407-408.
318 id at 396.
319 s 4A(b)(3). See SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 390.
320 s 4A(a)(11).
321 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 132.
322 id at 399.

(iv) Matters related to investors

Investor access to issuer disclosures

Intermediaries must make the issuer disclosures available to the SEC and potential investors not later than 21 days before the first day on which securities are sold to any investor.[323] According to the SEC:

> The issuer disclosure requirements should benefit investors by enabling them to better evaluate the issuer and the offering. Requiring intermediaries to make the issuer information publicly available and easily accessible on their platforms would reduce information asymmetries between issuers and investors and would enhance both transparency and efficiency of the market.[324]

An intermediary would be prohibited from requiring any person to establish an account with the intermediary in order to access this information.[325]

Personal information concerning potential and actual investors

Identifying information

Intermediaries are prohibited from compensating promoters, finders or lead generators for providing the intermediary with personal identifying information concerning any potential investor.[326]

The SEC noted that this prohibition would help to remove the incentive for high-pressure sales tactics and other abusive practices.[327] The SEC noted, however, that intermediaries may have a legitimate need for referrals to the intermediary's platform. Accordingly:

> It would be acceptable under the proposed rules, therefore, for an intermediary to make payments to advertise its existence, provided that in doing so, it does not pay for the personally identifiable information of investors or potential investors.[328]

Privacy of information

Intermediaries must also take such steps as are required by SEC Rules to protect the privacy of information collected from investors.[329] That information may include details of the income and net worth of the investor, given the US approach to the maximum funds that each investor can contribute (see further Section A3.4.1).

The SEC has commented that:

> requiring a funding portal to comply with privacy obligations would help protect the personally identifiable information of investors and potential investors, consistent with how it is protected by other financial intermediaries.[330]

Risk disclosure

Intermediaries must provide general disclosures to investors related to the inherent risks involved in CSEF (including the speculative nature of start-up companies and the illiquid nature of their securities) and such other investor education materials as the SEC deems

323 s 4A(a)(6).
324 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 390-391.
325 id at 165.
326 s 4A(a)(10).
327 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 200.
328 ibid.
329 s 4A(a)(9).
330 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 410.

appropriate,[331] and ensure that investors review such disclosures, affirm the risk of loss and answer various questions.[332]

In this context, the SEC has indicated that the intermediary would be required to undertake this exercise each time an investor seeks to make an investment commitment.[333] Also, the questionnaire required under the proposed rules would help address concerns that nothing more is required of an investor than a mere self-certification.[334]

The required educational materials would be set out in the SEC Rules.[335] In regard to their utility, the SEC has observed that:

> the effectiveness of the educational materials to enhance investor protection would vary depending upon the education and experience of retail investors. In addition, a presentation that highlights the risks of securities-based crowdfunding could discourage investor participation.[336]

Investor limits

Intermediaries must make such efforts as the SEC determines appropriate to ensure that no investor in a 12 month period exceeds the CSEF investment limits[337] (see Section A3.4.1 *Maximum funds that each investor can contribute*).

Advice to investors

Funding portals are prohibited from offering investment advice or making recommendations to investors.[338] The concept of investment advice could, for instance, include any promotion of a particular offer, such as a funding portal pointing out that the offer is attracting a number of investors.

To avoid limiting the utility of funding portals, the SEC is considering introducing a conditional safe harbour that would permit funding portals to engage in a range of activities without breaching this prohibition.[339] For instance:

> We anticipate that some funding portals may wish to limit, to some extent, the scope of their businesses by, for example, specializing in offerings by issuers in certain industries or geographic locations. In some circumstances, these limitations could be viewed as providing investment advice. To accommodate reasonable limitations, the proposed safe harbor would permit a funding portal to apply objective criteria to limit the offerings on its platform, without being deemed to be providing investment advice. Those criteria would be required to be reasonably designed to result in a broad selection of issuers offering securities through the funding portal's platform and be applied consistently to all potential issuers and offerings, so as not to recommend or implicitly endorse one issuer or offering over others. The criteria also would be required to be clearly displayed on the funding portal's platform.[340]

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331 s 4A(a)(3).
332 s 4A(a)(4).
333 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 174.
334 id at 172.
335 id at 153-154.
336 id at 389.
337 s 4A(a)(8).
338 s 3(a)(80) of the Securities Exchange Act of 1934 (introduced by s 304 of the JOBS Act).
339 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 224-246.
340 id at 229-230.

In the view of the SEC, this approach should help investors better appreciate any niche focus of a particular funding portal and the scope of the offers available on that funding portal's platform.

Solicitation

Intermediaries are prohibited from soliciting transactions for securities offered or displayed on their portals, or compensating employees or agents for doing so.[341]

Investor funds

Intermediaries must prevent the issuer having access to CSEF proceeds until a designated funds target for that company is reached and also allow all investors to cancel their commitments to invest as determined by SEC Rules.[342]

Intermediaries themselves are prohibited from holding or managing any investor funds or securities.[343] The proposed rules would oblige intermediaries to direct investors to transmit the funds directly to an account with a qualified third party bank, which has agreed in writing to hold the funds and to transmit them to the issuer or the investors, depending on whether the offer was completed or was cancelled.[344] Also:

> the requirement that the [bank] account in which funds are deposited be exclusively for the benefit of investors and the issuer would help prevent the intermediary or other parties from claiming or otherwise unlawfully taking funds from that account.[345]

Online communications

The proposed rules would require an intermediary to provide channels on its online platform through which investors can communicate with one another and with representatives of the issuer about offers made available on that platform.

As observed by the SEC:

> A premise of crowdfunding is that investors would rely, at least in part, on the collective wisdom of the crowd to make better informed investment decisions[346]

and that:

> individuals decide whether or not to invest after sharing information about the idea or business with, and learning from, other members of the crowd.[347]

The communication channels proposed by the SEC are intended to provide a centralized and transparent means for members of the public that have opened an account with an intermediary to share their views about investment opportunities and to communicate with representatives of the issuer to better assess the issuer and investment opportunity.

Also, though communications between investors could occur outside the intermediary's platform, communications by an investor with a crowdfunding issuer or its representatives about the terms of the offer would be required to occur through this single intermediary

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341 s 3(a)(80) of the Securities Exchange Act of 1934 (introduced by s 304 of the JOBS Act).
342 s 4A(a)(7).
343 s 3(a)(80) of the Securities Exchange Act of 1934 (introduced by s 304 of the JOBS Act).
344 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 181-184.
345 id at 400.
346 id at 376.
347 id at 11.

online platform through which the offer is conducted. This requirement is designed to provide transparency and accountability, and thereby further the protection of investors.

The proposed rules would also require the intermediary to make the communications on the online channels publicly available for viewing, though only persons who had opened an account with the intermediary could post comments on the online platform.[348]

The SEC also proposes disclosure rules to deal with possible conflicts of interest that could arise in the use of these online communication channels. For instance:

> The proposed rules also would require any person posting a comment in the communication channels to clearly and prominently disclose with each posting whether he or she is a founder or an employee of an issuer engaging in promotional activities on behalf of the issuer, or is otherwise compensated, whether in the past or prospectively, to promote the issuer's offering.[349]

A3.3.2 Canada

Set out below are the CSEF proposals in the March 2014 OSC Paper as they apply to intermediaries.

In setting out a proposed regulatory framework for intermediaries (see below) the March 2014 OSC Paper also raised for comment the general question whether that framework would permit intermediaries to appropriately carry on business and whether other requirements should be imposed on intermediaries to protect the interests of investors.[350]

(i) Sole online only intermediary

An issuer will only be permitted to offer its securities to the crowd through one intermediary during the distribution period established by the issuer.[351] An offer document cannot be posted on any other website.[352]

The OSC argued that:

> All relevant information should be included in one place (i.e., the portal's website) for ease of investor reference and to facilitate the exchange of information and views that is conducive to eliciting the 'wisdom of the crowd'. It will also make it easier to monitor both the distribution and investment limits.[353]

(ii) Permitted types of intermediary

Registration requirement

CSEF offers must be conducted through an online intermediary registered as a restricted dealer.[354]

The OSC described this licensing requirement for intermediaries as a key investor protection element in CSEF:

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348 id at 175-179.
349 id at 178.
350 March 2014 OSC Paper at 21.
351 s 11 and s 15(4) of Annex D-3 of Appendix D at D-50 – D-51.
352 Appendix D at D-23 – D-24 and s 16(2) of Annex D-3 of Appendix D at D-51.
353 Appendix D at D-12.
354 Appendix D at D-30 and ss 4 and 7(c) of Annex D-3 of Appendix D at D-47 – D-48.

> Registration is necessary to address, among other things, potential integrity, proficiency and solvency concerns that may apply to funding portals and the persons operating them, as well as potential concerns relating to conflicts of interest and self-dealing. The registration requirement is also intended to serve as a safeguard against funding portals being used to facilitate fraudulent offerings of securities through the internet.[355]

Intermediaries must comply with general registrant requirements, including account opening, reporting, record-keeping and record-retention requirements, but with certain adjustments to other licensing requirements to take into account the CSEF provisions applicable to them.[356]

Intermediaries will also be subject to a minimum net capital requirement of $50,000 and a fidelity bond insurance obligation providing for coverage of at least $50,000 (to help insure against the loss of investor funds that may occur if, for example, an intermediary or any of its officers or directors breaches the prohibitions on holding, managing, possessing or otherwise handling investor funds or securities).[357]

Similar to other registrants, the intermediary will be required to act honestly, fairly and in good faith.[358]

An intermediary must provide quarterly reports to the regulator on various aspects of the CSEF activities on its website.[359] Issuers will have obligations to provide some of this information, but the obligation could be delegated to the intermediary. The regulator may also request other information or information on a more frequent basis.[360]

Also, changes in control of the intermediary will require regulatory approval.[361]

The regulator has exemption powers in regard to the obligations applicable to CSEF intermediaries.[362]

Advertising its existence

An intermediary may advertise its existence, the fact that crowdfunding offers can be made through its online portal and the fact that information about such offers is posted on its website.[363]

CSEF offers only

An intermediary acting in connection with CSEF offers of a particular issuer cannot also offer those securities under other exemptions to the prospectus requirements, nor can it act as an intermediary in any secondary transactions in those securities, such as clearing or settling any trades in an issuer's securities.[364]

The OSC pointed out that these limitations apply only to activities in connection with a distribution of securities through the CSEF process. An intermediary may engage in other

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355 Appendix D at D-30.
356 s 29 of Annex D-3 of Appendix D at D-55 – D56.
357 Appendix D at D-34 and s 44 of Annex D-3 of Appendix D at D-60.
358 Appendix D at D-31 and D-34 and s 29(3) of Annex D-3 of Appendix D at D-56.
359 s 48 of Annex D-3 of Appendix D at D-61.
360 Appendix D at D-39 – D-40.
361 Appendix D at D-35. The test of 'control' in this context is set out in s 3 of Annex D-3 of Appendix D at D-47.
362 s 49 of Annex D-3 of Appendix D at D-62.
363 March 2014 OSC Paper at D-38.
364 Appendix D at D-30, D-33 and D-41 and ss 31 and 32 of Annex D-3, at D-56. Also the intermediary cannot act as an investment dealer, portfolio manager or investment fund manager: D-31.

types of crowdfunding activities that do not involve a distribution of securities, such as donation funding, reward funding or pre-purchase funding.[365]

(iii) Matters related to issuers

Ineligible issuers for a particular intermediary

An intermediary must not allow an issuer access to the online portal to publish its offer if the intermediary, or any officer, director or significant shareholder of the intermediary or of any affiliate of the intermediary:

(a) has beneficial ownership of, or control or direction over, more than 10% of the issued and outstanding securities of the issuer, or securities convertible into securities of the issuer, or

(b) except as permitted under (a), otherwise has an economic interest in the issuer.[366]

Checks on issuers

The intermediary must take reasonable steps to establish that the business of the issuer will be conducted with integrity and in the best interests of the security holders of the issuer, based on the information contained in the issuer's application and the results of background checks.[367]

Background checks

For this purpose, intermediaries will be required to conduct background checks on issuers, and their directors, executive officers, promoters and control persons, to verify the qualifications, reputation and track record of the parties involved in the key aspects of the offer. The checks will include identifying criminal and regulatory issues.[368]

The OSC has indicated that, at a minimum, an intermediary should conduct the following checks:

(a) for issuers:

(i) the existence of the issuer and its business registration, including a review of the issuer's constitutional documents

(ii) criminal record and securities enforcement history checks

(iii) bankruptcy/liquidation checks, and

(iv) court record checks, where available

(b) for directors, executive officers, control persons and promoters of the issuer:

(i) criminal record and securities enforcement history checks

(ii) bankruptcy checks, and

(iii) court record checks, where available.

365 Appendix D at D-89.
366 s 39 of Annex D-3 of Appendix D at D-59.
367 Appendix D at D-6.
368 Appendix D at D-35 - D-36 and ss 35 and 36 of Annex D-3 of Appendix D at D-57 – D-58.

An intermediary may retain a third party to perform these checks. However, the statutory obligation remains with the intermediary.[369]

An intermediary must deny access to an issuer if, based upon its review of the issuer's application and information obtained through background checks, it believes that the business of the issuer may not be conducted with integrity and in the best interests of security holders because of, among other reasons, the conduct of the issuer, or any of the issuer's executive officers, directors, promoters, or control persons.[370]

Due diligence on the issuer's offer

An intermediary must have the proficiency that a reasonable person would consider necessary to perform its role competently, including to understand the structure, features and risks of each security coming within a CSEF offer on its website.[371]

An intermediary is expected to develop this understanding based on a review of the issuer's articles of incorporation, other relevant constitutional documents and other materials included in the issuer's application for access to the intermediary's portal. For example, if an issuer proposes to offer securities that contain restrictions on voting, or contain redemption rights that allow the issuer to redeem the shares in certain circumstances, or that insiders or promoters of the issuer hold another class of securities that have multiple votes, the intermediary should understand that it may be misleading to investors if the issuer describes the securities as 'common shares' or does not disclose the existence and material terms of the securities held by the insiders and promoters.[372]

Likewise, if an issuer is part of a corporate group, and the issuer's interest in the business or the assets of the business are owned through one or more subsidiaries, the intermediary should understand the features and risks of the capital structure of the corporate group and assess whether the issuer's disclosure adequately discloses these risks.[373]

Within this framework, an intermediary must review the information intended to be presented by the issuer on the portal's website for the purpose of forming a reasonable belief that the information adequately sets out:

- the general features and structure of the security to be offered
- issuer-specific risks
- parties involved and any inherent conflicts of interest, and
- the intended use of funds raised through the issue.

However, this obligation does not include an obligation to assess:

- the merits or expected returns of an investment to purchasers, or
- the commercial viability of a proposed business or offer.[374]

369 Appendix D at D-91.
370 Appendix D at D-32 and s 37(b) of Annex D-3 of Appendix D at D-58.
371 s 30(1) of Annex D-3 of Appendix D at D-56.
372 Appendix D at D-89.
373 ibid.
374 s 30(2) of Annex D-3 of Appendix D at D-56.

Also, business plans must be prepared by the issuer's management. Intermediaries will not be required to assess the commercial viability of these plans.[375]

In addition, the intermediary is not obliged to determine whether an issuer's milestones are realistic or achievable or to assess the experience of the directors or executive officers of the issuer.[376]

The OSC was of the view that:

> Many [intermediaries] will realize the importance of conducting due diligence on issuers, especially if the portal expects to maintain its business in what is expected to be a very competitive market.[377]

Duty to act

While an intermediary will not be automatically liable for the accuracy or completeness of the issuer information, it may not include on its website any issuer information or communication that appears to be false, deceptive, misleading or contains a misrepresentation. Likewise, an intermediary must deny access by an issuer to its online portal if the intermediary has reason to believe that the issuer or its offer is fraudulent The intermediary must terminate any such offer and must also report immediately to the principal regulator if fraud is discovered during the distribution period.[378]

Issuer access agreements

Before an intermediary may permit an issuer to access its online portal, the intermediary must enter into an 'issuer access agreement' with that issuer.[379]

The issuer access agreement must contain various provisions, including a confirmation from the issuer that it will comply with the intermediary's posting policies, including confirmation that the information that the issuer provides to the intermediary or posts on the intermediary's website will:

- comply with applicable securities legislation
- not contain unduly promotional statements or material that cannot be reasonably supported or any misrepresentation
- be presented in a fair and balanced manner, and
- not be misleading.[380]

Assistance to issuers

An intermediary may assist an issuer in the preparation of an offer document, business plan or other permissible document, provided that the service is limited to assisting the issuer to comply with its disclosure obligations and to ensure that the information is presented in a fair, balanced and reasonable manner.[381]

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375 Appendix D at D-37.
376 Appendix D at D-89.
377 March 2014 OSC Paper at 27.
378 Appendix D at D-32, D-36 – D-37 and ss 37-38 of Annex D-3 of Appendix D at D-58 – D-59.
379 s 34 of Annex D-3 of Appendix D at D-57.
380 Definition of 'issuer access agreement' in s 1(1) of Annex D-3 of Appendix D at D-45.
381 Appendix D at D-31 – D-32 and s 33(2)(d) of Annex D-3 of Appendix D at D-57.

Intermediaries may also assist issuers to meet their disclosure and record-keeping obligations. However, the provision of such assistance is at the discretion of the intermediary and will not be a condition of intermediary registration.[382]

Obligations that intermediaries may place on issuers

As part of its gatekeeping role, an intermediary may, at its discretion, impose upon issuers such other requirements as the portal considers desirable to protect the interests of investors. An intermediary may develop standard form documents for that purpose.[383]

Payment from issuers

An intermediary must disclose all compensation, including fees, costs and other expenses, that it may charge to, or impose on, an issuer.[384]

In regard to the forms of payment, the OSC noted that if an intermediary has a financial stake in a particular issuer, it may have an incentive to promote that issuer over other issuers on its portal. However, the OSC also noted that that many start-ups and small and medium enterprises may have limited resources to pay intermediary fees. The OSC therefore proposes that issuers be permitted to pay these fees in securities of the issuer (if agreed by the intermediary), provided this compensation is fully disclosed to investors, and the investment would not result in the intermediary owning or controlling more than 10% of the issuer.[385]

Beyond that, an intermediary may not invest in an issuer or underwrite an issuer on its website.[386]

The March 2014 OSC Paper raised the question whether permitting issuers to pay intermediary fees in securities of the issuer is appropriate:

> The [requirements] would allow [intermediary] fees to be paid in securities of the issuer so long as the [intermediary's] investment in the issuer does not exceed 10%. Is the investment threshold appropriate? In light of the potential conflicts of interest from the portal's ownership of an issuer, should [intermediaries] be prohibited from receiving fees in the form of securities?[387]

Conflicts of interest

Intermediaries must identify and appropriately deal with any conflicts of interest that may arise in the activities of the online portals.[388]

Also, an intermediary must not participate in a 'referral arrangement' except to compensate a third party for referring an issuer to it.[389]

(iv) Matters related to investors

Screening and education of investors

Risk warnings to investors must be set out at the top of the issuer offer.[390]

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382 Appendix D at D-39.
383 Appendix D at D-33 – D-34.
384 Appendix D at D-37and s 40(b)(iii) of Annex D-3 of Appendix D at D-60.
385 Appendix D at D-32.
386 Appendix D at D-33.
387 March 2014 OSC Paper at 21.
388 Appendix D at D-37.
389 s 46 of Annex D-3 of Appendix D at D-61.
390 The wording is set out in Appendix D at D-67.

In addition, an intermediary must prominently state on its online portal that:

- no securities regulatory authority or regulator has approved or expressed an opinion about the securities offered on the portal
- 'A crowdfunding investment is highly risky. You may lose all your investment and you may not be able to sell any securities you purchase'.[391]

An intermediary will not be subject to 'client-specific' know-your-client and suitability requirements for investors taking up issuer offers that are posted on the intermediary's website.[392]

Rather, an intermediary must take reasonable steps to ensure that investors understand the risks of a crowdfunding investment.[393] In that respect:

> [an intermediary] should not rely solely on the risk acknowledgement form signed by an investor.[394]

Without being prescriptive, the OSC has indicated that for the purpose of ensuring that investors understand the risks of a crowdfunding investment, an intermediary might require investors to:

- correctly answer questions in an interactive questionnaire conducted at the time of the account opening that demonstrates that the investor understands the level of risk generally applicable to investments in start-ups, emerging businesses, and small issuers and the risk of illiquidity, and
- correctly answer questions in an interactive questionnaire conducted annually thereafter.[395]

Investor limits

Intermediaries must obtain a written certification from investors that they are complying with the annual investment limit.[396] Also, further, cumulative investments made by the same investor on the intermediary's platform must be monitored by the intermediary to ensure that the annual investment limit is not exceeded.[397]

Advice to investors

General prohibition

An intermediary is prohibited from providing recommendations or advice to investors about specific securities.[398] It cannot recommend or endorse a particular issuer or offer on its website.

For instance, commenting to investors on the merits of, or expected returns from, an issuer offer on its website would constitute a recommendation or advice.[399] Also, highlighting,

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391 s 40(b)(i), (ii) of Annex D-3 of Appendix D at D-59 – D-60.
392 Appendix D at D-34. The term 'client-specific suitability' refers to the obligation to determine that an investment is suitable for a particular client in light of the particular client's investment needs and objectives.
393 Appendix D at D-38.
394 Appendix D at D-91.
395 Appendix D at D-38.
396 ibid.
397 Appendix D at D-38 – D-39.
398 Appendix D at D-31 and s 33(1) of Annex D-3 of Appendix D at D-57.
399 Appendix D at D-32.

showcasing or spotlighting a particular issuer on its website could be considered as a form of express or implied recommendation, endorsement or advice to investors.[400]

Exemptions

An intermediary may perform various actions which otherwise might be seen as coming within the general prohibition on providing advice to investors, provided that those actions would not be viewed by a reasonable person as an assessment of the quality or commercial viability of a crowdfunding offer, namely to:

- present or display information about an issuer or a crowdfunding offer on its website, if the information is presented or displayed in a fair, balanced and reasonable manner
- use objective criteria to limit the CSEF offers on its platform, provided the criteria are disclosed on the website, are applied consistently, and would not be viewed by a reasonable person as a recommendation or endorsement
- prohibit crowdfunding offers on its website based on a good faith determination that an issuer is not complying with securities law
- assist an issuer in the preparation of an offer document, business plan or other permissible document, provided that the service is limited to assisting the issuer to comply with its disclosure obligations and to ensure the information is presented in a fair, balanced and reasonable manner
- provide general information and educational materials to potential purchasers about crowdfunding offers, provided that the information and materials are presented in a fair, balanced and reasonable manner
- provide on its website search functions or other tools for potential purchasers to search, sort or categorise crowdfunding offers available on the funding portal's website according to objective criteria, and
- provide communication channels or discussion boards to enable potential purchasers pursuant to a crowdfunding offers, to communicate with one another and with representatives of the issuer about a crowdfunding offer displayed on the intermediary's website provided that communication by a person can be traced back to its author.[401]

Advertising and solicitation

An intermediary will not be able to advertise the offer or solicit transactions of securities offered on its platform, other than through posting an offer (and other permitted documents[402]) on its platform.[403] This prohibition includes an intermediary compensating its employees or agents to solicit the sale of securities on the online platform.[404]

However, an intermediary may advise potential investors, or advertise the fact (for instance, through social media), that a CSEF offer is being made, or will be made, through its online portal.[405]

400 Appendix D at D-90.
401 s 33(2) of Annex D-3 of Appendix D at D-57.
402 s 16 of Annex D-3 of Appendix D at D-51.
403 s 18(1) of Annex D-3 of Appendix D at D-51.
404 Appendix D at D-31.
405 Appendix D at D-24 and s 18(2), (3) of Annex D-3 of Appendix D at D-52.

Prohibition on lending to investors

Intermediaries will be prohibited from lending money, extending credit or providing margin to any investor or recommend that an investor use borrowed money to finance any purchase of a security.

Under this approach, intermediaries (as well as issuers) and their respective directors and executive officers, must not lend or finance, or arrange lending or financing (for instance, from an affiliate), for an investor to purchase securities of the issuer through CSEF.[406]

This approach was seen as helping to address concerns associated with retail investors using leverage to invest through crowdfunding. Also, to permit intermediaries to fund investors in crowd-based fundraising 'would create a conflict of interest which cannot be properly managed'.[407]

Payment from investors

An intermediary must disclose all compensation, including fees, costs and other expenses, that it may charge to, or impose on, an investor.[408]

Online communications

Intermediaries may (but are not obliged) to provide online communication between issuers and investors. If an intermediary chooses to offer a discussion board or other means of communication between investors and/or an issuer and its investors (for example, via chat rooms or a blog), it must ensure that all comments made within such forum can be traced back to their authors.[409]

The intermediary must also monitor postings to confirm that the issuer is not making statements or providing information that are inconsistent with the crowdfunding offer document and may remove any material that it deems inappropriate or raises investor protection concerns.[410]

Material change in the offer

Where a material change in the offer occurs, the intermediary must notify committed investors of the change and require reconfirmation of their commitment within five business days. If reconfirmation is not received within that time, the investment must be automatically cancelled and the funds returned.[411]

Cancelled offer

Intermediaries will be required to notify committed investors within five business days if the offer is cancelled and must take appropriate steps so that investor money is returned.[412]

Investor funds

Intermediaries will not be able to hold, handle, or have access to, investor funds or assets of investors.[413] Indicia of holding or having access to an investor's funds or assets include:

- holding an investor's securities, certificates or cash for any period of time

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406 Appendix D at D-33 and ss 10 and 45 of Annex D-3 of Appendix D at D-49 and D-60.
407 Appendix D at D-93.
408 s 40(b)(iii) of Annex D-3 of Appendix D at D-60.
409 Appendix D at D-39 and s 33(2)(g) of Annex D-3 of Appendix D at D-57.
410 s 41 of Annex D-3 of Appendix D at D-60.
411 Appendix D at D-35.
412 ibid.
413 Appendix D at D-33 and s 42 of Annex D-3 of Appendix D at D-60.

- having authority (e.g., a power of attorney) to withdraw funds or securities from an investor's account
- accepting funds from an investor directly (e.g., a cheque made payable to the intermediary) or accepting funds on the investor's behalf from a custodian
- acting in the capacity of a trustee for an investor
- having, in any capacity, legal ownership of, or access to, the investor's funds or securities.[414]

Rather, intermediaries must arrange for reputable third parties to handle investor funds.[415] These funds would have to be held externally in a trust or escrow arrangement until the offer minimum has been achieved.[416]

However, to a limited extent, intermediaries may be able to provide directions as to when and to whom client funds may be released.[417] In this context, the intermediary must take reasonable steps to confirm that the minimum offer threshold is achieved before investor funds are transferred to the issuer.[418]

A3.4 Investors

Under both the US and Canadian approaches, investors must be provided with certain information by issuers, and have remedies against issuers for any misinformation provided.

For this purpose, the US and Canadian approaches can be compared on a series of elements applicable to investors:

(i) permitted types of investor

(ii) maximum funds that each investor can contribute

(iii) risk acknowledgement by the investor

(iv) cancellation rights

(v) resale restrictions

(vi) shareholder rights.

In particular, placing monetary limits on the size of investments that may be made by investors, either by reference to their financial position (USA), or generally (Canada), is designed to limit the adverse impact on investors of poor investment decisions. To some extent this represents a quantitative rather than qualitative approach to investor protection.

414 Appendix D at D-92.
415 s 43 of Annex D-3 of Appendix D at D-60.
416 Appendix D at D-31.
417 ibid.
418 Appendix D at D-37.

A3.4.1 United States

Set out below are relevant provisions in the JOBS Act and the draft SEF Rules (October 2013) as they apply to investors.

(i) Permitted types of investor

There are no restrictions on who can be a CSEF investor. Instead caps apply to the funds that each investor can invest (see ***(ii),*** below).

(ii) Maximum funds that each investor can contribute

There are various approaches (alone or in combination) that could be taken to the funds that an investor could put into CSEF if the intention is to limit the possible losses to retail investors through CSEF. They include:

Investor cap per issuer: various approaches

- *first approach*: limiting the number of CSEF issuers in which an investor may invest in one year
- *second approach*: limiting the monetary amount that an investor may invest in each CSEF issuer in one year
- *third approach*: limiting the monetary amount that an investor may invest in each CSEF issuer in total (not per year)
- *fourth approach*: limiting the monetary amount that an investor may invest in each CSEF issuer per offer by that issuer

Investor cap on all issuers

- *fifth approach*: limiting the total monetary amount that an investor may invest in all CSEF issuers in one year, irrespective of that person's income or net worth
- *sixth approach*: limiting the total monetary amount that an investor may invest in all CSEF issuers in one year according to that person's income or net worth
- *seventh approach:* limiting the total monetary amount that an investor may invest in all CSEF issuers, regardless of time.

The *eight approach* is to place no mandatory cap on the funds that an investor could put into CSEF.

The JOBS Act has adopted the *sixth approach,* with two caps:

- *lower cap:* for an investor with an annual income or net worth below $100,000, the investor's annual aggregate investment in CSEF securities is capped at the greater of $2,000 or 5% of the investor's annual income or net worth
- *higher cap:* for an investor with an annual income or net worth of at least $100,000, the investor's annual aggregate investment in CSEF securities is capped at 10% of the investor's annual income or net worth, not to exceed $100,000.[419]

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419 s 4(a)(6)(B).

While no additional cap is made for accredited investors under Title III of the JOBS Act, equity offers can also be made to them, promoted online or through other means, under Title II of the JOBS Act.

These cap amounts are to be periodically adjusted based on the consumer price index.

The SEC noted that the investment caps would limit the potential upside for investors in the CSEF market:

> This might particularly affect the decisions of those with large portfolios who might be able to absorb losses and understand the risks associated with risky investments. For these investors, the $100,000 aggregate cap might limit their incentive to participate in the securities-based crowdfunding market, compared to other types of investments, potentially depriving the securities-based crowdfunding market of more experienced and knowledgeable investors and possibly impeding capital formation. Limiting the participation of such investors would be likely to negatively affect the informational efficiency of the securities-based crowdfunding market because sophisticated investors are better able to accurately price such offerings.[420]

The SEC also noted that the investment caps could limit the ability of investors to diversify within the CSEF market by:

> limit(ing) an investor's ability to choose a sufficiently large number of investments to offset this risk and to recover the due diligence costs of sufficiently investigating individual investments. One potential solution to this diversification problem would be to invest smaller amounts in more ventures. The drawback is that the costs associated with identifying and reviewing investment opportunities are, to a large extent, fixed.[421]

In regard to compliance with the investment caps, the proposed SEC Rule would provide that before permitting an investor to make an investment commitment on its platform, an intermediary must have a reasonable basis to believe that the investor comes within the investment caps.[422] However, the SEC also recognises the difficulties that this may impose on intermediaries. Accordingly, the SEC proposes that, notwithstanding that investors might make inaccurate representations, whether intentionally or not:

> an intermediary may rely on an investor's representations concerning compliance with the investment limits unless the intermediary has reason to question the reliability of the representations.[423]

In regard to reliance on an investor's representations, the SEC also commented that:

> it would not be reasonable for an intermediary to ignore other investments made by an investor in securities sold in reliance on [the CSEF provisions] through an account with that intermediary or other information or facts about an investor within its possession.[424]

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420 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 354.
421 id at 355.
422 id at 168.
423 id at 396.
424 id at 170.

(iii) Risk acknowledgement by the investor

The investor must positively affirm an understanding that the entire investment is at risk and that the investor would be able to bear such a loss.[425] The investor must also answer various questions demonstrating an understanding of various risks.[426]

(iv) Cancellation rights

The SEC has proposed that investors have an unconditional right, for any reason, to cancel their acceptances up to 48 hours prior to the end of the offer period:

> Under this approach, an investor could reconsider his or her investment decision with the benefit of the views of the crowd and other information, until the final 48 hours of the offering.[427]

In the view of the SEC:

> the proposed rules strike an appropriate balance between giving investors the continuing benefit of the collective views of the crowd and then, if desired, to cancel their investment commitments, while providing issuers with certainty about their ability to close an offering at the end of the offering period.[428]

The SEC considers that issuers should be entitled to vary the securities offer price ('dynamic pricing') during such time as investors have cancellation rights:

> the investor's ability to cancel his or her investment commitment could mitigate potential concerns that dynamic pricing could be used to provide preferential treatment to certain investors (*e.g.*, when an issuer offers better prices to relatives or insiders). We also believe that the proposed cancellation rights would address the concerns about time pressure on the investment decision because investors would have the opportunity to cancel their investment commitments if they decide to do so.[429]

If there is a material change to the terms of an offer, including the offer price, or to the information provided by the issuer regarding the offer, the proposed rules would require the intermediary to give each investor who has made an investment commitment notice of the material change and with the notice also stating that the investor's investment commitment will be automatically cancelled unless the investor reconfirms his or her commitment within five business days of receipt of the notice:

> We believe that when material changes arise during the course of an offering, an investor who had made a prior investment commitment should have a reasonable period during which to review the new information and to decide whether to invest. This notification would be required to be provided by e-mail or other electronic media.[430]

(v) Resale restrictions

Securities purchased under the CSEF provisions are subject to certain resale restrictions for one year.[431]

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425 s 4A(a)(4)(B).
426 s 4A(a)(4)(C).
427 SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 193.
428 ibid.
429 id at 377.
430 id at 195.
431 s 4A(e).

The SEC has described this restriction, which it recognises may impede securities price discovery, as nevertheless important for investor protection:

> By restricting the transfer of securities for a one-year period, the proposed rules would give investors in a business a defined period to observe the performance of the business and to potentially obtain more information about the potential success or failure of the business before trading occurs.[432]

(vi) Shareholder rights

Consistent with the JOBS Act requirement,[433] the proposed SEC rules would require an issuer to provide a description of its ownership and capital structure. This disclosure would include:

- the terms of the securities being offered and each other class of security of the issuer, including the number of securities being offered and/or outstanding, whether or not such securities have voting rights, any limitations on such voting rights, how the terms of the securities being offered may be modified and a summary of the differences between such securities and each other class of security of the issuer, and how the rights of the securities being offered may be materially limited, diluted or qualified by the rights of any other class of security of the issuer;
- a description of how the exercise of the rights held by the principal shareholders of the issuer could affect the purchasers of the securities
- the name and ownership level of persons who are 20% or more owners
- how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions
- the risks to purchasers of the securities relating to minority ownership in the issuer and the risks associated with corporate actions including additional issuances of securities, issuer repurchases of securities, a sale of the issuer or of assets of the issuer or transactions with related parties; and
- a description of the restrictions on the transfer of the securities.[434]

A3.4.2 Canada

The OSC made the following general observations about the implications of CSEF for investors:

> [CSEF] will allow retail investors to participate in the various funding stages of start-ups and SMEs, providing broader access to investment opportunities. However, crowdfunding may be a highly risky investment and investors may experience a high probability of loss, even if there is no fraud. Many start-ups and SMEs are expected to fail. Canadian data shows that only 72% of SMEs that entered the marketplace in 2007 survived for two years and only 51% of SMEs that entered the market place in 2005 survived for five years. The survival rate of issuers that rely on equity crowdfunding may be lower since there is the possibility of adverse selection. Businesses with good prospects may gravitate towards donation or rewards-based crowdfunding or other

[432] SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 377-378.
[433] s 4A(b)(1)(H).
[434] SEC Proposed Crowdfunding Rules under Title III of the JOBS Act (October 2013) at 56-57.

> cheaper sources of financing whereas less successful businesses may use securities-based crowdfunding because they are unable to raise funds from other sources.
>
> However, investors that participate in securities-based crowdfunding may do so for a number of different reasons to support an early stage business and not strictly as an investment. Further, the requirements for investors to sign a risk acknowledgment form and the requirement for the portal to provide general information and educational materials to investors will help investors understand the high risk of investing in a business through crowdfunding. In addition, any investment loss will be limited because of the restrictions on the amounts an investor can invest.[435]

Set out below are the CSEF proposals in the March 2014 OSC Paper as they apply to investors.

(i) Permitted types of investor

There are no restrictions on who can be a CSEF investor. Instead caps apply to the funds that each investor can invest (see ***(ii),*** below).

(ii) Maximum funds that each investor can contribute

There are various approaches (alone or in combination) that could be taken to the funds that an investor could put into CSEF, if the intention is to limit the possible losses to retail investors through CSEF. They include:

Investor cap per issuer: different approaches

- *first approach:* limiting the number of CSEF issuers in which an investor may invest in one year
- *second approach:* limiting the monetary amount that an investor may invest in each CSEF issuer in one year
- *third approach*: limiting the monetary amount that an investor may invest in each CSEF issuer in total (not per year)
- *fourth approach*: limiting the monetary amount that an investor may invest in each CSEF issuer per offer by that issuer

Investor cap on all issuers: different approaches

- *fifth approach:* limiting the total monetary amount that an investor may invest in all CSEF issuers in one year, irrespective of that person's income or net worth
- *sixth approach:* limiting the total monetary amount that an investor may invest in all CSEF issuers in one year according to that person's income or net worth
- *seventh approach:* limiting the total monetary amount that an investor may invest in all CSEF issuers, regardless of time.

The *eight approach* is to place no mandatory cap on the funds that an investor could put into CSEF.

While the US JOBS Act has adopted the *sixth approach*, the Canadian proposal has adopted a combination of the *fourth and fifth approach*.

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[435] March 2014 OSC Paper at 26-27.

Under the proposals, an investor's investment in securities of a particular issuer through CSEF cannot exceed $2,500 per offer by that issuer (*fourth approach*). In addition, a purchaser's total investment in all CSEF offers during a calendar year cannot exceed $10,000 (*fifth approach*).[436]

In putting forward this combined approach, the OSC argued that having low investment limits minimizes an investor's exposure. Also, specified maximum dollar amounts are easier to administer than the *sixth approach*, as adopted under the US JOBS Act, that requires calculations based on an investor's annual income or net worth. In addition, it avoids the concern, under the *sixth approach*, that investors may be unwilling to share their tax returns or other personal financial information with issuers or portals to establish they are investing within the prescribed limits.[437]

With each investment, the intermediary is responsible for verifying that the investor is not exceeding the caps, more specifically that in any 12 month period:

- the investor is not investing more than $2,500 in a particular offer
- the investor will not have invested more than $10,000 through the portal of that intermediary.

However, an investor will be required to certify that he or she is within the investment limits. The OSC considered that:

> self-certification bolstered by a portal monitoring compliance by the investor with the investment limits based on investments made by the investor through the portal is a reasonable and practical approach.[438]

To reinforce this approach, the purchaser of the CSEF securities must purchase them as the principal.[439]

(iii) Risk acknowledgement by the investor

Investor will be required positively to affirm that they understand they are making a high-risk investment.

For this purpose, prior to an investor entering into an agreement to purchase securities through the CSEF process, the investor must sign a risk acknowledgement form in which the investor confirms that he or she falls within the investment limits and also acknowledges the risks associated with the investment, including the following:

- it is a very risky investment
- the investor could lose all of the money invested
- the investor may never be able to sell the securities
- the investor will be provided with less disclosure than public companies provide

436 Appendix D at D-15 and s 9 of Annex D-3 of Appendix D at D-49.
437 Appendix D at D-15.
438 Appendix D at D-16.
439 s 7(e) of Annex D-3 of Appendix D at D-48.

- the investor will not have the benefit of protections associated with an investment made under a prospectus
- borrowing money increases the risk of an investment
- the intermediary portal will not be responsible if the investor loses all or some of the money invested.[440]

The risk acknowledgement form may be signed by an online signature.[441]

The issuer must retain the signed risk acknowledgement form for eight years after the distribution.[442]

The OSC commentary stated that:

> Requiring that an investor sign a risk acknowledgement form may help to alert the investor to the risks of the investment, including that the investor may lose his or her entire investment.[443]

(iv) Cancellation rights

An issuer that offers securities under the CSEF process must provide an investor with a contractual right to cancel an agreement to purchase the security by delivering a notice to the issuer within at least 48 hours prior to the date of completion of the distribution disclosed in the issuer's offer document.[444]

The OSC considered that a right of withdrawal would provide an investor with a 'cooling off' period to consider the disclosure provided and reflect on his or her investment decision.[445]

An investor also has withdrawal rights in the event of material changes in the offer.[446]

(v) Resale restrictions

The investor education materials must make it clear to investors that there are significant resale restrictions and the securities cannot be resold through the intermediary portal.[447]

Securities of a non-reporting issuer

Securities of a non-reporting issuer acquired through crowdfunding cannot be resold until the issuer becomes a reporting entity, unless the sale is made under a prospectus exemption other than the crowdfunding exemption (for instance, to a sophisticated investor).[448]

The OSC expressed concern about permitting a sale before an issuer becomes a reporting entity and is therefore subject to the continuous and timely disclosure requirements.[449]

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440 Appendix D at D-38, D-78 – D-80, and s 20(1) of Annex D-3 of Appendix D at D-52.
441 Appendix D at D-87.
442 Appendix D at D-17 and D-18 and s 20(2) of Annex D-3 of Appendix D at D-52.
443 Appendix D at D-17.
444 s 21 of Annex D-3 of Appendix D at D-52.
445 Appendix D at D-18.
446 See *Material change in the offer* under (iv) in Section A3.3.2 of this report.
447 Appendix D at D-41.
448 ibid.
449 Appendix D at D-19.

Securities of a reporting issuer

Securities of a reporting issuer acquired through crowdfunding are subject to a four month hold period.[450]

(vi) Shareholder rights

It is not proposed to require that crowd investors be provided with shareholder rights, such as tag-along or pre-emptive rights.

Rather, an issuer must disclose the specific risks to investors if such rights are not provided and that the absence of such rights affects the value of the securities.[451]

In regard to dilution, the offer document must contain the following statement:

> The rights of purchasers of the securities under this offering may be diluted or negatively affected as a result of a number of factors, including the rights and characteristics of other securities already issued by the issuer, future issuances of securities by the issuer, and potential changes to the capital structure and/or control of the issuer.[452]

Further, the risk acknowledgement form to be signed by investors will identify the potential risks which may arise.

An intermediary may, in its discretion, impose requirements for the granting by the issuer of tag-along or pre-emptive rights to investors.[453]

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[450] ibid.
[451] Appendix D at D-69.
[452] ibid.
[453] Appendix D at D-19.

Appendix 4 Europe

This Appendix outlines developments in CSEF in the European Union, including the provisions in Italy, being the first EU member to introduce CSEF laws, as well as developments in the UK.

A4.1 Overview

The European Union (EU) approach to crowd sourced funding generally, including CSEF, has been influenced to a considerable degree by the global financial crises, which reduced the lending activities of banks in Europe, making access to finance by European businesses more difficult.

For instance, the stated aim of the *Entrepreneurship 2020 Action Plan - Reigniting the entrepreneurial spirit in Europe* (2013) is to increase the level of employment through reinforcing entrepreneurship across Europe. It invites EU Member States to:

> assess the need of amending current national financial legislation with the aim of facilitating new, alternative forms of financing for start-ups and SMEs [small to medium enterprises] in general, in particular as regards platforms for crowd funding.

The European Commission Consultation Paper *Crowdfunding in the EU–Exploring the added value of potential EU action* (October 2013) pointed out that:

> European SMEs largely depend on bank financing, but since the financial crisis banks are much more restrictive in their lending.[454]

In consequence:

> In the context of SME's finance ecosystem, it appears that crowdfunding may respond to the needs of many small start-ups that do not manage to access bank finance, venture capital or reach the stage of initial public offering (IPO). Crowdfunding could thus contribute to bridging the finance gap for small firms and innovative projects. It could complement other sources of finance. Better access to finance for small businesses would promote entrepreneurship and ultimately contribute to growth and job creation. Crowdfunding creates opportunities to turn larger groups of people, who otherwise would not have access to traditional channels of finance, into small-scale entrepreneurs.[455]

The Consultation Paper identified a range of opportunities, risks and challenges with crowdfunding.[456]

In a communication *Unleashing the potential of Crowdfunding in the European Union* (27 March 2014), which refers to various types of crowdfunding, including CSEF, the European Commission proposed various steps to support the growth of crowdfunding in the EU, including the formation of an Expert Group and Stakeholder Forum to provide advice and expertise to the Commission in this area. The Commission also noted that as crowdfunding is a global activity, the Commission will closely follow international

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454 p 6. See also IOSCO, *Crowd-funding: An Infant Industry Growing Fast* (February 2014), Figure 2 on p 13.
455 p 7.
456 pp 6-9.

developments and will support efforts to promote regulatory convergence of approaches at the international level. The Commission will report back on progress in the course of 2015.

In addition to these general EU initiatives, various specific CSEF and other forms of crowd sourced funding approaches have been adopted, or are under consideration, in various EU Member States, including Italy and the UK.

A4.2 Italy

In late 2012, the Italian Parliament passed a decree which included the recognition and legalisation of equity-based crowdfunding.[457] In July 2013 the Italian securities regulator (Commissione Nazionale per le Società e la Borsa) (CONSOB) issued regulatory provisions necessary for their implementation,[458] thus making Italy the first country in Europe to operate CSEF laws.

In various respects, as explained below, the Italian approach, as it applies to issuers, intermediaries and investors, differs from that in the USA or Canada.

A4.2.1 Issuers

Types of issuer

CSEF in Italy is limited to 'innovative start-ups'. To be 'innovative', a firm must be recognised as such by the Chamber of Commerce, because, for example, it has invested in R&D activities or employs researchers.[459] To be a 'start-up', the firm can be no more than 48 months in existence.

There is no equivalent requirement in the US legislation or the Canadian proposals.

Maximum funds that an issuer may raise

The maximum funds raised by an eligible start-up through CSEF cannot exceed €5 million per year.

A4.2.2 Intermediaries

Permitted types of intermediary

CSEF investments must be arranged through 'permitted managers', covering broker-dealers/financial institutions and other persons who match requirements of professionalism and trustworthiness, to comply with anti-laundering laws and the EU *Markets in Financial Instruments Directive* (MiFID).

Matters related to issuers

Intermediaries are responsible to verify that the start-ups have satisfied all the necessary requirements to register on the portal.

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457 Article 30 of *Decreto Crescita* (Growth Decree), *Raccolta diffusa di capitali di rischio tramite portali online* (widespread collection of venture capital through online portals).

458 CONSOB, Regolamento (delibera n. 18592 del 26 giugno 2013) in materia di *'Raccolta di capitali di rischio da parte di imprese start-up innovative tramite portali on-line'* (equity crowdfunding).

459 The company purpose should expressly include the 'development and commercialisation of high-tech value products or services'.

Matters related to investors

The EU MiFID includes obligations on ‘permitted managers’ concerning matching an investor’s profile to investment risk. However, there will be an exemption from MiFID for small investments (investments not exceeding €500 from each investor, and €1,000 total per year in CSEF for each investor) provided the investors, when contributing through a crowdfunding platform, take a test to demonstrate that they are aware of the risks they are taking when investing, and that they can afford the possible loss of the amount invested.

A4.2.3 Investors

Threshold sophisticated investor involvement

Professional investors[460] and/or CONSOB-registered institutions must own at least 5% of the equity of a crowdfunded firm after the crowdfunding exercise, for that method of fundraising to be valid. The apparent intention is to give some form of comfort to small investors that the investment is worthwhile, given that one or more sophisticated investors has chosen to invest.

There is no equivalent requirement in the US legislation or the Canadian proposals.

Cancellation rights

Investors can withdraw their commitment at any moment until the crowdfunding campaign is closed.

Subsequent withdrawal rights

Start-ups using CSEF must insert a clause in their constitution which guarantees investors the right to withdraw from the investment and to sell their shares back to the firm, in case the major shareholder sells its stake to a third party (‘tag along’ right).

There is no equivalent right in the US legislation or the Canadian proposals.

A4.2.4 Future assessment

It is proposed that in mid-2014, CONSOB will evaluate the impact of the regulation on the Italian crowdfunding market and decide whether it is necessary to modify the law in some respect.

A4.3 United Kingdom

A4.3.1 Background

In August 2012, the Financial Conduct Authority (FCA) published a consumer information bulletin called *Crowdfunding: is your investment protected?*. The bulletin warned investors that many crowdfunding opportunities are high-risk and complex and are suited to sophisticated investors only. The document also pointed out that these types of investments

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[460] In Europe, professional investors (described as ‘professional clients’) are defined by the EU *Markets in Financial Instruments Directive* (MiFID) Annex II as individuals or organizations who possess the experience, knowledge and expertise to make investment decisions and properly assess risks. That classification can be satisfied if the investor meets at least two of the following criteria:

- having carried out market transactions of at least €50,000 at an average of 10 transactions per quarter for a year
- having a financial instrument portfolio worth more than €500,000
- having worked in a professional position relevant to the transactions envisaged, and in the financial sector.

are generally illiquid and that investors should be careful about investing over the internet because of the risk of fraud.

The FCA bulletin also stated that:

> We believe most crowdfunding should be targeted at sophisticated investors who know how to value a start-up business, understand the risks involved and that investors could lose all their money.

Subsequently, the FCA authorised some intermediaries which it considered had the necessary skills and expertise to publish equity offers on their websites.[461] This form of CSEF was confined to a relatively small group of investors, namely those persons who self-certified that they came within various prescribed tests of being sophisticated investors.

The FCA published a Consultation Paper *The FCA's regulatory approach to crowdfunding (and similar activities)* (October 2013) (the Consultation Paper) dealing, among other things, with the future regulation of CSEF.

The FCA subsequently issued a Policy Statement PS14/4 *The FCA's regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media* (March 2014) (PS14/4) which confirmed and outlined its approach to the regulation of CSEF in the UK (and some other matters).

The relevant rules to implement PS14/4 commenced in April 2014.[462]

A4.3.2 Overview of the regulation

The UK approach to CSEF adopts a different regulatory arrangement than that applying under the US JOBS Act or the Canadian proposals.

The FCA regulatory structure for what it terms 'investment-based crowdfunding' covers the processes by which licensed intermediaries may market 'direct offers' to various classes of investors to acquire 'non-readily realisable securities' in issuers.

The FCA regulation is designed to be 'media-neutral' in that it applies to all intermediaries marketing these types of direct offers, whether using online platforms or other media:

> This was done with [the FCA's] competition objective in mind and in order to provide appropriate protection for all investors however they invest … In our view the same protection should apply to investors whether they engage with firms online or offline as a result of direct marketing or through telephone selling of investments.[463]

To be a 'direct offer', the promotion needs to contain an offer or invitation, and specify the manner of response or include a form by which a response may be made.[464]

The concept of 'non-readily realisable securities' is designed to cover equity or debt securities of small and medium enterprises for which there is no, or only a limited, secondary market, and which, therefore, would pose a liquidity risk for investors. The concept therefore excludes from the FCA regulatory provisions for investment-based crowdfunding those securities which are 'readily realisable', meaning securities that are admitted or about to be

461 See, for instance, Crowdcube, Seedrs Limited.
462 The relevant rules are set out in Appendix 1 of PS14/4.
463 Sections 4.18 and 4.19 of PS14/4.
464 Section 4.12 of PS14/4.

admitted to an official listing; or traded, or soon to be traded, on a recognised investment exchange or designated investment exchange. However, a secondary market does not cover an online bulletin board on which people can list securities they wish to sell.[465]

The various rules that apply to issuers, investors and intermediaries concerning direct offers to acquire non-readily realisable securities are outlined below.

The FCA noted that review of the rules may be necessary in the future:

> We think our approach provides adequate investor protection and sufficient flexibility for [intermediaries] to operate and arrange finance for small and medium enterprise. However, greater prescription is an option that the FCA may consider in the future, depending on how the market evolves. We will review the market and our regulatory approach in the coming years.[466]

A4.3.3 Matters concerning issuers

Types of issuer

CSEF in the UK is effectively limited to issuers that are public companies. Although there is no maximum number of shareholders of a UK private company (in contrast with the Australian 50 non-employee shareholder cap[467]), the prohibition on public offers of private company shares remains in the UK context[468] (as indicated in FCA Policy Statement PS14/4).

Types of permitted securities

The regulatory structure applies to offers of any non-readily realisable securities (see above).

Maximum funds that an issuer may raise

There is no prescribed maximum. However, depending upon the amount sought, an issuer may have to publish a prospectus or other disclosure document (see below).

Disclosure by the issuer to investors

Issuers are subject to the prospectus provisions, though UK corporate law contains some exemptions for promotions of small securities issues.[469]

Coming within an exemption from the prospectus requirements still imposes some disclosure requirements on an issuer. According to one commentary on UK corporate law:

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465 Section 4.11 of PS14/4.

466 Section 2.19 of PS14/4.

467 See Section A2.1.2 of this report.

468 Section 4.20 of PS14/4 confirms that ss 755 and 756 of the UK Companies Act 2006 will continue to apply. Private companies in the UK are prohibited by s 755 from issuing shares to the public, or any section of the public. ‘Any section of the public’ is widely interpreted and can apply to any group of people, however few. The exemptions in s 756 are limited to persons with an existing or previous connection with the company.

469 Footnote 15 of PS14/4 states: ‘Exemptions are available in relation to promotions for small securities issues. If the total consideration for securities offered does not exceed 100,000 Euros (or equivalent amount) FSMA s86 may provide an exemption to FSMA s85. If offers fall below the €5 million limit, they may be exempt from the need for a prospectus under the Prospectus Directive. In relation to business that is not MiFID business, due to the exemption in the FPO article 70, the FSMA s21 financial promotion restriction does not apply to any communication that is included in listing particulars, supplementary listing particulars, a prospectus, or a supplementary prospectus or any other document required or permitted to be published by the listing rules or the prospectus rules. In relation to business that is MiFID business, exemptions are available for third party prospectuses.’

> If a prospectus is not required, the offer document (or information memorandum or other marketing material) would not have to comply with any regulatory criteria. The only constraints would be under the common law, and subscribers could have remedies against the directors for negligent misstatement and/or deceit if incomplete or misleading information is provided. It would therefore be prudent for the contents of the offer document to follow the prospectus requirements as far as possible, as well as including appropriate 'health warnings', even if these are not mandatory (e.g. that the value of the shares may fall, and that the investor may not get back all the money he/she paid for them). In this regard it would be appropriate to undertake due diligence and verification of the offer document to ensure that the contents are factually correct.[470]

An issuer is also subject to various general application disclosure rules, depending upon the nature of the offer and the nature of the investor. They include:

- FCA *Conduct of Business Sourcebook* (COBS) 2.2.1R: information disclosure before providing services
- COBS 4.7.1R: information to be disclosed in direct offer financial promotions
- COBS 6.1: information concerning various charges and remuneration.

A4.3.4 Matters concerning investors

Permitted types of investors

The classes of investors to which direct offers of non-readily realisable securities can be made are limited to 'professional clients' (sophisticated investors) and some retail investors.

The Consultation Paper proposed that authorised intermediaries, in addition to being able to communicate offers in non-readily realisable securities to sophisticated investors, be permitted to make these offers to the following classes of retail client:

- retail clients who are certified or self-certify as sophisticated investors
- retail clients who are certified as high net worth investors
- retail clients who are venture capital contacts or corporate finance contacts
- retail clients who confirm before a promotion is made that, in relation to the investment promoted, they will receive regulated investment advice,[471] or investment management services from an authorised person, or
- retail clients who certify that they will not invest more than 10% of their net investible portfolio (i.e. excluding their primary residence, pensions and life cover) in non-readily realisable securities.[472]

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470 UK Institute of Directors Guidance Note *Share issues by private companies*.

471 The rules relating to suitability of investment advice are detailed in chapter 9 of the FCA *Conduct of Business Sourcebook*.

472 Section 4.16 and Annex D of Appendix 1 of the Consultation Paper.

The Consultation Paper proposed that where regulated investment advice is not provided, intermediaries should apply an appropriateness test[473] before sending retail clients direct offer financial promotions for non-readily realisable securities. This would help ensure that only clients who have the knowledge or experience to understand the risks would invest.

The Consultation Paper also commented that:

> Given our consumer protection objective, our aim is to ensure that only those retail investors who can understand and bear the various risks involved are invited to invest in [non-readily realisable securities]. If [intermediaries] target this wider but still restricted audience of retail investors appropriately, this may result in greater access to alternative (non-bank) finance options for businesses seeking finance.[474]

PS14/4 confirmed the approach taken in the Consultation Paper (described above) in regard to the classes of retail investors (in addition to sophisticated investors) to whom offers of non-readily realisable securities could be made through an authorised intermediary, whether through its online portal or using other media, and when an appropriateness test would apply. The relevant rules are set out in the FCA *Conduct of Business Sourcebook*.[475]

According to an FCA media release accompanying PS14/4:

> The new rules for securities-based crowdfunding keep the crowd in crowdfunding by allowing anyone to invest up to 10 per cent of their available assets.[476]

PS14/4 noted that its approach to permit CSEF offers to be made to various classes of retail investors, under certain conditions:

> [is] aimed to provide ordinary retail investors, who may lack the knowledge, experience and resources to understand and cope with the risks, with both the freedom to invest and proportionate protection when they are invited to invest in non-readily realisable securities that involve potential for significant capital losses.[477]

Maximum funds that each investor can contribute

As indicated above, retail investors who rely on the certification that they will not invest more than 10% of their net investible portfolio (i.e. excluding their primary residence, pensions and life cover) in non-readily realisable securities are limited to that cap, which applies independently of any period. This investor linked cap (the *seventh approach*) represents a different approach to that adopted in the USA or Canada.

There is no investment cap on sophisticated investors, or other categories of eligible retail investors, in regard to the acquisition of non-readily realisable securities.

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473 The rules on appropriateness are detailed in chapter 10 of the FCA *Conduct of Business Sourcebook*. In the context of CSEF, the rules would require that where a retail client does not receive regulated investment advice, intermediaries must assess the appropriateness of the transaction for a particular client. For this purpose an intermediary would have to ask the client for information and determine whether the client has the necessary experience and knowledge to understand the risks involved in relation to the product on offer, and also warn the client if the intermediary determines the transaction is not appropriate.

474 Section 4.4 of the Consultation Paper.

475 See Annex D of Appendix 1 of PS14/4.

476 FCA Press Release 6 March 2014.

477 Section 4.4 of PS14/4.

A4.3.5 Matters concerning intermediaries

Permitted types of intermediary

Intermediaries must be authorised by the FCA before being permitted to market non-readily realisable securities to eligible investors, whether through the internet or otherwise. Authorised intermediaries, and their representatives, must comply with the FCA Handbook requirements (which include the *Conduct of Business Sourcebook*).[478]

Intermediary checks on issuers

Apart from conducting some basic checks, for instance that an issuer is in fact incorporated and the persons acting on behalf of the issuer are in fact corporate officers, intermediaries are not obliged to conduct due diligence checks of issuers that use their websites. Rather, as indicated in PS14/4, they have disclosure obligations in regard to whether they have conducted due diligence:

> In satisfying the financial promotion rules we expect sufficient detail to be provided to give a balanced indication of the benefits and the risk involved, including whether or not any due diligence has been carried out on [an issuer], the extent of the due diligence, and the outcome of any analysis.[479]

However, the FCA has also indicated that, in line with FCA Principles, firms that operate investment-based crowdfunding platforms are expected to conduct their businesses with integrity and have system and controls to mitigate the risk of offers being made in contravention of applicable legislation.[480]

Intermediary obligations in relation to issuer promotions

Intermediaries that communicate or approve financial promotions concerning crowdfunding offers will need to ensure that they comply with applicable financial promotion rules, particularly the requirement for the promotion to be fair, clear and not misleading.[481] The FCA commented that:

> Vulnerable investors may be more susceptible to emotive advertising highlighting the social benefits of the investment, or high headline rates of return compared to lower interest rates on deposit accounts. Younger investors may also be more susceptible to social network promotion of platforms. To guard against this, we suggested that we would place particular emphasis on the need for communications to these groups to be fair, clear and not misleading.[482]

Also, intermediaries, as well as issuers, must satisfy themselves that issuers are meeting any requirement to publish a prospectus (or satisfy themselves that an exemption applies).[483]

Intermediary vetting of investors

Intermediaries must ensure that their retail clients are eligible (see Section A4.3.4) before communicating direct offer promotions of non-readily realisable securities to them. However, PS14/4 indicated that repeat appropriateness assessments by intermediaries of retail clients who have not received advice will not be required if it is reasonable to consider

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478 Section 4.3 of PS14/4.
479 Section 4.22 of PS14/4.
480 Section 4.20 of PS14/4.
481 Section 4.22 of PS14/4.
482 Section 2.2 of PS14/4.
483 Section 4.20 of PS14/4.

that an earlier assessment is still current.[484] Also, where retail clients certify that they will not invest more than 10% of their net investible assets in non-readily realisable securities, intermediaries can communicate such offers to that individual for 12 months after the date of the statement without a new certification from that individual. During that period intermediaries do not need to ensure that individuals continue to qualify on an ongoing basis.[485]

Disclosure of inherent risks to investors

The FCA noted in PS14/4 that investors face significant inherent risks when buying non-readily realisable securities. These include the risk of capital loss (which is exacerbated if the price paid for a security is based on an over-valuation of the business), the risk of dilution of shareholder value, the risk that dividends will not be declared, and illiquidity risk (the lack of a secondary market).[486]

The FCA indicated that intermediaries are obliged to provide fair, clear and prominent risk warnings. However, boiler-plate standard warnings may not suffice:

> As the risks involved when investing in different non-readily realisable securities vary greatly, depending on the nature of the investment offered, it may not always be meaningful or helpful to present consumers with a single, uniform FCA-approved risk warning. Different warnings will be needed in differing circumstances, for different investments and audiences.[487]

Conflicts

Intermediaries are expected to manage any conflicts of interest fairly, both between themselves and their issuer or investor clients, and between the issuer and investor clients.[488]

Intermediaries not to hold investor funds

To avoid complex compliance requirements for intermediaries that would otherwise be applicable, the practice has been that intermediaries do not hold investor funds. Rather, funds are not provided from investors until a stipulated target amount has been reached, whereupon they are transferred directly from the investors to the issuer.

484 Section 4.24 of PS14/4.
485 Section 4.28 of PS14/4.
486 Section 4.14 of PS14/4.
487 Section 4.21 of PS14/4.
488 Section 4.20 of PS14/4.

Appendix 5 New Zealand

This Appendix outlines the New Zealand approach to CSEF, which began in April 2014.

A5.1 Overview

The Financial Markets Conduct Act 2013 (the Act) and Financial Markets Conduct (Phase 1) Regulations 2014 (the FMA Regulations) contain provisions that are designed to facilitate CSEF. They came into force in April 2014. These provisions, in the CSEF context, substitute for the regulatory regime otherwise pertaining to equity-raising by corporate entities.

In implementing this initiative, the New Zealand Government stated that new forms of intermediated fundraising such as CSEF:

> enable funds for small businesses and individuals to be raised in internet-based market places, potentially more efficiently than through traditional public or private offerings.[489]

Also:

> Enabling crowd-funding was highlighted in the Government's Business Growth Agenda as an initiative to support early-stage and growth companies to access the risk-capital they need to grow … Permitting crowd-funding platforms will open up significant new opportunities for small businesses to raise growth capital.[490]

Part 6 of the Act and the associated Regulations provide for applications to be made to the Financial Markets Authority (FMA) to be licensed to provide a 'crowd funding service' for the purposes of CSEF. For this purpose, the FMA has published *Crowd funding Part B1: Your guide to applying for a market service licence* (April 2014) (FMA Crowd funding guide).

Issuers making CSEF offers through licensed CSEF intermediaries will be exempt from the normal requirement to register a Product Disclosure Statement.[491]

New Zealand CSEF offers would not qualify for mutual recognition in Australia,[492] and therefore some adjustment to these arrangements may be necessary.

The elements in the New Zealand approach are set out in the following sections of this Appendix.

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489 See the New Zealand Government *Building Capital Markets* Progress Report (February 2013) of its *Business Growth Agenda* at 23.

490 Office of the Minister of Commerce Cabinet Paper *Financial Markets Conduct Regulations Paper 4 – Licensing regimes* at paras 124-125.

491 FMA Crowd funding guide at 3.

492 Chapter 8 of the Corporations Act provides a general mechanism for mutual recognition of securities offers by entities registered in other jurisdictions. New Zealand is a recognised jurisdictions: definition of 'recognised jurisdiction' in s 1200A(1), Corp Reg 8.1.03. However, only offers for which a prospectus is required are recognised.

A5.2 Issuers

A5.2.1 Types of permitted securities

CSEF is limited to shares in companies. A share does not include a financial product that will be converted, or is or may become convertible, into another financial product.[493]

A5.2.2 Maximum funds that an issuer may raise

Issuers may raise a total of $2 million in each 12 month period through a combination of CSEF to retail investors and any fundraising through the New Zealand equivalent of the small-scale personal offers exception (in s 708 of the Australian legislation). However, investments from wholesale investors will not count in determining whether the fundraising is within the cap:

> This means that issuers will be able to raise more than $2 million per year (sometimes much more) through crowd funding services if some of the investors are wholesale investors under the FMC Act.[494]

Intermediaries must ensure that issuers do not exceed fundraising limits. For this purpose, intermediaries must maintain adequate systems and procedures to ensure that issuers do not exceed the issuer cap of $2 million in any 12 month period that the issuer uses the intermediary's service.[495]

An intermediary must notify the FMA if that party knows or suspects that an issuer that uses the service has committed, is committing, or is likely to commit a contravention of the $2 million aggregate limit.[496]

A5.2.3 Disclosures in the offer documents

Intermediaries must have adequate disclosure arrangements with issuers to give investors, or to enable investors readily to obtain, timely and understandable information to assist investors to decide whether to acquire particular shares on offer on the intermediary's website (for example, through initial disclosure, or question and answer forums, or other information that is made available).[497]

In considering whether the disclosure arrangements are adequate, the FMA must have regard to:

- the limits (if any) on the amount that retail investors may invest in an issuer; and
- the amount that issuers may raise through the CSEF process.[498]

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493 FMA Reg 16(4).
494 Ministry of Business, Innovation & Employment, *Financial Markets Conduct Regulations: First Exposure Draft* (October 2013) at paragraph 58.
495 FMA Reg 17(1), FMA Crowd funding guide at 18.
496 FMA Reg 26.
497 FMA Reg 17(1).
498 FMA Reg 17(2).

Minimum disclosure arrangements

The minimum disclosure arrangements include:

- a dedicated webpage on the intermediary facility for each offer, which is simple to access and navigate and available to all investors
- disclosure of a description of the issuer business and the purpose of the fundraising
- disclosure of the terms of the offer, including:

price

minimum funding sought

duration of the offer

amounts raised (updated regularly)

investor caps (if any)

rights attaching to the shares (and details of any other securities of the issuer)

- information about how shares can be sold, including about any available secondary markets
- the names and positions of the issuer's directors and senior managers (intermediaries could also consider requiring disclosure of their education, skills and experience)
- arrangements with issuers to supply required information.[499]

An intermediary's disclosure arrangements should also cover how the intermediary will review the information issuers' supply to check that it is understandable and timely (when disclosed) or state how the intermediary will rely on the issuer to do this.[500]

Discretionary disclosure arrangements

Intermediaries may also consider including:

- a Q&A function on their websites
- information from the Companies Office about issuers, or links to the Companies Office 'Company Summary' webpages for issuers.[501]

Level of disclosure linked to any investor cap

The FMA has indicated that if voluntary investor caps are not imposed, or they are high, or the issuer is trying to raise significant amounts of capital, the FMA would usually expect that the arrangements for disclosure to the crowd include extra disclosure such as providing a business plan, details of how funds will be used, key risks and key financial information, such as financial statements.[502]

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499 FMA Crowd funding guide at 16.
500 ibid.
501 ibid.
502 ibid.

A5.2.4 Liability of issuers

An issuer using CSEF will be subject to liability for any misstatements or unsubstantiated representations it makes (unless it can prove a defence, for instance that the contravention was due to a cause beyond its control and it took reasonable precautions and exercised due diligence to avoid the contravention).

A5.3 Intermediaries

A5.3.1 Licensing

A person wishing to provide a crowd funding service must be licensed for that purpose. A person provides a crowd funding service if:

- it provides a facility by means of which offers of shares in a company are made; and
- the principal purpose of the facility is to facilitate the matching of companies who wish to raise funds with many investors who are seeking to invest relatively small amounts.[503]

To be licensed, an intermediary must:

- have fair, orderly, and transparent systems and procedures for providing the service[504]
- satisfy capability standards.[505]

In addition, the directors and senior managers of the intermediary must be fit and proper persons to hold their respective positions.[506] The FMA has laid down minimum standards in this regard.[507]

A number of other licensing requirements apply, including in relation to the internal governance, financial resources, indemnity insurance, and information technology arrangements of intermediaries, and a plan to protect the interests of relevant issuers or investors if the intermediary services are terminated.[508]

A5.3.2 Procedures for attracting new clients

The procedures employed by an intermediary for attracting new clients (both issuers and investors) must ensure that they get sufficient information to make informed decisions about the financial services offered, and that these services are not inappropriately marketed.[509]

The intermediary will need to describe how it intends to attract clients to its service, such as using advertising or referrals.[510]

The intermediary will also need to demonstrate how its procedures will ensure it meets various obligations, including:

503 FMA Reg 16(1)(a). See also FMA Crowd funding guide (April 2014) at 3.
504 FMA Reg 17(1).
505 FMA Crowd funding guide at 11-12.
506 FMA Crowd funding guide at 9.
507 FMA Crowd funding guide at 9-10.
508 FMA Crowd funding guide at 22-36.
509 FMA Crowd funding guide at 13.
510 ibid.

- the requirement for a written client agreement with investors
- fair dealing obligations, including the process to ensure its advertisements are not misleading or deceptive
- the obligation to provide a disclosure document to investors, with particular attention to disclosure in respect of the nature and extent of due diligence conducted on issuers and the use of the facility by persons associated with associated with the intermediary
- the obligation to provide a warning statement to investors, and to get their confirmation that they have seen the warning.[511]

A5.3.3 Disclosures by intermediaries to intending investors

Intermediaries will be required to provide a service disclosure statement to retail investors and enter into written client agreements with them, dealing adequately with:

- how the platform's investment processes operate
- the mechanisms to deal with interactions between issuers and investors
- any ongoing monitoring of issuers that the platform proposes to perform
- how any investor money is handled by the intermediary
- the fees and charges that will apply to investors
- how investors can make complaints.[512]

The service disclosure statement must also contain the risk warning statement.[513]

A5.3.4 Due diligence checks on issuers

Intermediaries must have anti-fraud and fair dealing policies that enable them to assess issuers, and if needed, exclude them from using the online facility.[514]

Anti-fraud

Intermediaries are required to conduct checks to exclude offers by issuers on their websites where there is evidence that directors, senior managers or controlling owners of the issuer are not of good character and reputation.

At a minimum, this must involve:

- checking, against publicly available and readily accessible information, the identity of the issuer and information provided by the issuer relating to the identity and character of its directors and senior managers; and
- excluding an issuer from using the service if the provider is not satisfied as to the identity of the issuer or of the issuer's directors and senior managers, has reason to believe that any of the issuer's directors or senior managers are not of good character; or has reason

511 ibid.
512 FMA Act s 423 and FMA Regs 36–47.
513 FMA Reg 36(3).
514 FMA Crowd funding guide at 14.

to believe that the issuer is not likely to comply with the obligations imposed on it under the service.

The intermediary must have adequate systems and procedures to implement this policy.[515]

The FMA has indicated that the anti-fraud policy must, at a minimum, confirm the identity and character of the issuer's directors and senior managers from publicly available and readily assessable information. This should include searching relevant public registers (such as the Companies Register and Insolvency Register) and the internet (for relevant news articles or other commentary) to identify evidence of:

- bankruptcy or involvement with insolvent companies
- information that may question the identity of directors or senior managers
- convictions for fraud or dishonesty – or involvement in litigation or other disputes.

The intermediary must also identify the criteria to help assess this information and to make decisions about allowing issuers to use the service.[516]

Fair dealing

An intermediary must has an adequate policy for excluding an issuer from using the service if the provider has information (for example, from checks or assessments it carries out (if any)) that gives it reason to believe that the issuer, in relation to any dealing in shares using the service, has:

- engaged in conduct that is misleading or deceptive or likely to mislead or deceive; or
- made a false or misleading representation in contravention of s 22 of the Act; or
- made an unsubstantiated representation in contravention of s 23 of the Act.

The intermediary must have adequate systems and procedures to implement this policy.[517]

The FMA has indicated that the fair dealing policy of an intermediary must enable it to exclude an issuer from using the service in certain circumstances. An intermediary's fair dealing policy should set out:

- the steps the intermediary will take if it identifies identify actual or suspected evidence of misconduct of the type set out in Regulation 17(1)(e) (see above)
- the process an intermediary will use to exclude an issuer, and how that exclusion will be given effect to, for example through appropriate provisions in agreements with issuers.[518]

515 FMA Reg 17(1).
516 FMA Crowd funding guide at 14.
517 FMA Reg 17(1).
518 FMA Crowd funding guide at 14.

Other due diligence

The intermediary must maintain clear and transparent information about what due diligence the intermediary has and has not carried out on issuers, so investors can make reasonable judgments about the risks of investing.[519]

More specifically, the intermediary must disclose the nature and extent of the checks, if any, of the risks involved with the shares that are subject to the offer, or disclose that such checks are not part of the intermediary's service.[520]

A5.3.5 Conflict of interest

An intermediary must have adequate systems and procedures for handling conflicts between the commercial interests of the provider (or of its associated persons) and the need for the provider to have fair, orderly, and transparent systems and procedures for providing the service.[521]

An intermediary will be required to identify and deal with conflicts of interest in a fair, orderly and transparent way. An intermediary must have adequate systems and procedures for handling conflicts between its commercial interests and the need to have fair, orderly and transparent systems and procedures.[522]

For this purpose, an intermediary must clearly and prominently disclose:

- if the intermediary or anyone commercially associated with the intermediary has a direct or indirect interest in any offer made through the intermediary's facility
- the nature and extent of the interest (or intended investment) and any fees the issuer pays the intermediary above the standard disclosed amount.[523]

A5.3.6 Fees charged by the intermediary

The intermediary must clearly and prominently disclose all fees paid by issuers in connection with the offer, whether direct or indirect and however described.[524]

A5.3.7 Intermediary investment in an issuer

Intermediaries will be permitted to invest in offers made on the intermediary's website, provided they provide details of the likely nature and extent of such investment (if known).[525]

If an intermediary, or an associated person, wishes to invest in this manner, the intermediary must explain how its systems and procedures for handling conflicts of interest will ensure other investors are not prejudiced. An intermediary must also ensure that potential conflicts are disclosed clearly and prominently on its facility.[526]

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519 FMA Crowd funding guide at 15.
520 FMA Reg 36(1)(f)(iii).
521 FMA Reg 17.
522 FMA Crowd funding guide at 17.
523 ibid.
524 ibid.
525 ibid.
526 ibid.

A5.3.8 Investor funds

If intermediaries receive, hold, pay or transfer funds from investors to pay for investments, they must comply with the broker obligations in the Financial Advisers Act, meaning that the funds must be held in trust.[527]

An intermediary must also disclose how investor money is received and dealt with.[528]

A5.3.9 Dispute resolution

Intermediaries are expected to have a complaints process, including belonging to a dispute resolution scheme, as required under the Financial Service Providers (Registration and Dispute Resolution) Act 2008. This is one of the requirements of registering to become a financial service provider to retail clients.[529]

A5.3.10 Indemnity insurance

An intermediary must maintain an appropriate level of professional indemnity insurance cover for its business.[530]

A5.4 Matters related to investors

A5.4.1 Permitted types of investor

There are no limitations on who may invest through CSEF.

A5.4.2 No investor cap

Unlike the proposals in the USA or Canada, there are no limits on how much can investor can invest in CSEF.

Rather, when assessing an intermediary's arrangements the FMA is required to consider the limits (if any) on the amount that retail investors may invest.[531]

The FMA has indicated that if voluntary investor caps are not imposed, or they are high, or the issuer is trying to raise significant amounts of capital, the FMA would usually expect that the arrangements for disclosure to the crowd include extra disclosure such as providing a business plan, details of how funds will be used, key risks and key financial information, such as financial statements.[532]

A5.4.3 Risk disclosure

An intermediary must ensure that a warning statement is prominently displayed on the home page of its online site; and on a page on the site, immediately before the investor uses the site to apply for, or otherwise acquire, equity.

The warning statement must be in the following form:

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527 FMA Crowd funding guide at 18.
528 FMA Reg 36(1)(e), Reg 45(c).
529 FMA Crowd funding guide at 20.
530 FMA Crowd funding guide at 31.
531 FMA Crowd funding guide at 15.
532 FMA Crowd funding guide at 16.

> Equity crowd funding is risky.
>
> Issuers using this facility include new or rapidly growing ventures. Investment in these types of businesses is very speculative and carries high risks. [Omit these sentences if the facility is confined to issuers for whom the sentences would be inapplicable]
>
> You may lose your entire investment, and must be in a position to bear this risk without undue hardship.
>
> New Zealand law normally requires people who offer financial products to give information to investors before they invest. This requires those offering financial products to have disclosed information that is important for investors to make an informed decision.
>
> The usual rules do not apply to offers by issuers using this facility. As a result, you may not be given all the information usually required. You will also have fewer other legal protections for this investment.
>
> Ask questions, read all information given carefully, and seek independent financial advice before committing yourself.[533]

A5.4.4 Risk acknowledgement by the investor

Investors will be required to affirm to the intermediary that they understand the risks involved in CSEF. For this purpose, an intermediary must obtain from each crowd investor, a confirmation to the following effect:

- I confirm that I have seen the warning statement about crowd funding; and
- I understand that equity crowd funding is risky and I may lose my entire investment; and
- I confirm that I could bear that loss without suffering undue hardship; and
- I understand that the usual legal protections do not apply to this investment; and
- I understand that I may not be given the same information as is usually required by New Zealand law for investments.[534]

The confirmation must be obtained in writing in a separate document or, if it is obtained by electronic means, through a process by which it is obtained separately from the agreement to use the intermediary service.

The confirmation must be obtained by the intermediary before the investor is authorised to use the intermediary service.[535]

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533 FMA Reg 27.
534 FMA Reg 28(1).
535 FMA Reg 28(2), (3).

Appendix 6 Respondents

Australian Securities Exchange
Law Council of Australia
Australian Small Scale Offerings Board
BizzBuild
Minter Ellison
Marina Nehme
Capital Technologies Pty Ltd
Chuffed
Community Sector Banking
ClearSky
Ramin Marzbani
CrowdfundUP Pty Limited
B Morgan, D Kuch & J Ngo
CrowdIQ
Daniel Meyerowitz-Katz and Hannah Glass
Elaine Liew
Capital Potential
Emma Tomkinson
Gerard Shea
Innovation Australia
iPledg (Andy Tompkins & Bryan Vadas)
Kylie Hammond & Roger Buckeridge
Cassandra Wilkinson
Philanthropy Australia
Matthew Vitale
Norton Rose Fulbright
Office of the NSW Small Business Commissioner
Oscar Scherl
Pennam Partners
Social Business Australia
Pete Cooper
CLEANaS
Tom Camphin
Pozible and Clearpoint Counsel
Queensland Government
Robyn Donnelly
Seaview Consulting
Squareknot
Andrew Ward
Australian Community Renewable Energy