Submission to the Economics Legislation Committee

(Senate Standing Committees on Economics)

Corporations Amendment (Crowd-Sourced Funding) Bill 2015

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Introduction

This submission is in response to the inquiry that is currently being conducted into the introduction of crowd-sourced funding ('CSF') in Australia. The aim of this submission is to provide an informed debate on the critical issues raised by the Corporations Amendment (Crowd-sourced Funding) Bill 2015 ('The Bill').

If any of the responses require further explanations, please contact Dr Marina Nehme from the University of New South Wales, Australia at

General Observations

In line with the approach of other countries such as the United States, United Kingdom, Italy and New Zealand, the Bill proposes three key safeguards to protect investors. These safeguard target the regulation of businesses, intermediaries and investors. This submission will be referring to three proposals: One proposal—referred to in this paper as the CAMAC model—has been put forward by the Corporations and Markets Advisory Committee ('CAMAC').[1] The other proposal—referred to in this paper as the NZ model—is based on the

[1] CAMAC was established in 1989 to provide the responsible Minister with an independent source of advice on the amendment of the corporations legislation, the operation and administration of that legislation, and the enhancement of financial services laws to ensure their efficiency: <www.camac.gov.au>. Despite the central role CAMAC has played in implementing reforms that have cut red tape and enhanced business efficiency, the Australian government is planning to abolish CAMAC: Australian Securities and Investments Commission Amendment (Corporations and Markets Advisory Committee Abolition) Bill 2014.

NZ law reforms in this area.[2] The option put forward by the Bill will be referred to as the Bill model.

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

- Currently the Bill **excludes over 99.7% of companies** from accessing CSF. Such a reality defeats the purpose for introducing legislation to facilitate CSF as only a very small minority of companies will be able to raise funds through this mode of finance. Accordingly, serious consideration should be made to allow small and medium enterprises ('SMEs') to rely on this mode of finance.
- The current maximum amount that can be raised by a company through CSF is too high and not justifiable. A more modest cap is needed.
- The Bill imposes limited governance requirement for certain companies with the aim of encouraging proprietary companies to convert to public companies. While such a move is welcomed, these requirements need to be expanded to cut red tape and to ensure that proprietary companies have an incentive to invest in CSF.
- Businesses should only be allowed to raise money based on milestones present in their business plan. This would raise their accountability as they would have to justify any delays in reaching a milestone to investors before they can raise more funds on the market. Reaching a milestone sends a signal to the market about the viability and potential of the project. It may also lower instances of fraudulent activities and curtail any losses investors may suffer due to a project.
- The regulation imposed on intermediaries is well balanced. However, civil penalties as well as criminal penalties should be introduced to the system.
- ASIC's power should be expanded to ensure ASIC can efficiently regulate this area of the law.
- **Financial literacy** strategies should be attached to CSF. A questionnaire to test investors' understanding of the risks involved with CSF and the factors to consider when investing through CSF, such as signals to look for, would also be beneficial.

Safeguard 1- Business Regulation

One of the safeguards proposed in Australia is the imposition of certain regulations on businesses who are trying to raise capital from the public. This is an important safeguard because there is a risk of fraud and business failure attached to crowdfunding.

a The Cap

Both the CAMAC and the NZ models impose a cap on investments through CSF. The proposed cap under both models is $2 million (AUD) in any 12 month period limited to one class of shares – ordinary fully paid shares.[3] This cap is appropriate for the following reasons:

- Around the world to date the average amount raised by different types of crowdfunding is less than $2 million (AUD). For example, in 2014, the average amount that a business raised from Peer to Peer ('P2P') lending was $103,618 (US).

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[2] Australian Government, *Crowd-Sourced Equity Funding – Discussion Paper* (December 2014) , 7, <http://treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Crowd%20Sourced%20Equity%20Funding/Downloads/PDF/CSEF%20Discussion%20Paper.ashx>.

[3] This cap excludes funds raised under existing prospectus exemptions for wholesale investors. See Australian Government, above n 2, 9.

In the case of CSF, the average amount varied from region to region, with averages ranging from $175,000 (US) in North America to an average of $342,260 (US) in Asia.[4]

- The $2 million (AUD) cap is consistent with the seed capital requirement that the majority of start-ups may need.[5]

However, the Bill model ignores both recommendations and introduces a cap of $5 million (AUD) in any 12 months period. While this cap is supported and promoted by ASSOB,[6] no justification has been put forward to explain the need to raise the cap to this amount. The cap supported by the CAMAC and NZ models seems more justifiable then the one put forward by the Bill model. In fact, only Italy has adopted a higher cap than the one proposed by the Bill. Most countries have adopted a cap that varies between $1-2 million.

Accordingly, **a return to the $2 million cap is recommended**.

b Type of Company

In addition, the NZ model allows all types of companies to raise capital through CSF. This approach is simple and allows companies of all sizes to benefit from this form of finance. However, to apply such a system in Australia is difficult due to the cap imposed on proprietary companies:[7] such companies may not have more than 50 non-employee members.[8] The existence of this cap goes against the spirit of CSF which is trying to raise small amounts of money from large numbers of people. Accordingly, the CAMAC and Bill models have stated that only public companies would be able to rely on CSF to raise funds from the market. Such a limitation is problematic since it would exclude small businesses, who are most likely to be proprietary companies, from raising capital through this form of finance. It does not provide a solution to the problem that led the policy communities to reach consensus on this form of finance: the shortfall of capital for SMEs.

While it can be argued that proprietary companies may convert to public companies and this would allow them to raise funds through CSF, this suggestion does not take into account the reality that, even if a company becomes a public company, it may not have the necessary resources or funds needed to comply with the legislative requirements attached to public companies.[9] For this reason, CAMAC put forward a proposal for the establishment of a new type of company: the exempt public company. Such a company would be exempt from following the compliance requirements imposed on public companies by the *Corporations Act 2001* (Cth) for a period of up to three to five years.[10] At the end of that period the company would revert to being a public company and would have to comply with the compliance requirements set out in the legislation. This option was partially adopted by the Bill model. While not creating a new type of company, the Bill provides that companies that qualify for CSF –unlisted public companies with share capital – may be eligible for limited

[4] Massolution Crowd Power business, *2015CF The Crowdfunding Industry Report* (Massolution, 2015), 15.
[5] CAMAC, *Crowd Sourced Equity Funding – Report* (May 2014), 58.
[6] See for example, ASSOB, CAMAC Crowd Sourced Equity funding Submission (2014) 3, <http://www.camac.gov.au/camac/camac.nsf/byheadline/pdfsubmissions_6/$file/assob_csef.pdf>.
[7] 98.9% of companies are in fact proprietary companies: Robert Austin and Ian Ramsay, *Ford, Austin and Ramsay's Principles of Corporations Law* (LexisNexis, 2015) 169.
[8] *Corporations Act 2001* (Cth), s 113.
[9] Terence Wong, 'Crowd funding: Regulating the New Phenomenon' (2013) 31 *Company and Securities Law Journal* 89, 98.
[10] Ibid 52-53; Australian Government, above n 2, 9.

governance requirements for five years if they have just been created or they have recently been converted to a public company and they plan to raise capital via CSF.[11] Such companies have the following concessions:[12]

- Unlike general public companies, they are not required to hold an annual members' general meeting for five years;
- They are only required to provide online financial reports to shareholders for a period of five years. No hard copies are required to be sent to the members.
- While public companies have to appoint an auditor within one month of registration, for the first five years, companies eligible for limited governance requirements do not need to do so until they raise more than $1 million (AUD) from CSF or other offers requiring disclosure.

Although this proposal deals with the shareholders limitation imposed on proprietary companies, there is doubt regarding whether the limited governance imposed on these companies is enough to encourage proprietary company to convert to public company to access CSF. For instance, if the company raises more than $1 million (AUD), it will have to appoint an auditor. Further, costly continuous obligations under the *Corporations Act 2001* (Cth) will apply as the company will be deemed as unlisted disclosing entities.[13] Half yearly reports will also then be required to be provided by such companies.[14] Consequently, the current concessions are really minimal and do not necessarily encourage proprietary companies to be converted to a public company as the governance cost remains high. **Broader concessions may be needed to ensure that the company does not have continuous disclosure obligation imposed on it for a certain period of time.**

Further, the nature of the exemption is temporary. There is an assumption that at the end of the specified five year period, a business that attracted crowdfunding as an exempt public company will have the necessary resources to be able to comply with the legislative requirements attached to a public company. However, this may not be the case and, consequently, compulsory conversion to a public company may negatively impact the affairs of the business. Accordingly, it is crucial to get the timing of when such a conversion occurs correct.

In determining what length of time is appropriate before requiring a business to convert from being an exempt public company to being a public company, it is important to consider a range of factors. Firstly, the life cycle of a business has seven stages: seed stage, start-up stage, growth stage, established stage, expansion stage, mature stage and exit stage.[15] As CSF is aimed at encouraging and promoting innovation as well as providing funding to small businesses, a number of businesses may be testing their ideas through crowdfunding and may still be at a seed stage. The biggest hurdle then is to convert their business idea into a successful commercial venture and this could take years to achieve.[16] Further, if the venture involves the development of a new product, the product development cycle has to be

[11] Corporations Amendment (Crowd-source Funding) Bill 2015 (Cth), cl 738ZI.
[12] Ibid.
[13] *Corporations Act 2001* (Cth), ss 111AL, 675.
[14] *Corporations Act 2001* (Cth), s 285, 302.
[15] Thierry Janssen, 'The Seven Stages of Business Life Cycle' (white paper, Just in Time Management Group, 2013) <http://www.justintimemanagement.com/sites/default/files/WP-The-7-stages-of-business-life-cycle-Thierry-Janssen.pdf>.
[16] Karish Manchanda and Pushkala Muralidharan, 'Crowdfunding: A New Paradigm in Start-Up Financing' (2014) (1) *Global Conference on Business and Finance Proceedings* 369, 369.

considered, as this involves different stages which include project strategy, development process, organisational and firm characteristics.[17] According to empirical research conducted in this area, newer and more complex projects are associated with longer development times.[18] In the case of crowdfunding, many start-ups may not have the necessary tools, knowledge or infrastructure required to be able to complete their project in a short period of time.[19] As such, a majority of start-ups take longer than expected to produce their product.[20]

Further, research has shown that the average product development cycle for a product is 27 months. However, the development of a product does not ensure its success.[21] Commercialisation of the product is still necessary and is essential for the success of the business.[22] This process would then take an average of 4.5 months in the case of an organised and experienced person.[23] This would mean that a company developing a new product may not start generating profit until at least three years after it had become an exempt public company. As such, it is recommended that the time for conversion should not be less than five years. This is especially the case as by the fifth year more than half of the businesses would have failed. Accordingly, by this time, it is most likely that the exempt public companies remaining are the ones that have a good chance of succeeding in their business. However, as the product development cycle may vary from one case to the next, ASIC[24] should be given the power to allow exempt public companies to apply for an extension of the five year exemption period if needed. This will ensure the flexibility of the system and enhance businesses' chances of success. However, **such an exemption power is not currently present in the Bill model and should really be introduced.**

c Other Restrictions

The Bill model currently excludes 99.7% of companies from raising capital through CSF. However, it goes further by limiting the types of eligible companies. In addition to the fact that public listed companies and their related parties cannot raise capital via CSF, the only companies that are allowed to do so are companies that fulfil the following two requirements:[25]

- Companies that have a consolidated gross asset of less than $5 million (AUD); and
- Companies that have a consolidated annual revenue of less than $5 million (AUD).

It is assumed that companies that fulfil these requirements will be SMEs. However, the gross assets and gross revenue tests combined with the governance costs of running a public company limits the companies that will in the future raise capital through CSF in Australia.

[17] Abbie Griffin, 'Modeling and Measuring Product Development Cycle Time Across Industries' (1997) 14(1) *Journal of Engineering and Technology Management* 1.
[18] Abbie Griffin, 'The Effect of Project and Process Characteristics on Product Development Cycle Time' (1997) 34(1) *Journal of Marketing Research* 24, 24-25; Malte Brettel, Rene Mauer, Andreas Engelen and Daniel Kupper, 'Corporate Effectuation: Entrepreneurial Action and Its Impact on R&D Project Performance' (2012) 27 *Journal of Business Venturing* 167, 171.
[19] Sramana Mitra, 'Can Crowdfunding Solve the Startup Capital Gap' *Harvard Business Review* (Online, 24 July 2013) <https://hbr.org/2013/07/can-crowdfunding-solve-the-sta>.
[20] Ethan Mollick, 'The Dynamics of Crowdfunding: An Exploratory Study' (2014) 29 *Journal of Business Venturing* 1, 11-13; Ethan Mollick and Venkat Kuppuswamy, 'After the Campaign: Outcomes of Crowdfunding' (UNC Kenan-Flagler Research Paper No. 2376997, January 2014) 5-6, <http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2376997>.
[21] Abbie Griffin, 'Product Development Cycle Time for Business-to-Business Products' (2002) 31 *Industrial Marketing Management* 291, 296.
[22] Griffin, above n 17, 1.
[23] Griffin, above n 21, 296.
[24] ASIC is the corporate and financial services regulator in Australia.
[25] Corporations Amendment (Crowd-source Funding) Bill 2015 (Cth), cl 738H.

This will then be akin to the limitation present in the Italian model which has been deemed as inappropriate as it limits the pool of companies that can raise capital via CSF.[26] As such, **the current proposed model in front of the Parliament is too restrictive and excludes the majority of Australian companies from relying on CSF.**

Safeguard 2- Intermediary Regulation

The second safeguard proposed relates to the regulation of intermediaries. Such regulation is especially important due to the key role online platforms play in bringing together businesses and investors:[27] the intermediary controls which projects go on its platform and which investment opportunities are available to investors. As these platforms play the role of gatekeepers, it is in their best interests to limit fraud and attract successful ventures since poor quality projects would negatively impact their profitability. If an intermediary can develop a reputation as being trustworthy, this would raise investor confidence in the platform and would attract more investors to it as they would trust the platform to promote viable projects.[28]

a Importance of the Intermediary

Although there are intrinsic and extrinsic motivations for an intermediary to closely monitor the projects it promotes, it is important to regulate these online platforms to safeguard investors. A close look at existing platforms reveals a lack of transparency in relation to failed ventures: instead, intermediaries only promote their successful projects. This may be misleading to the average investor.

Further, the majority of intermediaries have not been generating any profit, which means that they are at risk of failure.[29] The collapse of an online platform may result in the loss of data or contracts entered into between investors and businesses and may cause investors to lose their investments. For example, in 2011 P2P lending platform Quakle closed, leaving

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[26] CEF is only available to certain types of businesses classified as 'innovative start-ups'. Very strict rules apply to this classification: the definition requires a business to have been in existence for no more than 48 months and be recognised as 'innovative' by the Chamber of Commerce, a concession that has to be updated every six months. A business may be viewed as innovative if its purpose, for example, is 'the development and commercialisation of high-tech value products or services'. The strict classification excludes a number of businesses including many start-ups, which goes against the reason for having introduced the legislation in the first place. Consequently, since the introduction of the exemption less than 20 projects have been able to rely on CEF to raise the capital necessary for them to get off the ground. Further, the total amount raised through the CEF exemption has been less than €1.5 million.
For this reason, in 2015, the Italian Government expanded the eligibility criteria from 'innovative start-ups' to 'innovative SMEs'. However, even the expanded criterium is viewed as narrow and restrictive as it still excludes the majority of businesses from applying for funding. According to Moody, 'in 2012, only 10% of Italian manufacturing companies qualified as being high technology-intensive. High technology-intensive SMEs, as per the decree, would need to have above-average research and development expenditures and value added activities' to be able to access this form of finance.

[27] CAMAC, above n 5, 87.

[28] Joan MacLeod Heminway, 'The New Intermediary on the Block: Funding Portals under the Crowdfund Act' (2013) 13 *UC Davis Business Law Journal* 177, 185-6.

[29] Eleanor Kirby and Shane Worner, *Crowd-Funding: an Infant Industry Growing Fast* (Staff Working Paper of the International Organisation of Securities Commissions Research Department, SWP3/2014, 2014), 25-26; Eric Chaffe and Geoffrey C Rapp, 'Regulating Online Peer to Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry' (2012) 69(2) *Washington and Lee Law Review* 485, 506.

investors with few remedies to recover their investments.[30] As such, it is important for an intermediary to have a data retention system that will continue to make all information available even if the platform fails. Further, clients' funding should go into a separate account. This would ensure that invested funds are protected if the platform collapses.

b Licence Requirement

In view of the role that online platforms play in the process of CSF, both the CAMAC and the NZ models require intermediaries to be licensed.[31] This would permit ASIC to monitor each online platform and ensure that the conditions of its licence are met. Due to the nature of the intermediary, there are two possible existing licences that might apply:

- an Australian financial services licence (AFSL);[32] and
- an Australian market licence (AML).[33]

The Bill model requires intermediaries to hold a new type of AFSL that expressly authorises the provision of crowd-funding services.[34] This approach makes sense and is to be commended. Applying for this licence is both more straightforward and less costly than applying for an AML. An AFSL would also present fewer entry barriers to intermediaries since such a licence is issued by ASIC if the legislative requirements are met,[35] while an Australian market licence may only be issued at the discretion of the relevant Minister.[36] Further, an Australian financial services licence would provide investors with a range of protections,[37] including the establishment of compensation arrangements[38] and internal and external dispute resolution processes.[39]

Additionally, under both the CAMAC and the NZ models the intermediary is required to conduct limited due diligence checks on businesses that are raising capital on its platform, and may not provide financial advice regarding any investment. Instead they are to provide a generic risk warning to investors.[40] The Bill model adopts a similar approach by referring to the intermediary as a gatekeeper.[41] The due diligence requirement will help reduce the risk of fraud,[42] while the generic risk warning requirement will highlight to investors the risks their investment may involve. Under the Bill, the intermediary will be required to conduct prescribed checks and must not publish information about a company if it is not satisfied as to the identity of the company, its directors and officers.[43] **While these obligations may be**

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[30] Rupert Jones, 'Quakle Collapse Serves as Warning to Peer-to-Peer Investors' *The Guardian* (15 February 2014, Online) <http://www.theguardian.com/money/2014/feb/15/quakle-collapse-warning-peer-to-peer-investors>.
[31] Australian Government, above n 2, 9.
[32] An Australian financial services licence is required if a person is running a financial services business, *Corporations Act 2001* (Cth), s 911A.
[33] An Australian market licence is needed if a person is operating a financial market, *Corporations Act 2001* (Cth), s 791A.
[34] CAMAC, above n 5, 87, 93-94; Corporations Amendment (Crowd-source Funding) Bill 2015 (Cth), cl 738C.
[35] *Corporations Act 2001* (Cth), s 913A.
[36] *Corporations Act 2001* (Cth), s 795B(1).
[37] See *Corporations Act 2001* (Cth), s 912A.
[38] *Corporations Act 2001* (Cth), s 912B.
[39] *Corporations Act 2001* (Cth), s 912A.
[40] Australian Government, above n 2, 9.
[41] Explanatory Memorandum, Corporations Amendment (Crowd-Sourced Funding) Bill 2015 (Cth), 30.
[42] Steven Bradford, 'Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others' (2014) 83 *University of Cincinnati Law Review* 371, 375.
[43] Corporations Amendment (Crowd-source Funding) Bill 2015 (Cth), cl 738Q; Explanatory Memorandum, Corporations Amendment (Crowd-Sourced Funding) Bill 2015 (Cth), 30-35.

costly, they are essential to ensure the protection of investors and enhance the corporate governance of the intermediary.

c Others – Fee Structure

One of the key differences between the CAMAC and the NZ models relates to the fee structure that may be relied on by the intermediary. The CAMAC model prohibits any remuneration being paid to the intermediary based on the amount of securities issued or of funds raised by the business.[44] The NZ model does not have such a limitation and only requires the disclosure of any fees paid by the business.[45] The NZ approach takes into account the fact that intermediaries around the world are already struggling to break even.[46] Similar observations can be made regarding the ASSOB platform in Australia.[47] The additional licensing requirement it is proposed will be imposed on these platforms will add to their business cost and make them less viable. Consequently, intermediaries should be able to choose and adopt any fee structure that matches their business model, as long as the fees earned by the platform from businesses are flagged to investors. However, any other conflict of interest, such as the provision of investment advice to investors, should be prohibited for the protection of consumers. The current Bill model is silent on this matter. However, it is assumed that fees will be allowed as long as conflict of interest is managed in accordance with s 912A, the key obligation applying to all AFSL.

d Penalty Regime

While the CAMAC and NZ models are silent on the matter of penalty regime, the Bill model notes that any breach by the intermediaries of its obligations regarding the CSF offer may result in criminal action. The proposed penalties are a maximum 60 penalty units and/or one year imprisonment.[48] While this may send a message that the obligations imposed on intermediaries are very important, the amount of the fine imposed in low and should be raised. Further, the chances of such action being taken are minimal. **Civil penalty regime should be introduced in the context of these specific obligations.** This will ensure that the regulator has a range of enforcement tools at its disposal to deal with the breach.

However, it is important to acknowledge that the regulator has currently other tools at its disposal to deal with these breaches of licence obligation. Under the *Australian Securities and Investments Act 2001* (Cth), ASIC has the power to enter into enforceable undertakings to deal with any breach of the law. Enforceable undertakings can be described as a promise enforceable in court.[49] It takes the form of a settlement in which the alleged offender (who may be called ‘the promisor’) and ASIC start negotiations in relation to the alleged breach of the law and reach a compromise to deal with that alleged breach. The benefit of an enforceable undertaking is that it attempts to prevent similar breaches of the law from occurring in the future. It further will allow both the regulator and the intermediary to develop an understanding best practices regarding compliance with the law in this area.

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[44] CAMAC, above n 5, 113.
[45] Australian Government, above n 2, 9.
[46] Kirby and Worner, above n 29, 25-26; Chaffe and Rapp, above n 29, 506.
[47] Australian Small Scale Offerings Board Limited and Controlled Entities, *Financial Report for the Year Ended 30 June 2014* (2014) 7.
[48] Corporations Amendment (Crowd-source Funding) Bill 2015 (Cth), cl 34.
[49] Marina Nehme, ‘Enforceable Undertaking: A Restorative Sanction’ (2010) *Monash University Law Review* 108.

Safeguard 3- Investors' Regulation

The third safeguard proposed relates to imposing regulation on investors. A review of the different approaches adopted or lobbied for around the world indicates that the level of obligations imposed on investors varies, with some countries adopting very few limitations on investors while others have more restrictive rules that curtail investors' freedom. For instance, New Zealand allows investors to invest in CSF as long as they have signed a document acknowledging the risk that this form of finance involves.[50] Italy goes one step further by requiring investors to complete a questionnaire to ensure that they understand the risks attached to CSF.[51] However, the most popular model, adopted in countries such as the US[52] and the UK,[53] is very restrictive as it imposes a cap on the CSF investments that a person can make in a period of 12 months.

a The Cap

In Australia, the CAMAC model would only allow a person to invest $2,500 (AUD) in any one business in a 12 month period, with a maximum of $10,000 (AUD) to be invested in CSF during that period.[54] This proposal is more rigid than the NZ model, which does not have any compulsory investment caps attached to it.[55] Further, the total cap on investments in CSF proposed by the CAMAC model is much lower and less flexible than the caps adopted in countries such as the UK[56] and the US[57] and as such had little appeal. The Bill model proposes a waterdown cap which is aimed to protect investors while giving them the choice and the right to invest their money as they wish. A $10,000 (AUD) cap per investor in a period of 12 months (with the possibility of altering this cap by regulation) is introduced.[58] However, this cap is qualified as it is the maximum amount that can be raised by an individual on one platform and in the same company. **This does encourage investors to diversify their investments and will allow them to invest in other companies if they wish to do so.**

b The Nudge

The imposition of investment caps stems from the nudge theory. This theory seeks to enhance the understanding and management of heuristic influences on human behaviour which affects the decision-making of individuals. With this understanding, it aims to reshape existing choices of individuals through choice architecture.[59] The investment caps recommended by the CAMAC model are designed to change behaviour by limiting the number of businesses individuals can invest in. The fact that there is a limitation is intended to stop a person from

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[50] *Financial Markets Conduct Regulation* (NZ), reg 197(1).

[51] Commissione Nazionale Per Le Societa'E La Borsa (CONSOB), Regolamento Consob n. 18592 sulla raccolta di capitali di rischio da parte di start-up innovative tramite portali on-line, article 15.

[52] *JOBS Act*, s 302.

[53] Financial Conduct Authority, *Conduct of Business Sourcebook* (COBS) 4.7.7, 4.7.10.

[54] CAMAC, above n 5, 146.

[55] Australian Government, above n 2, 10.

[56] See Financial Conduct Authority, *Conduct of Business Sourcebook* (COBS) 4.7.10: the investor should no invest more than 10% of their net assets in non-readily realisable securities in a period of 12 months.

[57] See *JOBS Act*, s 302: the aggregate amount sold to an investor does not exceed the greater of $2,000 or 5% of the annual income or net worth of the investor if their annual income or their net worth is less than $100,000 or 10% of their annual income or net worth (to a maximum of $100,000) if the annual income or the net worth of the investor is equal or more than $100,000.

[58] Corporations Amendment (Crowd-source Funding) Bill 2015 (Cth), cl 738ZC.

[59] Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions About Health, Wealth and Happiness* (Penguin Group, 2009).

rushing into any particular investment and instead make them reflect on whether such an investment is possible or whether they should save their funds and invest it in other, more promising businesses.[60] Curtailing investment choices through caps is a paternalistic approach to CSF and may go beyond the liberal paternalism promoted by the nudge.[61]

However, applying such a paternalistic approach may be not only justified but warranted, as people's decision-making is not generally clever or logical and a herd mentality may apply.[62] These deficiencies are likely to be accentuated in an online environment where investors may be trading more actively and speculatively.[63] With CSF and financial markets in general, history has demonstrated that there is a seemingly irresistible movement of the crowd toward bad investments, with investors being 'sucked into the vortex of the market whirlpool'.[64] Some may even say that the crowd is destructive, impulsive and will exhibit a new persona separate from its members as the individual consciousness vanishes from the crowd.[65] The crowd is then perceived as a single being and 'is subjected to the law of the mental unity of the crowd'.[66] As a result of this, the crowd is viewed as irrational, and this characteristic would be dangerous in the case of CSF where fraud and business failure may become rife.

More recent research, however, suggests that the crowd may not be irrational.[67] For instance, the rush toward bad investments in the past may not have been conducted by an irrational crowd. The crowd may have had promising leads and motivations and reasons that guided them to particular investments.[68] Additionally, a crowd may be wise.[69] The aggregate judgment of the crowd is more accurate than the judgment of individuals.[70] Aristotle, for instance, noted that when people come together, 'they may surpass – collectively and as a body, although not individually – the quality of the few best … When there are many who contribute to the process of deliberation, each can bring his share of goodness and moral prudence; … some appreciate one part, some another, and all together appreciate all'.[71] With crowdsourcing, for example, the crowd has been able to provide more original and superior problem-solving outcomes.[72] Individuals involved in crowdsourcing are motivated by extrinsic and intrinsic factors to make a contribution to a particular project.[73] The technology

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[60] Ibid 53-56.
[61] Ibid 13.
[62] Ibid 66.
[63] Brad Barber and Terrance Odean, 'Online Investors: Do the Slow Die First?' (2002) 15(2) *The Review of Financial Studies* 455, 456.
[64] David Dreman, *Psychology and the Stock Market: Investment Strategy Beyond Random Walk* (Amacom, 1977) 99; for examples of corporate collapses resulting from the madness of crowds see Charles Mackay, *Extraordinary Popular Delusions and the Madness of the Crowd* (Wordsworth Reference, 1995, originally published in 1841).
[65] Gustave Le Bon, *The Crowd: A Study of the Popular Mind* (trans, Digireads, 2008) 13, 18 [trans of: *Psychologie des Foules* (first published in 1895)].
[66] Ibid 13.
[67] Yochai Benkler, *The Wealth of Networks: How Social Production Transformed Markets and Freedom* (Yale University Press, 2006); Barry Libert and Jon Spector, *We are Smarter than Me: How to Unleash the Power of Crowds* (Prentice-Hall, 2007).
[68] See for example, Eugene White, *Crashes and Panics: The Lessons from History* (Dow Jones-Irwin, 1988).
[69] James Surowiecki, *The Wisdom of Crowds* (Anchor Books, 2005).
[70] Francis Galton, 'The Ballot-Box' (1907) 75 *Nature* 509.
[71] Aristotle, *Politics* (Oxford University Press, 1972) 123 [trans Ernest Barker].
[72] Darren Bragham, 'Crowdsourcing as a Model for Problem Solving: An Introduction and Cases' (2008) 14(1) *Convergence: The International Journal of Research into New Media Technologies* 75.
[73] Mark Wexler, 'Reconfiguring the Sociology of the Crowd: Exploring Crowdsourcing' (2011) 31(1/2) *International Journal of Sociology and Social Policy* 6, 12.

now allows for millions of independent ideas to come together without the danger of too many compromises being made by individuals in the crowd.[74]

Further, with CSF, a range of people will be coming together from different backgrounds with different knowledge and experience and that may make the crowd wiser.[75] The more diverse a group is, the better it is at solving problems, as each member of the group will be bringing new information which will enhance its decision-making in the end.[76] Homogeneous groups, on the other hand, are often victims of 'group think':[77] their mental efficiency and moral judgment are influenced by in-group pressure which may lead to the deterioration of decision-making.[78] Accordingly, the diversity of people that will be attracted to CSF may result in better outcomes for investors.

Of course, this does not mean that people will always make good decisions when investing in SMEs through CSF, as there is always the danger that the crowd may become polarised and homogeneous.[79] Further, some investors may be investing as a result of a hyped-up project without considering the value of the project properly. As such, investor-targeted protections need to be in place. However, such protections do not need to adopt the paternalistic approach of the investment cap. The approach to investor regulation proposed by CAMAC is also problematic from an enforcement perspective: **who will enforce the caps?** To require the intermediary to ensure that investors on their platform are in compliance with the cap may be costly for the intermediary. Further, **if this responsibility is placed on the intermediary and an investor breaches the cap, what penalties will then apply**? The imposition of penalties may be a draconian approach to protecting investors. It may even go against the national mood that has been supportive of CSF. A different solution, that would provide protections to investors while promoting their interest in investments, may be needed instead. **As such the fact that the Bill model loosens the limitation on investors is welcomed as the cap imposed will still allow investors to diversify their investments via CSF while also providing the intermediaries with a rule that they can easily implement. If they find that an investor is investing more than $10,000 (AUD) in the same company, the intermediary can easily stop that transaction from going forward.**

c Promoting Financial Literacy

It is suggested that CSF may be viewed as a social experiment to boost financial literacy.[80] Financial literacy is very important as it can develop and promote individuals' autonomy of choice: it will open the door for the average person investing in CSF to be treated as a free rational being and would prevent the CSF exemption from sliding into overbearing paternalism.[81] People who are becoming interested in investment will be self-motivated to learn how to enhance their decision-making in this area. A culture that enables them to find

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[74] Bragham, above n 72, 80.
[75] Clintin Davis-Stober, David Budescu, Jason Dana and Stephen Broomell, 'When is a Crowd Wise' (2014) *Decision* 79, 80.
[76] Scott Page, *Diversity and Complexity* (Princeton University Press, 2011); Lu Hong and Scott Page, 'Groups of Diverse Problem Solvers Can Outperform Groups of High-Ability Problem Solvers'(2004) 101(46) *Proceedings of National Academy of Sciences of the United States of America* 16385.
[77] Irving Janis, *Groupthink: Psychological Studies of Policy Decisions and Fiascoes* (Cengage Learning, 2nd ed, 1982).
[78] Ibid 9.
[79] Tonis Vaga, 'The Coherent Market Hypothesis' (1990) 46(6) *Financial Analysts Journal* 36, 39.
[80] Cody Friesz, 'Crowdfunding and Investor Education: Empowering Investors to Mitigate Risk and Prevent Fraud' (2015) 48 *Suffolk University Law Review* 131, 146.
[81] Benkler, above n 67, 140.

out what they need to know will lead to better decision-making of the crowd. It is important to allow people to adopt the right norms and practices in their investments.[82] One key element an education campaign to boost financial literacy should highlight to investors is the fact that there are a number of signals that ought to be considered when investing in CSF. These signals provide information regarding a project's viability and so may enhance the decision-making of investors.[83] In addition to the traditional signals referred to in the literature of crowdfunding,[84] it is suggested that regulation to protect investors could add one more signal which would lower the information asymmetry between a business and investors:[85] **businesses attempting to raise more than $100,000 (AUD) in one go should only be able to do so if they raise the funds in stages. Each stage would be a milestone which, when reached, would allow the business to raise more money to achieve the next milestone in the project.** This would provide additional information to investors regarding their initial investment: is the business meeting its milestones on time? If it is, it may attract more investors or encourage existing investors to increase their stake in the company. On the other hand, if milestones are not met, questions will be raised regarding the reasons behind the delay. Evidence of delays may deter new investors from investing in the business. Such milestones may limit fraudulent activities in the sphere of CSF and may also limit the losses of investors.

This education campaign to boost financial literacy could be conducted jointly by ASIC, as part of its financial literacy program, and the intermediaries in CSF, since they play a gatekeeper role between businesses and investors. In addition, an approach similar to the Italian system might be adopted, so that investors are required to complete a questionnaire demonstrating their understanding of the risks and the factors to consider when investing in CSF. It is to be hoped this will raise investors' awareness of investments in general and so enhance financial literacy. This is important as it may also impact how investors perceive their superannuation.

d Investors' Protection

Lastly, investors still need a regulatory policy that protects their interests. This is particularly important since CSF is relied on when SMEs wish to raise a small amount of money from a large pool of investors. In instances where misleading or fraudulent conduct by businesses or intermediaries occurs, investors have few resources available to them: it is unlikely that individual investors would have invested enough money in a project to justify bringing a legal action against the business or the intermediary. A class action may also be unlikely as

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[82] Cass Sunstein and Reid Hastie, *Wiser: Getting Beyond Groupthink to Make Groups Smarter* (Harvard Business Review Press, 2015) 13.

[83] Gerrit Ahlers, Douglas Cumming, Christina Gunther and Denis Schweizer, 'Signaling in Equity Crowdfunding' (2015) 39 (4) *Entrepreneurship Theory and Practice* 955; Todd Moss, Donald Neubaum and Moriah Meyskens, 'The Effect of Virtuous and Entrepreneurial Orientations on Microfinance Lending and Repayment: A Signaling Theory Perspective' (2015) 39(1) *Entrepreneurship Theory and Practice* 27; Sibin Wu, Bin Wang and Yuanquing Li, 'How to Attract the Crowd in Crowdfunding?' (2015) 24(3) *International Journal of Entrepreneurship and Small Business* 322.

[84] Ibid; Fania Valeria Michelucci and Francesca Silvia Rota, 'The Success of Non-Profit Crowdfunding: First Evidences from the Italian Web-Platforms' (2014) *Torino: DIGEP—Dipartimento di Ingegneria Gestionale e della Produzione, Politecnico di Torino* 1, 5 <http://www.dii.univpm.it/sites/www.dii.univpm.it/files/dii/allegati/MichelucciRota.pdf>.

[85] Haewon Yum, Byungtae Lee and Myungsin Chae, 'From the Wisdom of Crowds to my Own Judgment in Microfinance through Online Peer-To-Peer Lending Platforms' (2012) 11 *Electronic Commerce Research and Applications* 469.

the gains for lawyers running such a case are limited.[86] Consequently, ASIC must take an active role in monitoring and regulating CSF. Actions and initiatives similar to those of the Attorney General in Washington State and the US Federal Trade Commission may be necessary to send a message to businesses that they will be held accountable if they are involved in misleading or fraudulent conduct through CSF, irrespective of the fact that the losses to individual investors may be relatively small.

However, from the regulator's perspective this may be problematic, as ASIC has a limited budget. Accordingly, the full-scale audit of ASIC that is currently taking place[87] should consider improving the regulator's budget to enable it to achieve its objectives in protecting consumers, even in the CSF sphere. ASIC should additionally be equipped with administrative enforcement powers that would allow it to act quickly to stop a fraudulent scheme from taking place. To provide ASIC with intervention powers may also be desirable. Such powers would allow the regulator to stop the promotion of a particular product or business venture if ASIC believed there is a high risk of fraud or deception in the product.[88] This power would allow ASIC to act to protect consumers without having to prove that a breach of the law has occurred.[89]

Conclusion

CSF is a social phenomenon. Through its use of social media, it has attracted people who have previously never been interested in investing in companies. Instead of being feared, this interest should be nurtured through the promotion of investors' financial education. **<u>A questionnaire to test investors' understanding of the risks involved with CSF and the factors to consider when investing through CSF, such as signals to look for, would also be beneficial.</u>** To rely on caps on investors is too restrictive and may stunt the development of CSF in Australia. It is further problematic as such caps are not only paternalistic but go against the national mood which is supportive of CSF. Issues regarding monitoring and enforcing the caps would also be raised.

To enhance the protection of investors, ASIC should take an active role in monitoring CSF and be willing to sue in case of fraudulent action. Further, if ASIC believes that a project should be withdrawn due to possible fraudulent activities attached to the venture, the regulator should be provided with tools that would allow it to stop CSF of the project from proceeding. Equipping the regulator with additional intervention powers may be a possibility.

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[86] Jorge Pesok, 'Crowdfunding: A New Form of Investing Requires a New form of Investor Protection' (2014) 12 *The Dartmouth Law Journal* 146, 149.

[87] Sarah Thompson, Jonathan Shapiro and James Eyers, 'Abbott puts ASIC under the Microscope in Funding and Operations Review' *Australian Financial Review* (Online, 24 July 2015) <http://www.afr.com/business/banking-and-finance/abbott-puts-asic-under-the-microscope-in-funding-and-operations-review-20150723-gij1t6>.

[88] The Financial System Inquiry conducted in 2014 recommended that ASIC should have product intervention orders at its disposal: see Commonwealth of Australia, *Financial System Inquiry – Interim Report* (July 2014), Recommendation 22, 206.

[89] For a discussion on product intervention powers, see Dimity Kingsford Smith and Marina Nehme, 'Product Intervention Powers: A Legal, Comparative and Policy Analysis' (2015) <http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Consultations/2014/Financial%20System%20Inquiry%20Final%20Report/Submissions/PDF/Kingsford_Smith_Dimity_and_Nehme_Marina.ashx>.

As the gatekeeper between businesses and investors, the intermediary online platform should have a financial services licence with limited duty of care. Conflicts of interest that may arise for the intermediary as a result of CSF should be banned. One exception can be made and it relates to the fee structure of the platform. The intermediary's fee structure should be disclosed to investors to highlight any conflicts of interest that may exist.

For businesses, limiting the amount that may be raised through CSF to a cap of $2 million (AUD) in a 12 month period seems more reasonable and justifiable than a $5 million (AUD) cap. However, businesses should only be allowed to raise amounts that are more than $100,000 (AUD) through stages to send a signal to the market about the viability and potential of the project. Including these limitations in the CSF exemption to the fundraising provisions will promote this form of finance and may actually make it a source of capital to SMEs while providing the necessary protection to investors. Further, serious consideration need to be taken to promote CSF in all types of companies. Transition from a proprietary to a public company should attract more serious temporary concessions as the current proposed concessions under the Bill model are minimal and will exclude most companies from raising capital via CSF.

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