The regulation of crowdfunding in Australia: where are we and what's to come?

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Small and medium-sized enterprises (SMEs) often struggle to source affordable debt financing through traditional lending channels. Many of these difficulties are unavoidable and intrinsic to the nature of SMEs. When compared with larger corporate operations, SMEs particularly those in the "start-up" phase are typically viewed by lenders as a higher credit risk by virtue of their speculative earnings potential and smaller (if not totally absent) pool of securable assets. It is for these reasons that SMEs have in recent times started to explore alternative funding arrangements.[1]

This article examines one such source of alternative funding, the raising of capital through "crowdfunding". We explain the concept of crowdfunding, provide an overview of the current state of the regulation of crowdfunding in Australia, and outline recent moves by the Australian Government and industry bodies towards the development and adoption of a new, bespoke regulatory regime.

What is crowdfunding?

The term "crowdfunding" refers to the practice of raising funds through the pooling of relatively small financial contributions from a large number of investors to finance a business or to fund the commercialisation of a new product, usually facilitated through an online platform.[2]

This modern source of capital raising gained momentum after the 2003 launch of ArtistShare by Brian Camelio, a Boston-based musician and computer programmer.[3] In more recent times, a number of crowdfunding platforms have emerged, the more notable of which include Kickstarter, Indiegogo and Crowdfunding.com.[4] As an example of the capacity of crowdfunding to raise funds, in March 2015 the Palo Alto-based Pebble Time raised US$20,338,986 via Kickstarter for the development of a third generation smartwatch.[5] Interestingly, there have also been historical instances of crowd-sourced financing models, such as the funding of New York's famed Statue of Liberty through citizens of France paying for the construction of the statue and citizens of the United States paying for its pedestal.[6]

Crowdfunding can prove particularly attractive to SMEs and entrepreneurs looking to raise capital quickly as, unlike in a traditional debt financing, it generally does not require:

i) a detailed credit assessment or due diligence;
ii) an underlying securable asset base; or
iii) negotiations with financiers or the execution of formal finance documentation.

The types of crowdfunding

There are four generally accepted types of crowdfunding:

- *reward-based crowdfunding*, where financial contributions are made in anticipation of a benefit in current or future goods;
- *donation-based crowdfunding*, where contributions are pooled in support of a social cause;
- *equity-based crowdfunding*, where financial contributions are made for or in anticipation of a stake in a growing company; and
- *lending-based crowdfunding*, where discrete financial contributions are collected and offered as debt repayable with interest.[7]

These categories of crowdfunding can be further classified according to the benefits offered to investors. Models that have a reward or donation basis are generally described as "patronage crowdfunding", while models that accord to the equity and lending forms (the subject of this article) are referred to as "investment crowdfunding".[8]

The two sectors of crowd-sourced financing that are experiencing the most rapid growth, and the greatest potential to disrupt the current state of existing debt and equity markets, are those within the investment crowdfunding space.[9] The most dominant models here are crowd-sourced equity funding (CSEF) and peer-to-peer lending (P2PL).

Crowd-sourced equity funding

Under the CSEF model, the "crowd" of individuals make contributions in exchange for securities or equity

in a company.[10] In this sense, there are many similarities between the CSEF model and the traditional issue of share capital by a company. CSEF is uniquely characterised, however, by the use of online intermediary platforms to sell typically small equity interests (or even other securities, such as debentures) issued by companies to a potentially unlimited number of individuals or entities.[11]

Peer-to-peer lending

P2PL is a debt-centric model that enables financial contributions to be made in return for a relative proportion of resultant profit.[12] It is described as "peer-to-peer" as the lending arrangements are entered into between a lender and borrower directly, with the operator of the online platform in some cases being a contracting party with the lender and borrower (collective investments) and in other cases merely providing a facilitation and administrative role (direct loan agreements).

Risks associated with crowdfunding

Like all forms of financing, crowdfunding is not without risk. Common risks associated with crowdfunding include:

- *fraudulent dealings* — the risk that funds sourced by a platform operator or the issuer may be misappropriated or mismanaged.[13] These risks are arguably greater when models that do not provide for immediate financial or other benefits (such as the donation-based crowdfunding model) are employed;
- *meeting of the minds* — the risk that, in the absence of clearly defined investment terms, those who source crowdfunding may deny investors their expected share in returns;[14]
- *failure* — the risk that investors may not receive anticipated benefits (financial or otherwise) due to the failure of the project, idea or cause;[15]
- *dilution* — the risk that the initial "crowd" of investors could be diluted by subsequent equity issues;[16] and
- *broader risks to intermediaries* — intermediary platform operators could be held accountable for the losses incurred by investors.[17]

Global initiatives — growing trend towards the regulation of crowdfunding

A number of developed markets such as the United States, Italy and New Zealand have acknowledged the arrival of crowdfunding as a genuine source of finance to complement traditional debt and equity financing.[18] Rather than attempt to reconcile crowdfunding with their existing regulatory regimes, these jurisdictions have been proactive in discussing, developing and implementing laws to regulate crowd-sourced financing.

A comprehensive CSEF regime was introduced in New Zealand in mid-2014 and has proved to be a particularly important point of reference in the Australian debate on crowdfunding. Under the New Zealand regime:

- all incorporated entities may raise capital through CSEF;[19]
- the amount an issuer may raise though CSEF is capped in a 12 month period at $2 million (excluding contributions from wholesale investors);[20]
- investors are required to sign a risk acknowledgement statement;[21] and
- there are only recommended caps on investors.[22]

This rather liberal regime has received significant approval by members of the Australian Government, with the Minister for Communications Malcolm Turnbull suggesting that his preferred approach is a wholesale adoption of the New Zealand legislative regime.[23]

Existing regulation of crowdfunding in Australia

Despite the increasing prevalence of crowd-sourced funding across many global markets, Australia has been slow to recognise and adapt to the phenomenon.

Australian regulatory bodies (such as the Australian Securities and Investments Commission (ASIC)) have sought to apply existing regulatory frameworks to crowdfunding models.[24] In 2012, ASIC issued guidance to this effect,[25] stating that a number of factors, including the type of "reward" offered to investors and the mode of platform used, could lead to a scheme being classed as either a managed investment scheme, the provision of financial services requiring an Australian financial services (AFS) licence, or fundraising according to ch 6D of the Corporations Act 2001 (Cth).

We examine below these key regulatory regimes and their impact on the ability to "crowd fund" in the Australian context.

Managed investment schemes

ASIC has indicated that crowd-sourced funding for a discrete purpose may be classed as a managed investment scheme and therefore subject to regulation under ch 5C of the Corporations Act 2001 (Cth) (Corporations Act).[26] Under the Corporations Act, a "managed investment scheme" refers to a scheme in which money (or money's worth) is contributed by people in order to acquire rights to prospective benefits produced by the scheme.[27] This could occur where money from discrete investors is pooled to offer debt finance to a company, with interest and capital repayments payable by an intermediary for distribution to the investors in proportion to their investment.

When funding is crowd-sourced in this way and legislative exceptions are unavailable, the funding scheme will likely be classed as a managed investment scheme. Importantly, the scheme may also require registration, which will mean that its responsible entity will need to be incorporated as a public company and hold an Australian financial services licence (AFSL) permitting it to offer financial products and operate the scheme (discussed below).[28] Given the onerous regulatory and compliance requirements applicable to such schemes, crowdfunding models that fall within the definition of managed investment schemes are unlikely to be workable in the Australian market.[29] To this end, the current framework regulating managed investment schemes is largely incompatible with the rationale that underpins crowdfunding.[30]

Financial services licensing

ASIC's guidance also indicates that online intermediary platforms that facilitate crowdfunding may be classed as issuers of a financial product.[31] If this is the case, an online platform will be required to "hold or obtain an [AFSL] with the appropriate licence authorisations or be an authorised representative of an [AFSL] holder", and duly provide investors with disclosure documents such as a financial services guide or product disclosure statement.[32] Although ASIC has accepted that contributions made in anticipation of possible returns of nominal value (which would not be classified as a "financial product" under s 763A of the Corporations Act) will not invoke regulation under the Corporations Act or by ASIC generally, it is worth noting that the same guidance further indicates that reward-based crowdfunding models may involve the provision of financial services or a financial product. Care must therefore be taken by intermediaries that facilitate CSEF and P2PL, as these models appear especially likely to fall within the existing AFSL regime.

Fundraising

ASIC has also indicated that crowdfunding may fall within the framework contained in ch 6D of the Corporations Act, which regulates corporate fundraising in Australia. ASIC's guidance states that crowdfunding schemes "may be required to lodge a prospectus or other complying disclosure document [with ASIC]"[33] if they issue securities or solicit applications for securities.[34] The Corporations Act also prohibits proprietary companies from issuing securities to the general public,[35] and allows public companies to issue securities only if a prospectus or other complying document is lodged with ASIC.[36]

It is worth noting that almost all examples of crowdfunding by SMEs and start-ups will be unable to rely on the so-called "20/2/12" rule for small-scale fundraisings.[37] Under this rule, a proprietary company is not required to lodge a disclosure document with ASIC if it seeks to raise funds of less than $2 million from less than 20 investors over a 12-month period. Obviously this exception is largely incompatible with crowdfunding schemes that typically rely on a far greater number of investors.[38]

Recent regulatory developments

In what appears to be a reaction to the growing global interest in crowdfunding, the Australian Government has signalled a clear intention to consider more appropriate methods of regulating crowd-sourced funding within the Australian market.

In its federal budget released on 15 May 2015, the government recognised for the first time the potential for crowdfunding as a viable alternative to traditional debt and equity financing options.[39] The importance of crowdfunding to Australia, and the need for regulatory reform, was also recognised in the recent report of the Financial System Inquiry (the "Murray report") (Inquiry), which concluded that the Australian Government should "graduate fundraising regulation to facilitate securities-based crowdfunding and consider more holistic regulatory settings to facilitate internet-based financing".[40] According to the Inquiry, Australia's current regulatory settings can be seen as impeding the growth of crowdfunding. [41]

The CAMAC proposal

In its 2014 report on crowd-sourced equity funding, the Australian Corporations and Markets Advisory Committee (CAMAC) recommended that a specific regulatory regime be implemented for CSEF in Australia. The CAMAC's recommendations included:

- the creation of a new type of company, the "exempt public company", specifically for use by equity crowdfunding issuers;
- the licensing by ASIC of online intermediaries;
- an "investor cap" for individual investors of no more than $2500 to any particular issuer in any 12 months and no more than $10,000 in total during any 12-month period; and
- an "issuer cap" on total capital raised through equity crowdfunding of no more than $2 million during any 12-month period.

Insights from the Productivity Commission

The Australian Government recently directed the Productivity Commission (the Commission) to prepare a report into the key drivers for Australian business set-ups, transfers and closures, including the current financing needs of businesses and the impact of greater regulation in presently unregulated spaces such as crowd-sourced funding.