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Crowdfunding – the update

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Introduction

On 19 December 2014, the Australian Government requested the Productivity Commission (**PC**) to enquire into and report on the barriers to setting up, transferring and closing a business and to identify options for reducing barriers, where appropriate. An issues paper was released and public submissions sought by 20 February 2015. A draft report (also subject to submissions) was issued by the PC on 21 May 2015 and the final PC report is expected by the end of August 2015.

The ability of small businesses to access debt or equity finance was raised as a crucial issue. Specifically, '*crowd sourced equity funding*' (colloquially called **crowdfunding**) was identified as an area to enquire into, as well as necessary reforms to accommodate it. This newsletter focuses on crowdfunding as covered by the 21 May 2015 PC report in terms of how crowdfunding might be managed and regulated.

What is crowdfunding?

There is no universal definition of this term as crowdfunding incorporates donations or gifts to entrepreneurs, as well as the process of entrepreneur funding by raising money from the public (commonly via the internet) where the characterisation of the fundraising could be debt or equity. There is also '*reward crowdfunding*' where providers of donations get products or services as a reward for the donation.

The PC's crowdfunding proposals

Debt or equity crowdfunding currently faces obstacles in the fundraising provisions of the *Corporations Act 2001* (Cth). In essence, the fundraising activity is regulated unless:

1. Crowdfunding offers are made to sophisticated or professional investors; or
2. In the case of retail investors, personally made offers are made to no more than 20 investors over no more than 12 months where the total raising does not exceed $2 million (20/12/$2M rule).

The PC has put forward two regulatory models involving equity crowdfunding where retail investors are involved, i.e.:

1. The Corporations and Markets Advisory Committee (**CMAC**) model; and
2. The New Zealand (**NZ**) model.

The CMAC model

This refers to the proposal made in a discussion paper released by CMAC in October 2013. Certain exemption criteria constitute the basis to be met in order to avoid prospectus type regulation, namely:

1. The funding vehicle needs to be a public company with capitalisation (shareholder funds) of no more than $10 million. This exemption would lapse once the company has a predetermined level of annual revenue or if the capital raised exceeds a certain amount.

2. Retail investors would be restricted from providing unlimited funding under a modified 20/12/$2M rule i.e. $2 million maximum can be raised each 12 months with each investor limited to investing $2,500 with any one company and limited to investing no more than $10,000 in four companies over 12 months.

The NZ model

NZ has legislation and regulations in place to enable crowdfunding to occur. Crowdfunding falls under specific exemption conditions from prospectus type regulation. The substance of the exemptions is that each NZ company can raise up to $2 million in any 12 months period from the NZ public through a licensed equity crowdfunding platform.

The PC ultimately considered recommending to the Australian Government a two tiered model for crowdfunding i.e.:

1. Unlimited restrictions on sophisticated and professional investors investing in companies (whether or not crowdfunded) as allowed at present under the *Corporations Act 2001* (Cth); and

2. The CMAC or NZ model catering for retail investors but with an investment limit set for each investor as a protective element.

Crowdfunding and other countries

There are a large number of countries which allow crowdfunding without prospectus type regulation. Australia lags behind other countries in this respect. This is possibly due to the cautious nature of the Australian Securities and Investments Commission which has ongoing concerns based on inexperience and knowledge of investors, the high propensity for failure of the funding company and other risks, including promoter fraud. Indeed, the PC cited the 2014 report provided to the International Organisation of Securities Commissions by Kirby and Warner as highlighting a failure rate of around 50% for crowdfunded companies.

What happens next?

The PC is having public hearings in Sydney, Melbourne and Canberra between 22 and 30 June 2015. Public submissions are sought in the interviewing period up to the end of August 2015 which could '*mould*' or alter the PC's thinking as the draft report transforms into the final report to be provided to the government. It will then be up to the government to take whatever action it decides is appropriate in terms of reforming the law affecting crowdfunding.

Observations

The regulatory protections now in the *Corporations Act 2001* (Cth) primarily exist for the benefit of retail investors. If adult retail investors are imposed with an investment limit on crowdfunding, it will limit their losses on the highly risky nature of crowdfunding. Crowdfunding is not a conventional activity and given the model proposed by the PC, it is thought that a good case has been made out for reforms which, hopefully, will provide an accessible way for companies to raise capital.

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