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## CAMAC's Report on Equity Crowdfunding: Does it Pave the Way to Bridge the Capital Gap for Start-Ups and Small Scale Enterprises in Australia?

*By Russell Lyons, Adam Levine, Andrea Beatty and Becki Tam*

The Corporations and Markets Advisory Committee (CAMAC) released its report on crowd sourced equity funding (CSEF) this month following its Discussion Paper released last September and its receipt of approximately 40 submissions from government, industry and legal bodies.

### Background

CAMAC's report proposes a regulatory regime specifically designed for and to facilitate CSEF in Australia. Industry has, broadly speaking, welcomed CAMAC's proposals as a step forward in recognising the key role that CSEF may play in the development of innovative start-ups and other small enterprise companies in the Australian economy.

The Federal Budget for 2014-2015 announced the abolition of CAMAC and the transfer of its functions to Treasury. Therefore, it remains to be seen to what extent and how quickly CAMAC's proposals will be taken up in Australia. The implementation of CAMAC's blueprint for a CSEF structure will require legislative amendments to the *Corporations Act 2001 (Cth)* (the Act) and/or specific Class Order relief, together with the development of template documents and regulatory guidelines overseen by the Australian Securities & Investments Commission (ASIC).

### Key Features

Some of the key features of CAMAC's proposed CSEF regulatory system are:

- **Exempt Public Company** – introduction of a new corporate entity, being an 'exempt public company' that an intending CSEF issuer could be incorporated as or convert to.
- **Type of Security** – CSEF issuers would be limited to the issue of new shares that are in one class per offer. Options over unissued shares and convertible or debt securities are excluded. An issuer could still provide crowd investors with 'other rewards' or 'perks' attached to the share offer provided the reward was available to all crowd investors and without financial obligation.
- **Cap on Value of Funds Raised by Issuer** – a CSEF issuer would not be allowed to raise more than AUD2 million in any 12 month period, where the AUD2 million cap would include any amounts raised under the small scale personal offer exemption of section 708(1) of the Act, but would not include funds raised under the sophisticated investor exemption of s 708(8) of the Act. In addition, the AUD2 million cap would be reduced by any funds that any entity in the issuer group has raised in the 12 month period through CSEF, including under the small scale personal offers exemption.
- **Cap on Amount Invested by Crowd Investor** – a single crowd investor would not be allowed to invest more than AUD2,500 in a particular CSEF issuer over 12 months and overall, would not be able to invest more than AUD10,000 in all CSEF issuers

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over 12 months. The investor would be required to self-certify to an intermediary that it was under the cap.

CAMAC notes that these cap amounts may be relatively arbitrary at the onset, but provide a necessary framework to protect investors. CAMAC did not support any sanction being imposed on an investor who breaches an investor cap. An eligible crowd investor would be a person over the age of 18 years, whether resident in Australia or elsewhere.

- **Standard Disclosure Template** – a CSEF issuer would be required to disclose information in a standard template about the entity, the share offer, shareholdings by principals, whether any officers, directors, founders, promoters, related parties or persons with 20% or more voting shares will receive any proceeds from the CSEF funds raised, the risks of dilution, the business plan and use of funds to be raised and any previous CSEF offers. CSEF offer documents would not be required to be lodged with ASIC. ASIC should be granted stop order powers where a misleading offer documents remained published on an intermediary's website.
- **Licensed Intermediary** – a CSEF licence would be required to be obtained from ASIC by an intermediary to permit it to host a CSEF offer as well as conduct any secondary market where CSEF shares could be traded. Mere registration to act as an intermediary was not considered appropriate by CAMAC given the role that intermediaries would be required to play in the CSEF process, including conducting some due diligence on vetting issuers and avoiding conflicts of interest.
- **Limited Due Diligence** – an intermediary must conduct some limited due diligence checks on an issuer and its management (as distinct from the greater business of an issuer) before publishing the issuer's equity offer on its portal. Issuers would be required to fill out a template, limited due diligence report to represent that the template requirements are accurate and certify that there is no undisclosed material information relating to whether or not the intermediary should publish the offer on the website. Intermediaries should not be required to design a due diligence check for each issuer. Any subsequent material changes to the issuer would have to be made known to the intermediary.

### Other Highlights of CAMAC's Proposal

- **CSEF Offers** – a CSEF offer would only be permitted to be conducted through one licensed intermediary, operating online only. No transfer of funds or shares can take place until the CSEF offer is completed (ie unless the subscription threshold is reached and cooling off periods have expired). An issuer could also offer other equity during the CSEF offer period and accept oversubscriptions to a CSEF offer.
- **Pricing of Shares** – the price per share should be at the discretion of the issuer. However, an issuer should be obliged to indicate how the price per share was arrived at, and how it compares with the price per share of any other class of shares, as well as who are the holders of any other class of shares.
- **Length of Offer** – an issuer's offer document should disclose how long the offer will remain open. CAMAC proposes a three month period to ensure that the information in the offer document does not become stale.
- **Holding Funds** – a prohibition on intermediaries' holding or managing crowd investor funds except where an intermediary is authorised to do so under the terms of its

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licence which, at a minimum, should require that funds be held in a separate segregated trust account.

- **Cooling-Off and Withdrawal Rights** – crowd investors would have a cooling-off right to unconditionally withdraw within five working days and other opt-out/withdrawal rights if an issuer becomes aware of a 'material adverse change' concerning itself and is required to amend the offer documentation and advise the intermediary.
- **Risk Disclosure Statements** – intermediaries would be required to issue a risk disclosure statement to crowd investors and to receive acknowledgement of such a statement before the investor be permitted to engage in CSEF.
- **External Dispute Resolution** – licensed intermediaries would be required to have internal and external dispute resolution processes available to issuers and crowd investors, similar to the process Australian Financial Services License (AFSL) holders are required to have where retail clients are involved.
- **Ban on Financial Advice** – a general ban on intermediaries to provide financial or investment advice in regard to any offers on their website.
- **Ban on Lending** – a prohibition on an intermediary lending to crowd investors to invest in offers on the intermediary websites.
- **Disclosure of Fees** – full disclosure to crowd investors of all fee arrangements between an issuer and an intermediary. Also, a prohibition on an intermediary engaging in conflict of interest situations, including having an interest in the issuer or being paid in shares of the issuer or according to the amount of funds raised.
- **Controls on Advertising** – an intermediary would be prohibited from soliciting crowd investors to accept CSEF offers on their website, such as a prohibition of feature sections of the website such as 'Staff picks' and 'What's hot', or proactive suggestions.
- **Resale Provisions** – share resale restrictions should apply only to persons associated with the issuer where they wish to sell a significant proportion of their equity holding within a prescribed period of any CSEF offer. CAMAC suggested the restriction might operate to prevent an associated person selling 10% or more of their shares within 12 months after a CSEF Offer.
- **Intermediary Liability** – that intermediaries be civilly liable to the extent that the intermediary had actual (not constructive) knowledge of the misleading or omitted information, or actual knowledge or participation in, the fraud (and did not act) and an investor suffers loss. Primary liability should otherwise rest on, and an investor should have primary remedies against, the issuer, its officers and any other persons involved in any inadequate disclosure. Generic risk warnings should point out the possible limitations of remedies an investor may have against an issuer and its directors given the start-up or small enterprise nature of the business concerned.
- **Ongoing Reporting** – 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, especially if an issuer is contemplating further CSEF offers and wants to keep website users informed.

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### Additional Information

#### *Exempt Public Company Form*

The 'exempt public company' would be exempt from:

- the requirement to hold an annual general meeting
- the requirement to have financial reports audited
- preparing half yearly financial reports unless certain capital (ie AUD5 million for six months) or turnover (ie AUD5 million per annum) thresholds were reached. At the expiry of a period of time, for example three years, the exempt public company would automatically revert to a public company and be subject to all the compliance obligations of a public company.

In order for a company to be eligible to be an 'exempt public company', CAMAC did not believe it would be necessary to impose an 'innovative start-up' test, as required in other countries.

CAMAC also proposed that certain companies would not be eligible, such as:

- investment or financial institutions who may raise funds through Chapter 6D of the Act
- listed companies
- companies that have previously made regulated public offers (other than offers made under the excluded offer provisions of s 708 of the Act)
- 'blind pools' where investors put funds into an enterprise without a business plan or an enterprise whose funds are ultimately to be made available for another enterprise
- companies with substantial capital, for example, those with more than AUD10 million.

It is interesting to note that some online portals which, under the current regulatory regime, offer equity to emerging enterprises have commented that the requirement that start-ups become public companies imposes an unnecessary compliance burden that could stifle the new venture. CAMAC did not propose an approach to liberalise the small scale offers exemption for public offers by proprietary companies, as well as increasing the number of permitted shareholders of a proprietary company, currently capped at 50 non-employee shareholders, or dispensing with the cap altogether.

CAMAC did state that ASIC should have the discretion to adjust the requirement that a public company have at least three directors (with two resident in Australia) where an exempt public company applicant has provided good reasons.

#### *Classes of Securities*

CAMAC considers that a CSEF issuer may have on issue more than one class of share, but that a CSEF offer must only be in relation to one specific class of share. This would allow an issuer to have a 'founder' or 'preferred' class of share, with voting, dividend and other rights that permit these shareholders to remain in control and to receive a 'premium' return from any profits generated. However, issuers should be obliged to clearly set out the comparative rights (or lack of rights) of shares they are offering the crowd and to warn an investor of the risk of dilution through subsequent capital raisings which may include preferential shareholder rights over crowd investors.

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### *Enforcement of Issuer Cap*

CAMAC proposes that enforcement of the AUD2 million issuer cap be the responsibility of the intermediary. For this purpose, intermediaries must maintain adequate systems and procedures to ensure that issuers do not exceed the issuer cap in any 12 month period that the issuer uses the intermediary's service.

### *Licensing of Intermediary*

CAMAC deferred from forming a view as to what specific licence would be required and in what circumstances a market licence may be required. Treasury is presently considering the interrelationship between an AFSL and an Australian Market Licence.

CAMAC suggested that the licence requirements for CSEF intermediaries may include consideration that the intermediary:

- be fit and proper
- have systems and procedures dealing with risk management and conflicts of interest
- conduct fair advertising
- have a written client agreement with investors and disclose the nature and extent of due diligence conducted on an issuer
- have adequate financial resources.

### *Fees Paid by Issuers*

CAMAC proposes that an issuer should be prohibited from 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 the 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 document.

### **Contact Us**

Please contact us with any questions or if you require advice in relation to capital raising via the internet, licensing or regulatory requirements and any other fundraising or investment advisory services to be conducted in Australia.

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