Will equity crowdfunding work in Australia?

The Senate has passed a bill to allow companies to access crowd-sourced equity (CSF). But its conditions make 99.7% of Australian companies ineligible and the lowered governance requirements that some companies may qualify for may not outweigh the costs of accessing CSF.

CSF is similar to other forms of crowdfunding in that it enables companies to raise funds through an online portal. The difference is that investors receive a share of the company rather than a product or service. They can now buy up to A$10,000 of equity in a company through a licensed CSF platform.

Eligible companies will be able to raise up to A$5 million a year this way. The government sees this as a remedy for a shortage of finance for small and medium enterprises (SMEs) and start-ups.

Over the 15 months since the idea was first touted – a different bill was introduced in 2015 – the legislation has undergone a series of changes and proposed amendments. This include fundamental aspects such as the size and type of companies that are eligible.

The bill that passed was introduced in late 2016 and contains improvements on the original. But there is still more to do to create a thriving CSF culture.

The safeguards

The bill that passed the Senate introduces three safeguards to protect investors.

1) Regulation imposed on companies seeking capital from CSF

At first glance, the regulation imposed on companies seems reasonable. Eligible companies are able to raise A$5 million through CSF. This is generous when compared to other countries that have capped CSF at A$2 million . Further, while companies must produce a disclosure document when they raise capital through CSF, it is not as onerous as those required for other methods of fundraising .

However, one key feature of the legislation is that it restricts CSF to public unlisted companies that are limited by shares, and with less than A$25 million in gross assets and annual revenue. These criteria alone exclude proprietary companies and many public companies. More than 99.7% of companies will not able to raise capital through CSF .

The legislation excludes foreign companies from raising CSF in Australia. It also excludes companies and their related parties from accessing CSF if their purpose is investment. This can be contrasted with other countries. In New Zealand, all companies can access CSF. In the United States, United Kingdom and Canada, only a small proportion of companies are excluded.

The more inclusive approach adopted by these countries allows CSF to achieve the aims of promoting innovation and remedying the shortage of finance that SMEs face.

2) Regulation imposed on crowd-sourcing platforms

Crowd-sourcing platforms, and Australia already has a few , must have a financial services licence . The platform also must comply with a range of obligations specified in the 2016 bill, such as vetting the companies seeking capital through CSF. This allows the intermediary to act as a gatekeeper, but compliance will be onerous.

The fact that only a small pool of companies can access CSF will lead to ferocious competition. The platforms could find it challenging to generate profits. This would affect the viability of platforms and create a barrier to entry.

We have already seen examples of overseas intermediaries struggling in this sphere. For instance, in Italy, where very few companies can use CSF, only one CSF intermediary now exists. In New Zealand, a number of intermediaries were quickly established but some have already withdrawn from the market.

3) Regulation imposed on investors

Australia has not imposed a general cap on investment as other countries have.

The US caps investment by those with less than US$100,000 of income or net worth to US$2,000 or 5% of the annual income or net worth (whichever is greater) within a 12-month period. If annual income or net worth is equal to or greater than US$100,000 they can invest 10% of their annual income or net worth (to a maximum of US$100,000) within 12 months.

In the UK, an investor should not invest more than 10% of their net assets in non-readily realisable securities (such as equity in an unlisted company) in a 12-month period.

The Australian legislation adopts a more balanced approach. It only limits the amount investors can invest in each company to A$10,000.

One contentious issue in the 2015 bill was the duration of the cooling-off period that allowed investors to withdraw their offers if they changed their mind. A cooling-off period can be a boon for investors but problematic from a business perspective as it could result in market manipulation. Industry contested the proposed five-day cooling-off period.

As a result, the 2016 bill shortened the period to 48 hours. This would be similar to the cooling-off period applied in the Canada. However, after debating this matter in the Senate, the final legislation was amended again and the cooling-off period is back to five working days

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The trade-off

Like its predecessor, the 2016 bill attempts to remedy the issues raised by the fact that only a small percentage of companies are able to access CSF. For instance, it reduces corporate governance requirements for newly registered or converted public companies if they wish to access CSF.

Consequently, if a proprietary company desires to raise funds through CSF it can convert to a public company and be exempt from certain compliance requirements imposed on public companies for a period of five years:

- It is not required to hold an annual members' general meeting for five years.
- It is only required to provide online financial reports to shareholders for a period of five years. No hard copies are required to be sent out.
- 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 A$1 million from CSF or other offers requiring disclosure.

At first glance this may be appealing, but the concessions do not outweigh the significant costs of converting from a proprietary to a public company.

For instance, if the company raises more than A$1 million it will have to appoint an auditor. The company will also be deemed an " unlisted disclosing entitity " and be obliged to continuously disclose information. This can be costly.

How to make it work

In the end, the small number of companies that can access CSF, as well as the regulatory burden on the companies and platforms, creates a barrier to a thriving CSF culture. But there are different models that may be used to remedy this issue.

One idea is to create a new type of company that allows SMEs to raise capital while at the

same time limiting their governance requirements.

Another, more complex option would be to review all the types of companies that we have under the statute to see whether these forms of corporations fulfil their objectives. This review is overdue and may provide answers to a range of problems facing businesses and investors. It may, for instance, result in a simplification of the corporate structure.

The current legislation is just a first step to closing the funding gap for SMEs.

Marina Nehme receives funding from the Centre for International Finance and Regulation

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