Playing to the Crowd? A Critical Analysis of Equity Crowdfunding in the Financial Markets Conduct Act 2013

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Abbreviations

FMA	Financial Markets Authority
FMCA	Financial Markets Conduct Act
FMCB	Financial Markets Conduct Bill
FMCR	Financial Markets Conduct Regulations
IPO	Initial Public Offering
MBIE	Ministry of Business Innovation and Employment
MED	Ministry of Economic Development

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I Introduction

Stu McKinlay and Sam Possenniskie were two Wellington based entreprenuers with a pipe dream. Their colloborative brainchild being the award winning 'Yeastie Boys' craft beer. The pair describe themselves as "brewers without a brewery."[1] The dynamic duo had already cemented their brand within Asian and American markets and wished to permeate the United Kingdom beer scene in collaboration with people who had a passion for the product. Whilst institutional investors were referring to the investment opportunity as "dumb money" Sam and Stu saw it more like "love money".[2] The Yeastie Boys sought to raise NZ$500,000 through an equity crowdfunding campaign via PledgeMe. The emergence of the equity crowdfunding market turned a once pipe dream in to an attainable reality. The facilitation of this market has allowed friends, family and people passionate about the Yeastie Boys to support and become part of their dream whilst "drinking beer and making a few dollars."[3] Being a labour of love type venture, the boys were looking for people wanted to "high-five and hug"[4] at AGM's as opposed to investors who were interested solely in profit production. The Yeastie Boys hit their half a million dollar target within half an hour of opening their PledgeMe campaign. This capital allowed their expansion into the United Kingdom backed by the support of 204 loyal shareholders.

Crowdfunding is a hypernym used to describe an increasingly widespread form of fundraising. Equity crowdfunding latches on to the traditional way of raising capital with a techonogically assisted, new age spin. This allows those seeking to raise funds access to exponentially more contributors of capital. Groups of people pool money, generally of small individual contributions, to support a particular goal.[5] This form of capital raising can and has been used in a variety of situations, such as charities and

[1] Alida Smylie and Chris Keall "Yeastie Boys raise $500K crowdfunded equity in 30 minutes flat" (2015) The National Busines Review <www.nbr.co.nz>.
[2] "Yeastie Boys set to sell a piece of their pie" (2014) < www.scoop.co.nz>.
[3] "Yeastie Boys set to sell a piece of their pie" (2014) < www.scoop.co.nz>.
[4] "Yeastie Boys set to sell a piece of their pie" (2014) < www.scoop.co.nz>.
[5] Meredith Cross, Director of the Division of Corporation Finance U.S. Securities and Exchange Commission "Testimony on Crowdfunding and Capital Formation" (Speech to the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the U.S. House of Representatives, Committee on Oversight and Government Reform, Washington, 15th September 2011).

business projects; President Barack Obama himself raised over US$100 million in the 2008 presidential election.[6]

There are four main types of crowdfunding: ‘The Donation Model’, ‘The Reward and Pre-Purchase Models’, ‘The Lending Model’ (commonly referred to as Peer-to-Peer lending in New Zealand), and ‘The Equity Model’. The focus of this dissertation is the fourth model, ‘Equity Crowdfunding’. Equity crowdfunding is a form of financing in which entrepreneurs make an open call to sell a specified amount of equity or bond-like shares in a company on the Internet, hoping to attract a large group of investors. The online platform provides the means to facilitate these transactions.[7]

The first two models, donation and reward crowdfunding are the most prevalent forms of crowdfunding. Financial market laws do not regulate these, as they are not classed as investments. The lending and equity models however, are types of financial return crowdfunding.[8] Due to these returns, the latter two models of crowdfunding fall within the ambit of securities law, giving rise to regulation in most jurisdictions.

The year 2013 marked a complete legislative overhaul of securities markets regulation in New Zealand. Spurred by the Global Financial Crisis and the preceding collapse of numerous finance companies the Key lead National Government, facilitated by the Ministry of Business, Innovation and Employment (MBIE), set out to restore investor confidence in New Zealand’s capital markets. One of the main initiatives to do so was the incorporation of equity crowdfunding within this new “once in a generation”[9] legislation, the Financial Markets Conduct Act 2013 (FMCA). The provision that facilitates equity crowdfunding appears to be a departure from the trend of investor protection within the FMCA.

[6] Brian Huang “The 2008 Election and the Impact of the Internet” (2008) Indiegogo Blog <go.indiegogo.com>.
[7] Gerrit K. C Ahlers and others “Signaling in Equity Crowdfunding” (2015) 39(4) Entrepreneurship Theory and Practice 955 at 6.
[8] Eleanor Kirby and Shane Worner "Crowd-funding: An Infant Industry Growing Fast" (February 2014) International Organization of Securities Commissions at 4. <www.iosco.org>
[9] Simon Power “Government releases draft bill on securities law” (Realeases from the Minister, 9 August 2011).

Since the 1970's securities markets in New Zealand have been heavily regulated on a basis of investor protection.[10] However, the implementation of the FMCA shows a fundamental shift away from traditional policy and regulation of such markets.

The ambition of this dissertation is to explore equity crowdfunding from a legal perspective. I will highlight a particular interest in the regulatory theory surrounding regulation of capital markets and consider the pragmatic approach the FMCA legislation has taken in diverging from a high level of regulation surrounding disclosure and investor protection where licensed intermediaries are involved. Ultimately concluding why, despite the rift in purpose, equity crowdfunding fits within the FMCA.

The market regulator, the Financial Markets Authority (FMA), has thus far granted seven licenses to crowdfunding platforms. Four of these platforms have run successful campaigns thus far. Snowball Effect, one of New Zealand's first two equity crowdfunding platforms, since it's first offer in August 2014 has had eight successful public offers supported by 1460 investors, raising NZ$8.5 million from the public. The rest of the market has raised NZ$4.2 million.[11] PledgeMe, a platform which 'crowdfunded' itself to provide the equity based service, has run six successful equity crowdfunding campaigns raising $1.6 million from 533 investors for businesses that range from a craft brewery to a wind turbine manufacturer.

Chapter II will outline what equity crowdfunding is and the legislation to which it sits. I will then describe the licensing requirments for a platform wishing to facilitate equity crowdfunding as prescribed by the FMA and the arising liability for breaches of these conditions.

Chapter III identifies the policy behind the reform of securities regulation in New Zealand. More specifically, I will explain why the legislature has chosen to incorporate equity crowdfunding in to our legislative framework. This discussion will

[10] Shelley Griffiths "Securities Regulation" in J Farrar and S Watson (eds) *Company and Securities Law in New Zealand* (2nd ed, ThomsonReuters, Wellington 2014) at 1026-1027.

[11] Josh Daniell "A year in numbers - infographic" (2015) Snowball Effect <www.snowballeffect.co.nz>

stem from an overview of regulatory theory and assess whether the conflicting purposes of the exclusion and general Act can sit together.

Chapter IV examines the culture of capital markets, distinguishing New Zealand from other jurisdictions. On this analysis, I will explain why New Zealand has chosen not to adpot particular regulations and statutory frameworks surrounding equity crowdfunding internationally.

Chapter V finally provides predictions for the future of this market and proposes recommendations as to where the legislation and regulators should go from here.

II Regulating Equity Crowdfunding in New Zealand

This chapter canvasses the legislation surrounding equity crowdfunding. Accordingly, it is a heavily descriptive chapter that aims to provide the context necessary for the analytical discussion that follows.

Part 1(a) will outline the legislative framework pertaining to 'regulated offers' under the FMCA. This is critical to appreciate the difference in approach to regulation where the crowdfunding exclusion is concerned.

1 The Legislation

a. Regulation of an 'offer'

An offer is a 'regulated offer' unless it is excluded under Schedule 1 Part 1 of the FMCA. This distinction is entirely contingent upon *whom* the offer is being made to. Regulated offers are subject to obligations under the Act. These offers require the production of the primary disclosure document, the "Product Disclosure Statement" (the PDS). This document is to be supplemented by more extensive information available online in a register of offers if financial products[12] administered by the Registrar of Financial Advisers.[13]

The purpose of the PDS, which is to be "clear, concise and effective",[14] is to assist the "prudent but non-expert person" to decide whether or not to acquire the financial product.[15] The details are prescribed under regulation 23 of the Financial Markets Conduct Regulations. Every PDS for offers of equity securities must contain all of the information specified in Part of Schedule 3 and must be one of either; 60 A4 pages or 30 000 words.[16]

The PDS and register perform essential roles because a regulated offer cannot be made to the public *unless* the issuer has prepared a PDS and the information has been lodged on the register.[17] Disclosure must be made before applications for the financial

[12] Financial Markets Conduct Act 2013, s 6
[13] Financial Markets Conduct Act 2013, s 6
[14] Financial Markets Conduct Act 2013, s 61
[15] Financial Markets Conduct Act 2013, s 49
[16] Financial Markets Conduct Regulations 2014, reg 23
[17] Financial Markets Conduct Act 2013, s 53

products in question are accepted.[18] The FMA will have an initial consideration period for the PDS and other documents. The nature and extent of the consideration is at the FMA's discretion but after accepting an application, issuing financial products is prohibited for a period of 5-10 working days.[19]

Part 1(b) will now turn to examine the specific regulation of equity crowdfunding within the FMCA and identify the policy decisions behind the implementation of the licensing regime.

b. Regulation of an offer through the equity crowdfunding exclusion

The FMCA and corresponding regulations provide for two new forms of capital raising. These are 'crowdfunding' and 'peer-to-peer lending'. Under the Act, financial products offered through licensed intermediaries are not subject to the standard disclosure obligations for financial products that apply under the financial markets legislation. 'Licensed Intermediaries' for this purpose are persons licensed to provide equity crowdfunding or peer-to-peer services under Schedule 1 Part 1 of the FMCA.

The FMCA creates a licensing regime that enables providers of equity crowdfunding to provide licensed services under the supervision of the regulator, the FMA. Due to the exemption of disclosure obligations, the protection of investors is derived from the licensing regime contained in Part 6 of the FMCR rather than Part 3 (disclosure of offers of financial products). Licensed providers remain subject to various requirements; this includes disclosing to clients the nature of the services provided. They are also subject to FMA supervision. Usual disclosure relating to financial products under Part 3 involves preparing a Product Disclosure Statement (PDS) and lodging information on the register, the content of each prescribed by the regulations. These onerous disclosure obligations make compliance difficult. The consumption of time, cost and significant liability where obligations are not fulfilled makes capital raising impractical for entrepreneurial enterprises.

Generally, the obligations imposed on equity crowdfunding providers are fewer than those that apply to issuers on a registered exchange. A company issuing securities

[18] Financial Markets Conduct Act 2013, s 50
[19] Financial Markets Conduct Act 2013, s 65

through a crowdfunding service is subject to less disclosure requirements than a company listed on the New Zealand Exchange (NZX). Thus companies can raise funds using the limited disclosure regime provided under the exclusions within the FMCA. In turn this reduces the compliance costs and enables investors to invest in early start up financing, this provides funds for emerging companies with significant potential for growth.

The term 'crowd funding service' is defined in regulation 185 of the FMCR. A person is providing this service if two elements are satisfied: first, the person provides a facility by means of which offers of shares in a company are made; and the principle purpose in doing so is to facilitate the matching of companies that wish to raise funds with many investors who are seeking to invest "relatively small amounts".[20] The FMCA does not cover donation and rewards based crowd funding, these types of crowdfunding can be thought of as 'crowd sponsoring' since there is no financial return for the backers and these activities remain unregulated under the Act.[21]

Part 6 of the FMC regulations allow equity crowdfunding services to be licensed. The provisions provide additional eligibility criteria, such as adequate systems and procedures to ensure that issuers do not raise more than NZ$2 million in any 12-month period. Disclosure arrangements are also set out under Part 6, these include disclosure statements for retail investors, conditions and client agreements.

The FMA reglulates a number of populations, these include crowdfunding platforms as intermedairies among others such as capital markets, governance, product providers, savings schemes and providers and distributors. The FMA aims to build investor confidence by assessing and monitoring compliance, conduct and competency of market participants. This defferal of enforcement and regulation to the FMA from the legislature is demonstrative of the rift between legislative purposes. Stepping away from a heavily regulated investor focus in the Act toward a self-regulated market akin to the former regulatory model in the Securities Act in the exclusions.

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[20] Financial Markets Conduct Regulations 2014, reg 185 (1)(a)

[21] Alma Pekmezovic and Gordon Walker "Equity Crowdfunding in New Zealand" (2015) 33 Companies and Securities Law Journal 63 at 65.

The next section outlines the most significant aspects of the crowdfunding regulations; specifically identifying the standard and obligations platforms are required to meet. Second, the liability attaching to breaches of requirements will be explored.

c. Licensing requirements

All intermediaries providing a crowdfunding service must be licensed by the FMA. License obligations are intended to mitigate the risks associated with equity crowdfunding. The major focus and purpose behind the license conditions are investor protection. Confidence in the equity crowdfunding market inevitably transfers to the broader capital markets in New Zealand. Thus the FMA and MBIE are acutely aware that should the crowdfunding market fail, it runs the risk of investors losing faith in capital markets entirely. As a result stringent disclosure and monitoring obligations are set out in the licensing regime.

The framework further protects itself by ensuring investors are aware of the high-risk nature of equity crowdfunding and thus allocate the risk between investor and issuer through contractual agreements and warning statements. A markedly different approach to the consumer focus of the general FMCA, moreover a pragmatic decision to share risk where the legislature has identified it should lie.

The criteria for obtaining a license is set out in s 396 of the FMCA and additional eligibility criteria apply under reg 186 of the FMCR.
Section 396 provides:[22]

- the provider must have fair, orderly and transparent systems for facilitating the service
- the service is designed primarily for offers by persons other than the provider and its associated persons
- the provider has an adequate policy for identifying and managing the risk of fraud by issuers using the service (anti fraud)
- the provider has adequate disclosure arrangements to give investors, or to enable investors to readily obtain, timely and understandable information to assist investors to decide whether to acquire the shares (for example through initial disclosure, or question and answer forums) and

[22] Financial Markets Conduct Act 2013, s 396

- the provider has an adequate policy (a fair dealing policy) for excluding an issuer from using the service if the provider has information that gives it reason to believe that the issuer has engaged in conduct that is misleading or deceptive or is likely to mislead or deceive.

There are ongoing obligations for these platforms; providers must meet and maintain certain minimum standards as set out by the FMCA and applicable regulations. Part 2 of the FMCA outlines the general fair dealing obligations, these also apply to crowd funding services; this includes the prohibition of false and misleading statements.

Once granted the duration of a license continues in force until the close of its expiry date (unless sooner cancelled).[23] Each platform has discretion to impose further rules. For example the length of an offer, Snowball Effect limits this to a maximum of 30 days (60 with extensions). If the funding target is not reached within the offer period, the offer will expire and the invested money, which is held in trust, will be returned to the relevant investors' bank accounts. In some circumstances the offer may be extended beyond the offer period at the platforms discretion.[24]

(i) Disclosure

Disclosure is integral to capital markets. The theory behind such intervention will be discussed under chapter III. Despite crowdfunding's exclusion from the onerous disclosure obligations in Part 3 of the Act, the regulations still prescribe a stringent disclosure regime for issuing companies and the service provider itself.

Regulation 215 provides that a disclosure statement for a service provider must contain a description of the following:[25]

- the nature of the service provided
- how investors and issuers apply for, and apply and obtain access to the facility and the eligibility criteria that apply
- how investments are made and financial products are issued under the service and;
- how investor money is received and dealt with.[26]

Regulation 196 imposes an additional obligation to make a specific warning statement available. This is specified in 196(2):[27]

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[23] Financial Markets Conduct Act 2013, s 407

[24] "Frequently asked questions" (2015) Snowball Effect <www.snowballeffect.co.nz>

[25] Financial Markets Conduct Regulations 2014, reg 215.

[26] Financial Markets Conduct Regulations 2014, reg 215(1).

[27] Financial Markets Conduct Regulations 2014, reg 196(2).

Warning statement about crowd funding

> Equity crowd funding is risky.
>
> Issuers using this facility include new or rapidly growing ventures. Investment in these types of businesses is very speculative and carries high risks.
>
> You may lose your entire investment, and must be in a position to bear this risk without undue hardship. New Zealand law normally requires people who offer financial products to give information to investors before they invest. This requires those offering financial products to have disclosed information that is important for investors to make an informed decision. The usual rules do not apply to offers by issuers using this facility. As a result, you may not be given all the information usually required. You will also have fewer other legal protections for this investment.
>
> Ask questions, read all information given carefully, and seek independent financial advice before committing yourself.

These obligations are an attempt by the legislature to overcome information asymmetry between issuer and investor. By providing prospective investors with furture projections and company information, they are able to make a educated investment decisions thus allocating risk between investor and issuer. The warning statement acts as a mechanism of investor protection to ensure effiecieny and transparency in the market.

(ii) Investor Confirmation

Investor confirmation is an acceptance of shared risk. Intermediaries must receive acknowledgement of the investor's intention to enter in to a risky venture with full appreciation of the possible outcomes. Confirmation must be obtained to the effect that investors have seen and understood the warning statement and appreciate the risks involved. The confirmation must be in writing in a separate agreement, this is the only restriction on who may invest. Here, New Zealand's legislative framework differs from that of other jurisdictions. This will be further explored in chapter IV.

The agreement of confirmation appears to be a safeguard for the issuing company and platform should the venture fail. This simultaneously promotes the notion of investor autonomy. Whilst these requirements aim to caution prospective investors, the regulations fall short of absolute protection. A divergence from outright paternalism is evident; the underlying policy instead indicates a pursuit of economic objectives.

(iii) Issuer Cap

The issuer cap is the only limitation the FMCA has put on equity crowdfunding. This is an obligation on the issuer, not on the platform. Caps on the amount an issuer can raise encourages diversification and limits losses from particular issuers. It does not limit investor losses however if there were systemic problems with listings on a particular crowdfunding platform.[28] Under regulation 186(1)(g) companies using a crowdfunding service are limited to raising an aggregate sum of NZ$2 million in any 12-month period. There is no limit on the number of investors in an issuing company, nor are there any caps on investment amounts. I will further expound the reasoning behind New Zealand's decision not to impose an investor cap in chapter V.

(iv) Anti-fraud and Fair-dealing

At the forefront of any legislature's contemplation when drafting statutory provisions is the possibility and inevitability of fraud and unfair conduct. Thus the regulations have incorporated a requirement for each platform to ensure they have adequate procedures in place to mitigate this risk. The requirements for anti-fraud and fair-dealing policies are set out in regulation 186. The policy must, at a minimum, ensure that the provider checks information about the identity of the issuer, its director and senior managers. The obligation to exclude an issuer also applies if there is reason to believe that the issuer is not likely to comply with the obligations imposed on it under the service or if the issuer has engaged or is likely to engage in misleading or deceptive conduct.

Whilst the regulations have prescribed a minimum standard of compliance, it is at the platforms discretion as to how they monitor their specific anti-fraud and fair-dealing policies. The frameworks proposed by each intermediary are scrutinised by the FMA when assessing whether or not to grant a service provider licence. This allows for an appropriate level of discretion and flexibility dependent on each provider.

[28] Cabinet Business Committee "Financial Markets Conduct Regulations Paper 4 – Licensing regimes" (2013) MBIE-MAKO-4363783 at [135].

(v) Conflicts of Interest

Providers must have adequate systems and procedures for handling conflicts between the commercial interests of the provider and the need for the provider to have fair, orderly and transparent systems and procedure for providing the service.[29]

(vi) Client Agreement

The final regulation to touch on is regulation 223, which provides that client agreements apply to equity crowdfunding platforms. This standard form agreement creates a contractual relationship between the investor and crowdfunding platform. As a result, contractual obligations and remedies arise. The client agreement must be entered in to before an investor applies for or acquires any financial products under the service. Regulation 225 goes on to list implied terms, which are by default inherent in the agreement. This includes that a licensee must take exercise the care, diligence and skill that a prudent licensee providing the service would exercise in the same circumstances.[30] This will be discussed in detail under liability.

Agreements for crowdfunding services must include how investors and issuers obtain access to the facility and the relevant eligibility criteria in each case. The agreement must provide adequately for how investor money is received and dealt with and the frequency and extent to which the provider engages in monitoring its licensees. The fees pertaining to the service must also be specified within the client agreement.[31] Analogous to the written investor confirmation, this agreement ensures that both parties are well aware of the investment being entered into. It also further emphasises the allocation of risk over both parties, this must be distinguished from a traditional provider and consumer relationship.

The next section will examine the avenues of recourse and liability attaching to an issuer or provider should a breach arise.

[29] Financial Markets Conduct Regulations 2014, reg 186(1)(h)
[30] Financial Markets Conduct Regulations 2014, regs 224 and 225(1)
[31] Financial Markets Conduct Regulations 2014, regs 227(a), (c)-(e).

2 Liability

Offers are excluded on the basis that the intermediary is responsible for carrying out identity and creditworthiness checks on the issuer, and the investor can rely on these procedures, the terms of issue of the licence and the disclosures made by (or through), and their contract with the intermediary.[32] In what circumstances and to whom liability attaches in the case of a breach (such as disclosure) is an integral part of any licensing regime. Breaches by licensed intermedaries liable under the Part 3 regime as it does not extend to the crowdfunding exclusion. However, avenues of liability exist for both the provider and issuer. Accountability arises for breaches of mandatory disclosure and other license obligations. This section will explain liability for breaches which can be civil (under Part 6 and Part 2 of the Act), criminal or a mixture of both.

a. License Obligations under Part 6

Section 38 sets out where civil liability arises for contraventions of the Act, this includes the Part 6 services provisions.[33] When a provision is contravened, the court may make a declaration of contravention[34] for the purposes of enabling the FMA or an investor, to apply for a compensatory order under s 494 or other civil liability order under 497.[35] In addition, the court, on the application of the FMA, make a pecuniary penalty order, payable to the Crown.[36] Action plans are an important tool, because the FMA can agree on remedial action to impore on-going performance and monitor its implementation. There are two tiers of pecuniary penalties. The higher tier has a maximum pecuniary penalty the greatest of: the consideration for the transaction constituting the contravention, three times the gain made or loss avoided by the contravention, $1,000,000 for an individual or $5,000,000 in any other case.[37] Any other civil liability provision has a maximum of $200,000 for the individual or $600,000 in any other case.[38]

[32] Victoria Stace and others "Financial Markets Conduct Regulation: A Practitioner's Guide" (LexisNexis, Wellington, 2014) at 129.
[33] Financial Markets Conduct Act 2013, s 485
[34] Financial Markets Conduct Act 2013, s 486
[35] Financial Markets Conduct Act 2013, s 487
[36] Financial Markets Conduct Act 2013, s 489
[37] Financial Markets Conduct Act 2013, s 490(1)
[38] Financial Markets Conduct Act 2013, s 490(2)

Civil liability attaches to many licence obligations, including the general reporting condition, the condition to notify the FMA regarding suspected contraventions of Part 2 and of the issuer cap, providing a disclosure document about the service to investors, providing risk warnings and receiving investor confirmation that they have read those risk warnings.[39]

Where the regulations do not provide for breaches of license conditions, the breach will have licensing consequences only. The FMA has significant powers in the case of a licence contravention, which include censure of the licensee, requiring an action plan to be submitted, giving directions and suspending or cancelling the licence if it is satisfied the issuing requirements of s 396 are no longer met.[40] The FMA may also vary or revoke, add to or substitute any conditions of the licence.[41] Failure to submit an action plan or to comply with FMA directions gives rise to civil liability including a pecuniary penalty, as does failure to notify the FMA of a contravention or potential contravention of a market services licensee obligation in a material respect.[42]

Therefore, where a licensee is acting fraudulently and knowingly allows its processes to be contravened, civil liability including a pecuniary penalty can be attached through the failure to report the contravention.[43] Liability can also attach to a licensee where it is "involved in a contravention", similar to secondary party liability under s 66 of the Crimes Act 1961.[44] Where the licensee simply fails to ensure its processes are followed, such as making sure adequate disclosure is given, and is unaware that this process was not properly followed, then licensing consequences apply. This could make it difficult to find a licensee liable where an issuer makes a false or misleading statement, which would appear, to the licensee to be true and adequate disclosure, restricting this avenue of liability where the issuer is insolvent. In such a case though, liability would be better placed on the issuer where possible, as the issuer is the one making the disclosure about the offer through the crowdfunding platform.

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[39] Financial Markets Conduct Act 2013, s 38
[40] Financial Markets Conduct Act 2013, s 414
[41] Financial Markets Conduct Act 2013, s 403(1)(b)
[42] Financial Markets Conduct Act 2013, s 449(4)
[43] Financial Markets Conduct Act 2013, s 412
[44] Financial Markets Conduct Act 2013, s 533

Another avenue for liability against the provider is where it breaches the terms of the required client agreement. Implied into the client agreement is a duty to, when exercising any powers or performing any duties in relation to the service, "exercise the care, diligence, and skill that a prudent licensee ... would exercise in the same circumstances".[45] This constitutes a contractual breach in which the duty of care owed is similar to that of duty trustees and directors.[46] Due to this relationship, trust and company law may be relevant in assessing whether the duty has been breached in any particular case.[47]

In sum, where provisions under the licensing requirements of Part 6 are breached, civil liability arises. This can be via a compensatory order to the investor or a pecuniary order payable to the Crown on application to the FMA. Where the regulations do not provide for breaches of license conditions, the FMA can still impose licensing consequences. These actions are aimed at the platform itself; this makes it difficult to attach liability to the issuer, especially regarding disclosure. Part 2 better deals with recourse against the issuer for breaches.

b. Fair Dealing oligations under Part 2

Part 2 breaches of the Act also give rise to civil liability. This part pertains to fair dealing obligations relating specifically to financial products.[48] Part 2 allows for the conduct of the issuer to be monitored and liability enforced, as Part 3 does not cover their actions. Sections 19-23 apply to those acting “in trade”[49] by operating a business, activity of commerce of undertaking, it therefore applies to both the licensee and issuer. Part 2 prohibits misleading or deceptive conduct generally,[50] false or misleading representations about specified aspects of the financial product[51] or unsubstantiated representations.[52] Conduct that may mislead the public as to the nature, characteristics, suitability for a purpose or quantity of financial products and

[45] Financial Markets Conduct Regulations 2014, reg 43
[46] Trustee Act 1956, ss 13B and 13C; and Companies Act 1993, s 137.
[47] Henry Hillind “Exploiting the Crowd: The New Zealand Response to Equity Crowd Funding” (LLB (Hons) Dissertation, Victoria University of Wellington, 2014) at 23.
[48] Financial Markets Conduct Act 2013, s 17
[49] Financial Markets Conduct Act 2013, s 12
[50] Financial Markets Conduct Act 2013, s 19
[51] Financial Markets Conduct Act 2013, s 22
[52] Financial Markets Conduct Act 2013, s 23

services is also prohibited.[53] Further, these provisions also catch the intended inclusion of misleading information for the purposes of committing fraud.[54] Pecuniary penalties can apply to all of these provisions (excluding a contravention of the general prohibition against misleading or deceptive conduct in s19).[55]

Directors are often overoptimistic and wish to present their forecasts in the best possible light, this point will be expanded upon under regulatory theory in chapter III. Because of this overoptimism, attaching liability becomes difficult where an issuer overstates the prospects of their venture, such as indicating inflated profit forecasts or downplaying the risks. Case law helps to clarify what constitutes 'misleading'. *Jagwar Holdings* established that inflated profit forecasts are misleading only where the directors who gave them did not in fact believe them to be true or had no reasonable basis on which to find them to be true.[56] The directors of Lombard Finance in *Jefferies v R*[57] made statements inflating projections of success and omitted crucial financial information to its investors. These actions would be more difficult to bring within the scope of s 19 as there is no requirement that material information be disclosed, only that the conduct is misleading.[58] The lack of clarity in the application of the provisions creates the potential for inconsistencies where misleading statements are made by negligent issuers.[59]

Unsubstantiated representations are representations made by a person who has no reasonable grounds for making them, irrespective of whether they are false or misleading. Section 23 prohibits such conduct. The Act limits the application of this objective test, as it cannot apply to representation made in disclosure documents or register entries.[60] The crowdfunding exclusion however does not come within the meaning of disclosure document[61] thus; liability can be attached where an issuer of an equity offered via a crowdfunding platform makes an unsubstantiated representation.

[53] Financial Markets Conduct Act 2013, ss 20 - 21
[54] Financial Markets Conduct Act 2013, s 38
[55] Financial Markets Conduct Act 2013, s 489(3)
[56] *Jagwar Holdings Ltd v Julian* (1992) 6 NZCLC 68,040 (HC) at 104-105.
[57] *Jeffries v R* [2013] NZCA 188.
[58] Henry Hillind "Exploiting the Crowd: The New Zealand Response to Equity Crowd Funding" (LLB (Hons) Dissertation, Victoria University of Wellington, 2014) at 23.
[59] Henry Hillind "Exploiting the Crowd: The New Zealand Response to Equity Crowd Funding" (LLB (Hons) Dissertation, Victoria University of Wellington, 2014) at 24.
[60] Financial Markets Conduct Act 2013, s 26
[61] Financial Markets Conduct Act 2013, s 6

As aforementioned, the objective test also relies on a *reasonable* person expecting that the representation would be substantiated[62] and whether the grounds, which the presentations were made, were *reasonable* ones. The prohibition requires claims to be supported and justified, which increases consumer confidence by increasing the credibility of claims.[63]

Ambiguity arises surrounding whom must the statement be misleading to. Dobson J in *Feltex*[64] assumed that any 'prudent non-expert' investor would seek financial advice, thus what would be misleading to them would not be to a financial adviser. It is not evident from the legislation whether the retail investor on an equity offered via a crowdfunding platform is presumed to be advised. Given the nature and pragmatic effect of clause 6, I would contend that the legislation suggests the investor was not advised.[65] Therefore a statement in an offer to this type of investor would be misleading if such an investor were misled.

As pecuniary penalties cannot be applied for when there is liability under s 19, it may be more favourable for investors pursue liability in the other provisions. The specified representations that must not be false or misleading do not cover forecasts or the financial situation of a company.[66] These could potentially be argued to mislead as to the nature or characteristics of the financial product, although "whether financial viability of an investment affects the inherent qualities of a product is tenuous."[67] Liability will most likely be limited to s 19, providing only civil penalties.

Directors of the issuer company under the equity crowdfunding exclusion, involved in the contravention are not treated as having contravened Part 2 provisions as they would be for a contravention of s 82.[68] A director may still be found liable for being involved in the contravention, but this must be proven by the prosecution rather than

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[62] Financial Markets Conduct Act 2013, s 23(3)
[63] Ministry of Consumer affairs *Consumer Law Reform Additional Paper: Substantiation* (November 2010) at 9-10.
[64] *Houghton v Saunders* [2014] NZHC 2229, Dobson J
[65] "Toward understanding the Financial Markets Conduct Act 2013; Insights from the past" in McCracken and Griffiths (eds) *Making Banking and Finance Law: a Snapshot* (Ross Parsons Centre Sydney University Press, Sydney, 2015) Forthcoming at 7.
[66] Financial Markets Conduct Act 2013, s 22
[67] Henry Hillind "Exploiting the Crowd: The New Zealand Response to Equity Crowd Funding" (LLB (Hons) Dissertation, Victoria University of Wellington, 2014) at 25.
[68] Financial Markets Conduct Act 2013, s 534

being automatic, creating a further hurdle to liability.[69]

Whilst liability attaches to issuers for misleading and deceptive conduct, pecuniary penalties are only available for sections 20-23. Where a misleading and deceptive conduct occurs generally, under s 19 only civil penalties will apply. This, in addition to the restriction on director's liability, limits the scope of the liability regime under Part 2 in relation to the equity crowdfunding exclusion.

Further liability attaching to issuers occurs under criminal law provisions. These will be outlined in the following section.

c. Criminal Law

Two avenues of criminal liability may be available against an issuer acting under the clause 6 exclusion. The Act creates a general offence for knowingly making or authorising a false or misleading statement in a document required by or for the purposes of the Act.[70] This is not limited to the narrow definition of disclosure document in section 6.

> **6 disclosure document** means any of the following:
> (a) a PDS:
> (b) a disclosure document under clause 26 of Schedule 1:
> (c) information made available under subpart 4 of Part 3:
> (d) a disclosure statement or other information made available under subpart 4 of Part 6

Any document provided by an issuer to investors in reliance on the exclusion is likely 'for the purposes of the Act', thus this element is easily satisfied. The test is slightly different to that in section 19 and requires the statement to be false or misleading in a 'material particular'.[71] The maximum for this offence is a sentence of five years, a fine not exceeding NZ$200,000 or both.[72] Contraventions of other defective disclosure provisions carry significantly higher penalties and adopt the standard of recklessness.[73] The lower restriction and higher threshold for equity crowdfunding seems appropriate given the restrictions on the amounts an issuer may raise under the

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[69] Financial Markets Conduct Act 2013, s 533
[70] Financial Markets Conduct Act 2013, s 512
[71] Financial Markets Conduct Act 2013, s 512(1)
[72] Financial Markets Conduct Act 2013, s 512(2)
[73] knowing or recklessly contravening s 82 can give rise to a maximum imprisonment of 10 years, a fine not exceeding $1,000,000 or both for an individual, or a fine not exceeding $5,000,000 in any other case. See Financial Markets Conduct Act 2013, s 510(3).

exclusion and the lower disclosure requirements.[74] Due to the NZ$2 million issuer cap and lowered disclosure standards, heavy fines and lower mens rea standard would be unreasonable.

Liability may also be found under the Crimes Act.[75] The recently amended legislation now criminalises the publishing of any false statement with intent to induce a person to acquire financial products under the Act, either knowing or reckless as to whether it is false in a material particular, with a maximum imprisonment of 10 years.[76] This would predominantly apply to issuers but could conceivably extend to a platform provider in which allowed the false statement to be published.[77] As identified, the liability regime has difficulties in holding the provider and issuer liable for misleading or incorrect information. The regime overall is not as clear as it is for breaches of the main inadequate disclosure provisions of the Act and generally has lower penalties.

There are obligations on platform providers to adhere to the licensing requirements under Part 6 and there are obligations on issuers of equities in equity crowdfunding to comply with the fair dealing provisions under Part 2. Failure to comply with these provisions exposes intermediaries and issuers to both civil and in certain situations, criminal liability. However, the overall purpose of the equity crowdfunding provisions is to relieve issuers of the onerous burden of disclosure placed on other issuers of regulated offers. To evaluate the policy behind this, it is appropriate to consider regulatory theory of equity fundraising activity. It is only through such analysis that we will get a clearer picture of whether the equity crowdfunding provisions meet the policy objective.

[74] Henry Hillind "Exploiting the Crowd: The New Zealand Response to Equity Crowd Funding" (LLB (Hons) Dissertation, Victoria University of Wellington, 2014) at 25.
[75] Financial Markets (repeals and Amendments) Ac 2013, sch pt. 1
[76] Crimes Act 1961, s 242.
[77] The promoter of the company NearZero received five years and three months jail time on conviction under this section, after claiming to have made a breakthrough in relation to lossless compression technology which he did not have, subsequently raising $5,300,000: see *R v Whitley* DC Nelson CRI-2008-042-3052, 10 August 2010 at [6].

III Policy behind the FMCA

The equity crowdfunding exclusion is part of the FMCA, but in many ways it departs from the policy choices made in respect of issuing financial products to the investing public. This chapter considers the specific purposes and policies of the FMCA in light of general theories of financial market regulation.

1 The FMCA General Purposes

Sections 3 and 4 set out the main, and additional, purposes of the legislation:[78]

> **3 Main purposes**
>
> The main purposes of this Act are to—
>
> (a) promote the confident and informed participation of businesses, investors, and consumers in the financial markets; and
>
> (b) promote and facilitate the development of fair, efficient, and transparent financial markets.
>
> **4 Additional purposes**
>
> This Act has the following additional purposes:
>
> (a) to provide for timely, accurate, and understandable information to be provided to persons to assist those persons to make decisions relating to financial products or the provision of financial services:
>
> (b) to ensure that appropriate governance arrangements apply to financial products and certain financial services that allow for effective monitoring and reduce governance risks:
>
> (c) to avoid unnecessary compliance costs:
>
> (d) to promote innovation and flexibility in the financial markets.

The purpose FMCA seems to represent a tilt in the position from efficient capital markets to overt investor protection.[79] The overall scheme of the definition and designation provisions in the FMCA can be seen as reflecting a deliberate choice to take a different approach from the Securities Act 1978. The difference between the two approaches could be summarised as the Securities Act having cast a wide net in defining securities, and then using an extensive set of exemptions to achieve appropriate outcomes, whereas the FMCA is drafted to have a narrower set of

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[78] Financial Markets Conduct Act 2013, ss 3 and 4.
[79] Victoria Stace and others "Financial Markets Conduct Regulation: A Practitioner's Guide" (LexisNexis, Wellington, 2014) at 22.

definition for financial products, but with the designation power providing a "call-in" function whereby the FMA as market regulator can bring financial instruments within the FMCA regime if it considers it appropriate to do so.[80]

To illustrate this shift in purposive focus, the theory behind regulation of capital markets must first be outlined.

a. Regulatory Theory

Capital markets operate on the basis of an investor – issuer relationship. These markets exist to facilitate the raising of capital for issuing companies and to provide investment opportunities for investors. At a fundamental level, the tension within securities market regulation is that, on the one hand, it must promote investor confidence and market integrity and, on the other hand, it must promote competitiveness, efficiency and liquidity.[81] Based on this delicate intersection of purpose and objectives, regulation is necessary to ensure the relationship remains symbiotic and the market remains efficient. Due to the public nature of capital markets, a divergence emerges from traditional company law principles to those of consumer focus and high levels of regulation, as Shelley Griffiths aptly states, "the fundraising process is where company law assumes a public face".[82]

'Securities', now referred to as 'financial products' under the FMCA can be distinguished from other commodities or things, and as such are regulated more tightly than contracts in other areas of law. As stated by Heath J in *R v Moses*, "an offer of securities to members of the public has never been treated as akin to offers to acquire other commodities." [83] These intangible goods aim to be passive recipients of an income stream. The value of such a 'product' is largely contingent on the expected future performance of the issuing company and thus so are the claims to the future income of companies. Projecting the expected future performance of a company is, by

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[80] Evan Jones "Has the Supreme Court *Turned and Waved* Goodbye to the Essence of the New Zealand Securities Regime? An Analysis of the Purposes Underpinning Securities Market Regulation in New Zealand" (LLB (Hons) Dissertation, University of Otago, 2013) 48.
[81] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 122.
[82] "Toward understanding the Financial Markets Conduct Act 2013; Insights from the past" in McCracken and Griffiths (eds) *Making Banking and Finance Law: a Snapshot* (Ross Parsons Centre Sydney University Press, Sydney, 2015) Forthcoming at 18.
[83] *R v Moses* [2011] NZHC 646 at [35].

definition, an exercise in conjecture and thus financial products necessarily involve an element of risk. Directors and managers in a company are in a better position than prospective investors to judge the likely nature of the risks the company will face, and the extent to which the business will cope should they encounter them. Due to this disparity in knowledge, it is possible for companies to misrepresent prospects in order to recruit investors. It is this asymmetry of information between companies seeking capital and market participants willing to invest, that market regulation seeks to address.[84] Predictions about the future are inherently uncertain.

Regulation differs at different stages. The overarching aim behind regulation at the 'Initial Public Offering' (IPO) stage is undoubtedly investor protection. The goal is not to insulate investors from sustaining losses, but instead instill confidence and enable investors to make informed choices and efficient resource allocation decisions, and to be protected form fraudulent issuers.[85]

Given these underlying purposes, the touchstone of regulation of capital markets is disclosure. Justice Brandies appropriately encapsulated the legislative approach to disclosure in his quote:[86]

> "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."

Mandatory disclosure combines elements of investor protection with a minimum level of intervention for business. The rationale for mandatory disclosure reflects the inherent tension between investor protection, which involves regulation, and business interests, which resist intervention and cost. James Williams aptly refers to the complex dynamics at work as: [87]

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[84] Louise Gullifer and Jennifer Payne *"Corporate Finance Law: Principles and Policy"* (Hart Publishing, Portland, 2011) at 459.

[85] Louise Gullifer and Jennifer Payne *"Corporate Finance Law: Principles and Policy"* (Hart Publishing, Portland, 2011) at 416.

[86] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 122.

[87] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 122.

> "Reflecting the myriad interests at play in this arena and the highly politicized nature of regulation itself, one of the most notable features of this regulatory mandate is its internal tensions and contradictions."

Investors are protected by disclosure so that they are able to make informed investment decisions based on publicly available information or are able to pay others to do it for them.[88] Disclosure however, comes at a cost, and to find the appropriate balance of costs and benefits is the task of each regulator based on economic objectives, political policies and public pressure. This was noted in a discussion paper on the 'Financial Markets Conduct Bill' (FMCB) by MBIE, which requires any person seeking investment from the public to inform the market of the material facts relevant to their proposals. This is an attempt to overcome the aforementioned information asymmetries between issuers and investors and to achieve the broad goals of securities regulation by using the future of materiality.

One of the objectives disclosure seeks to achieve is promoting an efficient market price. Mandatory disclosure is used at IPO stage in order to provide investors with the information they need to decide whether to purchase the offered securities. At this stage, disclosure merely provides the information to theoretically ensure that investors are informed before investing and are aware of a company's projected performance. This departs from the 'buyer beware'[89] function that disclosure was previously aimed at providing under the Securities Act.

The rationale shifts to market efficiency once the securities, now called financial products under the FMCA, have been listed on a market. The efficient capital markets theory centers upon the premise that prices within the market at any time "fully reflect" the available information.[90] Markets can theoretically self-regulate where accurate information is available and investors are confident. With accuracy, money will move to those who can use it most effectively, thus investors will make optimal choices regarding their investments. In turn, an informed securities market will not

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[88] Shelley Griffiths "Regulating Private Offers of Securities: Time for a Major Rethink" (2009) 15 NZBLQ 105 at 105.

[89] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 122.

[90] Eugene Fama "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25(2) The Journal of Finance 383 at 383.

only enhance the value of high quality companies, but also the value of the marketable securities of public companies in aggregate.[91]

Disclosure is not the "panacea for all ills or risks associated with securities market investment, nor should it be."[92] Risk is inherent in securities market investment. Disclosure is a form of protection for investors but is not intended to do more than inform and give investors an opportunity to assess, take advice and make reasoned decisions. An opportunity to receive relevant and timely information before investing should not, however, be denied lightly and without adequate consideration. The concept of "buyer of beware"[93] has never been considered appropriate when dealing with offers of securities given the ongoing interest in the company by virtue of an investment and the absence of any tangible asset.[94]

Despite a heavy focus on investor protection, especially at IPO stage, an over-emphasis on such protection runs the risk of under-emphasizing the importance of investors making informed decisions and removes incentives for investors to do their homework. Whilst it is paramount to overcome information asymmetry, disclosure frameworks should not 'protect' investors at all times. Investors should be compelled to research and understand the documents disclosed to them as both 'prudent' and 'non-expert' market participants. It is imperative to mark a distinction between disclosure for the purpose of promoting investor confidence and that of investor protection. The former Securities Act allocated risk to both issuer and investor. This required investors to responsibly assess the risk of each investment, and encouraged extensive consideration when entering the market.

As Shelley Griffiths noted,[95] a balance must be struck between the costs and benefits of disclosure. Too much disclosure can become costly and confusing where there are

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[91] Summary of the 'Efficient Capital Markets Theory' in Louise Gullifer and Jennifer Payne *"Corporate Finance Law: Principles and Policy"* (Hart Publishing, Portland, 2011) at 456.

[92] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 122.

[93] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 122.

[94] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 122.

[95] Shelley Griffiths "Regulating Private Offers of Securities: Time for a Major Rethink" (2009) 15 NZBLQ 105 at 105.

no firm guidelines or requirements surrounding what must be disclosed to an investor. Whilst disclosure is integral in the functioning of efficient capital markets, it can become a double-edged sword. It does not necessarily follow that floods of information available in the market will necessarily correspond to the most efficient market. Investors can only absorb and digest so much information, thus over-disclosure poses a legitimate threat to efficacy. The market theoretically can become flooded with superfluous information. Not only does excessive information pose an economic burden, the clarity of information is also threatened. An appropriate disclosure regime should not protect investors at all times, but incentivize investors to read and understand disclosure documents to be informed as both prudent and non-expert.[96]

b. The FMCA

Building a more competitive and productive economy for New Zealand was one of the central priorities Prime Minister John Key identified for the Government to achieve. MBIE stated in the Business Growth Agenda 2014 that growing competitive businesses creates jobs and increases exports to the world.[97] Further, that business confidence and growth would create sustainable, high-paying jobs and boost New Zealand's standard of living.[98] The Agenda aimed at 'future direction' identified six key areas of focus to achieve these goals and encourage confidence and further investment; export markets, infrastructure, natural resources, skilled and safe workplaces, innovation and finally capital markets.[99] The establishment of the FMA and the implementation of the Financial Markets Conduct Act 2013 aimed to improve the regulatory framework that governs New Zealand's capital markets.

MBIE has adopted eleven policies to ensure the growth of New Zealand's capital markets.[100] The initiative represents significant steps toward the creation of fairer,

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[96] Louise Gullifer and Jennifer Payne *"Corporate Finance Law: Principles and Policy"* (Hart Publishing, Portland, 2011) at 459.

[97] Ministry of Business, Innovation and Employment *Business Growth Agenda: Future Direction 2014* (June 2014) at 4.

[98] Ministry of Business, Innovation and Employment *Business Growth Agenda: Future Direction 2014* (June 2014) at 4.

[99] Ministry of Business, Innovation and Employment *Business Growth Agenda: Future Direction 2014* (June 2014) at 4.

[100] Ministry of Business, Innovation and Employment *Business Growth Agenda: Future Direction 2014* (June 2014) at 30.

more efficient and more transparent financial markets.[101] The FMCA brings New Zealand in to line with international securities law, bolstering areas of strength and working towards remedying weaknesses revealed in the wake of the Global Financial Crisis. A major focus was growth of investor confidence. At the time of the 2014 Business Growth Agenda, overall confidence has risen 5 percentage points to 59 per cent from 54 per cent.[102]

New Zealand's economic context illustrates the call for legislative reform. It is a common misconception that this legislation has arisen from the Global Financial Crisis; the move toward heavier regulation and broader disclosure had in fact been in the pipeline since early 2000's. The period between 2006 and 2010 saw many New Zealanders, the so-called "Mum and Dad investors", lose significant amounts of money as a result of multiple finance company collapses. Poorly regulated financial intermediaries, advisors and their practices undermined investor outcomes. In many cases, these offerings were characterised by confusing and misleading disclosure of risks, inadequate supervision by trustees and statutory regulators, and uninformed and ill-advised investors. Finance companies were thus able to offer much lower interest rates than were justified by their risks, and to engage in a variety of practices that raised risks further.[103] The collapse in finance companies inarguably contributed to this reform, fuelling the calls for better enforcement of securities law in New Zealand.[104] The FMCA's shift toward investor protection can be seen as an attempt to placate retail investors and stimulate growth and instill confidence once more in New Zealand's capital markets.

The language in the FMCA also colours a protective purpose, specifically the use of 'consumer' and 'financial product'. Where securities and investments are inherently risky, this risk must be borne by someone. The language under the Securities Act

[101] Ministry of Business, Innovation and Employment *Business Growth Agenda: Future Direction 2014* (June 2014) at 33.

[102] Ministry of Business, Innovation and Employment *Business Growth Agenda: Future Direction 2014* (June 2014) at 33.

[103] Shelley Griffiths "Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions" Unpublished paper, Corporate Law Teachers Conference, Brisbane, 2011 at 23 and 24.

[104] Shelley Griffiths "Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions" Unpublished paper, Corporate Law Teachers Conference, Brisbane, 2011 at 23 and 24.

referred to investor and security where both investor and issuer shared the risk. Consumer and product, language used in the FMCA, connote a purpose where by those investing warrant protection through legislation. Further evinced by the significant amount of risk borne by companies and directors under the FMCA. A product, in essence, is something that can be used up, or be protected by a warranty.

Securities as discussed earlier can easily be distinguished from a typical commodity; based on this distinction, the former Securities Act favoured self-regulation to overt investor protection, at the risk of paternalism. Disclosure requirements should be intended to promote confidence in investors to make good decisions rather than protect them from making poor ones.[105] Thus, purpose should be aimed at 'confident participation' of business and investor.[106] I contend however, that the purposes protection and confidence are intertwined; investors will be more likely to participate, and with greater confidence, if the risks are minimised and able to be factored into investment decisions. The question is whether the appropriate balance has been struck within the FMCA to allow for an efficient and confident market and its participants.

2 Specific justifications for Equity Crowdfunding in Schedule 1

The fifth policy identified in the aim of building capital markets was 'Supporting Crowd Funding and Peer-to-Peer-Lending'. The Business Growth Agenda 2013 stated that New Zealand needed more high-growth, innovative businesses to increase economic growth. Additionally, those businesses would need access to sufficient risk capital.[107] MBIE sought to create opportunities for new and innovative forms of capital raising by supporting crowdfunding and peer-to-peer lending. Thus enabled both these forms of capital raising under the Financial Markets Conduct Act 2013. Crowdfunding and peer-to-peer lending were identified to be of particular benefit to small businesses and individuals who may not be able to source funding through more traditional methods. Internet-based markets have been recognised as facilitating innovative ways for small businesses and individuals to raise money more efficiently.

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[105] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 122.

[106] Evan Jones "Has the Supreme Court *Turned and Waved* Goodbye to the Essence of the New Zealand Securities Regime? An Analysis of the Purposes Underpinning Securities Market Regulation in New Zealand" (LLB (Hons) Dissertation, University of Otago, 2013) 49.

[107] Ministry of Business, Innovation and Employment *Business Growth Agenda: Future Direction 2014* (June 2014) at 33.

As discussed under regulatory theory, the usual way to deal with offers to the public is to require significant amounts of disclosure, but since 1978 New Zealand has recognised the impracticality of this for certain offers that were not public per se, for example to business associates, experienced investors and family members. This however created a problematic, uncertain test. Schedule 1 Part 1 provides exemptions for certain offers from the requirement to provide a full PDS. These exclusions include wholesale investors and persons in a close relationship with the issuer.[108] The Schedule 1 Part 1 exclusions have been developed to pursue a similar pragmatic approach as the Securities Act and in addition have this special carve out for equity crowdfunding. These platforms are a specialised kind of exception.

Exclusions from the disclosure regime are traditionally justified where investors are assumed to either have the expertise to protect themselves,[109] where the investor is "protected by the inherent restraints on an issuer of a social and business kind"[110] or where the investor is assumed to be able to obtain information relevant to the securities offered.[111] These are policy reasons for exclusions where the "need for protection of the investor is outweighed by the costs associated with giving it".[112]

The FMCA includes prescriptive guidelines regarding disclosure for an IPO and the stock exchange (NZX) remains heavily regulated, however the equity crowdfunding exclusion provided under Schedule 1 Part 1 of the FMCA, appears contrary to the overall purpose of the Act. The crowdfunding exclusion reduces compliance costs, but is not supported by any of the traditional investor protection policy considerations like the majority of the Act. Instead, the crowdfunding exclusion reflects aforementioned policy of the Business Growth Agenda seeking to create opportunities for "new and innovative forms of capital raising" to support high-growth businesses to raise money more efficiently.[113] Although this approach is consistent with the main

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[108] Financial Markets Conduct Act 2013, Sch 1 Part 1 ss 3,4,5.
[109] *Lawrence v Registrar of Companies* [2004] 3 NZLR 37 (CA) at [32].
[110] *Lawrence v Registrar of Companies* [2004] 3 NZLR 37 (CA) at [31].
[111] S*ecurities Commission v Kiwi Cooperative Dairies Ltd* [1995] 3 NZLR 26 (CA) at 32.
[112] *Lawrence v Registrar of Companies* [2004] 3 NZLR 37 (CA) at [27].
[113] Ministry of Business, Innovation and Employment *Business Growth Agenda: Future Direction 2014* (June 2014) at 37.

purposes of the Act, it seems out of kilter with the general tilt in legislative purpose toward investor protection.[114]

Despite crowdfunding services not being required to prepare a PDS or make register entries, the FMCA and the regulations prescribe specific disclosure requirements and standards, as outlined in chapter II. The overall effect of the exclusion is to relax the previously strict enforcement of disclosure obligations for this type of service, with commentators indicating the exclusion "recognises ... the fundamental role of the internet in business and communities", providing retail investors and businesses with more flexibility and control in how they respectively invest and raise risk capital.[115] Minimizing compliance costs to promote innovation reflects a more modern, forward thinking understanding of securities law, recognising compliance for its own sake can become a disincentive to capital raising and entrepreneurialism.

As equity based crowdfunding platforms are a new mechanism for firms to raise capital (even compared to person-to-person lending), it is difficult to anticipate what forms of crowdfunding will prove most beneficial and what regulatory problems they will pose.[116] This made it difficult to design an effective regulatory environment in advance, thus MBIE adopted a relatively flexible approach, subject to careful supervision by the FMA.[117]

3 Should Equity Crowdfunding be in stand-alone legislation

Despite the misalliance in purpose between the Schedule 1 Part 1 exclusions and the Act generally, it still seems appropriate to have legislation pertaining to equity crowdfunding within the FMCA. These exclusions are a pragmatic approach to overarching policy objectives. Due to the innovative nature of the ventures fundraised through licensed intermediaries, there is a strong argument that overregulation will stifle their success. Whether purely economically burdensome or because future

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[114] Financial Markets Conduct Act 2013, ss 3(b) and 4(d).

[115] Hayley Buckley "Exploding the crowdfunding myths" *The National Business Review* (online ed, New Zealand, 12 April 2014).

[116] Cabinet Business Committee “Financial Markets Conduct Regulations Paper 4 – Licensing regimes” (2013) MBIE-MAKO-4363783 at [126].

[117] Cabinet Business Committee “Financial Markets Conduct Regulations Paper 4 – Licensing regimes” (2013) MBIE-MAKO-4363783 at [126].

projections are impossible and unknown, there is validity in these lowered requirements to ensure the aim of the exclusion can be achieved.

The court in *SEC v Realston Purino Co* considered the essential nature of a 'public offering' for the purposes of deciding whether an offer to key employees was covered by an exemption. It was held that since exempt transactions are those as to which there is no practical need for disclosure, "the applicability of section 4(1) should turn on whether the particular class of persons affected need the protection of the Act." [118] An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering".[119]

The general principles behind the exemptions are that only retail investors require the protections given by Part 3 disclosure. Disclosure compliance is costly and that cost is not justified where the investors are capable of looking after their own interests. Investors who can fend for themselves do not require Part 3 disclosure. These investors are:[120]

> "Unlikely to agree to unfavorable offers without obtaining information, subjecting it to due consideration and seeking appropriate advice. Their position will be such that they are either able to negotiate the terms of the offer, or are able to reject unsuitable offers in favour of alternative offers from other issuers."

The inference to be drawn here is that it would be impractical for those who have sufficient commercial sensibility or possess a measure of bargaining power to require disclosure.

The target market of equity crowdfunding is quite the opposite to that referred to in the general principles; in fact it is specifically the general public as retail investors, whom the Government are encouraging to invest. The licensed intermediaries exclusion thus presents itself as a dramatic outlier. However, due to the limits imposed on investment amounts and the nature of the equity gained from such investments, I contend an adequate level of disclosure and consideration has been

[118] *SEC v Realston Purina Co* 346 U.S. 119 (1953) at 125.
[119] Victoria Stace and others "Financial Markets Conduct Regulation: A Practitioner's Guide" (LexisNexis, Wellington, 2014) at 126.
[120] Review of Securities Law – Discussion Paper June 2010 (MED) at 45-50. as cited in Victoria Stace and others "Financial Markets Conduct Regulation: A Practitioner's Guide" (LexisNexis, Wellington, 2014) at 126.

achieved. Investors within this class have identified themselves, as having acknowledged the associated risk with these types of investments and as a result of the client agreements should be under no illusion of any excess protection. Those individuals who participate in equity crowdfunding have therefore created their own class of investor; and such a class warrants exemption.

MBIE in conjunction with the legislature clearly identified a desire to allow this form of capital raising to occur, and have adapted securities legislation to facilitate this. It seems that in legislating, a balance has been struck between regulation by way of disclosure and reluctance to stifle innovation. As the amount invested through these platforms is typically nominal, policy makers have decided that less regulation thus less protection is required.

It is inevitable that during the evolution of the equity crowdfunding market, an issuing company will fail. Herein lies the risk that the policy surrounding the legislation may be reviewed too harshly and quickly. It is conceivable that the FMA as regulator, in response to negative publicity and investor backlash, could too readily abolish the regime entirely. In order to mitigate this risk it would be prudent for MBIE to carry out a regular review on the status of the framework and equity crowdfunding market. This proposition will be further advanced under chapter V (1).

It is not in contention whether or not such activity should be regulated, the crux of the issue is, however, the level of regulation required. If equity crowdfunding is carelessly regulated, or not regulated at all, then the market could easily attract fraudulent behaviour and financial failures, and develop on undesirable reputation as an unregulated highly risky venture, both for entrepreneurs and investors. Equally if it is regulated with undue vigour, crowdfunding's development will be stultified, with similar opportunity costs to careless regulation or no regulation.[121] This reasoning follows from the objectives observed in regulatory theory and promotes the more traditional approach of self-regulation to ensure fair and efficient capital markets.

[121] Terrance Wong "*Crowd funding: Regulating the new phenomenon"* (2013) Company and Securities Law Journal 31(2) 89 at 93.

Aside from investor protection and efficiency of the markets, raising capital is an objective of market regulation. New Zealand's economy places a great deal of importance on getting capital to the right places. Facilitating the raising of capital is where securities law meets a range of New Zealand's economic imperatives, and promotes positive incentives. These include encouraging entrepreneurship, self-responsibility and economic efficiency.[122] Responsible capital raising balances disclosure and investor protection, thus an argument could be made that the Government has struck this balance via the exclusion of licensed intermediaries. The inherent risk and nature of projects funded through these licensed intermediaries is balanced by the rewards investors stand to gain. By allowing a lower level of disclosure, these exemptions sit outside the underlying consumer focused purpose in which the rest of the Act seems to promote.

Despite the benefits of strong investor protection, an essential element to the success of crowdfunding is the relatively low regulatory burden on entrepreneurs. Crowdfunding allows small parcels of funds to be attracted quickly and easily to small businesses and start up companies that do not have the funding or resources to comply with the more onerous regulatory requirements in debt and equity. Arduous regulatory requirements will inevitably discourage entrepreneurs and investors from entering a crowdfunding market, or drive them in to an alternative market. However, some regulation for investor protection purposes may encourage crowdfunding entrepreneurs into a crowdfunding market with greater investor confidence.[123] A crowdfunding regulatory regime must be carefully designed due to the risks of crowdfunding becoming a dangerous conduit for fraudulent enterprises to circumvent each nation's investor protection laws.[124]

If we look again to regulatory theory and the idea of a self-regulated market, disclosure is still a necessary and integral component of the legislation to ensure functioning of the platforms. Each licensed intermediary is incentivised to provide adequate disclosure documentation in order to entice investors and run successful

[122] Victoria Stace and others "Financial Markets Conduct Regulation: A Practitioner's Guide" (LexisNexis, Wellington, 2014) at 16.

[123] Terrance Wong "*Crowd funding: Regulating the new phenomenon*" (2013) Company and Securities Law Journal 31(2) 89 at 93.

[124] Terrance Wong "*Crowd funding: Regulating the new phenomenon*" (2013) Company and Securities Law Journal 31(2) 89 at 93.

capital raising campaigns. Further, investors should be incentivised to read disclosure documentation in order to share in the risk that is carried with any investment opportunity. Warning statements are issued in addition to disclosure documentation to form some type of 'protection' to investors and to discharge some of the risk from the platforms.

Whilst the FMCA as a whole may overall favour a more paternalistic approach than the former Securities Act 1978, aside from these exclusions, this is not obviously problematic. Currently, all investment schemes are regulated under the FMCA and it would be significant departure from the status quo to sit these platforms in their own piece of legislation. As it stands, the legislative framework defers a significant amount of control and discretion to the FMA to regulate. This seems like the most fitting approach in order to allow this new form of fundraising to flourish and allow for self-regulation to prevail in this new 'mini market'.

IV Other Jurisdictions

It is apparent based on the success of many enterprises that equity crowdfunding in New Zealand is a positive thing. The way equity crowdfunding has latched on to the traditional way of raising capital with a techonogically assisted, new age spin is what makes this an intriguing and exciting prospect. The internet is infinite and borderless; this allows worldwide access and to investors and issuers alike. By broadening the base in which capital can be raised for entrepreneurs and start up businesses, equity crowdfunding is pursuing the policy goals outlined by MBIE in the Business Growth Agenda 2013.

Due to the international nature of this fundraising and the potential it holds, a global outlook is essential. New Zealand must continue to examine what other jurisdictions are doing in regard to regulating equity crowdfunding and assess whether we can learn from or incorporate alternative frameworks into our own. First we must outline why our statutory framework works within our jurisdiction, and highlight differences in capital market cultures elsewhere.

1 Culture of Capital Markets

New Zealand has a unique market culture. To some observers, our legislative framework specifically pertaining to regulation is seen as 'lax'. [125] Multiple contributory factors allow our market to function efficiently this way, two of which are size and concentration of ownership.

First, the population of our nation and size of our markets is comparatively small. This allows for transparency and an ease of oversight thus less regulation. There is no doubt that New Zealand's capital market is more self-regulating than that of the United States due to the size disparity.[126]

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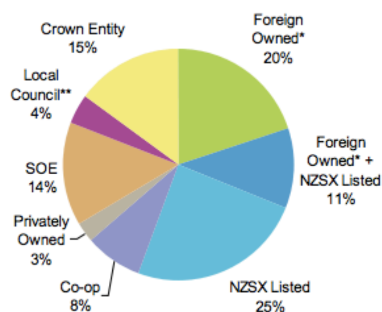
[125] Joanne Gray *"Kiwi crowdfunding regime easier than Australia's"* (2015) Australian Financial Review <www.afr.com>.

[126] Lauren Rosborough, Geordie Reid, and Chris Hunt "A primer on New Zealand's capital markets" (2015) 78 RBNZ Bulletin 3 at 3.

Figure 5. Ownership of New Zealand's largest 200 companies, weighted by equity



Source: New Zealand Management Magazine December 2008.

** More than 50% overseas controlled*
*** Includes Regional Community Trusts*

The above figure[127] highlights the ownership of New Zealand's largest 200 companies. New Zealand's listed market is characterised by concentrated ownership.[128] John Coffee observes that the level of enforcement intensity is a product of the ownership structure that pertains in particular markets. Among other things, a market with the high level of retail ownership creates a political demand for greater enforcment. Both the United States and Australia are characterised by a high level of retail ownership.[129] Retail investors are predominantly individuals who trade less frequently and in smaller amounts than that of large managed funds and organisations. Whilst retail investors typically exert less influence on capital markets compared to institutional investors, due to information assymetry and imbalances in power, from a policy perspective they warrant greater protection. As a result, their needs are generally at the forefront of the legislature's mind when imposing regulatory framework. This is furthered by the argument that these individuals make up the voting public and thus determine the legislature in a democratic society. Thus, in nations with a high population of retail investors such as the United States and Australia, their regulatory framework will inevitably favour an investor protection focus.

The New Zealand market, despite fewer retail investors, does not escape political pressures from disgruntled investors. Most recently jilted 'Mum and Dad' investors

[127] Ministry of Business, Innovation & Employment "Capital Market Development Taskforce" (2012) Ministry of Economic Development at 12 < www.med.govt.nz>.
[128] Shelley Griffiths "Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions" Unpublished paper, Corporate Law Teachers Conference, Brisbane, 2011 at 23.
[129] Shelley Griffiths "Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions" Unpublished paper, Corporate Law Teachers Conference, Brisbane, 2011 at 24.

have expressed discontent since the collapse of many finance companies, thus contributing to the reform. Whilst as observed above, the FMCA marks a tilt toward investor protection, our framework still remains less regulated than our Trans Tasman partner, Australia and 'pillar of democracy' the United States.

John Coffee, as cited in Shelley Griffiths' article 'Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions', identifies the United States as a 'dramatic outlier' in regulatory framework.[130] He further notes that the United States exhibits a level of intensity of enforcement, both public and private, that distinguishes it from other markets.[131] Interesting, the only jurisdiction where 'the approach to enforcement appears to be at least as aggressive as that of the United States' is Australia.[132] Both the United States and Australia have a dramatic influence on New Zealand's legislation and policy making processes. Thus this recognition of culture is of particular note and following these nation's lead should be not be blindly entered in to.[133]

To further distinguish national investment cultures, Australia and the United States tend to favour overregulation and a far more paternalistic legislative framework. An example of this is the imposition of investor caps within equity crowdfunding regulation. These caps will be assessed in the context of New Zealand culture in the following section.

Since it's conception, there have been critiques of the New Zealand's FMCA, specifically pertaining to the regulation of equity crowdfunding. A recent Australian Finance review quoted that New Zealand's framework was a 'light touch', 'too easy'

[130] Shelley Griffiths "Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions" Unpublished paper, Corporate Law Teachers Conference, Brisbane, 2011 at 24.
[131] Shelley Griffiths "Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions" Unpublished paper, Corporate Law Teachers Conference, Brisbane, 2011 at 23.
[132] Shelley Griffiths "Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions" Unpublished paper, Corporate Law Teachers Conference, Brisbane, 2011 at 23.
[133] Shelley Griffiths "Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions" Unpublished paper, Corporate Law Teachers Conference, Brisbane, 2011 at 23.

and ‘too lax’.[134] The following analysis provides some background to these criticisms by exploring the alternatives.

2 Comparative Analysis

After assessing how other jurisdictions are incorporating and regulating equity crowdfunding, it is crucial to analyse whether New Zealand should incorporate the any of these regulations and polices and distinguish where we should not.

a. Investor Caps

Overregulation has already been discussed as a danger to the facilitating of the crowdfunding service as well as a stifling of innovation and dangerous line to tread. Currently, the FMCA has imposed no cap on the amount that each investor may invest in an issuing company (bar the NZ$2 million limit on each campaign). MBIE discussed imposing caps during the drafting of New Zealand’s framework in exposure drafts. The decision not to impose investor caps in New Zealand is more liberal compared to international jurisdictions, reflecting policy that favours innovation and growth over strict consumer protection. The United States and United Kingdom have both implemented caps relative to the individual investor's income or assets, while Canadian territories have proposed a set cap. It is conceivable that New Zealand’s liberal approach could be to the investor’s detriment.

The cabinet business committee ultimately concluded that the reasons against the cap were difficulties in enforcement, disagreement surrounding what the limit should be and a risk that a cap would create incentives for issuers to make separate offers to investors in reliance on the ‘small offer’ exemption rather than the prescribed intermediaries exemption.[135]

The FMA has alternatively allowed for caps to be imposed by each platform at their discretion. This seems to be a better place for this type of regulation to sit at present. By deferring the decision surrounding investor caps to each intermediary allows

[134] Joanne Gray *“Kiwi crowdfunding regime easier than Australia's”* (2015) Australian Financial Review <www.afr.com>.

[135] Cabinet Business Committee “Financial Markets Conduct Regulations Paper 4 – Licensing regimes” (2013) MBIE-MAKO-4363783 at [126].

flexibility for each company to be assessed on a case-by-case basis. This in turn allows the FMA to observe how the market is evolving and whether to consider the implementation of caps at a later stage.

The United States Securities and Exchange Commission (SEC) announced proposed rules on 23 October 2013 to regulate crowdfunding under the Title III of the Jumpstart Our Business Startups Act (JOBS Act), with a focus on investor protection. The JOBS Act provides an exemption from usual registration requirements for offers through crowdfunding platforms that have in place issuer and investor caps. The issuer cap imposes an aggregate cap of US$1 million in any 12-month period on the amount an issuer may raise through crowdfunding platforms. The investor cap is scaled, allowing aggregate investments in any 12-month period of either 10 per cent of an investor's annual income or net worth if it is equal to or more than US$100,000 with a maximum cap of US$100,000, or 5 per cent of an investor's annual income or net worth if it is less than US$100,000 with a minimum cap of US$2,000.[136]

Australia's latest proposed regulatory framework imposes similar investor caps. Retail investors are capped at AUS$10,000 per offer and AUS$25,000 in aggregate in any given year. Additionally, issuers must be incorporated as a public company in Australia and are limited to certain small enterprises that have not raised funds underexisting public offer arrangements.[137]

The United Kingdom Financial Conduct Authority (FCA) has recently implemented rules in the Conduct of Business Sourcebook (COBS), which allow retail clients to invest through crowdfunding platforms from 1 April 2014, so long as they are 'restricted investors'. A 'restricted investor' is an individual who certifies they will not invest more than 10 per cent of their net assets in a 12-month period into non-readily realisable securities and accepts that such securities hold a significant risk of losing the entire investment. Such a class of investors may now receive direct-offer financial promotions relating to non-readily relisable securities. The cap does not

[136] Jumpstart Our Business Startups Act Pub L No 112-106, § 302(a), 126 Stat 306 at 315 (2012).
[137] Australian Government "Facilitating crowd-sourced equity funding and reducing compliance costs for small businesses" (August 2015) at 4.

apply to advised retail clients, a distinction that New Zealand has not yet clarified by means of our legislation.

The idea of an investor cap based on income and net worth seems to proceed on an assumption that a wealthy or high salary earner equates to adequate financial literacy.[138] Whether or not this is true, the United States and United Kingdom have clearly identified these investors as being in a better position to bear any future losses from this type of investment. Legislators are treading a fine line between liberal regulation allowing autonomous investment and paternalistic overregulated statutory frameworks. From these comparisons, it is evident on which side of the line New Zealand has chosen to lie.

b. Integrate across the Tasman

It is a commonly posited view that New Zealand and Australia should strive for a single Trans Tasman economic market. While there are good reasons for consistency, and integreation, between Australia and New Zealand markets, there is no need for the detail to be identical. As already noted, Australia is at the opposite end of the spectrum to us from a regulatory standpoint. Australia has a completely different concentration of ownership, as well as overarching purposes. For legislators to blindly imitate Australia's framework, it may ultimatley lead to 'enforcement and regulation strategies that are in fact sub-optimal for the New Zealand market'.[139] Throughout the legislative process, differences in market cultures, government strategy and economic policies must be acknlowegded and considered.

c. Only allow for areas of innovation and growth

To assess another alternative, the Italian Parliament has regulated their crowdfunding statute to only facilitate for innovative start-ups recognised by the Chamber of Commerce.[140] Italy legislated in late 2012 to permit equity crowdfunding and did not set any investor caps. Italy did choose to impose a EUR€5 million cap however on

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[138] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 127.

[139] Shelley Griffiths "Enforcement of Company and Securities Law in New Zealand; the Fall of Feltex and Future Directions" Unpublished paper, Corporate Law Teachers Conference, Brisbane, 2011 at 24.

[140] Commissione Nazionale per le Sociea e la Borsa *Regulation on The collection of risk capital on the part of innovative start-ups via on-line portals* (July 2013), art 2(1)(c).

the amount an issuer may raise per year.[141] The legislature further implemented restrictions including requiring at least five per cent of backing to be by "professional investors or by banking foundations or by innovative start-up incubators".[142]

This decision was clearly one of policy, to facilitate growth of a specific area in the economy. As identified in MBIE's reports and agendas, the current FMCA and FMCR legislation is working toward its own specific purpose in growing our capital markets, specifically facilitating capital raising for SME's.

[141] Commissione Nazionale per le Sociea e la Borsa *Regalomenti emittenti* (October 2013), art 34-ter(1)(c).
[142] Commissione Nazionale per le Sociea e la Borsa *Regalomenti emittenti* (October 2013), 24(2).

VI Predictions and Recommendations for the Future of Equity Crowdfunding

Despite many investors losing confidence due to recent events over the last few years, the addition of equity crowdfunding is a postive one. The purposive pendulum of capital market regulation continues to swing, but the legislature has struck an appropriate balance between consumer protection and economic objectives. Rigorious legislation is self-defeating, there is no point in providing protection that is "all form and no substance".[143] The licensing regime, monitored by the FMA, instead is stringent and constructed with a purpose of investor protection. This allows the legislative framework within the FMCA to maintain a pragmatic role, merely facilitating the possibility of this market, demonstrating the reluctance of the legislature to overtly regulate the actions of its users.

The FMA released its first annual report on the new regime under the FMCA in October this year. This first year of implementation has seen investor confidence grow 4%. 65% of investors now state they are "very of fairly confident" in New Zealands financial markets. This was identified as one of the main goals in implementing the FMCA post Global Financial Crisis. The report further points to the six new crowdfunding licenses issued within the year and the NZ$12.5 million that has been raised via crowdfundig and peer-to-peer lending platforms thus far.[144]

The FMA has acknowledged the success of the FMCA's "top of the cliff"[145] regulatory regime, essentially turning the former Securities Act 1978 on it's head. This approach has seen the FMA mature in to a "substantive conduct regulator",[146] vigilantly monitoring licensees to mitigate civil and criminal causes of action.

This new market is inclined to self-regulate, platforms are incentived to promote successful and prosperous companies to ensure targets are met and investors satisfied.

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[143] McKenzie McCarty "Cabinet gives green light to equity crowdfunding" (2014) NZ Lawyer <www.nzlawyermagazine.co.nz>.
[144] "Insights from FMA's first Annual Report under new regime" Buddle Findlay (2015) <www.buddlefindlay.com>.
[145] "Insights from FMA's first Annual Report under new regime" Buddle Findlay (2015) <www.buddlefindlay.com>.
[146] "Insights from FMA's first Annual Report under new regime" Buddle Findlay (2015) <www.buddlefindlay.com>.

Despite concerns of fraudlent behaviour, where this were to occur, the visible damage of fraud will not be significantly large to each participant who has only invested a small amount, and will potentially be widely dispersed across the global interest community.[147]

Through self-reulation, the the interests of platform, issuer and investor align. It is, to many investors, the high-risk, unknown and cutting edge nature of these companies which compels them to invest. The FMCA caters to this niche market by harnessing the inherent desire for 'high risk high reward' thrilling investments, fetterred by minimal disclosure and warning statements to avoid an overtly paternalistic framework.

Whilst thus far succesful, crowdfunding is still very much in its infancy. I will now outline some recommendations and predictions for the future direction of equity crowdfunding in New Zealand.

1 Review by MBIE of the equity crowdfunding market and legislation

It is my recommendation that the legislation and market of equity crowdfunding is reviewed by MBIE in the short term, akin to the annual regulatory report the FMA prepares regarding the NZX.[148] I suggest a five yearly system review of; the status of platforms, successful campaigns and amounts invested and raised, this should be independent of the FMA.

Five years in an appropriate timeframe as mentioned in chapter III (3), if the regime were to be reviewed too early and too harshly the framework risks abolition. It is important to appreciate the market is still in its infancy and thus needs time to develop and evolve. Further, it is critical that the review is undertaken independently of the FMA. Conflicts arises and credibility lost should the evaluation of the equity crowdfunding maket be carried out by its own regulator. It would therefore be prudent for MBIE to outsource such analysis and reporting to ensure independence and impartiality.

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[147] Terrance Wong "*Crowd funding: Regulating the new phenomenon"* (2013) Company and Securities Law Journal 31(2) 89 at 93.
[148] Financial Markets Conduct Act 2013, ss 38 and 39

The report should include an analysis of whether the objectives and policies MBIE set out in the Business Growth Agenda have been achieved, and evaluate any issues with the legislative framework. I contend a longitudinal study be incorporated in to this review process to evalute the performance of each campaign and monitor any economic loss or regulatory failures.

At this point, MBIE, at the request of the legislature should reassess the implementation of investor caps and the level of regulation within the statute based on performance and results. A global perspective should not be diverted from, and the New Zealand legislature should continue to look to emerging international frameworks for guidance, ideally working toward integration within the international sphere.

Equity crowdfunding remains a new, innovative initiative. Whilst foresight is possible, the future of our new 'mini-market' is still relatively unknown. With the international element and high economic growth rate, regular checks and oversight are imperative to avoid the failure and a loss in confidence. MBIE and the FMA must together ensure that investors will not lose confidence in New Zealand's capital markets entirely should cracks emerge in the legislation.

2 Evolution of a Secondary Market

The possibility of a secondary market for equity crowdfunded assets is a very real and exciting one. Currently, equity crowdfunding investors are impeded by their inability to resell their shares in issuing companies. A secondary market provides companies and investors with an 'independent trading platform' as a market place to buy, manage and sell assets. Syndex has recently launched a platform for this exact purpose and aims to "help stimulate trade in secondary markets and generate more interest in crowdfunding and other direct investment."[149] This company aims to partner with current platforms creating a "symbiotic relationship".[150] Australian

[149] Jonathon Cotton "Investors get opportunity to trade crowdfunding shares with secondary market start-up, Syndex" (2015) Ideolog <idealog.co.nz>.

[150] Jonathon Cotton "Investors get opportunity to trade crowdfunding shares with secondary market start-up, Syndex" (2015) Ideolog <idealog.co.nz>.

owned Equitise, an equity crowdfunding platform already licensed and operating in New Zealand, has also expressed its plans to diversify in to the secondary market.

The FMCA provides for such a facility, however Syndex is not yet licensed by the FMA. The new company has identified disclosure as one of their key focuses. This clearly plays to the cautious investor. Promising reporting, updates and transparency is a way for platforms to entice investors where the standard disclosure regulatory regime is absent.

The emergence of a secondary market will inevitably grow the primary market for crowdfunded shares for those reluctant to enter on the basis of illiquidity.[151] It is difficult to predict the possible legislative implications of this second market at this stage, however it will be intriguing to observe the development of this additional dimension within equity crowdfunding.

[151] **Illiquid** is the state of a security or other asset that cannot easily be sold or exchanged for cash without a substantial loss in value. Illiquid assets also cannot be sold quickly because of a lack of ready and willing investors or speculators to purchase the asset. "Definition of illiquid" (2015) Investopedia <www.investopedia.com>.

VI Conclusion

This dissertation has surveyed the specific provisions pertaining to equity crowdfunding within the FMCA, with the ambition of deciding whether the exclusion under Schedule 1 Part 1 sits within the overall purpose of the Act. After exploring the statutory framework, licensing and liability regimes and legislative purpose. I conclude it does.

The inherent tensions within capital markets regulation continue to plague New Zealand's legislative framework and the FMCA is demonstrative of numerous policies fusing with pragmatism.

The legislature has adequately balanced the 'myriad of interests' at play within this highly politicised sphere of regulation.[152] The evident disparity between underlying purposes is mitigated by the oversight provided by market regulator, the FMA. Further, as identified in chapter V, New Zealand's unique culture facilitates such innovation and progression within our legislation.

Technology continues to develop at a rapid pace and the number of internet users grows exponentially. I contend, therefore, that we will continue to see equity crowdfunding grow as this market phenomenon fully develops and evolves both domestically and globally. The FMCA's incorporation of equity crowdfunding has broadened the base of capital sourcing for issuing companies. Additional money injected into high growth areas will stimulate our economy and encourage innovation. The self-regulating nature of equity crowdfunding combined with the protections provided in the licensing regime adequately share and allocate risk between investor, issuer and platform.

Filmmakers, politicians, entrepreneurs and now everyday people are permeating the online market with crowdfunding campaigns. Equity crowdfunding has seized the opportunity created by this generation of social networkers amidst the cyber sphere. Online platforms have revolutionised investing entirely. As a result of internet

[152] Steve Macbeth "The 'Wealthy Investor' Test within the 'Small Offers' Disclosure Exemption: A Threat to the Integrity of the Financial Markets Conduct Act 2013" (2014) 20 NZBLQ 121 at 122.

expansion, society's accessibility to online markets and investment opportunities has increased eminently, allowing simple and instant investment opportunities at the click of a button. Crowdfunding has democratised capital markets by allowing retail investors to become involved in highly innovative start-ups, a sphere traditionally dominated by wholesale investors such as venture capitalists and angel investors.

As the FMA and MBIE continue to monitor the expansion of the crowdfunding market, inevitable kinks will be ironed out and this equity market will ultimately develop, adjusting to it participants. So yes, equity crowdfunding is playing to the crowd – the next question is, how will the crowd react?

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