CROWD-SOURCED EQUITY FUNDING: THE REGULATORY CHALLENGES OF INNOVATIVE FINTECH AND FUNDRAISING

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Do you think that if it were introduced, with such regulations and such safeguards, it would give additional facility for enterprise directed by intelligence, and create additional facilities for the investments of the middle and working classes?

John Stuart Mill: I think it would do both these things; and above all, which is very important, it would enable personal qualities to obtain in a greater degree than they can now the advantages which the use and aid of capital affords. It would enable persons of recognised integrity and capacity for business to obtain credit, and to share more freely in the advantages which are now confined in a great degree to those who have capital of their own.¹

I INTRODUCTION

In many ways debate about how best to legislate and regulate crowd-sourced equity funding grapples with concerns similar to those that existed at the time of the introduction of limited liability in the United Kingdom. How best can we balance the interests of investors and businesses seeking to raise funds? In Australia, these policy deliberations are taking place within a broader debate as to how to formulate a regulatory framework supportive of innovation and entrepreneurship. This article considers how these objectives might be achieved to the best advantage of small business and the economy. The immense potential of innovative businesses may turn on the effectiveness of such policy development and its place within the legal framework. I posit that the legal challenge is to recognise that the regulation of crowd-sourced equity funding is not a simple matter of accommodating new fundraising activities within an existing legal framework designed for big business. Rather, the law must re-conceptualise its approach to fundraising to be consistent with the broader policy ambition of supporting the businesses most likely to require access to non-traditional, innovative funding models such as crowd-sourced equity funding; namely innovative firms, entrepreneurial businesses, start-ups, and other micro, small, and medium-sized enterprises which have emerged in recent times. Part II considers the regulatory challenges and policy underlying the introduction of crowd-sourced equity

funding regulation. I propose that a flexible regulatory approach is needed. The challenges in supporting innovation and entrepreneurship include the shape and range of corporate forms available to enterprise. In Part III crowdfunding and fintech are explained. Part IV outlines amendments to the Corporations Act 2001 (Cth) introducing crowd-sourced equity funding. Part V examines the extent to which the law has met its policy objectives. In Part VI the article suggests that the introduction of crowd-sourced equity funding legislation has cast a sharp light on the restrictive nature and shape of corporate forms available in Australia. It is time to rethink the corporate form in Australia with a firm eye on the reality of the corporate landscape and an understanding and acknowledgement of the long term economic benefits of the innovation agenda. The article concludes in Part VII.

II REGULATORY CHALLENGES

A Background

Balancing competing interests arising in crowd-sourced equity funding poses a significant regulatory challenge. Many investors can be unsophisticated. The risk of fraud and highly speculative investments is real. Companies seeking growth or access to capital through crowdfunding tend to be new firms, micro, small and medium-sized enterprises (MSMEs) at an early, vulnerable stage of their development. Investment is facilitated by companies that themselves are exposed to uncertainties created by their disruption of markets with innovative technology. One of the central objectives of the legal and regulatory framework is to maintain confidence in efficient markets. The question that remains is how to balance these various interests while creating an environment conducive to innovation.

Innovators offer considerable opportunity for all economies. MSMEs, start-ups and entrepreneurs potentially have an economic impact that belies their size. The economic benefits that flow from new firms are premised upon rapid growth, an absence of barriers to entry to markets, and their proclivity for innovation. Research emerging from the Organisation for Economic Co-operation and Development (‘OECD’) suggests that governments ought to harness this potential by introducing targeted innovation strategies favourable to entrepreneurship and innovation, and encourage new business within all sectors of the economy. While statistically only a very few new firms will experience rapid growth, the impact of even a few successes benefits growth and productivity more generally throughout the economy via associated employment. These recommendations are reflected in calls for policy development. The National Innovation and Science Agenda recognises that innovation is ‘critical for Australia to deliver new sources of growth, maintain high wage jobs and seize the next wave of economic prosperity’, and requires establishment of a ‘culture that backs good ideas and learns from taking risks and making mistakes’.

3 Ibid.
Corporations and Markets Advisory Committee (‘CAMAC’) acknowledged that crowd-sourced equity funding could address the ‘capital gap’ experienced by start-ups struggling to ‘transition to growth despite the quality of their ideas and the dedication of their promoters’. The capital gap exists where the business needs access to finance in order to ‘continue to its next stage of development, but cannot attract further funding from traditional financing sources and is not yet able to conduct an initial public offer of its securities’. Crowd-sourced equity funding can lower a key barrier to entry to the market for low net worth entrepreneurs.

Studies of the manner in which legal and regulatory frameworks support MSMEs, including those that are entrepreneurial, repeatedly identify access to finance as a bottleneck barrier to entry; survival of these very small entrepreneurial and innovative firms depends upon access to finance, particularly in early stages.

B Policy Objectives of the Australian Approach to Crowd-sourced equity funding

The policy driving the introduction of crowd-sourced equity funding is to provide ‘start-ups and small innovative firms’ with access to new opportunities for fundraising within a regulated environment. This was supported by the Productivity Commission, the Murray Inquiry, the Innovation and Science Agenda, and the Industry, Innovation and Competitiveness Agenda. Crowd-sourced equity funding is well suited to supporting start-ups, entrepreneurial and innovative firms.

devlopment resonates in budget documents communicating to the public the need to support small business. The budget document describes business as, ‘The Engine Room of the Australian Economy’, stating ‘Small Business Drives Growth and Creates Jobs’, and further states that ‘96% of all Australian businesses are small business employing over 4 1/2 million people and producing over $330 billion of our nation’s economic output per year’.

7 Ibid.
9 Explanatory Memorandum, Corporations Amendment (Crowd-Sourced Equity Funding) Bill 2016 (Cth), 17. This was expressed in the same terms in the Explanatory Memorandum accompanying the earlier Bill. See Explanatory Memorandum, Corporations Amendment (Crowd-Sourced Equity Funding) Bill 2015 (Cth), 16. As will be explained below, the legislation did not have an easy passage through Parliament.
10 Productivity Commission, above n 4, Recommendation 6.1; Australian Government, National Innovation and Science Agenda, above n 5, 3, 5, 8; Australian Government, Industry, Innovation and Competitiveness Agenda (2014), 81; Australian Government, Financial System Inquiry Report (‘Murray Inquiry’), Recommendation 18, 177-180. See Explanatory Memorandum, Corporations Amendment (Crowd-Sourced Equity Funding Bill 2016 (Cth), 8, 17, 36, 83, 88, 90, 102-105, for repeated references to the need to support small-scale businesses, particularly those that are innovative, emerging, or start-ups.
This article argues that despite the opportunity to provide greater access to innovative forms of finance for small enterprise, the law will find it difficult to meet its policy objective: in order to avail themselves of this type of finance, firms must take on a corporate form more suited to much larger organisations. The law does not match the size of the enterprises that the policy has the greatest capacity to assist. Rather, new and small enterprises are expected to adopt a corporate form designed for more sophisticated, larger entities, in order to fit within an essentially pre-existing regulatory framework with minor modifications. This was not the approach recommended by CAMAC in its final report. CAMAC recommended the adoption of a regulatory approach for crowd-sourced equity funding, but advised that existing corporate structures under our Corporations Act 2001 (Cth) were not optimal for crowd-sourced equity funding. Larger public companies are already able to take advantage of the proved and effective fundraising mechanisms enabled by Chapter 6D of the Corporations Act. For smaller firms, those most likely to be new and innovative, the present corporate forms act as a barrier to entry for access to finance provided by crowd-sourced equity funding. Even given the small-scale funding allowances in Chapter 6D, the existing corporate forms prohibit small companies from accessing the most essential element of crowdfunding: ‘the crowd’. A more flexible regulatory approach is needed. This article proposes that this be achieved via a rethinking of the corporate form, consistent with the broader policy ambitions for business outlined above. This proposal is informed by a consideration in Part III of the nature of crowdfunding and the fintech that enables it.

III WHAT IS CROWDFUNDING?

A Crowdfunding – A Primer

At its essence, crowdfunding is goal-driven microfinance at scale. Crowdfunding is innovative in the way that it uses technology to form connections between an entity seeking to raise funds, potential investors, and an intermediary facilitating the fundraising project. These connections enable substantial sums to be raised from large numbers of contributors, each making a modest contribution towards the fundraising goal. Crowdfunding is not a new phenomenon, but its reach and potential have been amplified by the ubiquity of the internet and low-cost access to web platforms designed to facilitate both communication of information regarding the project seeking finance, and the collection of funds. The reach of the call for funds

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11 The Explanatory Memorandum acknowledges that it is start-ups and emerging companies that are most likely to want to raise capital via crowd-sourced equity funding. See Explanatory Memorandum, Corporations Amendment (Crowd-Sourced Equity Funding) Bill 2016 (Cth), 102.

12 Australian Government, Corporations and Markets Advisory Committee, above n 6, 12, 18–20.

13 Ibid 18.

14 Mollick contends that crowdfunding is a unique form of fundraising with multiple points of origin, only one of which is microfinance. See Ethan Mollick, ‘The Dynamics of Crowdfunding: An Exploratory Study’ (2014) 29(1) Journal of Business Venturing 1, 2.

the networked dynamics of the internet coalesce, enabling crowds of investors to form in a manner involving new and interesting crowd-dynamics and behaviours, some of which raise red flags for financial regulators. Contributors are likely to be ordinary members of the general public. While they may be unsophisticated, in that they lack experience with investment, as ‘novel investors’ they represent a vast potential capital market, given their willingness to invest. Even small individual contributions from a crowd can, given sufficiently large numbers, converge into a sizable capital injection. Crowdfunding can capture this willingness to invest, even very small sums, in a low-cost, accessible framework.

Crowdfunding provides an alternative to traditional finance sought from one or more banks, or professional, highly sophisticated investors. Those seeking crowdfunding are typically early stage, innovative or entrepreneurial enterprises. Lehner et al have identified that crowdfunding leverages both its legitimacy and attractiveness to contributors based upon ‘either its “social character” or the “radical innovativeness” of an idea’. The business seeking to raise funds may be disrupting

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16 See further Mollick, above n 14, 2–3; Othmar M Lehner, Elisabeth Grabmann, and Carina Ennsgraber, ‘Entrepreneurial Implications of Crowdfunding as Alternative Funding Source for Innovations’ (2015) 17(1–2) venturecapital 171, 172; Lehner et al consider the ‘crowd’ in crowdsourced funding as both ’a sociological concept and entity’, citing John Drury and Clifford Stott, ‘Contextualising the Crowd in Contemporary Social Science’ (2011) 6(3) Contemporary Social Science 275.

17 Well-studied behavioural tendencies of crowds formed online, such as herding, may be observed. This will be discussed further below.

18 The phenomenon of crowdfunding is sometimes described as turning customers into investors. See for example Andrea Ordanini et al, ‘Crowd-funding: Transforming Customers into Investors through Innovative Service Platforms’ (2011) 22(4) Journal of Service Management 443.

19 Valančienė and Jegelevičiūtė, above n 15, 41.

20 For an extensive discussion of the democratisation of access to capital markets see Ethan Mollick and Alicia Robb, ‘Democratizing Innovation and Capital Access: The Role of Crowdfunding’ (2016) 58(2) California Management Review 72; Lehner has described crowdfunding as an ‘emancipation of the crowd’ and ‘part of the emerging power struggle between incumbent institutions, bureaucracy and creative individuals with a desire for societal change’. Othmar M Lehner, ‘The Formation and Interplay of Social Capital in Crowdfunded Social Ventures’ (2014) 26(5–6) Entrepreneurship & Regional Development 478, 495; Scholars have described this type of finance in terms of taking advantage of the crowd for mutual benefit. See Paul Belleflamme, Thomas Lambert, and Armin Schwienbacher, ‘Crowdfunding: Tapping the Right Crowd’ (2014) 29(5) Journal of Business Venturing 585, 586; the crowd is ‘tapped’ for its surplus or disposable finance, albeit in small, individual contributions. See Jake Hobbs, Georgiana Grigore, and Mike Molesworth, ‘Success in the Management of Crowdfunding Projects in the Creative Industries’ (2016) 26(1) Internet Research 146, 147.


22 Lehner, Grabmann, and Ennsgraber, above n 16.

23 Ibid 172.
market incumbents, endeavouring to establish a new market or niche, or both. These factors may, in combination, make finding traditional financing challenging.

Further, crowdfunding may have value to entrepreneurial and innovative enterprise beyond its capacity to raise funds, since it facilitates a dynamic interrelationship between the contributors and the entity seeking funds. This allows for the leveraging of social capital of crowd connections, which may lead to an interplay influencing the fledgling enterprise’s understanding of the market, or the reshaping of its business plan.

Crowdfunding takes place on ‘fintech’ platforms. Crowdfunding via a fintech intermediary is a typical example of innovative use of technology in the provision of financial services. The technology is not just the delivery mechanism for the financial service. Rather, the financial service is designed and built specifically to harness the interconnectedness and interactivity possible via the technological platform. Its reach is premised on the reach of the internet, and designed to capture or penetrate existing or potential markets via mobile technologies, social networks, and big data. In only selecting those ventures most likely to both succeed and bolster the reputation of the platform, the fintech platform may itself act in a de facto regulatory manner.

The fintech platform may offer services assisting the fledgling business such as attending to preliminary legal requirements. These platforms typically use web-based, mobile enabled platforms to disseminate information about the crowdfunding opportunity, and enable participation by processing the collection and distribution of funds raised. Potential investors become part of the web-based ecosystem created by the fintech platform when they sign up for alerts, install the platform’s app, like the platform’s page on social media or visit its webpage. The project is pitched in a highly visual format designed for an unsophisticated audience. While there is some text, the information conveyed is generally dominated by video and graphics. Projects state their financial goal and remain open for a limited time of one or two months.

Earlier research has identified that crowdfunding established its viability at a time when traditional finance for high-risk ventures was scarce following the global financial crisis. See Bruton et al, above n 8, 12; Lehner, Grabmann, and Ennsgrabner, above n 16.

Lehner, above n 20, 494–495; these interplays and their effects demonstrate that elements of ‘crowdsourcing’ of ideas remain at the foundation of crowdfunding. See Jeff Howe, Crowdsourcing: Why the Power of the Crowd Is Driving the Future of Business (2009).

Fintech is a portmanteau of ‘financial technology’. Fintech is an emerging sector disrupting the traditional provision of banking and financial services.


Earlier studies have identified drivers of successful crowdfunding campaigns. These drivers include audio-visual features. See Paul Belleflamme, Thomas Lambert, and Armin Schwenbacher, ‘Individual Crowdfunding Practices’ (2013) 15(4) Venture Capital 313; Jake Hobbs, Georgiana Grigore, and Mike Molesworth, above n 20, 148; Mollick, above n 14.

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28 Lam and Law, above n 15.
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B Types of Crowdfunding

Crowdfunding can take a number of forms: Crowdfunding can be investment or reward based. While this article is predominantly concerned with crowd-sourced equity funding as a type of investment-based crowdfunding, the features of reward-based crowdfunding are explored in order to illuminate the general nature of crowdfunding and to distinguish investment-based crowdfunding.

1 Reward-Based Crowdfunding

Reward-based crowdfunding can involve a product, an altruistic reward or charitable goal. An early example illustrates the impact of crowdfunding as microfinance at scale prior to the introduction of the internet. In 1885 Joseph Pulitzer made a front-page appeal in his newspaper calling on the working people of New York to donate sufficient funds to complete construction of the pedestal of the Statue of Liberty. For want of a pedestal, the pieces of the statue lay in crates on Bedloe Island. Pulitzer incentivised contributors by promising that every contributor’s name would be published in his newspaper. The fundraising goal of $100,000 was reached within months via contributions from more than 125,000 people most of whom donated less than $1.

One of Australia’s most successful reward-based crowdfunding schemes involved father and son inventors who had developed an innovative bee hive allowing for the easy removal of honey with minimal disruption to the bees. In an effort to secure funding before taking the hive to market, they embarked on a crowdfunding campaign via the Indiegogo crowdfunding platform. Their goal of $70,000 to fund the

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34 It has been observed that some contributors are motivated simply by achieving a desired goal and receive no further reward than the gratification of having achieved it. See Tim Kappel, ‘Ex Ante Crowdfunding and the Recording Industry: A Model for the US’ (2008) 29 Loyola of Los Angeles Entertainment Law Review 375; Colombo, Franzoni, and Rossi-Lamastra, above n 33, 76.


37 Ibid; US National Park Service, Pulitzer: In Depth, above n 35.


39 Indiegogo, above n 32.
production of 100 hives was reached within minutes of the campaign’s launch.\footnote{40} Their campaign broke crowdfunding records for the speed at which pledges were made.\footnote{41} The campaign raised more than USD 13.2M and the fledgling company had orders for 35,000 hives.\footnote{42}

Reward-based crowdfunding such as that involved in the bee hive campaign may involve pre-ordering of the innovative product.\footnote{43} Frequently the product has barely reached a prototype stage, and funds are sought to enable the enterprise to engage in production. This type of crowdfunding enables fledgling, innovative enterprises to access capital, maintain control over their innovation and business, and test the market for their product.\footnote{44} Pre-ordering crowdfunding generally takes a make or break approach to fundraising: If the fundraising does not meet the threshold required for production, the venture does not proceed. In this manner, the crowd collectively evaluates the venture in determining whether to financially support it.\footnote{45} Pre-ordering allows the enterprise to establish multiple price points for its products, thus leveraging the potential for profit against the risk taken by the contributor.\footnote{46} This can be done by price points or pledges discriminating between those ‘who pre-purchase the product, and other “regular” consumers, who wait until the product reaches the market to purchase it’ and, thereby, to extract larger profits from the latter.\footnote{47} Price point variation can accommodate hybrid reward-based crowdfunding that includes elements of charitable giving with pre-ordering.\footnote{48}


\textbf{41} Ibid.


\textbf{43} Belleflamme, Lambert, and Schwienbacher, above n 20, 586.

\textbf{44} See further Lam and Law, above n 15, 12.

\textbf{45} Bruton et al, above n 8, 12; Colombo refers to these as ‘all or nothing’ models. See Colombo, Franzoni, and Rossi-Lamastra, above n 33, 75.

\textbf{46} Belleflamme, Lambert, and Schwienbacher, above n 20, 586.

\textbf{47} Ibid; see for example: Travis — I Speak 80 Languages, so Can You! Indiegogo <https://www.indiegogo.com/projects/2059128>. The price differentiation available in this campaign is typical. This Indiegogo campaign was for a prototype stage, artificial intelligence equipped personal voice translator allowing the user to communicate in 80 languages. At the close of the campaign in April 2017, the project had raised USD 628,236 from 3630 contributors, far exceeding its USD 80,000 fundraising goal. Earliest contributors were offered the lowest price point for the translator: USD 99. As early bird pricing was exhausted, higher price points became available in turn: USD 109, USD 129, USD 149. Other price point options included buy one and give one, charitable donations with the contribution, or included lifetime rewards in the way of additional translator features. Contributors that did not secure the pre-production price points including these lifetime rewards, would only have access to these additional features by annual subscription. Limited discounted price points were available to contributors committing to a bulk purchase of 50 or 100 devices. This campaign also speaks to the speed at which innovative ideas can test and establish their market via crowdfunding campaigns. The cofounders of the business came up with the idea for the translator in April 2016 and completed their product design in December 2016. The first prototype was developed in February 2017 and the campaign launched on Indiegogo the following month. Production was promised to begin in April 2017, with delivery planned to contributors in mid 2017. The retail launch is planned for late 2017.

\textbf{48} See for example, \textit{Farhug: Hug Loved Ones From Anywhere In The World} Kickstarter <https://www.kickstarter.com/projects/parihug/parihug-hug-loved-ones-from-anywhere-in-the-world>. In this fully funded campaign on Kickstarter, a prototype has been developed for Internet-connected devices with the appearances of soft toys. The idea is that one hugger will
These features of reward-based crowdfunding put the enterprise in a strong position to establish their business case and in turn, access credit or capital via other means should it be required to grow or sustain the business. Where these businesses choose to instead pursue venture capital, it is far more likely that they would be required to relinquish equity or agree to terms that are designed to secure a high return for the investor. Access to credit can be a barrier to market entry for these early-stage, entrepreneurial or innovative firms.

Success of reward-based crowdfunding campaigns is frequently expressed in terms of the number of projects meeting or exceeding their stated financial goal, but this does not take into account that even projects that meet their goal can fail to deliver their projects on time, and some fail to deliver at all. Furthermore, exceeding the stated financial goal may not be a good indicator of success, since overfunding has been revealed as the single greatest indicator that a project will be delayed. It is yet to be seen whether these difficulties remain confined to reward-based crowdfunding or whether they will manifest in crowd-sourced equity funding. Mollick’s study, one of the most comprehensive to date, raised concerns about the capacity of entrepreneurial endeavours to learn on the run when undertaking reward-based crowdfunded ventures:

Among the unanswered questions about the crowdfunding model is whether successful crowdfunding leads to the successful development of goods and services, and, potentially, viable ongoing ventures. The nature of crowdfunding also differs from other forms of fundraising for new ventures, in ways that potentially complicate the outcomes of crowdfunded projects. In crowdfunding, the money is raised up front, and, in the case of reward-based crowdfunding, without any clear legal obligation from the project initiator to deliver their promised rewards. For the dishonest, this creates an opportunity for fraud. But, even for those who intend to deliver on their obligations, it requires significant foreknowledge about the budget and schedule required to create the promised goods or service, in order to raise the proper amount of money. The process of entrepreneurship often involves altering plans as new knowledge is acquired, but crowdfunded ventures do not have this ability, since they have to deliver projects promised before any of this new learning takes place, using budgets that were established very early in the venture process. This suggests that crowdfunded projects are at risk of delays, or even failure, as initial resource endowments may prove inadequate.

hug its soft toy, and the other hugger will hug the second soft toy. The devices are equipped with haptic sensors that transfer the hug and heartbeat of one hugger to the other via its haptic pair. Price points range from just a few dollars to USD 3000. Contributors can pledge at price points that allow for the enterprise to arrange for the donation of devices to a ‘charity, hospital, foundation or family in need’. At the highest price point the engineer and founder of the enterprise will fly to the contributor’s child’s classroom to talk to students about engineering or entrepreneurship. At the lowest price point contributors receive an email of appreciation and access to videos of the manufacturing process. For USD 10, contributors receive a luggage tag. The device itself becomes available for contributors pledging USD 75 or more.

50 Mollick, above n 14, 11–12.
52 Ibid 11.
Entrepreneurial readiness to engage in crowdfunding is not confined to reward-based crowdfunding. In crowd-sourced equity funding, the sophistication, maturity and skill of the entity seeking contribution in communicating its value and establishing trust is a critical determinant of success in persuading contributors to invest.

2 Crowd-sourced Equity Funding

Crowd-sourced equity funding seeks to raise capital. A call for funds is made to a large number of people, offering equity in the entity in exchange for the contribution. Crowd-sourced equity funding is a form of investment-based crowdfunding. It is similar to reward-based crowdfunding in many respects: The offer is made via fintech to a large audience, in order to ensure the formation of a crowd of investors. Rather than a reward or a product, contributors receive an equity interest. As Belleflamme et al put it, the contributor’s reward is a ‘share of future profits’. Crowd-sourced equity funding is supported in a growing number of countries including the United States, the United Kingdom, France and Ireland. Crowd-sourced equity funding is well established in New Zealand.

Contributors in crowd-sourced equity funding are investors. Risk assessment, trust, and the visible behaviour of others will all inform the decision to invest. Risk factors include ‘the performance of the campaign’, ‘information asymmetries’ between the entity seeking to raise funds and the investor, and the nature of the equity interest. This means that signalling from the entity seeking to raise funds is likely to influence the investor’s behaviour. Ahlers et al argue that signalling is of particular importance in crowd-sourced equity funding for two reasons. Firstly, the entity seeking finance is typically a start-up, and it must ‘clearly signal its value to small investors’. Secondly, since the crowd-sourced equity campaign is likely to target unsophisticated investors, signalling plays a significant role, since these investors are not generally skilled at risk assessing potential investments. Visible behaviour of others can have dynamic effects, including the influence of early investment, and herding. Risk associated with the nature of the equity interest includes, in the instance of shares, whether the interest is vulnerable to dilution and the rights that attach to the share.

A number of studies have concluded that entrepreneurial entities seeking to crowdfund typically choose between reward-based and equity funding based on their capital requirements, selecting crowd-sourced equity funding where a large capital injection is required, and reward-based funding to fill smaller capital gaps.

53 See Ahlers et al, above n 29, 958.
54 Ibid 955.
55 Belleflamme, Lambert, and Schwienbacher, above n 30, 315.
56 A number of crowd-sourced equity funding platforms operate in New Zealand including, for example, Snowball Effect. In its first year of trading, it raised NZD 12.4 million in equity across 21 companies. See: NZ’s Leading Online Investment Marketplace Snowball Effect <https://www.snowballeffect.co.nz>.
57 Belleflamme, Omrani, and Peitz, above n 21, 13; Mollick, above n 14, 3.
60 Ahlers et al, above n 29, 957.
61 Belleflamme, Lambert, and Schwienbacher, above n 30, 19.
62 Ahlers et al, above n 29, 955.
63 Ibid.
64 Zhang and Liu, above n 33; Belleflamme, Omrani, and Peitz, above n 21, 21. Herding behaviours and the influence of early contribution are considered further below.
65 Belleflamme, Lambert, and Schwienbacher, above n 30, 315; Belleflamme, Omrani, and Peitz, above n 21.
IV THE LEGAL FRAMEWORK APPLYING TO CROWDFUNDING

In this Part, the legal framework applying to the forms of crowdfunding discussed in Part III will be considered. The legal framework applying to crowdfunding turns on the same issue which lies at the heart of crowdfunding taxonomies: what does the contributor receive in exchange for their contribution?

A Reward-based crowdfunding

Where the contributor merely makes a donation, the crowdfunding is unlikely to fall within any current legal regulation of consumer protection or financial services. Where the contributor is to receive a product or a service, even via a pre-purchase arrangement, the Australian Consumer Law, Schedule 2 of the Competition and Consumer Act 2010 (Cth) may apply. The enterprise must not engage in misleading or deceptive conduct. Further, Australian Consumer Law, s 29 offers specific consumer protections prohibiting false or misleading representations about goods and services. Section 29 captures enterprises engaged in a pre-ordering reward-based crowdfunding, as it applies to persons engaged in the supply or possible supply of goods or services, or the promotion by any means of the supply or use of goods or services. Since crowdfunding campaigns typically features statements regarding product features, performance characteristics, uses, benefits, accessories, standards, quality, value, grade, composition and style, the prohibitions in s 29 should be taken into account. Mindfulness of these legal obligations is required from the earliest stages of designing the promotional material for the campaign, and is of acute concern when engaging in any potential redesign of early prototypes, even where that redesign is based on feedback sourced from the crowd.

B Crowd Sourced Equity Funding

The Corporations Amendment (Crowd-sourced Funding) Act 2017 (Cth) (‘CSFA’) introduces a new legal framework for crowd-sourced equity funding. The Act amends both the Corporations Act and the Australian Securities and Investments Commission Act 2001 (Cth). The CSFA allows eligible entities to raise up to AUD 5 million each year via crowd-sourced equity funding. This is accomplished via the introduction of a new crowdfunding regime in the Corporations Act, Pt 6D.3A. The object of this new Part is to provide a disclosure regime for small unlisted companies engaging crowdfunding issuing securities. Crowd-sourced funding falling within Pt 6D.3A is generally exempt from the existing fundraising requirements contained in the Corporations Act, Parts 6D.2 and 6D.3.

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66 Competition and Consumer Act 2010 (Cth) sch 2 (‘Australian Consumer Law’) s 18.
67 Australian Consumer Law s 29(1).
68 Australian Consumer Law s 29 also prohibits misleading and deceptive statements regarding the availability of facilities for the repair of goods or of spare parts for goods; place of origin; the need for any goods or services; the existence, exclusion, or effect of any condition, warranty, guarantee, right, or remedy; or concerning a requirement to pay for certain contractual rights.
70 Corporations Act 2001 (Cth) s 738A.
71 Ibid ss 703B, 725A, respectively.
The policy objectives of the CSFA were two-fold. Primarily, the law would provide a framework that would allow small enterprises and start-ups to access innovative fundraising and remove regulatory barriers impeding cost-effect access to equity fund-raising. Secondly, it would ‘promote and protect’ market participants including investors and fintech involved in facilitating access to crowd-sourced equity funding, thus ensuring confidence in financial markets.

The CSFA did not have an easy passage through parliament. The CSFA was based on the Corporations Amendment (Crowd-sourced Funding) Bill 2016 (Cth). A different Bill, put to parliament the year before, had been subject to extensive debate, despite in-principle support for crowd-sourced equity funding from Opposition and Independent members. Both Bills were the subject of consideration by the Senate Economics Legislation Committee. Debate focused mostly on restricting consumer access to crowd-sourced equity funding, and the restrictions to be placed upon entities raising funds in this way. The CSFA makes frequent mention of its regulations. In 2015 an exposure draft of the proposed regulations to accompany the earlier Bill were released by Treasury in a call for consultation and submissions. While no regulations for the 2016 Bill have been released, it is likely that they will be similar to those designed to accompany the earlier Bill.

1 The Separate Regime for Crowd-Sourced Equity Funding: Pt 6D.3A

Earlier in this article it was explained that crowdfunding involves the connection and cooperation of the entity seeking to raise funds, contributors and the fintech intermediary. The CSFA targets each of these participants in an effort to meet an ongoing policy objective of ensuring trust and confidence in the market. These protections will be considered in turn.

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72 Explanatory Memorandum, Corporations Amendment (Crowd-Sourced Equity Funding) Bill 2016 (Cth), 8, 17, 36, 83, 88, 90, 97, 102-105.
73 Ibid, 97.
74 The Corporations Amendment (Crowd-sourced Funding) Bill 2015 (Cth).
(a) Entities seeking to raise funds

Part 6D.3A allows entities that meet strict requirements to raise up to AUD 5 million each year via crowd-sourced equity funding. The company seeking to raise funds and the offer itself must both be ‘eligible’ for the purposes of Pt 6D.3A. An eligible company can only have one offer open at a time.78 Related entities cannot be used to circumvent these requirements. Related entities are considered frequently throughout Pt 6D.3A including in establishing the eligibility of the entity and the offer.79 A company otherwise eligible to make an offer is prohibited from making the offer if a related party has an offer that is open or suspended.80 Offers are eligible to be made under Pt 6D.3A where they meet all the following requirements:81

1. An Offer for Securities
   The offer must be an offer for securities.82 Crowdfunding schemes that do not involve the offer of securities, such as the reward-based schemes considered above, remain outside the ambit of this Part.

2. Eligible CSF company
   The offer of securities must be made by an ‘eligible CSF company’.83 An ‘eligible CSF company’ is defined in s 738H to mean: an unlisted public company, limited by shares, with its principal place of business in Australia, with a majority of its directors ordinarily residing in Australia, meeting the assets and turnover test, with no related parties that are a listed corporation, and with no intention, on the part of either the company nor any of its related parties, to invest in securities or interests in other entities or schemes. The assets and turnover test is set out in s 738H(2): It is satisfied if at the time, the company and all of its related parties, have consolidated gross assets of less than AUD 25 million and consolidated revenue of less than AUD 25 million.

3. Securities issued are fully paid ordinary shares
   The securities must be of a class specified in the regulation. The Exposure Draft of the proposed Corporations Amendment (Crowd-sourced Funding) Regulation 2015 (Cth), included a stipulation that these securities be fully paid ordinary shares.84

4. Issuer Cap
   The offer must be within the AUD 5 million ‘issuer cap’ stipulated in s 738G(2).85 The issuer cap is the sum of the total of the maximum

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78 Corporations Act 2001 (Cth) s 738R.
79 Ibid ss 738G, 738H. Note the definition of ‘related party’ in s 9 has been repealed and replaced with a new definition. In Chapter 2E ‘related party’ now takes its definition from s228, and in Part 6D.3A, ‘related party’ means (a) a related body corporate of the company; (b) an entity controlled by a person who controls the company or an associate of that person.
80 Ibid s 738R.
81 Ibid s 738R.
82 Ibid s 738G(1)(f).
83 Ibid s 738G(1)(a).
84 Ibid s 738G(1)(b).
84 Exposure Draft, Corporations Amendment (Crowd-Sourced Funding) Regulation 2015 (Cth), above n 77, Regulation 6D.3A.01.
85 Corporations Act 2001 (Cth) s 738G(1)(d).
amount to be raised by the offer and amounts raised by the company or its related parties from:

(i) CSF offers in the preceding 12 months, and
(ii) offerings exempt from compliance with Part 6D because they were small-scale offerings within Corporations Act s 708(1) or to sophisticated investors through a financial services licensee under s 708(10).

5. The use of the funds

There must be no intention that the funds raised in the offer be used by the company itself or its related parties for investment in securities, other entities or schemes. A company cannot fall within the definition of an ‘eligible CSF company’ unless it satisfies a similar requirement in s 738H.

To make an offer under Pt 6D.3A, a disclosure document called a ‘CSF offer document’ is required. The document must be ‘worded and presented in a clear, concise and effective manner’. It must contain the ‘CSF offer’ as well as prescribed information including risk warnings, information about the offer, the company making it, and investor rights. The exposure draft of the proposed regulations to the 2015 Bill stipulated that the following risk statement be included in the offer document:

Equity crowdfunding is risky. Issuers using this facility include new or rapidly growing ventures. Investment in these types of ventures is very speculative and carries high risks.

You may lose your entire investment, and you must be in a position to bear this risk without undue hardship.

Even if the company is successful, the value of your investment and any return on the investment could be reduced if the company issues more shares.

Your investment is unlikely to be liquid. This means you are unlikely to be able to sell your shares quickly or at all if you need the money or decide that this investment is not right for you.

Even though you have remedies for misleading statements in the offer document or misconduct by the company, you may have difficulty recovering your money.

There are rules for handling your money. However if your money is handled inappropriately or the person operating the platform on which this offer is published becomes insolvent, you may have difficulty recovering your money.

Ask questions, read all information given carefully, and seek independent financial advice before committing yourself to any investment.

The company making the offer has responsibility for obtaining and retaining written consents before arranging for the publication of the CSF offer document. These include consent from each director of the company making the offer, any proposed directors identified in the offer document, and any person whose statement is

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86 Ibid s 738J(1).
87 Ibid s 738K.
88 Ibid s 738J(2). ‘CSF offer’ is defined by s 738B to mean an eligible offer expressed to be made under Part 6D.3A.
89 Exposure Draft, Corporations Amendment (Crowd-Sourced Funding) Regulation 2015 (Cth), above n 77, Regulation 6D.3A.03.
90 Corporations Act 2001 (Cth) s 738M(1).
included in the CSF offer document. In relation to the latter, the legislation requires consent to the inclusion of the statement ‘in the form and context’ in which it appears.\footnote{Ibid s 738M(2)(a).} Consents must be kept by the company making the offer for seven years. Failure to comply with these consent provisions prior to arranging for the publication of the CSF offer document is an offence of strict liability.\footnote{Ibid ss 328C; 328D.}

Certain eligible CSF companies can receive up to five years relief from reporting requirements, and be exempt from holding annual general meetings and audit requirements.\footnote{Ibid ss 738ZI, 250N(5), 250N(6), 301(5).} These exemptions are only available where the eligible CSF company was registered as a public company limited by shares, or converted from a proprietary company limited by shares, and converted its registration to a public company limited by shares stating its intention to make a CSF offer. This cannot merely remain an intention. To take advantage of the exemptions, the CSF offer must actually be made within 12 months of its registration or conversion.\footnote{Ibid s 738ZI.} The exemptions can be lost if the company no longer meets the eligibility requirements under s 738ZI. If the company stops being covered under s 738ZI or if its CSF offers raises AUD 1 million or more, an auditor must be appointed.\footnote{Ibid ss 328C; 328D.}

(b) Contributors

The CSFA seeks to prioritise protections for people investing in crowd-sourced equity offers, and demonstrates that parliament was mindful of unsophisticated investors engaging in crowd-sourced equity funding. This is evident in the risk statement outlined above. The eligibility requirements imposed on CSF offers and companies seeking to engage in fundraising under Pt 6D.3A are directed at ensuring that the regime is robust and in a strong position to protect investors. Additional protections, including an investment cap and cooling off rights, are afforded to unsophisticated investors who fall within the definition of a ‘retail client’.\footnote{Ibid ss 738D, 738ZC, 738ZD.}

‘Retail clients’ of financial services have for some time been afforded additional protection by the \textit{Corporations Act}, Ch 7. A person that fits the definition of ‘retail client’ in Ch 7, is a ‘retail client’ for the provision of the crowd-funding service relating to a particular CSF offer. Sections 761G and 761GA define ‘retail client’ for the purposes of Ch 7. These provisions capture the investors most likely to become involved in crowd-sourced equity funding. Indeed, these provisions operate so as to assume that all investors are ‘retail clients’, unless otherwise excluded. The main exclusion is contained in s 761GA: Sophisticated investors, experienced in investment and in using financial services, do not generally fall within the definition of ‘retail client’ because they have the capacity and experience to assess the merits of the offer, the value of the offer, the risks, their own informational needs, and the adequacy of the information that they have been provided about the offer.\footnote{Ibid s 761GA.}

Investment by ‘retail clients’ in CSF offers is capped at $10,000 each year with the same CSF company. The CSF Intermediary must reject an application made by a retail client in excess of this cap.\footnote{Ibid s 738ZC(1).} If application for the issues of securities under the
CSF has been made jointly by 2 or more persons, then compliance with the cap is calculated by treating the applications pro-rata. CSF offers can only be made by publishing the CSF offer document on the platform of a CSF intermediary. CSF intermediaries must hold a financial services licence expressly authorising the provision of crowd-sourced equity funding services.

Gatekeeper obligations are imposed on the CSF intermediary. It must not publish a CSF offer document before conducting prescribed checks on the identity of the company making the offer, its eligibility to crowdfund under Pt 6D.3A, and information about the directors and others named in the offer document. These obligations may extend to checking whether the offer document contains prescribed information, such as details of any disqualifications from management, criminal offences or civil penalty contraventions committed by persons named in the offer document. The CSF intermediary must conduct these checks to a reasonable standard. Checks may be to a reasonable standard where made in reliance upon relevant, reliable and independent documentation.

Other obligations imposed on the CSF intermediary include requirements to ensure that the prescribed risk warning, and cooling off periods are prominently displayed on the platform and, availability of technological facilities to those accessing the CSF offer to enable the making of applications, and communication with each other and to ask questions of the company or the CSF intermediary.

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99 Ibid s 738ZC(2).
100 Ibid s 738ZD.
101 ‘Explanatory Memorandum, Corporations Amendment (Crowd-Sourced Funding) Bill 2016 (Cth)’ 24.
102 Corporations Act 2001 (Cth) s 738L(2). This provision requires that these matters must be stipulated in the hosting arrangements between the company and the CSF intermediary. It is an offence for the company to make a CSF offer otherwise that in accordance with s 738L(1) and (2); s 738L(3).
103 Ibid s 738L(1).
104 Ibid s 738C.
105 Ibid s 738Q imposes the gatekeeper obligations; these matters were stipulated in Exposure Draft, Corporations Amendment (Crowd-Sourced Funding) Regulation 2015 (Cth), above n 77, Proposed Regulation 6D.3A.11.
106 Exposure Draft, Corporations Amendment (Crowd-Sourced Funding) Regulation 2015 (Cth), above n 77, Proposed Regulation 6D.3A.11.
107 Corporations Act 2001 (Cth) s 738Q(1).
108 Exposure Draft, Corporations Amendment (Crowd-Sourced Funding) Regulation 2015 (Cth), above n 77, Proposed Regulation 6D.3A.12.
109 Corporations Act 2001 (Cth) 738ZA(1).
110 Ibid s 738ZA(8).
111 Ibid ss 738ZA(3)(a); 738ZA(5).
V. Does the Law Meet its Policy Objectives?

A. Corporate Form

1. The legislative intent

Primarily the CSFA sought to provide a framework through which small enterprise, start-ups and ‘early-stage innovators’ could access equity-fundraising without the burden of existing costly regulatory barriers.\(^{112}\) The legislation misses its mark in this key respect: it requires even start-ups to become public companies in order to access crowd-sourced equity funding. Limited governance requirements are available to firms that take this path, including exemptions from annual general meetings, and audit. The hope of the legislation meeting this policy objective is premised upon these accommodations being sufficient to entice start-ups and early stage innovators to take the form of a public company.

It is small business that is most likely to face a capital gap that could be assisted by crowd-sourced equity funding. Many may not even have bothered to adopt a corporate form. It is not clear from the perspective of this legislation, that there is any advantage in doing so. This is a significant failure since most business in Australia is small: 97.5% have fewer than 20 employees.\(^{113}\) More than 99% of Australia’s 2.37 million companies take the same form, propriety companies, limited by share.\(^{114}\) Of the remainder, just over 2000 are listed public companies.\(^{115}\) MSMEs dominate the business and corporate landscape.\(^{116}\) Start-ups and new, small innovative enterprises are most likely to take on the relatively inexpensive compliance regime of the proprietary form, and generally would only consider taking on the governance burdens associated with a public company as an antecedent step to listing. The single biggest policy failure of the CSFA was forewarned by CAMAC: these businesses are unlikely to incorporate as a public company simply to access crowd-sourced equity funding because the ‘set-up and ongoing compliance costs of a public company could absorb a significant portion of any funds raised through the crowd’.\(^{117}\) The ongoing costs of remaining a public company seem a high price to pay for limited exemptions. Furthermore, the difficulties associated with transitioning back to a proprietary company may weigh heavily on companies for which crowd-sourced equity funding wasn’t everything they had hoped. This is an opportunity lost. Supporting innovation depends upon access to finance but also upon recognition that innovative businesses are vulnerable in periods of growth, and tend to be start-ups.


\(^{115}\) Ibid.

\(^{116}\) Australian Bureau of Statistics, above n 113. ABS data collected since June 2011 is revealing of a strengthening preference for companies as vehicles to conduct business in Australia. The ABS statistics only include businesses that are actively trading and have an ABN. Not all holders of an ABN are incorporated; not all companies have an ABN. ASIC, ‘Annual Report 2015-2016’, above n 114. Not all of these companies may be actively trading. ASIC has power to deregister abandoned companies pursuant to Corporations Act 2001 (Cth), s 489EA.

\(^{117}\) CAMAC, above n 6, 15.
This leaves start-ups, innovative and entrepreneurial companies in the same position as all other MSMEs when it comes to choice of business vehicle. They need not incorporate. The most alluring incentive for small business to incorporate may be limited liability. Limited liability is only available to companies in Australia via incorporation. However, limited liability may be of no practical value to small entities if, in order to secure traditional finance, those behind the business are required to offer their personal assets as security.

Businesses that choose to incorporate to obtain limited liability may incorporate as a proprietary or public company. Proprietary companies are subject to numerous restrictions but have a less onerous and less expensive compliance regime than public companies. Proprietary companies, limited by shares must have no more than 50 non-employee shareholders, and except for limited exceptions, cannot engage in activities that require disclosure to investors pursuant to the Corporations Act, Ch 6D. Proprietary companies can be registered with a sole shareholder/director. Small proprietary companies have reduced financial reporting requirements. To qualify as a small proprietary company, the company must have two of the following features: fewer than 50 employees, gross assets of less than AUD 12.5 million, or consolidated annual revenue of less than AUD 25 million. While there are some exceptions to the requirement not to engage in activities that would amount to fundraising within Ch 6D, these exceptions are extremely limited. Proprietary companies may seek to raise funds within the small-scale exceptions. These restrictions combine to preclude access to ‘the crowd’, the significance of which has been raised earlier in this article.

Limited mechanisms for access to capital are a continuing problem for proprietary companies. The need for diversity in approaches to financing the activities of these small organisations has been in the world spotlight for some time and may push an agenda for rethinking the suitability of the existing range of legal entities available for small, start-up and innovative business. The OECD continues to urge policy development giving MSMEs access to a range of options for access to finance across a risk spectrum in order to allow them to ‘obtain the forms of finance most suited to their needs at different stages of their life cycle and become more resilient in the face of crisis, thus enabling them to contribute to economic growth that is inclusive and stable’. The OECD has been monitoring and reporting on access to finance since 2007. The value of the OECD reports is that they are based upon a longitudinal study of the manner in which entrepreneurs and MSMEs access finance. The 2017

118 Corporations Act 2001 (Cth) s 112(1).
119 Ibid s 113. Chapter 6D contains the fundraising provisions, from which CSF offers are mostly exempt. See discussion above.
120 Ibid s 114.
121 Ibid s 45A(2).
122 Corporations Act 2001 (Cth), s 708.
125 The objective of the research is to develop a framework useful to stakeholders, especially policy makers, when analysing and evaluating the merit and significance of approaches to finance and their capacity to meet the needs of small enterprises, both from the perspective of the entities themselves and the broader policy perspective underlying why these small entities are supported.
report revealed that alternative financing, including crowd-sourced equity funding continues to grow, but faces a number of challenges including a lack of strategic vision among entrepreneurs, who may themselves have an unsophisticated financial knowledge base. Barriers to entry loom large for these businesses when considering accessing financial services other than debt: ‘potential investors are dissuaded by the opacity of the SME finance market, a lack of investor ready projects and exit options, as well as persisting regulatory impediments’.126

Limited liability is a powerful incentive to incorporate for new businesses, however not all small innovators will necessarily adopt a corporate form. Bar the lure of crowd-sourced equity funding, they are unlikely to chose to incorporate as public companies and those that incorporated as proprietary companies are unlikely to be considering transition to public companies. This will be a barrier to entry. Rather than remove barriers to accessing finance, barriers have been created for precisely the companies most in need of access to the crowd.

2 Historical Perspective

Much of the debate surrounding crowd sourced equity funding resonates in earlier debates associated with the introduction of limited liability in the United Kingdom in the 1850s.127 Crowd-sourced equity funding aims to enable opportunities for new investment for small-scale, unsophisticated investors, and anticipates that with a greater capital base, crowd-funded businesses will be better placed to access credit and opportunity. While it is hoped that crowd-sourced equity funding will have a positive effect on economic activity, there are concerns for trust and confidence in the market should it be impacted by rogue businesses exposing unsophisticated investors to extensive losses. Prior to the introduction of limited liability in 1855,128 there was considerable focus on whether it would have a positive or negative effect on economic activity.129

Those who considered that limited liability could stifle economic activity argued that enterprises with limited liability could find it difficult to access credit, and thus be disadvantaged.130 Those in favour of limited liability argued economic activity would increase since it would entice new investors, specifically those from middle and working classes who would benefit from the protection of limited liability when investing their savings.131 This echoes the economic hope now resting on crowd-sourced equity funding, and the concerns for the protection of unsophisticated investors that engage in it.

at all. The data set, comprised of country reports on access to finance from various countries, has become increasingly more useful in showing trends over time across key indicators: debt, equity, asset-based finance and framework conditions. Reports include a focus on recent developments in financing small entities and outline approaches taken to meet challenges, such as non-performing loans. In 2016 Australia participated in the OECD country reports for the first time.

OECD, above n 123, 20.


127 Limited Liability Act 1885 (UK).

128 Halpern, Trebilcock, and Turnbull, above n 127, 118; Hunt, above n 127.

129 Halpern, Trebilcock, and Turnbull, above n 127, 118.

130 Halpern, Trebilcock, and Turnbull, above n 127.
A policy imperative remains to give small, entrepreneurial and innovative business access to a variety of modes of finance, including crowd-sourced equity funding. John Stuart Mill’s insights on small scale or unsophisticated investors and new participants in markets still ring true today. Mill was not of the view that limited liability would encourage middle and working class investment, since they were not affected by unlimited liability in the same way as the affluent. Mill observed that when middle and working class people invested, they tended to invest everything they had; when their investment was lost, they lost everything. Unlimited liability could reap no more from them. Their wealth was made entirely vulnerable by the investment itself, not by exposure beyond that investment. Rather, Mill saw limited liability as capable of generating increased economic activity because it would encourage a broader range of people, including those from the middle and working classes without capital, to engage in enterprise for themselves, and that these limited liability enterprises would benefit from investment flowing from the increased willingness and benevolence of sophisticated, generally wealthy investors.

Mill’s insights remain relevant. Through a combination of confining access to crowd-funding to firms able to afford the initial and ongoing expenses of taking the form of an unlisted public company, and safeguarding unsophisticated investors through caps and cooling off periods, we may have unwittingly created an elaborate crowd-sourced equity funding regime that best serves sophisticated investors. These investors may take advantage of this opportunity to move into spheres previously dominated by venture capitalists. It may also subtly influence and shift or dilute their investment from pre-existing capital markets.

3 The legislative outcome

Both Bills were referred to the Senate Economics Legislation Committee for inquiry and report. The Committee sought to understand why proprietary companies had been excluded. It was explained that government had opted to use the existing regulatory structures provided for public companies, adapting them to accommodate small enterprise, because this pre-existing structure already provided for the marketing of securities to the public, and it has various stepped-up requirements in order to provide disclosure and then ongoing reporting, essentially, to the shareholders of companies. Proprietary companies were considered unsuitable because they have reduced reporting requirements, are limited to 50 shareholders and are generally closely held. Thus the task of providing start-ups and small innovative businesses with access to crowd-sourced equity funding appears to have been conceptualised as how best to fit a new regulatory problem (caused by the disruptive technology) within the existing regulatory framework. This approach may have caused the development of the law to lose sight of its objectives, distracted by how best to fit it within the existing regulatory framework.

At the time of the introduction of the 2016 Bill, the government conceded that more work needed to be done to address whether crowd-sourced equity funding should

132 Mill, above n 1, 407–408.
133 Ibid.
134 This was revealed in Mill’s testimony before the Select Committee of the House of Commons on Investments for the Savings of the Middle and Working Classes. See ibid 407–409.
136 Ibid.
be available to proprietary companies. A public consultation draft of the proposed legislation extending crowd-sourced equity funding to proprietary companies was released in May 2017. If passed, the proposed law will allow proprietary companies to engage in crowd-sourced equity funding provided that they comply with increased reporting and audit requirements. They will require a constitution that provides exit options for crowd-funding shareholders. Given the long pathway to law faced by the original crowd-sourced funding Bills, this Exposure Draft will almost certainly face the same level of scrutiny and adjustment. This article does not propose to address the adequacy of the exposure draft or its fitness for purpose; this should be the subject of future research. This article does seek to address the impact of such a new law on the CSFA.

For the moment at least, the relevant question is: Who among the target market of the primary policy objective would be inspired to take up the public company crowd-sourced equity funding regime? The governance relief offered by the public company regime is limited to five years. There is no guarantee that this will be sufficient to accommodate the innovation lifecycle of small, start-up or innovative companies, nor that the business would achieve sufficient scale to be in a position to afford the ongoing compliance costs associated with a public company within that time. Transitioning back to a proprietary company is neither easy nor inexpensive. The two legislative schemes create a regulatory environment where a proprietary company must become more like a public company to engage in crowd-sourced equity funding, and a new public company seeking access to this funding may behave less like other public companies while it enjoys a hiatus from the full extent of governance expectations. This suggests that the existing regulatory framework ought to have been rethought, not just in terms of how to ‘fit’ crowd-sourced equity funding within the existing regulatory framework, but whether the corporate forms currently on offer support the needs of small businesses, especially start-ups and innovative businesses most likely to seek access to crowd-sourced equity funding. This article supports rethinking the current range of corporate forms available to small and innovative business, and in Part VI proposes how this could be done.

B Promoting and Protecting Market Participants

The CSFA has met its second policy objective to ‘promote and protect’ market participants such as investors and fintech involved in facilitating access to crowd-sourced equity funding. Each of these will be considered in turn.

137 Commonwealth, Parliamentary Debates, House of Representatives, 24 November 2016, 4307 (Scott Morrison, Treasurer).
139 Exposure Draft Explanatory Memorandum, Corporations Amendment (Crowd-Sourced Funding for Proprietary Companies) 2017 (Cth), 12-13.
140 Ibid 15-17.
141 These concerns were acknowledged by the Senate Economics Legislation Committee, Parliament of Australia, ‘Corporations Amendment (Crowd-sourced funding) Bill 2015’ (2016), 22-23 citing Submission 12, Pitch Partners, paragraph 1.24 and Submission 7, Dr Marina Nehme, 3-4.
Investors

The CSFA has imposed an impressive range of investor protections, including the cooling off period and the investor cap. There is no general cap on investment, such as that in the US or UK, rather the cap is limited to investment in a particular company in a particular year.

‘Ex ante it is impossible to know who will win and who will lose the innovative game,’ 142 Faced with this implicit uncertainty, it is the role and justification of law to deal with the ‘peculiarities and imponderables of innovation processes’. 143 Here that social contract includes the law’s tolerance of failure in innovation, business or venture failure. It also includes supporting those damaged in the wake of policies to support innovation. Limiting the amount individual investors can invest is one way of accomplishing this. It may sound unreasonable or over-protective to include investor protections; there are after all no limits to what Australians can spend on other speculative investments, or even gamble away on horse races, football, or poker machines. Yet, these investor protections play an important and necessary role. The online nature of crowd-sourced equity funding adds a new dimension to traditional issues with investor protection in fundraising since it can be affected by the dynamics of the crowd. Early contributions are linked to triggering a pattern of reinforcement, that in turn triggers new contributors from within the crowdfunding ecosystem to act. 144 Early contributions are the single biggest early indicator of a campaign’s success. 145 Yet another concern for regulators is that crowdfunding can be affected by herding behaviour, where the decision to invest is influenced by the online visibility of the behaviour of other investors. 146 This phenomenon is experienced in peer to peer lending facilitated via online platforms. 147 The cooling off period can enable an investor time to reconsider, perhaps free from the influence of the crowd.

Both the cooling off period and the cap assist in addressing unique regulatory challenges associated with the emergence of the crowd. The crowd can, in and of itself, influence the emergence of new markets, as well as their establishment or failure. Communication in the provision of financial services has traditionally focused upon the adequacy of the disclosure document. Crowd theory suggests that regulators may need to consider crowd psychology and how crowds engage collectively in ‘sensemaking’ in the environment in which markets emerge and where information regarding that market is exchanged. 148 Timing is a critical dynamic in entrepreneurial success, since success is premised upon acting fast, while the crowd is still forming or is somewhat destabilised by the innovation, and before new niches emerge in the market. 149 These timing tensions are important regulatory considerations that are difficult to control. The cooling off period goes some way towards striking a balance between the entrepreneurial imperative to move fast on the one hand and, on the other, allows the investor time and space free of the cognitive influence of the crowd dynamic to re-evaluate the decision to invest.

143 Ibid.
144 Colombo, Franzoni, and Rossi-Lamastra, above n 33, 94–97.
145 Ibid 95.
147 Ibid.
149 Ibid 243.
C Fintech

New technologies such as fintech facilitating crowd-sourced equity funding may initially present a conundrum given their disruptive character. The place of fintech within the existing regulatory framework may be unclear to the company itself and the regulator. It is a sector characterised by technological innovation, rapid change and growth. These issues present ‘a pacing problem’ making it somewhat difficult for regulators to have a full understanding of the regulatory problems presented by these technologies. ASIC has acknowledged the risks associated with rushing in to regulate before having a full understanding of the regulatory problems presented by new and potentially disruptive technology. These matters contribute to the importance of engaging in co-operation with foreign regulators and other initiatives that will allow ASIC to come to a full understanding of the regulatory issues while supporting business throughout its lifecycle. The CSFA evidences the success of the Australian approach to supporting fintech. Two critical elements underlying this success are the Innovation Hub and international cooperation to facilitate the expansion of Australian fintech into global markets.

The Innovation Hub bears a striking resemblance to a number of other ASIC initiatives to introduce behavioural economics into their regulatory strategy. The idea is that by working with the businesses early, and nudging them in the direction of compliant behaviour, they are more likely to comply with the law and the regulatory framework. The Hub provides an opportunity for ASIC to work with innovative businesses to come to a full understanding of the regulatory issues while engaging their participation to have a full understanding of the regulatory problems presented by these technologies. These matters contribute to the importance of engaging in co-operation with foreign regulators and other initiatives that will allow ASIC to come to a full understanding of the regulatory issues while supporting business throughout its lifecycle.

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number of innovative start-ups including crowd-sourced equity funding businesses, marketplace lending and blockchain business models. 156

Globally regulators are taking progressive stances toward fintech. Their pro-innovation approaches, and responsiveness to new risks demonstrates recognition that a better understanding of the regulatory problems presented by fintech can be informed by their cooperation with other regulators. 157 International cooperation agreements between regulators serve multiple purposes. They position cooperation among regulators of fintech as vital to keeping abreast of new developments in fintech and associated regulatory challenges and approaches. They recognise that innovative fintech is optimised for mobility and highly likely to seek cross-border market expansion. 158 Australia was an early mover in this responsive approach, entering into the very first of these cooperative agreements with the United Kingdom’s Financial Conduct Authority in March 2016. 159 The agreement contains a referral mechanism allowing one regulator to refer a fintech business established in its own market to the other. 160 Aside from any benefits to the companies seeking expansion into the market abroad, it is hoped that the referrals will assist in shared learning as to innovation and early understanding of emerging issues in the regulation of innovative businesses.


157 Greg Medcraft, Chairman ASIC, ‘Future of Fintech and Regulation’ (Speech delivered at the British Australian Fintech Forum 2017, London, United Kingdom, 20 April 2017) 2 <http://asic.gov.au/about-asic/media-centre/speeches/future-of-fintech-and-regulation/> where Medcraft explains that ASIC’s philosophy underpinning the regulation of fintech involves ‘being flexible and adaptable to the speed and nature of the change; resisting the temptation to jump before we properly understand developments; ensuring — as far as we can — that our regulatory responses are technology neutral […]; ensuring we have the skills and expertise to be an effective regulator in this space’.


160 Not all cooperation agreements include referral mechanisms, but the agreement between the FCA and ASIC does.
These initiatives leave ASIC in a strong position to stay abreast of regulatory issues and developments with fintech in Australia and abroad. This will inform its approach to the regulation of crowd-sourced equity funding.\textsuperscript{161}

VI REVISITING THE CORPORATE FORMS AVAILABLE TO AUSTRALIAN BUSINESS

A A call for re-evaluation of the corporate form

Perhaps it is time to re-evaluate the corporate form in Australia. The bulk of Australian businesses are MSMEs, yet our corporations law is designed for the complexities presented by large enterprises. If we are to successfully construct and implement policies supportive of innovation and entrepreneurship, then we must consider whether the corporate forms currently available are conducive to our policy goals. The present array of corporate forms has little sensitivity to the full spectrum of sizes and level of sophistication of companies. This is brought into sharp focus by the difficulties presented in seeking to accommodate access to crowd-sourced equity funding for those companies most likely to be innovative start-ups. An evaluation of the corporate form could address a range of concerns for small enterprises. MSMEs fail at high rates and when they do fail, tend to fail cataclysmically,\textsuperscript{162} but there is no dedicated insolvency regime for these small entities. MSMEs could benefit from a corporate law regime that offers them a simplified

\textsuperscript{161} It is noted that other regulatory initiatives have been introduced in Australia to support fintech. This includes the regulatory sand box launched in December 2016. Sand boxes are increasingly used by regulators in working with fintech and disruptive technologies to provide an opportunity for testing. They are designed to assist fintech by reducing the costs of testing the business model and the time it will take for the enterprise to bring its product or service to market. However, since a crowd-sourced equity funding model would not be eligible for testing in the sandbox, this is not an initiative that at present supports fintech seeking to engage solely in crowd-sourced equity funding. A restricted range of financial services may be tested in the sandbox. The Regulatory Guide explains that some products and services are excluded as they are ‘illiquid and not easily reversed’: ASIC, ‘Testing Fintech Products and Services without Holding an AFS or Credit Licence’ (Regulatory Guide (‘RG’) 257, February 2017) RG 257.67. See also RG 257.20, RG 257.22-24, RG 257.70 <http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-257-testing-fintech-products-and-services-without-holding-an-afs-or-credit-licence/>; ASIC, Regulatory Sandbox <http://asic.gov.au/for-business/your-business/innovation-hub/regulatory-sandbox/>; Medcraft, ‘Future of Fintech and Regulation’, above n 157, 4–5.

dispute resolution process. Difficulties arising with the legal fiction of the separate legal entity are particularly acute in small closely held companies. Temptation to engage in wrongdoing, abusing the corporate form and limited liability is evident, for example in phoenix activity.\textsuperscript{163} MSMEs and their creditors would benefit from clearly articulated frameworks for veil piercing in closely held companies. While our current corporate law accommodates single person companies, and offers reduced red tape to small companies, more can be done.

Access to finance is critical to MSMEs. Crowd-sourced equity funding is one avenue supporting entrepreneurial and innovative enterprise, but there are others, including a proposal for a dedicated MSME security exchange.\textsuperscript{164} Such an exchange would provide a mechanism for broadening the range of capital and finance available to small entities.\textsuperscript{165} This is worthy of further consideration. So too is consideration of how to address cash flow difficulties. Due to constraints in accessing finance and capital, MSMEs can be particularly reliant upon cashflow. Mechanisms to assist cash flow such as a dedicated late payment regime would benefit MSMEs reliant on timely payment of debts in order to sustain their business. The Tungsten study in the UK revealed that late payments put a quarter of UK SMEs at risk of insolvency.\textsuperscript{166} MSMEs are vulnerable to the effects of late payment since it ‘disrupts cashflow, reduces profits, restricts growth, particularly with small firms who are least able to bear the additional costs of arising from payment delays’.\textsuperscript{167} Prompt payment is the subject of regulatory support and legislation in the UK and the EU,\textsuperscript{168} and is largely supported by scholars of public procurement, though there is some dissent about the best regulatory approach.\textsuperscript{169}

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\textsuperscript{164} OECD, New Approaches to SME and Entrepreneurship Financing: Broadening the Range of Instruments (2015). This report was prepared by Lucia Cusmano, Senior Economist, OECD Centre for Entrepreneurship, SMEs and Local Development.

\textsuperscript{165} Ibid.


\textsuperscript{167} Andrew Erridge, ‘Involved of SMEs in public procurement’ (1998) 2 Public Procurement Law Review 37, 41.


B A Simplified Business Entity Purpose Built for Small, Start-up and Emerging Innovative Business

Perhaps a simple extension of crowd-sourced equity funding to existing proprietary companies, with a limited range of safeguards, as proposed by the 2017 Exposure Draft will be an adequate response, however it will most likely still represent a missed opportunity. This article argues that consideration also ought to be given to introducing a simplified business entity in Australia. The focus of such a rethink ought to be on how to accommodate growth and changes in the way that companies might seek to access capital at different stages throughout their development. A purposefully designed simplified business entity could specifically target the needs of entrepreneurial and innovative enterprise, accommodating its need to take risk while carefully managing the more concerning aspects of their risk profile, including for example, investor protection.

Such an entity should have limited liability and be a separate legal entity as these are vital to supporting risk-taking in business and investment. Accountability, governance and reporting requirements exist for the protection of investors and to ensure confidence in markets. These requirements could be designed flexibly, scaling up based on a range of features such as capital-raising methods and investor profiles; these are features which may change as the entrepreneurial or innovative enterprise develops. Such an entity ought not to be designed to be a half-way house or stepping-stone amid existing corporate structures. That is, the entity ought to be flexible enough to accommodate the entity throughout its life-cycle, with no requirement or expectation of transition or incorporation into a more sophisticated, traditional form at later stages of growth or fundraising. Accommodating such flexibility will require that the simplified business entity sit outside the public/private company dichotomy.170

A rethink framed in terms of flexible design to meet the needs of entrepreneurial or innovative enterprise through various stages of growth would enable us to identify and evaluate inherent or antiquated inflexibilities in our corporate law. The introduction of the CFSA has demonstrated key inflexibilities of a system dividing limited liability companies into those that are proprietary and those that are public, and raised questions as to whether the distinction remains necessary.171 New Zealand’s practices and late payment in UK companies’ (2001) 28(7 & 8) Journal of Business Finance and Accounting 1013; Nicholas Wilson and Barbara Summers, ‘Trade Credit Terms Offered by Small Firms: Survey Evidence and Empirical Analysis’ (2002) 29(3 & 4) Journal of Business Finance and Accounting 317. For dissection on regulatory approach see Rafeal Baron, ‘Ending the Commercial Siesta: The Shortcomings of European Union Directive 2011/7 on Combating Late Payments in Commercial Transactions’ (2013) 38(2) Brooklyn Journal of International Law 699. This view is shared by some industry groups including Small Business UK: Ben Lobel, Late payment terms remain miserable for small business <http://www.smallbusiness.co.uk/news/outlook/2498991/late-payment-terms-remain-miserable-for-small-businesses.html>.

170 It is worth recalling that the distinction between proprietary and public companies first appeared in Australia upon the introduction of new audit and reporting requirements for companies; the introduction of proprietary companies, facilitated flexibility for small companies by exempting them from these requirements. See: Companies Act 1896 (Vic); R P Austin and I M Ramsay, Ford, Austin and Ramsay’s Principles of Corporations Law (16th ed 2015) [5.130].

171 The Senate Committee considering the Crowd-sourced Equity Funding Bills acknowledged how this might be addressed via an expansion of categories of proprietary companies or the introduction of hybrid companies. See Senate Economics Legislation Committee, Parliament of
decision to abolish the distinction between public and private companies underpins the present flexibility of its corporate law to facilitate access to various forms of capital raising, including crowd-sourced equity funding.\textsuperscript{172}

The Productivity Commission recommended consideration of the feasibility of a new simplified business entity conducive to the specific needs of entrepreneurial and innovative business.\textsuperscript{173} It observed that such an inquiry would raise tax issues, and recommended that it be undertaken as part of Treasury’s concurrent, broad-scale review into the tax system: the White Paper on the Reform of Australia’s Tax System.\textsuperscript{174} Neither the White Paper nor the recommended rethink into the feasibility of a simplified business entity occurred. The White Paper stalled upon a change of leadership in the government, and while no paper or report was issued, Treasury indicates this Inquiry is complete.\textsuperscript{175}

This article argues that the re-evaluation of the corporate form should take place, and that it take a similar approach to that adopted by UNCITRAL Working Group I: to think small first. This working group is identifying new simplified pathways for MSMEs in formation, dispute resolution, access to finance, access to credit, and insolvency.\textsuperscript{176} It has approached this task by identifying legal obstacles that these enterprises may face throughout their life cycle. While the work of this group is ultimately directed at assisting developing countries, the identification of obstacles and establishment of best practice in the developed world has revealed that much of the complexity of corporate law is outdated and unnecessary for most business.\textsuperscript{177} The ‘think small first’ approach has been taken to ensure that the model developed will work well for MSMEs, and provide a ‘predictable and stable corporate framework to support trade, entrepreneurship, and economic progress that promotes good commercial behaviour and deters corruption’.\textsuperscript{178}

The minimum needs of MSMEs were

\textsuperscript{172} New Zealand Law Commission, Company Law Reform and Restatement (Report No 9, 1989), 18, 58. The classification of public and private companies was described by the Commission as ‘crude’, inflexible, and unnecessary given the variety of ways the law protected investors and the public interest. See ibid 32, 55, 58.

\textsuperscript{173} Productivity Commission, above n 4, Recommendation 3.1, 93-95.


\textsuperscript{175} Treasury, Reviews and Inquiries Reviews and Inquiries <http://www.treasury.gov.au/ConsultationsandReviews/Reviews>.


\textsuperscript{177} Secretariat, ‘Draft Legislative Guide on an UNCITRAL Limited Liability Organization: A Note by the Secretariat, Working Group I (MSMEs), Twenty-seventh Session, Vienna, 3-7 October 2016’, 5.

\textsuperscript{178} Ibid 6.
broadly identified as *freedom, autonomy and flexibility; speed and simplicity; identity and visibility; certainty in and protection of their property rights; and to control and manage their business.*\(^{179}\) The Working Group agreed that these goals could not be achieved by simply reforming ‘outdated company law regimes, but rather to develop a separate and innovative approach, based on the collective experience of the delegations, and to specifically tailor it to MSMEs’.\(^{180}\)

The array of models considered thus far by UNCITRAL can inform consideration of an appropriate form of a simplified business entity and suggest what might be possible to achieve in reconsidering the range of available corporate structures in Australia. First, a simplified model law proposed by Germany and France contained just 12 articles, three of which dealt with insolvency, restructuring and the resolution of disputes with creditors.\(^{181}\) Secondly, the French Entrepreneurial SAS has been examined.\(^{182}\) In this entity, the entrepreneur receives limited liability without incorporating, but must nominate which of its assets are to be available to creditors and which are personal assets protected by limited liability. A third model considered the Italian approach to allowing small entrepreneurial and innovative enterprise to form a networked enterprise, the *contratto di rete*.\(^{183}\) This limited liability enterprise allows for asset segregation and is designed to facilitate cooperation between entrepreneurial enterprise. The benefits of this model are that it ‘facilitates internationalization of MSMEs and cross-border cooperation’ and assists small and start-up entities to achieve scale by serving as a ‘tool to link MSMEs to larger companies by permitting MSMEs to be connected to the supply chain of such companies’. The fourth model considered was the Colombian Simplified Corporation (‘SAS’).\(^{184}\) Members and managers are protected by limited liability. Disputes arising in internal management and those with outsiders are subject to arbitration.\(^{185}\) Through this process of consideration and evaluation of various models, it has been revealed that one of the benefits of reviewing the fitness of corporate law to meet the needs of small business, is the flow-on benefits to streamlining and improving corporate law generally for all businesses.\(^{186}\)

The success of any simplified entity is predicated upon the legal framework in which they might be implemented having a strong insolvency regime, a legal regime that imposes fiduciary duties on the managers of the entity and a well-financed,

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179 Ibid 4–5.
180 Ibid 5.
185 Ibid. The model legislation is set out in this document.
186 Ibid 2.
efficient and active regulator. These are strengths of the Australian legal system and suggest that a simplified legal entity purposefully designed to meet the needs of entrepreneurial and innovative enterprise might function well here.

VII CONCLUSION

This article has considered regulatory challenges underlying the introduction of crowd-sourced equity funding in Australia. The policy imperative was framed in terms of how best to create an environment supportive of entrepreneurship and innovation. A central challenge facing entrepreneurial and innovative companies is access to finance. While capital requirements may not be a barrier to market entry, access to capital is fundamental to survival and success. Under capitalisation is persistently reported as a contributing factor of company failure.187 Crowd-sourced equity funding is the new tool in the access to finance tool-box for Australian companies, but its restriction to public, unlisted companies may well prove to be a barrier to entry for the very firms that this form of capital raising is best placed to assist. A simple extension to existing proprietary companies may also not be entirely effective.

This article has argued that the regulatory challenge is not simply accommodating crowd-sourced equity funding into our existing regulatory framework. The struggle to accommodate access to crowd-sourced equity funding for both proprietary and public companies, is revealing of the lack of flexibility inherent in our existing legal framework to support innovation, entrepreneurship and start-ups. Rather than tinkering at the edges of the law, what is called for is a rethink of the range of corporate forms in Australia and their suitability for supporting entrepreneurship and innovation. Such a rethink may be timely given that technological disruption of corporate law is likely to continue apace and may extend to new forms of corporations made possible by new and innovative technologies.188

Nevertheless, there is a balance that must be struck between enabling enterprise to pursue the economic benefits of innovation and entrepreneurship on the one hand and ensuring confidence in markets through the protection of investors on the other. The risks in extending crowd-sourced equity funding to any small legal entity (irrespective of corporate form) include that they are simply unprepared or unable to afford to operate with the level of sophistication required when raising large capital sums. The failures and delays associated with over-subscribed reward-based crowd funding are suggestive of this. It is important in all our considerations of how to support small, entrepreneurial, start-up and innovative enterprise that we focus on

supporting growth in a responsible way. These concerns ought to remain front of mind in the development and consideration of all aspects of any simplified entity.