EQUITY CROWDFUNDING IN NEW ZEALAND:
A PROGRESSIVE EXPERIMENT

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Equity crowdfunding in New Zealand: A progressive experiment

Abstract

When the first tranche of provisions of the Financial Markets Conduct Act 2013 ('the FMC Act') came into force on 1 April 2014, a new licensing regime for crowdfunding service providers ('CSPs') was introduced into New Zealand law – one of the most progressive and innovative operating in the world today. The regime works on the basis that an offer of financial products to an investor does not require the FMC Act's standard disclosure documents necessary for an initial public offering, if the offer of financial products is by, or through, a licensed CSP and the offer is under the market service licence held by the CSP.

The paper starts with an overview of the nature of equity crowdfunding and how it implicates securities law. It then briefly outlines how this activity was regulated in New Zealand previously and discusses how the new regulatory framework operates. The final part of the paper describes how the crowdfunding markets have developed in the last two years and identifies future developments and potential threats to the operation of New Zealand's crowdfunding regime.

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1. Introduction

When the first tranche of provisions of the Financial Markets Conduct Act 2013 ('the FMC Act') came into force on 1 April 2014, a new licensing regime for crowdfunding service providers ('CSPs') was introduced into New Zealand law – a regime that is one of the most progressive and innovative operating in the world today. The regime works on the basis that an offer of financial products to an investor does not require the FMC Act's standard disclosure documents necessary for an initial public offering if the offer of financial products is by, or through, a licensed CSP and the offer is under the market service license held by the CSP.

The paper starts with an overview of the nature of equity crowdfunding and how it implicates securities law. It then briefly outlines how this activity was regulated in New Zealand previously and discusses how the new regulatory framework operates. The final part of the paper describes how the crowdfunding markets have developed in the last two years and identifies future developments and potential threats to the operation of New Zealand's crowdfunding regime.

2. Growth of s Crowdfunding

A. The Social Media Phenomena

Crowdfunding as a means of raising funds for not-for-profit or for-profit enterprises has received a great deal of attention globally in recent years. The advantage that crowdfunding has over more traditional models of financing is that it uses social networks as the medium for attracting financing. "Social networks have the potential for using crowdfunding to reach large numbers of people. Since crowdfunding is designed to reach a large number of people, limiting the fundraising request to a small amount from each donor can provide meaningful funding" (Hazen 2012, pp 1736-1737)). Crowdfunding has been recognised in New Zealand, as it has been elsewhere, as a potentially rich source of financing for charitable, social or business projects and ventures. Bellaflame et al (2014, p 586) observed that it is a concept that originates in the "broader concept of crowdsourcing, which refers to the 'crowd' to obtain ideas, feedback and solutions to develop corporate activities." In contrast for crowdfunding the objective is to collect money for a specific venture, project or business through a variety of financing models that use the Internet, generally through social networks (Twitter, Facebook, LinkedIn and other specialised blogs). The term 'crowdfunding' encompasses a variety of business financing models that all use the Internet.

B. Types of Crowdfunding Sites

There is growing international literature on crowdfunding, and the following is a summary of the different types of this form of fundraising. Bradford (2012) identified five types of crowdfunding activities, which are distinguished by what investors are promised in return for their investment or contribution. These are (1) the donation model; (2) the reward mode; (3) the pre-purchase model; (4) the lending model—sometime referred to as peer-to-peer lending; and (5) the equity model. Bradford (2012) observed that while the first three of these models have not attracted the attention of financial market regulators, the same cannot be said for peer-to-peer to peer lending and equity crowdfunding.

What equity crowdfunding enterprises offer investors, in return for their investment in a business or enterprise, is something of value. This may include shares in a new company or a right to a share of profits and it is this characteristic which brings the activity to the attention of regulators and policymakers. Worldwide, equity crowd fundraising has been slow to develop due to the possibility that this form of capital raising may invoke wider primary market securities law that in general strictly regulate, through various registration and disclosure hurdles, the raising of funds from the public. However, some countries have moved to encourage equity crowdfunding recognising that it provides the opportunity for small and medium companies to access capital that may not otherwise be available.

The International Organization of Securities Commissions ('IOSCO') Committee for the Regulation of Market Intermediaries published a report of responses to a survey it had carried out to gauge members' current or proposed crowdfunding regulatory programs. The IOSCO Committee observed a "variety of approaches to regulating crowdfunding" (IOSCO 2015, p. iii) although there were some high-level similarities. An identified common objective was to achieve a "balance between risks/investor protection related concerns and the positive role securities markets can play in supporting economic recovery and growth through the promotion of crowdfunding" (IOSCO 2015, p 111).

Kirby and Worner (2014), in an earlier IOSCO staff working paper, identified three regulatory responses to regulating crowdfunding. The first is where the regulator bans equity crowdfunding. In the second option, equity crowdfunding is legal, but there is regulation that creates high barriers to entry; in these jurisdictions, there is no equity crowdfunding market. Under the third regime, equity crowdfunding is permitted, but there are strict limits on who can invest, the number of investors allowed to invest, the size of the company issuing equity or other similar regulatory requirements. The crowdfunding regime in New Zealand falls within this third category of regulatory responses, although as outlined in this paper, the level of controls on investors and issuers are relatively light-handed (Minister of Commerce Cabinet Paper 2011).

3. Crowdfunding Regulation in New Zealand

A. Policy Objectives and Crowdfunding

In New Zealand, the Securities Act 1978, before 1 April 2014[1] controlled the raising of funds from the public who, in exchange for their investment, acquired an interest in certain identified forms of securities. Any entity wishing to offer securities to the public for subscription was required to comply with the disclosure requirements of the Securities Act. These included preparation of extensive disclosure document encompassing both a lengthy and heavily prescribed prospectus and an investment statement. Furthermore, the drafting of certain definitions in the Securities Act, together with a number of amendments to the disclosure rules and the addition of a number of new exemptions, had combined to create uncertainty as to which fundraising arrangements were subject to the Securities Act and which offers were not (Ministry of Economic Development 2010). These factors together with the serious potential consequences for noncompliance had resulted in an environment where the permitted exemptions were interpreted very narrowly, an outcome that was considered counterproductive to the development of New Zealand's capital markets.

A government review of New Zealand's securities law in 2010 observed that "narrow exemptions…harm investors by preventing them from participating in private securities offers" (Ministry of Economic Development 2010, p 47), and also harm businesses seeking funding. The review recommended significant changes to be made to New Zealand's securities laws, including reforms to free up private markets and for securities law to build stepping stones from private fundraising to public share markets. The recommendation reflected the very tight commercial lending market that existed in New Zealand at the time.

However, the Securities Act 1978 did not prohibit equity crowdfunding. Instead this form of fundraising, together with peer-to-peer lending, simply triggered the disclosure requirements of the Securities Act, which was not a viable option for early-stage businesses seeking small amounts of capital (Barrett 2012). Exemptions from the disclosure requirements of the Securities Act were possible if the securities were only offered to eligible persons (wealthy and/or experienced investors),[2] professional or large investors[3] or other persons with close association to the issuer.[4] Barrett (2012) observed that none of these exemptions was conducive to equity crowdfunding. Furthermore, although the Securities Commission and its successor the Financial Markets Authority ('the FMA')[5] had authority to grant individual exemptions to issuers from the Securities Act's disclosure rules, exemptions for fundraising via crowdfunding were unlikely to be granted given the courts' narrow interpretation of the exemptions generally (ibid.). The interpretation had its origin in the view that the predominant policy objective of the Securities Act was consumer protection, and this could be best achieved through full disclosure to consumer investors.

However, the express purposes of the Financial Markets Conduct Act 2013 as set out in section 3 and 4 make it clear that protection of consumers is only one of the parties whose interests need to be considered. Section 3 provides:

3. 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.

The objectives of confident and informed participants in the financial markets which are fair, efficient and transparent are supplemented by additional purposes in section 4:

4. 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 market 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.

Gibbons (2014, p. 16) observed:

> [O]ne of the key things achieved by the purpose provisions of the FMCA is that the various purposes of securities law are given better relativity, and investor protection is made less central. This is important in creating the right incentives, both for issuers and for investors. It also avoids the simple (perhaps simple-minded) approach that some case law seems to support, where investor protection is everything, and other purposes of securities law are subservient or ignored. It is submitted that a simplistic approach is the wrong approach: under the FMCA, different aspects of purpose must be weighed and balanced more evenly.

The last objective of section 4 – innovation and flexibility in the financial markets – is one that permeates the approach taken to crowdfunding regulation in New Zealand. Regulatory flexibility is achieved by the design of the framework regulating crowdfunding in New Zealand. First, the FMC Act contains a number of mandatory requirements that apply to all regulated intermediaries (which include CSPs). The requirements include recordkeeping and reporting obligations, and FMA has oversight and enforcement powers. There are also specific requirements that apply only to CSPs, which are supplemented by more detailed requirements in the Financial Market Conduct Regulations 2014 ('FMC Regulations'). Finally, FMA is able to stipulate additional conditions for particular types of service providers. Conditions can be modified by FMA at any time as innovations in financial products occur or to address any perceived gaps in the regulatory framework.

The approach taken in New Zealand is to regulate through licensing persons who undertake crowdfunding services. Minister of Commerce Cabinet Paper (2011), while recording the government's approval of a new licensing regime for regulated intermediaries, stated that the regime will

> [a]llow new intermediaries to be authorised by FMA to provide certain types of services. A person licensed as a regulated intermediary would be able to take on responsibility for meeting certain regulatory requirements, such as disclosure, record keeping etc, on behalf

of an issuer. This regime would be used where it is impractical for an issuer to meet the requirements of securities law and a supervised intermediary is better placed to do so.

Section 390(1) of the FMC Act provides that a person may hold a market services licence to act as a CSP or peer-to-peer lending intermediary, although the FMC Act is drafted to allow other forms of intermediary service to be added by later regulation. FMC Regulation 185 defines a CSP as when a person provides a facility by means of which offers of shares[6] in a company are made and the "principal purpose of the facility is to facilitate the matching of companies who wish to raise funds with many investors who are seeking to invest relatively small amounts." Therefore, the form of crowdfunding authorised under the FMC Act and the FMC Regulations is limited to equity crowdfunding. The following subsection discusses the eligibility requirements in more detail.

B. CSP Licensee Criteria under the FMC Act and the FMC Regulations

One of the most important of criteria for any service provider seeking a licence from FMA is to be registered under the Financial Service Providers (Registration and Dispute Resolution) Act 2008. Any financial service provider wishing to operate in New Zealand must be registered under this Act, and details of the entity, its business and management are then available to be searched on an online public register. To be registered, the provider must also be a member of an approved dispute resolution service, details of which are shown on the online register. In terms of the specific requirements for intermediary services such as a CSP under the Financial Service Providers Act, the regulator – namely, FMA is required to undertake an assessment of the applicant's suitability to operate as a CSP. As part of this process, an applicant's directors and senior managers must certify that they are fit and proper persons to hold their respective positions. Furthermore, FMA must be satisfied that the applicant is not likely to contravene its licence obligations and that the applicant "must be capable of effectively performing the service" (FMC Act, section 396(1)).

FMC Regulation 186 details additional eligibility conditions for a CSP. These include that the provider has adequate policies and procedures for identifying and managing the risk of fraud by issuers using the service. The policy should also operate to exclude any issuer that a provider considers is unlikely to comply with the obligations imposed on it by the CSP. Accordingly, the regime places the responsibility for conducting due diligence and vetting of offerors on each CSP, who must disclose their selection criteria to potential investors at the time such investors sign up with an individual CSP. There is no requirement for a CSP to make publicly available its selection criteria, although the websites for the leading crowdfunding providers in New Zealand (Snowball Effect, PledgeMe and Equitise) do provide general guidance to potential issuers seeking to undertake equity crowdfunding on how their respective selection processes work. The most successful CSP at the time of writing (Snowball Effect) has reported that less than 2 per cent of companies that express interest in raising funds on its platform make it to the marketplace (Daniell and Rose 2016) which suggests that at least at the top end of the market, rigorous screening of potential issuers occurs.

All licensed CSPs are also required to make sure there are certain mandatory warnings on their respective websites and to have in place adequate disclosure arrangements to enable investors to readily obtain timely and understandable information in relation to any share acquisition decision, including initial disclosure or question-and-answer forums. A CSP must also have an adequate fair dealing policy and procedures for excluding an (existing) issuer from using the service if the provider has reason to believe that the issuer has engaged in conduct that is misleading or deceptive, in contravention of sections 22 and 23 of the FMC Act.

In addition, all crowdfunding service providers must have adequate systems and procedures for ensuring that an issuer does not raise more than $2 million in any 12-month period. This is the only financial limit in the FMC Act and FMC Regulations as, unlike regimes in other jurisdictions, there is no limit on how much an individual investor can invest through equity crowdfunding in any year or in total. There is also no rescission, cancellation or cooling off period as found or proposed in other jurisdictions (IOSCO 2015). There are also no limits on the size of the issuer, although to date only small and medium entities have undertaken equity crowdfunding to retail investors. As discussed later in the paper, the lack of limits on the amount an individual investor can invest or on the size of an issuer has allowed some CSPs to develop new services providing the infrastructure for non-crowdfunding issuers seeking capital from private or wholesale investors. These initiatives are likely to assist some CSPs to become more financially viable as they develop their business models (Smylie 2016a).

C. FMA's Standard Licence Conditions and Specific Conditions for Individual Licensees

The final layer of regulation in the licensing of a CSP is the power given to FMA under the FMC Act to impose conditions on any licensee and to revoke, add to or alter such conditions at any time (sections 402-403). FMA has adopted a two-step approach to laying down conditions. First, it has published, and recently amended, a document setting out the standard conditions for crowdfunding service licences. The FMA describes these conditions as minimum standards that the FMA expects providers to meet. While a number of the standard conditions simply explain FMA's expectations as to conditions imposed by the FMC Act or the FMC Regulations, others provide an insight into FMA's concerns as to the risk of platform failure as evidenced by the requirements to disclose to FMA any negative net tangible asset ('NTA') calculation and the need for independent audit of such processes. The standard conditions were updated for a second time in March 2016 after FMA had undertaken consultation at the end of 2015. The major change was to the financial resources standard condition that now details how CSPs must calculate their NTA and notify FMA as soon as practicable if it is negative. This calculation is required to be undertaken monthly and on other dates if there is a reason to suspect that a CSP's NTA is not positive.

There have also been changes to the condition clarifying that a qualified auditor must be appointed to prepare a report in respect of the calculation of the NTA during the accounting period. This report is required to be sent to FMA at the end of each accounting period. As discussed later, there has already been one CSP which closed in New Zealand due to increasing competition in the market. FMA also has the power to impose specific conditions on individual licensees. All eight crowdfunding providers licensed to date have special conditions imposed for their registration under the FMC Act. The most common conditions are that service providers must not provide any secondary market for the equity securities offered through its service unless and until FMA approves that secondary market and that the provider will maintain the same or better standards of capability, governance and compliance as was the case when FMA assessed the provider's application.

D. Reporting and Record Keeping Obligations and Enforcement

The FMC Act also specifies a number of reporting and record keeping requirements that apply to all licensees under Part 6 of the FMC Act. First, there is a general requirement on all licensees to report to FMA that is triggered by certain events such as insolvency, bankruptcy of directors, senior managers and key personnel or civil, criminal, regulatory, or disciplinary proceedings being taken against the licensee, an authorised body, director, senior manager or key personnel (FMC Act, section 412 and FMC regulation 191). Also, any changes in directors, senior managers or key personnel or the auditor, a change of name or legal structure, entry into a major transaction, or a person obtaining or losing control of the licensee or an authorized body must be reported. In relation to crowdfunding licensees, FMC Regulation 195 requires CSPs to notify FMA if they know or suspect that an issuer has committed a significant breach of the fair dealing provisions of the FMC Act or a contravention of the $2 million limit.

FMA has a range of powers in the event of a material contravention or likely contravention of a licensee's obligations, a material change in the circumstances of the licensee or the licensee has provided materially false or misleading information in the licence application or any application to amend the license. Section 410 defines a material change of circumstances as a change that adversely affects the licensee's capacity to perform the market service covered by the license or a change that means the requirements of the FMC Act as to the conditions and requirements of a licensee are no longer met. FMA's enforcement powers include censure, requiring licensees to submit an action plan of corrective measures and give directions. In addition, FMA may suspend a license in such circumstances or revoke, vary or substitute any conditions of a license (FMC Act, section 414 (1)-(4)). A suspension can be for a specified period or until a specified requirement is met. A license can be suspended or cancelled under section 408 if the licensee requests FMA to do so, or FMA is satisfied that the licensee or an authorised body has died, ceased to exist or become incapacitated, or become subject to an insolvency event; or as a result of enforcement action by FMA.

4. Disclosure Obligations of Crowdfunding Service Providers

As stated above, the FMC Act places the responsibility on individual CSPs in terms of the protections for consumer investors. This is mainly achieved through three disclosure requirements in the FMC Act and Regulations. First, each CSP must ensure that on its website platform there is a warning statement about the risks of crowdfunding. The warning statement must be on the site's homepage, on a page before the investor uses a site to apply for a product, and also on all application forms. FMC Regulation 196 requires that the wording to be used on the warning statement is as follows:

> **Warning statement about crowdfunding**
>
> Equity crowdfunding 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.
>
> (*Omit these sentences if the facility is confined to issuers for whom the sentences would be inapplicable.)
>
> 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.

Accordingly, the warning statement only deals with generic risks that may arise out of equity crowdfunding. It does not address the risks of individual issuers, such as any unique risk to any individual issuer or increased risk associated with particular industry types.

FMC Regulation 197(1) also provides that a provider must obtain, from investors, confirmation that they have seen the warning statement and understand that the investment is risky on the following terms:

I confirm that I have seen the warning statement about crowdfunding and—

- I understand that equity crowdfunding is risky and I may lose my entire investment; and
- I confirm that I could bear that loss without suffering undue hardship; and
- I understand that the usual legal protections do not apply to this investment; and
- I understand that I may not be given the same information as is usually required by New Zealand law for investments.

The confirmation must be obtained in writing in a separate document or, if it is obtained by electronic means, through a process by which it is obtained separately from the agreement to use the service. Furthermore, the confirmation must be obtained by the provider before the investor is authorised to use the service (FMC Regulation 197(2)-(3)). It is concerning to note that there is no requirement to warn investors that selling shares in crowdfunded company may be difficult given the illiquid nature of most securities in non-listed companies. It is likely that many retail investors may not appreciate the difficulties if they need to divest themselves of shares at a later stage. A warning to this effect is present on FMA website and some of the licensed platforms are including statements warning of on-sale problems.

Second, licensed CSPs are also required to provide a disclosure statement to retail investors (FMC Act, section 423). The stated statutory purpose (FMC Act, section 425) of a disclosure statement is to provide information that is likely to assist a retail investor in deciding whether to proceed with the service provided by the CSP or to change any instruction in relation to the service. A disclosure statement must be given before the investor enters into a client agreement. A disclosure statement for a crowdfunding service is called a Service Disclosure Statement or 'SDS', and FMC Regulations 215(a)-(h) prescribe that it must contain a brief description of all of the following matters:

- the nature of the service provided;
- how investors apply for, and obtain, access to the facility and the eligibility criteria that apply. Accordingly, individual service providers are able to impose criteria on investors who use this site;
- how issuers apply for, and obtain, access to the facility and the eligibility criteria that apply;
- how investments are made and financial products are issued under the service;
- how investor money is received and dealt with.

In addition, the SDS must state the nature and extent of the checks and assessments made by the provider of the following:

- each issuer that offers financial products under the service;
- the directors and senior managers of those issuers; and
- the risks involved in those financial products (or, if checks and assessments of those risks are not made as part of the service, a statement to that effect).

The SDS must also set out any fees that an investor will have to pay to a CSP as well as contact details for the provider, how investors may complain about the service to the provider and details of the compulsory dispute resolution scheme for all intermediary services. Finally, an SDS must be accompanied by any required documents and comply with all other requirements of the FMC Regulations (relating to content, form, presentation, and similar matters).

If a SDS contains a statement that is false or misleading or is likely to mislead, or there is an omission from the disclosure statement of any required information and the statement or omission is materially adverse from the point of view of the retail investor, the contravention may give rise to civil liability under the FMC Act (sections 427 and 449(3)). If FMA seeks to impose a civil pecuniary penalty for such contravention then the maximum fine will be the highest amount of consideration for the relevant transaction, 3 times the amount of the gain made or loss avoided and $ 1 million in the case of an individual or $5 million in any other case (s 449(2)). There are also criminal sanctions under section 511 if a person or entity knowingly or recklessly provided a false or misleading disclosure statement, which includes a SDS, or one that contains an omission of required information, where the misstatement or omission is materially adverse from the point of view of an investor. It is also an offence to provide a service to a person who has been provided with a false or misleading disclosure statement.

The third document regulating the relationship between an individual CSP and an investor is a contract called a client agreement (FMC Act, section 430, FMC Regulations 224, 225, 227). In general, the agreement must provide adequately for the use and operation of the facility, including how investors and issuers apply for and obtain access to the facility and the eligibility criteria in each case. In addition, it must state how investments are made, how financial products are issued under the service and how investor money is received and dealt with, to the extent that this is part of the service.

5. The Regulatory Framework: Other Rules

No specific rules regulate the disclosures made by issuers seeking equity crowdfund raising, either in relation to the material disclosed to potential investors interested in acquiring shares in the issuer or requiring on-going or periodic disclosures to any new shareholders if the campaign is successful. Issuers are, however, bound by the following general rules of the FMC Act and the Companies Act 1993, which regulates corporate disclosures.

A. Fair Dealing

Part 2 of the FMC Act introduced a new principles-based, fair-dealing regime generally applying to all financial products and services supplied under the FMC Act or other financial markets regulations, unless exempted. The key provision –section 19 – sets out a broad prohibition against false and misleading statements about financial products and financial services. Additional sections prohibit the making of false or misleading statements and unsubstantiated representations (sections 20-23). Therefore, the fair dealing regime does apply to any statements, projections or representations to potential shareholders made by an issuer seeking crowdfunding equity. However, one of the exemptions to these rules is conduct that contravenes section 427 of the FMC Act since such conduct is subject to separate liability. Section 427, discussed above, prohibits a licensed service provider from providing a SDS, or providing the service to a person who was required to be provided or has been provided with a disclosure statement, that contains a false or misleading statement or omits required information.

However, a contravention of any of sections 19 to 23 of the FMC Act will only give rise to civil liability. Under subpart 3 of Part 8 of the FMC Act, FMA cannot seek pecuniary penalties for breach of certain provisions, which include these sections.[7] For FMA to seek a pecuniary penalty order, the High Court must first make a declaration that the person contravened a civil liability provision. The declaration of contravention can also be used by any person, such as an investor who has suffered a loss because of the contravention, to make a compensation order in favour of such a person (FMC Act, section 494(1)). At the time of writing, FMA has not taken any actions against corporate crowdfunders, but it is clear that the regulator is monitoring such disclosures. One issue that media articles have highlighted is the perceived self-assigned valuation of assets and future forecasts (Smylie 2015a). While FMA's response to date has been to warn investors to do their own research or seek the advice of financial advisers, it is unlikely that investors do understand the risks involved, especially with respect to valuation methods and the instability of start-up businesses.

B. Companies Act 1993 and Financial Reporting Requirements

An issuer, who makes a regulated offer under Part 3 of the FMC Act, is classified as a FMC reporting entity. As a FMC reporting entity it is subject to the reporting and disclosure requirements of the FMC Act. The only exception is when the entity has less than 50 shareholders (FMC Act, section 452). All FMC reporting entities (which include licensed service providers) are required to prepare general purpose financial statements and have them audited by a qualified auditor within four months of the end of the financial year ('balance date'). In addition, copies of the statements and audit report must be lodged with the Registrar of Companies (FMC Act, section 461H). Corporate issuers, which are incorporated under the Companies Act 1993, are also bound to include the statements and report in the annual report which is sent to shareholders prior to the annual meeting (Companies Act 1993, s 209). Furthermore, if the issuer is also listed on the New Zealand Stock Exchange (NZX), then it also subject to additional periodic disclosure requirements and the continuous disclosure rules contained in the NZX Listing Rules.

Small-medium ‘private’ companies have lesser reporting and ongoing disclosure requirements, although as discussed below, some companies which have increased the number of shareholders through equity crowdfunding, will have identical disclosure and reporting requirements to those applying to a FMC reporting entity. Under Part 11 of the Companies Act 1993, there are five categories of companies that may trigger these reporting requirements. However, only two are potentially relevant to crowdfunding issuers. The first is if the company is classified as ‘large.’ A large company is one that in any accounting period either its revenue is greater than $30 million or assets exceed $60 million.[8] The second category, which is more likely to apply to crowdfunding issuers is any company with 10 or more shareholders. However, a company which has 10 or more shareholders (and is not a large company or a public entity) and the constitution does not preclude it from ‘opting’ out, then 95 per cent of shareholders, entitled to vote and voting at any meeting within the opting period, may vote to opt out of all or any the requirements to prepare financial statements that comply with generally accepted accounting practice (‘GAAP’) and to appoint a qualified auditor (Companies Act 1993, sections 201, 206).

At first glance the reporting requirements would appear to catch most companies that have undertaken successful equity crowdfunding campaigns as it would be unlikely that such companies would be able to muster the 95 per cent vote necessary to opt out. However, a significant number of the campaigns have offered non-voting shares to their new investors, and the voting shares remain controlled by the original founders or substantial investors. In such cases, the original (voting) shareholders may be in a position to opt out of these requirements. Finally, any company that is caught by the Companies Act 1993 requirements, as outlined above, is also required to prepare an annual report that must be sent to shareholders in the same manner as for FMC reporting entities.

All companies incorporated under the Companies Act 1993 are required to call an annual meeting within six months of the balance sheet date and not later than 15 months after the previous annual meeting (Companies Act 1993, section 120). However, it is possible to waive the requirement for calling an annual meeting if 75 per cent of shareholders sign written resolutions covering all matters that need to be passed at such a meeting (Companies Act 1993, section 122). Accordingly, most equity crowdfunded companies will need to call an annual meeting, although as discussed above, some issuers may be able to avoid this requirement, especially if they have issued non-voting shares to their new investors.

6. The New Zealand Regime – An Analysis

A. Platforms

In New Zealand, in just over two years since New Zealand's crowdfunding legislation came into force, the equity crowdfunding space is already becoming crowded, as eight crowdfunding service providers have been licensed.[9] The first two CSPs to be licensed have continued to dominate equity crowdfunding activity in New Zealand. These are 'Snowball Effect' and 'PledgeMe'. The financial statements for both companies indicate that neither made a profit for the financial year ending 31 March 2015, although it is reported that Snowball Effect forecasts a small profit for the 2016 financial year (Boot 2016). PledgeMe was an established donation and reward funding platform (Murray 2015) that extended its operations to equity crowdfunding. Its website accessed on 15 June 2016 states that it has successfully undertaken 12 equity fundraisings, with one of its early campaigns raising $500,000 for a craft brewer, the Yeastie Boys, in 30 minutes. Snowball Effect has been the most successful of the CSPs (Murray 2015) and it reports that it has 70% of the crowdfunding market in New Zealand (Boot 2016). Also, in April 2016 its application for a peer-to-peer lender or debt crowdfunder service provider was approved by the FMA.

Murray (2015) argued that Snowball Effect and PledgeMe are serving distinct market segments with larger, more established companies seeking larger amounts using The Snowball Effect. Snowball Effect was also the first service provider to run a campaign only open to wholesale investors[10] who were offered convertible notes. Offers to wholesale investors are also exempted from complying with the standard disclosure requirements for regulated offers under the FMC Act (schedule 1, clause 3). Accordingly, while convertible notes do not fall within the definition of shares and cannot be offered to retail crowdfunding investors, Snowball Effect is diversifying the services it provides by offering its facilities set up for retail crowdfunding to companies seeking wholesale investors. These facilities include technology to verify investor identity in order to comply with anti-money laundering obligations, electronic signing of legal documents and managing payments through the online platform (Smylie 2015c).

Other service providers are also endeavouring to carve out distinct markets. Equitise is an Australian company registered in New Zealand and promotes itself as a trans-Tasman investment platform. It was set up pending crowdfunding legislation in Australia being enacted and currently Australian companies are raising funds on Equitise's New Zealand platform under the trans-Tasman Mutual Recognition Scheme which is regulated by both the Australian Securities and Investment Commission (ASIC) and FMA.

Liftoff has a specific Māori, or indigenous, business focus and promotes itself as providing a partnership model. However, its first two campaigns failed (Smylie 2015b). Crowdcube is a New Zealand company that is a joint venture between Armillary Private Capital and UK-based Crowdcube which was founded in 2010. The latest crowdfunding service provider, AlphaCrowd, states that it is going to focus on digital and technology companies and has at the time of writing launched two campaigns. It has also reported that it intends to focus on targeting Chinese investors. Another platform, Propellar also has significant Hong Kong based support. However, one CSP – 'My Angel Investment Ltd' – which was licensed in March 2015 to target science and engineering companies, has already ceased to operate. It announced in March 2016 that for financial reasons it was not able to continue and had only run one unsuccessful campaign in 2015. The closure of My Angel Investments Ltd does raise the question as to how many licensees can operate in the New Zealand crowdfunding arena.

In addition to competition within the CSP market, there is potential for competition from other providers, such as a licensed exchange. The only licensed exchange in New Zealand is the New Zealand Stock Exchange (NZX), which in 2015 set up a new exchange – NXT – aimed at medium-sized issuers that have a market capitalization of between $10 million and $100 million. NXT has reduced governance and disclosure rules compared to issuers listed on the NZX, which is the main board. It is still too early to see if there is any competition between the equity crowdfunding market and NXT (Murray 2015), although it is more likely that equity crowdfunding will provide a stepping stone for small and medium issuers to raise funds before seeking to list on NZXT.

B. Ongoing Issuer Disclosures

Equity crowdfunding has certainly experienced rapid growth since it was introduced into New Zealand's financial markets in 2014, although it is likely that the honeymoon period is over. Although, at the time of writing there have been no recorded corporate failures of companies that have successfully raised equity through crowdfunding, there have been comments in the media, from investors and from CSPs that crowdfunded companies need to improve their post-fundraising communications. As discussed above, most crowdfunding companies will need to share their financial statements with their shareholders at the end of the financial year, but are not subject to the more rigorous disclosure requirements of listed entities which are required to release interim financial statements as well as comply with the continuous disclosure regime.

It is unlikely that many investors understand the distinction between the disclosure requirements placed on listed issuers and crowdfunded companies. In particular those companies whose statements in their crowdfunding prospectus regarding potential growth and profit forecasts were viewed as overly ambitious, the ongoing lack of disclosure has been the focus of media criticism (Smylie, June 10 2016 and 13 June 2016). Both Snowball Effect and PledgeMe have reported that they had become aware of investor concerns that some crowdfunded companies are failing to disclose information on their performance to shareholders. Snowball Effect has started publishing a quarterly report containing company updates as a response. Simeon Burnett, Snowball Effect CEO was quoted as stating that "[a]s a result of discussions with investors in recent months it has become apparent that the level of engagement that we hoped to facilitate hasn't occurred in some instances" (Smylie 2016a).

7. Conclusion

Barrett (2012, p. 306) observed that if equity crowdfunding was to be introduced into the SME sector in New Zealand, four fundamental requirements would need to be meet:

> Firstly, a sufficiently large number of SMEs with high growth potential that are able to present useful information to potential investors must be present. Secondly, a pool of informed micro angel investors, who are prepared to take the risk of investing in start-up companies, must be available. Thirdly intermediaries who are knowledgeable and reliable, and have the skills to act as share nominees, perform due diligence, trusteeship and so forth, should be willing to enter and stay in the market. Finally, a regulatory framework needs to be established that is nimble and flexible enough to calibrate, possibly at short notice, the appropriate balance between investment risk and consumer protection.

While equity crowdfunding for small and medium companies is now part of New Zealand's capital markets, this has occurred very rapidly and without all four of these requirements firmly in place. First, the fact that some issuers released statements with overly ambitious forecasts and inflated valuations at the time of their crowdfunding campaigns and are failing to keep investors updated on progress may undermine investor confidence in crowdfunding. Many of the crowdfunded companies would have operated as closely held 'private' companies in the past and have yet to adjust their communication strategies to meet investors' expectations about ongoing disclosures and corporate updates. While CSPs can encourage crowdfunded companies to improve their practices in this regard, the relationship between a CSP and a company is contractual and once a company has successfully raised equity via the CSP, that contract is performed. Unless a company undertakes a second round of crowdfunding in the future, the CSP will not necessarily have any future dealings with the company. Accordingly in the future, there may need to be legislative reform to close this expectation gap between investors and the crowdfunded companies.

There is also some doubt whether many retail investors do understand the risks of investing in crowdfunding companies. In early-to-mid 2000s, a large number of retail investors suffered substantial losses when a number of finance companies collapsed demonstrating that many investors do not understand the basic principles of risk and return. In addition to the risk of corporate failure, many investors may not appreciate the liquidity risk as there is still no secondary market for shares in crowdfunded companies in New Zealand. As to Barrett's third requirement of knowledgeable and reliable intermediaries, the equity crowdfunding market has already become crowded in New Zealand and one platform has already failed. While some of the CSPs are carving out distinct market shares and diversifying the services they provide, there is an ongoing risk of portal failure. Overall, any crowdfunding regime has to balance investment risk and consumer protection. Although the New Zealand experiment appears to be successfully achieving this balance, issues relating to disclosure both at the time of the fundraising and about ongoing progress may undermine investor confidence in the future.

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[1] While the part of the Financial Markets Conduct Act 2013 that governs crowdfunding licensing came into force on 1 April 2014, the majority of the Act came into force on 1 December 2014.

[2] Securities Act 1978 defines an eligible person as wealthy if the person has certified net assets over $2,000,000 (section 5(2CC)) or gross annual income at least $200,000 (section 5(2CD)). Section 5(2CE) sets out the requirements for a person to be considered experienced in investing money or experienced in the industry or business to which the security relates.

[3] Under the Securities Act 1978, section 3(2)(a)(iia)-(iib), an offer to persons who are each required to pay a minimum subscription price of at least $500,000 or have paid previously a minimum subscription price of $500,000 is not an offer to the public for the purposes of the Act.

[4] Under the Securities Act 1978, section 3(2)(a)(i), an offer only to relatives or close business associates of the issuer or a director of an issuer is not an offer of securities to the public for the purposes of the Act.

[5] The Financial Markets Authority Act 2011 commenced on 1 May 2011 on which date the Securities Commission was disestablished and replaced by the Financial Markets Authority.

[6] Shares, for the purpose of crowdfunding, do not include a financial product that will be converted, or may become convertible, into another financial product.

[7] Financial Markets Conduct Act 2013, s 489. Also see s 38(2) that provides that a pecuniary penalty awarded for any contravention of sections 19 to 23 must not exceed the maximum of the greatest of the consideration for the relevant transactions, 3 times the amount of the gain made or the loss avoided, and $1 million in the case of an individual or $5 million in any other case.

[8] These figures include assets and revenue of any subsidiaries, as defined in section 45 of the Financial Reporting Act 2013.

[9] As 1 June 2016, licenses for the following crowdfunding service providers are listed on FMA website: PledgeMe; Snowball Effect; Crowdcube; Equitise Pty Ltd, My Angel Investment Ltd, Liftoff Ltd, Propellar New Zealand Ltd, Alphacrowd Limited.

[10] A wholesale investor must meet one of a number of criteria. The criteria include an investor's net assets exceeding $5 million for the two most recent financial years, or having a portfolio of financial products exceeding $1 million in the two most recent financial years or entered into transactions to acquire financial product worth this amount, or the investor's principal business is investing in financial products, or as a financial adviser or broker in relation to financial products, or an eligible investor as certified by an independent lawyer, accountant or financial adviser or the person is investing $750,000 or more.

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