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Abstract

Many small and medium enterprises (SMEs) struggle to raise capital in New Zealand’s private capital markets. These SMEs are also generally too small to viably list on the public markets. The Financial Markets Conduct Act 2013 (FMCA) and the regulations made under that Act partially addressed this problem by allowing businesses to equity crowd fund up to $2,000,000 per annum from retail investors through licensed intermediaries, without having to comply with the FMCA’s Part 3 disclosure requirements. This paper argues that after examining the apparent success of crowd funding in New Zealand and weighing up the risks to investors of the more limited disclosure requirements that apply to crowd funded offers, that there is a strong case for raising the cap to $5,000,000 per annum.

Key words: “crowd funding”, “investment”, “capital raising”, “securities”, “equity”
I Introduction

Small and medium enterprises (SMEs) employ 29 per cent of all employees in New Zealand and generate 26 per cent of the country’s gross domestic product. Historically these businesses have struggled to raise capital due to high costs and difficulties in finding potential investors. A range of public and private initiatives have been pursued to improve SMEs’ access to capital. To help increase early-stage investment the New Zealand government established the New Zealand Venture Investment Fund in 2002. This fund currently has $245,000,000 under management. It invests in venture capital funds and directly into businesses with high growth potential. New Zealand’s Exchange (the NZX) developed the NXT and NZX Alternative Market (NZAX) as public exchanges with lower disclosure requirements to improve SMEs’ access to public capital. While these developments have improved SMEs’ access to capital, many still struggle to access the capital they need in New Zealand’s relatively thin capital markets to make the leap to large internationally competitive businesses.

Cabinet decided in early 2011 that crowd funding platforms could become licensed intermediaries, under the Financial Markets Conduct Bill. New Zealand’s government then observed and was influenced by the development of crowd funding in the United Kingdom and the United States. As part of its Business Growth Agenda, the government

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1 Ministry of Business Innovation & Employment “Small Enterprise” (10 August 2018) <www.mbie.govt.nz>, SMEs have up to 20 employees.
3 New Zealand Venture Investment Fund “About NZVIF” <www.nzvif.co.nz>.
4 Jenny Ruth “NZX admits the NXT market has failed, so what’s next” The National Business Review (online ed, New Zealand, 22 August 2017); see also New Zealand’s Exchange “NZX Alternative Market (NZAX)” <www.nzx.com>; see also NXT “About NXT” <www.nxt.co.nz>.
5 New Zealand Government Building Capital Markets (February 2013) at 23.
7 At 237.
identified crowd funding as an initiative to improve access to capital for early-stage and growth companies’. 8

The Financial Markets Conduct Act 2013 (FMCA) and subsequent Financial Markets Conduct Regulations 2014 (the FMC Regulations) have promoted equity crowd funding in New Zealand by providing a concessionary disclosure regime for offers made through licensed intermediaries. 9 New Zealand has taken a simple, light-handed and liberal approach in regulating crowd funding. 10 For example, unlike other jurisdictions, New Zealand declined to impose individual investor caps. 11 Crowd funding is regulated in New Zealand by requiring offers to be made through licensed intermediaries and by limiting the total amount issuers can raise (in aggregate) from crowd funding, peer-to-peer lending 12 and small offers 13 to $2,000,000 per annum. 14

Equity crowd funding’s growth helps SMEs to quickly, cheaply and easily raise capital from retail investors, reducing their reliance on wholesale investors. 15 Investing in startups has become more accessible, offering retail investors new investment opportunities and the ability to diversify their portfolios. 16

New Zealand’s crowd funding regime appears to be relatively successful so far. 17 This perceived success has been the driver for one of the major calls for reform, raising the

12 Financial Markets Conduct Regulations, reg 185, peer-to-peer lending is offering debt securities through a licensed intermediary.
13 Financial Markets Conduct Act, sch 1 cl 12, Small offers are personal offers of debt or equity securities that raise up to $2,000,000 per annum from up to twenty people.
14 Financial Markets Conduct Regulations, sch 8 cl 7.
15 “In with the crowd” Exporter Magazine (online ed, New Zealand, 8 July 2015) at 20.
$2,000,000 per annum cap. Josh Daniell, a co-founder of Snowball Effect, New Zealand’s largest crowd funding platform by market share, has called for the cap to be raised to offer businesses seeking to raise between $2,000,000 and $10,000,000 an alternative capital raising method. Following a string of campaigns that successfully raised $2,000,000, PledgeMe’s CEO, Anna Guenther, acknowledged that a case for increasing the cap exists. She suggested that businesses that raised $2,000,000 could have benefited from raising more.

In light of New Zealand’s crowd funding regime’s apparent success, this paper considers the merits of increasing the $2,000,000 cap. It concludes that the benefits to SMEs from raising the cap to $5,000,000 likely outweigh the potential risk increases to retail investors. Consideration is also made to the possible introduction of additional protections to mitigate the increased risks to retail investors.

II The International Emergence of Equity Crowd Funding

The internet began disrupting industries in the 1990s and early 2000s. It enabled entrepreneurs to solicit funds from a geographically dispersed crowd of unknown investors. The first recorded instance of internet crowd funding was when a British rock band funded a tour through online donations from fans in 1997.

Crowd funding is the pooling of a large number of small contributions from many supporters to fund a company or project via the internet. Initially, only projects and causes utilised crowd funding. In 2003 a website called ArtistShare launched. It enabled musicians to solicit donations from fans to help them fund the production of digital

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18 Snowball Effect “About Snowball Effect” <www.snowballeffect.co.nz>.
19 Josh Daniell “New Zealand’s equity crowdfunding regulations – should we re-visit the $2m cap?” (4 May 2016) Snowball Effect <www.snowballeffect.co.nz>.
20 Elly Strang, “Ocho smashes PledgeMe record, hits $2 million – but is it a sign New Zealand’s crowdfunding rules need to change?” Idealog (online ed, New Zealand, 21 November 2017).
22 Pekmezovic and Walker, above n 16 at 357.
24 Ministry of Business Innovation & Employment, above n 6, at 67.
recordings. Maria Schneider was the first artist to use the platform. She raised about USD 130,000 to record a jazz album. She rewarded her backers by letting them download the album.\textsuperscript{25} Rewards based crowd funding grew with the launch of Indiegogo in 2008 and Kickstarter in 2009.\textsuperscript{26} An example of a crowd funded project was Pebble Technology. Pebble raised USD 10,266,845 from 68,929 backers to develop a smartwatch in 2012. Backers who pledged over USD 99 received a Pebble smartwatch.\textsuperscript{27}

Following the global financial crisis, many SMEs struggled to receive financing from banks.\textsuperscript{28} Some entrepreneurs and SMEs turned to the crowd for funding instead.\textsuperscript{29} Rather than rewards, businesses issued equity or debt securities.\textsuperscript{30} Intermediaries between issuers and investors (crowd funding platforms) emerged. Despite being unauthorised when it launched, Crowdcube became the first equity crowd funding platform in the United Kingdom in February 2011.\textsuperscript{31} The United Kingdom’s Financial Conduct Authority subsequently proposed a set of rules for crowd funding in October 2013. These became law in April 2014.\textsuperscript{32} The United States passed the Jumpstart Our Business Startups Act 2012 to enable crowd funding.\textsuperscript{33} However, the crowd funding enabling provisions only came into force in May 2016.\textsuperscript{34}

\textsuperscript{26} At 2.
\textsuperscript{28} Pekmezovic and Walker, above n 16, at 368.
\textsuperscript{29} At 360.
\textsuperscript{30} At 363.
\textsuperscript{31} Steven Dresner \textit{Crowdfunding: a guide to raising capital on the internet} (Wiley, Hoboken (New Jersey), 2014) at 206.
\textsuperscript{32} Financial Conduct Authority \textit{The FCA’s regulatory approach to crowdfunding over the internet, and the promotion of non-readily realisable securities by other media} (Policy Statement 14/4, United Kingdom, March 2014) at 5.
\textsuperscript{33} Jumpstart our Business Startups Act Pub L No 112–106, § 302, 126 Stat 306 at 315 (2012);
\textsuperscript{34} Schwartz, above n 10, at 248.
III New Zealand’s Crowd Funding Regime

A Objectives of Regulating Crowd Funding

Regulating crowd funding involves balancing the competing objectives of protecting investors and facilitating the provision of capital to businesses.\(^{35}\) Finding a balance between these objectives is key to a regime’s success. If investors lack sufficient protection they will not provide capital, but if protections are too high, the burdens on issuers will push them to seek capital elsewhere.\(^{36}\)

B Crowd Funded Businesses Are Risky

Crowd funded SMEs have more uncertain prospects than larger more established businesses due to the difficulty in assessing their chance of success and potential profitability.\(^{37}\) The risks for investors are heightened by the high failure rate of SMEs. It is estimated that between 2010 and 2013 about a quarter of New Zealand SMEs failed.\(^{38}\) This is not a uniquely New Zealand phenomena. The United Kingdom’s Financial Conduct Authority predicted that crowd funding investors will likely lose all their money as most startups fail,\(^{39}\) and Harvard lecturer, Shikhar Ghosh, found that three quarters of startups fail.\(^{40}\)

C Disclosure Exemption

The FMCA imposes a general rule that offers of financial products require disclosure under Part 3 of the Act.\(^{41}\) This includes preparing a Product Disclosure Statement (PDS) and making disclosures on an online public register.\(^{42}\) This process is expensive and typically involves engaging investment bankers and lawyers.\(^{43}\) Traditionally issuers have

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37 Schwartz, above n 10, at 255.
38 “Cutting the small business failure rate” Sunday Star Times (online ed, New Zealand, 1 September 2014)
41 Section 39.
42 Section 48.
43 Daniell, above n 19.
been able to avoid disclosure, where all investors are either: professionals who are deemed to have the ability and skill to protect themselves; or regarded as protected by social or business restraints; or have the ability to obtain relevant information. In these cases, the costs from disclosure are believed to outweigh the need for investor protection.

The FMCA created another exemption to the disclosure regime where issuers offer equity securities to retail investors through licensed intermediaries. Instead of a PDS, crowd funding promotes communication between issuers and investors. Platforms must also have adequate disclosure arrangements that enable investors to readily obtain timely and understandable information that will assist them in their investment decisions. This can include initial information disclosure, question and answer forums or subsequently making information available. For example, PledgeMe requires issuers to provide investors with information including the businesses’ description, its plan, current financials and forecasts.

Licensed intermediaries, including crowd funding platforms, are also required to issue a Service Disclosure Statement (SDS) to retail investors. The SDS’s contents are prescribed in the regulations and include information on the platform’s service, its fees, the nature and extent of disclosure the platform requires of issuers and the nature and extent of the checks and the assessments it carries out on prospective issuers, its management and the risks involved. The SDS aims to assist retail investors in their decision to invest through a particular platform.

D Asymmetric Information

Despite its effectiveness having been questioned by industry practitioners, academics and the judiciary; mandatory information disclosure informs investors, reduces information

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44 Lawrence v Registrar of Companies [2004] 3 NZLR 37 (CA) at [32].
45 At [31].
46 At [27–28].
47 Schedule 1 cl 6.
48 Ministry of Business Innovation & Employment, above n 6, at 239.
49 Financial Market Conduct Regulations, reg 186.
50 PledgeMe “Plan” PledgeMe.Learn <guide.pledgeme.co.nz>.
51 Financial Market Conduct Act, s 423.
52 Regulation 215.
53 Financial Markets Conduct Act, s 425.
asymmetries and encourages retail investor participation in financial markets. Some commentators have suggested that crowd funding’s lack of disclosure leads to less informed retail investors and information asymmetries, where issuers know considerably more about the risks, merits and value of an investment than prospective investors. This is especially true for crowd funded businesses which have uncertain prospects and are inherently risky.

Asymmetric information can result in a ‘market for lemons’ developing. Darian Ibrahim has suggested that if retail investors cannot easily distinguish between high and low-quality investments, they will discount the price they are willing to pay for all investments. If this occurs, higher quality issuers may opt for different capital raising methods. Therefore, retail investors would end up investing in risky, low-quality businesses or lemons, as these would be the only businesses that crowd fund.

E Reputational Intermediaries

Reputational intermediaries can reduce asymmetric information risks to retail investors. Financial intermediaries, like auditors and investment banks, vouch for an issuer’s quality by lending them their reputational capital. As repeat financial market players, an intermediary’s reputation is linked to businesses it represents. To maintain their reputation, intermediaries will aim to ensure their clients succeed.

Reputational intermediaries, including crowd funding platforms, are unlikely to promote businesses they believe are unlikely to succeed. If a platform promotes many businesses who subsequently fail, its reputation will decrease and retail investors will be unlikely to invest in its offers. Aware of this, issuers will be less likely to use that platform as offers

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55 “Crowdfunding taking off, but beware” The New Zealand Herald (online ed, Auckland, 7 April 2015).

56 Schwartz, above n 10, at 255.

57 At 255.


59 At 598.
on it will be less likely to succeed due to having a smaller investor pool. A platform’s success is tied to the success of the businesses it promotes.\textsuperscript{60}

\textit{F Wisdom of the Crowd and Cornerstone Investors}

In the absence of a PDS, crowd funding investors partly rely on the collective wisdom of the crowd. The views and insights of a diverse range of individuals can uncover risks, ascertain an investment’s quality and reduce information asymmetries.\textsuperscript{61} The crowd is believed to be relatively good at identifying winners and lemons.\textsuperscript{62} Ibrahim has even suggested that it can sometimes be better than experts at picking winners.\textsuperscript{63}

Businesses that do not sufficiently pass the crowds scrutiny are unlikely to reach their minimum targets.\textsuperscript{64} Campaigns that do not reach their minimum target are unsuccessful. As pledged investments in unsuccessful campaigns are returned, investors are protected from investing in businesses the crowd does not back.\textsuperscript{65} Investors are also less likely to invest in businesses with few backers as such a business would not appear to have passed the crowd’s scrutiny.

Offers generally need early backers, like the business’ fans and followers, to generate the momentum it needs to succeed.\textsuperscript{66} PledgeMe estimates that 75 per cent of investors have some pre-existing connection to businesses they invest in.\textsuperscript{67} Cornerstone investors also help generate momentum and lend an offer credibility.\textsuperscript{68} The crowd will acknowledge that someone has purchased a large block of shares when it considers the business’ prospects and valuation.\textsuperscript{69} Offers that cannot attract a cornerstone investor or pass the scrutiny of those with insights into the business are unlikely to gain sufficient momentum to succeed, protecting investors without these insights.

\textsuperscript{60} Schwartz, above n 10, at 270–271.
\textsuperscript{61} Ministry of Business Innovation & Employment, above n 6, at 239; Andrew Schwartz “The Digital Shareholder” (2015) 100 Minn L Rev 609 at 661.
\textsuperscript{62} At 661.
\textsuperscript{63} Ibrahim, above n 58, at 597.
\textsuperscript{64} Schwartz, above n 10, at 267.
\textsuperscript{65} Schwartz, above n 61, at 662–663.
\textsuperscript{66} Schwartz, above n 17, at 939.
\textsuperscript{67} At 940.
\textsuperscript{68} At 935–936.
\textsuperscript{69} At 935.
Ferdinand Thies and Michael Wessel suggested that momentum can cause herd behaviour, where investors cease exercising their own judgement or conducting their own research, and instead follow the investment decisions of others.\textsuperscript{70} Investors that invest in campaigns with momentum might invest in businesses they would otherwise not have invested in, resulting in some businesses being funded that would have otherwise been unsuccessful.\textsuperscript{71} Alma Pekmezovic and Gordon Walker recognised that while herding helps businesses raise capital, it undermines the crowd’s collective wisdom and its protections to retail investors.\textsuperscript{72}

\textbf{G} \hspace{1cm} \textit{Liquidity Risk}

Crowd funding investors can profit from their investment by receiving dividends or by selling their shares at a profit on a secondary market or to an acquirer of the business. These investors face liquidity risks as they may struggle to realise any profits.\textsuperscript{73} Crowd funded businesses are unlikely to pay dividends as they are typically early-stage growth companies that are either unprofitable or which reinvest their profits. These businesses are also not required to list on a secondary market. Therefore, investors will likely have to wait for the business to have an IPO or be acquired to realise their investment.\textsuperscript{74} Some industry practitioners have suggested that it may take between five and seven years before investors can expect to profit from their investment.\textsuperscript{75}

\textbf{H} \hspace{1cm} \textit{Benefits to Businesses}

Crowd funding’s major benefit to businesses is that it enables them to appeal to a wide pool of potential retail investors without the costs from Part 3 disclosure.\textsuperscript{76} Women, ethnic minorities and those outside metropolitan centres have traditionally struggled to attract


\textsuperscript{71} Gordon Burtch “Herding behaviour as a network externality” (paper presented to International Conference on Information Systems, Shanghai, December 2011) at 13.

\textsuperscript{72} Pekmezovic and Walker, above n 16, at 396.

\textsuperscript{73} Financial Conduct Authority, above n 32, at 37.

\textsuperscript{74} PledgeMe “Info for Investors” PledgeMe.Learn <guide.pledgeme.co.nz>.


\textsuperscript{76} Daniell, above n 19.
venture capital. Ethan Mollick suggests crowd funding improves access to capital for these groups. As the crowd can be better at selecting winners, crowd funding investors will sometimes fund and benefit businesses that professional investors would overlook. While crowd funding is not appropriate for all businesses and not all campaigns succeed, it does benefit some businesses.

I Benefits to Retail Investors

Crowd funding benefits retail investors by enabling them to invest in startups and SMEs, an asset class previously difficult for them to access. Crowd funding investors, who are motivated by the hope of return, benefit from early-stage businesses having high potential returns. Retail investors also gain diversification opportunities. Investors can also derive non-financial benefits by supporting businesses they believe in. The crowd funding campaigns of OCHO, Hikurangi Cannabis and Renaissance Brewery illustrate this. OCHO began as a community effort to maintain chocolate manufacturing in Dunedin after Cadbury announced it would close its Dunedin chocolate factory. Hikurangi Cannabis aims to be the first producer of pharmaceutical grade cannabis in New Zealand. It received investor support partially because it aims to help reignite the East Coast economy. Some beer fans invested in Renaissance Brewery just “for a bit of fun”.

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77 Ethan Mollick “The Danger of Crowding Out the Crowd in Equity Crowdfunding” (2014) 2(8) University of Pennsylvania Public Policy Initiative 1 at 2.
78 Ibrahim, above n 58, at 597.
79 Pekmezovic and Walker, above n 16, at 351.
80 Financial Conduct Authority A review of the regulatory regime for crowdfunding and the promotion of the non-readily realisable securities by other media (United Kingdom, February 2015) at [35].
82 Feit, above n 80; Alexandru Godoroja “Equity Crowdfunding: Identifying success drivers for a new financing model” (Scholarship Paper, Stockholm School of Economics, 2014) at 16.
83 Ocho Newco “Ocho and Own the Factory” (November 2017) PledgeMe <www.pledgeme.co.nz>.
84 “Thousands register interest in medical cannabis venture share offer” The New Zealand Herald (online ed, Auckland 27 April 2018).
85 Tom Pullar-Strecker “Renaissance Brewing, first NZ company to get equity crowdfunding, goes into administration” (10 October 2017) Stuff <www.stuff.co.nz>.
The $2,000,000 cap (for crowd funding, peer-to-peer lending and small offers) limits the exemption to the general rule that PDSs are required to issue financial products to retail investors. The cap was a compromise between increasing SMEs access to public capital and limiting the exposure of risks to retail investors. It ensures crowd funding is only used for relatively small capital raisings where the cost of complying with the normal disclosure regime outweighs the benefits from raising funds. The cap protects retail investors as an aggregate by limiting the total losses if a business fails.

After considering crowd funding’s risks and benefits, the Ministry of Business Innovation and Employment proposed setting the aggregate cap for crowd funding, peer-to-peer lending and small offers at $2,000,000 per annum to align with the $2,000,000 per annum cap for the small offers exemption in the then Financial Markets Conduct Bill. This proposition was later adopted. However, as recognised by the Australian Government’s Corporations and Markets Advisory Committee, cap levels are somewhat arbitrary as they involve balancing two competing tensions.

Other Regulatory Protections

Protections for retail investors exist in addition to the $2,000,000 cap. The main protection is the FMA’s licensing of crowd funding platforms, especially its oversight, supervisory and enforcement role. Platforms have to be licensed by the FMA to operate. They must have “fair, orderly and transparent systems and procedures for providing the service”, anti-fraud and fair dealing policies, and adequate systems and procedures to implement them and ensure issuers do not raise over $2,000,000 per annum through the platform. As discussed above, platforms must have adequate disclosure arrangements to enable investors to readily obtain timely and understandable information. Platforms must also

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86 Cabinet Business Committee, above n 8, at 15.
87 Ministry of Business Innovation & Employment, above n 6, at 240.
88 Craig Foss “Crowd Funding gets green light” (press release, 27 February 2014).
89 Australian Government Corporations and Markets Advisory Committee Crowd Sourced Equity Funding: Report (May 2014) at 59.
90 Pekmezovic and Walker, above n 16, at 409.
92 Sections 396–397.
93 Financial Markets Conduct Regulations, reg 186.
display a specific warning statement (prescribed in the FMC Regulations) that highlights crowd funding’s risks and the lower disclosure requirements on both its website homepage and to investors before they apply to acquire financial products through its service. To invest, retail investors must confirm they understand crowd funding’s risks and lower disclosure requirements and certify that they can lose their entire investment without enduring undue hardship.

Crowd funding issuers remain subject to the Fair Dealing Rules in Part 2 of the FMCA. These rules, based on the corresponding provisions in the Fair Trading Act 1986, set out mandatory behaviour standards for operators in financial markets. False and misleading conduct and false, misleading and unsubstantiated representations are prohibited and investors can enforce breaches.

L International Approaches

Australia’s regulatory framework is both more liberal and restrictive than New Zealand’s. Only businesses with gross asset values and annual revenue less than AUD 25,000,000 can crowd fund. These businesses can raise up to AUD 5,000,000 per annum. Investors can only invest up to AUD 10,000 per company per annum.

The United States is more restrictive than New Zealand. Issuers can raise up to USD 1,000,000 per annum. Investors are capped on the amount they can individually invest through crowd funding each year. The cap depends upon their income and net worth, ranging from USD 2,000 and USD 100,000. Unlike New Zealand, the United States has deep pools of venture capital and angel investors. Therefore, businesses in the United States have a lower need for a higher issuer cap than those in New Zealand.

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94 Regulation 196.
95 Regulations 197(2).
97 Financial Markets Conduct Act, s 19–22.
98 Corporations Act 2001 (Cth), s 738H.
99 Section 738G.
100 Section 738ZC.
101 Securities Act 15 USC § 77(a)(6)(A)
102 Securities Act 15 USC § 77(a)(6)(B)
103 Schwartz, above n 17, at 952.
Canada is more restrictive than New Zealand. Issuers can raise up to CAD 1,500,000 per annum.\textsuperscript{104} Individual non-accredited investors (similar to New Zealand’s retail investors)\textsuperscript{105} can invest up to CAD 2,500 per campaign unless they are in Ontario where they can invest up to CAD 10,000.\textsuperscript{106} Canada’s restrictive approach to issuer and investor caps has contributed to its regime being labelled as “punching below its weight compared to international markets.”\textsuperscript{107}

The European Union permits crowd funding issuers in member states to raise up to EUR 1,000,000 per annum through crowd funding equity without a prospectus.\textsuperscript{108} Member states can also refrain from requiring a prospectus for issuers offering less than EUR 8,000,000 per annum.\textsuperscript{109} Some member states have more liberal crowd funding regimes than New Zealand. Germany has decided to allow crowd funding issuers to raise up to EUR 8,000,000 per annum without a prospectus, France also plans to implement this limit.\textsuperscript{110}

\textbf{IV \hspace{1em} Success of Crowd Funding in New Zealand}

The successfulness of crowd funding in New Zealand should be examined to determine whether the competing objectives are appropriately balanced or whether the cap should be increased. This involves considering how many businesses have successfully crowd funded, the quantity of equity raised and these businesses’ subsequent performance. Trends that have emerged provide additional insights into what may happen if the cap were increased.

\textsuperscript{104} Multilateral Instrument 45–108 Crowdfunding (MI 45–108) 2016 (Canada), s 5(1)(b).
\textsuperscript{105} See National Instrument 45–106 Prospectus Exemptions (NI 45–106) (Canada), s 1.1.
\textsuperscript{106} Multilateral Instrument 45-108, s 5(1).
\textsuperscript{107} National Crowdfunding Association of Canada \textit{2016 Alternative Finance Crowdfunding in Canada} (Toronto, 13 December 2016) at 66.
\textsuperscript{108} Regulation 2017/1129 on the prospectus to be published when securities are offered to the public [2017] OJ L168/12 (EU), art 1(3).
\textsuperscript{109} Article 3(2).
\textsuperscript{110} Therese Torris “Germany raises the Equity Crowdfunding Limit to €8 Million” (29 June 2018) Crowdfund Insider <www.crowdfundinsider.com>.
Snowball Effect and PledgeMe became the first licensed crowd funding platforms on 30 July 2014.111 New Zealand now has six licensed platforms.112 Snowball Effect, Equitise and PledgeMe are the largest platforms by capital raised.113 Renaissance Brewery ran the first successful crowd funding campaign in August 2014, raising its maximum target of $700,000 from 287 investors.114 A wide range of businesses have since successfully crowd funded.

A Success of Campaigns

Campaigns ‘succeed’ and issuers receive the pledged money if the self-imposed minimum target is reached.115 Crowd funding campaigns in New Zealand have been relatively successful. Success rates across the first three years was 78, 57 and 64 per cent respectively. These years respectively had 21, 15 and 28 successful campaigns. Despite the relatively high success rate, only eight campaigns reached their maximum target in the first year, one in the second and six in the third.116 Compared to the United States where about only 50 per cent of campaigns succeeded in its regime’s first year, New Zealand’s crowd funding campaigns have been relatively successful.117

Crowd funding has successfully facilitated the provision of capital to SMEs. The average capital raised per successful campaign across the first three years has been increasing, being $590,000, $720,000 and $750,000 respectively.118 In total $12,400,000, $10,800,000 and $13,400,000 was raised in the first three years respectively. While this may seem small, it is significant when compared to New Zealand’s total early-stage investment from

111 Financial Markets Authority, above n 8.
114 “First crowdfunding effort reaches goal” The New Zealand Herald (online ed, Auckland, 25 August 2014).
115 Snowball Effect “Raising capital with Snowball Effect” (15 March 2016) <www.snowballeffect.co.nz>.
117 Schwartz, above n 17, at 946.
118 CrowdReady “New Zealand Equity CrowdFunding – 1st Year in Review”, above n 116; CrowdReady “New Zealand Equity CrowdFunding – 2nd Year in Review”, above n 116; CrowdReady, above n 113.
2015 to 2017 of $63,000,000, $92,000,000 and $217,000,000 respectively. The size of crowd funding in New Zealand is more clearly illustrated when compared to the United States. After scaling for New Zealand’s economy’s size, New Zealand had thirteen times more crowd funding campaigns than the United States in its first year. These campaigns raised about thirty times as much capital.

B The crowd

Across the first three years of crowd funding in New Zealand 2503, 1490 and 2840 people respectively, invested in crowd funded businesses. The number of investors in the fourth year will likely be considerably higher after OCHO attracted 3,549 investors and Hikurangi Cannabis 1,119.

Investors do not appear to be overinvesting through crowd funding. The average investment size across the first three years was $4,300, $7,100 and $6,100 respectively. The average number of investors in successful campaigns over these years was 152, 82 and 142 respectively. Campaigns that raised $2,000,000 had more investors than average. All attracted over 390 investors and many attracted considerably more. Individual investors also do not appear to invest more in larger offers.

C Information on Crowd Funded Businesses

Crowd funding can benefit businesses diverse in age and size. Pre-money valuations have ranged from nominal amounts, for pre-revenue businesses such as OCHO, to higher

119 “Mid-market private equity builds on increasing investment activity” (23 May 2016) New Zealand Private Equity and Venture Capital Association <www.nzvca.co.nz>.
121 Schwartz, above n 17, at 929.
122 CrowdReady “New Zealand Equity CrowdFunding – 1st Year in Review”, above n 116; CrowdReady “New Zealand Equity CrowdFunding – 2nd Year in Review”, above n 116; CrowdReady, above n 113.
123 Ocho Newco, above n 83; Waiapu Investments “Waiapu Investments - Hikurangi Cannabis” (May 2018) PledgeMe <www.pledgeme.co.nz>.
124 CrowdReady “New Zealand Equity CrowdFunding – 1st Year in Review”, above n 116; CrowdReady “New Zealand Equity CrowdFunding – 2nd Year in Review”, above n 116; CrowdReady, above n 113.
125 This is discussed in section III D below.
126 A campaign that raised $2,000,000 with 390 investors has an average investment of $5,128, which is consistent with the average size of all investments.
valuations for established businesses like Powerhouse Ventures. OCHO’s pre-money valuation was $57,100,127 whereas Powerhouse’s was $25,000,000. The average equity offered remained fairly constant across the first three years at 14, 10 and 14 per cent respectively. Not all businesses have offered small minority stakes. For example, Hikurangi Cannabis and OCHO both offered majority stakes. Business ages have ranged from month old startups, like OCHO, to mature businesses like seventeen-year-old clothing brand, Andrea Moore. This is reflected by the average age of businesses that crowd fund being eight years.

D Campaigns that Have Reached the $2,000,000 Cap

Startups and established businesses have both successfully raised $2,000,000. Wine company, Invivo, was the first to raise $2,000,000 after attracting 438 investors in twelve days in early 2015. Later that year, technology investment fund, Punakaiki Fund, raised $2,000,000 from 391 investors. ParrotDog beat Invivo’s record in 2016 by raising $2,000,000 in two days from 812 investors. OCHO broke ParrotDog’s record in late 2017 after raising $2,000,000 in 30 hours. Health food producer, Little Bird Organics, then raised $2,000,000 in just over a week from 659 investors in early 2018. In May

127 Ocho Newco, above n 83.
128 CrowdReady “New Zealand Equity CrowdFunding – 2nd Year in Review”, above n 116.
129 CrowdReady “New Zealand Equity CrowdFunding – 1st Year in Review”, above n 116; CrowdReady “New Zealand Equity CrowdFunding – 2nd Year in Review”, above n 113; CrowdReady, above n 113. See also “Share-trading hope for crowdfunding investors” The Sunday Star Times (online ed, New Zealand, 8 February 2015), investors have been offered both voting and non-voting equity shares, although non-voting shares are more common.
130 Ocho Newco, above n 83; Waiapu Investments, above n 123.
131 Ocho Newco, above n 83; Andrea Moore and Brian Molloy “Andrea Moore” Snowball Effect <www.snowballeffect.co.nz>.
132 Schwartz, above n 17, at 944.
135 “Craft beer brewer raises $2 million in two days” The New Zealand Herald (online ed, Auckland, 12 August 2016); Parrotdog “Parrot Dog Brewery” (2016) PledgeMe <www.pledgme.co.nz>.
136 Elly Strang, above n 20.
2018, Hikurangi Cannabis set a new record by raising $2,000,000 in 17 minutes. The campaign’s popularity crashed the site and many retail investors missed out on buying shares.\(^\text{138}\)

\[E\] Circumventing the $2,000,000 Cap

In order to raise over $2,000,000, some businesses have conducted parallel offers to wholesale investors. For example, mortgage broker and peer-to-peer lender, Squirrel Group, sought to raise $1,970,000 from retail investors and $3,000,000 from wholesale investors in March 2016. The campaign successfully raised $3,424,400.\(^\text{139}\) Zeffer Cider sought to raise $1,800,000 in May 2018.\(^\text{140}\) Zeffer successful raised $2,418,443 after a wholesale investor invested just over $1,000,000.\(^\text{141}\)

\[F\] Pre-IPO Funding

Some New Zealand businesses have used crowd funding to raise capital before an initial public offering (IPO). Powerhouse Ventures expressed its intention to list on a public exchange during its crowd funding campaign in early 2016 where it raised $1,764,192.\(^\text{142}\) Powerhouse listed on the Australian Securities Exchange (the ASX) in late 2016.\(^\text{143}\) Similarly, CropLogic crowd funded $512,000 in 2016 before listing on the ASX in 2017.\(^\text{144}\)

\[V\] The Success of Crowd Funded Businesses and Platforms

\[A\] Exit Opportunities

Excluding the ASX listings of Powerhouse Ventures and CropLogic, New Zealand crowd funding investors have not yet experienced any sort of remunerative exit options such as

\(^{138}\) Madison Reidy “Medicinal cannabis company’s investment round crashes crowdfunding site” (10 May 2018) Stuff <www.stuff.co.nz>.


\(^{141}\) Zeffer Cider “Zeffer Cider surpasses target once again” (press release, 27 June 2018).

\(^{142}\) Powerhouse Ventures “Powerhouse Ventures” Snowball Effect <www.snowballeffect.co.nz>.

\(^{143}\) Powerhouse “Powerhouse lists on the ASX” <www.powerhouse.co.nz>.

\(^{144}\) Calida Stuart-Menteath “CropLogic issues prospectus for $8m ASX IPO” The National Business Review (online ed, New Zealand, 14 July 2017).
an IPO or the businesses’ acquisition.\textsuperscript{145} Due to the infancy of crowd funding in New Zealand, the absence of remunerative exit options is not surprising and does not suggest the regime is failing investors. In the future, when some of these crowd funded businesses are acquired or list on secondary markets, it will be possible to examine the successfulness of crowd funding for investors.

While no crowd funding businesses have listed on NZX operated exchanges, businesses can still reduce liquidity risks to investors by operating internal share trading systems or by subscribing to external share trading platforms like ShareMart or Unlisted.\textsuperscript{146} For example, Parrotdog currently subscribes to ShareMart, it had previously managed share trading internally.\textsuperscript{147} Crowd funding platforms can apply to the FMA to operate their own secondary markets.\textsuperscript{148} While none have yet done this, Snowball Effect is currently considering launching one. Concerns over the lack of regulation and protection for investors in these markets do however exist.\textsuperscript{149} If more secondary markets developed and crowd funded businesses subscribed to them, the liquidity risk for investors would decrease and it would be easier to gauge a businesses’ relative success.

\textit{B Failures of Crowd Funded Businesses}

While fraud is common in some countries there is no evidence that this has occurred in New Zealand’s crowd funding market.\textsuperscript{150} The legislative regime and the role played by crowd funding intermediaries appears to have successfully mitigated this risk. Some businesses that ran successful crowd funding campaigns have however failed, leaving investors out of pocket.

Automatic boat load maker, Balex Marine, went into liquidation in May 2017. Belax raised $330,000 in October 2016, almost $700,000 below its maximum target. The

\begin{footnotesize}
\begin{enumerate}
\item Schwartz, above n 17, at 930.
\item “Parrotdog plans $1.4m capital raise via crowdfunding platform PledgeMe” The National Business Review (online ed, New Zealand, 21 November 2017); Parrotdog “Shareholders: Buying and selling Shares in Parrotdog Brewing Limited” <parrotdog.co.nz>.
\item Financial Markets Conduct Act, s 315.
\item Nikki Mandow “Snowball Effect Looks at launching secondary market” (9 May 2018) Scoop <www.scoop.co.nz>.
\item Schwartz, above n 17, at 930.
\end{enumerate}
\end{footnotesize}
businesses’ failure to raise its maximum target left it in a tight cash position. It quickly burnt through its cash due to the high manufacturing costs and slow sales. All crowd funding investment was subsequently lost.

Manufacturer of hydropower turbines and related equipment, HydroWorks, raised $1,446,003 in December 2015. HydroWorks planned to raise more capital through an ASX listing. In August 2017 all crowd funding investment was lost after HydroWorks went into liquidation.

Renaissance Brewery went into voluntary administration in 2017 after suffering cash flow difficulties from falling sales revenues. Renaissance was later sold leaving a shortfall for creditors. All crowd funding investment was lost.

Andrea Moore was a profitable business when it had raised its maximum target of $750,000 in August 2016. Following late deliveries, creditors defaulting and roadworks outside its stores, Andrea Moore went into liquidation and receivership in January 2018. After no buyer emerged Andrea Moore announced it would wind down and all crowd funding investment would be lost.

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155 Equitise, above n 153.
157 Moore and Molloy, above n 131.
159 Tamsyn Parker “Andrea Moore investor complains to market watchdog” The New Zealand Herald (online ed, Auckland, 5 August 2018).
Personal delivery service, LazyAz, raised $240,000 in October 2016.\textsuperscript{160} It went into liquidation in June 2018, citing insufficient working capital to cover operation costs after incurring substantial debt early on.\textsuperscript{161} All crowd funding investment is likely to be lost.\textsuperscript{162}

CropLogic and Powerhouse Ventures, who crowd funded prior to listing on the ASX, have since seen dramatic falls in their share prices. By 28 June 2018, CropLogic’s share price had fallen from its listing price of AUD 0.20\textsuperscript{163} to AUD 0.032\textsuperscript{164} and Powerhouse Ventures’ share price had fallen from a listing price of AUD 1.07\textsuperscript{165} to AUD 0.18.\textsuperscript{166}

To date of writing, crowd funded businesses appear to have lower failure rates than SMEs and startups. The performance of Powerhouse Ventures and CropLogic illustrates however that just because a business has not failed does not mean the investment will generate positive returns. It is likely to be too early to determine whether crowd funding investments will prove successful for investors due to the difficulty in measuring the success of businesses that have survived when their shares are not traded on a secondary market. The apparent survival of crowd funded businesses suggests however that investors are not being overexposed to failed business ventures.

\textit{C The Development of Reputational Intermediaries}

The lack of significant failure levels of crowd funded businesses could be due to reputational intermediaries successfully developing in New Zealand. Andrew Schwartz argues that New Zealand crowd funding platforms have taken their role very seriously as they understand how vital it is to protect their reputation.\textsuperscript{167} For example, Snowball Effect only lists about two per cent of businesses that approach it.\textsuperscript{168} PledgeMe however, does not

\begin{itemize}
\item \textsuperscript{160} Aimee Shaw “Young Guns – The app-based biz earning $3000 a week – Aryaman Taore” \textit{The New Zealand Herald} (online ed, Auckland, 27 December 2016).
\item \textsuperscript{161} Aimee Shaw “Delivery service Lazy Az, founded by then-17-year-old, in liquidation” \textit{The New Zealand Herald} (online ed, Auckland, 18 June 2018).
\item \textsuperscript{162} See generally Imran Kamal \textit{Liquidators First Report: Lazy Az Limited} (Liquidation Management, 13 June 2018).
\item \textsuperscript{163} CropLogic \textit{CropLogic: Supplementary Prospectus} (7 August 2017) at 2.
\item \textsuperscript{164} ASX “CropLogic Limited” <www.asx.com.au>.
\item \textsuperscript{165} Powerhouse Ventures \textit{Powerhouse Ventures Prospectus} (2 August 2016) at 6.
\item \textsuperscript{166} ASX “Powerhouse Ventures Limited” <www.asx.com.au>.
\item \textsuperscript{167} Schwartz, above n 10, at 271.
\item \textsuperscript{168} Schwartz, above n 17, at 932.
\end{itemize}
prevent businesses from launching offers, it instead offers them feedback and requires them to undergo a six-week crowd funding training course. This is an effective screening mechanism as almost half the applicants drop out during the course.

VI Benefits to Issuers of a Higher Cap

A Increasing Access to Capital

To raise capital, SMEs can approach both public and private markets, although both have their drawbacks. Increasing the cap could assist some SMEs that seek to raise over $2,000,000 but currently struggle to raise capital in the public and private markets. Assisting these businesses is the strongest argument for raising the cap.

1 Public Markets

New Zealand SMEs have generally opted against raising capital via an IPO. In 2015 and 2016 there were seven IPOs on the NZX and in 2017 there was only one. IPOs are costly, requiring the preparation of a PDS and numerous listing associated expenses. Technology startup Xero listed on the NZX in 2007, seeking to raise $15,000,000 in expansion capital. Xero incurred about $1,100,000 in listing associated costs; including brokerage fees, share registry expenses, legal fees, investment advisory fees, accounting fees, advertisement costs and printing and distribution costs. Some of the investment bankers involved in Xero’s IPO have since suggested that Xero would face even higher costs if its IPO were issued today. The New Zealand government’s IPO of Mighty River

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169 Schwartz, above n 17, at 933; see also PledgeMe “Prepare Yourself “PledgeMe.Learn <guide.pledgme.co.nz>.

170 Schwartz, above n 17, at 932.

171 Brian Gaynor “Why does the NZX have so few IPOs and what does this mean for investors and the economy” The New Zealand Herald (online ed, Auckland, 27 May 2017).

172 Jamie Gray and Liam Dann “Big Read: Who ate all the IPOs?” The New Zealand Herald (online ed, Auckland, 11 May 2018).


174 At 74.

175 Tim Hunter “We couldn’t float Xero today, says Cameron” The National Business Review (online ed, New Zealand, 11 December 2017).
Power raised $1,700,000,000\textsuperscript{176} and cost approximately $48,700,000\textsuperscript{177}. While fees for larger IPOs are considerably higher, smaller IPOs have proportionally higher costs. Fees comprised about seven per cent of the capital Xero raised compared to about three per cent of what Mighty River Power raised.

Aside from IPO associated costs, listed businesses incur additional ongoing costs from listing fees and complying with continuous disclosure obligations. For SMEs seeking to raise relatively small amounts, these costs can be prohibitively high, often outweighing the benefits of raising money\textsuperscript{178}. This limits the attractiveness of this capital raising method and could be one of the reasons for New Zealand’s low number of IPOs. Smaller businesses in the United States have also tended to shy away from IPOs due to higher costs\textsuperscript{179}.

The NZAX was established in late 2003 to try and cater to smaller businesses\textsuperscript{180}. Following recommendations from the Capital Market Development Taskforce, the NZX launched the NXT in June 2015 to replace the NZAX. The NXT aimed to encourage small businesses to approach the public markets for capital. It reduced the costs of becoming a listed company by having simpler listing and disclosure rules. It targeted businesses seeking to raise between $5,000,000 and $20,000,000 that would have market capitalisations between $10,000,000 and $100,000,000 after listing\textsuperscript{181}. In August 2017, the NZX began a review of the NXT after it had only attracted four businesses\textsuperscript{182}. After receiving market feedback, the review concluded that the multitier market structure was complicated, had failed to attract smaller issuers to the public markets and had not reduced

\textsuperscript{176} “$6b cash rush boosts stock exchange” \textit{The National Business Review} (online ed, New Zealand, 27 August 2013).

\textsuperscript{177} New Zealand Government and Mighty River Power \textit{Initial Public Offering of Ordinary Shares in Mighty River Power Limited Investment} (5 April 2013) at 238.


\textsuperscript{179} Xiahui Gao, Jay Ritter and Zhongyan Zhu “Where Have All the IPOs Gone” (2013) 48 Journal of Financial and Quantitative Analysis 1663 at 1675.

\textsuperscript{180} “NZAX trading continues to fall” \textit{The Sydney Morning Herald} (online ed, Sydney, 5 February 2004); see also New Zealand’s Exchange, above n 4.

\textsuperscript{181} “Capital Markets: Crowdfunding, NXT next on list” \textit{The New Zealand Herald} (online ed, Auckland, 14 May 2015).

\textsuperscript{182} Ruth, above n 4.
costs. Market participants suggested a single board would be more effective. In response, the NZX is currently planning to consolidate the NXT and NZAX into its main equity board. Efforts by public markets to cater to SMEs have proved unsuccessful. It is unlikely this will change with the removal of these junior exchanges, especially given the proposed equity board requires a minimum market capitalisation of $15,000,000.

2 Private Markets

With the public markets not catering to SMEs, these businesses are forced to turn to private markets to raise capital. In private markets, SMEs can structure an offer to avoid Part 3 disclosure and the associated costs by fitting within an exclusion in Part 1 of Schedule 1 of the FMCA. Aside from crowd funding, the most relevant exclusions for SMEs are by making offers to only wholesale investors, relatives or close business associates. Small offers are also exempt.

3 Family and Business Associates

The first source of funding for many SMEs is family and close business associates. The FMCA has recognised this by allowing offers to be made to close business associates and relatives of the issuer or its directors without Part 3 disclosure. This source of funding may no longer suffice as an SME grows. Those with close relationships may have invested all they are willing and able to invest, leaving the business to source capital elsewhere to pursue its growth.

4 Small Offers

Small offers are personal offers that allow businesses to raise up to $2,000,000 (debt or equity) per annum from up to twenty investors. Personal offers can only be made to and accepted by people who had a gross income over $200,000 in the last two years or who are...

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184 At 15.
185 Financial Markets Conduct Act, s 39.
186 Schedule 1, cl 3, 4 and 5.
187 Schedule 1, cl 12.
189 Schedule 1, cl 4–5.
190 Ibrahim, above n 188, at 1417.
likely to be interested in the offer for one of the stated reasons in the legislation. These reasons include any previous contact between the offeror and offeree, a professional connection or any statements by the offeree that suggest they would be interested in the offer.\textsuperscript{191} Small offers allow SMEs to raise funds from their networks and a limited pool of other potential investors. As small offers cannot be advertised, they are of limited use for SMEs with limited networks and connections.\textsuperscript{192} Additionally, the small offers exemption does not assist SMEs seeking over $2,000,000.

5 Wholesale Investors

Wholesale investors allow businesses to avoid Part 3 disclosure and raise more capital than what close personal connections can provide or the $2,000,000 that can be raised through small offers.\textsuperscript{193} Wholesale investors include investment businesses, government agencies, ‘large’ persons and people who meet the investment activity criteria.\textsuperscript{194} Those who self-certify themselves as eligible investors can also be wholesale investors.\textsuperscript{195}

Wholesale investors, including private equity funds, venture capital funds and high net worth individuals, are a key source of funding for some SMEs.\textsuperscript{196} Searching for wholesale investors can be however a costly and time-consuming process with uncertain results.\textsuperscript{197} This process is relatively more difficult in New Zealand due to the country’s relatively thin private capital markets.\textsuperscript{198} While these markets have developed in recent years, it remains difficult for some SMEs to raise sufficient capital.\textsuperscript{199} Additionally, some wholesale

\textsuperscript{191} Schedule 1, cl 12.
\textsuperscript{192} Schedule 1, cl 13.
\textsuperscript{193} Schedule 1, cl 3.
\textsuperscript{194} Schedule 1, cl 3; Schedule 1, cl 39 defines ‘large’ persons as having net assets or total consolidated turnover of over $5,000,000 in the last two financial years; See sch 1, cl 38 for who meets the investment activity criteria.
\textsuperscript{195} Schedule 1, cl 41; Schedule 1, cl 3, Persons are wholesale if the minimum amount payable in the offer is $750,000, or they would have acquired $750,000 of that financial product upon accepting that offer.
\textsuperscript{196} Pekmezovic and Walker, above n 16, at 373–374.
\textsuperscript{197} Ibrahim, above n 58, at 576; Pekmezovic and Walker, above n 16, at 374; Daniell, above n 19.
\textsuperscript{198} New Zealand Government, above n 5, at 23.
\textsuperscript{199} Capital Market Development Taskforce, above n 178, at 56.
investors may take a hands on approach to managing their investment, making them inappropriate for entrepreneurs who wish to retain control.\footnote{Ibrahim, above n 58, at 590.}

6 Could crowd funding fill the gap?

After considering the various capital raising options available for SMEs, there appears to be a gap for businesses who seek over $2,000,000 but are not large enough to justify the costs of raising capital through an IPO.\footnote{Daniell, above n 19.} Wholesale investors cater to the capital needs of some of these businesses, but not all.\footnote{New Zealand Government, above n 5, at 23.}

This gap is partially filled by businesses conducting parallel offers to wholesale investors, circumventing the $2,000,000 cap. The size of the investor pool for the balance of the funds sought over $2,000,000, is however significantly reduced, making raising additional capital relatively more difficult.\footnote{Daniell, above n 19.} If wholesale investors do not emerge during the offer, the business will need to incur additional costs in seeking them out to raise its desired amount. Raising the $2,000,000 cap would assist SMEs who are too small to raise capital via the public markets by providing another funding option to seeking out wholesale investors.

B A Route to a Public Listing

It is desirable to increase the number of public listings as both retail and institutional investors benefit from having more investment and diversification opportunities. Many KiwiSaver funds partially invest in New Zealand listed companies.\footnote{Brian Gaynor, above n 171.} More domestic investment and diversification opportunities would benefit these funds, their members and further the government’s goal of increasing retirement savings.\footnote{KiwiSaver Act 2006, s 3.}

Crowd funding could become a stepping stone in an SMEs’ journey to the public market, fulfilling the role soon to be vacated by the NZAX and NXT. SMEs who crowd fund over $2,000,000 will be accelerated in their growth to the stage where conducting a future...
capital raise via an IPO could be viable.\textsuperscript{206} Increasing the cap could lead to more listings and the associated benefits.

\subsection*{C Benefits of Attracting More Investors}

Individual investor allocations can be scaled down in oversubscribed IPOs so that individual investors do not miss out.\textsuperscript{207} Retail investors cannot acquire shares in crowd funding campaigns however once $2,000,000 is raised. For example, many retail investors missed out on investing in Hikurangi Cannabis after it reached $2,000,000.\textsuperscript{208} Hikurangi Cannabis would have attracted more investors if the cap were raised. In general, larger crowd campaigns also tend to have relatively more investors.\textsuperscript{209} A higher investment cap will therefore likely lead to businesses raising over $2,000,000 attracting more investors than current crowd funding campaigns.

Shareholders that are keen to see their company succeed can become loyal customers and avid brand advocates.\textsuperscript{210} Some ParrtotDog shareholders have illustrated this by promoting ParrotDog beer to others and forgoing purchasing other beer brands.\textsuperscript{211} Grassroots promotion like this can greatly assist an SMEs’ growth. Raising the $2,000,000 cap could increase the benefits that arise from having many shareholders.

A potential drawback of having more shareholders is that the issuer could become subject to the Takeovers Code. Businesses with over 50 shareholders or parcels of shares with voting rights become code companies.\textsuperscript{212} Issuers can avoid becoming a code company through issuing non-voting shares\textsuperscript{213} or using nominee structures where investors acquire shares in a single nominee.\textsuperscript{214} Accordingly, many issuers have decided to issue non-voting shares, mitigating this potential drawback.\textsuperscript{215}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{206} The New Zealand Herald, above n 181.
\item \textsuperscript{207} See New Zealand Government and Mighty River Power, above n 177, at 8.
\item \textsuperscript{208} Waiapu Investments, above n 123.
\item \textsuperscript{209} See section IV B.
\item \textsuperscript{210} Aaron Titter “The ins and outs of equity crowdfunding” (1 November 2015) Ministry of Business Innovation and Employment <www.business.govt.nz>.
\item \textsuperscript{211} Hamish Rutherford “ParrotDog set to launch new crowdfunding campaign” (19 November 2017) Stuff <www.stuff.co.nz>.
\item \textsuperscript{212} Takeover Code Approval Order 2000, sch 1 rule 3A.
\item \textsuperscript{213} Takeovers Panel “The Takeovers Code and Crowdfunding” <www.takeovers.govt.nz>.
\item \textsuperscript{214} “Nominee options: An alternative shareholder structure” Snowball Effect <www.snowballeffect.co.nz>.
\end{itemize}
\end{footnotesize}
VII Effects on Investors from a Higher Cap

A Balancing Objectives

The cap’s level should be set by balancing the competing objectives of assisting businesses to raise capital and limiting retail investors’ exposure to risk. To assess whether the cap should be increased, the additional exposure of risks to retail investors’ needs to be considered and then weighed up against the increased benefits to SMEs from a higher cap.

B Additional Risks to Retail Investors

Retail investors face risks from the inherent riskiness of SMEs, asymmetric information and lack of liquidity. Raising the cap could expose more retail investor capital to these risks. However, the average amount invested by individual investors has remained relatively constant and larger offers have succeeded by attracting more investors, rather than having individual investors investing more. Campaigns seeking over $2,000,000 will therefore likely succeed by attracting more investors rather than by investors investing more. Individual retail investors are therefore unlikely to increase their exposure to a particular business’ risks if the $2,000,000 were raised.

1 Inherent riskiness

Crowd funded businesses appear to have lower failure rates than the predictions that influenced the $2,000,000 cap's implementation. Retail investors could be exposed to less risk than initially contemplated. Therefore, the cap could be increased without exposing retail investors to more risk than the regime intended.

While raising the cap will expose more retailer investor capital to inherently risky SMEs, individual investors are unlikely to be exposed to additional risks if they do not invest more. Daniell has argued that a retail investor would be better off investing in businesses raising over $2,000,000 as they are generally more established and carry lower risks. Therefore, while increasing the cap could lead to more crowd funding investment, the

215 The Sunday Star Times, above n 129.
216 See section IV B.
217 See section V B.
218 Daniell, above n 19.
additional investment is more likely to be in businesses with less risk than those that currently crowd fund.

2 Information asymmetries

Raising the cap could expose retail investors to more investment opportunities where information asymmetries exist. The wisdom of the crowd and reputational intermediaries can reduce these risks.

Commentators have suggested that the businesses not getting funded are generally those that should not be, indicating that the wisdom of the crowd appears to be working in New Zealand. As larger campaigns generally need more investors, businesses raising over $2,000,000 will need to pass the scrutiny of more prospective investors. To generate sufficient momentum to raise over $2,000,000 a significant cornerstone investor will likely be needed. Therefore, the wisdom of the crowd will play a greater role in protecting investors in these larger offers. The reputational intermediaries that have developed will also continue to play a role in protecting investors from risks associated with information asymmetries. Platforms will likely scrutinise issuers raising over $2,000,000 more as they are likely to suffer relatively greater reputational damage if such a business fails.

3 Liquidity risks

Increasing the cap will likely lead to retail investors holding more illiquid shares. However, given that individual investors are unlikely to invest more in each business, they are unlikely to be exposed individually to additional liquidity risks. Daniell has argued that investors are likely to face lower liquidity risks from investing in businesses that raise over $2,000,000 than investing in the businesses that currently crowd fund. This is because businesses raising over $2,000,000 are likely to be larger and more mature, and therefore closer to a liquidity event such as an IPO or being acquired. These businesses are also more likely to subscribe to a secondary market service due to them likely being larger and having more shareholders. Being larger would make subscribing to one relatively more affordable for them and having more shareholders will make trading easier. If businesses raise over $2,000,000, the demand for the platforms to develop secondary markets for crowd funded businesses will likely increase. The development of secondary markets will

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219 “Crowdfunding taking off, but beware”, above n 55.
220 Daniell, above n 19.
reduce liquidity risks for crowd funding investors. Therefore, although increasing the cap will lead to more illiquid shares, it is likely that the shares in companies that raise over $2,000,000 are going to be more liquid.

C Benefits to Investors

Despite potential additional risks to retail investors, there are also benefits from a higher cap. By increasing the cap, retail investors would be less likely to miss out in investing in popular businesses that they wished to support. The potential returns on these businesses could be higher, as popular businesses have likely passed the crowd’s scrutiny. Retail investors will also receive diversification benefits from being able to invest in more businesses and in ones that are likely to be larger and more mature than those that currently crowd fund.

VIII Proposed Reform

A Increasing the Cap

This paper argues that the FMC regulations should be amended so businesses can raise up to $5,000,000 per annum from crowd funding, peer-to-peer lending and small offers. Out of that total, only $2,000,000 should be able to be raised from small offers and peer-to-peer lending combined. This change will assist SMEs that currently struggle to raise capital. Whether the cap for peer-to-peer lending and small offers should be increased, requires weighing up the merits and risks involved, those considerations are outside the scope of this paper.

While some have suggested that the cap should be raised to $10,000,000, it is not yet clear whether such a high limit is necessary. If many businesses reach the proposed $5,000,000 cap and subsequently succeed, then the cap should be re-evaluated at that stage. In addition to the successfullness of crowd funded businesses, future considerations of whether the cap should be increased beyond $5,000,000 should have regard to whether smaller businesses have listed on the NZX under its new listing rules and whether any crowd funding platforms have developed secondary markets.

221 Daniell, above n 19.
B Additional Protections for Investors

A higher cap will assist SMEs to raise capital but will also expose retail investors, as an aggregate, to more risks as more retail investor capital will be invested in inherently risky early-stage businesses where information asymmetries and liquidity risks exist. Consideration of potential additional protections for investors is therefore warranted.

1 Individual retail investor caps

To limit individual retail investor’s exposure to a particular business, individual retail investor caps could be implemented. For example, retail investors could be restricted to investing a maximum of $50,000 per annum through crowd funding or they could be limited to investing up to $50,000 in businesses seeking to raise over $2,000,000. Both of these approaches limit the total exposure of crowd funding risks to individual retail investors, not retail investors as an aggregate. This may not be very effective as it is retail investors as an aggregate that are likely to be exposed to increased risks from a higher cap, not individual retail investors. While imposing individual investor caps would be consistent with other jurisdictions, the New Zealand government declined to implement them. The likely reasons were that they would be difficult to enforce and that they were not imposed on small offers. Industry practitioners supported this decision.

While introducing investor caps would not limit the ability of wholesale investors to become cornerstone investors, it would prohibit retail investors from doing so. Cornerstone investors are often required for offers to generate enough momentum to succeed. Introducing individual investor caps may make it more difficult for these larger offers to succeed.

Due to New Zealand’s crowd funding regime’s apparent success, this paper suggests individual caps should once again be rejected. Imposing caps only on businesses raising over $2,000,000 is inconsistent with the current regime as businesses raising over $2,000,000 are likely to be less risky than those raising under $2,000,000 where no cap

222 Hillind, above n 11, at 49.
223 Cabinet Business Committee, above n 8, at [139]–[140]; Hillind, above n 11, at 52.
224 See Mackenzie McCarty “Cabinet gives green light to equity crowdfunding” NZ Lawyer (online ed, New Zealand, 28 February 2018) for comments from Hayley Buckley, partner at law firm Wynn Williams; See Jonathan Cotton “The real deal with NZ’s equity crowdfunding love affair” idealog (online ed, New Zealand, 14 August 2015) for comments from Josh Daniell of Snowball Effect.
would apply. Individual retail investor caps are unlikely to address the additional risks to retail investors as an aggregate from allowing businesses to crowd fund over $2,000,000.

2    Requiring cornerstone investors

Requiring a cornerstone stake, such as 20 per cent, to be subscribed to before an offer seeking over $2,000,000 is launched would be a better protection. One or a small group (for example up to five) of either retail or wholesale investors could subscribe to this stake. These cornerstone investors would be incentivised to closely scrutinise the business and its prospects before committing to invest in it. The due diligence conducted by these cornerstone investors reduces the risks from asymmetric information to other retail investors who come along for the ride. This practice is called syndication and is common in angel investing groups. Unlike investor caps, this protection would mitigate the risks of the crowd backing businesses with poor prospects. Cornerstone investors currently have an important role in crowd funding in New Zealand, especially for businesses seeking to raise relatively large amounts. This requirement will increase the protections to retail investors as an aggregate and is unlikely to impose substantial burdens on businesses seeking over $2,000,000.

3    Assisting the development of secondary markets for crowd funded investments

The FMA could assist the development of a secondary market for crowd funded shares to reduce liquidity risks to retailer investors both individually and as an aggregate. Issues would arise over how such secondary markets should be regulated and whether continuous disclosure requirements apply. Snowball Effect’s proposed secondary market allows businesses to set limited trading windows to mitigate continuous disclosure costs. The development of a secondary market where issuers could allow their shares to be traded at certain times would be beneficial. The FMA may wish to assist licensed platforms in developing secondary markets if the investment cap is increased to $5,000,000. The FMA could issue platforms with the appropriate licences and offer them appropriately scaled-back regulatory requirements, especially around continuous disclosure.

225 Schwartz, above n 10, at 263.
226 At 261.
227 Schwartz, above n 17, at 936.
228 Mandow, above n 149.
IX Conclusion

Considering the apparent success of the crowd funding regime in New Zealand to date and the need to help SMEs access capital, there is a strong case for raising the investor cap to $5,000,000. While this may put more retail investor capital at risk in total, it is unlikely that the risks individual retail investors are exposed to will increase. Key protections for retail investors have already developed, including the reputations of platforms and the wisdom of the crowd. Additional protections for offers over $2,000,000, such as requiring a cornerstone investor or the FMA assisting in the development of a secondary market warrant further consideration.
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