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CROWDFUNDING THE REVOLUTION:

TOWARDS THE REGULATION OF EQUITY CROWDFUNDING

by

Mlungisi Mahlangu (201247688)

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SUPERVISOR: PROFESSOR KATHLEEN VAN DER LINDE

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DECLARATION

This serves to confirm that I, Mlungisi Mahlangu,
Student number: 201267688,
and enrolled student for the Programme: LLM (Corporate Law)
Faculty of Law.

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Per aspera ad astra.

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1. ABSTRACT

A key mechanism to unlock socio-economic development, particularly amongst young people is the active support of entrepreneurship. One of the ways of encouraging entrepreneurship is by expanding access to finance, particularly through informal channels as traditional capital and financial markets are out of reach for many, particularly in nascent industries or for emerging businesses.

The advent of the fourth industrial revolution, and the technological innovation it brings, could be a key catalyst to providing small business and entrepreneurs with access to new financial markets. One such market is the ability to raise small amounts of money from a large number of people.

The challenge for companies seeking to access crowd finance is that traditional legislation is focussed on the protection of investors and not necessarily on the liberalisation of investment choices.

In order to give crowdfunding an opportunity to grow as a market, a balance will need to be struck between keeping the costs of accessing the crowdfunding market at a minimum without compromising on investor protection. A key way of doing this will be through the relaxation of the regulatory framework relating to the offering of securities to the public, the establishment of regulated crowdfunding platforms and the standardisation of the constitutional documents of issuers. Without these interventions, it is unlikely that a buoyant crowdfunding market can exist.

2. INTRODUCTION

One of the stated aims of the Companies Act[1] is the promotion of innovation and investment in South African markets.[2] Although the term "markets" is not defined, or used elsewhere in the Companies Act, given that among the other purposes of the Companies Act is encouraging entrepreneurship and enterprise efficiency,[3] the creation of optimum conditions for the aggregation of capital for productive purposes,[4] and

[1] Companies Act 71 of 2008.
[2] s 7(c).
[3] s 7(b)(ii).
[4] s 7(g).

reaffirming the company as a means of achieving economic and social benefits,[5] the Companies Act is intended to provide for all companies, and not only those that operate within the formal structures of the financial markets.[6]

A way in which developing countries can improve the socio-economic position of their citizens is by fostering innovative market practices and ensuring that the law (or any applicable legislative framework) is simple to understand and comply with, with the effect that it does not serve as a barrier to innovation.[7]

The need for improved socio-economic conditions in South Africa cannot be understated.[8] One of the means that are generally accepted to curb the dire socio-economic state of developing countries is the creation of suitable conditions for entrepreneurship to thrive.[9] Entrepreneurship in turn can be catalysed s by expanding access to finance.[10] The concentrated structure of the South African banking system fosters a lower level of access to financial services,[11] particularly for micro, small and medium enterprises.[12] This is a trend so for such enterprises in so-called low income countries.[13] Technology, and the innovation it brings, can be a key catalyst to providing small business and entrepreneurs with access to new financial markets.[14]

[5] s 7(d).

[6] Mongalo *An overview of company law reform in South Africa: From the Guidelines to the Companies Act 2008* Acta Juridica: Modern Company Law for a Competitive South African Economy (2010) xxii.

[7] Bellantuono and Lara *Law, Development and Innovation* (2016) 194.

[8] The National Department of Statistics, South Africa estimates that approximately half of South Africa's adult population lives in poverty. See Maluleke *Men, Women and Children: Findings of the Living Conditions Survey 2014/15* Statistics South Africa South Africa (2018) 13.

[9] Tau *Searching through dustbins* (2019) xiii. See also South African National Planning Commission *South African National Development Plan 2030* (2012) 119 where it is argued that regulatory reform and government support are key catalysts for boosting entrepreneurship which, in turn, will boost economic growth and employment.

[10] Lewis and Gasealahwe *Lowering barriers to entrepreneurship and promoting small business growth in South Africa* (2017) 8.

[11] Lewis and Gasealahwe (n 10) 36.

[12] Huang, Chiu, Mo and Marjerison "The nature of crowdfunding in China: initial evidence" 2018 *Asia Pacific Journal of Innovation and Entrepreneurship* 300.

[13] Huang, Chiu, Mo and Marjerison (n 12) 301.

[14] Lewis and Gasealahwe (n 10) 26 and Huang, Chiu, Mo and Marjerison (n 12) 301.

One of the markets that technology has made available to entrepreneurs, is access to capital and financing from "the crowd", an avenue outside of the formal financial markets operating in South Africa.[15]

Crowdfunding has not been formally defined in South African law and, considering that stokvels have found themselves part of the daily lives of South Africans for a long time,[16] crowdfunding is not a new phenomenon.[17] The advent of technological innovation has, however, given a new lease on life for crowdfunding which is generally defined as follows:

> "an umbrella term describing the use of small amounts of money, obtained from a large number of individuals or organisations, to fund a project, a business or personal loan, and other needs through an online web-based platform."[18]

There are primarily four types of crowdfunding, two are regarded as community based or altruistic crowdfunding forms and the other two are considered commercial or profit motivated.[19]

The community based crowdfunding forms are donation based crowdfunding and reward crowdfunding.[20] These forms do not provide a financial return on the amounts contributed, instead they are commonly used to enable support for charitable causes or the early stage contribution towards the development of an innovative product, with the hope to receive a non-monetary benefit or other form of recognition for such contribution. Other than the imperative to not support or be engaged in criminal activity, community based crowdfunding does not raise many corporate law issues.[21]

[15] Lewis and Gasealahwe (n 10) 36.

[16] South African National Planning Commission *South African National Development Plan 2030* (2012) 375.

[17] Makina *The emergence of crowdfunding in South African financial markets* South Africa (2017).

[18] Kirby and Worner "Crowdfunding: An infant industry growing fast" (2014) *IOSCO Staff Working Paper* 8.

[19] Kirby and Worner (n 18) 8.

[20] Kirby and Worner (n 18) 8.

[21] The most pertinent corporate law obligation would be the need to pay the appropriate tax on the contribution, which is likely to be the payment of donations tax in the event that the receiver does not give an appropriate quid pro quo for the contribution. It is, however, possible for the receiver to apply for and obtain an exemption from having to pay donations tax for example in the event that the receiver undertakes public benefit activities.

The commercial or profit-motivated forms of crowd funding are peer-to-peer lending and equity crowd funding. These two forms are defined as follows:

> "Peer-to-peer lending is a form of crowd-funding used to fund loans which are paid back with interest. Equity crowd-funding is the raising of capital through the issuance of stock to a number of individual investors using the same method as crowd-funding." [22]

Peer-to-peer lending reportedly makes up 91% of the market for alternative funding in South Africa.[23] One possible reason for this may be that the regulatory environment for making and receiving loans is institutionalised,[24] relatively simple and certain.[25] The environment in relation to so-called equity crowdfunding is not so and requires either the adaptation of existing regulatory frameworks in order to ensure their suitability or the creation of a new regulatory framework.[26]

This dissertation examines the regulatory regime that applies to equity crowdfunding in South Africa and assesses whether such a regime is appropriate in the light of the imperatives of crowdfunding. This dissertation also analyses what regulatory enhancements or innovative measures can, in the light of international practice, be introduced in South Africa in order to ensure that the crowdfunding revolution occurs in a manner that addresses South Africa's immense socio-economic challenges.

Particular focus will be placed on models followed in the United States of America and China who, respectively through the African Growth and Opportunity Act and BRICS are likely to facilitate the investment in nascent industry in South Africa. That they have fundamentally divergent corporate and regulatory cultures, and entrepreneurial cultures which are both outward looking and based on strong domestic fundamentals is also a benefit for this study.

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[22] Kirby and Worner (n 18) 8.

[23] Lewis and Gasealahwe (n 10) 36.

[24] Lewis and Gasealahwe (n 10) 36.

[25] See generally the National Credit Act 34 of 2005 (the "NCA") which provides for the establishment of the National Credit Regulator to, among other things promote and support the development of a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry. The NCA is intended to democratize access to debt finance – section 60 of the NCA establishes a "right to credit" which proscribes a credit provider's right to refuse credit to reasonable commercial grounds.

[26] Lewis and Gasealahwe (n 10) 36.

3. MODELLING CROWDFUNDING REGULATION

Despite the legal rules regulating the conduct of business in general, as well as taxation and insolvency being important considerations in understanding corporate finance decision-making,[27] this dissertation will only consider the necessary infrastructure and key role players of crowdfunding in the light of their interaction with the law.

There is at present no internationally recognized or standardised model through which equity crowdfunding is facilitated.[28] Most models that have been reported on are either designed by way of a statutory framework or are bespoke and take into account the characteristics and needs of local investors,[29] as well as the desire to ensure that the manner in which equity crowdfunding is designed and implemented benefits (or at least meets the expectations) of all relevant stakeholders.[30] A key feature of crowdfunding is that it aims to operate outside of the bureaucratic channels established by existing financial markets.[31] As some commentators observe:

> "The crowdfunding business ecosystem enables the demand and supply side of the investment process to interact directly without the intermediary functions that were provided by many financial institutions."[32]

The goal of equity investment is normally to obtain a return from the investment made or to influence or partake in development within a particular sector. The enabling environment for equity crowdfunding can be designed in a manner that encourages investment in key or strategic sectors.[33] This may also resonate with investors whose goals may transcend solely achieving financial returns.[34]

[27] Myers "Capital Structure" 2001 *Journal of Economic Perspectives* 81 100. See, however, Deakin "Corporate governance, finance and growth: Unravelling the relationship" in Mongalo (ed) "Modern Company Law for a Competitive South African Economy" (2010) Juta and Co Limited: Cape Town 191 192.

[28] Huang, Chiu, Mo and Marjerison (n 12) 301.

[29] European Commission *Proposal for a regulation of the European Parliament and of the Council on European crowdfunding services providers for business* COM Brussels (2018) 4.

[30] Huang, Chiu, Mo and Marjerison (n 12) 301.

[31] Huang, Chiu, Mo and Marjerison (n 12) 301.

[32] Huang, Chiu, Mo and Marjerison (n 12) 313.

[33] Huang, Chiu, Mo and Marjerison (n 12) 305. See, for example section 12J of the Income Tax Act 58 of 1962 which provides a tax benefit to investors in some types of early stage growth companies.

[34] Huang, Chiu, Mo and Marjerison (n 12) 314.

4. CROWDFUNDING IN THE UNITED STATES OF AMERICA

The United States model of equity crowdfunding, which provides an exemption under the United States of America's Securities Act, 1933 for issuers a pursuant to the federal Jumpstart Our Business Starts Act[35] (the "**JOBS Act**"), envisages three main actors in an equity crowdfunding transaction.[36] The first is the entity that seeks to raise funds from the public (the issuer), the second is the platform through which the funds will be raised (the platform) and the third is the party that seeks to invest in the issuer (the investor).[37] The model introduced by the JOBS Act is not the only model applicable in the United States, as different States within that country have introduced their own requirements and models for crowdfunding.

The JOBS Act has restrictions on who may act as crowdfunded and also restrains the extent to which individuals may invest in platforms.[38] Generally, any company may be an issuer under the regime provided for by the JOBS Act, crowdfunded although issuers are required to disclose to the Securities and Exchange Commission (for publication) certain prescribed information, as well as any other information as may be required by the SEC in order to protect investors or serve the public interest.[39]

Issuers, who must be domestic companies of the United States,[40] are also required to interact with the general public only through the SEC or the platform, as applicable.[41] An interesting, but not altogether unique, feature of the crowdfunding regulation in the United States is that platforms are tasked with educating and protecting investors by ensuring that investors are aware of, and understand, the risks of crowdfunding investment.[42]

[35] Public Law No 112-106, 126 Stat. 306.

[36] Rubock "The Risk of Money Laundering Through Crowdfunding: A Funding Portal's Guide to Compliance and Crime Fighting" 2014 *Michigan Business and Entrepreneurial Law Review* 115.

[37] s 302 of the JOBS Act which introduces amendments to the United States Securities Act of 1993 which exempts certain platforms from having to comply with some provisions of the Securities Act of 1993.

[38] Rubock (n 36) 116.

[39] s4A(b)(1)(I) of the Securities Act of 1933.

[40] Rubock (n 36) 117.

[41] s4A(b)(2) to (5) of the Securities Act of 1933. Schwartz "Keep It Light, Chairman White: SEC Rulemaking Under the Crowdfund Act" 2014 *Vanderbilt Law Review En Banc* 43 51.

[42] s 302 of the JOBS Act.

Platforms are not permitted to offer investment advice or hold investor funds in trust,[43] however they are required to take measures to reduce the risk of fraud being perpetuated by an issuer, including through conducting limited issuer due diligence.[44] That the JOBS Act only requires limited issuer due diligence to be undertaken is understandable as not only does this keep the costs of accessing crowdfunding minimal, but it also takes into account that many businesses that will make use of crowdfunding are early stage or untested businesses which require funding from unconventional sources in order to incubate or test the models upon which such businesses are based.[45]

5. CROWDFUNDING IN CHINA

The model prescribed by the JOBS Act in the United States of America is similar to the general practice in China,[46] although there are some notable nuances in the Chinese model.

The first is that platforms in China are not standalone entities, they are intrinsically connected with e-commerce platforms and virtual payment solutions, which ensures that access to financial markets to raise funding is linked with access to a customer base in order to facilitate product offtake and enhance the bankability of an issuer.[47]

The second nuance is that as opposed to conventional crowdfunding involving only the issuer, the platform and the investor, the Chinese model involved a fourth participant. This participant plays a role in facilitating the crowdfunding transaction and is normally commissioned by an issuer. The typical functions that this party would assume include managing the investment on behalf of investors (which may even entail such party exercising the rights in the issuer that an investor normally would thereby assume the role of a proxy or representative shareholder).[48]

The third nuance is the possible syndication of investors into a single vehicle, which will be tasked with making a direct investment in an issuer,[49] and the fourth nuance

[43] s 304 of the JOBS Act.

[44] s 302 of the JOBS Act.

[45] Huang, Chiu, Mo and Marjerison (n 12) 313.

[46] Huang, Chiu, Mo and Marjerison (n 12) 313.

[47] Huang, Chiu, Mo and Marjerison (n 12) 315.

[48] Li J "Equity Crowdfunding in China: Current Practice and Important Legal Issues" 2016 *The Asian Business Lawyer* 64.

[49] Li (n 48) 63.

being the availability of a licensed exchange that serves (in theory) as an exit mechanism for investors thereby ensuring that investments made in an issuer are not illiquid.[50]

In the syndication model, investors participate in a crowdfunding venture on the basis of their trust in a lead investor (who is tasked with making the decision to invest in an issuer and also assembling the syndicate in order to scale the investment).[51] While the lead investor is required to invest in the issuer on the same terms as the crowd, the lead investor does not have to invest through a platform or through the syndication vehicle and is rather required to disclose to investors how it votes on matters pertaining to the issuer and also disclose the details of any transaction in which it buys additional shares or disposes of shares.[52] There is also a practice in China (although seemingly not well developed) of using either voting pool-type arrangements (that each investor can accede to) or of organising by way of a limited liability partnership as opposed to using a company as a vehicle for syndication.

6. POSSIBLE MODELS FOR CROWDFUNDING GLEANED FROM THE PRACTICE IN THE UNITED STATES OF AMERICA AND CHINA

The models observed in the United States of America and China focus on the role of a platform as a catalyst for connecting the offerors and acquirers of shares. Even though practice in China goes further than providing only for a platform that connects offerors and acquirers of shares, the role played by a platform in China remains similar to that played by a platform in the United States.

The Chinese model provides (at least ostensibly) for additional safeguards for investors through the presence, altogether apart from the platform, of a party that facilitates the crowdfunding transaction and exercises rights on behalf of the investors. The Chinese model also provides for the investment by members of the public through a syndicate which may at first blush appear to be an additional layer in the crowdfunding model however, if considered in the totality of the scheme within which it operates, it may be a separate expression of the platform model in that investors ultimately invest in the

[50] Li (n 48) 64.
[51] Li (n 48) 73.
[52] Li (n 48) 74.

syndicate (and not in an underlying issuer) as their gateway to having exposure to crowdfunded assets.

The impact of South African law on a crowdfunding model will therefore depend largely on the role that is played by the platform. To this end, three models are considered in the light of current South African law and depending on the extent of a platform's participation in the crowdfunding process: (i) the issuer uses the platform as a mechanism to make offers to the public, the only role played by the platform will be the dissemination of information to members of the public - the platform therefore serves as a marketplace for connecting investors and issuers ("**passive platform model**"); (ii) the platform serves as a marketplace for connecting investors and issuers, however it is tasked (similarly to the model in the United States of America under the JOBS Act) with undertaking limited issuer due diligence, facilitating the disclosure of information by issuers to investors and ensuring that investor funds are not disbursed until the fundraising target of an issuer has been reached ("**active platform model**"); and (iii) investors' discretion in which issuers to invest in is constrained (whether voluntarily or institutionally) and investors essentially make their investment decision on the basis of their trust in an established and experienced entity that pools the funds of investors and invests them in issuers ("**fund model**"). For present purposes, the nuances between the Chinese syndication model and the Fund Model are not explored further as the Chinese model, properly construed, would fall either within the passive platform model or the active platform model.

7. PASSIVE PLATFORM MODEL

7.1 Making an offer to the public

An important feature of equity crowdfunding, depending on the model that is followed, is that it involves the offering of securities to members of the public.[53] Chapter 4 of the Companies Act broadly defines an offer to the public to include any offer of securities to be issued to any section of the public.[54] In order for these provisions to apply, an offer must have been made to the public an invitation to solicit an offer would not suffice. The Companies Act does not provide a helpful definition of what constitutes an

[53] Sing "Regulation of Equity Crowdfunding in Singapore" 2015 *Singapore Journal of Legal Studies* 46 47; Huang, Chiu, Mo and Marjerison (n 12) 309; Li (n 48) 61.

[54] s 95(1)(h).

offer,[55] it does, however, provide that an offer can be made in any way, therefore an offer made electronically or through an intermediary would constitute an offer for purposes of Chapter 4 of the Companies Act.[56] In order to ascertain what constitutes an offer, the principles espoused by common law must be followed.[57] It is trite that in order to constitute an offer, a statement must be an unambiguous expression of an intention to contract which, if accepted, would give rise to a binding agreement.[58]

The broad[59] definition of what constitutes the public is intended, subject to the exceptions provided for by the Companies Act, to bring within the ambit of regulation all instances where an offer is made and there is no prior connection between the offeror and the offerrees[60] and reflect the reasoning of Nugent JA in *Gold Fields v Harmony Gold*:[61]

> "To qualify as an offer to the public it would seem to me that the terms of the offer would at least need to be capable of being offered to and accepted by the public at large…. But an offer that is made to the public would necessarily be in terms that would enable it to be made to and accepted by the public at large, and it could thus be made with indifference to any random section of the public. An offer to sell shares, for example, in return for cash, is capable of being made to the public at large, and might thus be made as much to that section of the public that resides in Bloemfontein as to the section of the public that resides in Upington."[62]

The purpose of this broad definition is ensuring that all persons to whom offers are made are entitled to obtain, by way of a prospectus or a written statement, sufficient information to enable them to assess the merits of the offer[63] and ultimately make a decision as to whether the offer is one they wish to accept.[64]

Excluded from the scope of what constitutes an offer to the public is an offer under circumstances set out in section 96 of the Companies Act, as well as a secondary offer

[55] s 95(1)(g).

[56] Delport (ed) *Henochsberg on the Companies Act 71 of 2008* (2019) 364. See also, generally, the Electronic Communications and Transactions Act 25 of 2002.

[57] Delport (n 56) 364.

[58] Van Jaarsveld v Ackermann 1975 2 SA 753 (A) at 757D.

[59] Delport (n 56) 364.

[60] Delport (n 56) 366.

[61] *Gold Fields Limited v Harmony Gold Mining Company Limited* 2005 (2) SA 506 (SCA).

[62] Gold Fields (n 61) paras 13 and 14.

[63] s 100(2)(a)

[64] Delport (n 56) 365.

(being an offer made by a third party of the securities of an issuer)[65] is excluded by section 96 as it is made through an exchange.[66]

The exceptions from an offer to the public provided for by section 96 of the Companies Act apply to persons who are regarded as not requiring a prospectus in order to make their investment decision, such persons are therefore already in possession of the information that they would require in order to make an investment decision or are reasonably able to acquire it.[67]

Among these persons are those whose ordinary business is to deal in securities,[68] the Public Investment Corporation SOC Limited,[69] banks, pension funds and financial services providers,[70] existing holders of the issuer's securities and persons related to such existing holders,[71] qualified investors (i.e. persons who intend to invest a minimum of one million Rand (or such other amount not less than R100,000 as may be prescribed) to acquire securities made pursuant to the offer),[72] employees of the issuer pursuant to an employee share scheme[73] or directors or prescribed officers of the issuer,[74] or an offer which, in the aggregate seeks to raise a maximum of a million Rand (or such other amount not less than R100,000 as may be prescribed) and complies with certain restrictions contained in the Companies Act (a "**small cap offer**").[75]

The making of a secondary offer through an exchange is regulated by the Financial Markets Act (FMA)[76] while the making of a secondary offer through informal markets is regulated by Chapter 4 of the Companies Act, however the information required to be

[65] s 95(1)(m).

[66] s 95(1)(h).

[67] Delport (n 56) 365.

[68] s 96(1)(a)(i).

[69] s 96(1)(a)(ii).

[70] s 96(1)(a)(iii) to (vi).

[71] s 96(1)(c). To the extent that the offer is made only to such persons or their related parties and is not renounceable. An offer is non-renounceable if it is only capable of being accepted by the person to whom it is made. See Cassim FHI (ed) *Contemporary Company Law* (2011) 596.

[72] s 96(1)(b).

[73] s 96(1)(e).

[74] s 96(1)(f). To the extent that the offer is made only to such persons or their related parties and is not renounceable.

[75] s 96(1)(g).

[76] 19 of 2012. See also s 101(2).

disclosed in making such offer is substantially less than that required for primary offers.[77]

In order to achieve efficiencies of cost and time, issuers will either have to craft their offerings in a manner that fits within the exceptions provided for in the Companies Act, or comply with the provisions pertaining to offers made to the public. The time and expense associated with making an offer to the public that is not exempt relate mostly to the requirement that an issuer of securities to the public accompany such offer with a registered prospectus.[78] An alternative to producing a prospectus would be making the primary offer by way of an advertisement that contains all of the information that the Companies Act requires to be contained in a prospectus.[79] This too, however, is likely to be a costly exercise.

A prospectus is required to contain all the information that an investor may reasonably require to assess the assets and liabilities, financial position, profits and losses, cash flow and prospects of the company in which a right or interest is to be acquired, and to assess the securities being offered and rights attaching to them.[80] An issuer may apply to the Companies and Intellectual Property Commission (the "**Commission**") for permission to exclude information that is required to be disclosed in a prospectus.[81] This exemption may only be granted by the Commission in limited instances[82] and provided that the omission of such information would not unduly prejudice a potential investor.[83] This potential exemption is useful, but does not go far enough in expediting the process to be followed by issuers as an application must be undertaken on a case by case basis,[84] compounded by the fact that the Commission is not time bound in

[77] s 101(6).

[78] s 99(2).

[79] s 98(1).

[80] s 100(2)(a). As an alternative to issuing a prospectus and for secondary offers, the person disposing of the securities could make use of a previously issued prospectus (updated with any material changes in the condition of the company) or by way of a written statement, the contents of which will be far less onerous than a prospectus (s 99(2), 99(3) and 101(2). Given that the focus of this dissertation is fundraising activity by issuers, options which can be used by the issuer for fundraising (as opposed to those open to an investor for exit) are focussed on.

[81] s 100(9).

[82] That is, where the publication of the information would be unnecessarily burdensome on the issuer, cause serious detriment to the issuer or be against the public interest.

[83] s 100(9)(b).

[84] s 6(2).

considering an application and is not empowered to provide a general exemption to all issuers.[85]

Due to the nature of crowdfunding being such that a relatively small amount of money is raised from a large number of investors, the only exception to the definition of an offer to the public that is likely to apply to an issuer is the making of a small cap offer.

Unlike the other exceptions from an offer to the public whose purpose is to not require the publication of a prospectus for sophisticated investors or persons who are expected to have knowledge of the affairs of an issuer (or at least be in a position to ascertain the condition of the issuer as a result of being "insiders"),[86] the purpose of the small cap offer provisions (which are almost a restatement of the provisions of section 144(c) of the Companies Act 61 of 1973) is to ensure that a private placement that raises a small amount of money does not have to comply with the requirement to produce a prospectus.[87]

In order to qualify as a small cap offer, an offer (or the series of offers of which it forms part) must be made in writing, not be accompanied by or made by means of an advertisement, not incur any selling expenses, be finalised within six months of the date that it was first made, be accepted by no more than 50 persons acting as principals and not seek to raise more than one million Rand as currently prescribed under Reg 45(2) of the Companies Act.[88] The issuer must also not have made another offer (or series of offers) within an immediately prior period of 12 months as currently prescribed under Reg 45(1) of the Companies Act.

The structuring of crowdfunding investment by issuers as small cap offers could potentially be the ideal way for the Passive Platform Model to assist with connecting issuers and investors. A small cap offer could be made by an issuer every 12 months,[89] thereby providing a steady stream for meeting its medium term working capital requirements.

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[85] s 6(2).

[86] Delport (n 56) 365.

[87] Blackman *Commentary on the Companies Act* (2002) Ch6-11.

[88] s 96(1)(g).

[89] Yeats "Public offerings of company securities: a closer look at certain aspects of chapter 4 of the Companies Act, 71 of 2008" 2010 *Acta Juridica* 117 123.

The requirements of section 96(1)(g) are not onerous and platforms could assist in ensuring that offers raise the currently maximum permissible amount (one million Rand) from up to 50 investors acting as principals, that investors are refunded for any offers which are not finalised within six months and provided that platform fees are charged to the investors and not the issuer (so that no selling expenses are incurred by the issuer). Any primary offer which falls outside the scope of this exception (and is not otherwise excluded from the ambit of an offer to the public) would have to be accompanied by a registered prospectus. Non-compliance with this requirement (for example by an issuer using more than one platform to raise more than the prescribed caps raise funds from more than 50 people, or therefore undertaking more than one offer in the prescribed 12 month period) would be an issuer risk as the issue allotment would be void non-compliance with the law thus entitling all investors to be refunded the amount of their subscriptions.

Despite the apparent ease with which an issuer may be able to comply with section 96(1)(g), an aspect of this exemption that warrants closer inspection is the requirement that, in order to qualify as a small cap offer, the offer (and any other offer within the same series of offers) may not be accompanied by or made by means of an advertisement. The small cap offer provisions are often used as a mechanism to make offers to a limited number of persons who have a prior connection with the issuer. For this reason an advertisement is generally not required to be made to them in order to communicate the terms of the offer.

The Companies Act defines an advertisement quite broadly as:

> "any direct or indirect communication transmitted by any medium, or any representation or reference written, inscribed, recorded, encoded upon or embedded within any medium, by means of which a person seeks to bring any information to the attention of all or part of the public."

An issuer setting up a website or placing an advert on a website, newspaper or online catalogue would most certainly amount to an advert, although it is not clear whether an online platform established for the purposes of providing members of the public with access to crowdfunding opportunities would be caught by the broad definition. It is also

not clear whether the person bringing information to the attention of the public need necessarily be the issuer or whether the platform may qualify as such person.[90]

The word "advertisement" has not been the subject of much judicial interpretation although the case law on this point suggests that an advert is made by a person who intends for the public to come to the knowledge of such information[91] and that merely making known the existence of an opportunity would not necessarily constitute an advertisement.[92] It may therefore be possible for potential issuers to approach platforms to assist them with their fundraising and, if the platforms have discretion on whether or not to list any particular issue, the approach to platforms by an issuer would not be an advert (and consequently not an offer to the public). This would also be so if the approach by an issuer to the platform is not an offer but rather a means by which the issuer invites potential investors to consider subscribing for shares in the issuer.[93] Platforms would, in turn, make known to the public the availability of opportunities to invest in issuers on their portal (however without promoting or endorsing any particular offer by an issuer as this may be regarded the provision of "advice" in relation to the subscription - with potential consequences under FAIS and the FMA).

7.2 Limitations imposed by the type of company

The Companies Act recognises two primary forms of privately owned profit companies, public and private companies. There is no requirement in Chapter 4 of the Companies Act that an offer to the public be made by a public company,[94] however, in order to qualify as a private company, the memorandum of incorporation of a company must restrict the transferability of the securities of the company and prohibit the company from offering its securities to the public.[95]

[90] Under the JOBS Act an issuer is bared from directly promoting its own crowdfunded security, however it may appoint an outside promoter to do so provided that the compensation to be paid to the promoter (and the manner of its calculation) is disclosed to the SEC. See Schwartz (n41) 53.

[91] *R v Hees* 1944 1 PH D7 (T).

[92] *R v Alexander* 1954 3 SA 383 (N) at 387D.

[93] Delport (n 56) 54(13). The issuer would have to ensure, that the terms of the invitation are such that their mere acceptance would give rise to a contract.

[94] s 99(1)(a).

[95] s 8(2).

Unlike the Companies Act 61 of 1973 the current Companies Act does not restrict the number of shareholders of a private company to fifty.[96] That profit companies may have an unlimited number of shareholders[97] aides in the permissibility of using the small cap offer mechanism for crowdfunding. Although the Companies Act should limit a private company's ability to make use of the small cap offer in order to ensure that fundraising using this mechanism does not continue in perpetuity or cause the company to have an unmanageable number of shareholders.[98]

The common ways in which the transferability of securities may be restricted is through the memorandum of incorporation of a company providing for pre-emptive rights on the sale of the securities of the company[99] and the transfer of securities of the company having to be authorised by the board of that company, although any other restriction would suffice for this purpose.[100]

It is not altogether clear whether a company that makes an offer that, but for the application of the exemptions provided for in section 96(1), would be regarded as an "offer to the public" will be considered a private company for purposes of the Companies Act other than Chapter 4. Some authors contend that given that the word "public" is not defined generally in the Companies Act and the definition of "offer to the public" in section 95 only applies to Chapter 4 of the Companies Act, the word "public" must, except when used in Chapter 4, be given its ordinary grammatical meaning.[101]

This anomaly, which is a carry-over from the Companies Act 61 of 1973,[102] should be addressed either by an appropriate amendment of the Companies Act or through an exemption being granted by the Commission. The classification of a crowdfunding entity as a private company is important as it will minimise the costs of operating the entity.[103] Private companies (save to the extent that they are required by their

[96] s 20 of the Companies Act 61 of 1973.

[97] Cassim (n 71) 69.

[98] This could be achieved through limiting the number of shareholders, adding number of 8 hours to calculation of public interest score or cap amount raised in this way.

[99] This should be distinguished from the pre-emptive rights on the issue of securities of the company, as provided for in s 39(2).

[100] Cassim (n 71) 71.

[101] Delport (n 56) 54(12).

[102] Delport (n 56) 54(12).

[103] Cassim (n 71) 67.

memorandum of incorporation or the Companies Act)[104] do not have to comply with the enhanced accountability and transparency requirements provided for by the Companies Act.[105]

By way of illustration, public companies[106] are required to appoint an auditor,[107] have an audit committee[108] and also appoint a company secretary[109] (except if it is a subsidiary of a company that has an audit committee and such other company's audit committee will also serve as the audit company of the subsidiary company).[110] Making these requirements applicable to issuers would increase the compliance costs of their operation and potentially erode the benefits that a small cap offer would provide to issuers.

7.3 Financial services regulation

Apart from the Companies Act, the offering of, or trading in securities by any persons in South Africa is governed by the Collective Investment Schemes Control Act 45 of 2002 (CISCA), the FMA, the Banks Act 31 of 1920 (Banks Act) and the Financial Advisory and Intermediary Services Act 37 of 2002. Of these, the CISCA and FMA are most relevant to crowdfunding.

The Banks Act will not be relevant to the general scheme of crowdfunding as none of the actors in the transaction will be required to apply for licensing[111], and register,[112] under the Banks Act as they will not be conducting the business of a bank which primarily relates to the acceptance of cash deposits from members of the public.[113]

It is typical of platforms in the United States of America and China to receive monies from the public and only disburse such funds to an issuer once the crowdfunding target has been met. While it may be argued that this constitutes taking deposits from the

[104] Private companies which are deemed sufficiently large enough, due to their public interest score, will have to comply with these requirements. S 28(2)(c).

[105] s 84(1).

[106] As well as the private companies described in n 104.

[107] s 90. Although some private companies must be audited

[108] s 84(4)(c).

[109] s86(1).

[110] s 94(2).

[111] s 12(1) of the Banks Act.

[112] s 17 of the Banks Act.

[113] *Standard Bank of SA Ltd v Minister of Bantu Education* 1966 1 SA 229 (N) at 476.

public, the Banks Act expressly excludes from the definition of "deposit" the taking of money as an advance in terms of a contract of sale and that is refundable in the event that a resolutive or suspensive condition forming part of that contract of sale is not met.[114]

The FAIS Act will also not be rarely relevant in the crowdfunding context as FAIS regulates the rendering of financial advisory and intermediary services (financial services) to clients. It is not envisaged that an issuer or a platform will, in the ordinary course, provide financial advice to investors in connection with their investment. None of the models observed in the other jurisdictions provide for any advisory services being provided in relation to the crowdfunded securities and it is unlikely that any advice would be provided issuers and investors by a Platform.

The FMA regulates the manner in which the trading of securities takes place. Two questions arise as regards the application of the FMA to the Passive Platform model. The first is whether the platform under this model can be regarded as an exchange and the second is whether the Passive Platform model necessitates to the provision of securities services.

The FMA defines an exchange as a person who constitutes, maintains and provides infrastructure for bringing together buyers and sellers of securities.[115] As envisaged, the Passive Platform Model does not fall within this definition as its primary purpose would be to facilitate the investment in an issuer by subscription and not sale. Further, in the event that an issuer is a private company, its securities will not fall within the definition of "securities" contained in the FMA as only securities of public companies are caught by that definition. This notwithstanding, the Registrar of Securities Services is entitled to designate an instrument similar to a security of a public company as a security for

[114] s 1 of the Banks Act. Whilst a subscription is not, per se, a sale it does (non the less) meet the common law definitional requirements (essentialia) of a sale (i.e. the delivery of a merx in return for consideration).

[115] s 1 of the FMA. The question of how to provide for an exit from a crowdfunding investment is not one which has been discussed at length by commentators or addressed in the crowdfunding regulation in the United States of America and China. One exit mechanism which has emerged, however, in China is a dedicated exchange which facilitates exit for such investors from their investments. Should a Passive Platform extend its operations from facilitating subscription into an issuer to providing an exit mechanism or facilitating secondary market activity, it would fall within the definition of an exchange. For an issuer's securities to be traded on an exchange would, however, require that the issuer relax any restrictions it has in place on the transferability of its securities with the consequence that the issuer comply with the enhanced accountability requirements applicable to public companies under the Companies Act.

purposes of the FMA. To date private company securities have not been so designated, however this power may be exercised in the interests of protecting investors, which is a fundamental tenet of financial regulation.[116]

Whether a platform provides securities services depends largely on whether the securities of an issuer will be regarded securities for the purposes of the FMA. If they are not so regarded, the activities of a platform provider will fall outside the definition of securities services. In the event that they are, it remains unlikely that the platform in a Passive Platform Model will be providing any advice on securities, managing securities on behalf of investors or buying and selling securities for its own account or as part of its business, Therefore consequences under the FMA are unlikely to arise.

8. ACTIVE PLATFORM MODEL

The considerations applicable to the passive platform model will apply to the Active Platform Model. However, the role played by the platform provider may make some of the provisions of the FMA applicable, particularly if the platform provider gives recommendations or guidance in relation to the issuer or its securities. Doing so would bring its conduct within the ambit of FAIS and the FMA, requiring licensing under this legislation.

This will also be so in the event that the platform provider under the Active Platform Model purchases and sells securities issued by issuers (but would not necessarily be the case if the issuer merely co-invests with investors as is the case in China where investors sometimes make their investment decisions based on the investment decisions of a lead investor).

A possible iteration of the platform model could be where a platform evaluates, for its own account, securities proposed to be issued by an issuer and purchases such securities for its own account. These securities could then be sold by a platform provider to the public by way of secondary offers. If sold by public auction or public bidding on the platform the platform provider would not have to produce a prospectus or prepare a written statement in relation to such securities.[117]

[116] Van Wyk, Botha and Goodspeed *Understanding South African Financial Markets* (2012) 113.
[117] s 101(3)(a)(ii).

The above model, however, would bring a platform provider within the remit of the FMA as although an exchange would not be operated,[118] the platform provider would be undertaking securities services (by buying and selling securities for its own account as part of its business). Given that one of the objects of the FMA is to ensure that securities services are provided in a fair, efficient and transparent manner[119] this model would be the subject of regulatory scrutiny, requiring licensing under the FMA and compliance with prescribed conduct requirements.[120]

9. **FUND MODEL**

The fund model is materially different to the active platform model and the passive platform model in that it involves investments being made by members of the public into a fund established for the purposes of investing in issuers. The decision whether to invest in an issuer will be made by the platform - members of the public will therefore obtain exposure to issuers through a platform and have no say on the issuers in which they invest (other than through to decisions of the platform on the fact that an issuer which would disclose in terms of holdings or asset allocation.

Under the Fund Model considerations of an issuer making an offer to the public are unlikely to arise as the offer to subscribe for securities would be made by the fund manager (being the platform operator under the Fund Model). Depending on how the platform operator of a Fund Model is organised, there could be consequences under CISCA (and possibly also under the FMA).

CISCA regulates collective investment schemes which it defines as a scheme through which members of the public are invited or permitted to invest money or other assets in a portfolio in return for which they receive a participatory interest in the portfolio which allows them to proportionately share in the risk and benefit of the investments underlying the portfolio.[121]

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[118] Given that in this model the platform would be selling securities for its own account and not facilitating secondary market activity.

[119] s 2(b)(i) of the FMA. Luiz and van der Linde "The Financial Markets Act 19 of 2012: Some Comments on the Regulation of Market Abuse" 2013 *South African Mercantile Law Journal* 458 458.

[120] s 6(7) of the FMA.

[121] s 1 of CISCA.

CISCA generally provides for three broad categories of collective investment schemes as designated in accordance with their underlying asset portfolios. A collective investment scheme may either be a collective investment scheme in securities (if the portfolio in which it is invested consists mainly of securities),[122] a collective investment scheme in property (if the portfolio consists of property shares or immovable property),[123] or a collective investment in participation bonds (if its portfolio mainly consists of participation bonds).[124] Given that the purpose of facilitating crowdfunding should be to provide small and medium South African enterprises with capital, foreign collective investment schemes will not be considered.

A platform provider under the Fund Model would necessarily be purchasing securities issued by issuers therefore the provisions relating to investment schemes in securities would be applicable. CISCA does not define what a "security" is, however the Registrar of Collective Investment Schemes is entitled to designate securities or classes of securities which may form part of a collective investment scheme portfolio,[125] and impose any further conditions and limits upon the investments made by a collective investment scheme.[126] The purpose of these limitations is the protection of investors.[127]

The Registrar of Collective Investment Schemes has determined, as a general matter, that collective investment schemes in securities may only invest in shares in public companies[128] and, if the company has a market capitalisation of less than R2 billion, the collective investment scheme may invest up to the lesser of 5% of the scheme assets in, or 5% of the shares of, such company.[129] At least 90% of the market value of a portfolio held by a collective investment scheme must consist of securities traded on an exchange and financial instruments which are liquid.[130]

[122] s 39 of CISCA.
[123] s 47 of CISCA.
[124] s 52 of CISCA.
[125] s 40 of CISCA.
[126] *Strydom N.O. and Others v Bakkes and Another* 2014 4 SA 29 (GP) at par. 11.
[127] *Strydom N.O. and Others v Bakkes and Another* 2014 4 SA 29 (GP) at par. 15.
[128] GG No. 37895 BN 90 of 8 August 2014 at par 1.
[129] GG No. 37895 BN 90 of 8 August 2014 at par 3(1).
[130] GG No. 37895 BN 90 of 8 August 2014.

The Registrar is empowered to exempt any person from these requirements,[131] and the Minister of Finance may exempt any person from the application of a provision of CISCA, however this will be done where the Minister or the Registrar (as the case may be) are satisfied that it would not lead to investor protection concerns.

Other than the requirement that a collective investment scheme invest only in the shares of public companies,[132] there is nothing restricting or prohibiting a collective investment scheme from investing in issuers. The scheme designed for collective investments is, however, not altogether suitable for the investment in issuers. This is due to the fact that the design of collective investment schemes (with the requirement that both a trustee and manager must be appointed to undertake the various administration tasks relating to the scheme)[133] makes it an expensive structure to establish and maintain.[134]

The investment by collective investment schemes in a number of as they have a high failure rate issuers would not only increase the administration costs of the scheme, but may not attain the advantage of a collective investment scheme (being the reduction of asset risk through diversification) as entities undertaking crowdfunding are considered high risk.[135] The compliance cost of operating as a collective investment scheme may therefore not have a commensurate benefit for a Fund Model platform operator. This is particularly so as a participatory interest in a collective investment scheme would amount to a security under the FMA, with the effect that the manager of the collective scheme and the trustee of such scheme would have to comply with the requirements of the FMA (as they would be engaged in the business of buying and selling securities and therefore providing securities services). In addition to complying with CISCA.

The investment by a collective investment scheme in issuers would also create practical difficulties with a legislative impact. Given the illiquid nature of crowdfunded securities and the high failure rate of small businesses (being the issuers most likely to have recourse to crowdfunding, the ability of a manager of a collective investment

[131] s 22 of CISCA.

[132] Which, it is hoped, issuers will not have to be as the compliance requirements for public companies under the Companies Act can be onerous.

[133] s 68(1) of CISCA.

[134] See, for example, s 93(1) of CISCA which sets out all of the permissible charges that can be levied by a manager.

[135] Van Wyk, Botha and Goodspeed (n 116) 184.

scheme to comply with capital maintenance[136] and liquidity[137] requirements would be severely constrained.

Evident from the foregoing discussion is that a collective investment scheme does not neatly fit within the scheme for crowdfunding, for this reason this mechanism for facilitating crowdfunding will not be considered further.

10. PROTECTING THE ROLEPLAYERS IN CROWDFUNDING

10.1 The potential risks in crowdfunding

An important consideration for crowdfunding regulation is how investors will be protected. By their nature, crowdfunding investments have a number of risks which must be taken into account. [138] The risks are split between those relating to the issuer (requiring the investor to be safeguarded), those relating to the investor (requiring other investors and/or the issuer to be safeguarded) and those relating to the platform.[139]

The exact extent of these risks, and their potential mitigation depend, to a large degree on the characterisation of the issuer (i.e. whether it is a public or a private company) and the role played by the platform. Given the possible regulatory impacts of an Active Platform Model under the FMA and the challenges that would come with an Active Platform Model operator taking risk in the shares of an issuer, it is unlikely that this model would work. It is therefore likely that a Passive Platform Model would be more suited for the development of a crowdfunding market in South Africa. The risks of crowdfunding are hence evaluated in the light of this model.

[136] s 88(1) and 89(1) of CISCA.
[137] s 96 of CISCA.
[138] Sing (n 53) 47.
[139] Sing (n 53) 60.

10.2 **Mitigating issuer risks**

Among the biggest risks pertaining to issuers are the high failure rate of early stage businesses, asymmetries of information between the investor and issuer, and the lack of liquidity of crowdfunding securities.[140]

The high failure rate of early stage businesses

There are a number of factors that could lead to the failure of an early stage business. What any crowdfunding regulation should seek to do is mitigate the factors that arise under corporate law. The most important of these will relate to the governance of an issuer, which refers to the manner in which the issuer is controlled and how its day to day operations are conducted.[141] It is trite that the day to day operations of a company must be undertaken under the control of the board of directors, save to the extent that the memorandum of incorporation of that company provides otherwise.[142]

Having crowdfunding investors obtain direct representation on the board may be a difficult and sometimes impractical exercise. As an alternative to the level of participation by investors, the issuer could be required to disclose the identity of its board of directors (as well as the skills and qualifications of such persons) as part of the process of raising funds. Any change in these persons would have to be notified to the crowdfunding investors.

Furthermore, the memorandum of incorporation of the issuer could also provide safeguards that lock in the disclosed purpose of the issuer including by restricting the issuer's powers to conducting only the business disclosed to potential investors,[143] thereby prohibiting any amendment of the memorandum of incorporation of the issuer without the approval of the and the investors and setting out matters (including the adoption or amendment of a budget and business plan for the issuer) that would require the approval of the majority of the investors.

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[140] Sing (n 53) 60 and 61.

[141] *Head of Department, Department Of Education, Free State Province v Welkom High School; Head Of Department, Department Of Education, Free State Province v Harmony High School* 2014 2 SA 228 (CC) at par. 60.

[142] s 66(1).

[143] s 15(2)(b).

Asymmetries of information between the investor and issuer

A useful tool for investor protection is the requirement that an issuer make disclosure of material matters when offering securities to the public,[144] and also on an ongoing basis thereafter.[145] Disclosure should not be an exercise in identifying all relevant matters and should be restricted to matters which are absolutely required to be disclosed. This is important as the more extensive the disclosure requirements are (and the more extensive the disclosures) the more expensive the offer process will be and the less likely that investors will actually read the disclosures.[146]

The directors of a company would be liable for the contents of any document that they sign or that is published on their behalf, irrespective of whether or not they actually know the contents of the document; what matters is that they create a reasonable impression to third parties that the document is accurate and can be relied upon.[147]

In the event that an issuer is required to produce a prospectus, it could be required to file a short form prospectus with the Commission in a form prescribed specifically for issuers.[148] This short form prospectus could cover the matters prescribed by Regulation 72(1) of the Companies Act, as well as a few additional matters (guidance for which can be obtained under the JOBS Act)[149] including the names, qualifications and experience of the directors and officers of the issuer, a description of the issuer's business, business plan and key customers and suppliers, the income tax returns and management accounts or audited financials (depending on the size of the offer), the intended use of the proceeds of the offer, the target offer amount as well as the minimum offer amount,[150] and the method used to determine the offer price of the securities offered.

In addition to the disclosure of these matters, the issuer should be required to report (at each annual general meeting of the company) on the progress made in achieving the business plan and also present financial statements.

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[144] Van der Linde "The Personal Liability of Directors for Corporate Fault - An Exploration" 2008 *South African Mercantile Law Journal* 439 446.

[145] Schwartz (n 41) 45.

[146] Schwartz (n 41) 46.

[147] Delport (392).

[148] s 100(2)(b).

[149] s 300(2)(b) of the JOBS Act.

[150] s 108(2).

In the event that the issuer is not required to produce a prospectus the issuer could be required to file a statement setting out matters similar to those that would be provided for in an issuer's prospectus. Since, it is argued, the private placement should only occur through a platform, the platform provider would have to undertake limited due diligence in order to satisfy itself of the contents of the written statement (in particular that it does not contain any glaring inconsistencies or misrepresentations, and covers all matters required by a reasonable investor to make a decision on the offer).

Lack of liquidity

Although the structure of a crowdfunded entity (widely held issuer, platform and investor) is similar to that of a listed entity, the difference in the pricing of the risk of investing on the stock market and an issuer presents some challenges. The risk of investing in a listed entity is reflected in the share price which in turn responds to the knowledge and expectations of professional advisors.[151] This provides a natural safeguard against a company issuing shares at a price that is too high or too low.

The problem of a lack of liquidity of shares is a common problem encountered by unlisted companies (particularly private companies with a limited shareholder base). This is compounded by the fact that ability (and expertise) of crowdfunding investors to require safeguards to be provided for in the issuer's memorandum of incorporation is limited. The lack of liquidity of an unlisted company has an adverse effect on the share price (as often shares must be disposed of at a discount in order to fund a willing buyer and, commonly for a private company, only after pre-emptive rights provisions have been followed). Prescribing a memorandum of incorporation for crowdfunded entities could (as an interim measure pending the establishment of a secondary market for crowdfunded shares) provide some relief to investors.

Granting a put option in favour of investors would be almost always inequitable and, if held against the issuer, could constrain the company's liquidity, as it is a contingent liability. There are other exit mechanisms issuer and any party that controls the issuer should be willing to concede in order to enjoy the benefits of crowdfunding. These provisions should include the right of an investor to require the majority shareholder to purchase its shares at no less than the subscription price in the event of a trigger event

[151] Easterbrook and Fischel "The Corporate Contract" 1989 *Columbia Law Review* 1416 1435.

occurring that would either materially impact the ability of the issuer to continue business in accordance with its business plan or in the event that the majority shareholder proposes to dispose of its shares, the crowdfunding investors should be entitled to dispose of their shares on the same terms or acquire those shares on those terms pursuant to a pre-emptive right on sale.[152]

In providing for those rights in favour of investors, the relative lack of liquidity of crowdfunded securities and the dominance that the majority investor in a crowdfunding entity enjoys must be taken into account. The lack of a liquid secondary market for these securities not only creates a potential for oppression of minorities but also limits the safeguards available to minorities against the destruction of the value of the issuer.[153] Liquidity is a powerful mechanism for investor protection as it allows investors to vote with their feet.[154]

10.3 Mitigating investor risks

Investor risks include limited or low levels of financial literacy, insufficient shareholder protection, the potential for unfair shareholder dilution, difficulty monitoring the issuer's performance or having meaningful input in the governance of the issuer, and being excluded from exit opportunities.[155]

As is the case in the United States of America, platforms should be tasked with providing investor education and training, and also, assessing whether a particular investor is reasonably capable of making rational investment decisions.

The remainder of the investor risks should be mitigated by way of a prescribed memorandum of incorporation for issuers, as discussed above, and should include a requirement that an issuer only issue a single class of shares (and no other security).[156]

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[152] Sing (n 53) 75.

[153] Schwartz (n41) 54.

[154] Easterbrook and Fischel (n 151) 1436.

[155] Van der Linde "Par-value Shares or No-par-value Shares - Is that the Question?" (2007) *South African Mercantile Law Journal* 473 485; Sing (n 53) 61 and 62.

[156] This would ensure that the rights afforded by s 37(3)(b) (being the right to vote on all matters to be voted on by shareholders) and to receive (pro rata) the net proceeds of a liquidation distribution) are afforded to the shareholders of a crowdfunded entity.

A further mechanism for ensuring investor protection would be limiting the amount that an individual investor may invest in a single issuer and also in aggregate during the course of a single year.[157] This would ensure that investors are not overly exposed to crowdfunded shares as an asset class and are therefore able to accept more risk as these securities would (theoretically) form a small part of their net worth.

10.4 Mitigating platform risks

The primary risks relating to platforms would be their ability to be used for money laundering,[158] their failure to perform their duties (thereby compromising the crowdfunding transaction or the protections available to investors) and being exposed to potential conflicts of interest.[159]

Money laundering

Platforms are susceptible to being used as platforms for money laundering,[160] not only by issuers but also by potential investors.[161] Money laundering is often not the subject of crowdfunding discussion as:

> "[m]oney laundering arguably does not raise investor protection concerns because the investor is often either paid back in full without knowledge of the illicit source of money, or is in collusion with the issuer."[162]

The response of regulators in the United States to money laundering concerns is to require that platforms comply with anti-money laundering regulations analogous to those applicable to registered financial intermediaries.[163] This option undoubtedly increases compliance costs and may not be the most effective solution given the relative large numbers of investors who each may invest a small sum of money. Nonetheless, a "risk-based" anti-money laundering is proposed by some authors,[164] on the basis that the limited compliance capital commanded by platforms should be allocated efficiently.[165]

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[157] Sing (n 53) 75.
[158] Rubock (n 36) 113.
[159] Sing (n 53) 63.
[160] Rubock (n 36) 113.
[161] Rubock (n 36) 114
[162] Rubock (n 36) 127.
[163] Rubock (n 36) 114.
[164] Rubock (n 36) 122.
[165] Rubock (n 36) 114.

A more cost-effective requirement that could be employed in order to reduce compliance costs for issuers, would be a requirement that all transactions by and between issuers, platforms and investors be conducted through the platform and by way of bank accounts registered in South Africa.

The requirement that transactions be conducted through registered bank accounts is currently not a feature of the United States model.[166] This would ensure that money laundering risk is managed indirectly by platforms, in reliance on the robust anti-money laundering protocols that banks are required to have in place.[167] That is not to say, of course, that platforms are completely absolved from reporting suspicious activity that they discover in the course of operating the platform or in the course of conducting issuer due diligence.[168]

Duties of a platform

The United States of America model places lots of emphasis on the role of the platform (or crowdfunding intermediary) in ensuring the integrity of a crowdfunding securities market and protecting investors.[169] Platforms are tasked with educating investors on the risks of investing,[170] mitigating against fraud being perpetuated against investors,[171] circulating disclosure documents to potential investors and the appropriate regulators,[172] refunding investors in the event that the fundraising target is not met,[173] and ensuring that firm funding commitments are made by investors.[174]

The fundamental purpose of a platform is creating a market to facilitate the offering of and investment in securities. As noted by Easterbrooke and Fischel markets are: "*economic interactions among people dealing as strangers and seeking advantage*".[175]

[166] Rubock (n 36) at n33 and n35.
[167] s 21C of the Financial Intelligence Centre Act 38 of 2001.
[168] Rubock (n 36) 126 and 127.
[169] Schwartz (n 41) 56.
[170] Schwartz (n 41) 57.
[171] Schwartz (n 41) 57.
[172] Schwartz (n 41) 58.
[173] Schwartz (n 41) 59.
[174] Schwartz (n 41) 59
[175] Easterbrook and Fischel (n 151) 1422.

A platform will provide to issuers and investors services similar to those provided by an exchange (as defined in the FMA) although, for reasons set out above, a platform would not be an exchange unless it facilitates secondary market activities (and only to the extent that the securities traded are those of a public company or the activity undertaken by the platform provider become prescribed as falling within the ambit of the FMA).

Like the model followed in the United States of America, platforms should either be authorized financial services provider (and therefore their conduct subject to regulation by the Financial Sector Conduct Authority) or designated as exchanges (however with lesser compliance requirements that take into account that their role is in relation to crowdfunding.[176] These requirements would address how platforms would be required to manage potential conflicts of interest.

11. **CONCLUSION**

The role that equity crowdfunding can play in enabling small businesses cannot be overstated.[177]

> "There is a substantial reservoir of entrepreneurial talents, activity and capital lay dormant in many emerging economies. So developing a regulatory framework that leverages advances of online financing technology can create an early-stage funding marketplace. This will facilitate capital formation while providing investor protection through education and training. The risk of online financing requires regulatory protection and collaboration with other entrepreneurial activities such as private sectors, incubators, accelerators and universities to build the culture of trust which is essential to promote web-based interactions."[178]

One of the ways of keeping the costs of crowdfunding to a minimum is through the prescription of standardised contracts to govern the relationship between the crowdfunding stakeholders.[179] There is no consensus as to the degree of control that is

[176] s 17 of the FMA sets out the rules which apply to exchanges. These rules would prove too onerous for the role played by platforms. It is therefore submitted that platforms should be made subject to the duties of a Manager as provided for under s 4 of CISCA.

[177] Robock Z *The Risk of Money Laundering Through Crowdfunding: A Funding Portal's Guide to Compliance and Crime Fighting* 2014 Michigan Business and Entrepreneurial Law Review 113.

[178] Huang, Chiu, Mo and Marjerison (n 12) 317.

[179] Li (n 48) 67; Easterbrook and Fischel (n 151) 1444.

necessary to ensure that disparate crowdfunding investors are able to vindicate their rights as securities holders.[180]

A standardised memorandum of incorporation which provides for the exit rights of shareholders through tag-along rights and deemed offer provisions, restricts the authority of the board to conduct business other than that for which the capital raise occurs, provides for pre-emptive rights on both subscriptions and sales and restricts the company from issuing more than one class of shares would be such mechanism. This approach accords with the view that corporate law is a mechanism by which open ended contracts are filled.[181] A standardised memorandum of incorporation would also assist investors in making their investment decisions as they would be to the extent that a prospectus is required as opposed to a written statement or update prospectus able to compare and contrast investments on a like for like basis [182] and also deal with the concern that the majority shareholder of the issuer is likely to have disproportionate power over the affairs of the company when compared to the crowd.

The classification of the issuer as a private or public company will also play an important role in establishing a market for crowdfunding as it will have a direct effect the accountability requirements and compliance costs of the issuer. To this end, an issuer should be classified as a private company or, if classified as a public company, exempted from the enhanced accountability and regulated company provisions of the Companies Act in order to ensure that it is able to maintain the flexibility it requires to undertake its business.

This flexibility should also be availed to an issuer, provided it has used the standardized memorandum of incorporation and not previously raised an aggregate amount exceeding a prescribed maximum amount for small cap offers and has a shareholder base not exceeding a maximum number of persons (acting as principals), in relation to how it is able to make its offers to the public. Either an abbreviated prospectus should be required of such firms or, it should be clarified that offers made through a platform that is already regulated do not amount to an advertisement, therefore availing to the

[180] Li (n 48) 76.

[181] Easterbrook and Fischel (n 151) 1416.

[182] Easterbrook and Fischel (n 151) 1435.

issuer the ability to raise capital through small cap offers without having to prepare and register a prospectus.

Providing for these matters will ensure the development of a crowdfunding culture that minimises complexity and cost and enables entrepreneurs to compete for access to capital through a channel that will no doubt democratize investment and become an avenue for the entrepreneurial spirit that South Africa's participation in the fourth industrial revolution requires.

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