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Dear Sir Madam

CROWD-SOURCED EQUITY FUNDING – SUBMISSIONS ON DECEMBER 2014 DISCUSSION PAPER

We are delighted to present our submissions on your Discussion Paper on Crowd-sourced Equity Funding published in December 2014.

Thank you for the opportunity to do so.

Yours faithfully



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Crowd-sourced Equity Funding

**Submissions on
December 2014 Discussion Paper**

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CROWD-SOURCED EQUITY FUNDING

Questions

- 1. Is the main barrier to the use of CSEF in Australia a lack of a CSEF regulatory structure, or are there other barriers, such as a lack of sustainable investor demand?**

The main barrier in Australia to the use of crowd sourced equity funding (**CSEF**) is the lack of a readily available, inexpensive and efficient means of raising funds from the public. The current regulatory structure is not sufficiently graduated in its requirements and cost burdens. There is more than sufficient and sustainable investor demand and there would be more than sufficient investment opportunities that could be made available to the investing public to diversify away from, principally, traditional listed equity offerings and real estate, and into manpower and knowledge intensive investment opportunities.

- 2. Do the existing mechanisms of the managed investment scheme regime and the small scale personal offer exemption sufficiently facilitate online offers of equity in small companies?**

The primary beneficiaries of investment opportunities in rapid growth emerging Australian businesses under the current regulatory regime are those persons who qualify as sophisticated investors, that is, Australia's most wealthy. It is a disappointing situation that, practically, only the wealthiest Australians are afforded the best opportunities to invest in Australia's most exciting wealth creation opportunities. This opportunity is afforded to them because the current exemption regime makes fundraising from them both highly efficient and the least costly.

This severe narrowing of the pool of eligible investors materially negatively impacts both the wider pool of potential investors – to whom these investment opportunities are closed – and enterprising Australian businesses looking to secure financial backing for their projects and ventures, particularly in the start-up, small and medium business sectors. The current narrower pool of eligible investors means that they can command materially more onerous commercial and legal terms, investing of materially preferred investment terms – usually in the form of preference shares or convertible notes - to founders, their employees, their family and friends, who as a result then bear most greatly the risk of the venture.

Whether or not the offers are made on-line are in our view not material to the CSEF regulatory regime; continuing technological convergence is increasing seen in other regulatory areas as the central reason for not focussing regulatory regimes on the means of content delivery. Rather, the central focuses should be the activity – fundraising – and content.

Regimes for the offer of different investment products, offered in different ways, should in our view be largely the same. The same regulatory regime should apply to whether the offer is made exclusively at an investor briefing, through intermediaries or on-line, or, and what is often the case, in all of these ways.

We also support the introduction of a standard issuer disclosure template for the presentation and content of offer documents for crowd-sourced equity and other

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funding. The current regime leaves the content to be disclosed in regulated equity fundraising documents to issuers and, largely, ASIC guidance. A more standardised approach should lead to lesser costs to issuers in their raisings with more of the funds raised applied to the productive endeavour at hand.

3. Other than the restrictions identified above in relation to limitations on proprietary companies, public company compliance requirements and disclosure, are there any other barriers to the use of CSEF in Australia?

We agree with CAMAC's observation that Australian start-up companies do fail due to a "capital gap". As a firm intimately involved in the IT, IP and entrepreneurial community, including as legal advisers to Australia's premier (and an affiliate of the US's premier) incubator for women entrepreneurs, it is our experience that Australia currently lacks professional investors willing to sufficiently commit the time and risk involved in supporting our start-ups. They are not filling "the gap". The gap is often experienced between the stages of (1) proof of concept / proof of market; and (2) the start-up turning a profit or a sustained and sustainable profit. Patient capital of this nature has diminished in general circulation for the start-up and the small to medium enterprise, as more money has been placed into superannuation funds. Many Australian superannuation and private equity funds in our experience seek liquid and mature enterprises in which to invest or the capital amounts involved in start-up funding are too small to warrant consideration. This is clearly demonstrated by the weight of their funds invested.

As a countervailing measure, perhaps individuals should have the opportunity to place some of their otherwise compulsory superannuation contributions into start-up investments if, say, their superannuation balances or net worth exceeds a specified amount or some other appropriate experience and education qualifications. Superannuation should in our view be primarily concerned with individuals' retirement incomes and not individuals' wealth creation or warehousing.

Further, the Australian investment community, outside of mining exploration, seems culturally adverse to heightened risk. Failure is regarded as an enduring stain. These attitudes may be acceptable in a largely branch economy, but as opportunities for Australia to act in that part of the supply or production chain diminish, the importance of home grown and headquartered Australian businesses of global capability increases. No one nurtures Australians better than Australia. Efficient, accessible fundraising is key to their nurture and eventual flourishing. An embrace of greater risk should lead to greater reward, which seems to sit well with our national character. Diggers are not known to squib a fight.

That Australia may become over-committed in investment in start-ups is empirically and comparatively presently a far-off thing. Information available to the writer suggests that Israelis invest in the order of 60 times per capita more into start-up funding than Australians. Australian venture capital, particularly early stage, funders are virtually non-existent and the Commonwealth Government's own [business.gov.au](http://www.business.gov.au) website confirms this¹.

¹ See <http://www.business.gov.au/grants-and-assistance/venture-capital/esvclp/Documents/ESVCLP-PartnershipList.pdf>

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4. **Should any CSEF regime focus on the financing needs of small businesses and start-ups only, or is there a broader fundraising role?**

The principal focus of a new regime that fosters CSEF should be small businesses and start-ups as it is they who have the most difficulties in raising debt funding from banks and other traditional funding sources. It is to just such organisations that Australia will need to increasingly turn to power economic activity and growth and it is just such organisations that would most benefit from a new fundraising regime that fosters CSEF.

We would however like to see a more widely based review of the fundraising regime in Australia. The *Corporations Act 2001* fundraising regime is based on a legislative scheme first seen in the *Corporations Law* and now some 25 years old. A comprehensive review of this most important part of our economic activity is overdue.

5. **Do you consider that, compared to existing public company compliance costs, the exempt public company structure is necessary to facilitate CSEF in Australia?**

We do not consider it necessary that there be a new class of company, the exempt public company. What we do consider beneficial and what in part underlies the exempt public company CAMAC recommendation is a graduated system of audit and disclosure requirements – using higher materiality thresholds and mandated disclosure topics - that could apply more widely to companies seeking to raise funds, which turns on annual turnover of the fundraiser and the amount being raised.

We also consider it sub-optimal to introduce specialised licensed online intermediaries as part of the crowd sourced equity fundraising process for the following principal reasons:

- that offers are made online should not be the central guiding determinant. Offers can be communicated in a number of ways. Offers made over the internet, by email or in person all warrant uniform regulation for like issuers seeking to raise like amounts in like circumstances.
- “intermediaries”, within the ordinary English meaning of that term, are already involved in the fundraising process; stockbrokers, accountants and lawyers.
- stockbrokers are already licensed and regulated under the AFS licensing regime; crowd funding over the internet is merely an additional means of distribution; additional licence permissions could be included in AFS licences with appropriate conditions.
- an auditor’s certificate as to financial matters could be given – in essence a certificate of trueness and correctness applying appropriate materiality thresholds and procedure. This certificate should be legislatively standardised, and in a form that is practical and supported by the audit profession. The certificate would accompany the disclosure document. What constitutes true and correct in the start-up context would be the subject of an accounting standard.
- similarly as to legal matters by lawyers.

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- markets and those who conduct them are already regulated under the *Corporations Act*. We consider it important that those who conduct markets be divorced from the other intermediaries mentioned above. They should have no economic interest in the outcome, truth or correctness of disclosure in relation to a particular issue. (*Cf.*, here the argued negative impact on truth in markets of ratings agencies by their having a financial interest in the rating of individual financial products, as opposed to when they did not).

Further, we consider a financial audit to be a key protection for investors, not only during the fundraising process but also at other times of the business cycle. Financial audits provide an effective and conventional means of ensuring that an issuer's assets and undertaking withstand financial scrutiny. It is an important check and balance.

We do not see the benefit of a retrospective full audit on conversion to a public company, covering past activities and financial years. Audits are best carried out on fresh activities with current directors, management and employees making the decisions and responding to questions. An audit is not a static paper-based function. The extent, or materiality threshold, of the matters for audit could be adjusted in start-up mode to lessen the time and cost burden of undertaking financial audits.

Working within the current reality of the professions, procedures, markets and their participants by enhancing current best practice would, in our view, lead to a more effective take up of the new legislation. If that were to eventuate, there would in our view be a larger impact for good on the Australian economy.

6. To what extent would the requirement for CSEF issuers to be a public company, including an exempt public company, and the associated compliance costs limit the attractiveness of CSEF for small businesses and start-ups?

If the disclosure, accounting and auditing requirements were graduated and appropriate to the entity's turnover and the funds being raised then the associated compliance costs should not be a substantial impediment.

7. Compared to the status quo, are there risks that companies will use the exempt public company structure for regulatory arbitrage, and do these risks outweigh the benefits of the structure in facilitating CSEF?

We do not support a separate exempt public company structure. Nevertheless, we do not see the introduction of such a structure at risk of regulatory arbitrage.

8. Do you consider that the proposed caps and thresholds related to issuers are set at an appropriate level? Should any of the caps be aligned to be consistent with each other, and if so, which ones and at what level?

The investor caps recommended in the report are too low. Their adoption would lead to undue administrative burdens for issuers.

Different limits should apply to allow sophisticated and professional investors access to crowd funding opportunities.

Investors should perhaps be permitted to opt out of specified limits in specified circumstances.

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Any limits should be indexed to an appropriate CPI or other measure.

Crowd-sourced equity fundraising as identified in the report should only be allowed for primary, not secondary offers. We say this as primary offers generally raise money for the venture, whereas funds raised from secondary offers are generally received by shareholders and promoters.

Share resale restrictions should also apply to persons associated with promoters and any licensed intermediary. The restrictions could mirror those that apply for ASX listed companies in relation to restricted securities. Restrictions could also be considered on the retirement of related party debt from funds raised.

9. Do CAMAC's recommendations in relation to intermediary remuneration and investing in issuers present a significant barrier to intermediaries entering the CSEF market, or to companies seeking to raise relatively small amounts of funds using CSEF?

We consider the introduction of intermediaries as postulated by CAMAC to be an unnecessary addition to the regulatory landscape. We see no benefit whatsoever in doing so.

A crowd-based funding model should be efficient and not add to regulatory complexity. We see no reason to create a new class of service provider to facilitate CSEF. Offer documents could be lodged with ASIC, with disclosure sign-offs received (and publicly disclosed) from accountants as to accounting, tax and audit matters, from solicitors as to legal matters and from the fundraisers' directors as to factual and commercial matters, including forecasts. Proceeding in this way would see a alignment to processes and disclosure channels already adopted for presently regulated fundraising. Fundraisers will not be required to establish relationships and incur costs with a new class of intermediary and established professional associations can regulate their existing members in this area of extended activity.

10. Do the proposed investor caps adequately balance protecting investors and limiting investor choice, including maintaining investor confidence in CSEF and therefore its sustainability as a fundraising model?

Again, the proposed investor caps are much too low and overly paternalistic.

11. Are there any other elements of CAMAC's proposed model that result in an imbalance between facilitating the use of CSEF by issuers and maintaining an appropriate level of investor protection, or any other elements that should be included?

We consider CAMAC's proposed model to be overly concerned with investor protection. There is a serious shortfall by international standards in Australia's equity investment in start-up and small businesses.

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- 12. Do you consider it is important that the Australian and New Zealand CSEF models are aligned? If so, is it necessary for this to be achieved through the implementation of similar CSEF frameworks, or would it be more appropriate for CSEF to be considered under the Trans-Tasman mutual recognition framework?**

We do not consider Trans-Tasman alignment as important. Australia would be better placed to align itself with accessible jurisdictions of greatest opportunity for Australian entrepreneurs: the United States and the financial hub of Europe, the United Kingdom. Of London, it has been reported:

London is emerging as the world leader for crowd funding, with more of the online revenue-raising campaigns being run out of the UK capital than cities in the US ... (*The Australian Financial Review*, 18 August 2014, page 23).

The apparent success of the UK approach lends much to an argument in favour of adoption here of its most central elements. Increased efficiency in extending or recognising UK compliant CSEF offers and raisings also has much to commend itself to the Australian context.

- 13. Do you consider that voluntary investor caps and requiring increased disclosure where investors contribute larger amounts of funds appropriately balances investor protection against investor choice and flexibility for issuers?**

Issuer caps are easily subverted by using a multiplicity of issuing entities. We see the US investor caps and those proposed by CAMAC as too low. The UK position here is supported. We should not be unnecessarily limiting the funding of ingenuity by our most ingenious. Compared to the level of start-up investment in Israel, we have much ground to catch up.

We consider issuer caps should be consistent across debt and equity funding, and for managed investment schemes. Adopting model rules for some management investment scheme investment should diminish complexity and increase market understanding and efficiency – complexity of the managed investment scheme instrument has been argued to be a justification for different rules to apply to offers of instruments in managed investment schemes when compared to offers of equity securities. At the end of the day, for both the investor and the issuer its mainly about money, risk and return.

While we generally consider investor caps to be paternalistic, we recommend that any investor cap be expressed as a percentage of net personal and controlled wealth and/or income (inclusive of superannuation held). This is a better reflection of financial capacity than a flat, one size fits all, monetary figure. It would also mean that more funds would be available to fill the current “capital gap” in this country for start-ups and small to medium enterprises, diminishing in some measure, in perhaps both absolute and relative terms, banks and other financial institutions as the primary financing source to the small to medium enterprise sector in Australia.

- 14. What level of direction should there be on the amount of disclosure required for different voluntary investor caps?**

We largely support CAMAC’s position as stated in section 4.7 of its May 2014 report. We additionally submit:

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- that any disclosure document template list include all matters included in the US’s list of matters on which disclosure must be made
- that the disclosure document additionally address:
 - for loss making companies, the projected date and assumptions at which the company will “break even”.
 - projected gross revenue and profits for the current financial year and for the two next following financial years.
 - intended “exit” and trading opportunities and mechanisms for investors and when they are projected to be available.
 - key personnel, their track record in, if a start-up, start-ups and, more generally, as to good fame and character, financial, technical and management acumen, as well as and the duration of their employment contract (with termination rights). Those convicted of offences involving or otherwise disciplined for fraud, dishonesty, breach of duty or dishonesty would not be permitted to avail themselves of crowd funding equity fundraising.
 - intellectual property owned, what, where and how.
 - grant moneys raised or applied for, their past and intended use and whether applications were rejected and why. If a Commercialisation Australia assessment of core technology or other core aspects of the business is available, it should be referenced.
 - available accumulated tax losses, if any, should be detailed.
 - hyperlinks to longer form documents for those who wish to know more should be permitted.

15. How likely is it that the obstacles to CSEF that exist under the status quo would drive potential issuers, intermediaries and investors to move to jurisdictions that have implemented CSEF regimes?

CAMAC’s expressed concern that worthwhile Australian entrepreneurs may move their businesses off shore is in our experience both very real and current. The US is a very strong drawcard for Australian innovators and entrepreneurs, particularly of software and other IT dependent technologies. Major factors initiating such moves include their larger market (bigger returns for similar effort), deeper venture capital pools, a more savvy investment community, a greater respect for the innovator and less aversion to risk.

It is more these concerns than the recently implemented CSEF regimes in overseas jurisdictions that lead Australian entrepreneurs seeking to raise funds to move overseas.

16. What are the costs and benefits of each of the three options discussed in this consultation paper?

We are not in a position to provide an informed response to this question.

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- 17. Are the estimated compliance costs for the CAMAC and New Zealand models presented in the appendix accurate?**

We are not in a position to provide an informed response to this question.

- 18. How many issuers, intermediaries and investors would be expected to take up online equity fundraising in Australia under the status quo, the CAMAC model and the New Zealand model?**

We are not in a position to provide an informed response to this question.

- 19. Are there particular elements of the New Zealand model that should be incorporated into the CAMAC model, or vice versa?**

We do not consider the New Zealand model to be the appropriate one to follow. Again, we recommend closer alignment to jurisdictions in which there are established, successful crowd funding models that lead into deep attractive markets for Australian innovators. The US and the UK should therefore be our most closely aligned jurisdictions. Such alignment would also make crowd funded investment by persons resident in those jurisdictions all the more attractive due to lessened perceived “jurisdictional risk”. Mutual recognition of crowd funding raisings so that anyone in Australia, the US and the UK could interchangeably invest in offerings made in each of these jurisdictions would be a most attractive regulatory outcome.

- 20. Are there particular elements of models implemented in other jurisdictions that would be desirable to incorporate into any final CSEF framework?**

Please see our responses to questions 13, 14 and 19.

- 21. Do the issues outlined in this consultation paper also apply to crowd-sourced debt funding? Is there value in extending a CSEF regime to debt products?**

There is considerable economic efficiency and therefore value in harmonising debt and equity fund raising regulatory regimes. The regulation of social fundraising should be left to the States and Territories by way of extension of their Charitable Fundraisings Acts.

- 22. To what extent would the frameworks for equity proposed in this discussion paper be consistent with debt products?**

Consistency should be heightened as much as possible.

- 23. Would any of the options discussed in this paper, or any other issues, impede the development of a secondary market for CSEF securities?**

We make no submissions on this question.