

Crowd-sourced Equity Funding

**Submission by the Office of the Australian Small Business
Commissioner**

February 2014

This submission by the Office of the Australian Small Business Commissioner (the ASBC)¹ addresses small business issues relating to the Treasury's Crowd-sourced Equity Funding (CSEF) discussion paper (the Discussion Paper). The submission is informed through our ongoing engagement with the business community, including dealings with individual small businesses and credit providers on financing matters.

The Discussion Paper seeks comments on characteristics of potential CSEF models, including a model proposed by the Corporations and Markets Advisory Committee (CAMAC) and a model similar to that recently implemented in New Zealand. The Paper also considers retention of the status quo as an alternative to these options.

Further to this submission, we would welcome the opportunity to be involved in additional consultation relating to ongoing developments on a CSEF framework, particularly concerning the reduction of regulatory barriers for small and family business in any proposed package.

GENERAL COMMENTS

We strongly support the Government's commitment to improving small business access to affordable finance to ensure that small businesses have the opportunity to establish and develop, including removing regulatory barriers for the use of CSEF in Australia. There are likely to be particular benefits for small business start-ups and the development of innovative new products.

We consider that small business finance can be divided into two categories: that to which a small business is entitled (payment of invoices or monies owed) and that which the small business is not entitled to but would like to have (equity, overdrafts, loans, credit).

Too often we see examples of small businesses not being paid or paid on time for the products or services that they have provided. This can be due to poor business practices and/or aggressive cash-flow management of other businesses, or a business' own poor contract management practices. We encourage small business to adopt professional contract management to ensure payment of what is due in a timely fashion.

As for the second category, obtaining finance to establish or grow is critical and the finance sector in Australia is able to manage this with minimal Government intervention. However, with the exit of some non-bank financing streams (such as finance companies) as a result of the Global Financial Crisis, as well as immature alternative financing options compared to

¹ The role of the ASBC is to provide information and assistance to small businesses, represent small business interests and concerns to the Australian Government, and work with industry and government to promote a consistent and coordinated approach to small business matters. The Australian Government is committed to transforming the ASBC into the Australian Small Business and Family Enterprise Ombudsman that will be a:

- Commonwealth-wide advocate for small businesses and family enterprises;
- Concierge for a dispute resolution service;
- Contributor to the development of small business friendly Commonwealth laws and regulations; and
- Seamless link with the Government's Single Business Service to help small businesses easily find out about other Government services and programmes, including general business advice.

other countries (such as venture capital and crowdfunding), access to finance still rates as a concern for many small businesses. In our experience, this is particularly the case for start-ups and those with minimal or no collateral. It is into this area that crowd-sourced equity funding and innovative financing options (such as peer-to-peer lending and crowd-sourced funding) could provide real benefits. This will be the case for start-ups and small businesses that have been operating for less than two years² since these businesses can find it difficult to obtain traditional equity or debt finance.

Australia appears to be lagging behind other countries such as the UK, US, Canada, Italy, France and New Zealand that have redrafted their fund raising legislation to support crowdfunding. In June 2014, the Commissioner met with the Chairman of the British Business Bank, Mr Ron Emerson, who confirmed that crowdfunding and other alternative small business financing options are areas that the British Business Bank is working hard on fostering in the UK.

APPROACHES TO REGULATION

Our Office strongly supports the Australian Government's deregulation and red tape reduction programme. As identified in the discussion paper, any regulatory framework for a CSEF needs to balance protection for investors while removing regulatory barriers and minimising compliance costs.

It is our experience that small business and family enterprise are disproportionately affected by regulations and the way in which they are enforced. This can be a result of small businesses having limited resources compared to larger businesses and also a poorer understanding of how to comply. That is not to say that small business and family enterprises should necessarily be treated differently or more leniently, but this disproportionate effect and impact of the cumulative burden on these businesses should be properly addressed in sector reform.

The discussion paper offers an opportunity to consider the impact of specific compliance costs for both issuers and intermediaries to improve outcomes for business. Approaches can include the adoption of facilitative approaches to regulation and its administration, with a focus on educating to comply rather than leaning to enforcement of compliance. It is our experience that the small business community responds more favorably when regulators take a facilitative and educative approach to regulation, rather than 'black-letter law' regulation with crackdown enforcement.

² Most financial institutions require the last 2 years financial statements from a business to assess the ability of the business to service the debt.

BUSINESS STRUCTURES

A number of stakeholders in the small business community, including some accounting professionals, have been calling for an overhaul of business structures to better suit the lifecycle of small business. This could be in the creation of a new structure or amendments or simplification to existing structures.

A typical small business may start as an independent contractor, sole trader or partnership, and as the business matures may move to a company structure or a hybrid approach that may incorporate a number of entity types (including trusts that are particularly used by family enterprises).

Our Office has received feedback identifying that the transition to a company structure (or other more sophisticated business structure) and the associated reporting and compliance requirements can be an area of confusion for small businesses and may lead to unintended breaches of the law.

Last year, we participated in the second Australian Taxation Office (ATO) led Fix-it Squad. This initiative brought together government, industry and professional associations, and small businesses to look at ways to reduce red tape and make it easier to transition from a sole trader to a proprietary limited company. One of the key issues in the transition was identified as company director duties, with many small businesses lacking an understanding of their legal obligations. The Australian Securities and Investments Commission has identified this as a small business priority area in 2015 and will be working with the ATO to improve small business understanding and compliance. Other work is also underway to develop educative solutions to better explain the transition process.

The discussion paper indicates that a business operating under a public company structure may avoid significant regulatory barriers associated with CSEF, however this would still come with increased costs and compliance requirements such as reporting and corporate governance obligations that may be too complex and expensive to be a real option for small businesses.³

While the majority of incorporated small businesses are private companies, the creation of a new category of public company, to be known as an 'exempt public company'⁴ could help to bridge this gap and relieve small business of some of the compliance requirements during a transitional period for the business.

Although limiting the period that a business can remain an exempt public company for three to five years may reduce abuse of this type of structure, we are keenly aware that it will often take far longer than this for a small business to grow beyond "small". This can particularly affect technological start-ups that require a sustained product development period before launch.

³ Crowd-sourced Equity Funding Discussion Paper, p 5.

⁴ *ibid*, p 20.

There are also international models that can be used for a comparison such as the S corporation model used in the US. The S corporation is often more attractive to small business owners than a standard (or C) corporation as it has some appealing tax benefits and still provides business owners with the liability protection of a corporation.⁵

Small business access

The discussion paper poses the question '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?'⁶

Data from the ABS shows that at June 2013 there were 2.08 million actively trading businesses⁷. Of these, only 720,000 were incorporated, leaving 1.36 million sole traders, trusts and partnerships ineligible to access the benefits of CSEF.

Further, actively trading businesses that do not have an ABN or are not registered for GST are not captured by the ABS data. As such there is no comprehensive register of businesses in Australia and the number of micro and small businesses ineligible to participate in CSEF is likely to be far in excess of 1.36 million. If particular benefits beyond equity raising are provided to CSEFs, consideration of how to make these benefits available more broadly should be undertaken.

It is suggested that equity finance may be a more suitable option than debt finance for start-ups.⁸ In our experience, many small business start-ups, including those which are declined for traditional debt finance, are often not looking for substantial funds. The compliance costs for incorporated businesses, while reduced with an exempt public company, are still significant and will limit the attractiveness of CSEFs as a funding option for many small start-ups.

Although there are very sound reasons (including protections for investors) for limiting issuer access to incorporated businesses, there may be criticism from some that this will exclude many of those start-ups which it is attempting to assist. Moreover, a move to CSEFs would need to be supported by an information and education campaign to ensure that existing or prospective small business operators are fully informed and are placed in a position to make a decision about the most appropriate structure for their particular circumstances (discussed further below).

⁵ <http://www.entrepreneur.com/encyclopedia/subchapter-s-corporation>

⁶ Crowd-sourced Equity Funding Discussion Paper, Question 6, p 13.

⁷ Australian Bureau of Statistics (ABS), June 2014, *Count of Australian Businesses, including entries and exits*, (CAT 8165.0). The ABS defines an actively trading businesses as having an ABN and being registered for GST.

⁸ Crowd-sourced Equity Funding Discussion Paper, p 4.

ACCESS TO INFORMATION AND JUSTICE

It is the view of our Office that government has a role in improving the business environment, with two enduring core responsibilities – namely the provision of information and justice. These twin pillars have a critical impact on the productivity and profitability of business.

It is a mantra of this Office that no small business should fail through a lack of access to information. By accessing appropriate information and resources, small and family businesses are empowered to work smarter, compete more effectively and reduce the costs of operating a business. This goes to the point above about ensuring that there is an appropriate education and information campaign regarding any changes to CSEF regulatory framework.

The British Business Bank has developed an extensive business finance guide that sets out the main things to consider and outlines sources of finance available to businesses – ranging from start-ups to SMEs and growing mid-sized companies⁹. This includes innovative financing sources such as crowd-sourcing. A similar guide for CSEF, incorporating information for both issuers and investors could be considered. Leveraging professional groups to provide information, such as accountants, is also recommended.

The second core responsibility of government is to provide an appropriate system of justice. The speedy, inexpensive resolution of disputes is crucial for business efficacy. Small businesses focus on plying their trade or profession. Disputes will arise from time to time, but small businesses often do not have the skills and resources on hand to deal with incidents as they arise. These disruptions to undertaking core business operations are not easily catered for and, depending on the particular type of dispute, can impact small businesses disproportionately.

The cost of a dispute for a small business is not just the financial cost of the lost business and the cost of pursuing a resolution (such as legal costs), but the opportunity cost and emotional stress involved. The opportunity cost includes what the small business would otherwise have achieved using the time and effort involved. Resolving a dispute takes someone out of operating their business. Added to this cost is the emotional stress that disputes have on business operators.

To assist access to justice, our Office recently launched an online dispute resolution tool– *Dispute Support*. This tool was developed with states and territories, consolidating dispute resolution information, resources and services available for small businesses Australia-wide. *Dispute Support* provides easy, tailored access to the most appropriate low cost service available to small business operators to resolve disputes, while also providing information on dispute resolution processes and strategies for avoiding and managing disputes.

⁹ <http://british-business-bank.co.uk/bfg/>

CAMAC's proposed framework has a requirement for intermediaries to have an Australian Financial Services Licence (AFSL), including membership of an external dispute resolution scheme.¹⁰ In a CSEF context, disputes could arise between any of the participants— issuers, intermediaries and investors. A substantial number of small business disputes arise due to a lack of communication or a deficiency in understanding a matter or obligation.

We consider it imperative that a low cost alternative dispute resolution mechanism be available to assist parties to resolve these disputes. Mediation has become a widely used and accepted method of resolving commercial disputes. It will often achieve results at a lower cost and speed than available through the more traditional approach of courts and tribunals. It also allows for a dose of commercial reality that can impact outcomes.

PROPOSED OPTIONS

Governments can be guilty of being overly prescriptive in legislation and regulation, trying to cover every conceivable outcome, risk or issue. In some circumstances, when the risks are low, covering the key issues and being silent on others can allow the market to shape the environment and result in better outcomes for business.

If either option 1 or 2 is chosen, we would urge the Government to impose the minimum restrictions deemed necessary to protect investors while allowing maximum uptake by small and medium issuers. This may be more capable of being achieved using the CAMAC model.

Option 1 proposes that eligible issuers be limited to certain small enterprises that have not raised funds under the existing public offer arrangements.¹¹ CAMAC recommended that eligibility to become, and to remain, an exempt public company be limited to companies with turnover below \$5 million per annum and capital of less than \$5 million.¹²

We are not aware of a turnover of less than \$5 million being on the statute book as a definition of a small business. Although we note there have been calls for the Australian Taxation Office's threshold for small business to rise to \$5 million¹³. The current definition for a small business entity used by the ATO is an individual, partnership, company or trust that is carrying on a business and has less than \$2 million aggregated turnover.

However, having said that, we are supportive of allowing access to CSEF as a funding option for as many small and medium businesses as possible, which the higher \$5 million threshold would facilitate.

¹⁰ Crowd-sourced Equity Funding Discussion Paper, p 8.

¹¹ *ibid*, p 8.

¹² *ibid*, p 20.

¹³ Recommendation (No. 30) in the Henry Review of the taxation system in 2008-09.

http://taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_afts_final_report_consolidated.pdf

In regards to Option 2, the discussion paper asks the question of whether it is important that the Australian and New Zealand CSEF models are aligned.¹⁴ While there are some definite benefits for business regulations to be aligned with one of our closest neighbours, we believe that this should only be done if the New Zealand CSEF framework is the best model. If the CAMAC model or similar is implemented, it is more appropriate for CSEF to be considered under the Trans-Tasman mutual recognition framework.

Option 3, maintaining the status quo, is not supported by the ASBC. While this option would result in no additional compliance costs for issuers and intermediaries¹⁵, it also offers no additional benefits for small business or investors. As raised under question 15 of the paper, this could also drive potential investors away.

CONCLUSIONS

The ASBC supports removing regulatory barriers for the use of CSEF in Australia as part of the Government's commitment to improving small businesses' access to affordable finance to ensure they have the opportunity to establish and develop.

In summary, our key observations are:

- Access to CSEF for issuers needs to be simple and made available to as wide an audience as possible, while balancing protections for investors;
- The establishment of an exempt public company structure is supported with reduced compliance costs;
- A comprehensive information and education programme needs to accompany changes to the CSEF framework so issuers and investors can make an informed business decision; and
- Access to a low cost alternative dispute resolution service should form a part of the approach.

¹⁴ Crowd-sourced Equity Funding Discussion Paper, question 12, p 15.

¹⁵ *ibid*, p 15.