EQUITY CROWDFUNDING

RESPONSE TO THE TREASURY DISCUSSION PAPER

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Australian Association of Angel Investors
The Home & The Voice Of Early-stage Investors

ABN: 44 127 412 515 | www.aaai.net.au | info@aaai.net.au

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This paper builds on the previous submission by the Australian Association of Angel Investors, Equity Crowdfunding Discussion Paper, December 2014. Recommendations in this paper have been changed and evolved through further consultation within the community and as a result of participating in the consultation process conducted by the Minister for Small Business and by Treasury.

POSITION

Australia has had legal equity crowdfunding longer than any other country. Now that we have been patient to migrate into the new age of Internet enabled crowdsourced equity funding it behoves us to implement a regulatory solution that embraces the future rather than seeking to enshrine the past.

The country needs a system that evades the perverse risk aversion that has become common practice and returns to our roots as an entrepreneurial community breaking new frontiers.

In an ideal world we could revise existing legislation to set a clear and consistent platform for the future that embraces all forms of crowdsourced investment for all asset types. However, the complexity of revising the Corporations Act and the many related pieces of legislation and regulation pose a challenge to realising an expedient response to the opportunity represented by CSEF. For that reason it would be practical to develop an interim regime based on regulatory reform under existing legislation. This has the added advantage of offering the chance to run a trial with a view to collecting experience and data to underpin a more complete revamp of the underlying legislation in the near term future (say 3-5 years).

In the 21st century regulation needs to avoid paternalism without completely abandoning prudent protection of interests. In the context of CSEF this means that the government should not be forcing artificial limits on investors any more than it limits investors' decisions on investing in property, listed shares, or any other asset. Similarly, limits placed on companies as issuers under CSEF need to be broadly consistent with the context and not fashioned through a narrow policy lens that fails to consider the consequences.

Operators of equity crowdfunding platforms should be free to use differing business models but, should not be exempt from suitable regulation if they choose to operate with the self-interest inherent in being promoters and/or operating managed investment schemes. Ultimately one would expect that equity crowdfunding platforms will evolve into trading markets, bringing much needed liquidity to the space which, in itself, will help de-risk the activity. However, trading markets are a more complex implementation challenge that should be part of the more comprehensive reform (3-5 years).

Australia must reclaim its position as a global leader not languish as an 'also ran'. Equity crowdfunding is an important and vital step in the evolution of the Australian economy to drive more diverse and more successful commercial enterprises. CSEF is about connecting people within the business sector and minimising the structural and regulatory barriers without leaving the participants devoid of reasonable standards of conduct and recourse.

TERMINOLOGY

The following provides some broadly used terminology[1] for describing the actors in the crowdfunding market:

- **issuers:** corporate entities that are registered as companies under the Corporations Act and are seeking to acquire money through sales of their shares, or offering of other securities or financial contracts (broadly classed as 'equity'), and

[1] Based on definitions found in the CAMAC Crowd sourced equity funding: Discussion Paper September 2013 with October 2013 update and reused in the Treasury Crowd-sourced Equity Funding Discussion Paper, December 2014

- **intermediaries:** the equity will be offered through online portals and mobile applications of Internet website operators that come within the jurisdiction of Australian regulators, and
- **promoters:** are intermediaries that take an active financial interest in the success of the offer and/or a share of the return eventually generated on the sale of equity issued in the offer ('carried interest' or 'share of the carry'), or actively market the offer, and
- **advisers:** providing financial advice and/or services to the issuers and/or the intermediaries to facilitate the transaction, and
- **investors:** those Australian residents and/or other persons who take-up the issuers' offers through the intermediaries and may be subject to the influence of the advisers.

RECOMMENDATIONS

This paper offers the following recommendations:

1. **Perspective:** equity crowdfunding is an arm's length public transaction that should be broadly aligned with the well-developed principles that govern such transactions in the existing public markets, i.e. stock exchanges, while being implemented within the context of small business and start-ups.
2. **Licensing:** issuers, intermediaries and advisers should be governed through the same financial services regulatory regime as currently applies to the provision of financial services and advice in Australia.

   For intermediaries this should mean being regulated as an AFSL licensee and as a registered managed investment scheme if their structure is a pooling/managed fund model. However, the AFSL for a CSEF platform, or a related Class Order needs to provide some tailoring of the constraints on services and products.

   For issuers there should be no licensing requirement to make use of CSEF.

   For advisers we need to enforce the existing licensing regime which has sound and relatively low cost requirements which deliver recognition of advisers and risk reduction for their clients. Where the intermediary is also the adviser the licensing will already be a requirement that is in place and only needs to be supported by appropriate transparency on potential conflicts of interest. For independent advisers there should be standards enforced that deliver a larger number of issuers the assurance they need to take advantage of CSEF with confidence.
3. **Corporate entity:** No special purpose company category need be created. Issuers should be either Proprietary Limited companies or Public companies as currently defined under the Corporations Act. This should deliver access to all other structures such as unit trusts.

   A trust requires a trustee which is the entity that interacts with third parties on behalf of the beneficiaries of the trust. It is a reasonable and low cost imposition to require a trust taking capital from the crowd to have a corporate trustee. That, in turn, brings to bear all the standards and protections of the Corporations Act and related legislation and regulation.

   The Pty Ltd company vehicle is the overwhelmingly most preferred for start-ups and small business. It is, however, time that the number of shareholders that trigger the requirement to be a public company be raised from 50 to between 200 & 400. One approach as part of the interim solution might be to make that a specific exemption only available to companies that raise investment through a CSEF platform. That would allow CSEF to happen and provide some experience and insight into the impact of the higher limit and potential for abuse or unintended results before making it more broadly available as part of the broader reforms (3-5 years).

Other requirements for a company using CSEF should include reasonable reporting/information sharing with shareholders to avoid abuse of small shareholders and to encourage issuers to benefit from engagement. Given that this type of reporting can all happen electronically and that the relevant information should all be readily available in a well-run business, this requirement should not be a significant burden or cost. This is similar to the BAS regime which is an insignificant impost on a well-run business and acts as a driver to push more businesses towards better management.

4. **Disclosure:** The first requirement is that disclosure be viewed as sharing specific information and not focused on a document-centric way of thinking. This will immediately reduce the cost of compliance.

   Accountability for disclosure compliance should be allocated to the intermediary while accountability for disclosure content must remain with the issuer or with the issuer's advisor if one is engaged for that purpose.

   The restriction on advertising an offer will need to be substantially relaxed to facilitate retail equity crowd funding. Within the context of an intermediary platform that enforces the appropriate disclosures, disclaimers and risk warnings there should no further restriction on an issuer's freedom to advertise the CSEF campaign on that platform through other channels.

   Issuers, intermediaries and advisors should be required to provide a level of disclosure consistent with the risk inherent in the transaction and the actual information available to them. At a minimum this should include a detailed description of the execution plan for the business, the historical and projected financial performance (down to major budgetary line items), the current and planned ownership structure including details of any and all classes of equity or debt issued or on offer, personal background information on the founders, directors and executive officers including current copies of ASIC report cards, ASIC banned persons reports, insolvency and bankruptcy checks and criminal records.

   Just as in those other asset investments the regulation should mandate a minimum level of information provided to investors and presented in a defined way to ensure transparency, ease of recognition and to promote common understanding. That defined way though is on the Internet via web pages and mobile apps so it is not a 'disclosure document'.

5. **Offer verification:** intermediaries should be required to provide a robust, thorough and transparent validation of the authenticity of the issuer and the offer, the content of such validation to be a part of the public record disclosed in the offer. This is likely to help supply significant elements of the disclosure information described above.

6. **Investor identity:** every investor should be required to be identified and validated as a private individual with a physical as well as electronic address verified and recorded by the intermediary. Full disclosure of investor identity to an issuer should be a required step in completing a transaction.

7. **Investor Knowledge:** it should be recognised that simple use of disclaimers, disclosures and other legal documentation is likely to be largely ineffective in actually alerting investors to degree and probability of the relevant risks. Intermediaries should be required to provide a solution that forces investors to complete an interactive process that can only be completed by a human being and demands actual consideration by the investor in order to qualify for the opportunity to respond to a particular offer.

8. **Investor exemptions:** intermediaries should be required to obtain and be accountable for verification of detailed identity records for all investors. Those records should include the classification of the investor as a retail, or an exempt investor and substantiate the exemption.

   Qualified Investor: There should be a new category of investor exemption based on experience, training and a continuing professional development regime rather than a financial means test. This would provide a more practical means of establishing investor knowledge, investor identity and the investor credibility required for the leader/follower model that is inherent in crowd structures. The AAAI has developed a curriculum and CPD model to serve this purpose.

9. **Investments**: issuers and intermediaries should be free to specify any minimum or maximum investment parcel size in dollar terms as well as any limit on total participation in an offer by any investor.

   No Cap: Investors should be free to invest in equity crowdfunded offers according to their own judgement without any regulatory limit.

   Safety Net: It might be advisable to levy a small tax on every investment transaction to achieve a user-pays funding of a counselling and social welfare service to support investors who overextend their financial commitment to equity crowdfunding. This could be supplemented by a small, marginal levy on the license fees paid by intermediaries.

10. **Fees:** all fees related to the transaction whether on the platform or in a separate arrangement between parties must be fully disclosed in detail as part of every offer.

    Where intermediary fees are structured as a success fee scaled according to the amount of funds raised and/or as a carried interest in the equity of the issuer then the intermediary should be considered a promoter. As a promoter the intermediary should not be afforded access to exemptions made available to independent intermediaries. Promoters should be subject to the obligations, liabilities, regulation and insurance requirements normally applicable to a promoter of an investment scheme to retail investors.

11. **Communications:** issuers should be required to establish and maintain an investor relations information channel that ensures all investors are provided with equal and equitable access to all information about the issuer post-investment. Intermediaries should be required to ensure and be liable for the proper and compliant provision of all information in regards to the offer. Intermediaries should be required to offer a solution compliant with a specified standard for all investor relations between the issuer and the investors subsequent to the transaction.

12. **Limits:** In an ideal world issuer's should only be limited in the amount of capital they raise in a CSEF campaign by the appetite of the crowd and the commercial realities of the issuer. After all, unlike pre-purchase crowd funding, the issuer in CSEF will have very real commercial limits to the capital raised driven by ownership dilution and similar factors. However, pragmatically there are issues related to concerns about money laundering and other regulatory factors that indicate a limit on capital raised will be required, at least for the interim regime (3-5 years).

    Each issuer should be able to raise up to $5m from up to 400 investors in any rolling 12 month period. While IPO is not a highly desirable development for many companies, the number of investors allows for unlisted companies to build their shareholding up to the basic entry limit for an ASX listing. This could be seen as creating a more harmonised and unified development environment for Australian growth companies.

13. **Pooling:** any intermediary that does not provide full, complete (less any previously notified fees) and transparent transfer of funds from investor to issuer should be categorised as a Managed Investment Scheme and regulated accordingly.

    Any intermediary that assumes a representative role in holding equity on behalf of the crowd investors should be tested as a Managed Investment Scheme.

    An intermediary that actually receives and holds crowd funds then makes investment where the investment decisions are not made directly by the members of the crowd is clearly operating as a managed fund and should be regulated accordingly.

DISCUSSION PAPER 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 is the regulatory structure. All the anecdotal evidence is that there will be and will remain an adequate level of investor interest. In this system it is inappropriate to describe it as investor demand as the CSEF market, as proposed by CAMAC, is driven by the intermediaries and, to a lesser extent, the issuers. So it is intermediary demand for issuer supply that is the defining behaviour. If the CSEF market were centred on the issuer or the investor then issuer or investor demand would be the right consideration.

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?

   No

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?

   A general lack of familiarity with and understanding of high-growth, start-up businesses and the risks associated with them is a real concern. To some degree this may inhibit investor participation but, it is also the basis for concern about investor quality, investor reaction to losses and adverse investor capture by intermediaries.

   This same issue of ignorance and misinformation is pertinent for the issuers as very few business people really understand, or have competence in the process of raising capital. This is an issue for all small businesses that might use CSEF, not just start-up companies.

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

   CSEF can be of value to a wide range of companies but, it should not be allowed to overlap with existing public equity funding channels such as stock markets and private placements for established companies.

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

   Yes. There are other means to addressing this need that would be preferable but, are unlikely to be practical given that they would require a substantial reform of existing legislation and regulation.

   However, it should be possible for an ordinary proprietary limited company to raise funds through CSEF if it does not breach the conditions already available under the Small Scale Offerings provisions. The only additional exemption required for this is to allow the private company to undertake the marketing of its CSEF campaign.

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?

   It depends entirely on the terms of the special purpose company. If done correctly, the issuers should be indifferent to the requirement for a special purpose company because it places no extra barrier to their planned capital raising. So the compliance costs should be comparable to those currently borne by a private proprietary company.

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?

   Yes there is risk but, they do not outweigh the benefits. It only requires prudent design to ensure the risks are minimised without compromising the benefits available to the intended participants.

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?

   No.

   It is unclear how CAMAC was measuring 'capital' and its proposed caps are internally contradictory. We suggest:

Caps and thresholds recommended by CAMAC - amended

Category	Cap or threshold
Eligibility to conduct a CSEF issue	~~Limited to certain companies with simple structures, with a cap of $10 million in capital~~ Limited to certain companies with simple structures, with a cap of $10 million in invested capital
Eligibility to become or remain an ~~exempt public~~ eligible company	~~Limit of $5 million in turnover per annum and $5 million in capital~~ Limit of $10 million in revenue per annum, $5 million in net profit per annum and $10 million in invested capital
~~Exempt public~~ companies eligible for exemption from auditing requirements	~~Limited to companies that have raised up to $1 million in funds via CSEF or any other prospectus exemption and cumulative expenses of $500,000~~ Limited to companies that have raised up to $3 million in funds via CSEF or any other prospectus exemption and cumulative expenses of $1 million since first raising funds and a total of less than 250 shareholders.
Cap on the amount of funds that can be raised via CSEF or other exemptions from disclosure requirements	~~Limit of $2 million per 12-month period for any individual or related group of companies~~ Limit of $5 million per 12-month period for any individual or related group of companies

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?

   No.

   Intermediaries can be free to offer fixed fees at various levels to accommodate different sizes of fund raising and some platforms overseas that use fixed fees only collect fees on successful campaigns.

   It is appropriate that intermediaries do not have an uncapped or conflict-generating interest in the outcome of a CSEF campaign. However, as described in our previous submission, we believe that there could be a category of intermediary known as a promoter that could use success-based proportional fees and take equity interests in issuers. The promoter would be required to undertake a higher level of AFS licensing burden, disclosure obligations, due diligence obligations and insurance coverage.

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?

   No. Investor caps are a flawed concept that is far too paternal and practically unworkable. Does the government mandate caps on the amount any individual can gamble at the casino, or on Tattslotto, or on property development, or on their own business venture, or on the stock market, or any other risky investment?

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?

    Yes.

    Personal liability of directors of intermediaries should be limited to the liabilities of the intermediary company and not include exposure to the issuers unless the subject of a claim for negligence or intentional breach of the Corporations Act which has resulted in direct, specific and quantifiable harm to the issuer and/or the investors.

    Mandatory training for CSEF company directors, officers and CSEF investors should be part of the system to ensure that the Australian CSEF market is robust, reliable, sustainable and scalable. Disclaimers about risk are entirely insufficient and have little legal worth when they are simply another click-thru screen, similar to the legal weakness of the lengthy license terms that users click to accept on many websites where the terms and their implications are frequently neither read nor understandable to the typical user.

    The education access should be a mandated service offered by intermediaries but, intermediaries should be prohibited from being the developer of the training content. This way the community interests can be aligned to ensure that the relevant training is available, appropriate and does not favour one intermediary platform over another.

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?

    No. Nice to have but, not need to have.

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?

    No.

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

    We do not support investor caps of any sort.

    In direct response to the question, substantial direction, otherwise there is no certainty in an already information poor transaction with substantial information asymmetries.

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?

    Very high as it is already happening.

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

    Status quo is not an option. Doing nothing guarantees that substantial capital, skills, knowledge and wealth generation will be lost overseas and thus further hinder the development of a robust and expanding entrepreneurial sector to drive the Australian economy forward.

    The excessively constrained CAMAC model based on its new special purpose company will increase regulatory complexity and costs since many of the proposed elements will prove difficult to police and enforce leading to spiralling regulatory costs (do we really need a CSEF Ombudsman and other such regulatory overburden??), increased litigation and ultimately a lack of confidence in the CSEF funding pathway.

There are similar concerns about the NZ model.

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

There is insufficient information about how the costs were derived but, they do not seem reasonable when compared with experience. Some are too high, some are too low and some do not measure the right metrics. For example:

- CAMAC estimates the hourly rate of AFSL compliance at $112.82 but, in reality there are very few small businesses or start-ups that employ staff on base salaries of over $220,000 and that level of salary would be prohibitive for the start-ups that will be the intermediaries.
- CAMAC estimates the cost of a start-up holding an AGM at $7,500 yet if this figure includes the salaries of staff then it is far too low and if it does not include internal labour costs then it is far too high.
- CAMAC estimates the cost of applying for an AFSL at $100,000 yet the normal external costs (primarily legal) are more like $25,000 and it is unlikely that there would be $75,000 of internal labour for that task (approximately 1.2 man years of effort at CAMAC estimated labour rates).

The end result is that the estimated costs cannot be taken as indicative or representative so cannot properly inform an evaluation and decision.

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

Under the status quo, other than a very small CSEF market for exempt investors which is most likely to primarily benefit the intermediaries there will be no take-up.

The differences between the CAMAC model and the New Zealand model are not many and tend to balance each other out, e.g. the disincentive of caps under CAMAC is offset by the higher cost of compliance under the New Zealand model.

As we have already seen in NZ, models like the CAMAC and NZ models have very slow take-up and do encourage either rapid growth or large capital raisings. The net result is that they will prove ineffective in creating a sustained, significant and near-term economic impact.

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

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

It would be highly desirable for the CSEF regime in Australia to be accompanied by a broad-based tax incentive for private individuals to invest in early-stage, high growth ventures similar to the Enterprise Investment Scheme in the UK. This tax incentive would not be limited to CSEF issuers and not all CSEF issuers would be eligible investments for the tax relief.

Modifications to the UK model would include provision for investments to be made by SMSF and for investments to be in other classes of shares provided the terms of those shares do not breach the control or proportional entitlement provisions.

The EIS is credited with making the early-stage investment market in the UK one of the most dynamic and successful in the world. A long standing policy of supporting private equity broadly and private investors specifically has enabled the UK to realise an economic revitalisation driven by the SME sector in a way that is sustainable, scalable and adaptable while operating in response to market demand and not government constrained "picking of winners".

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?

For the most part yes and there is great value in allowing a CSEF regime to support other types of securities including preference shares, redeemable shares, convertible notes and redeemable notes. The CSEF regime should not facilitate straight finance lending, or peer-to-peer lending, or other forms of debt that require collateral security and should not support lending that is not structured as an investment security. Debt provided under a CSEF regime should not be provided by a financial service that operates substantially for the purpose of generating interest income as the primary focus of business of the debt provider.

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

As mentioned above, provided that the debt instruments are structured for the purpose of investment and take into account the inherent risk of an equity investment without additional collateral security the frameworks are broadly applicable.

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

Constraints on the type of equity, e.g. ordinary shares, and caps on investors would artificially distort the profile of investments and the risk of investors to create perverse incentives that would adversely impact a secondary market.

A secondary market would exist to offer welcome liquidity to this risky asset class. Whether that liquidity could be realised remains to be proven and how the market could be regulated to avoid the sort of abuse that occurred in the pre-IPO secondary markets that arose around listings like Facebook is unclear.

Ideally, CSEF would include a secondary market however; this may be one of the features that must be part of the subsequent evolution, as noted in the recommendations above, once we have evolved a robust, efficient, equitable CSEF regime.