**Crowd-sourced Equity Funding Discussion Paper December 2014 [Treasury]**

Submission by Richard Wilkins 6 February 2015

**I set out below my responses to the questions in the Treasury discussion paper**

*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?* There are several barriers- most of which are significant- and it would be too simplistic to put forward only one as the "main" barrier. The debate would be helped by having reliable, and preferably independent, expert estimates of how much equity capital Australian small businesses wish/need to raise in a year, and how much of that is satisfied by stock market listings (probably none, depending on how "small business" is defined); angel, wholesale or other professional investors like venture and seed capital firms; and the provision of capital by employees or fewer than 50 shareholders. Thus how large is the equity shortfall that is not being met?

This is not a one-sided problem. Many small businesses are understandably reluctant to turn to outside investors, for fear of interference, loss of control, burden of external governance needs, disputes about business strategy, dividend policy etc. Hence business owners often prefer to seek debt finance, and consider equity from "strangers" only as a last resort. The discussion paper makes valid points about the difficulties in obtaining bank debt: however, that does have distinct advantages for business owners— providing bank covenants are met, the owners do not relinquish any control to the bank, the cost of funding is much lower than (third-party) equity, at least if secured, and there is only one party to deal with. To assess whether there is lack of equity supply available to small business, one also needs to know how large is the *realistic* and bona fide unmet level of demand for equity from the small business side. Irrespective of the regulatory structure, small business almost always presents much higher investment risks than larger or listed entities—even for well informed and sophisticated investors. That fact will not change by the introduction of CSEF- it merely spreads out the risks over a large number of (probably uncoordinated) investors.

*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- the limits are too narrow both for the $ cap and number of investors. I understand that the "20 investors and $2m cap" law was introduced in the original 2001 Corporations Act: if so, the cap would need to be over $3m now to allow for inflation. Also, limiting capital raising to a given amount each year is inflexible and unrealistic; very few businesses need to raise capital annually. I suggest below making the cap $5m over 24 months for a CSEF regime- and it would be desirable to amend s708(1) to similar amounts, irrespective of whether a CSEF regime is introduced. Moreover, it's hard to understand the rationale for allowing a proprietary company to have up to 50 non-employee shareholders (apparently with no $ cap) but limiting s 708(1) to 20 investors (and $2m cap) per annum.

It would be more justifiable—and commercially practical- to allow small scale offerings to be capped over 2 or 3 years, whether in one issue or several- up to say $5m in aggregate and by up to 50 investors.

*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?* Yes- see my response to Q1. As an investor, I doubt that compliance and disclosure requirements (which *are* necessary for investors) would be more than a minor factor in the overall 'burden'. Certainly, the $ cap and maximum number of investors are restrictive; but the major barriers are not regulation but the (very) high risk inherent in small business, its lack of liquidity for investors, and major differences of opinion between small business owners and prospective investors on commercial matters like required rates of return, exit mechanism, dividend policy and strategy-as well as governance. Government would be well advised to speak to professional providers of development capital funding in Australia and overseas, to understand how complex and fundamental these issues are. I understand that the rejection rate by professional investors for applications for equity finance by small companies is usually well over 90%, and often as high as 99%. That is even when the company has a well prepared business plan. There are a vast number of commercial factors for the two sides to agree on before investment can occur. Regulation is the least of the hurdles.

*4. Should any CSEF regime focus on the financing needs of small businesses and start-ups only, or is there a broader fundraising role?* There <u>is</u> a broader fundraising need, but CSEF is probably not the solution for that. Professional private equity investors are unlikely to be attracted to companies capitalised (after new equity) below $20m- in fact, more likely $50m) ; venture and seed capital investors would be, if the growth prospects were good enough, but those opportunities would represent only a small fraction of total capital needed). I don't know how wide the scope of angel investing is, but I suspect that there is a big equity funding gap for Australian companies ranging between say $5m and $20m total equity. CSEF is probably well suited to funding up to about $5m (perhaps even to $10m including existing equity): but that would require for example 5,000 investors providing $1,000 each - which is a big challenge. Given the lack of experience of CSEF systems- or markets- for investment purposes, as distinct from charity or benefit-related funding schemes- I believe this initiative should be limited to smaller business for at least 3 years until the challenges, risks and opportunities for Australia are better understood. I note from the FSI Final Report that CSEF mechanisms have only recently been established in the UK and New Zealand, and are still pending in Canada and the USA, so there is little international experience to follow. (There could be merit in looking at why the ASX Secondary Board didn't succeed, and how well markets like AIM in the UK are fulfilling their objectives- noting that CSEF is likely to present greater challenges commercially than those markets, even if the regulation is looser).

*"The terminology used to refer to the various participants in CSEF reflects that used in CAMAC's report for issuer; intermediary; and investor".* Government should define what it has in mind regarding the size and attributes of "small business"- i.e. its commercial features and capitalisation range, as opposed to the various types of company regulated by the Corporations Act.

*5. Do you consider that, compared to existing public company compliance costs, the exempt public company structure is necessary to facilitate CSEF in Australia?* No, and removing the requirement for annual audited accounts is a bad idea. That cost is low by comparison with the assurance that it gives to investors---in particular if there are large numbers of unrelated investors, and especially if there is to be no agm to hold the issuer's board to account.

*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?* The compliance costs are a very small and necessary factor, and a price worth paying to attract investors. I would expect the intermediary's fee and costs to be significantly higher than these.

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?* I believe that the arbitrage risk is low - and legislation could be prepared to ensure that companies would lose their special status if they haven't raised a given amount of CSEF within say 24 months. The risk would be small by comparison with the benefits to the small business sector of enabling CSEF. Taking Questions 6 and 7 together, I believe that there is no need to create a new class of company to facilitate CSEF.

*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, the caps are too low. See also my response to Question 2. I suggest new CSEF equity raisings be subject to a $5m limit in a 24 month period, to give more flexibility and efficiency to issuers in deciding their needs. It is not cost effective to raise capital frequently. I am a little uncomfortable that the CAMAC model proposes to exclude from the $ caps (i.e. making that additional) any capital that is raised under the existing wholesale investors' exemption (as well as the fact that the distinction between wholesale v retail investors is not yet resolved). It's hard to see the rationale for enabling CSEF (as well) if an issue has succeeded in attracting wholesale investors: I wouldn't rule it out, but more thought needs to be given to the policy purposes, potential conflicts and benefits.

Table 2 needs some clarifications. Does "capital" mean existing capital, immediately before the proposed issue? Does it mean total shareholders funds or only paid-in equity, and how would capital be counted, that has been eroded through accumulated

losses? I don't see merit in having different $ eligibility limits to be an exempt public company and to make a CSEF issue. They should be the same: somewhere between $5 and $10m. Most importantly, I do not believe that a company that raises equity from the public should be allowed an exemption from audit requirements. A properly conducted annual audit is at least as important a safeguard to investors as an initial disclosure document or due diligence---especially for an unlisted company, where the investor does not have the option of selling if he is dissatisfied. The commercial and governance risks of small business investment are very high already, and, in the absence of an agm, what mechanism will have investors have to hold the board and management accountable? Removing the requirement for annual audited accounts is unwise, and a deterrent to investors.

*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?* Although it is a laudable aim, it could be counterproductive to ban remuneration based on funds raised. This could be better left to market forces (at least until a policy review date). As a related matter, it seems to be implicit in the discussion paper that CSEF issues will not and may not be underwritten (and hence underwriting costs would not arise). Is that policy intended—if so, it should be made explicit? I agree with the proposal to prohibit intermediaries from investing in or having other financial interests in issuers, and from lending to or advising investors.

*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, they are too low. Contrast them with share purchase plans in listed entities, where an investor may invest up to $15,000 in one SPP and unlimited amounts per annum in aggregate between differing SPPs. [I understand that the SPP Class Order 09/425 applies only to listed entities---Government or ASIC should ensure that it explicitly does not apply to CSEF issues, to avoid regulatory arbitrage.] I suggest annual limits per investor of $5,000 per issue and $20,000 in total for CSEF, to allow for the CSEF risks being higher and disclosure standards lower. Perhaps there should be no *aggregate* annual limit for wholesale or sophisticated investors. The discussion paper does not appear to raise the question of whether *minimum* amounts per investor should also be stipulated- say $100 per person per issue, to prevent trivial investments. That would be worth considering. Does government intend that only Australian resident natural persons will be allowed to invest in CSEF, to ensure that the financial limits are not circumvented?

*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?* It's good that the (proposed) only permitted form of CSEF securities is one class of fully paid ordinary shares. For the avoidance of doubt, that should include the existing share capital. Investors must be certain that all existing and new shares have identical rights, including as to voting, capital and income. The constitution and any shareholders agreement should be disclosed in the issue documents, as should any material related party agreements. Any subsequent rounds of equity raising should be first offered prorata to current shareholders, before new investors are introduced, to avoid dilution; that would otherwise be a significant risk under CSEF where there are likely to be large numbers of very small shareholdings, but practical difficulties in coordinating them and preventing unfair capital raisings. The law should confirm that CSEF is limited to companies-i.e. that trusts and other ownership structures are not permitted to be issuers. Generic risks must be disclosed but there is a risk that this could become 'boilerplate'. The issuer should also disclose a fair and appropriate summary of business-specific risks that a 'reasonable investor' would require. Which party (if any) is liable for unsatisfactory disclosure or failures in due diligence?

*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 is more appropriate for CSEF to be considered under the Trans-Tasman mutual recognition framework?* NO.

*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. I prefer the CAMAC proposal to the NZ model on this point. I don't like the notion of having a sliding scale of disclosure depending on investor caps. Government policy must dispel any thought that the CSEF regime will be very light-touch regulation, perhaps on the inferred grounds that most or all investors will have only small amounts at risk. Poor disclosure or investor protection would quickly bring about failure of the regime.

*14. What level of direction should there be on the amount of disclosure required for different voluntary investor caps?* See previous answer-the concept is unsatisfactory.

*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?* I have no concrete information on this, but I think it's very unlikely. The expense and inconvenience for an Australian small business to move to another jurisdiction (even assuming that other jurisdictions enabled it) would be highly likely to outweigh the benefit of getting access to a CSEF regime. It would be sensible for such a business to look at Australian angel and other wholesale investors before taking that step—and if it couldn't raise sufficient interest from those parties or via the existing $2m cap, one would wonder why the business would persist in moving overseas. That might be a consideration for a services business that had some overseas trade, and a capital base large enough (perhaps over $20m) to warrant it—but even then I doubt it. Thus although it's possible, I'd be surprised if it has happened more than a very small number of times.

*16-20.* I cannot comment on these questions except on questions 17 and 19 below. *What are the costs and benefits of each of the three options discussed in this consultation paper?*

*17. Are the estimated compliance costs for the CAMAC and New Zealand models presented in the appendix accurate?* I cannot comment on this, but again urge Government to give adequate weight to *investors*' interests. There is no point in creating a CSEF regime that exempts most compliance and governance requirements on the grounds of saving costs for business, if it is unacceptable to otherwise willing but prudent investors.

*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?*

*19. Are there particular elements of the New Zealand model that should be incorporated into the CAMAC model, or vice versa*? I prefer the CAMAC model overall, but would prefer a stronger emphasis on risk and other commercial disclosures.

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

*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*? Many aspects do also apply, but there are additional points for debt. See also Question 22. This debate would need to explain whether it refers to securities-based debt products, or a wider group including ordinary loans. The FSI Final Report, under its Recommendation 18, makes a useful distinction between securities-based crowd funding- which could be either debt or equity) and peer to peer lending. I believe that Government should wait for 2 or 3 years to allow a CSEF (equity only) regime time to mature and demonstrate both its benefits and pitfalls, before considering extending it to securities-based debt products. (In any case, as I suggest under Question 22, I doubt whether <u>non</u> securities-based debt products could feasibly be provided through the CSEF regime or similar: peer to peer lending would be a more natural financing avenue for this development, and appropriate regulation.) This is partly because there are so many different versions of debt products, even just for loans, and their terms, whereas it is easier to stipulate that CSEF be limited to one class of fully paid ordinary shares.

Also, through requiring adequate warnings, it ought to be more straightforward to restrict CSEF investment to people who have some understanding of the (high) equity risks involved; in general, a wider section of the public might be enticed into debt products, and not adequately appreciate the risks to repayment of capital and income.

For example, very large amounts were lost only a few years ago, in property finance and investment companies—whether the debt products were called "debentures" or otherwise- because even relatively wealthy people didn't understand how much these products differed from bank deposits, or even the fact of the absence of security. It is welcome that ASIC and Treasury are looking at strengthening those rules (albeit too late for many investors): I fear that opening an untested CSEF regime to debt products could cause a repeat of those misfortunes. Even if they didn't risk such large losses per person, a crowd-sourced debt regime, with limited regulation and disclosure, could give rise to false expectations for thousands of people.

*22 To what extent would the frameworks for equity proposed in this discussion paper be consistent with debt products?* Any such policy would need to distinguish between securities-based crowd funding, and alternatives such as peer to peer lending. See also Question 21. Does Treasury intend that any debt crowd funding would have to be securities-based? If so, that should be made explicit. The frameworks would in any case need to be modified, and probably more complex. For example the questions of security, debt ranking v bank debt, term, interest payments and principal repayments: these are considerably different from equity which is –or should be – characterised as high risk in small unlisted companies.

As an experienced investor, I would be very cautious about investing in a <u>debt</u> crowd funding product in a small business. Amongst other matters, it would be very hard to determine appropriate pricing. In practice the level of risk and illiquidity of a debt instrument in a small business might often be not much less than equity (especially if it was subordinated to bank debt), but the issuers would likely baulk at the pricing required to reflect that. A better approach would be to see how peer to peer funding could be developed to facilitate small business lending—i.e. on a professional platform with an independent but expert operator to oversee many issues.

*23 Would any of the options discussed in this paper, or any other issues, impede the development of a secondary market for CSEF securities?* An exit mechanism is vital for any investment—even if it's years away. One of the biggest hurdles for CSEF is the uncertainty about when and how the equity can be sold, so a secondary market would be desirable. However, there are clear challenges. A secondary market would need to have some rules about compliance and disclosure: and they would have to be harmonised with the requirements of the law governing CSEF primary issues.

Since there would be, I assume, no requirement for continuous disclosure for CSEF shares in the secondary market, how could investors have confidence about what they were buying on that market? They would need (at least) annual audited accounts to be available on the issuer's website. Would a secondary market investor be able to rely on the initial disclosure documents? Would purchasers in the secondary market be subject to either the individual caps per issuer or aggregate annual caps?

If so, that would be different from the SPP regime, where a secondary market buyer has no limit on how much stock he can buy in one company, even though the original SPP subscriber was limited to $15,000. How long should CSEF shares be "seasoned" before they are considered "safe" for investors to buy on the secondary market without value caps?

The development of CSEF in Australia is timely and worthwhile. However, I urge Government to reflect deeply on what small businesses really need and on what they are prepared to offer to accommodate investors' requirements. Investor protection is paramount: without it, this regime would fail.