INITIATE:
CROWDFUNDING
Summit

Submission in response to the Treasury Discussion Paper on Crowd-Sourced Equity Crowdfunding

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General Comments

INITIATE crowdfunding, the organiser and convener of crowdfunding summits in Australia & New Zealand, appreciates the opportunity to provide input to the Australian Government processes to develop legislation on crowd-sourced equity finance.

Equity crowdfunding (or crowdinvesting) as it is known in other parts of the world, utilises the internet to raise funds for business firms. Rewards-based crowdfunding on websites like *Kickstarter*, *Indiegogo* and Australia's own *Pozible* have been used extensively by start-ups with new products to sell. The application of this form of fund raising to sell ownership in start ups and established ventures will provide a new way to raise capital for young businesses.

While the internet has been with us for quite some time now, it has been the advent of what is called Web 2.0 technology, and in particular social media and other online communication, that have enabled the growth of crowdfunding. Crowdfunding is currently being applied to smaller capital raises in other countries, though in the longer terms the efficiency of these methods are likely to extend to larger raises. Crowdfunding's mechanisms are part of a broader disruption to traditional information-based businesses. Just as traditional booksellers, newspapers and travel agents have been disrupted by internet platforms, traditional finance is also likely to be disrupted by what being termed "fintech" In addition to crowdfunding, *fintech* encompasses peer to peer lending and digital currencies such as bitcoin. While these will start off small, the experience in other sectors is that the efficiency of the internet to provide information-based services will be transformative. In this regard it is import to tackle the policy work on crowdfunding **not just as an add-on asset class or new channel of selling a traditional product, but rather as a first stage of a more significant change in the interaction between investors and capital raisers**.

The main barrier for crowdfunding is that this new approach to capital fundraising made possible by developments in internet technology is not recognised by current securities legislation. This technology permits *a transparent two way interaction* between capital raisers and investors in a similar manner to the way fundraising was done before the advent of mass media, though on a much larger scale. The regulatory regime that has applied to public share capital fund raising is a creature of mass media communications, which broadcasts information one way, and which requires regulation to ensure accuracy and lack of bias. In contrast transparent two way information flows provide more opportunity for investors to look after their own interests by asking the hard questions themselves in an open transparent forum, rather than requiring government regulators to intervene to ensure fairness and accuracy.

Is there a statement of risks being managed?

While recognising that the current Discussion paper is a first step in a process to develop a regulatory regime for CSEF, it is surprising to see that there is no high level regulatory risk assessment of the sector and this new technology. This needs to be generated to support the regulatory risk assessment process, otherwise too much of the discussion is based upon anecdotes and impressions rather than a rigorous assessment based on careful analysis.

Good practice regulation today requires regulators and governments to set out the risks they are dealing with and the way they intend to manage these. Several publications from international organizations provide a useful framework for this. The 2013 World Bank report identifies the main risks (pp44-49) as does a Research paper by the International Organization of Securities Commissions (IOSCO) (pp33-46).

A key aspect of CSEF is that many risks can be managed using different methods due to the technology involved. The current regulatory regime, which has its origins in the newspaper era,

assumes broadcast one-way communication and thus puts the onus on companies to disclose information - ie *push* it out. CSEF and shareholder management through social platforms enables transparent two way communication, which allows investors to *pull* information from companies. This is a crucial difference in investor-company relations that restores much of the balance that exists in smaller private investment transactions to larger scale capital raises.

Recommendation 1: Drawing on the information obtained from this round of consultation, Treasury should develop a regulatory risk profile of the sector that takes into account both the risks and the means by which these can be managed. This should quantify the risks the government sees and be calibrated by factual input from the industry and community.

Responses to Questions raised in the report

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 lack of a clear regulatory structure for raising funds online is a barrier, although several platforms, such as *ASSOB*, *Venture Crowd* and *Fat Hen* have established themselves in the space using alternative mechanisms.

Investment in start-ups and the capital available for new businesses in Australia is low in comparison to other parts of the world. New Zealand mobilises considerably more on a per capita basis than Australia. With the limited data available it is unclear whether there is strong investor demand for this sector in comparison with other investment opportunities. To diversify its economy and support the longstanding notion of a clever country, Australia needs to broaden the options for start up capital beyond traditional venture capital, which is not that prevalent in the economy anyway. Crowdfunding is proving to be a useful addition to the start up capital mix in Europe and is expected to be so in Australia. Thus there is likely to be good investor interest, although long term prospects will depend upon confidence in, and performance of, the sector in its initial years.

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?

As noted a number of platforms have been able to use mechanisms available under existing law. These are customised/bespoke solutions, however, which need to be explained to investors and thus do not promote a sector which has similar rules across all platforms, and thus is easier for the general public to understand.

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?

One issue that has arisen in New Zealand is the application of the takeover provisions to companies that raise funds through crowdfunding equity campaigns. This can result in them having more than 50 shareholders, even though the funds raised are less than $1 milion. The NZ government is considering an exemption to this for crowdfunded shares.

Recommendation 2: Australia should tackle the issue of takeovers in its primary legislation that implements CSEF.

Another issue that needs to be carefully considered is the civil liability of platform operators. In addition to negligence, the conditions imposed on platform operators under legislation can give rise to strict liability for breach of statutory duty.

Recommendation 3: Civil Liability should be confined to general negligence with its legal tests and not unwittingly extended to breach of statutory duty, with its strict liability. This will require careful legislative drafting.

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

Equity crowdfunding will add another valuable source of financing for these two sectors. It should be recognised that there are a number of applications for crowdfunding in the equity space and any regulatory solution should be flexible enough to address these. Innovative applications of crowdfunding includes testing hospitality concepts, financing commercial real estate investments, aviation finance, and distributed renewable energy generation.

For start-ups in particular, who generally require less than $1M, it is very difficult to provide audited financial statements when the business may not have been running that long. Any predictions will inevitably be inaccurate. In essence people are backing the founder(s), the business concept and its early products. In contrast an established business that wishes to raise an additional $2-4M will have ample supporting information.

Recommendation 4: The regulatory regime for CSEF needs to be able to accommodate and differentiate between these two extremes.

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, the public company model in Australia assumes a large company that has or will, raise significant money through a stock exchange. Its disclosure obligations reflect the size of its capital raising and the ongoing trading of its shares. CSEF extends the capital raising reach of small companies to the general public, though the amounts raised will still be small. A modified version of the private company rules is more appropriate for this size of company, especially as many will not grow to the size of a public company. Fifty (50) shareholders may have seemed an appropriate limit for private companies many years ago when communications were via mail and phone. Crowdfunding and web technology (eg social media) now permits greater interaction between shareholders and companies - ie it fundamentally changes the way this relationship and its associated risks can be managed. Provided CSEF funded private companies have an obligation to provide timely information to shareholders and answer shareholder queries in a transparent way, there should be no need to use the public company model.

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 would impose additional costs to use this particular form of capital raising that are unique. As it would involve change to a non standard corporate form, in addition to the unknown outcome of the crowdfunded capital raise, it would act as a significant deterrent. In particular the CAMAC requirement to adopt this form before the fund-raise could require a commitment to an an orphan corporate form that may need to be reversed at additional cost if the fundraise is not successful.

Recommendation 5: The proposed exempt public company not be pursued as a crowdfunding-specific option.

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. The exempt public company structure should be introduced in a separate regulatory reform if it is considered that there is a need for this corporate form. If existing public companies see an advantage in being exempt this will generate demand for this corporate form based on reduced disclosure without the introduction of the information exchange mechanisms provided by crowdfunding. This could work against public confidence in crowdfunding.

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?

An overall cap of $2M per 12 months appears appropriate and acts to manage the risk to the system and the overall exposure of investors. Using a risk based approach it may be appropriate to have a lower cap of $1M for start-ups without a trading history, and a higher limit of $3-5M for established businesses that can produce financial statements for several years of operation.

Individual Investor Caps not supported - The issue of investors "overcommitting" should be managed though disclosure. Investor limits are extremely difficult to enforce across multiple platforms without adding expense - which works against the objectives of CSEF. Additionally it is not rational or equitable to limit investments in one area when anyone can buy unlimited shares on the sharemarket at the wrong price, purchase properties that may be too expensive or without having any finance, or gamble without any limits.

On the other hand investors should be provided adequate and timely information to make their investment decisions.

Recommendation 6: The minimum information for a listing must be available to investors well before an offer opens to ensure they have time to read & digest it. Platforms should have to provide all the relevant listing information at least 24 hours or even a week before an offer goes live. Ideally this should be provided in a standardised form for disclosure (as suggested by CAMAC).

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?

Recommendation 7: Intermediaries/platform operators should have to fully disclose their fees. There could be a general requirement that they must be reasonable and relate to the cost of the listing. Otherwise it should be left to the market.

There is a conflict of interest if intermediaries are allowed to have an interest in issuers using their platform, although the New Zealand regime permits this. This should have to be disclosed if it is permitted.

Recommendation 8: If platforms are not allowed to invest in issuers there should be an exception where the platforms are raising money for themselves through crowdfunding.

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?

The concept of investor caps is paternalistic and difficult to enforce in practice. There are no limits on other "risky" investments or activities such as purchasing speculative mining shares, investing in emerging markets, buying commercial investment property or indeed gambling. Anyone who takes the time to find, research and make online investments is actively engaged in investing and will know they are doing this. Provided there are standard investor warnings about risk, they will make their own assessments about the amounts they can afford to risk. CAMAC's advice in this regard follows the model in the US under the JOBS Act. Individual limits are extremely difficult for a platform operator to enforce effectively, other than through expensive mechanisms such as industry information exchanges, which would work against the underlying rationale of lower cost business finance. It would be relatively easy for investors to work around any limit, should they wish to do this - eg through the use of trusts.

Recommendation 9: The risk warning should include advice that diversification is one of the best ways to manage the risk of business failure - ie don't put all your eggs in one basket. That warning could also refer the reader to advice on the ASIC website on the desirability of making small investments in multiple companies rather than a large investment in one company.

(NB The UK crowdfunding platform, *Seedrs*, recently disclosed that 12 of the 170 firms that had fundraised through their website since 2012 had failed, which emphasises the need for diversification.)

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?

As a first step CSEF should be confined to companies. The regulations could permit it to be extended to other entities once experience has been obtained from its application to the most common business form.

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?

Due to the Trans-Tasman mutual recognition framework and the ANZ-CER, the two regimes should be similar. There is scope for differences, though these should not be too great - eg the overall limits will need to be specified in the national currency. Since NZ does not require a specific company reporting structure or impose personal investor limits, it would be difficult to impose these in Australia without giving rise to differential treatment of issuers and investors.

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?

This could be a more suitable option to deal with investors who wish to make larger commitments. This would need to be reconciled with the regime for sophisticated investors. Larger contributions could trigger additional components in the investment process that follow the process of private capital. An alternative approach would be to distinguish between the disclosure required for different types of fund-raising. This would involve more limited disclosure for start ups with lower funding limits, since they have limited useful information to predict future earnings, and more extensive disclosure for larger capital raisings by established SMEs.

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

As explained earlier, this submission doesn't support the concept of investor caps, voluntary or otherwise. As noted below under question 20, tax deductions may provide an incentive to diversify investments.

Recommendation 10: If voluntary investor caps are put in place, the legislation must provide for easy amendment of any limits - eg through regulation or statutory instrument.

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?

If Australia imposes too many quirks in its equity crowdfunding regime - such as some of the features of the regime envisaged in the CAMAC report - issuers that wish to use this form of fundraising will move to other jurisdictions, or use other crowdfunding platforms that have established under alternative structures.

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

We do not have any specific data to respond to this question.

The information presented in the discussion paper seems simplistic and focuses on transaction costs, which will under-represent the true economic costs of the proposals.

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

The logic behind the calculations is not apparent so it is not possible to present an opinion.

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?

The demand for CSEF fundraising is difficult to assess at present. We have been provided with the information from the recent survey undertaken by the Crowdfunding Institute of Australia (CFIA). This information appears to be consistent with our understanding of the interest in crowdfunding in Australia.

As at June 2013 there was $A 557 billion invested in Self Managed Superannuation Funds in Australia. If 0.5% of this is eventually invested in SMEs and start-ups through CSEF, there would be $A 2.5 billion available to the sector. Other non-superannuation investments could easily add another $A1-2 billion. On the assumption of $1M per raise on average, this would be up to 4000 CSEF raises in the early years that the funding mechanism becomes available, although this is likely to depend upon the quality of the opportunities on offer, and early investor experiences. Overseas experience is that most investments through crowdfunding bring in up to 200 new investors. This would imply up to 800,000 investors, although a number of these will make multiple investments. The number of intermediaries is difficult to predict, though as this service depends upon volume for profitability, after an initial flurry of new entrants there is likely to be only a few platforms that consolidate and provide the service on an ongoing basis.

In comparison with the New Zealand model, the CAMAC model, with its dedicated corporate form, is likely to reduce the demand for crowdfunding due to the additional costs involved under this model. Both of these models will increase the level of online investment in comparison with the status quo, as they will make the investment process simpler than the current business introduction model.

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

The NZ licensing regime for crowdfunding was developed as a clone of the licensing regime for Peer to Peer lending, which involves different risks as these lending platforms have an ongoing role managing repayments and credit risk. The New Zealand regime left many aspects to the discretion of the regulator - eg capital requirements for intermediaries. It would be better to set out much of this in more detail in subsidiary legislation.

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

The UK has established several start up investment schemes (the Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS)) that provide investors with an income tax deduction for their investments in approved start up companies. A similar scheme in Australia would increase the funds available for start ups and innovation. Such a scheme could also be used to encourage diversification in a more effective way by limiting the deduction per investment in qualifying companies (eg $2000 per company). Such a scheme would be a more effective government intervention in the innovation and start up capital space than a subsidy provided by the government. This approach would involve validation of the underlying business models by the market rather than officials picking winners through a system of "entrepreneurship grants".

Recommendation 11: Establishing a scheme that permits a portion of investments in start ups to be deducted as income tax expenses would increase the funds available for innovation in Australia. At the same time such a scheme could be used to encourage investor behaviour that diversifies portfolios to minimise the risk of loss of investment and maximise the returns from these investments.

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?

Yes, they do as crowd-sourcing debt (crowd-lending or peer to peer lending) is another source of funding for start ups and SMEs. Addressing both equity and debt at the same time will allow firms to to develop their capital structures in an integrated and transparent way so that the holders of equity and debt finance can see the total financing picture for a particular firm.

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

Investor protection is more important for debt products as the protection of the principal is paramount. Some form of credit assessment and reporting should be mandatory before funds can be raised for lending. Likewise debt crowdfunding platforms need to establish mechanisms to deal with a number of scenarios that do not occur in the equity crowdfunding space, with its focus on the one off fundraise rather than an ongoing credit relationship- eg borrower default, lending platform closure or transfer.

Recommendation 12: A specific industry/sector risk assessment for crowd-lending or Peer to Peer lending needs to be undertaken before preparing any framework for regulating debt products.

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

No. Secondary markets should provide investors with the same information provided to initial investors to ensure that there is no problem with asymmetric information - eg through "pump and dump" activities. Sellers and platforms should have to disclose all information relevant to the shareholding being sold in a manner similar to the obligation on sellers in a real estate transaction.

- END -

About INITIATE Crowdfunding

The INITIATE: Pacific Crowdfunding Summit is the first and only full day event in the Pacific region that examines all aspects of crowdfunding: donation-based, rewards-based, equity-based and loan-based. Our first event was held in Wellington, New Zealand in November 2013. Our second event, and the first such event in Australia, was held in Sydney in September 2014.

Our events to date have highlighted the range and possibilities of crowdfunding. The event organisers fully endorse the sentiment of the *MIT Technology Review* which in 2012 predicted that crowdfunding is: –

"One of the Top 10 emerging technologies with the potential to transform the world."

Coming INITIATE events: Auckland, 27 March 2015
Melbourne, June 2015

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