Submission to

The Corporation and Markets Advisory Committee

(CAMAC)

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1. Overview

Camac has called for submissions (Govt considering Crowd Sourced Equity Funding - CSEF) In Advancing Australia as a Digital Economy: An Update to the National Digital Economy Strategy (June 2013), reference was made to holding an independent review of the regulation of crowd sourced equity funding (CSEF). CAMAC was asked to conduct that review.

Our understanding of the market indicates that the primary considerations must be:-

- Open up scope and market breadth to fund start ups and small business, from the broadest range of community or number of potential funders
- Investor protection concerns, espe-cially the "mum and dad" or retail investors
- Ensure costs of funding and subsequent compliance do not outweigh the benefits or the gains of CSEF. Need to ensure that sufficient compliance is called for to offer protection or comfort to investors, whilst keeping costs to the issuer to a minimum, offering quick and low cost access to funding for small business and start-up companies.
    - Best summed up by Canada's experience:-
        - *if the costs associated with investor protection are excessive, crowdfunding may not be a cost-effective capital raising method. At the same time, the Investor Survey suggests that investors would be concerned about the risks of crowdfunding and might not be prepared to invest through crowdfunding if they do not think there are adequate protections in place.*

2. Methodology

Given the existence of CSEF in various forms around the world for a number of years, there are many practical and working options with varying degrees of proven history. Most of the "heavy lifting" in terms of the framework has been addressed in one form or another, so the components exist for the Australian regulators to choose from to build our framework. We also are privileged to have the experience of the Australian Small Scale Offerings Board (ASSOB) who has more years of experience in CSEF than any other company in the world. With local knowledge relative to the local market, combined with many of the learnings from platforms and frameworks from around the world, we need not re-invent the wheel, but simply make incremental changes to the existing provisions to deliver the desired outcomes of CSEF, namely to provide start-ups and small business (relatively) quick, easy, low cost access funding from a broad based investor pool protected by a simple and transparent regulatory environment.

The introduction of new regulatory framework will have a flow on effect beyond simply that of the rules governing CSEF, which we recognise in this document and make some recommendations as to how such regulations may be slightly modified to accommodate the introduction of CSEF in Australia, whilst not losing the essence or the intended outcome for which they were implemented to regulate and protect.

Our proposed solution prefers the liberalising of the small scale personal offers exemption from the fundraising provisions, combined with making targeted amendments to the existing regulatory structure for CSEF, thus opening up CSEF to all investors. The timelines, dollar values, and figures used are for illustration purposes and are open for discussion and debate.

We therefore respectfully submit the following recommendations and suggestions to CAMAC to consider in each area of the proposed changes to regulation of CSEF in Australia.

3. Fraud

Guarding against fraud is perhaps the key consideration for the introduction of broad scale CSEF in Australia. ASSOB, who has had more experience in this field than any other organisation in the world, has found extraordinarily few cases of fraud in the current environment, namely due to:-

- The intermediary completing due diligence on the Issuer
- The initial cost to list the offering on the intermediary's platform
- The preparation of offer documents
- Minimum of 3 directors (as per pubic company requirements) who vouch for the business and have legal and fiduciary responsibility for the running of the company
- Having to issue audited accounts
- A mandatory 48 hour cooling off periods for investors

Such requirements make it more difficult for fraudsters who tend to opt for easier channels to commit deceit.

It can also be argued that whilst one of the concerns about CSEF is that fund raising being conducted on the internet may allow for broad scale fraud, the crowd may also be potentially more aware of any fraud due to the ability of such news to spread quickly over the internet.

4. Issuers

Our suggestions for the draft legislation are as follows:-

4.1 Scope

- The market experience in Australia through ASSOB indicates most raises are for amounts up to $2mil. It would therefore follow that a cap for CSEF raises of $2mil would accommodate the needs of a majority of the market.

4.2 Issuer Definition

- The purpose of CSEF is to provide a funding mechanism for start-ups and small business.
- The USA has recognised this in excluding investment companies from the CSEF provisions of the US JOBS Act.

- Italy, too, has confined CSEF to designated 'innovative start-ups'.
- We would suggest limiting Issuers to start-ups or small business with a maximum asset or capital value, a ceiling on the number of employees, a maximum of (three) years trading history, and/or a turnover threshold which they must come under to permit them to raise funds through CSEF.

4.3 Structure and Costs

- Need for issuer to be an incorporated entity.
- With regard to the structure of the overall legislation, we would recommend that there be an increase from the current small scale personal offers exemption allowing for a personal equity investment offer to investors, provided that no more than $2 million is raised in any 12 month period from no more than 20 investors, opening it up to 400 investors instead of 20.
    - We figured 400 investors based on allowing issuers to raise $2mil from the broader "crowd" including retail investors who could be capped at $5,000 in CSEF investments in any 12 month period.
- Given the above suggestion to allow up to 400 shareholders, thus exceeding the private company structure, the cost of compliance for a public company shareholding cap would be too onerous on a startup or small business. Therefore perhaps a new class of company or a sub-class under the definition of "Public Company" be considered, and we would suggest the class / sub-class of "**Provisional Public**". Provisional Public companies would be allowed to raise capital through CSEF public offerings and trade as a public company, albeit on a restricted or considered basis. Some of these may include:-
    - Allowed to raise capital with an Offer Information Statement (OIS) and/or Profile Statement rather than a full registered prospectus
        - Such a document could contain the following as currently being implemented in the USA:-
            - *a description of the business and its anticipated business plan*
            - *a description of its financial condition (including financial statements: see below)*
            - *the names of officers and directors and persons with a shareholding of more than 20%*
            - *the stated purpose and intended use of proceeds*
            - *the specified target offering amount and deadline to reach that target*
            - *the price of the securities*
            - *a description of the ownership and capital structure*
            - *Provision of financial statements, certified by an officer of the issuer if the specified target offering amount is $100,000 or less, reviewed by an accountant if that amount is up to $500,000 and audited if that amount is over $500,000*
                - Although for Australia we would suggest changing this to certification by an officer of the issuer if under $500,000 and

reviewed by an accountant if over $500,000, thus removing the need for auditing costs, and

- *such other information as the SEC prescribes by rule*

- The document could also contain additional documentation as required in Canada:-
  - *the type/nature of the securities being offered*
  - *the rights attached to the securities (including the impact on those rights if the issuer's operations and/or assets are located outside Canada)*
  - *A statement as to whether any directors, officers, promoters or related parties of the issuer will receive any of the proceeds*
  - *resale restrictions*
  - *statutory rights in the event of a misrepresentation, including a right of withdrawal*

- An alternative to the suggestion to move to a cap of 400 investors (sophisticated or non-sophisticated / retail investors) may be a cap of 200 retail investors, but allowing this number to be incrementally increased by an additional 25 retail investors for each sophisticated or institutional investor that comes on board – e.g. the cap of 200 retail investors is allowed to extend to 225 if one sophisticated investor invests, with the cap increasing a further 25 for each additional sophisticated investor that comes on board, until a total of 400 investors is reached.

- Allow provisional public classification until turnover meets a predetermined minimum, say $3mil per annum, at which point they must comply as per a full public companies.
  - Alternatively, provisional public companies may need to comply as full public companies after a period to time – say 3 years – to ensure they are focussed on accelerated growth in their initial years.
- Existing legislation regarding making false or misleading statement should obviously still apply.

4.4 Reporting

- As suggested above, Provisional Public companies should provide annual reports certified by an officer of the issuer if under $500,000 and reviewed by an accountant if over $500,000, thus removing the need for auditing costs, and
- The requirement for public disclosure of key financials and activities that may be of interest to shareholders.

4.5 Sophisticated / Informed Issuers

- Issuers need to acknowledged that they are "sophisticated" or "informed" issuers, acknowledging their understanding of what it means to be a public company offering shares to investors who will be registered shareholders with rights under the current and proposed legislation

- Perhaps the intermediary can provide an online questionnaire for the issuer to complete, demonstrating that they have the required knowledge to be informed issuers.

4.6 Foreign Participation

- Foreign issuers – precluded, to keep investment in Australia

4.7 Bad Actor Disqualification

- We would welcome similar legislation as adopted in USA with regard to their "bad actor" disqualification provisions, whereby issuers or other "covered persons" are disqualified from CSEF if they have been subject to a relevant criminal conviction, regulatory or court order or other disqualifying event . Covered persons include:
  - the issuer, including its predecessors and affiliated issuers
  - directors, general partners, and managing members of the issuer
  - executive officers of the issuer, and other officers of the issuers that participate in the offering
  - 20 percent beneficial owners of the issuer, calculated on the basis of total voting power.
- Many disqualifying events include a look-back period (for example, a court injunction that was issued within the last five years or a regulatory order that was issued within the last ten years).

4.8 Permissible Projects

- The Issuer is solely responsible for the content of the Project. The content must not:
  - infringe any intellectual property right, confidence or privacy of any third party
  - breach any applicable law
  - be defamatory of or likely to offend any person
  - be obscene or likely to offend any person
  - contain any link to any other website which contains information that would be in breach of any of the above clauses.

5. Investors

Our suggestions for the draft legislation are as follows:-

5.1 Share definition

- Investors are to be given a legal interest in shares rather than simply a beneficial interest in shares

5.2 Sophisticated Investor - Definition

- We do not believe that under new CSEF regulations that the definition for a Sophisticated Investor needs to be changed
    - Under the current regulation, a Sophisticated investor is defined as one who has AUD2.5 million net assets or a gross income of at least AUD250,000 for last two financial years

5.3 Foreign Ownership

- We believe that the current laws governing International investors need not be changed with the introduction of legislation permitting CSEF
    - Where offers are received from outside Australia these rules do not apply but local rules (from where the offer is made) may be applicable.
- This will then open up further potential funding opportunities for Australian start-ups and small business

5.4 Investor Limitations

- We believe that capping the potential investment of retail or unsophisticated investors will limit their risk exposure
    - In the USA the limits are $2,000 or 5% (whichever is greater) for people earning (or worth) up to $100,000, and $100,000 or 10% (whichever is less) for people earning (or worth) $100,000 or more.
    - We would recommend a similar cap in Australia relative to the average wage, and simplifying the cap methodology. We would suggest capping the investment of individuals at $5,000 per annum which may be spread over a number of CSEF investments.
- Self Managed Superannuation Funds should also be limited or capped to contain their exposure, albeit at a slightly higher rate, perhaps $10,000 per annum
- Laws allowing sophisticated and institutional investors should not be changed in the context of CSEF
    - It should be noted that whilst it is implied that sophisticated investors are knowledgeable regarding investment and that unsophisticated investors are not, many unsophisticated investors are well informed, and their ability to make informed and considered decisions should not be underestimated

5.5 Tax Considerations for Investors

- We believe there is merit in the UK model (ref the *Seed Enterprise Investment Scheme*) whereby the British government has offered tax incentives for investors purchasing equity in CSEF offerings to offset some of the risk associated with such investment. We see merit in both a consideration for the partial tax deductibility of the investment and relaxation of Capital Gains

Tax laws in respect of all CSEF investments or perhaps in those targeted industries into which the government wishes for funds to be channelled.

5.6 Risk Acknowledgement

- We see merit in the Canadian example where one equity crowdfunding portal requires that each potential retail investor answer a questionnaire to demonstrate that the investor understands the key risks associated with investing in a SME, including dilution, illiquidity and risk of loss. If they fail to answer the requisite number of questions correctly, the investor is not permitted to invest unless he or she successfully completes a tutorial. We would like to see such a qualification process made mandatory in Australia.
- Perhaps an industry body such as the Crowd Funding Association of Australia could act as a neutral and impartial educator for investors, providing guidance and awareness via online training and certification to potential investors.

5.7 "Tag Along" Rights

- We applaud Italy's CONSOB which mandates that start-ups using CSEF must insert a clause in their constitution which guarantees investors the right to withdraw from the investment and to sell their shares back to the firm, in case the major shareholder sells its stake to a third party ('tag along' right).
- Such rights also extend to where a minority shareholder can tag onto any offer a majority shareholder receives for their shares.
- We would welcome "Tag Along" rights being made compulsory under CSEF legislation in Australia to further protect retail investors and give them the same rights as larger shareholders.

5.8 Secondary Markets

- CSEF should be limited to new issues, excluding on-selling of existing securities
- Given that the primary consideration in legislating CSEF is the interest and financial well being of the retail investor, their ability to make a capital gain in the short to medium term should not be impeded.
- There should be no restriction on investors on-selling shares given that their success in achieving a capital gain augers well for the reputation of CSEF.
    - The ability to on-sell their equity also allows them to recoup should they require cash (guarding their liquidity) or should they feel that the investment is no longer for them.

6.0 Intermediaries

We believe that the role of the intermediary or platform must be to inform issuers and investors about the process, and not necessarily promote or make recommendations or provide financial advice. As such, their role is one of a business introduction service and therefore they should not be required to

hold an Australian Financial Services License. Defining platforms in this manner will keep licensing and compliance costs at a minimum for intermediaries, with any operating costs of the platform ultimately being borne by the issuer.

As mentioned previously in our submission, ASSOB has the most experience of operating a CSEF platform anywhere in the world and their excellent record of probity has lead us to base many of our suggestions and recommendations on their current operational process.

Our suggestions for the draft legislation are as follows:-

6.1 Licensing

- ASSOB operates under Class Order 02/273 which provides an exemption from the fundraising provisions of the Corporations Act for persons involved in making or calling attention to offers of securities through a business introduction service. We would recommend this be extended to intermediaries under the proposed CSEF legislation.
    - By virtue of the fact that it is the issuer who has intimate knowledge of the industry and the business, as well as being the ones being charged with the management and operation of same, all responsibility should be upon the directors of the issuer and not the intermediary to meet the disclosure and operational requirements.
    - Accreditation may also be acceptable whereby such a registration as suggested above be acknowledged by the Minister on the advice of ASIC, once sufficient evidence is provided by the intermediary that they have sufficient resources (including financial, technological and human resources) as well as Australian ownership.
    - Should the above recommendation regarding the role of the intermediary be followed, it would not constitute a managed investment scheme, therefore compliance costs for the intermediary (and ultimately the issuer) would be removed.
        - With the intermediary simply acting as a business introduction service and not as a managed investment scheme, communication between issuer and investor would be more direct with little chance of interference or misinterpretation from a third party.
- This is further supported by the proposed USA legislation which we feel should be cloned as part of the CSEF legislation in Australia:-
    - *Funding portals* (intermediaries) *cannot*:
        - *offer investment advice or make recommendations to investors. The concept of investment advice could, for instance, include any promotion of a particular offering, such as a funding portal pointing out that the offering is attracting a number of investors*
        - *solicit transactions for securities offered or displayed on its portal, or compensating employees or agents for doing so*
        - *hold or manage any investor funds or securities*

6.2 Pecuniary Interest

- We would strongly recommend the legislation include that the operator or associate cannot have any pecuniary interest in the outcome of an investment decision.

6.3 Guidance

- The government may wish to issue guidance as to the requirements for any offering by way of the information which should be required to potential investors. Such a template could then be adopted by intermediaries to use to present public offerings of issuers.
    - Perhaps guidance for the contents of such a template could be given by the Association of Australian Angel Investors based on the investment criteria required by Angels from issuers.

6.4 Disclosure

- It is imperative that it is incumbent upon intermediaries to explain the risks and speculative nature associated with investing in CSEF, as well as the illiquidity of the shareholding of investees.
- Both investors and issuers must acknowledge their understanding of the risks and liabilities of either party when they sign up to the site, as well as prior to listing or investing in a project.

6.5 Public Solicitation

- In the USA, Public Solicitation Ban has been lifted in light of CSEF, allowing the advertising of small scale personal offers
- Currently, in Australia, intermediaries can advertise an offer, but only to accredited, sophisticated or professional investors, or (at least) qualify any enquiries as being from such a person should the offering be advertised more broadly.
- We would recommend extending the current position in Australia to include the legislation as it exists in Canada:
    - *no advertising by an issuer would be permitted except through the funding portal or the issuer's website. However, the issuer would be able to use social media to direct investors to the funding portal or the issuer's website.*
- We would welcome the ability of the intermediary to display on the home page of its website the project "badges", outlining the name and type of the project (by category), their funding target and timeframe, and the dollars raised to date. Prospective investors could then "click though" after identifying their position (sophisticated or retail), as well as acknowledging their understanding of the risks associated with CSEF investing.

6.5 Reporting

- It would be beneficial to both the probity of the platform, the regulators and the industry as a whole if we followed the USA proposal regarding reporting and centralised data collection:-

- *Intermediaries must collect and transmit CSEF transaction data to the (SEC) for administration and data analysis.*
- This needs to be based on high level reporting for industry statistical data and not for governance or compliance purposes.

6.6 Transparency

- To enable the open flow of communication amongst the general public and so that experience, good and bad, can be shared between investors and prospective project supporters, we should adopt the following recommendation from the USA:-
  - *Intermediaries may be required to provide a public chatroom for investors to communicate with issuers and with each other. These means of communication provide opportunities to share information and views on the merits of particular investments, and may in some cases alert participants to possible fraud.*
    - No moderation of such a chatroom should be allowed other than removal of inappropriate comments or spam (with strict guidelines set down by the legislation) and a manner for storing any information which may have been moderated should it be necessary to revisit at a later time.
- In the interests of probity and transparency, we would suggest that the intermediary be a public company, subject to transparency and a public disclosure regime.

6.7 Minimum Operating Standards

- Given the breadth of experience of ASSOB in the CSEF space, much of the framework around the minimum operational standards already exists. As such, we would suggest the following ASSOB procedures be adopted as the mandated industry standard for CSEF in Australia:-
  - **Prior to investing**
    - Intermediary to make mandatory sign in and sign acknowledgement of risk awareness prior to being able to look at offerings
    - The platform to have issuer rules of admission, which are acknowledged prior to involvement by the issuer
    - Due Diligence undertaken by the intermediary to ensure a company is suitable for admission to the Platform
      - An example template of the format for due diligence checks is best demonstrated at www.crowdcheck.com under their "Compliance Check" product
    - Companies to be mentored by a corporate advisor to assess business model, scalability, path to market, competitive advantage, financials & valuation, board & management team strength, use of funds, development milestones and many other factors critical to success.
      - This perhaps may not form part of the minimum service offering required by a portal, but would definitely add value and protection to those involved in the process.

- Facilitate a session for the investors in which they could meet the founders, directors and management personally and 'walk-the-floor' of the business.
    - Again, this may not be part of the base service offering, but a suggested part of the service offered by intermediaries.
- Intermediary to provide templates of professionally prepared documents for the capital raising and make these available for easy download, as well as guidelines on how these need to be completed.

- **Services during the investment process**
    - Provision of templates and guidelines to proper equity ownership recording.
    - Minimum Subscription clearly detailed and managed.
    - Provision of guidelines around non-statutory trust accounting practices to hold funds until preconditions are satisfied.
        - An example of such a condition would be the “minimum amount to proceed” clause that is contained within each capital raising investment document. Until such time that the Minimum Subscription Amount (MSA) the company needs to fulfil its objectives through the equity capital raising has been received into the trust account, no funds are to be released to the company. If the company's offer fails to reach its target MSA within 4 months, all investor funds will be refunded by the trust account operator without loss or fees to the investors.
    - ASIC lodgment monitoring.
    - Adherence to initial and ongoing compliance requirements (as outlined by the intermediary) in addition to legislative obligations.
    - Cooling off periods prescribed.
    - Outline of reporting requirements for issuer.
    - Provision of guidelines regarding a quarterly directors responsibility statement.
- **Services provided after investing**
    - Company Profile page which tracks the company's performance and communication.
    - Enhanced investor relations through announcements.
    - Company Documents archived for download.

6.8 Share Issue and Transfer

- Should CSEF get the support and following as anticipated in Australia, there will be a need for a quicker, simpler, automated and more cost effective manner of registering the issue and transfer of shares.

6.9 Bad Actors

- We would welcome an extension of the “Bad Actors” disqualification proposed in 4.7 above to include intermediaries, their directors, general partners, executive officers, other officers, and beneficial owners.

6.10 Dispute Resolution

- As an intermediary only facilitates any transaction utilising the proposed model suggested in this submission, it would not be giving advice or taking a position in the transaction. As such, any disputes would only be between the issuer and the investor. The intermediary would act as a conduit to ASIC in reporting any breeches, or providing evidence and expert opinion in the event of any claims.

6.11 Small Scale Trial

- We would suggest a small scale trial for CSEF in Australia, with an initial trial period of (say) 4 to 6 platforms to trial the concept for (say) 2 years to review the operation of the concept before opening it up for all players to be allowed to run a CSEF intermediary platform.

We commend the Commonwealth Government for its forward thinking approach to funding small business and start-ups in Australia, and welcome any request for further discussion or involvement in the move to initiate changes in legislation to make broad based CSEF permissible in Australia.