



Crowd-sourced Equity Funding

Submission by *incubatr* to the Treasury's Discussion Paper concerning *Crowd-sourced Equity Funding*

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About incubatr

Incubatr is an intermediary platform for crowd-sourced equity funding currently in its' establishment phase.

At its' core, *incubatr* believes in the potential that capital and opportunity presents when unrestrained.

As an intermediary, *incubatr* aims to provide sources of funding for new ventures and established businesses. The aim is to drive growth and innovation whilst also democratising investment opportunity by broadening access to retail investors.

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Introduction

Incubatr welcomes the Government's commitment to drive greater innovation and investment via its consultation on the appropriate regulatory framework for Crowd-sourced Equity Funding (CSEF) in Australia.

CSEF is an innovative financing tool which permits otherwise untapped sources of finance to flow through to early stage ventures and to businesses requiring funds for growth. It concurrently provides further access to investment opportunities to retail investors which heretofore, have been limited in this context.

New ventures and small businesses are a significant driver of productivity and economic growth, however obtaining access to funds has proved increasingly difficult; especially in the present economic climate. This difficulty has been exacerbated by the regulatory restrictions prohibiting businesses from raising capital. Whilst *incubatr* acknowledges that the disclosure requirements (and other regulatory restrictions) serve an important consumer protection function, given the revolution in technology and the opportunity this presents for innovation and growth, a CSEF regulatory framework which seizes upon this opportunity whilst maintaining appropriate safeguards for investors is highly desirable.

It is appropriate that any review of the regulatory framework should consider the three core players in the CSEF model; the investors (whether they be retail or sophisticated), the new ventures and businesses seeking capital, and the intermediaries whose platforms make the CSEF model feasible and efficient. A suitable regulatory framework should ensure viability for the intermediary, whilst also providing opportunity for issuers and the necessary safeguards for investors.

Incubatr holds that the New Zealand model strikes a reasonable balance in achieving the above stated goals. Whilst the CAMAC model provides a suitable balance for supporting investment, reducing compliance costs for issuers and maintaining an appropriate level of investor protection, the suggested requirement for an Australian Financial Services License (AFSL), instead of a tailored licensing regime makes its viability for intermediaries questionable.

Maintaining the present regulatory position (that is, the status quo), *incubatr* submits, is not a desirable option. This position is premised on the view that this regulation, when enacted, did not have in its contemplation application to the CSEF context and is therefore not fit for purpose.

The overall view of *incubatr* is that the ideal model to facilitate CSEF in Australia should be a model closely resembling the New Zealand model or the CAMAC proposed model with modifications (to be discussed more fully below).

Opportunities Presented by Crowd-sourced Equity Funding (CSEF)¹

Review of CSEF

It is the position of *incubatr* that the predominant barrier to CSEF's implementation in Australia is the lack of a regulatory structure tailored to the CSEF model and concept. Whilst a form of CSEF may be achieved through the present framework, utilising a Managed Investment Scheme (MIS) and the small scale personal offer exemption (amongst other measures), this framework is severely limited in its applicability to the specific requirements of CSEF.

The MIS and small scale personal offer exemption do not provide a sufficient basis for allowing a large pool of investors to take an equity position in new ventures and businesses seeking growth. Pursuant to the small scale personal offer exemption, disclosure documents are not required where a person makes an offer of securities that results in an issue or transfer of those securities to 20 or fewer persons in a 12 month period.² By its very nature, CSEF requires that small contributions be made by the many and not just the few, and that the wisdom of the crowd be utilised. As stated earlier, this was not contemplated by the current regulatory framework.

In addition to issues with the small scale personal offer exemption, other requirements inherent in the MIS structure make this framework inappropriate for application to the CSEF context. Specifically, the MIS requirement for an AFSL and the utilisation of (only) a public

¹ Headings as per Treasury Discussion Paper with relevant questions addressed therein.

² Section 708(1) of the Corporations Act 2001 (Commonwealth)

company structure are particularly burdensome. The disclosure and compliance requirements are both capital and time intensive, and inappropriate to the average CSEF issuer and intermediaries for that reason. Resultantly, they do not sufficiently facilitate online offers.

The requirement for an AFSL (which is suggested in the CAMAC model), is also burdensome for intermediaries. It is both very expensive to maintain on an ongoing basis, and also posits a high 'entry' threshold that arguably goes above and beyond what is required in the CSEF context. It is in this regard that *incubatr* views New Zealand's licensing regime as striking the correct balance in terms of cost, ease of application for intermediaries and protection of investors.

The status quo position is further complicated by additional barriers to the feasible implementation of CSEF in Australia such as restrictions on advertising equity offers even if pursuant to the small scale personal offer exemption.³ Taken cumulatively, the regulatory burden, disclosure and compliance requirements, the lack of applicability to proprietary limited companies, and the requirement for an AFSL affect the viability of the model. Further, the requirements do not sit comfortably with the policy goal of CSEF to facilitate the movement of capital to new ventures and businesses in order to aid innovation and growth.

Whether it is desirable that there be a broader application of the CSEF concept depends partly upon the definition of small business; of which there is no consistent usage between various government departments.⁴ If the Australian Tax Office's definition of \$2M in turnover⁵ is utilised, then this is clearly inadequate as evidenced by CAMAC's suggested revenue limit of \$5M for the exempt public company. Putting aside definitional issues, it is *incubatr's* view that there is a broader financing role to be played by CSEF. The benefit and strength of CSEF is its potential to allocate capital effectively to businesses in need of capital. This is consistent with CSEF's core policy driver of fostering growth and innovation and it is therefore in *incubatr's* view that limits which are too restrictive should be avoided.

Whilst *incubatr* acknowledges that an extension of the CSEF principle to other areas may require reasonable additional regulatory safeguards, there is no reason (from a policy

³ Section 708(1) of the Corporations Act 2001 (Commonwealth)

⁴ <http://asic.gov.au/for-business/your-business/small-business/small-business-overview/small-business-what-is-small-business/>

⁵ *Ibid.*

perspective) that it should not be a considered extension to any forthcoming existing CSEF model. On the contrary, they seek to accomplish the same policy objectives.

Impact Analysis

Option 1: Regulatory Framework Based on the CAMAC Model

Incubatr holds the view that the exempt public company structure strikes the right balance between supporting investment, reducing compliance costs for issuers and maintaining an appropriate level of investor protection.

Compliance costs associated with the existing public company structure are too onerous for application to small CSEF issuers. Broad disclosure obligations, and the broad compliance imperatives necessitated by that structure are not in line with either the size of the CSEF issuer, nor the resources at their disposal. At a very basic level, issuers are seeking capital, therefore a capital intensive compliance regime is not suitable.

Incubatr is of the view that the exempt public company provides a more suitable and balanced position with:

- no continuous disclosure obligations;
- no requirement for an annual general meeting (AGM);
- no executive remuneration reporting;
- no half-yearly financial reporting;
- no financial report auditing (until more than \$1,000,000 has been raised, and \$500,000 expended).

The CAMAC recommendation for CSEF issuers to be public companies or exempt public companies may place an increased burden of disclosure and compliance on the issuers relative to those required for a small proprietary limited company. This notwithstanding, *incubatr* believes that provided the ability to transfer from a proprietary company to an exempt public company is streamlined, it should not unduly limit the attractiveness of the CSEF model for issuers. It is also *incubatr's* position that the associated investor protection that the exempt public company provides is a necessary ingredient to the CSEF model in Australia.

It is the position of *incubatr* that the exempt public company structure provides benefits to the overall CSEF model which outweigh the risks of regulatory arbitrage. The proposed eligibility requirements for an exempt public company, in particular the requirements relating to caps and thresholds, aid in this respect. Additionally, the timeframe suggested for the expiry of an exempt public company structure further militate against this risk.

Incubatr's preliminary view is that the proposed fundraising cap of \$2M in a 12 month period is appropriate for the CSEF regime as a starting point. As a reference point, the Australian Small Scale Offerings Board (ASSOB) has indicated that the average amount of capital it has raised for 176 organisations is \$522,915.00⁶. This looks to confirm that the limit is in the appropriate range. It should however be borne in mind that ASSOB's largest raising was for \$3.5M⁷. This suggests that there may be circumstances where a capital raising of over \$2M is appropriate outside of the ordinary Chapter 6D requirements in the Corporations Act 2001 (Commonwealth). Therefore, provision for this should be considered in the CSEF regime. A possible option would be something akin to New Zealand's model which holds that any capital raising above \$2M is not exempt from disclosure relief. *Incubatr* suggests that an analogous option would be to remove a number of the exemptions that apply solely to exempt public companies.

Incubatr holds the view that CAMAC's recommendations in relation to intermediary remuneration and investing in issuers may constitute a barrier to entry. Specifically, the requirements that intermediaries are not permitted to institute a fee structure by reference to a proportion of capital raised, and that they are not able to take an interest in an issuer or be paid in shares, is overly restrictive. This may not be a feasible option for early-stage start-ups that may have limited funds and poor cash flow in their establishment phase. Resultantly, these limits may make capital raising unachievable for some. This in turn limits the attractiveness of CSEF to intermediaries and brings into question the overall viability of the CSEF model. It is important that the remuneration for services rendered maintain a level of flexibility in order to aid the viability of the CSEF regime.

It is *incubatr's* view that New Zealand's model, which places no limits on fee structures or investment in the issuer is the most flexible and viable option. It balances this flexibility with the requirement that any arrangement (whether by way of equity stake or fee arrangement) should be clearly disclosed to all investors prior to their investment. As a corollary to this, it is *incubatr's* view that the intermediary should not be prohibited from making additional

⁶ <http://www.alchemyequities.com.au/content/equities/ASSOB>

⁷ *Ibid.*

equity investments beyond any initial equity provided as remuneration for the intermediary's services.

Incubatr's view is that the proposed retail investor caps of \$2,500 per issuer per 12-month period, and \$10,000 in total for the 12-month period are appropriate for the majority of investors when considered in terms of balancing investor protection and limiting investor choice. However, *incubatr* further holds that a hybrid model incorporating aspects of the New Zealand and US models may be appropriate. Specifically, the US model permits larger investment pursuant to means testing. This may be an option worthy of consideration in the Australian context where investors in a higher income bracket seek to make investments above and beyond the base caps. Similarly, New Zealand's requirement of increased disclosure may be applicable in the Australian context where both the issuer and investor seek to exceed the caps. This approach would ensure the balance between investor protection and investor optionality in CSEF in Australia. As a side note, *incubatr* do not view the voluntary investor cap as a desirable development in the Australian context for reasons of investor protection.

Option 2: Regulatory Framework based on the New Zealand Model

Incubatr considers that it would not be detrimental for the Australian and New Zealand models to be aligned through the implementation of similar CSEF frameworks. However, it is *incubatr's* view that care should be taken in having it form a part of the Trans-Tasman Mutual Recognition Framework. That is, whilst *incubatr* has no objection in principle to mutual recognition, if there are regulatory differences which incentivise regulatory arbitrage (by setting up in one jurisdiction instead of the other), then the value of mutual recognition should be called into question. To maintain the prudential nature of Australian regulatory protections for investors, *incubatr* holds the view that any mutual recognition be premised upon consistent frameworks.

Option 3: Status Quo

Existing regulatory obstacles and burdens are causing an increasing number of innovative, industry-disrupting start-ups to leave Australia and establish themselves in other jurisdictions with a more favourable climate for their growth and capital requirements.⁸ It is for this reason that a tailored and flexible CSEF regime be implemented.

⁸ <http://www.startupsmart.com.au/growth/the-australian-tech-start-up-brain-drain-why-are-our-founders-heading-overseas/2014021811714.html>

Future Directions

Incubatr are of the view that the crowd funding regime should be extended to debt products. There are a number of bases for this proposition. Firstly, there is no philosophical difference between the exchange of debt or equity for the provision of capital. In both cases they constitute the means of payment for the capital rendered by the investor. Therefore, to restrict access to capital for a business merely because it seeks that capital in the form of a loan (rather than by equity offering) runs the risk that small businesses requiring capital go without. A corollary to this is that businesses which could otherwise contribute to growth and innovation in the Australian economy are hamstrung.

Debt products have utility which are distinct from equity, and to have the flexibility of choice between the two provides optionality for investors and businesses. It is acknowledged that all loans should be appropriately priced (in terms of risk), so that they may be properly matched with the risk appetite of investors. Players in this space have shown that default rates can be competitive with the banks.⁹ Therefore, properly constituted, it should not put the capital of investors at a greater risk than if an equity stake were offered in its stead. Again, if it is thought that risk controls should be introduced to further mitigate the risks, *incubatr* would not be opposed to such measures.

Incubatr also holds that it is preferable that a secondary market is contemplated in the CSEF framework in Australia. The secondary market acts as an option for investors to exit from their investment, and necessarily means that there is liquidity in the market that would otherwise be illiquid. This is mutually beneficial for the investor and the issuers.

Conclusion

Incubatr holds the view that the CAMAC proposal provides a suitable balance for supporting investment, reducing compliance costs for issuers and maintaining an appropriate level of investor protection. The New Zealand model strikes a better balance in facilitating CSEF with regard to intermediary licensing requirements. It is *incubatr's* view that the status quo is too restrictive and will not result in sufficient capital being available to

⁹ <http://thenewdaily.com.au/money/2014/12/02/peer-to-peer-invest/>

properly serve the funding needs of small businesses and start-ups. As such, it would fail to support the innovation and growth that a strong CSEF regime could bring to Australia.

A handwritten signature in black ink, appearing to read 'Alexander Stankovski', with a long horizontal stroke extending to the right.

Alexander Stankovski
Chief Executive Officer
Incubatr

APPENDIX:

Incubatr Recommendation¹⁰

Issue	CAMAC model	New Zealand model	<i>incubatr</i> recommendation
Issuers			
Eligible issuers	Australian-incorporated issuers that must be either a public company or an exempt public company. Limited to certain small enterprises that have not raised funds under the existing public offer arrangements.	New Zealand-incorporated companies.	Australian-incorporated issuers that must be either a public company or an exempt public company as long as there is provision for a streamlined process for established Australian-incorporated issuers to transition to an exempt-public company.
Relief from public company compliance costs	Available to exempt public companies, with relief from a range of compliance requirements, including annual general meetings, and audit requirements (up to a certain threshold). Exempt status available for a period of up to three to five years, subject to turnover and capital thresholds.	No CSEF-specific exemptions.	Available to exempt public companies, with relief from a range of compliance requirements, including annual general meetings, and audit requirements (up to a certain threshold). Exempt status available for a period of up to three to five years, subject to turnover and capital thresholds.
Maximum funds an issuer may raise	Cap of \$2 million in any 12-month period, excluding funds raised under existing prospectus exemptions for wholesale investors.	Cap of \$2 million in any 12-month period, excluding funds raised under existing prospectus exemptions for wholesale investors.	Cap of \$2 million in any 12-month period, excluding funds raised under existing prospectus exemptions for wholesale investors; with a relief from a range of compliance requirements as per the recommendations under 'Relief from public company compliance costs'. Non-exemption from disclosure relief for capital raisings above \$2M.
Permitted securities	One class of fully paid ordinary shares.	One class of fully paid ordinary shares.	One class of fully paid ordinary shares.
Disclosure requirements	Reduced disclosure requirements, including a template disclosure document.	Minimum disclosure requirements, with issuers and intermediaries to have in place arrangements to provide greater disclosure where there are no or high voluntary investor caps or the issuer is seeking to raise significant funds.	Reduced disclosure requirements, including a template disclosure document. With capital raising over \$2M not exempt from disclosure relief.
Intermediaries			
Licensing	Hold an AFSL and comply with licensing requirements, including membership of an external dispute resolution scheme.	Be licensed and comply with licensing requirements, including membership of an external dispute resolution scheme.	Be licensed with CSEF-specific licence and comply with licensing requirements, including membership of an external dispute resolution scheme.
Due diligence	Undertake limited due diligence checks on the issuer.	Undertake limited due diligence checks on the issuer.	Undertake limited due diligence checks on the issuer.

¹⁰ Table 1: Key elements of the CAMAC and New Zealand models, Crowd-sourced Equity Funding, Discussion Paper, December 2014. Table per discussion paper with modification to include *incubatr* recommendations.

Risk warnings	Provide generic risk warnings to investors.	Provide disclosure statements and generic risk warnings to investors.	Provide generic risk warnings to investors.
Fee structures	Prohibited from being remunerated according to the amount of funds raised by the issuer, or in the securities or other interest of the issuer.	No restrictions on fee structures, although fees paid by an issuer must be disclosed.	No restrictions on fee structures, although fees paid by an issuer must be disclosed.
Interests in issuers	Prohibited from having a financial interest in an issuer using its website.	Permitted to invest in issuers using their platform, although details of any investments must be disclosed.	Permitted to invest in issuers using their platform, however the intermediary must place strict controls to prevent the suggestion or promotion of one issuer over another in the case where an intermediary has invested in the issuer beyond the equity provided as remuneration.
Provision of investment advice to investors	Prohibited.	Not specified in legislation.	Prohibited.
Lending to CSEF investors	Prohibited.	Not specified in legislation.	No comment.
Investors			
Investment caps	\$2,500 per issuer per 12-month period and \$10,000 in total CSEF investment per 12-month period.	Voluntary investor caps, with the level of disclosure dependent upon the level of any voluntary caps and the amount of funds the issuer is seeking to raise.	\$2,500 per issuer per 12-month period and \$10,000 in total CSEF investment per 12-month period with hybrid model incorporating US and/or New Zealand features.
Risk acknowledgement	Signature of risk acknowledgement statements prior to investment.	Signature of risk acknowledgement statements prior to investment.	Signature of risk acknowledgement statements prior to investment.