Australian Private Equity &
Venture Capital Association Limited

31 August 2015

General Manager
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: smallptycompanies@treasury.gov.au

Dear Sir/Madam,

Submission on Facilitating Crowd-sourced Equity Funding and Reducing Compliance Costs for Small Businesses Discussion Paper

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to make a submission to the Government's consultation paper on "*Facilitating crowd-sourced equity funding and reducing compliance costs for small businesses*" (the Consultation Paper).

AVCAL is the national association representing the private equity and venture capital industries in Australia. Our members comprise most of the active private equity and venture capital firms in Australia. These firms provide capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies.

We are supportive of the Government's plans to introduce a regulatory framework to facilitate the use of crowd-sourced equity funding (CSEF) in Australia, as part of broader efforts to help improve access to capital for startups and high-growth companies.

Other developed economies are already moving ahead in the implementation of policy frameworks for the use of CSEF, as part of a suite of comprehensive initiatives to support high-growth potential businesses. Within this context, we believe it is particularly important that the Government take steps to ensure that the right policy settings are in place to improve access to early stage capital for our best entrepreneurs, who increasingly find themselves competing for capital and talent in a highly competitive global marketplace.

In this submission, we have set out our views on the most important design features of a new CSEF policy framework. Fundamentally, we believe that the rules should be simple and cost-efficient, and principally targeted at successfully aligning the interests of startups and CSEF investors.

If you would like to discuss any aspect of this submission further, please do not hesitate to contact me or Dr Kar Mei Tang on 02 8243 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive
AVCAL

AVCAL SUBMISSION

AVCAL's overarching position that the CSEF framework must be economically feasible for both issuers and investors, and offer a credible alternative to other sources of funding. In particular, close consideration should be given to common features of CSEF policies in other jurisdictions such as New Zealand, Canada and the US which have been important success factors, and which can be suitably adapted into the Australian legal and regulatory framework. Some of the key common features in this regard include appropriate exemptions from prospectus provisions, and the fact that offers can be made to anyone "in the crowd" (as outlined in the CAMAC 2014 report "*Crowd sourced equity funding*").

AVCAL's recommendations on the design of the CSEF policy framework are guided by the position outlined above, and our responses to the issues posed in the Consultation Paper are accordingly set out below.

1. Exempt proprietary companies raising capital through CSEF from the shareholder limit

Questions

1. Should the law be amended to increase the permitted number of non-employee shareholders in a proprietary company and what would be an appropriate limit? Or do companies with more than 50 non-employee shareholders have a sufficiently diverse ownership base with limited access to information or ability to influence the affairs of the company to justify the greater governance requirements currently placed on them?

2. What are the benefits and risks? For example, would raising the limit expose risks to shareholder protection?

4. If the shareholder limit were increased, how should the law treat public companies which become eligible to be registered as proprietary companies but have issued shares under a disclosure document?

9. Should proprietary companies be able to access CSEF? What are the implications for the corporate law framework of permitting proprietary companies to do so?

10. If the shareholder limit is not changed for all proprietary companies, should proprietary companies be able to access CSEF?

If so, should the shareholder limit be changed specifically for proprietary companies using CSEF? What are the benefits and risks of this approach? Would the benefits outweigh the additional complexity of increasing the shareholder limit for a subset of proprietary companies?

If the shareholder limit were to be increased only for proprietary companies using CSEF, is 100 non employee shareholders an appropriate cap?

11. Should any increase in the shareholder limit solely for proprietary companies using CSEF be temporary, based on time and size limits? What are the benefits and risks of this approach?

If the increased shareholder limit is temporary, what arrangements should apply when a company is no longer eligible for the higher shareholder limit (owing either to the expiry of the time limit or exceeding the caps on company size)? Should it be required to convert to a public company? Or should it have the option to conform with the general proprietary company obligations, including the non employee shareholder limit?

12. If permitted to access CSEF, should proprietary companies using CSEF be subject to additional transparency obligations when raising funds via CSEF?

Do you agree with the proposals for annual reporting and audit? Should these be implemented by requiring proprietary companies that have used CSEF to comply with the obligations of large proprietary companies? Should any other obligations apply?

Given the Government has committed to introducing a CSEF framework for public companies that will include certain reporting exemptions, what are the benefits of permitting proprietary companies to use CSEF when they would be subject to additional transparency obligations?

Do you agree that these obligations should be permanent?

Currently proprietary companies are not able to engage in CSEF to any significant degree, given that they are restricted by the Corporations Act from having more than 50 non-employee shareholders and prohibited from making public equity offers (with some exceptions). For a successful CSEF regime to operate, the current shareholder cap would need to be either raised or removed, as the requirement for proprietary companies to convert to public companies once this limit is breached would be prohibitively costly for most startups and small companies.

The global CSEF evidence to date suggests that the current limit of 50 shareholders would be an immediate roadblock to a successful crowdfunding regime. For example, on the UK's second largest CSEF platform, Seedrs, the average investment amount is £1,089, and average number of investors per funded deal is 165.[1] In New Zealand, the average number of investors per successful CSEF campaign was 152 in the first year after CSEF legislation was passed in that country. The highest crowd responses were for Invivo and Punakaiki Fund with 439 and 392 investors respectively (which were also the two largest campaigns in terms of capital raised).[2] Given the average commitment per investor was NZ$4,300, and assuming a similar experience in Australia, the imposition of a 50 non-employee shareholder limit would significantly reduce the ability of startups to raise meaningful capital via CSEF.

In AVCAL's view, limiting the number of non-employee shareholders to 50 in order to remain exempt from prospectus provisions would be contrary to the CSEF policy objective of improving the funding options for small businesses, particularly those in the crucial early growth stages.

The current shareholder cap (and potentially even a higher cap of 100) would introduce a regulatory limitation on onshore CSEF that is not present in many competing jurisdictions. It would have the impact of restricting the amount that can be raised via CSEF from non-accredited investors. In particular, if average commitment sizes for a particular offering are small, the issuer's capital needs will remain unfulfilled even if strong latent retail investor demand exists.

Such a framework would create no significant improvement from the current exemptions available for small scale offerings and sophisticated investors.

In AVCAL's view, investor protection would be more appropriately achieved by limiting the amount of capital raised per non-accredited investor, rather than by limiting the number of investors that a proprietary business may crowdfund from. However, accredited (sophisticated high net worth) investors investing via a CSEF platform should be exempt from such individual investment caps so that there is competitive neutrality for them to invest either directly or via a CSEF platform.

[1] Source: Seedrs website.

[2] Source: Crowdready.com.au, "New Zealand Equity Crowdfunding 1st Year in Review", 18 August 2015.

Issuers may wish to impose their own limits on the number of shareholders in order to control the administration costs and other implications associated with a large shareholder base, but this should be at the discretion of the issuer or platform rather than through regulatory prescription.

AVCAL recommends that:

- A general exemption from public company compliance requirements should be available for eligible issuers that exceed the 50 non-employee shareholder cap as a result of raising capital through CSEF, and such issuers should not need to change their proprietary company status; OR
- Issuers that exceed the 50 non-employee shareholder cap as a result of a CSEF raising will convert to a public company status, but be exempt from public company compliance requirements in respect of disclosing entity rules.

To ensure that these exemptions are aligned with the business's size and growth stage, they could be set to be available for up to five years after a proprietary company's CSEF raising for companies with annual turnover and gross assets of less than $5m (consistent with the exemption arrangements for public companies using CSEF).

AVCAL supports the availability of CSEF to both public and proprietary companies. Regardless of the company's status, however, the policy framework should ensure that issuer boards and management are fully informed of their rights and obligations under the CSEF framework. As part of the information dissemination and issuer education process, it is vital for issuers to be properly advised and made aware of their obligations in relation to their CSEF investor base. These include:

- **Shareholder agreements:** Understanding the kind of capital structure and company type the business needs in line with its own objectives for attracting future capital. This includes determining whether it needs a shareholders agreement to deal with issues such as directorships, voting rights, and secondary trading of shares. For example, it may not be easy for an equity crowdfunded company to get future funding from angels, VC or PE funds or corporate investors if the original shareholders' agreement does not facilitate certain controlling rights being passed on to the new financial sponsor(s), 'drag-along' rights, or if there is already a very large and diverse shareholder base which may make it difficult for the new financial sponsor(s) to exercise its investment strategy. Therefore, it is important for issuers to take the appropriate steps to ensure their shareholder structures are set up to mitigate the risks of being deemed "uninvestable" by potential future investors, and to ensure that they are appropriately set up to manage their CSEF investor base.

- **Shareholder registers.** If there are a large number of shareholders, the startup will need to figure out how it will manage its share register and keep track of its shareholders over time.

- **Investor relations**. Are both issuers and investors clear on the reporting expectations under the reduced disclosure requirements? Even if investors have limited information rights, issuers should be prepared to receive inquiries from CSEF investors and devise a process around handling such inquiries.

- **Staff training**. Relevant startup employees may also need to receive the appropriate training on compliance with securities regulations, e.g. on insider trading and market manipulation.

Prioritising both investor protection and well-informed issuers, particularly in the early stages of policy implementation, is vital to ensuring the integrity and success of the CSEF framework. In this regard, AVCAL supports the Consultation Paper's stated intention to seek to simplify the compliance costs for businesses undertaking CSEF, including those in relation to:

- the requirement to make an annual solvency resolution;
- the requirement to maintain a share register;
- the execution of documents; and
- completion and lodgement of forms with the regulator.

2. Small scale offerings

Questions

5. Should the law be amended to increase the 20 investor limit and/or the $2 million cap? What would be an appropriate limit? Should the $2 million cap be linked to increase in line with the consumer price index (CPI)?

6. What are the benefits and risks of increasing the 20 investor limit and/or the $2 million cap? Who would benefit or bear the risk? Could there be unintended consequences from altering these limits, for example in terms of the definition of a sophisticated investor?

Feedback from existing CSEF participants clearly indicates that the existing mechanism of the small scale personal offer exemption does not sufficiently facilitate online offers of equity in small companies.

On the Australian Small Scale Offerings Board (ASSOB), on average a personal "crowd" of around 660 people view each offering, and around 20 invest.[3] This suggests that the current cap of 20 investors is already being tested by extant investor appetite for small scale offerings.

In light of the need to remove unnecessary roadblocks to small businesses' access to capital, AVCAL supports the policy option of reviewing the 20 investor limit and the $2m capital raising cap for small scale offerings, with a view to raising both thresholds. The higher thresholds should take into consideration:

- current evidence in relation to the investor appetite and amounts invested in small scale offerings both locally and globally; and
- ensuring competitive neutrality with the impending CSEF regime.

3. Annual fundraising cap and turnover/gross assets eligibility caps

Questions

13. Do you consider that an annual fundraising cap of $5 million, and eligibility caps of $5 million in annual turnover and gross assets, are appropriate for proprietary companies using CSEF? If not, what do you consider would be appropriate fundraising caps and eligibility criteria?

A $5m p.a. fundraising cap for issuers appears to be a reasonable starting point which should not unduly inhibit the immediate prospects for the overall CSEF framework. This threshold is not expected to be tested often in the near term, given that there have only been a handful of CSEF campaigns globally to date that have raised more than this amount. Nevertheless, this cap should be reviewed from time to time to ensure its continued relevance in line with market needs.

While the proposed $5m annual turnover and gross assets eligibility caps can also be viewed as starting points given the objective of providing consistency with the public company exemption thresholds for CSEF, these should also be reviewed in light of the evidence base, as it grows over time, in relation to investor needs and the profile of companies seeking capital through CSEF.

[3] Source: BRW, "Why equity crowdfunding for startups is right for Australia: Paul Niederer of ASSOB", 6 November 2014.