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Initial Submission regarding facilitating crowd sourced equity funding and reducing compliance costs for small businesses

On-Market BookBuilds welcomes the opportunity to provide a submission to the Financial System and Services Division into whether to extend the crowd sourced equity funding (CSEF) framework to proprietary companies, and ways to reduce compliance costs and make capital raising more flexible for small proprietary companies.

1. About Us

On-Market BookBuilds is an independent limited liability company that has licensed its intellectual property to the Australian Securities Exchange (ASX), and has been authorised by ASX to educate market participants about the ASX Bookbuild Facility. This submission has been prepared by On-Market BookBuilds independently of ASX. It should not be construed to represent ASX's views and is independent of any submission they may make on the issue of CSEF.

OMB has ~40 patents sealed or pending for its fair, transparent and efficient method of capital raising. These jurisdictions cover most of the world's significant equity capital markets.

Since launching, approximately $125m of equity raisings have used the ASX BookBuild facility. Companies that have used the facility to successfully raise capital, and their investors have been rewarded with an average return of approximately 75% over the period.

In May 2015, senior executives from OMB appeared before the NSW Select Committee on the Leasing of Electricity Infrastructure Leasing of Electricity Infrastructure. The Final Report of the Select Committee recommended:
"In regard to any sale being offered through an initial public offering, the committee acknowledges the evidence of On-Market BookBuilds, and encourages the Government to further investigate utilizing this method of sale."

Following the IPO of Royal Mail in the UK, the Lord Myners Inquiry (entitled 'IPOs and Bookbuilding in Future HM Government Primary Share Disposals' and released 16th December 2014) considered appropriate alternatives for future sales of

Government assets and capital raising methods generally. The report "strongly encouraged" OMB's technology for future UK Government privatisations.

UK Trade & Investment selected OMB amongst 10 successful Australian fintech companies to take part in a delegation to London this September, to coincide with London Fintech Week.

On-Market BookBuilds made three extensive submissions to the Financial Services Inquiry. While the FSI's Interim Report acknowledged the problems with the methods employed to raise capital in the Australian equity markets, the FSI's Final Report failed to make mention of the concerns that market participants had raised about capital raising methods employed by Australian equity markets.

Despite the BCA, AMEC, ASA, Governance Institute of Australia, ACSI, and AICD having made publicly supportive statements about the ASX BookBuild facility and submissions being made by the Australian Shareholders Association and fund managers that identified the problems and proposed solutions, no reasons were given by the FSI why they failed to address any of the issues and the solutions in their Final Report.

We note that an inquiry commissioned by the UK Government endorsed an Australian innovation, while a contemporaneous Australian inquiry did not.

2. Lack of investor protection for dilution

OMB welcomes CSEF mechanisms which enable companies to raise capital more efficiently. However, these mechanisms should not allow insiders to dilute existing shareholders unilaterally. Without protections in place to prevent incoming shareholders from being unfairly diluted, it is reasonable to anticipate that investors will become disillusioned as their ownership rights become diluted.

Currently, the ASX listing rules allow companies to make selective placements to investors selected by the Company (or more commonly its lead manager) of 15% of new equity per year (and in the case of companies less than $300m market capitalization, 25%). The traditional process is 'invitation-only', allocations are discretionary, the process of pricing and allocation is non-transparent, and there is no requirement for companies to disclose who the shares are issued to, or why on a pre-or post-transaction basis. There is no obligation to disclose what financial arrangements exist between the lead manager and the investors who were selected to receive discounted shares.

Unsurprisingly, much has been written about the conflicts of interest that occur where allocations are discretionary. Where allocations are discretionary, it is common practice that favourable allocations are made to parties that pay intermediaries commissions for other services such as brokerage. The amount, frequency and materiality of these commissions is not disclosed to the company or other investors.

Without putting in place protections against dilution, the proposed CSEF regime will facilitate the capacity for insiders to raise money from a more widespread group of investors, while allowing the benefits to accrue to company insiders and/or clients of the person that influences or controls discretionary allocations. A simple example in the following table shows how quickly existing shareholders will become diluted without protection:

Permitted % of discretionary dilution	**15%**	**25%**	**50%**	**100%**
Original Shares on Issue	100	100	100	100
After Yr 1 dilution	115	125	150	200
After Yr 2 dilution	132	156	225	400
After Yr 3 dilution	152	195	338	800
After Yr 4 dilution	175	244	506	1600
After Yr 5 dilution	201	305	759	3200
Effect of Dilution on holding	**% held by original (CSEF) shareholders**			
Investor's % holding	100%	100%	100%	100%
After Yr 1 dilution	87%	80%	67%	50%
After Yr 2 dilution	76%	64%	44%	25%
After Yr 3 dilution	66%	51%	30%	13%
After Yr 4 dilution	57%	41%	20%	6%
After Yr 5 dilution	50%	33%	13%	3%

We have not seen any proposed protections that would prevent incoming investors from being diluted without their consent and against their will.

A typical constitution of a Pty Ltd company allows directors to issue shares as they see fit. For example, a typical constitution will have words to the effect: *"The consideration payable for the issue of a share, option or other security will be the consideration determined by the directors at the time of issue of the share, option or other security and such other consideration as the holder of that share, option or other security and the company from time to time agree."*

It seems that a private company that raises capital from investors, then uses that capital to increase its equity value, can then dilute the incoming shareholders via the issue of new equity to insiders. Without any protections, existing shareholders have no practical or legal recourse. This is exacerbated in private companies where there is no market for them to even sell their (now-diluted) investment.

Used well, CSEF could reduce the capacity for investors to have their property rights steadily diluted away. However, without regulation, proposals that are designed to enhance CSEF – such as reduced fundraising disclosure requirements, reducing the audit requirements, and increasing the numbers shareholders permitted in companies that do not have to report to shareholders, are likely to be misused to benefit insiders by increasing the capacity for companies to dilute non-insider investors.

Fundamental Principles of Market Integrity – Requirements that CSEF platforms be licensed

The World Federation of Exchanges (comprising 62 publicly regulated stock, futures and options exchanges) has a core mission of ensuring that markets are fair, transparent and efficient. These measures of market integrity are fundamental principles of all modern financial markets. Likewise, this applies to Australia's regulated markets in secondary trading.

In contrast to the success of secondary trading markets, the failure to apply market integrity principles to the primary market has resulted in widely reported investor disillusionment. A survey conducted by the London Stock Exchange in 2011 found that "*95% of investors do not trust banks when they are pricing and allocating IPOs, or want more transparency from them." [Leadership In a Changing Global Economy: The Future of London's IPO Market - 8 December 2011]*

We respectfully submit that without any regulatory framework to ensure that CSEF platforms operate a fair, transparent and efficient market, that investors will have no confidence in the market structure.

We have not seen any protections that would prevent a company (and its advisers) from using its discretion to 'redline' some investors, and give favourable allocations to other investors. The current regime would not require disclosure of arrangements that could be used to systemically benefit some investors over others in allocations, without disclosure.

Without a requirement that the operators of CSEF platforms be required to operate according to generally understood principles of market integrity, there are no protections for investors. Furthermore, recent financial collapses – such as BBY, Sonray, Banksia, and MF Global show the importance of strong prudential and regulatory protections. No doubt the failure of a CSEF platform that impacts investor's accounts will have a negative impact on the industry.

We strongly recommend that the Government adopts a regulatory regime to ensure that CSEF platforms are appropriately regulated.

Unintended Effect of Current "Investor Protections"

The current regulations prevent ASX listed companies that are meeting their continuous disclosure requirements from issuing shares to 'retail investors' unless the issue is accompanied by a disclosure document.

The unintended effect is that retail investors can buy newly issued listed securities on-market 'yesterday' at full price, 'tomorrow' at full price, but cannot buy these same securities at a discount 'today'. This does not have the effect of protecting retail investors. It means retail investors have to pay a higher price than institutions and selected sophisticated investors when the securities resume trading after a capital raising. The result is investor disillusionment and an unfair market.

The Financial Markets Conduct Act 2013 (FMC Act) is replacing most of New Zealand's existing financial markets securities laws and is progressively coming into effect from 1 April 2014. The FMC Act introduces new exemptions allowing certain offers to be made without complying with the disclosure requirements set out in the Securities Act 1978. Among other initiatives, 'offers of financial products of the same class as quoted financial products' can be offered to the public without preparing a prospectus or an investment statement.

This permits retail investors to purchase new securities without a disclosure document, so long as the securities are the same as those currently quoted and traded on a licensed exchange. This is on the premise that continuously disclosing entities must provide all material information to the market. In this context, New Zealand regulatory authorities have concluded that retail investors (who may or may not hold those securities) should be not precluded from participating in these capital raising.

By providing access to all investors, both retail and institutional investors, and including all current shareholders, the dilution effect of the capital raising is significantly reduced for all non-participating shareholders and the cost of raising new capital is reduced.

We applaud New Zealand's move and recommend that the Australian Government follows this lead.

We suggest that, combined with a requirement to undertake capital raisings fairly, transparently and efficiently, this will greatly increase investor participation.

Summary of Recommendations

On-Market BookBuilds respectively makes the following submissions:

Recommendation 1:
Regulations be implemented that require primary equity raisings of companies to be conducted on a market that satisfies market integrity tests of fairness, transparency and efficiency, unless shareholder approval is obtained.

Such regulations will facilitate greater participation in equity raisings by changing market practice to allow the broadest *legally eligible* pool of investors to participate.

Recommendation 2:
Regulations be implemented to ensure that all shareholders are protected from dilutive share issues where they are prepared to pay the price offered to incoming investors. This protection could be supplemented with tag-along and drag along rights to protect minority shareholders, and ensure majority shareholders are not 'greenmailed'.

Recommendation 3:
Where a company undertakes a selective placement, regulations be implemented to require complete market disclosure of: any payments or agreements between a lead manager and selected allottees; reasons why eligible bidders are excluded and reasons why other bidders are invited to bid; and any fees payable by the company to the lead managers.

Such regulations will ensure the market is fairly informed of relevant information when selective placements occur.

Recommendation 3:
Exclusions from requirements to issue a prospectus with an issue of securities be expanded to include any offering of *continuously disclosing securities* that is made *on a regulated securities market.*

Such regulations will address current market unfairness while preserving protections for retail investors, and facilitate greater participation in equity raisings by increasing the size of the pool of legally eligible investors.

We also note this recommendation to the FSI was also made by the Australian Shareholders Association and leading fund managers.

Recommendation 4:
Specific Licensing arrangements for CSEF platforms should be implemented to ensure that the platforms are fair, transparent and efficient, that investors are protected in allocation policy, and that the CSEF platforms meet minimum requirements to promote investor confidence.

If you have any questions in regards to this letter, please feel free to contact us.

Yours sincerely,

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