22 January 2016

Corporations Amendment (Crowd-Sourced Funding) Regulation 2015

Submissions on the exposure draft

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1 Government Objectives

1.1 The objectives of the Commonwealth Government include:

- recognising that innovation and disruption are critical to productivity and seeking to provide a more complete productivity and innovation circle by providing for equity crowdfunding (i.e. meeting one of the deficiencies identified by the latest OECD ratings);
- enabling the Government to capture more information on raising seed capital in the private sector;
- creating an equity crowdfunding start point for further change in legislation based on experience obtained from this legislation's operation; and
- to be seen to be taking some action in innovation and disruption by having some conservative legislation in place for the equity crowdfunding industry.

1.2 The exposure draft regulation is detailed and shows significant care by Treasury however:

- it is not at all clear that this legislation will make a substantial improvement in the ability of start-ups to raise seed capital or that as a result of this legislation the so-called "consumer" investor to be able to sensibly contribute to this up start-up space;
- exposure draft concentrates on the "ECF offer document" when in fact attention should have been also focused on the nature of the Australian Financial Services License AFSL to be obtained by the financial intermediary or cloud platform promoter of start-up companies.

1.3 The legislation presupposes:

- there will be a substantial increase in seed funding of start-up companies using the proposed legislation; and
- while the legislation provides risks for the consumer, that some consumers will be advantaged by being able to participate in investments previously mainly available to wealthy or "sophisticated" investors.

However, it appears from empirical evidence both in Australia and in New Zealand, that start-up companies can either more easily find the necessary capital by other methods if the start-up has any potential, and that there are insufficient quality start-ups wishing to use this methodology for raising finance to make a platform viable. This is when one considers the amount of capital necessary to obtain the AFSL, prepare and have running appropriate software and sufficient staff to attend to the research required by the draft Regulation.

Such platforms as emerge may assist Australia by providing a later stage investment platforms and competition for local and overseas start-ups which may otherwise have used overseas jurisdictions. It may also enable sensible use of a percentage of superannuation holdings, given the spread of investment which is possible by large funds.

2 *Regulation 6D.3A.02 Contents of CSF offer document – Section 1: Risk warnings*

2.1 Delete "very" from the second line of the second paragraph;

2.2 in the second paragraph delete the word "must" and insert the word "should";

2.3 delete the sixth paragraph commencing "Even ……" and ending "…… money."

The difficulty with this paragraph is that start-ups are all about an appropriate business model for the business or consumer market which they are intending to supply. This means that often start-ups, realising that their initial business model is flawed, are forced to "pivot" and change their business model to something which was not intended at the time the seed capital was originally raised. It can be seen therefore, that an investor could easily argue that the change meant that the initial business model was a "misleading statement".

The whole point about the risk in start-ups is that they cannot demonstrate a track record of turnover and profitability and dividends for shareholders usually apparent with SMEs which have been successfully trading for a number of years. It can be seen that this paragraph is therefore inappropriate in a "risk warning" context. One cannot assume risk and then complain if the risk inherent in the investment, results in events which one took into account when the investment was made.

3 *Regulation 6D.3A.04 Contents of CSF offer document – Section 2: Information about the offering company*

3.1 The requested information is appropriate and well set out in the correct order. However, there is insufficient emphasis on a key aspect of information available to investors. This is the extent to which any of the moneys raised are to be used to repay any debts of the company and in particular any debts owing to officers of the company, shareholders of the company, persons associated with either officers or shareholders of the company and the amount of such debts. The reference to "debt" in (1) (f) is insufficient for this purpose.

3.2 add the following provision to clause (1)

(g) a list of all debts owing by the offering company to officers or shareholders or persons associated with officers or shareholders, specifying in addition to those debts,

whether the proceeds of monies to be raised by the proposed issue of shares are to be used in repayment of any of those debts.

This subject matter comprehensively covered in Section 3: Information about the offer (see clause (2)) save that there should be a description of relevant debts even if the proceeds are not to be used in repayment of those debts. It should also be listed for all officers and shareholders and not just those shareholders who meet specific criteria.

3.3 add the words "provided that there is an update of the consolidated statement of financial position to a date within 30 days of the date of the CSF offer document".

Under the existing provision accounts could be presented as part of the CSF offer document which were 11 months old.

4 Regulation 6D.3A.05 app contents of the CSF offer document – Section 3: Information about the offer

4.1 I consider that clause (2) is insufficiently clear and therefore have made the suggestion in 3.2 above.

5 Regulation 6D .3 A .06 Contents of the CSF offer document – Section 4: Information about investor rights

5.1 I make no comment on this section.

6 Regulation 6D.3A.10 Obligation of ESF intermediary relating to their platforms – applicant risk acknowledgement

6.1 Delete from clause (2) "and contains less information than a prospectus."

These latter words contain the strongly incorrect inference that a prospectus is issued by an issuer company that has more substance than a start-up and therefore carries less risk and the strongly incorrect assumption that an information memorandum produced by the issuer company is necessarily less accurate and somehow inferior to a prospectus. Firstly, when a prospectus is issued there is no quality assessment by ASIC as to the quality of the issuing company or the document or the issue in question; ASIC simply ensures that the prospectus complies with the requirements in the Corporations Act 2001. Secondly, there are companies listed on the ASX which have been unable, because of their inferior quality, to raise capital privately and offers approved by ASIC which should never have been offered to the public. The document registration compliance, that is, the prospectus part of ASIC, is different from the "enforcement" side of ASIC. Prospectuses are issued which the enforcement side of ASIC would consider

were inappropriate for consumer investment. A recent example is the Dick Smith prospectus and issue.

From clause (2)(a) delete "is risky" and insert the words "entails substantial risks".

Internationally there is far greater use of the term "crowdfunding" than there is of the term "crowd funding" and Australia should adopt the same nomenclature. In addition, it is appropriate to use the term "equity crowdfunding" as used in this provision as opposed to the phrase "crowd-sourced funding". This latter phrase is CAMAC hubris.

7 Regulation 6D.3A.11 Gatekeeper obligation of CSF intermediary – checks

7.1 Clause 1 – delete "starting to publish" and insert the word "publishing".

7.2 Add a clause (5) as follows:

(5) The CSF intermediary must disclose or ensure there is disclosed in the offer document a description of any information which it is required to check under Regulation 6.3A.11 but which it has been unable to substantiate and verify.

Essentially the Government is outsourcing an ASIC approval process to the intermediary. It is inappropriate for the legislation to make the intermediary's role far more onerous than ASIC has in respect of a prospectus. There is a subtle balance between protecting the consumer and creating an environment where risk can be assumed and met without significant disruption to the equity crowdfunding industry.

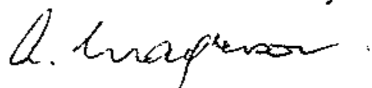
8 Regulation 6D .3 A .13 Obligation of CSF intermediary relating to their platforms – general CSF risk warning

8.1 In the statement in clause (2) delete "very" from the second line of the first paragraph, in the second paragraph delete the word "must" and insert the word "should" and delete paragraph 5.

The reasons for this change are set out in paragraphs 2.1, 2.2 and 2.3 above.

9 Omission from the Regulation

9.1 It is appropriate for Treasury to conduct a detailed examination of the AFSL process and the extent to which the AFSL requirements should have been altered or reduced for the intermediary company. This appears not to have been done.



Andrew Macpherson - **Macpherson Greenleaf** - 22 January 2016