SUBMISSION PAPER

Equity Crowdfunding (Crowd-Sourced Equity Funding)

Industry Feedback on new proposed Private Company Framework

June 2017

This Submission Paper was prepared by FinTech Australia working with and on behalf of its Members; over 120 FinTech Startups, VCs, Accelerators and Incubators across Australia.

Introduction and Background

This document was created by FinTech Australia in consultation with its Equity Crowdfunding (ECF) Working Group co-leads and members:

- Jack Quigley, CrowdfundUP
- Jonny Wilkinson, Equitise
- Andrea Gardiner, Jelix

In developing this submission, our ECF Working Group shared our early recommendations with other startup industry groups and ECF intermediaries in order to obtain as many viewpoints as possible in the development of our final submission.

We also undertook a roadshow across Australia to help explain the new proposed Private Company regime to the broader startup, legal, tax and investor community, and to seek feedback on Australia's ECF regime as a whole (both Private and Public).

The consultation roadshow consisted of a series of 6 meetup events in Adelaide, Brisbane, Melbourne, Perth and Sydney in early June, and featured both FinTech Australia member and non-member ECF intermediaries alongside experts from the Legal community and senior members of ASIC.

Through these meet-up events, FinTech Australia's ECF Working Group members received detailed feedback from the broader ecosystem and other intermediaries, many of whom also support the recommendations in this submission.

We also particularly acknowledge the support and contribution of BDO and King & Wood Mallesons to the roadshow and topics explored in this submission.

The full video recording of the Sydney/Perth Equity Crowdfunding consultation meetup has also been made available for viewing on FinTech Australia's Facebook page, and should be considered as part of this submission:
https://www.facebook.com/ausfintech/videos/653154711547233/

The move toward Equity Crowdfunding in Australia

FinTech Australia, its members and the broader startup community are excited by the possibilities of Australia's new Equity Crowdfunding regime. There is already a significant volume of research and data that speaks to the difficulties Australia's startups and SMEs face when it comes to obtaining capital to fuel their growth, particularly when it comes to startups where early-stage funding is still not readily available in Australia compared to other jurisdictions.

However, FinTech Australia's members are also wary of the potential risks associated with opening up opportunities for retail investors to invest in this kind of relatively high-risk asset class. Whilst it may be argued that many retail investors are used to investing in high-risk assets such as mining and prospecting stocks on the ASX, investing in early stage startups – many of whom are exploring previously uncharted technological territory whilst navigating shifting regulatory settings, particularly in fintech – presents a different set of challenges for retail investors to comprehend than they are normally used to.

It is for this reason we acknowledge that any new regime allowing investment into early stage, or even mid-stage companies positioning for growth and international expansion should carefully balance two needs:

1) It should be relatively light-touch and workable for startups and ECF Intermediaries – compliance should not be so costly and time consuming that this approach to raising capital becomes more expensive than other methods so the regime is not utilised; and

2) It should also provide investors with adequate protection, proportionate to the scale of the investment, with minimum disclosure settings that require companies and intermediaries to provide enough information to make a qualified investment decision.

We believe the Equity Crowdfunding Framework also needs to be considered as a continuum in order to avoid regulatory arbitrage or gaps, and ensure compliance obligations are considerate of, or even to align to, amounts raised and company size.

We also need to consider the implications of how the proprietary amendments and original framework will interact. Many of the features of the new proposed regime are still not clearly defined, particularly with respect to how they interact with the Public Company regime and other important existing legal frameworks such as the Takeover Rules in the Corporations Act.

Interactions with other frameworks is a complex issue unlikely to have a simple solution. We and our legal partners would like to discuss this in further detail with Treasury in coming weeks.

Specific to Intermediaries and Startups:

Framework Scope

In order to ensure Australia's ECF regime can be brought up to speed with other jurisdictions, it is important to consider the full scope of the framework, particularly relating to the types of investment vehicles which may be used by ECF intermediaries.

Consideration should also be given to allowing ECF intermediaries to establish and utilise an effective, simple single purpose vehicle to syndicate or 'house' multiple investments into an equity crowdfunding investment round, such as a unit trust, and to enable these vehicles to market the sale of units in these trusts to retail investors under the ECF regime.

The potential benefits of utilising this type of vehicle include:

- Risk mitigation for investors. Successful startup investors typically try to mitigate risk by developing a portfolio investing small amounts across many investments, aggregating their investments with a number of investors in a syndicate led by an experienced lead angel investor. Investing alongside an experienced lead angel investor who knows what to look for, and how to structure a round can form a useful risk mitigation strategy for less experienced investors.
- Reduce cost of administrative burden for founders. It can become cumbersome and expensive for a small startup to maintain a large register of ECF shareholders. A single purpose vehicle housing an investor syndicate can provide a single touch point with investors that may be more suitable for some busy startup founders.
- Better investor communications. In some cases, the presence of a lead investor or other ECF intermediary can increase the level of communication between the startup and its investors more broadly, which is useful when investors are seeking information about a company's progress. Broadly, we consider it best practice for Companies to ensure they are communicating progress to investors as often as their schedules can manage.

Some ECF intermediaries are already utilising this structure to syndicate investments, and are operating in a regulated manner that provides protections and safeguards for investors. As such, we feel that expanding the proposed ECF regime to include these types of vehicles would provide greater flexibility to the regime without compromising consumer protections.

Offer Document Guidelines and Requirements

FinTech Australia and its members recognise that companies undertaking to raise capital via ECF should ensure they are providing enough information about the company in order that the Investor understands what sort of business they are investing in. However this needs to be balanced to recognise that these investments are small scale and likely to be inherently speculative. So the documentation required for the 'Offer document' should not prove to be too onerous for the startup to produce, and should be easy to understand.

We believe there should be a principles based level of disclosure, focusing on transactions and balances that are material to an understanding of the company's operations and enable investors to understand the performance and solvency of the company. In our view this would limit the financial statements to including:

- A directors' report;
- The three primary statements (balance sheet, profit and loss account and cash flow statement);
- Accounting policies (explaining how they are applied, estimates and judgements); and
- Related party transactions.

The above requirement would not be onerous for a company to produce, and would also reduce the amount of material that would need to be reviewed or audited by an external party, which would also substantially reduce the cost of doing so.

Furthermore, there is a vast body of research focused on the United Kingdom and European Union that shows long-form detailed offer documents, similar to a prospectus, had the adverse effect of confusing investors rather than helping them comprehend the information they needed to make a sound investment decision (see N. Moloney, *How to Protect Investors: Lessons from the EC and the UK* (CUP, 2010)). It is also possible that a rogue operator may use a lengthy offer document to obfuscate important information about the company that may be of relevance to the Company's performance, or to give the impression that the company is more substantial than it is.

In summary, we recommend that Offer document guidelines and/or requirements should promote a reasonable, succinct approach to identifying key summary information relevant to investors. Our recommendation is that this be in the form of a short summary document or web page, as per the standard in the United Kingdom and New Zealand (see Appendix 1).

Compliance thresholds and raise caps

Adjustments are also needed to both existing Public and Private company frameworks, particularly in the area of compliance requirements and the thresholds that trigger these requirements.

It has been proposed that a Private company raising $1m and over is required to have an audit (in the existing Public framework, the requirement for an audit is deferred until either $1m has been raised or five years).

There are two levels of assurance that can be given by an auditor. A full audit provides *reasonable assurance* - a positive opinion that the financial statements are true and fair, and is a detailed process. A review, however, provides *limited assurance* - a negative opinion that the financial statements are not obviously incorrect, and is much less detailed. As a rule of thumb, a review costs around a third of the cost of a full audit.

Given a full audit can cost between $8-$20K, this is a substantial additional cost compared to the amount of capital being raised. It would make the ECF route of raising capital substantially more expensive - almost as expensive as a Business Loan:

Type of Capital raised	Amount	Costs associated	Total cost of raising capital
Credit Card	$1m	Interest @ 10 - 15% p.a.	$100K - $150K
Commercial Loan	$1m	Interest @ 4 - 20% p.a.	$40K - $200K
ECF (Proposed)	$1m	Audit: $8K - $20K Intermediary: $50K-$75K Legal fees: $5 - 10K	$63K - $105K
VC	$1m	Legal fees: $7K - $25K	$7K - $25K

Companies will already be required to produce an offer document which should lay out key information about the Company, ideally in a short-form summary that makes it simple for an auditor to review, and for a retail investor to comprehend. The requirement for two Company Directors who would also be liable for any incorrect disclosure of financial information should also act as an additional safeguard to ensure that accounts are not being constructed inaccurately.

We therefore strongly recommend that the audit requirement threshold is raised to companies raising more than $3m, with companies raising under that amount, whether private or public, only requiring at most a review of their financials by a qualified third party.

In the process of conducting our national ECF Roadshow, FinTech Australia also received feedback from a number of individuals that the $5m cap on the amount able to be raised by startups is too low. We recommend this be raised up to $50m similar to the US, given that we see signs of more mature startups and even medium businesses interested in using the regime. It is in the interests of the market that more mature businesses participate - it improves the risk profile for ECF, and allows more established players to set a good standard of conduct.

In balance, we recognise that Companies raising amounts more than $5m would obviously also need to provide increased disclosure obligations given the increased amounts raised, commensurate with the greater scale of the business (although individual investment caps for investors can remain at the same level).

Interaction with existing Public Company regime and other legislation

The Public Company ECF regime provided certain Public company governance and reporting concessions for companies that converted in order to make use of the regime.

With the introduction of the Private company framework, potentially within 6 months of the Public, it is proposed that these concessions will no longer be required (Item 1.57 in the Explanatory Memorandum). We believe that care needs to be taken to ensure that companies who have converted to utilise the Public company framework are provided a 12 month transition period once the new regime commences. This will allow companies adequate time to understand and prepare the required documentation to support their new obligations, and should include a continuation of these concessions, or a streamlined facility for companies who may also choose to convert back to a Private company to take advantage of the new regime for future raises.

Interactions with existing Takeover regimes also need to be explored further given the proposed 40% trigger threshold. This looks to be complex given this regime creates a new class of ownership. One example explored in greater detail below is in relation to Tag rights. It is unlikely this can be resolved at this stage of the consultation without further discussion with Treasury.

Specific to Investors

Impacts on maximum shareholder limits on disposal of ECF shares

The explanatory memorandum outlined how the disposal of shares obtained through an ECF offer would count toward a company's maximum shareholder limit.

We believe this should be reconsidered, particularly given that early-stage companies are meant to be fairly illiquid assets, and it is expected that ECF shareholders should not be trading their shares for an early exit unless in extreme circumstances, e.g. a death or a liquidation event, or hardship.

In any event, transfers of ECF shares amongst existing shareholders, or to professional / sophisticated shareholders, should not be a cause for regulatory concern.

However, for companies to ensure that they are not at risk of inadvertent breach of the maximum shareholder limit because of a transfer, the company may have to limit the ability of ECF shareholders to transfer their shares at all.

A scenario whereby this also potentially puts the company at risk is that the company's competitor may entreat a number of ECF shareholders to sell their shares to that competitor, thereby pushing the company beyond the 50 non-ECF shareholder limit and forcing the company to go public in a manner that is outside of the company's control.

We recommend that if necessary, ECF shareholders that are sold to others should retain their ECF share class status. Alternatively, the ECF shareholder should only be able to sell back to one of the company's founders or employees, though this solution is not ideal given it imposes undue restrictions or obligations upon the investor and also the company's shareholders.

Tag rights

The proposed requirement for an appropriate exit mechanism for ECF shareholders where any one shareholder acquires a relevant interest in excess of 40% is not an appropriate "tag right" in the context of a start up investment.

A more typical tag right in a proprietary or unlisted company context would normally only be triggered where there is an exit by a major shareholder (often a controlling shareholder - and in this context, it is not clear cut that there is control at 40%).

The current formulation would fetter the ability of a major shareholder to increase their stake in the company, and to invest more capital - but that is exactly what major shareholders should be able to do, without triggering a buy-out of other shareholders. This concept needs to be reconsidered.

Cooling-off period

FinTech Australia still does not support a cooling-off period. This does not happen in New Zealand or in the United Kingdom, which are regarded as leading jurisdictions for ECF. Investors are provided adequate time and information within which to make an investment decision. Allowing them to back out of an investment in a cooling-off period encourages poor investor behaviour, encouraging more of a "fear of missing out" mentality then a considered investment decision.

Also, given that investors are able to see the amounts invested during the cooling-off period, giving investors a "free pass" allowing them to invest and then pull out may also open up opportunities for market manipulation, potentially causing issues for the startup and the intermediaries and potentially forcing them to lower the price of their shares.

Appendix 1:

Below is an example summary table from Equitise's New Zealand platform, which has headline offer details for the company.

OFFER OVERVIEW

FitClassNow Pty Ltd (**"AirActive"**) is seeking between A$400,000 and A$750,000 investment against a pre-money valuation of $3.59M and $6.07/share (at the December 2016 milestone). This will equate to:

- 10.3% of equity and 65,874 shares for a raise of A$400k or
- 17.29% and 123,515 shares for a raise of A$750k

Offer FX RATE	NZD/AUD	1.0500

Share reconciliation	Minimum	Maximum
Opening shares outstanding*	590,917	590,917
Shares offered	65,874	123,515
Closing shares outstanding	**656,791**	**714,432**

*Please note 73,355 shares are scheduled to be converted at the conclusion of this raise. These are shares are part of an Incentive Share Pool detailed in full in the Cap table in the Documents section of the offer. The figures above represent the company's fully diluted position post-raise

Offer Overview		AUD	NZD
Share price	amount	$6.07	$6.37
Minimum investment	180 shares	$1,092.60	$1,147.23
Pre money valuation	equity	$3,586,866.19	$3,766,209.50
Offer amount	minimum	$399,994.79	$419,994.53
	maximum	$750,009.20	$787,509.66
Post money valuation	minimum	$3,986,860.98	$4,186,204.03
	maximum	$4,336,875.39	$4,553,719.16

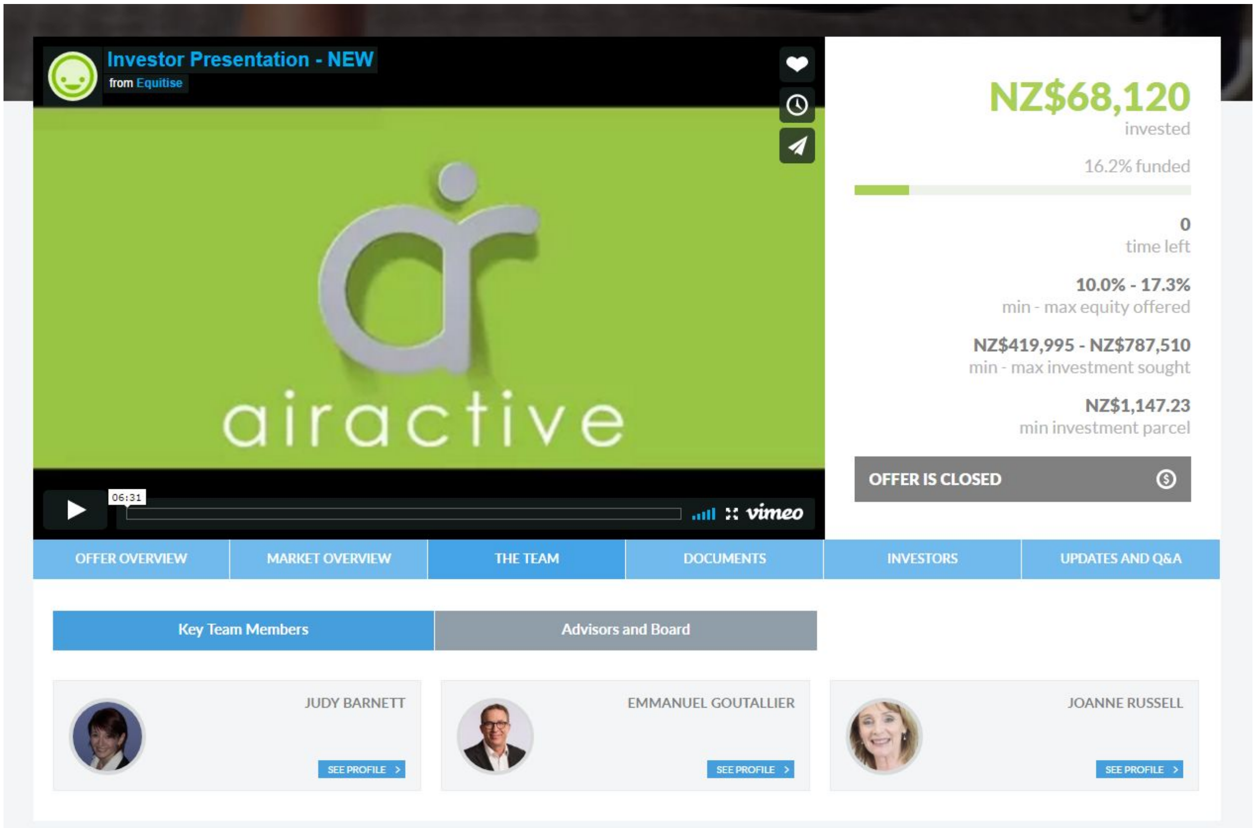
The purpose of the investment is to help AirActive move into Stage 3, understanding significant demand generation partnerships (Virgin/Velocity and Bupa) have been signed at national level. The timelines indicated in the diagram below are estimates and are subject to change.

Use of funds

Financial summary

How will my shares be held

Below is an example of the short-form summary of the Team and Offer Overview page, also from Equitise's New Zealand platform:


Investor Presentation - NEW
from Equitise
airactive
06:31
vimeo
NZ$68,120
invested
16.2% funded
0
time left
10.0% - 17.3%
min - max equity offered
NZ$419,995 - NZ$787,510
min - max investment sought
NZ$1,147.23
min investment parcel
OFFER IS CLOSED
OFFER OVERVIEW
MARKET OVERVIEW
THE TEAM
DOCUMENTS
INVESTORS
UPDATES AND Q&A
Key Team Members
Advisors and Board
JUDY BARNETT
SEE PROFILE
EMMANUEL GOUTALLIER
SEE PROFILE
JOANNE RUSSELL
SEE PROFILE

About FinTech Australia

FinTech Australia is the peak industry body for the Australian fintech Industry, representing over 120 fintech Startups, Hubs, Accelerators and Venture Capital Funds across the nation.

Our vision is to make Australia one of the world's leading markets for fintech innovation and investment. This submission has been compiled by FinTech Australia and its members in an effort to drive cultural, policy and regulatory change toward realising this vision.

FinTech Australia would like to recognise the support of our Policy Partners, who provide guidance and advice to the association and its members in the development of our submissions:

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- K&L Gates
- The Fold Legal