



Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir

Submission to Re:think Tax Discussion Paper

Innovation Australia is pleased to provide the attached submission in response to the discussion paper '*Re:think – Tax Discussion Paper*'.

Our submission addresses questions 39 (R&D Tax Incentive) and 40 (other measures to support innovation) of the Discussion Paper.

We have considered the importance of innovation to Australia, especially in the context of the government's Industry, Innovation and Competitiveness Agenda and the urgent need for Australia to develop new industries for future economic growth.

Our submission broadly addresses some of the issues raised by Treasury in its consultation with the Innovation Australia and the R&D Incentives Committee. A consolidated response is provided, drawing on the expertise and experience of members of Innovation Australia, its R&D Incentives Committee and our experience in providing oversight for programmes that support innovation.

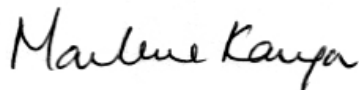
With respect to Q39, *Innovation Australia* invites consideration of the broad impact of the R&D Tax Incentive on Australia's economy and competitiveness in addition to the primary policy objective of supporting additional R&D in industry. In reviewing the R&D Tax Incentive, it should be acknowledged that the programme has been operating for a relatively short period and two full years of data will be available only after 31 October 2015. The review will seek to establish indicators of the programme's role in encouraging additional private sector R&D but also recognise the data limitations and the need for ongoing analysis over the medium-to-long term to assess the impact the programme is having on the economy.

Our submission supports ongoing stability in the programme, in terms of eligibility, rate of assistance and other aspects, essential to encourage companies to undertake additional research which usually involves long term investment. We also support the current principles which form the basis of the programme. The administrative support streamlines the programme and ongoing guidance reduces regulatory costs. The oversight provided by AusIndustry and the Australian Taxation Office via a risk based compliance framework is cost effective and efficient. We have provided anecdotal evidence on the impact of the programme on firms.

Innovation Australia has also addressed other programmes that may support innovation in response to Q40. We continue to support the Venture Capital Limited Partnership (VCLP) and Early Stage Venture Capital Limited Partnership (ESVCLP) programmes as well as the planned implementation of Crowd Sourced Equity Funding, Employee Share Options schemes and the re-direction of some investment from the Significant Investor Visa Programme to venture capital funds. We support the recommendations by the 2011 Board of Taxation Review of the VCLP and ESVCLP programmes. We have listed other incentives to support the development of STEM skills, export markets and greater international collaboration as well as between publicly funded research organisations and industry.

Innovation Australia is available for further consultation on the issues raised in our submission if required.

Yours sincerely



Dr Marlene Kanga AM
A/g Chair
12 June 2015

Attachment *Innovation Australia's submission to the Treasury's Re:think Tax Discussion Paper*

Innovation Australia

Response to Re-Think - Tax Discussion Paper March 2015

1. Background

Innovation Australia has a key role in providing independent advice to the Government on matters relating to innovation in business and industry, including appropriate financing to support innovation.

Innovation Australia has a legislated role to administer financial support for Australian innovation via the following programmes. Some of these use the tax system to provide support:

- The R&D Tax Incentive, over which the Board has oversight via its R&D Incentives Committee, is a targeted, easy to access, entitlement programme that helps businesses offset some of the costs of doing research and development (R&D). The Incentive is open to firms of all sizes in all sectors that are conducting eligible R&D and assists SMEs (Small and Medium Enterprises) that have not achieved profitability with much needed cash flow via a tax refund.
- The Early Stage Venture Capital Limited Partnerships (ESVCLP) and the Venture Capital Limited Partnerships (VCLP) programmes. Both were developed to stimulate Australia's venture capital sector with favourable tax treatment for investors. These structures attract both foreign and domestic investors who provide much needed capital for innovative Australian companies.
- A number of legacy programmes, now closed, that the Board continues to administer, including Pooled Development Funds (PDFs) and Commercialisation Australia (CA), both of which provided financial support for innovative companies in early stages of growth.
- The Innovation Investment Fund (IIF) Programme, though closed to new applicants, continues to provide venture capital support through 10-year innovation funds to develop high growth Australian companies by commercialising research outcomes.

The Tax Discussion Paper presents two questions relating to support for R&D and innovation in Australia. This submission addresses *Question 39* – relating to the R&D Tax Incentive and *Question 40* relating to other measures to support innovation.

Our submission also broadly addresses some of the issues raised by Treasury in its consultation with the *Innovation Australia* Board and the R&D Incentive Committee. A consolidated response is provided, drawing on the independent and diverse individual

expertise and experience of members of *Innovation Australia*, its R&D Incentives Committee and our collegiate experience in providing oversight for programmes that support innovation.

2. The Role of Innovation in supporting growth in the Australian economy

In an increasingly globalised economy, many countries have recognised the importance of R&D and innovation in creating new industries and driving economic growth. In addressing the questions raised in the Tax Discussion Paper and in subsequent consultations with Treasury, *Innovation Australia* has taken an holistic approach, addressing the need for new industries and innovation in Australia and the potential for government incentives via the tax system to support the growth and development of companies that will create future jobs, revenue growth, exports and ultimately greater tax income.

The urgent need to transform the economy has been recognised by the government's *Industry, Innovation and Competitiveness Agenda*. This submission is consistent with the objectives of the Agenda and the commitment of *Innovation Australia* to strive for the desired outcomes.

A vibrant, globally competitive and innovative economy is important for ongoing economic strength. With the decline in the mining boom, Australia can no longer rely on the boom and bust cycles of commodity prices. Rapid advances in science and technology are transforming business models and disrupting traditional value chains globally. To address the challenges set out in the Government's 2015 Intergenerational Report,¹ where the proportion of people in productive employment will be reducing and the cost of our ageing population increasing, innovation is imperative to Australia's future sustainability, growth and productivity improvement.

Australia is not alone in recognising the importance of innovation. For example, the European Union is committed to supporting research and development through its Horizons 2020 programme to create new industries and revitalise existing ones.² This includes a coherent strategy with a Euro 80 billion budget between 2014-2020, increasing government support for R&D to 3% of GDP, a focus on science and innovation in industry, the development of essential skills in science and technology and addressing the problems of sustainability and climate change. Many countries, including in Asia and North America, are expanding the range of tax support provided to innovative companies, including R&D tax credits, as well as other new initiatives.

Continuing support for R&D and innovation is an imperative for Australia, which currently ranks below the OECD average, putting us at a competitive disadvantage. Australia ranked

¹ See http://www.treasury.gov.au/~media/Treasury/Publications%20and%20Media/Publications/2015/2015%20Intergenerational%20Report/Downloads/PDF/2015_IGR.ashx

² See www.eia.org.uk/HORIZON2020.pdf

15th out of 27 OECD nations in government support for industry R&D, well behind New Zealand (8th) and Canada (12th).³

It is also increasingly clear that while Australia rates highly in terms of research inputs, it is not performing as well in terms of outputs – the commercialisation of research and the formation and growth of innovative companies. According to the Global Innovation Index 2014³, Australia ranked 17th out of 143 countries. It ranked 10th overall in the Input Sub-Index, with top 10 rankings for human capital and research (7th), infrastructure (7th), and market sophistication (10th). There were high rankings for tertiary education, R&D entities, and general infrastructure for R&D, reflecting the relatively high standards of Australia's education system.

However Australia did not rank highly in terms of outputs, the overall efficiency ratio of inputs versus outputs resulted in Australia being ranked 81st globally. By comparison, New Zealand has a higher efficiency ratio of 0.75 and ranked 66th globally. The main reason cited by the Global Innovation Index for the low efficiency score was low ranks for “Market sophistication”, and “Business sophistication”. This means that the uptake of innovations and translation to market is low compared to other high income countries.

According to the Global Innovation Index, Australia's innovation output performance is consistent with that of other resource rich economies where resource-extracting activities provide lower risk and higher returns in shorter time frames and tend to crowd out investments in other productive sectors, especially in innovation. This phenomenon has been called the “resource curse” or the “paradox of plenty”.⁴

Australia clearly has a gap in translating excellent research into world class products. In order to improve its performance to maintain or increase Australia's global competitive position, Australian industry needs to have appropriate incentives to invest in R&D and develop new technologies. To quote Dr Megan Clark former head of CSIRO, *“Australia must not get left behind and must invest in R&D at a rate greater than GDP growth. Right now we risk being one of the few developed and developing countries to fall below this key benchmark. You can tweak all you like around the edges but nothing can help you if you let that fundamental investment level drop.”*⁵

³ See OECD Science Technology and Industry Scoreboard, 2013, <http://www.oecd.org/sti/scoreboard.htm>.

⁴ See The Global Innovation Index 2014.

⁵ Dr. Megan Clark AC, Ralph Slatyer Address on Science and Society, Canberra, 25 May 2015, see: <http://crca.asn.au/2015-ralph-slatyer-address-on-science-and-society/>.

a. Financial support over the innovation cycle

Figure 1 shows the risk and revenue profile of innovating companies and the role of current government programmes that support industry research and development, innovation and commercialisation. The R&D Tax Incentive provides essential support at the early stage of innovation where external financing is rarely available, especially in the Australian market. For example, recent *Innovation Australia* discussions with several innovating companies confirmed that the main source of funding for company R&D was cash flows from revenues and investment by the owners of the companies.

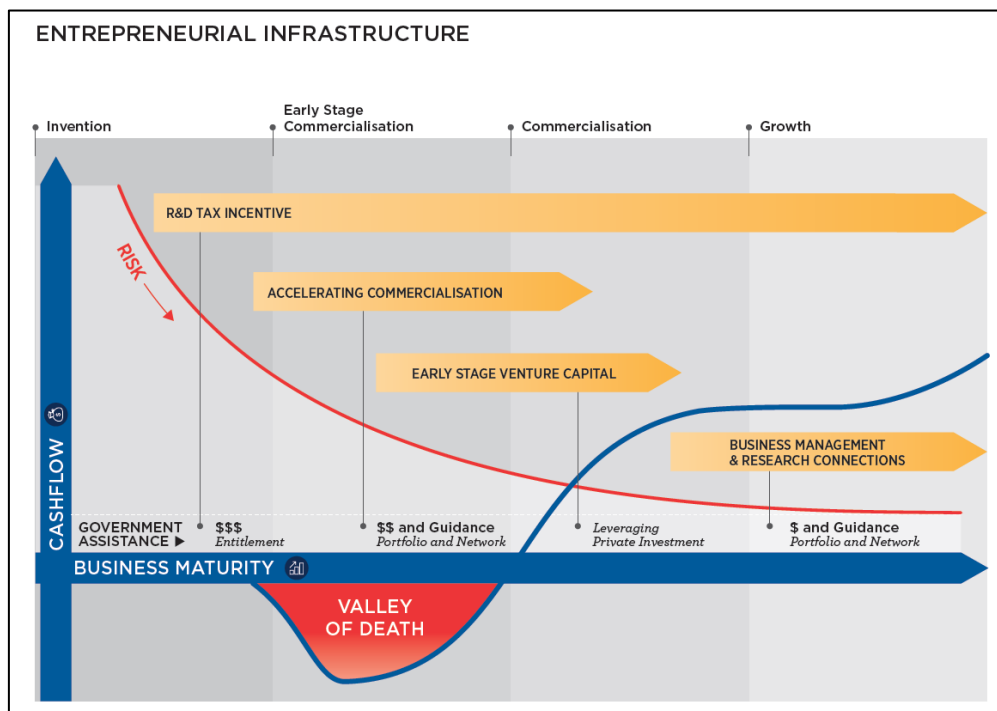


Figure 1: AusIndustry Support Programmes across Innovation Life Cycle

Effective, sustainable innovation outcomes are dependent on an effective, multi-faceted innovation ecosystem across the innovation life-cycle. This ecosystem includes, amongst other things, a highly skilled work force, increasingly skilled in science, technology, engineering and mathematics (STEM); appropriate incentives and support for research and development where new ideas, products, services and processes are created and developed; and financial support to enable small innovative companies to establish and take the best advantage of their discoveries.

The R&D Tax Incentive provides limited but vital support for the high-risk, research stage of innovation in Australia particularly in light of the lack of early stage venture capital. The Early Stage Venture Capital Limited Partnership (ESVCLP) and the Venture Capital limited Partnership (VCLP) programmes, which provide tax concessions for investors in venture

capital funds, are recognised as the "heroes of the venture capital market in Australia."⁶ However more needs to be done to attract risk capital into early stage innovation.

3. R&D Tax Incentive

Question 39 in the Tax Discussion Paper, focuses on whether the R&D Tax Incentive encourages additional R&D activity. However this issue needs to be considered more broadly in terms of the role of R&D undertaken by companies in building a strong economy. The R&D Tax Incentive provides urgently needed support for industry-based R&D that can lead to the development of innovative companies.⁷ This is essential to boost Australia's economic growth. The benefits that accrue are expected to outweigh the costs.

a. Policy Objective of the R&D incentive

The legislation implementing the R&D Tax Incentive programme states the following Object:

"The object of this Division is to encourage industry to conduct research and development activities that might otherwise not be conducted because of an uncertain return from the activities, in cases where the knowledge gained is likely to benefit the wider Australian economy."

The R&D Tax Incentive has the policy objective of providing support to innovative companies by reducing the cost of R&D and to encourage industry **to conduct additional R&D.**

Australia is one of the few countries in the world which has only one significant programme to support R&D, compared to other countries that have a range of programmes, including reduced tax rates, accelerated depreciation on R&D assets and super deductions, patent related incentives, tax holidays etc.⁸ It is essential to continue this programme as a critical enabler (often the first stage) in supporting innovation in Australian industry. This has been recognised by the Australian government, as reiterated by The Hon Joe Hockey, Treasurer in his speech to the Australia-Israel Chamber of Commerce, which also lists the many programmes provided by the Government of Israel to support that nation's innovation agenda.⁹

⁶See Australian Financial Review 6 May 2015, Jonathan Barouch, *A budget wish list from tech start-ups*

⁷Through this submission references to R&D are as defined in the *Tax Laws Amendment (R&D) Act 2011* for Core R&D Activities, i.e. "... experimental activities whose outcome cannot be known or determined in advance. is based on the principles of science...conducted for the purpose of generating new knowledge."

⁸ EY: World Wide R&D Incentive Reference Guide 2013-14, available from <http://www.ey.com/GL/en/Services/Tax/Worldwide-R-D-incentives-reference-guide---Country-list>

⁹ Treasurer Joe Hockey to Australia-Israel Chamber of Commerce, 22 April 2015, <http://jbh.ministers.treasury.gov.au/speech/014-2015/>

Importantly, the R&D Tax Incentive supports start-up firms and may influence the decision to undertake additional R&D. For example:

- StartUpAus, a not for profit organisation of entrepreneurs in the technology space, has indicated that the R&D Incentive “provides valuable support to high-growth companies.”¹⁰
- A recent opinion piece in the Australian Financial Review¹¹ also emphasised the importance of the R&D Incentive to innovative companies, stating “The R&D Tax Credit should be left on the table. It works.”
- Visits by *Innovation Australia* to companies leveraging the R&D Tax Incentive in Brisbane on 20 May 2015 confirmed the role of the Incentive in supporting their R&D efforts specifically in terms of assisting with cash flow and costs associated with R&D. Some companies indicated that they might not have remained in Australia without this support.
- SME technology companies attending at the Accelerating Commercialisation Expert Network function in Melbourne on 27 May 2015 provided similar feedback, as confirmed by *Innovation Australia*, also attending this function.
- Customer testimonials and stories collected and published by AusIndustry highlight the programme’s role in incentivising investment in R&D that otherwise would not have gone ahead or would have occurred at lower levels and more slowly, and as result would have led to lost opportunity and reduced ability to compete in domestic and global markets (**Attachment 3**).

Innovation Australia does not yet have comprehensive recent data on the impact of the R&D Tax Incentive on company behaviour as the current programme commenced on 1 July 2011 and two full years of data will not be available until after 31 October 2015. However there is clear anecdotal evidence that it has a positive impact in terms of **management of R&D projects and improved decision making**, as well as being **an additional source of finance**.

- StartUpAus indicates that “VC-backed firms are responsible for 10% of all business R&D expenditure in Australia” and that “VC--backed companies spend on average 200 times more on R&D per employee than other businesses”¹² This would indicate that there is a strong correlation between R&D by firms focussed on commercialised outcomes and recognition of this effort by venture capital firms.

¹⁰ See StartUpAus Crossroads 2015 Report, <http://startupaus.org/crossroads/>

¹¹ See Australian Financial Review 6 May 2015, Jonathan Barouch, *A budget wish list from tech start-ups*.

¹² See StartUpAus Crossroads 2015 Report, <http://startupaus.org/crossroads/>

- A survey conducted by the former Department of Industry Tourism and Resources in July 2007 indicated a significant positive impact on firm behaviours as a result of using the then R&D Tax Concession. 86% of firms reported a positive impact *during* their R&D project and 98% of firms reported long-term behavioural change. The benefits that accrued to firms included better management of R&D projects, higher budgets (due to the financial support provided) and increased profits, through accelerating the R&D to achieve commercialisation outcomes more quickly.¹³
- A 2015 review of the UK R&D Tax Credit reports that 28,500 small and medium companies and 7,000 large companies claimed the credit in 2012-13. The review indicated an additionality factor of up to 2.53.¹⁴ A previous HMRC UK study, conducted in 2010, indicated an additionality ratio of 3.0. The 2015 UK study also reviews the impact of the R&D Tax Credit in a large number of countries and the range of additionality factors is up to 3.0. The variations depend on the type of programme and other factors. Given the similarities of the principles and structure of the Australian R&D Tax Incentive programme, a similar level of additionality can be assumed for Australian companies. This level of additionality compares favourably with that estimated for the Medical Research Future Fund (MRFF) which has a net benefit factor of 3.39 across the Australian health system in terms of health and productivity gains and that has on-going government support.¹⁵ The recently renewed Cooperative Research Centres (CRC) program, an enduring pillar of the government's programme for industry-research collaboration and commercialisation for 25 years, has an estimated overall net benefit factor of 3.1.¹⁶

The benefits of the R&D Tax Incentive also derive from **long term continuity** and the ability to **build capability** in new technologies. Ongoing research also builds the **absorptive capacity** of companies, to understand and keep up with rapidly evolving technology, to adapt and their technology and products.

Another uncosted benefit is the extent to which companies undertaking R&D **remain in Australia** and create **spill over effects** for the economy. The R&D Tax Incentive enables companies to remain in Australia even if their major markets are overseas. For example:

- Companies visited by *Innovation Australia* in Brisbane on 20 May 2015, confirmed that the current R&D Tax Incentive is an incentive for companies, especially SMEs, undertaking R&D to remain in Australia.

¹³ Department of Industry Tourism and Resources, How R&D Assistance Influences Company Behaviour, July 2007.

¹⁴ See HM Revenue and Customs, "Evaluation of Research and Development Tax Credit", March 2015

¹⁵ See Deloitte Access Economics, Extrapolated returns from investment in Medical Research Future Fund (MRFF), Australian Society for Medical Research, October 2014.

¹⁶ The Allen Consulting Group, The economic, social and environmental impacts of the Cooperative Research Centres Program, 2012, www.acilallen.com.au/cms_files/acgcreprogramreview2012.pdf

- The customer stories presented in **Attachment 3** confirm that the R&D Tax Incentive is a key factor in remaining in Australia. For example, customer stories for Flipscreen and Paranta Biotech include direct quotes from the companies that without the programme they would have likely moved overseas.
- Multinationals undertake R&D in Australia for several reasons. According to GE, the R&D Tax Incentive supports the location of R&D facilities in high technology and advanced manufacturing in Australia along with a multicultural workforce and strong legal systems that protect intellectual property.¹⁷ Boeing has been based in Australia for decades and collaborates with the CSIRO, CRCs and universities and has supported innovations among its Australian suppliers. It cites the R&D Tax Incentive as a way of partially offsetting high cost, albeit high quality R&D in Australia.¹⁸ Multinationals in the food industry also acknowledge the support of the R&D Tax Incentive in reducing costs. However their accounting systems do not always permit direct offsetting of the Incentive to R&D costs and a tax credit at the same rate is perceived as being more readily attributable to reducing R&D costs.¹⁹

b. Eligibility - Principles of the R&D Tax Incentive Programme

The R&D Tax Incentive programme commenced on 1 July 2011, implementing the recommendations of the 2008 Cutler Review¹⁹ to make a number of significant changes to the previous R&D Tax Concession programme. With more clearly articulated **eligibility requirements**, more generous benefits, particularly for SMEs, **improved compliance arrangements and better guidance materials and customer education**, the R&D Tax Incentive is both **better targeted and more effective**.

While the **regulatory burden has been somewhat reduced**, companies are required to clearly articulate the purpose and process of their R&D. For example an R&D management plan is no longer needed as part of the registration process but the purpose of the claimed activities must be stated.

Given that sufficient data to review the programme will not be available until after a full two years of operation, our view is that it is premature to draw conclusions about the effectiveness of the current scheme and its eligibility requirements. It is important to provide **a level of stability** for the programme to enable companies to invest in R&D with confidence.

The Department of Industry and Science in consultation with Treasury will undertake a review of the programme in accordance with expenditure review principles once two full years of data becomes available after 31 October 2015 (when late balancing firms have lodged their claims).

¹⁷ Comments by Geoff Culbert, President & Chief Executive, GE Australia, New Zealand and PNG, at US Ambassador's Innovation Roundtable, Sydney 28 May 2015.

¹⁸ Comments by Maureen Dougherty, President, Boeing Australia and South Pacific, at US Ambassador's Innovation Roundtable, Sydney 28 May 2015.

¹⁹ Consultations by Innovation Australia Board Member at meeting with Chief Scientist and multinational food companies, Melbourne, 20 November 2014.

Some of the eligibility risks, identified in previous reviews²⁰, have been addressed in the R&D Tax Incentive through the need to identify core and supporting R&D activities and the dominant purpose test for supporting activities. While it is still too early to draw firm conclusions, the experience of *Innovation Australia* and the R&D Incentives Committee is that:

- The tightening and clarification of eligible expenditure has and will continue to result in a reduction of ineligible expenditure claims being funded than would otherwise be the case. This helps to ensure a higher rate of return from investments in genuine R&D activities for each dollar of revenue foregone as well as containing programme costs.
- Confidentiality requirements as well as cases before the Administrative Appeals Tribunal prevent discussion of specific examples. However concerns raised in the review in 2008 and subsequently about large "whole of project claims" in some sectors and large investments in certain activities (incorporating expenditure not normally deemed or intended to count as eligible expenditure) appear to have been dealt with. This is consistent with the policy intent of incentivising and rewarding only genuine R&D.
- Far from being the heavy administrative burden some participants expected, or "crowding out" genuine R&D investment undertaken (for example in a production environment), the rules surrounding eligible expenditure have generally been taken on board by programme participants.
- Australian companies are claiming the R&D Tax Incentive in increasing numbers. Over 13,000 companies are expected to claim the Incentive in 2013-14, an approximately 10% increase on the previous year.²¹

A productive compliance culture emerges when administrators and programme participants understand and embrace the rules and procedures with supporting behaviour. Importantly, this compliance culture is a necessary condition that reinforces the desire for a long term commitment to stability and continuity in the eligibility and incentive criteria of the programme. This in turn helps to ensure the R&D Tax Incentive encourages companies to conduct R&D activities that might otherwise not be conducted in the absence of government support.

Innovation Australia supports the retention of the **broad principles** of the R&D Tax Incentive programme:

- It is an entitlement programme and is accessible by all incorporated entities engaged in R&D, irrespective of size and industry sector and without attempting to pick winners. The system is open to invention and innovation in all sectors – often the biggest breakthroughs occur where they are least expected and in fields that may create new technologies that do not exist today.

²⁰Venturous Australia, 2008

²¹AusIndustry data, unpublished.

- The rates of tax offset (45% for most small and medium sized companies and 40% for all others, to the limit of \$100 million) provide the equivalent assistance of 15 cents and 10 cents for every dollar of R&D respectively. This modest rate remains particularly attractive to small entities that use it as an additional source of finance. The refundable tax offset to small companies in a loss position supports much needed cash flows in the high-risk, critical start-up phase before they get to the threshold of profitability.
- It is administered efficiently by AusIndustry, via an online registration process, online guidance, extensive outreach through its State Office network, and an effective compliance framework, and by the Australian Tax Office, via the taxation system. This reduces compliance costs for claimants and administrative costs to the Government.
- It applies to companies and not to trusts, partnerships and other entities, ensuring a high level of integrity.
- Companies have a level of certainty of the amount of the offset and the timing of the receipt of these funds as it is administered through the tax system.

Innovation Australia encourages support for a broad based R&D incentive rather than ongoing changes that narrow the number, size or industry sectors the scheme covers. The programme will generate the greatest benefits if it remains a scheme that is broadly acceptable to all companies.

For example, a review of Ireland's Tax Credit Scheme after 10 years of operation in 2013 and involving 1,000 companies and direct consultations with 100 entities indicated a positive impact for additional R&D and for the economy. The Minister for Finance, Mr. Michael Noonan said: *"The results of the review are clear. The Irish R&D Tax Credit regime has been a significant driver for increasing R&D spend in Ireland over the last decade, the scheme itself continues to be 'best in class' internationally, and it remains a significant aspect of Ireland's successful formula for attracting foreign direct investment, which is jobs rich."*

The Irish R&D Tax Credit is available to all corporate tax payers regardless of the size of firm or sector in which they operate. While the R&D Tax Credit may not appear as targeted as in some countries, the policy framework is a deliberate choice to keep the Irish regime competitive for firms of all sizes, industry and origin. As a small nation with an open economy, the policy in Ireland is to encourage any type of firm to innovate and perform R&D, regardless of sector or industry.²²

²²Ireland Department of Finance, Review of Ireland's Research and Development (R&D) Tax Credit 2013, see http://budget.gov.ie/Budgets/2014/Documents/Department_of_Finance_Review_of_Ireland's_R&D_Tax_Credit_2013

c. The need for long term stability

While considering the central policy objective of supporting additional R&D, *Innovation Australia* submits that it is essential to have policy continuity and stability as a fundamental determinant of “the test of additionality”. Stability is necessary in terms of the eligibility criteria for companies able to claim the incentive and for the way companies register and claim the incentive. Stability is also needed for the rate of the incentive, which is already modest, to enable innovating companies to invest with confidence.

Innovation Australia had previously stated the need for stability in our Submission to the Senate Economics Legislation Committee’s inquiry into Tax Laws Amendment (Research and Development) Bill 2013 in February 2014, to enable companies to make medium to long term decisions on investments in R&D projects. This is especially important as these investments are very risky and the outcomes are unknown. Without this confidence, the programme may simply result in windfall gains to R&D that would have taken place anyway and will not have the desired effect of additional R&D. Changes to the R&D Incentive, increases speculation of further changes in future and undermines confidence in the programme more broadly.

This view is consistent with the quantitative analysis undertaken by the OECD that on the impact of public R&D expenditure on business R&D. The study concluded: “*Direct funding as well as tax incentives are more effective when they are stable over time: firms do not invest in additional R&D if they are uncertain of the durability of the government support.*”²³ The research indicates that the inherent nature of industry R&D that makes firms sensitive to uncertainty, including uncertainty of government support. Firstly, R&D involves specialised knowledge, expertise and equipment, it takes time to hire people and build laboratories. There are usually additional costs involved and uncertainty on how long these can be maintained. The uncertainty may be the result of economic factors, firm performance and other exogenous factors in addition to government policy. Firms tend to take a long term view and usually do not want to commence projects that cannot be maintained over a period of time.

d. Administration, Compliance and Regulatory costs

Although there is a large consulting service industry for the R&D Tax incentive, which implies a significant **regulatory cost**, we believe that much of this is the result of marketing by organisations providing tax and other advice. The relative certainty of outcomes from the programme supports the consulting industry when marketing to prospective clients. We believe that this cost is market driven and will prove to be relatively inelastic to any changes in the R&D Tax Incentive.

²³Dominique Guellec and Bruno van Pottelsberghe: The Impact of Public R&D on Business R&D, OECD Science and Technology Working Papers 2000/04, http://www.oecd-ilibrary.org/science-and-technology/the-impact-of-public-r-d-expenditure-on-business-r-d_670385851815

As the R&D Tax Incentive was implemented on 1 July 2011, we recommend **stability** in terms of the broad principles of the programme. Changes to the rate and other aspects of the programme will create **uncertainty and complexity** and will increase reliance on external advice and the consequent **cost to industry**.

As the R&D Tax Incentive reduces the risk involved in investment in R&D and enables companies to attract private investment, there is a high probability that if the programme is significantly altered, there would be a particularly severe impact on smaller companies.

AusIndustry has developed simplified on-line application forms for R&D registration and Advance/Overseas Findings. These have extensive embedded help and associated guidance. The on-line registration form is effective in ensuring a high level of **compliance** with the programme and reducing the burden and costs of registration. However, there is always room for improvement and enhancement. This is an on-going task which is monitored by the R&D Incentives Committee.

The R&D Incentive Committee meets with stakeholders at the national and state level to discuss the operation and administration of the programme.²⁴ These and other major industry groups involving start-up companies and entrepreneurs have not raised issues relating to the cost of complying with the programme.

A suite of both general and targeted **guidance documents** support industry understanding of the R&D Tax Incentive and there is regular communication with stakeholders (e.g. National and State Reference Groups, business.gov.au website, AusIndustry State Office workshops etc.). Further guidance could be provided to sectors that are likely to benefit from the Incentive. For example, promotion of the Incentive for collaborative partnerships between industry and publicly funded research organisations (PFROs) and industry Growth Centres may increase the impact of the programme.

Programme guidance is now focussed on online delivery through the website www.business.gov.au. Supporting its guidance products, AusIndustry, through its State Office network, conducts extensive customer education and engagement programmes to inform eligible companies of the Incentive and to equip them to understand how to comply with the programme.

AusIndustry has an effective **compliance monitoring** programme. Approximately 15 percent of companies are reviewed annually as part of the compliance framework and of more than 12,000 entities lodging claims; fewer than 10 have proceeded to review by the Administrative Appeals Tribunal. AusIndustry uses a risk based approach to identify companies at risk, seek further information and escalate reviews as required to ensure a high level of programme integrity.

²⁴For example the National Reference Group meets bi-annually and the State Reference Groups meet quarterly, both comprising stakeholders of the R&D Tax Incentive programme.

e. Programme Cost and Benefits

Based on total registered R&D expenditure claims of around \$20 billion in 2012-13 (the only complete year of claims since implementation of the R&D Tax Incentive from 1 July 2011), estimated total support through the programme is \$2.5 billion²⁵. However some of the foregone tax revenue is clawed back via shareholders of publicly listed companies that have a reduced company tax rate if they claim the R&D Tax Incentive and therefore are unable to pay fully franked dividends.

The limit of \$100 million of R&D expenditure that can attract the full rate of Incentive under the programme from 1 July 2014 will further reduce the cost of the programme, the savings estimated at approximately \$350 million per year (based on Treasury estimates of the previously proposed 'Better Targeting' measure that proposed to exclude companies with aggregated annual turnover of greater than \$20 billion).

We understand that the Government is also pressing ahead with a 1.5% rate reduction in the R&D Tax Incentive. While we understand that this is a budgetary measure, the changes to the programme and lack of stability will create uncertainty in an already risky environment to the detriment of further investment in R&D. Since the R&D Tax Incentive is leveraging between 7 and 10 times the investment by companies in R&D (as the Incentive is between 10% and 15% of R&D expenditure by firms), the rate reduction and further changes, would be to the detriment of the Government's objective of a more innovative and competitive economy.

The programme must be considered in terms of the net impact on the economy not just the direct costs to the Government. All firms undertaking R&D, large and small, also pay additional company tax on increased revenues from their technology products and employ more highly skilled people who also pay tax as individuals. There are also the wider benefits to the supply chain supported by companies engaged in R&D and the broader economy.

In addition there are other spill over effects from R&D such as an increase in STEM skills and the absorptive capacity of firms to absorb new technology. Some of these benefits have not been measured for Australia. For example, investment of larger firms, particularly technology intensive ones can provide the largest social benefits from R&D.²⁶

Innovation Australia notes the need to address debt and deficit issues confronting Australian Governments and highlighted in the Intergenerational report and the need for budget savings. In that context our conclusion about the benefits to the Australian economy and society from the R&D Tax Incentive programme over the 2015-2025 decade and beyond warrants it to be dealt with in much the same way as the Government in the UK dealt with their programme during a period of considerable budget pressure.

²⁵See Australian Government 2014-15 Science, Research and Innovation Budget Tables
, (<http://www.industry.gov.au/innovation/reportsandstudies/Pages/SRIBudget.aspx>)

²⁶See Bloom, Schankerman and Van Reenan in their 2013 study "Identifying Technology Spillovers and Product Market Rivalry" *Econometrica* Volume 81 Number 4, July 2013, pp.1343-1397.

The UK has increased R&D support for small companies, extended the programme to large companies, enabled all companies to report R&D assistance as an "above the line benefit"; and provided refundable benefits to both large and small companies. During 2008, at the time of the Global Financial Crisis, R&D tax credits for current R&D expenses have were made more generous, enhanced deduction rates were increased to 175 percent for SMEs and to 130 percent for larger companies and the eligibility criteria for the SME credit were broadened, with a doubling of the thresholds applied to employment, assets and turnover. The enhanced deduction rate for SMEs was further increased to 200 percent in 2011 and to 225 percent in 2012. This expansion of its R&D programme during difficult economic times across all sectors has been considered to be beneficial for the UK.”²⁷

The expansion of support for R&D recognises the huge potential benefits to the economy. For example, a report by PwC on the potential opportunities and benefits of developing digital technologies and innovation in Australia indicated a potential to increase Australia's GDP by 3.5 per cent, and create more than 500,000 new jobs in the 20 years to 2034.²⁸

f. An essential source of finance

The R&D Tax Incentive is an essential source of finance, especially at the high risk stage of a company's development. The definition of R&D in the legislation itself requires that the technical outcome of the research must be “unknown” at the outset of the R&D project (also see **Figure 1**). With no certainty of the technical outcome and the result being an intangible asset, the risk is extremely high, no financial institution will provide debt financing without backing of tangible assets such as bricks and mortar (usually the company owners' home). The R&D Tax Incentive, as the Object of the legislation states, is intended to address the risk of uncertain returns. By providing a ‘guaranteed return’ of a portion of R&D investment, it reduces this risk and so improves the ability of these companies to attract finance.

The main sources of financing for many SMEs are from the owners' personal resources and from personal connections, friends and family or high net worth individuals who have a personal interest in the technology, as confirmed in our recent visits to several companies based in Brisbane.

Start-up companies all over the world have a similar risk profile: at the high risk, early start-up phase there is little opportunity for external funding. Mobility of international sources of funds is limited. Venture capital is available once a concept or technology has been developed. Much of the early stage venture capital funding is backed by successful entrepreneurs who, as individuals, are ready to provide financial support for other high risk ventures.²⁹

²⁷See: Oxford University Centre for Business Taxation, Trends in UK BERD after the Introduction of R&D Tax Credits, http://www.sbs.ox.ac.uk/sites/default/files/SBS_working_papers/TrendsInUKBERD_1.pdf

²⁸See PwC, <http://www.pwc.com.au/consulting/publications/expanding-australias-economy.htm>, April 2014.

²⁹ See for example the profile of sources of company finance by company age in, Australian Private Equity Venture Capital Association, Submission to Financial Systems Inquiry, August 2014.

With the growth of internet service companies, there is always a potential unicorn, a company with no sales revenue but with huge potential. There are very few unicorns (hence the name as they occur rarely) so investment in a company with no proven technology is extremely rare.

g. The importance of STEM Skills

The benefits of R&D go beyond the actual value of the research. R&D builds STEM skills in the workforce and increases the absorptive capacity of companies to take up innovations at a faster rate. The importance of STEM Skills has been recognised in several recent reports.

While the importance of STEM skills is not directly addressed in the Tax Discussion Paper, we have included this issue for completeness as part of the need for an effective eco-system for innovation. Research has shown that there is a direct correlation between STEM skills and innovative output.³⁰ In an increasingly technological world, the demand for STEM skills is increasing rapidly. In the US, the percent of jobs requiring STEM skills has doubled since the Industrial Revolution, to 20 percent of the workforce, and further increases are expected, not only at the university level but also for trades and technicians. The US Federal government is funding a large number of programs to boost higher-level STEM education, particularly for minorities and women.

A recent report by PwC indicates that 44 percent of Australian jobs are at risk from new technologies and 75 percent of new jobs will require STEM skills.³¹ Australia's Chief Scientist has also recommended a STEM strategy for Australia.³²

It is clear that there is an urgent need to address the decline in the number of students studying science and mathematics, the enabling subjects for further studies in STEM. Recent reports have recommended increased focus in this area as jobs of the future will be increasingly reliant on new technologies.³³

It is the submission of *Innovation Australia* that a broader, more encompassing definition of STEM skills is also important to Australia, including technicians and advanced trades as well as university graduates. STEM skills support R&D and vice versa, increasing the absorptive capacity of the economy in the uptake of new technologies. The R&D Tax Incentive supports the development of these skills that are essential to R&D. Wages of highly skilled STEM workers are usually part of eligible expenditure claimed via the programme and provides incentives for such employment. For example companies visited by *Innovation Australia* and using the R&D Tax Incentive had a significant proportion of STEM workers at various

³⁰See Brookings Institution, *The Hidden STEM Economy* 2013, <http://www.brookings.edu/research/interactives/2013/the-hidden-stem-economy>

³¹See PwC Report: *Smart Move*, April 2015, <http://pwc.docalytics.com/v/a-smart-move-pwc-stem-report-april-2015>

³²See: *Science, Technology, Engineering and Mathematics in the National Interest: A Strategic Approach*, July 2013, <http://www.chiefscientist.gov.au>

³³See PwC Report, *Expanding Australia's Economy*, May 2015, <http://www.pwc.com.au/consulting/publications/expanding-australias-economy.htm>

levels. They also tended to have collaborative relationships or were spin-offs from universities or were sponsoring students to undertake research relevant to their organisation at the doctoral level, demonstrating the absorptive capacity of these firms.

In addition to skills, R&D develops a culture of innovation, one that is responsive to new ideas and solutions. This is expected to have significant economic impact, consistent with the government's *Industry Innovation and Competitiveness Agenda*.

4. Other support for Innovation

Question 40 in the Tax Discussion paper raises the issue of other means of support for innovation to encourage investment in innovation and entrepreneurship.

Support for innovation through the tax system must be considered in a broad context of creating an eco-system which links education, research in publicly funded institutions and universities and R&D in industry along with the commercialisation of these outcomes.

Australia has invested heavily in physical asset industries such as the automotive industries in the past. It now needs to invest in the development of technologies that will support the industries of the future.

In addition to developing the infrastructure and skills needed for future industries, support is needed to develop the venture capital industry. Australia significantly lags global competitors on venture capital investment as shown in **Figure 2**, for venture capital (VC) investment by country for 2010:

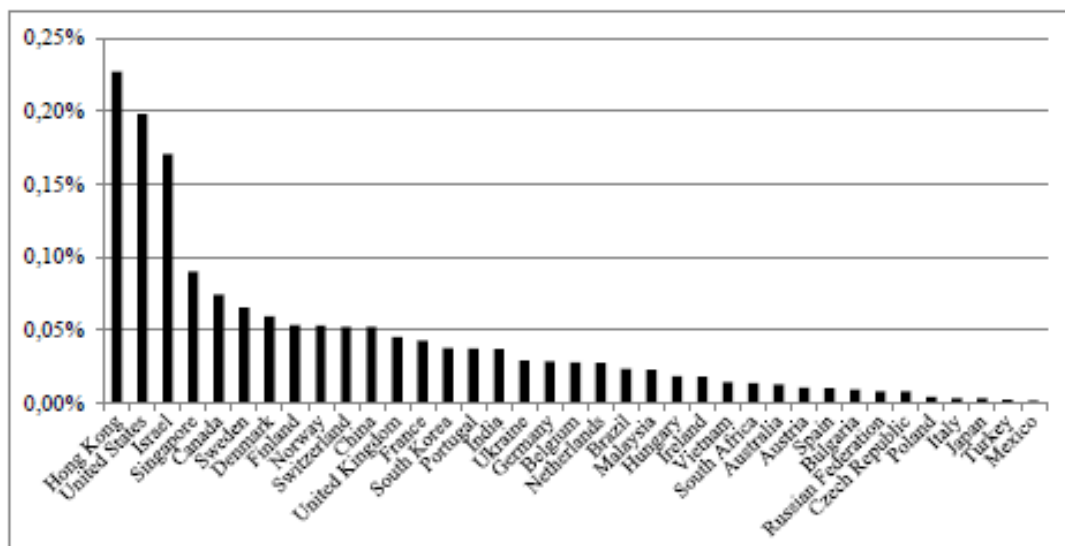


Figure 2: Country Comparison of Investments by Venture Capital Firms, 2010³⁴

³⁴Source: Josh Lerner and Joachim Tag, *Institutions and Venture Capital*, Research Institute of Industrial Economics, IFN Working Paper No. 897, 2012, <http://www.ifn.se/wfiles/wp/wp897.pdf>

According to a StartUpAus, total domestic VC investment in Australia (in companies at all stages, not just start-ups) is currently A\$9.55 per capita per annum, compared to over A\$400 in Singapore, A\$170 in Israel, A\$135 in the United States and A\$30 in South Korea. VC Investment in Australia can be compared with the amount that is bet at the Melbourne Cup on one day in the year, approximately \$9 per capita.³⁵

a. Current tax advantaged venture capital programmes

The Venture Capital Limited Partnership (VCLP) and the Early Stage Venture Capital Limited Partnership (ESVCLP) programmes have both been acknowledged as the "heroes" of the venture capital market.³⁶

Innovation Australia supports the recommendation of the Board of Taxation Review 2011³⁷ that the main design features of the VCLP and ESVCLP should be retained except for the following changes which were agreed by the former Government and announced as part of the 2013 'Venture Australia' initiative but not subsequently enacted:

For VCLPs:

- a. Clarifying the definition of eligible domestic investors that is consistent with the definition for foreign investors and enabling the flow through of favourable tax treatment for superannuation funds and managed investment trusts (MIT);
- b. Enabling MITs to invest in VCLPs and retain their MIT status;
- c. Removing the restriction on investment by foreign venture capital "fund-of-Funds" provided that the fund is widely held.

For ESVCLPs:

- a. Permitting an investee to have flexibility to invest in other complementary ventures;
- b. Providing *Innovation Australia* with discretion to permit the 20 percent foreign investment cap to be exceeded, provided that the investment has material national benefit;
- c. Enabling Australia MITs to invest as a limited partner in ESVCLPs;
- d. Where the limited partner in a ESVCLP is a trust, providing investors in that trust with access the special tax treatment accorded under the ESVCLP regime.

³⁵ See Crossroads 2015, www.StartupAus.org

³⁶ See Australian Financial Review 6 May 2015, Jonathan Barouch, *A budget wish list from tech start-ups*

³⁷ Board of Taxation, *Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime*, June 2011.

Ineligible activities

Providing guidance on ineligible activities and empowering Innovation Australia to provide binding advice in relation to eligible investments.

In addition the scope of investors that can participate in VCLP and ESVCLP should be reviewed to take advantage of emerging sources of investment as described below.

b. Sources of finance for early stage innovations to be implemented

Employee Share Options Scheme

Innovation Australia support's the Government's plans for favourable tax treatment of Employee Share Options Scheme which will support the cash flow of innovative companies by enabling employees to be paid in shares rather than a conventional salary package. This is particularly important in the high risk start-up phase of small companies where the management of cash flow is critically important.

Crowd Sourced Equity Funding

Crowd Sourced Equity funding will also support the supply of much needed capital for early stage and start-up companies. Investors would tend to be individuals who are more likely to support high risk, early stage companies than venture capitalists or financial institutions.

Innovation Australia made a detailed submission to Treasury in February 2015, supporting the proposal for crowd sourced equity and debt funding. This submission is attached for further information (**Attachment 1**).

Significant Investor Visa Programme

Innovation Australia supports the Government's changes to the Significant Investor Visa (SIV) programme that will mandate part of the applicant's investment into venture capital through funds registered as ESVCLPs and VCLPs as this will inject much needed funds into this sector.

Due diligence should also be undertaken for options that would utilise a portion of the funds raised by the SIV Programme as a funding source for a new "Fund-of-Funds" vehicle. This could include the option of such a fund being a co-investment vehicle for initial or follow on investments in early stage companies. The due diligence should also focus on how such a "Fund-of-Funds" vehicle could support the expansion capital needs that may be identified in the strategic plans being developed by the five growth centres.

c. Other suggested proposals for support for innovation

Evolving models of investment in early stage innovative companies

Funding for early stage companies is changing and support through the tax system should recognise and take advantage of these new models. Conventional models of venture capital firms tend to raise funds from institutional investors. New approaches are emerging that complement the traditional model including:

- Corporations that are increasingly involved, such as Westpac's Reinventure Fund, which uses the ESVCLP vehicle, and Lend Lease Ventures;
- High net worth individual angel investors who are generally successful entrepreneurs and are using their experience to build new companies;
- Family offices and individuals with significant investments in their superannuation funds;
- Diverse channels for mobilising and managing capital including incubators and accelerators (that may take equity positions in start-ups in return for facilities and networks); and
- Crowdsourced equity funding.

Tax incentives to encourage investment in early stage innovative companies need to be flexible and open to accommodate the changing models and to support the evolution of new ones. In addition regulatory changes may be required, for example, to enable superannuation funds to invest in early stage companies.

A more detailed paper on the evolution of funding sources for early stage companies is included at **Attachment 2**.

We suggest the following for consideration for favourable tax treatment and which would provide essential support to the development of early stage innovations. Innovation Australia does not have the resources to model the impact of these proposals which have been drawn from discussions with stakeholders and industry.

Co-Investment government and private sector funds

In addition to the VCLP and ESVCLP, other forms of tax advantaged investment schemes could be considered.

The Innovation Investment Fund (IIF) Programme though closed to new applicants is a co-funded model that continues to provide venture capital support through 10-year innovation funds to develop high growth Australian companies by commercialising research outcomes.

The IIF programme contributed \$724 million of capital commitments (\$401 million public and \$323 million private) to the Australian venture capital sector over 16 years and was a significant factor in supporting more than 120 start-ups. Of this, \$530 million has been invested and total returns to date are \$505 million, \$336 million to private investors, due to their preferential treatment in the IIF model and \$169 million to the government.³⁸ The programme provides a model for co-investment by government in early-stage companies and the lessons learned can be used to develop new models for co-investment.

There is a strong case for government co-investment in a venture capital fund and these have been established as a key initiative in many countries. These include the New Zealand Venture Investment Fund (NZVIF), Singapore's Early Stage Venture Fund (ESVF) scheme, Israel's Yozma programme, the US Small Business Administration's US\$1billion Early Stage Innovation Fund under President Obama's Startup America initiative.

The NZVIF was established to support small innovative companies. For independence and continuity, NZVIF was set up to operate as a private investment business, developing and managing products for the early stage and VC investment markets. It operates as a fund-of-fund, governed by a private sector board of directors who have oversight of an investment management team that invests into VC funds. It supported companies like Xero and continues to support high potential companies in New Zealand. NZVIF has \$300 million of funds under management which are invested through two vehicles - the \$260 million Venture Capital Fund-of-Funds and the \$40 million Seed Co-investment Fund. Investments are made either through privately managed venture capital funds, or alongside experienced angel investors.³⁹

Importantly, the NZVIF is flexible enough to accommodate the traditional venture capital funds as well as investments by angel investors as individuals or groups.

The Medical Research Future Fund (MRFF) diverts government funding to R&D in the medical research sector with presumably a plan for commercialisation and spin off of companies with new technologies. Similar funds could be considered for other sectors.

Favourable tax treatment for equity investments in start-up companies by angel investors

There is increasing evidence of a large pool of funds from high net worth individuals and family offices who may invest directly in early stage companies if there is a tax incentive to do so. The tax incentive could be provided in the form of capital gains relief and on operating costs.

Individuals tend to be more likely than institutions to invest in early stage ventures. This was confirmed anecdotally during the recent visits to innovating companies in the Brisbane area.

³⁸Source: Unpublished AusIndustry data, March 2015.

³⁹ See <http://www.nzvif.co.nz>

Incentives for Superannuation Funds to invest in innovation

Superannuation funds are growing in Australia and represent long term patient capital that could be used as a source of early stage capital with appropriate tax incentives.

The favourable tax status of superannuation has attracted much recent attention. In an environment where fiscal consolidation is required this is not surprising. It is appropriate for this review of the tax system to explore options for encouraging greater superannuation investments in early stage and expansion capital as well as other asset classes such as economic and social infrastructure. Such options should include exploring whether any conditionality regarding the future tax treatment of such large institutional investors should be linked to their investments in specific designated asset classes.

The removal of regulatory constraints on types of investments and tax incentives for superannuation funds, especially for those with significant balances, could include incentives to invest in venture capital vehicles, similar to the Significant Investor Visa programme or in early start-up companies. This would also require appropriate balancing of risks with superannuation portfolios but also take account of the long term nature of these investments.

Large industry superannuation funds have already commenced investment in innovation funds. For example, the \$200 million Medical Research Commercialisation Fund (MRCF) involves four superannuation funds: Hostplus, HESTA, Australian Super and Statewide Super that have combined with Brandon Capital to establish the Fund.⁴⁰ In part this outcome has its origins in successful investments in Brandon's IIF Life Sciences Fund.

Innovation Australia understands that following on from this initiative, some Funds have commenced dialogues to invest in high growth firms that are in need of \$5 million - \$10 million of expansion capital for their next phase of growth.

Innovation Australia would also suggest that a leadership dialogue is required to better align the views of Government, firms and investors about investment opportunities in the SME space. Such leadership dialogues in Denmark have resulted in the evolution of joint pension fund-Government fund-of-fund investment vehicles for SMEs and with a clear strategy for developing an eco-system for innovation.⁴¹ Pension funds in Denmark are willing to invest in this fund-of-funds as it now has the economies of scale and VC investment experience necessary for institutional investors including pension funds, insurance companies and sovereign wealth funds to be able to consider VC as an asset class when incorporated into their multi-billion-dollar portfolios.⁴² In the UK, the Merseyside Pension Fund, which

⁴⁰The \$40 million MRCF IIF, LP (a Venture Capital Limited Partnership (VCLP) was established under an Innovation Investment Fund (IIF) license (Round 3) from the Commonwealth of Australia. See: <http://www.brandoncapital.com.au/funds/medical-research-commercialisation-fund>

⁴¹See Christian Motzfeldt, *Vækstfonden – The Danish model for financing funds*, April 2014, Motzfeldt is the CEO of the Danish Growth Fund (Vækstfonden), <http://www.svca.se/wp-content/uploads/2014/04/Christian-Motzfeldt.pdf>

⁴²Gordon Murray and Marc Cowling, *Evaluation of the Danish Growth Fund*, April 2014, <http://www.vf.dk/nyheder-og-analyser/analyser/2014/evaluating-2014.aspx>

provides pensions for local government employees in the Liverpool region, has redirected US\$400 million towards funds that support local regeneration and enterprise development.⁴³

In the UK, *Investing 4 Growth*, a partnership of six local government pension funds, announced was formed in June 2014 for investment that create societal benefits alongside financial returns. West Midlands, Greater Manchester, West Yorkshire, South Yorkshire, Merseyside and East Riding sought to invest in a way that not only met their risk and return needs, but which was also likely to have a “positive and measurable economic impact.”⁴⁴

Tax incentives for incubators

Incubators have been successfully established in several capital cities including Sydney⁴⁵ and Melbourne⁴⁶. These provide essential support in the form of facilities, mentoring and access to venture capitalists in return for equity in the start-up companies. Tax incentives for such incubators will encourage more to be established and provide early stage support for innovative companies. In particular, incubators specialising in certain technology sectors would provide an eco-system and mutual support systems for early stage companies.

Tax relief for protecting intellectual property

The process of applying for patents is expensive and can take several years. As Australian companies are usually small and compete in global markets, protection for their intellectual property is essential. Protection of patents and trademarks is often considered too expensive for companies with limited cash flows, leaving their intellectual property vulnerable to infringement.

An accelerated tax deduction for patent and trademark application costs would support innovative companies.

Tax relief for sales of licensed patented technologies could provide support for innovative companies. However these sales would probably be made once the technology is proven and patents established (this usually takes up to 10 years). Such a proposal would provide support for companies that have established their technologies and international sales rather than for early stage companies.

⁴³ See Principles for Responsible Investment (PRI) Merseyside Pension Fund, http://2xjmlj8428u1a2k5o34l1m71.wpengine.netdna-cdn.com/wp-content/uploads/ESthemedinvestingcasestudy_Merseyside.pdf

⁴⁴ See <http://www.localis.org.uk/article/1704/Local-authority-pension-funds-commit-152m-to-responsible-investment-project.htm> and www.investing4growth.co.uk

⁴⁵ For example, Fishburners, Stone and Chalk, Australian Technology Park.

⁴⁶ Small Technology Cluster (STC)

Capital gains relief on asset disposal attributable to R&D or patents.

Capital gains relief on disposal of technology assets will support the ongoing development of new technologies and support the recycling of capital to other early stage ventures. There is anecdotal evidence that technology developers tend to be serial entrepreneurs and on disposing of a technology are very likely to use their experience and their funds to develop another new idea.

Tax incentives for collaboration between industry and publicly funded research institutions and universities

Our submission has already indicated the need to improve Australia's performance in translating excellent research into commercialised outcomes. It is well understood that Australia performs poorly for industry-research collaboration, ranking last among OECD countries for collaboration between industry and universities/PFROs.⁴⁷ Recent Australian Bureau of Statistics Data⁴⁸ also underlines the fact that industry still looks to industry as a preferred innovation collaboration partner rather than the PFRO sector.

Appropriate incentives could be provided to encourage collaboration between industry and publicly funded research organisations (PFROs) which would yield significant benefits to the economy.⁴⁹ Additional guidance may be needed to support SMEs in particular in using the R&D Tax Incentive when collaborating with PFROs. The five industry growth centres recently established by the government could also provide a vehicle for such collaboration.

There is considerable research on the benefits of collaboration with PFROs, especially for small companies. For example, the Brookings Report on Advanced Industries notes that with in a world of rapidly evolving technology, advanced industry firms should develop new models and strategies for innovation including collaboration with public research institutions, universities, competitors, customers, entrepreneurs and venture capital funds as “no company can know everything it needs to know on its own”.⁵⁰

Open innovation and collaborative models work best on large platform innovations, such as the commercialisation of ultra-lightweight materials in manufacturing or energy storage in advanced batteries. Government can provide appropriate incentives to encourage open collaboration that will accelerate research and commercialisation of new products. In the US, it is recognised that as technological complexity increases, more large firms will need to embrace supplier development models such as Nissan's Supply Chain Initiative with the University of Tennessee Center for Industrial Services.⁴³ Boeing also indicated it uses a

⁴⁷ See OECD Science Technology and Industry Scoreboard, 2013, <http://www.oecd.org/sti/scoreboard.htm>, page 127.

⁴⁸ See: ABS 8158.0, 2014

⁴⁹ See: Innovate and Prosper, Ensuring Australia's Future Competitiveness through University-Industry Collaboration, March 2015, <https://www.atn.edu.au>

⁵⁰ <http://www.brookings.edu/research/reports2/2015/02/03-advanced-industries#/M10420>

supplier chain development model in Australia, creating valuable spill over effects for the industry.⁵¹

Another example of collaborative innovation is the US Department of Energy (DOE) that has five Energy Innovation Hubs that facilitate collaboration between multiple research teams in industry and PFROs to develop transformative energy technologies, for example in the areas of solar energy and batteries and energy storage.⁵²

In the US, President Obama established the Nationwide Network for Manufacturing Innovation (NNMI) to scale up advanced manufacturing technologies and processes. Government investment will be matched by private and state funds to create an initial network of up to 15 institutes, with 45 proposed over the next 10 years. This is a model for co-investment and collaboration between government and industry to create public-private partnerships to solve industry-relevant problems.⁵³

Collaborative partnerships can also be facilitated by ensuring that a proportion of university-funding for research is allocated to projects that involve technology transfer and commercialisation- getting new technologies out of the laboratory and into firms. This would accelerate the rate of commercialisation from universities and other PFROs.

For some time, the cultural change required to increasingly drive collaboration between these two sectors has been discussed in terms of providing incentives or changed performance measures to “kick start” the change process. This has often revolved around measurements to incentivise change to drive PFRO collaboration with industry, rather than two-way incentives. However there is also an opportunity to encourage industry to collaborate with PFROs, using the R&D Tax Incentive. This could be achieved through administrative changes and guidance support for business to be aware of and consider PFROs within the scope of service providers for their innovation pipeline requirements.

It is important that such programmes require participating entities to have agreements on ownership of the intellectual property that is developed. This has been an impediment with some universities and PFROs, although there is anecdotal evidence that more flexible and open approaches have developed.

⁵¹Comments by Maureen Dougherty, President, Boeing Australia and South Pacific, at US Ambassador's Innovation Roundtable, Sydney 28 May 2015.

⁵² See: <http://science.energy.gov/bes/research/doe-energy-innovation-hubs/>

⁵³ See: <http://manufacturing.gov/nnmi.html>

Collaboration between government and industry through procurement

Procurement spending across all Australian governments represents approximately 10 percent of Australia's GDP. Procurement is also a core driver of our economy. In 2011-12, the Commonwealth Government signed over 82,000 contracts, representing a combined value of about \$41.7 billion in expenditure.⁵⁴

In a time of fiscal constraints, public procurement to support innovation by using intelligent purchasing, public agencies can stimulate private sector innovation, generally or in specific sectors, that will eventually sustain competitive advantage in a global economy, *without significant additional cost*. Governments have well-established procedures to ensure probity, manage risk and ensure value for money. However, current procurement policies do not explicitly consider an additional role of government procurement – to foster cost-effective innovation.

Public procurement can also produce secondary benefits, for instance, by helping bring research more quickly to the development of commercially valuable deliverables. Further, public purchases of innovative products are often seen as a positive endorsement of their effectiveness and stimulate further purchases, not just in the private sector but also in other public sectors – for instance, at different levels of government or in offshore markets.

Internationally, public procurement is being used increasingly to stimulate demand-led innovation. For example, the European Parliament updated the EU rules on public procurement by shifting from the “lowest price principle” to new provisions allowing for environmental and social considerations and innovation to be taken into account when public contracts are awarded.⁵⁵ In the US, public procurement has been used strategically to support certain industries or the development of certain technologies, such as the US Farm to Fleet bio-fuels purchasing programme by the Navy.⁵⁶

The US Government Small Business Innovation Research (SBIR) programme is a highly competitive programme that encourages domestic small businesses to engage in Federal Research/Research and Development that has the potential for commercialisation. 11 Federal government agencies use their mandated allocation of 2.8 percent of their budget to R&D to support the SBIR. The collaborative programme enables small business to meet the demands of government departments and thus achieve rapid commercialisation.⁵⁷

⁵⁴ See: Department of Finance (2014), Statistics on Commonwealth Procurement Contracts <http://www.finance.gov.au/procurement/statistics-on-commonwealth-purchasing-contracts/>

⁵⁵ See: http://ec.europa.eu/internal_market/publicprocurement and <https://www.innovation-procurement.org/>

⁵⁶ <http://farmfutures.com/story-usda-navy-expand-farm-fleet-biofuels-program-0-105976>

⁵⁷ <https://www.sbir.gov>

Tax incentives for international collaboration to develop advanced technology

Tax incentives for international collaboration for new technologies, with both public and private entities, could be considered. Such international collaboration could be with for example, accelerated depreciation or capital gains relief for developed technologies may provide an incentive to draw on overseas capital to develop new technologies in Australia.

Tax support for STEM skills training and development

Recognising the importance of STEM skills to new industries and the future economy, tax incentives for companies providing support for research students (such as PhD students) would facilitate collaboration between industry and universities and the rapid commercialisation of new technologies. In Germany, for example, the majority of PhD students work in industry. This results in rapid commercialisation of research efforts. For example a company visited by *Innovation Australia* in Brisbane, funds a PhD student at the University of Queensland and derives tremendous benefit from the scholarship paid as it provides access to the expertise and university facilities at relatively low cost.

The development of research skills in industry and industry awareness of the capabilities of PFROs through collaborative projects that involve industry placements for research projects will develop an effective eco-system and paths to commercialisation.

5. Conclusion

The Australian economy is making a transition from dependence on the mining sectors and export of commodities to a knowledge economy where advanced industries in manufacturing and new technologies will dominate. This challenges need to be addressed with a strategic approach to develop an ecosystem that support innovation. Support for innovation through the tax system is one aspect of the support framework. This support needs to be considered an investment with returns in the form of new jobs, economic growth and increasing prosperity.

Our submission has addressed the benefits of current programmes that support innovation and has suggested others for consideration especially in the context of the government's *Industry, Innovation and Competitiveness Agenda*. We will be pleased to consult with Treasury and respond to further queries if required.

Attachments

1. Innovation Australia, Submission to Treasury on Issues Paper on Crowd Sourced Equity Funding, February 2015.
2. Early Stage Capital for Innovation and Entrepreneurship, Advice from the Non-Executive Members of Commercialisation Australia Board, May 2015.
3. Case Studies on the R&D Tax Incentive available from: <http://www.business.gov.au/grants-and-assistance/innovation-rd/RD-TaxIncentive/Program-Information/Pages/CustomerStories.aspx>.



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Dear Sir

Innovation Australia is pleased to provide the attached submission in response to the discussion paper "Crowd Sourced Equity Funding" prepared by Treasury.

Our submission is generally supportive of the model proposed by the discussion paper and makes comments regarding additional considerations. We have also referenced our submission to the CAMAC review on CSEF in November 2013 and have attached it for your information.

In addition to the issues raised in the discussion paper, we recommend consideration of the peer-to-peer lending and establishing a streamlined regulatory framework for crowd based financing by equity and debt.

The use of internet communication technologies and crowd based funding presents an opportunity to support the development of a new industry with positive implications for employment and economic growth. We recommend that any regulatory model consider the wider strategic implications that are consistent with the Australian Government's *Industry Innovation and Competitiveness Agenda* to create a knowledge economy and to develop financial services.

I would be pleased to meet you to provide further clarification if required.

Yours sincerely

A handwritten signature in cursive script that reads "Marlene Kanga".

Dr Marlene Kanga AM
A/g Chair
6 February 2015

Attachment Innovation Australia's submission to the Treasury's *Crowd Sourced Equity Funding Discussion Paper*

Innovation Australia

Submission to Issues Paper on Crowd Sourced Equity Funding

Innovation Australia has a key role in providing independent advice to the Government on matters relating to innovation in business and industry. Accordingly, this submission is made in response to the discussion paper, “Crowd Sourced Equity Funding” issued by Treasury in December 2014.

Innovation Australia prepared a detailed submission to the review on Crowd Sourced Equity Funding (CSEF) by the Corporations and Markets Advisory Committee (CAMAC) in November 2013. We refer to this submission in our current paper and attach it for further reference.

Crowd Sourced Funding provides a strategic opportunity for Australia, not only to support innovation and innovative companies by providing new sources of capital to start-ups and small business, it is also an opportunity to create a new industry which provides financial services to the world.

The ability to establish a viable crowdfunding industry in Australia will be an important test of our ability to follow our own economic blueprint – to continue to transition our economy to a predominantly knowledge based one - through the progressive digitisation of existing and new products and services. It is also an important new channel that might positively strengthen a key economic pillar of the Australian economy – financial services.

With increasing speed and ease of international communications, location is no longer a factor in determining where successful markets will develop. Australia has many comparative advantages such as robust legal systems, lack of corruption, sound infrastructure and an educated work force. This presents an opportunity to create innovative, transparent, robust and market friendly structures for an environment that provides opportunities for investors and issuers as well as employment and growth in the economy.

Innovation Australia therefore believes that careful regulatory design for crowdsourced funding is important to not only provide a framework for how the industry will operate, but to ensure that the industry is given the best chance possible to establish and flourish in a competitive global financial environment.

While the issues raised by the CSEF discussion paper are sound, we encourage a review of the broader strategic implications of establishing a crowd sourcing platform for both debt and equity which can create further benefits in addition to supporting innovation. The regulatory framework needs be balanced, providing adequate safeguards but without being overly onerous to any area of the value chain. It is important that Australia capture the benefits of the crowd funding model and not lose them to other, more competitive, jurisdictions with “lighter touch” regulatory regimes, including New Zealand.

Principles for Regulatory Framework for Crowd Sourced Funding

In our 2013 submission, *Innovation Australia* proposed the following principles and framework for establishing the regulatory framework for crowd sourced equity funding arrangements in Australia:

A regulatory regime needs to strike an appropriate balance between investor protection and the compliance costs to issuers and intermediaries. We believe that the regulatory settings should seek to facilitate the greater opportunities that crowd sourced equity funding offers for:

- entrepreneurs, start-ups and early stage businesses to access finance;
- investors to make modest investments across a range of investment options ;
- other potential benefits to emerge for businesses and investors, such as market validation;
- economic benefits to be gained in Australia;

and do this while providing protection to issuers, intermediaries and investors.

To achieve the desired outcomes of facilitation and protection, a balanced approach to regulatory policy settings should be designed that:

- facilitates a market with lower transaction costs;
- is proportionate, based on risk and limitation of damage;
- is outcomes-based, not prescriptive;
- ensures transparency and flows of information, in particular to facilitate a market based on reputations.

Consistent with our previous submission, we recommend:

1. Support for the establishment of exempt public company status for CSEF participants consistent with the proposed limitation on size by capital and/or revenue and the time frames for becoming and retaining exempt company status.
 - a. In our assessment, the proposed model in the discussion paper (Option 2) is more appropriate than the New Zealand model in this respect to promote the formation of a market unencumbered by the compliance requirements of public companies.
 - b. This is balanced by the requirement of intermediaries to hold an Australian Financial Services License including membership of an external dispute resolution scheme and insurance requirements.

2. Other risks¹ be addressed by:

- A standard template generic risk warning for investors which is included in the risk disclosure statement signed by participating investors;
- A dedicated website, similar to the New Zealand Financial Markets Authority website with information and risks associated with both crowd sourced equity funding and peer-to-peer lending (see www.fma.govt.nz);

3. Relationships between investors, intermediaries and issuers be managed via the supporting mechanisms recommended by the discussion paper.

However one exception is in relation to the relationship between intermediaries and issuers. Here we support the New Zealand model that provides reasonable arrangements for intermediaries to participate in the take up of an issuer's shares, and to charge fees commensurate with the size of the offering. We are satisfied that the requirement for intermediaries to hold a financial services license provides adequate controls and an appropriate balance of incentive for participation by intermediaries and risk mitigation.

4. Clarity is needed on the structure and responsibility of the proposed regulatory framework. We note the New Zealand model has the Financial Market Authority which is responsible for both CSEF and peer-to-peer lending. Such a streamlined framework with a single responsible authority provides the required safeguards for the market as well as opportunities for dissemination of relevant information.
5. A review of CSEF arrangements is made in two and a half years, with any changes to be implemented after three years. This would enable sufficient time for the market to develop and to address any unforeseen risks and circumstances.
6. Peer-to-peer lending with an appropriate regulatory framework being introduced at the same time as CSEF. There are important strategic reasons for Australia not to fall behind others in establishing the regulatory regime to facilitate access to both debt and equity for start-ups, entrepreneurs and SMEs.

In our assessment, the New Zealand peer to peer model for debt issuance is relevant and provides a useful guide to Australian authorities for a regulatory framework. The emphasis here is on “light versus heavy handed” regulation with standardised risk disclosure arrangements. Limits on the size of participation similar to those in CSEF are included. The emphasis is on regulating the intermediaries through licensing

¹The Australian Securities and Exchange Commission (ASIC) and others have flagged such concerns in their submissions to the Murray Financial Systems Inquiry.

arrangements and borrowers through their compliance with the Financial Markets Conduct Act.

Conclusion

Innovation Australia believes that the approach we have suggested accomplishes the objectives of promoting and supporting innovation to enhance innovation and competitiveness in Australia.

As we have stated in our 2013 submission to the CAMAC review, CSEF not only offers potential to broaden access to capital, it will also provide an opportunity for some market validation of the product at an early stage. This latter aspect may assist in attracting investors in a second fund raising round.

Furthermore, this approach supports transparency and a level playing field by ensuring that all investors have access to the same information in a single location. It is also the model which best enables the collective wisdom of the crowd to be mobilised by facilitating online communication between investors about issuers, intermediaries and other players, which is critical given the division of labour in the due diligence process.

Subject to regulatory safeguards, it should be left to the market to decide who invests and where. The principal protection to investors will be caps on the amount that may be invested in any year by an individual.

Innovation Australia also encourages a consideration of the strategic implications of establishing a successful crowd sourcing platform for both debt and equity in Australia and the implications of creating a new financial service as an opportunity for the Australian economy.

We will be pleased to discuss our submission and provide further information if required.

Attachment 1: Detailed Responses to Questions in CSEF Discussion Paper

Attachment 2: *Innovation Australia* Submission to CAMAC Review on Crowd Sourced Equity Funding, November 2013.

Attachment 1**Detailed Responses to Questions in CSEF Discussion Paper**

Innovation Australia provides responses to the questions raised in the CSEF Discussion paper below. Detailed responses were previously provided in our 2013 submission to the CAMAC review to questions raised in that paper. Our responses below reference some of these previous responses as relevant. The full submission is included as an Attachment.

1. Is the main barrier to the use of CSEF in Australia a lack of a CSEF regulatory structure, or are there other barriers, such as a lack of sustainable investor demand?

As stated in our submission to CAMAC in November 2013, *Innovation Australia* believes that the market will determine the extent to which crowd sourced equity funding is used in Australia. It will depend on the risk appetite of investors to purchase shares in a diverse range of companies, an online platform as well as the track record established by issuers of shares and the intermediaries who select companies that eventually deliver returns to the investor.

2. Do the existing mechanisms of the managed investment scheme regime and the small scale personal offer exemption sufficiently facilitate online offers of equity in small companies?

As stated in our submission to CAMAC in November 2013, a regulatory framework specific to crowd sourced equity funding should be established to enable the full potential of the crowd to be harnessed. Please also see our detailed responses to Q 1, 2 and 3 in our November 2013 submission which addresses this issue.

3. Other than the restrictions identified above in relation to limitations on proprietary companies, public company compliance requirements and disclosure, are there any other barriers to the use of CSEF in Australia?

Our response to Question 10 in our submission to CAMAC in November 2013 discussed a number of additional matters including the need to ensure that the tax system does not pose barriers or operate as a disincentive to participation in CSEF.

4. Should any CSEF regime focus on the financing needs of small businesses and start-ups only, or is there a broader fundraising role?

Our submission to CAMAC in November 2013 addressed the issue of debt funding which now also has emerging platforms for crowd sourced debt and peer to peer lending.

We also note that crowd sourced funding for social enterprises and not-for profit organisations is also emerging. We have not addressed the regulatory and other safeguards that would apply to such funding.

5. *Do you consider that, compared to existing public company compliance costs, the exempt public company structure is necessary to facilitate CSEF in Australia?*

We support the exempt public company structure as stated in our response to Q1, 2, 3 and 9 in our submission to CAMAC in November 2013.

6. *To what extent would the requirement for CSEF issuers to be a public company, including an exempt public company, and the associated compliance costs limit the attractiveness of CSEF for small businesses and start-ups?*

The proposal for an exempt public company with reduced disclosure requirements for a limited time will assist small and innovative companies in their early years, and will make CSEF more attractive to these issuers.

7. *Compared to the status quo, are there risks that companies will use the exempt public company structure for regulatory arbitrage, and do these risks outweigh the benefits of the structure in facilitating CSEF?*

We have no information to assess the extent to which this might occur. However, the limitations of size of company and time frames for this structure to exist are likely to preclude the extent to which this structure would be misused.

8. *Do you consider that the proposed caps and thresholds related to issuers are set at an appropriate level? Should any of the caps be aligned to be consistent with each other, and if so, which ones and at what level?*

Our response to Q4 (iii) and (iv) and Q8 in our submission to CAMAC in November 2013 proposed investor caps which are consistent with the proposals in Option 2.

9. *Do CAMAC's recommendations in relation to intermediary remuneration and investing in issuers present a significant barrier to intermediaries entering the CSEF market, or to companies seeking to raise relatively small amounts of funds using CSEF?*

Our response to Q5 in our submission to CAMAC in November 2013 addressed a number of issues relating to intermediaries which are generally consistent with the proposals in Option 2.

10. Do the proposed investor caps adequately balance protecting investors and limiting investor choice, including maintaining investor confidence in CSEF and therefore its sustainability as a fundraising model?

Please see our response to Q4 (iii) and (iv) and Q8 in our submission to CAMAC in November 2013 which addresses investor caps. These are generally consistent with Option 2.

11. Are there any other elements of CAMAC's proposed model that result in an imbalance between facilitating the use of CSEF by issuers and maintaining an appropriate level of investor protection, or any other elements that should be included?

Please see our response to Q4 in our submission to CAMAC in November 2013 which makes comment on additional controls to protect investors.

12. Do you consider it is important that the Australian and New Zealand CSEF models are aligned? If so, is it necessary for this to be achieved through the implementation of similar CSEF frameworks, or would it be more appropriate for CSEF to be considered under the Trans-Tasman mutual recognition framework?

Innovation Australia does not consider that an alignment with the New Zealand model is necessary as geographic boundaries are not relevant in an on-line environment. Moreover, Australia should establish a regulatory framework that is attractive to Australian and international players in an increasingly globalised on-line market.

13. Do you consider that voluntary investor caps and requiring increased disclosure where investors contribute larger amounts of funds appropriately balances investor protection against investor choice and flexibility for issuers?

Please see our response to Q4 in our submission to CAMAC in November 2013 which makes comment on additional controls to protect investors.

14. What level of direction should there be on the amount of disclosure required for different voluntary investor caps?

Please see our response to Q4 in our submission to CAMAC in November 2013 which makes comment on additional controls to protect investors.

15. How likely is it that the obstacles to CSEF that exist under the status quo would drive potential issuers, intermediaries and investors to move to jurisdictions that have implemented CSEF regimes?

There is a demand for financing for small innovative companies which is unmet by current provides in the Australian market. The increase ease of obtaining financing in an on-line environment is likely to encourage Australian companies to seek funds elsewhere if the status quo is maintained.

16. What are the costs and benefits of each of the three options discussed in this consultation paper?

Innovation Australia does not have the resources to estimate the costs and benefits of the three options. However it should be noted that there are non-financial costs including market sentiment that may determine the success of CSEF in Australia.

17. Are the estimated compliance costs for the CAMAC and New Zealand models presented in the appendix accurate?

See our response to Q16 above.

18. How many issuers, intermediaries and investors would be the expected take up online equity fundraising in Australia under the status quo, the CAMAC model and the New Zealand model?

Innovation Australia does not have the data to provide any estimates.

19. Are there particular elements of the New Zealand model that should be incorporated into the CAMAC model, or vice versa?

Innovation Australia believes that the model should be suited to the Australian environment to facilitate CSEF and address the market failure to raise funding, especially for small innovative companies. We support a “light-touch” regulatory framework with a single regulatory authority for equity and debt funding.

20. Are there particular elements of models implemented in other jurisdictions that would be desirable to incorporate into any final CSEF framework?

Please see our response to Q4 in our submission to CAMAC in November 2013 which makes comment on the frameworks established in the US, UK and Canada (Ontario).

21. Do the issues outlined in this consultation paper also apply to crowd-sourced debt funding? Is there value in extending a CSEF regime to debt products?

Innovation Australia agrees that any frameworks that are established should also include peer to peer lending.

22. To what extent would the frameworks for equity proposed in this discussion paper be consistent with debt products?

Our submission to CAMAC in November 2013 provided extensive comment on investors, intermediaries and issuers and the types of controls and disclosure requirements that would support crowd funding. With changes appropriate for debt raising, a similar framework could be established.

We also recommend a streamlined regulatory framework with a single regulatory authority responsible for both CSEF and peer-to-peer lending, as established in New Zealand via the Financial Markets Authority (FMA). The authority also has provides good information for issuers, intermediaries and investors via its website (see www.fma.govt.nz). The website provides information for market participants, including compliance requirements, lists of registered providers of services and information on regulatory and enforcement actions. Such an authority could also provide reports on periodic reviews of the performance of the market for crowd based financing.

23. Would any of the options discussed in this paper, or any other issues, impede the development of a secondary market for CSEF securities?

We continue to hold the view, in accordance with our response to Q4 (vii) in our submission to CAMAC in November 2013, which recommended a ban on a secondary market for CSEF securities.

Innovation Australia

Submission to the Review of Crowd Sourced Equity Funding being undertaken by the Corporations and Markets Advisory Committee

Declaration of Interest

Innovation Australia is an independent statutory body established under the Industry and Research Development Act 1986. The mission of Innovation Australia is to increase the economic return from successful technology-based enterprises in Australia by guiding the Australian Government's investment in the commercialisation of the nation's research and development and innovation.

Introduction

Driving innovation is critical to maintaining and improving Australia's competitiveness. Access to finance is the principal barrier faced by innovative technology based companies in the early stages of their business development. It also represents a significant challenge to a broader range of small and medium sized businesses. Crowd sourced equity funding has the potential to provide access to wider sources of finance for these Australian businesses. We therefore believe it is important that regulatory measures are established to enable crowd sourced equity funding in Australia. We note that a number of countries are introducing regulation or examining options in advance of doing so and it is important that Australian technology startups and other businesses are not placed at a disadvantage to their international counterparts.

We consider that a statutory and compliance structure specific to crowd sourced equity funding should be established to allow share transactions across an online platform, as this will enable the full potential of the crowd to be harnessed. A regulatory regime needs to strike an appropriate balance between investor protection and the compliance costs to issuers and intermediaries.

We believe that the regulatory settings should seek to:

- facilitate the greater opportunities that crowd sourced equity funding offers for:
 - entrepreneurs, startups and early stage businesses to access finance;
 - investors to make modest investments across a range of investment options ;
 - other potential benefits to emerge for businesses and investors, such as market validation;
 - economic benefits to be gained in Australia;

and

- provide protection to issuers, intermediaries and investors.

The current regulation of investment is based on mandatory disclosure, which feeds into a due diligence model. In practice, many investors do not carry out the due diligence themselves, but rely on the services and reputations of other parties, such as financial advisers or market analysts and commentators; that is, there is a division of labour on due diligence. When designing the regulation of crowd sourced equity funding there is an opportunity to recognise that disclosure of information, on its own, is not sufficient for the market to operate efficiently. What is also needed is the division of labour on due diligence. This cannot exist without information being available in the marketplace to establish the reputations of those that turn the detailed information for due diligence into a form that many investors prefer to access. (See Box 1 for further discussion).

To achieve the desired outcomes of facilitation and protection, a balanced approach to regulatory policy settings should be designed that:

- facilitates a market with lower transaction costs;
- is proportionate, based on risk and limitation of damage;
- is outcomes-based, not prescriptive;
- ensures transparency and flows of information, in particular to facilitate a market based on reputations.

We believe that the extent to which crowd sourced equity funding is mobilised in Australia will be determined by the market and will depend, ultimately, on the appetite of investors to transact the purchase of shares in a diverse range of companies across an online platform. For technology startups, this appetite will be influenced by the track record that platform providers are able to establish for selecting companies which deliver returns and innovative new products and services.

Box 1 The significance of reputation

In highly complex fields, citizens often cannot or do not want to do “due diligence” on all their decisions. Here they typically make decisions by relying on reputations. Indeed economist John Kay argues that reputation is the “normal market mechanism for dealing with asymmetric information.” ...

In many ways reputation can be understood as a particularly important aspect of the division of labour. As the world becomes more complex and as our expertise grows, markets for information become richer – more intermediated. As our expertise grows new areas of specialism grow. The individual actor in the economy cannot realistically exercise “due diligence” in all their choices. Instead they require access to expertise which is mediated. Once the need for expertise is identified, the question that then arises is how one should choose an expert.

Most professional services are heavily regulated often at substantial cost with little clear benefit. And yet very little if any of that regulation is directed towards improving the quality of the information on which reputations for expertise are based.

Those seeking to maximise transparency should also consider the architecture of the information ecology. For there are many things that can be done to create a situation where information that would be useful comes into existence and is disseminated to those who can benefit from it – and those who can discipline others to perform better with their buying and other choices. Thus for instance if investment advisors and/or share brokers kept independently auditable ‘sample portfolios’, we could, over a period of time, measure their performance. (Extracts from *The Ecology of Information and the Significance of Reputation*, Dr Nicholas Gruen).

Suitability of crowd sourced equity to finance technology startups

There are challenges to be addressed in applying the crowd funding model to equity investing. The success and recent proliferation of other types of crowd funding, for example the donation, reward and loan based variants, may not translate into a similar enthusiasm for crowd sourced equity investing. Some of the reasons for this include:

- the complex nature of equity investing;
- the challenges that widened share ownership will bring to small, hitherto closely owned enterprises in relation to management and compliance issues (including the cost to the issuer of dealing with the intermediary, of maintaining a share register and obtaining shareholder agreements);
- the impact on subsequent capital raising and the eventual sale of the company.
- increased exposure to intellectual property theft following the disclosure of information to a wide audience on the internet; premature exposure to competition and to copycat activities.

Where the business activities of a company involve significant research development and testing, are capital intensive and require a long runway to market, the founders need informed shareholders who comprehend fully the risks of early stage investing and the time to realisation of the investment. Existing business owners will need to weigh these considerations against the need for capital and the market validation that a successful crowd fundraising may offer.

Frequently, the individual who contributes money to a crowd funded project does so to support a cause to which some attraction is felt. This is termed “donation funding” in the Discussion Paper and is arguably the variant of crowd funding where the interest and imagination of large numbers of people is most likely to be captured to deliver the large numbers of small monetary contributions on which the concept of crowd funding rests. The use of crowd funding to attract donations to fund university research projects is an interesting development which is gathering pace in the United States. The collaboration between Deakin University and the crowd funding platform provider Pozible is an example in Australia.

If crowd sourced equity investing attracts sufficient interest, the benefit to the company seeking finance will be access to a significantly larger pool of investors. This would translate into large numbers of small shareholders (as noted in the Discussion Paper, this would require legislative change as the number of shareholders a private company may have is currently limited to 50). This would present issues for a technology startup which may need to raise larger amounts of capital in a later funding round. These matters will need to be addressed through some form of nominee and pooling or other arrangements, including possibly a variation of the class rights attaching to crowd equity investors.

For these reasons, while online crowd sourced funding platforms offer opportunities for linking angel and high net worth investors with technology start-up companies, and for building on existing networks and developing new ones, some have argued that crowd funding is less likely to open up early stage investing to large numbers of small investors. The counter argument is that issues which

are presented as potential obstacles ought not to be insurmountable. The ingenuity of financial markets would tend to support the latter view.

Crowd sourced equity funding for SMEs

In the case of the more typical small closely held business (i.e. not technology startups), the owner will be unlikely to want to offer equity to external investors that would have the effect of diluting the ownership of the company. A more attractive option would be loan finance via an online crowd funding platform, subject to having a sufficient revenue stream from which to make interest payments. More widely held ownership is likely to be of less concern where the venture is a new community focussed cooperative to address a geographically local need and where the likelihood of raising finance through other means is remote.

Conclusion

Despite the uncertainties that arise and the attendant challenges in adapting crowd sourced funding to raise equity capital for companies, the difficulty that small companies face in accessing finance from traditional sources suggests that governments will want to look carefully at the potential of crowd funding to open up new sources of capital, facilitated through an appropriate regulatory regime. This would allow the market to decide how, and the extent to which, the concept should be developed and applied in practice within the boundaries of that regulatory regime.

Responses to questions posed in the Discussion Paper

Question 1 *In principle, should any provision be made in the corporations legislation to accommodate or facilitate CSEF. If so, why, if not, why?*

Response

Yes, provision should be made in the corporations legislation to accommodate or facilitate CSEF. CSEF has potential to improve access to finance for some early stage knowledge rich companies and for a broader range of SMEs. The full extent of this potential will become clearer over time as the market develops and responds to the new opportunities of an enabling regulatory framework. Other countries are taking steps to introduce enabling regulatory regimes and it is desirable that, in Australia, we should examine the options for a workable facilitative framework. The question should be viewed in the broader context of the need to ensure the existence of a competitive business environment for entrepreneurs seeking to establish and build innovative new companies. Seen through this prism, CSEF is a piece of the jigsaw. The popularity and recent rapid growth of existing online crowd sourced funding platforms would not have been predicted by many. It would be wrong to assume that the equity based model will not generate interest and establish a presence. As noted in our introductory remarks, the market should ultimately determine how, and the extent to which, CSEF should be developed and applied in practice, within the boundaries of an enabling regulatory regime.

Question 2 *Should any such provision:*

- (i) *take the form of some variation of the small scale offering exemption and/or*
- (ii) *confine CSEF to sophisticated, experienced and professional investors? If so, what, if any, change should be made to the test of a sophisticated investor in this context, or*
- (iii) *adopt some other approach (such as discussed in Section 7.3, below).*

Response

Investment in early stage companies tends to revolve around trusted networks of investors, professional advisers, experienced executives and entrepreneurs. These relationships are built up over time. From this perspective, it may be argued that a variation of the small scale offering exemption (see Discussion Paper, page 19) coupled with a limitation to sophisticated investors (albeit possibly with some expansion of the existing definition) would adequately serve the early stage company sector. Nevertheless, for the reasons noted in response to Question 1 and also the fact that CSEF has the capacity to serve a much broader range of enterprises than the technology start up alone, we consider that it is appropriate that a self-contained statutory and compliance structure for CSEF, open to all investors be established (that is, Option 5 identified in the Discussion Paper). This regime should require that an offer for securities is conducted through a sole intermediary, operating online only, consistent with the proposed crowd funding rules published by the US SEC and as noted in the discussion paper (first update version). This model is appropriate to harness the full potential of the crowd. Variations to the small scale offering exemption and/or confining CSEF to sophisticated investors will not enable CSEF in the true sense but will deliver crowd funding without the crowd. They will not capture the enthusiasm and the scale that the crowd has to offer and that have been demonstrated in the high growth in non-equity crowd funding activity over the past two years. CSEF not only offers potential to broaden access to capital, it will also provide an opportunity for some market validation of the product at an early stage. This latter aspect may assist in attracting investors in a second fund raising round.

Furthermore, this approach supports transparency and a level playing field by ensuring that all investors have access to the same information in a single location. It is also the model which best enables the collective wisdom of the crowd to be mobilised by facilitating online communication between investors. By enabling the sharing of knowledge and information among investors, this helps to disseminate information that will form reputations about issuers, intermediaries and other actors, which is critical given the division of labour in the due diligence process.

Subject to due regulatory safeguards, it should be left to the market to decide who invests and where. The principal protection to investors will be caps on the amount that may be invested in any year according to an individual's net income.

Question 3 *In the CSEF context, what changes, if any, should be made, and for what reasons, to the regulation of:*

- (i) *proprietary companies*
- (ii) *public companies*

(iii) managed investment schemes. *In considering (iii), should the disclosure obligations of issuers to investors differ, in principle, if investors are investing directly (as equity holders in the issuer) or indirectly (through acquiring an interest in a managed investment scheme) and if so, how and why?*

Response

(i) The shareholder cap should be raised to enable large numbers of investors to contribute relatively small amounts of money. If this change is not made, while companies will be able to choose from a larger pool of investors, they will not be able to aggregate significant amounts of capital by raising small contributions from many investors (the current cap for a small proprietary company being 50 non-employee shareholders).

(ii) The need to facilitate access to CSEF by unlisted public companies is less apparent and of a lower order priority, albeit that these companies do not have the same options for raising capital as a listed public company. Nevertheless, a decision has been made to become an unlisted public company in the knowledge of the attendant regulatory and compliance obligations and this itself could be indicative of a degree of confidence in the ability of the company to raise capital as an unlisted public company through existing means. A regulatory regime for CSEF should not preclude public unlisted companies from participating.

(iii) Managed investment schemes involving pooled investment through a trust framework are not well-suited as a vehicle for crowd sourced equity investing. Investments are held on trust for the scheme members by the responsible entity and this divorces the retail investor from the investee company. An important feature of, in particular, the donor-based crowd funding model, is the connection or affiliation the individual contributor has towards the funded project. It would not be desirable to introduce a regime which might remove or weaken this connection. This said, a regime might allow access by managed investment schemes to online CSEF platforms as an additional feature. This would enable people who preferred to invest through a managed scheme to do so.

Question 4 *What provision, if any, should be made for each of the following matters as they concern CSEF issuers:*

(i) **types of issuer:** should there be restrictions on the classes of issuers permitted to employ CSEF (for instance, investment companies are excluded from the CSEF provisions of the US JOBS Act. In Italy, CSEF is confined to designated ‘innovative start-ups’)

(ii) **types of permitted securities:** what classes of securities of the issuer should be able to be offered through CSEF

(iii) **maximum funds that an issuer may raise:** should there be a ceiling, and if so what, on the funds that can be raised by each issuer in a particular period through CSEF. Should that ceiling include any funds raised under the small scale personal offers exemption

(iv) **disclosure by the issuer to investors:** what disclosures should issuers have to provide to investors

(v) **controls on advertising by the issuer:** what controls, if any, should there be on advertising by an issuer

- (vi) **liability of issuers:** in what circumstances should the directors or controllers of the issuer have liability in relation to CSEF. What defences to liability should apply
- (vii) **ban on a secondary market:** should CSEF be limited to new issues, excluding on-selling of existing securities
- (viii) **any other matter?**

Response to Question 4

(i) **types of issuer:** We would urge against confining CSEF to a particular class of company, as in Italy where access is limited to “innovative start-ups”. Apart from issues of definition which arise with the adoption of generic descriptions when it is sought to set parameters for eligibility, it is desirable that Australian companies should have access to the broadest range of sources of capital and markets. Investment fund companies should be excluded as under the US JOBS Act 2012 and as proposed for the Canadian regime. The regime should be limited to Australian incorporated issuers. If CSEF is facilitated through regulation in Australia, this will be done to improve access to finance for Australian SMEs principally. It would be difficult and costly to perform due diligence on foreign companies and similarly to enforce local regulatory provisions.

We also note the US SEC has proposed that companies without a specific business plan or a plan which is simply to engage in a merger or acquisition with an unidentified entity should be excluded. The basis for this is to ensure that investors are provided adequate information to make an informed decision. We would support a similar exclusion in an Australian regime for like reason.

(ii) **types of permitted securities:** ordinary shares; non-convertible preference shares; non-convertible debt securities that are linked only to a fixed or variable interest rate; and, shares that are convertible into ordinary shares or non-convertible preference shares. This is consistent with the Canadian proposal and recognises that the exemption is intended to facilitate capital raising by small and medium sized companies and that, accordingly, complex products need not and ought not to be accommodated under this exemption. Furthermore, such products are less likely to be well understood by the majority of retail investors and therefore the associated investment risks not properly appreciated.

(iii) **maximum funds that an issuer may raise:** a limit of no more than \$1.5 million in a 12 month period would constitute an appropriate ceiling, in line with the current Canadian proposal. It will be consistent with the capital requirements of many start-ups and pitched at a level which is able to help to bridge the gap between founders and angel finance and formal venture capital. It will also be suitable to meet the capital requirements of a broader range of small businesses which may wish to raise capital via a crowd funding platform.

The ceiling could exclude funds raised under the small scale personal offers exemption given the conditions which apply, including the limitation to 20 investors.

(iv) **disclosure by the issuer to investors:** there is a premium to be gained from low transaction costs for issues of securities. In all cases when designing regulation of financial markets, there is a balance to be struck between, on the one hand, the need to provide reliable and useful information to the investor and, on the other hand, the costs the issuer has to bear in providing the information to

meet the relevant disclosure requirements. The use of investor and issuer financial caps and the facilitation of information sharing over online communication channels are important features of CSEF which ought to enable regulation with less costly compliance burdens on the issuer.

The stepped approaches provided under the US JOBS Act and in the Canadian proposal are an attempt to strike this balance. Of these two, we believe the approach taken in the US legislation is to be preferred. The issuer must provide financial statements, certified by an officer of the issuer if the specified target offering amount is \$100,000 or less, reviewed by an accountant if that amount is up to \$500,000 and audited if that amount is over \$500,000. Noting that many investors will not undertake due diligence themselves, information available to the investor (and actors that the investor relies on, by reputation, to interpret the information) should include the principal risks facing the issuer as well as recent financial statements. Information should also be provided about the key personnel of the issuer, including recent experience. We note, for example, that the US SEC is proposing to require disclosure of the business experience of directors and officers of the issuer during the last three years.

We also strongly urge consideration of the establishment of a lower tier of investment which would be accompanied by only very limited issuer disclosure requirements. This tier might be capped at, say, a maximum investment of \$250 and would facilitate investment in social enterprise, while not being confined to that sector. Similarly, this tier would enjoy exemption from the income or net wealth qualifications applying to individuals making larger investments.

Ongoing disclosure should include provision of annual statements. The issuer should also maintain books and records which contain: information on shares and securities issued by the issuer, the price and date; the names of all holders of shares and securities and the size of their holdings; and, the use of funds raised.

We do not comment further on the disclosure to be provided by the issuer save to observe that, in the context of early stage investing there are certain key matters about which it is important for investors to have information and these matters should guide the information that issuers provide. Not all of these matters need to be the subject of obligatory disclosure but there is unlikely to be any harm in requiring disclosure, or establishing a system that rewards disclosure (through information that forms good and bad reputations - see earlier discussion). They include:

- explanation of the product, process or service and basic description of any technology it is dependent on for its functionality
- what is the edge or competitive advantage over what is currently available in the market that will make it successful
- what are the principal risks the company faces including any risks associated with the technology
- any estimates prepared of size of market
- milestones and path to market
- what the capital raised will be used for
- key personnel (directors and senior executive management) and the roles of, including the continued involvement of the inventor of any relevant technology

- how any intellectual property is protected and whether the issuer is aware of any disputes concerning it or challenges to the validity of any associated patents or other forms of intellectual property protection
- anti-dilution, “tag along” and “drag along” rights

(v) **controls on advertising by the issuer:** we support the controls provided under the US JOBS Act. In particular, we consider it important that the intermediary’s online platform is the sole location for access to information about the offer. This will assist with overall regulation and the provision of a level playing field for all investors.

(vi) **liability of issuers:** we comment that investor protection and confidence demands that issuers should be liable for statements they make which they know or ought to have known were false or misleading.

(vii) **ban on a secondary market:** CSEF should be limited to new issues, excluding on-selling of existing securities. The primary purpose of enabling CSEF should be to improve access to capital for small companies, that is, via new issues.

(viii) **any other matter?** No other comments are made.

Question 5 *In the CSEF context, what changes, if any, should be made, and for what reasons, to the current licensing requirements applicable to intermediaries?*

Response

We comment in broad terms that the licensing requirements need to reflect the role of the operator of an online CSEF platform. The principal role should be to host investment opportunities in an efficient and transparent manner for the benefit of issuer and investor. Some platform providers may offer additional services such as access to mentors and other advisers. However, we suggest that they should not hold investors’ funds. This allows for less stringent licensing arrangements while not compromising investor protection, but being sufficient to ensure the integrity of the CSEF regime.

Pending fundraising targets being met, investors’ funds should be held by an external agent appropriately licensed for such purpose. We note the proposed US SEC rules require transmission of funds by the investor directly to an account with a qualified third party bank. Platform providers should also not provide financial or investment advice. A licensing regime should recognise this limited role but nevertheless require a platform provider to demonstrate that it has adequate capital, human and technological resources to perform its function. This should enable overly burdensome regulatory arrangements to be avoided.

Question 6 *What provision, if any, should be made for each of the following matters as they concern CSEF intermediaries:*

(i) *permitted types of intermediary* (also relevant to Question 5):

(a) *should CSEF intermediaries be required to be registered/licensed in some manner*

Response

Our comments below are to be read with our response to Question 5. We believe there should be a licensing regime. An appropriate approach would be to require for platform operators (intermediaries) to register with the Australian Securities and Investments Commission to enable a central register of platform operators to be maintained and to address investor protection issues including integrity, proficiency and solvency requirements. The degree of regulation will depend on whether intermediaries will be permitted to hold investors' funds or securities, as to which, we have expressed the view that they ought not to be (see Response to Question 5). The discussion paper suggests some alternative approaches for handling investors' funds at paragraph 2.2.3.

(b) *what financial, human, technology and risk management capabilities should an intermediary have for carrying out its role*

Response

We do not comment in detail but would note that in all cases there will need to be a sufficient minimum level of human, technology and risk management capabilities to ensure that investors are able to have confidence in the CSEF market. At the same time it is desirable to avoid over regulation of intermediaries as this may impede unnecessarily the development of the market. Platform providers should be required to carry standardised warnings about the risks of equity investing and the especially high risks associated with investing in technology start-ups.

The need for an intermediary to build reputation in the CSEF market is likely to mean that those specialising in hosting early stage technology companies will carry out significant due diligence before agreeing to host a company on their platform. In such a case the operator's human resources will need to include individuals with experience in early stage investing and the operator will build its brand and reputation around the quality of the investment opportunities it hosts. Other operators will run less highly curated platforms. There may be opportunities for intermediaries to make use of others with expertise for example, business incubators could be involved in the due diligence vetting process. Online channels of communication between investors will be an important feature to facilitate information sharing and to build the reputation of participants in the CSEF market.

There will also need to be secure online payments systems and systems to guard against fraud and money laundering.

- (c) *what fair, orderly and transparent processes must the intermediary be required to have for its online platform*

Response

Issues of process should be addressed by regulation to ensure a measure of standardisation which will support market integrity and investor confidence. Basic information about the offer, the issuer and the intermediary should be provided.

- (d) *should an intermediary be required to have an internal dispute resolution and be a member of an external dispute body, such as the Financial Services Ombudsman*

Response

We consider these two requirements to be appropriate.

- (ii) *intermediary matters related to issuers:* these matters include:

- (a) *what, if any, projects and/or issuers should intermediaries not permit to raise funds through CSEF*

Response

No view is expressed. Our interest in CSEF lies principally in the potential it may have to improve access to finance for innovative early stage Australian companies.

- (b) *what preliminary/ongoing due diligence checks should intermediaries be required to conduct on issuers and their management*

Response

To build and protect their reputation, intermediaries will seek to undertake basic enquiries about companies and key personnel. These might include: searches to establish the identity of a company including registered office, to check that financial accounts have been filed up to date, to ascertain the existence of any charges on the company's business and assets and pending legal actions and judgments; searches against directors, officers and significant shareholders to establish, among other matters, background and the absence of bankruptcy and director disqualification orders. It will be important for investors to be able to access a verification of the identity of the issuer, and also information about the issuer to inform their decision about the investment. A due diligence vetting process for issuers would enable this. However, it is not essential that it be the intermediary that undertakes the due diligence. Other actors could provide this service, as long as the information is made available to potential investors at the time they are considering the investment, that is, on the online crowd sourcing platform. The regulatory settings should be designed to create a systems where the results of due diligence are communicated to the investors, but with the flexibility to allow the market to establish the means for delivering this outcome.

(c) what preliminary/ongoing due diligence checks should intermediaries be required to conduct on the business conducted by issuers

Response

We believe that enquiries about the business conducted by the issuers are principally matters between the issuer and the investor. We have commented on the type of information that an investor might wish to obtain and consider before making a decision to proceed with an investment (Response to Question 4 (iv)).

(d) to what extent should intermediaries be held liable for investor losses resulting from misleading statements from issuers made on their websites

Response

Provided that the intermediary has exercised reasonable care to verify the accuracy of matters that it is required by regulation to verify (to be decided but these would be matters capable of ascertainment and verification by routine enquiry), and provided that the intermediary does not have knowledge or reason to suspect that statements made by the issuer are not true, liability for misleading statements made by the issuer should rest with the issuer as maker of the statement. The intermediary should not be held liable. For the situation to be otherwise would risk placing undue burden on the intermediary and operate as a disincentive to the establishment of a CSEF market in Australia. Intermediaries should post notice on their website where material statements made by issuers have not been able to be verified by the intermediary (or agents instructed on the intermediaries' behalf) and that investors should make their own enquiries prior to subscribing for shares. Intermediaries should not be permitted to recommend or endorse particular investment opportunities.

(e) to what extent should intermediaries be held liable for investor losses resulting from their websites being used to defraud investors

Response

Provided that the intermediary has exercised reasonable care to verify the accuracy of matters that it is required by regulation to verify (to be decided), liability for investor losses should rest with the issuer and the investor should pursue legal remedy against the issuer.

(f) what possible conflict of interest/self-dealing situations may arise between issuers and intermediaries (including intermediaries having a financial interest in an issuer or being remunerated according to the amount of funds raised for issuers through their funding portal), and how these situations might best be dealt with

Response

Where any element of the intermediary's remuneration is linked to the amount of funds raised, the intermediary should be under an obligation to disclose this fact to investors. The intermediary and its officers should be prohibited from having any financial interest in the issuer, consistent with the US SEC proposals.

- (g) *what controls should be placed on issuers having access to funds raised through a CSEF portal*

Response

Access by the issuer to funds raised should not be permitted until the issuer's fund raising target has been achieved. Intermediaries should not be permitted to hold or manage any investor funds. This allows for less stringent licensing arrangements while not compromising investor protection. Pending fundraising targets being met, investors' funds should be held by an external agent appropriately licensed for such purpose. We note the proposed US SEC rules require transmission of funds by the investor directly to an account with a qualified third party bank, which has agreed to hold the funds and to transmit them to the issuer or investors, depending on whether the offering is completed or cancelled.

- (iii) *intermediary matters related to investors:* these matters include:

- (a) *what, if any, screening or vetting should intermediaries conduct on investors*

Response

Basic identity checks should be carried out by the intermediary or an agent instructed for the purpose as a measure of protection against fraud. Intermediaries will need to comply with existing anti-money laundering regulations.

- (b) *what risk and other disclosures should intermediaries be required to make to investors*

Response

Standard warnings should be developed which it would be obligatory for all intermediaries to carry on their online platform. These should take the form of a basic "health" warning to draw the investor's attention to the high risk of loss of capital associated with investments in companies which are in the early stages of business development. A short warning is more likely to be read and considered, compared to a long detailed warning. A short warning could then direct investors to more detailed information. In this, attention should be drawn in general terms to risks linked to technology, market, intellectual property and competing products. There should also be a recommendation to take legal and financial advice and attention should be drawn to the risks of dilution of first round shareholdings as a consequence of later funding rounds and to the illiquid nature of investments in technology startups, and that there will typically be a lack of dividends during the early development stages. Attention should also be drawn to the potential impact of preferential shareholder rights on returns to ordinary shareholders.

- (c) *what measures should intermediaries be required to take to ensure that any investment limits are not breached*

Response

Consideration should be given to a regime of self-certification for investors. The important issue is for prospective investors to be adequately appraised of the high risk of loss of capital associated with early stage investing, the illiquid nature of the investment, the risk of dilution and the lack of dividends.

- (d) *what controls should be placed on intermediaries offering investment advice to investors*

Response

Intermediaries should not be permitted to provide financial advice.

- (e) *should controls be placed on intermediaries soliciting transactions on their websites*

Response

The intermediary should not be permitted to solicit transactions but be limited to hosting and publishing the investment opportunity on the website. We support safe harbour provisions proposed by the US SEC to enable intermediaries to apply criteria to limit offerings on its website to, for example, specific industries, without being deemed to be soliciting transactions or providing investment advice.

- (f) *what controls should there be on intermediaries holding or managing investor funds*

Response

Intermediaries should not be permitted to hold or manage investors' funds. See response to Question 6 (ii) (g).

- (g) *what facilities should intermediaries be required to provide to allow investors to communicate with issuers and with each other*

Response

We believe that information and knowledge sharing among investors has the potential to improve the investment decision making process in the crowd funding context. Accordingly we concur in the US SEC proposal to require intermediaries to facilitate communication between investors on its online platform.

- (h) *what disclosure should be made to investors about being able to make complaints against the intermediary, and the intermediary's liability insurance in respect of the role as an intermediary*

Response

No comments are made.

- (i) *what disclosure should be made about the commission and other fees that intermediaries may collect from funds raised*

Response

Where any element of the intermediary's remuneration is linked to the amount of funds raised, the intermediary should be under an obligation to disclose this fact to investors. No additional comments are made save that there should be rules to provide for disclosure of remuneration arrangements to ensure transparency.

- (j) *what, if any, additional services should intermediaries provide to enhance investor protection*

Response

No additional comments.

- (iv) *any other matter?*

Question 7 *In the CSEF context, what provision, if any, should be made for investors to be made aware of:*

- (i) *the differences between share and debt securities*

Response

Basic information could be provided. Beyond this, these are matters on which an investor may be expected to obtain legal advice, should additional information be desired, having regard to the cost of obtaining advice relative to the amount to be invested. As noted earlier, the intermediary should be required to recommend that prospective investors obtain legal advice before entering into a binding commitment to invest.

- (ii) *the difference between legal and beneficial interests in shares*

Response

Similarly, beyond the provision of basic information, this is a matter on which legal advice should be obtained by the investor, where appropriate.

(iii) any classes of shares in the issuer and its implications for investors. A related question is whether disclosure, alone, would suffice.

Response

Beyond the matters noted earlier as regards information and warnings the intermediary should be required to provide to the investor, these are matters about which the issuer should be required to provide full and comprehensive disclosure to the prospective investor via the intermediary's online platform. Attention should, for example, be drawn to any limitation upon crowd equity shareholders' voting rights.

Question 8 What provision, if any, should be made for each of the following matters as they concern CSEF investors:

(i) permitted types of investor: should there be any limitations on who may be a CSEF investor

Response

We would propose no limitation on who may be an investor, consistent with the US and Canadian proposals and with investor protection being provided through investment caps based on income.

(ii) threshold sophisticated investor involvement (Italy only): should there be a requirement that sophisticated investors hold at least a certain threshold interest in an enterprise before it can make CSEF offers to other investors

Response

No. It is considered that such a restriction, while having some benefit in de-risking the investment for the less well informed investor, would run strongly counter to the objective of increasing access to capital. The protection for the investor should focus around caps on how much may be invested relative to net income and wealth.

(iii) maximum funds that each investor can contribute: should there be some form of cap on the funds that an investor can invest. In this context, there are a number of possible approaches under *Issuer linked caps* and under *Investor linked caps*

Response

There should be a cap. As noted in the discussion paper, investment caps are an important measure of investor protection. We believe the US model is to be preferred, that is, limiting the total monetary amount that an investor may invest in all CSEF issuers in one year according to that person's income or net worth. A cap where the investor is limited to what he may invest in any one intermediary on an annual basis (a part of the Canadian proposal) may be unduly restrictive as investors may wish to direct their investment through a preferred intermediary with a strong track record or due to some other attributes of that intermediary. We also believe the per annum aggregate CAD10,000 limit under the Canadian proposal to be unduly restrictive. We prefer the investment limits under the JOBS Act which are set out in paragraph 4.4.1 of the discussion paper.

(iv) **risk acknowledgement by the investor:** should an investor be required to acknowledge the risks involved in CSEF

Response

This is a useful way to emphasise and draw attention to the risks of early stage investing.

(v) **cooling off rights:** should an investor have some right of withdrawal after accepting a CSEF offer

Response

Since CSEF is aimed at the retail investor, this consumer protection type of measure is appropriate.

(vi) **subsequent withdrawal rights (Italy only):** should an investor have some further withdrawal right subsequent to the offer

Response

No comments are made.

(vii) **resale restrictions:** should there be restrictions for some period on the on-sale of securities acquired through CSEF

Response

We consider there should be such restrictions to prevent the manipulation of the share price through “pump and dump” activities.

(viii) **reporting:** what ongoing reporting should be made by the intermediary and/or issuers to investors in regards to their investment

Response

Issuers should be required to report to investors with audited annual financial statements

(ix) **losses:** what recourse should investors have in relation to losses resulting from inadequate disclosure

Response

No additional protection to the CSEF investor beyond the recourse available to other investors.

(x) **remedies:** what remedies should investors have in relation to losses resulting from poor management of the enterprise they invest in

Response

None beyond those already existing under the law

(xi) **any other matter?**

Question 9 *Should any accommodation for CSEF in the Corporations Act be in the form of incremental adjustments to the existing provisions, or be in the form of a self-contained regulatory regime for CSEF?*

Response

See responses to questions 1 and 2. We believe a self-contained regulatory regime is required rather than incremental adjustments to existing provisions.

Question 10 *What, if any, other matters which come within the scope of this review might be considered?*

Response

Consideration might be given to a means of tracking the performance of companies hosted on and funded through online CSEF platforms so that this data is available for investors in the future to facilitate informed decision-making. This may focus the attention of intermediaries on the quality of the companies they host.

Intermediaries might be encouraged to consider publishing their portfolio performance on their website. This would be a means of shaping market behaviour other than by prescription.

Disclosure does not necessarily need to be mandatory. Often the immediate cause of lack of information in the market is the lack of a well-recognised standard to report against. Here the first task is to establish one or encourage one to emerge. Once it has, the best performers will generally have an incentive to report against it and this will put pressure to disclose on other players, lest they be seen to have something to hide. The desired outcome of information disclosure can be achieved without compulsion.

We also draw attention to the need, in considering what appropriate policy settings might be, that consideration is given to any implications that internet enabled CSEF may have for the tax system. It is desirable that the design and administration of the tax system should not pose barriers or operate as a disincentive to participation in the CSEF market, for example, the system should not unduly raise transaction costs.

EARLY STAGE CAPITAL FOR INNOVATION AND ENTREPRENEURSHIP

ADVICE FROM NON-EXECUTIVE MEMBERS OF THE COMMERCIALISATION AUSTRALIA BOARD

J Bingley, C Bridges-Taylor, L Hammond, L Read, T Surtees, B Whan

MAIN MESSAGES

There is a long-standing, unresolved shortfall in the allocation of capital by the market to start-up and early stage, technology-based and innovation-intensive ventures in Australia. That this does significant harm to Australia's productivity and competitiveness is borne out not only by fundamental economic understanding of the drivers of productivity and competitiveness in advanced economies, but also by practical evidence on a daily basis.

The changing nature of early stage equity capital markets (ESECM) includes a shift from institutional to individual investors as sources of capital, and from the familiar VC Funds model to other structures, entities and channels to mobilise and manage capital. These changes thus far appear mainly to have lead to greater capital allocations to "lean" start-ups that are largely software-based and web-mediated and have relatively low capital requirements.

As a consequence, there remain major economically and socially important areas of innovation that are linked to the national R&D effort and have larger capital requirements and longer development cycles (e.g. biotechnology, medical devices, nanotechnology, new materials, new manufacturing, energy efficiency), which continue effectively to be denied access to adequate capital.

The emerging characteristics of the ESECM require that Governments revisit the problem of capital allocation, and understand why past policy interventions to address this have been only partially successful and will be inadequate in the future.

There is a range of possible Government responses in the short term, some already under public discussion, which would assist in alleviating the capital drought. They include the regulation and tax treatment of employee share option schemes, which currently materially affect investor perceptions of risk, and the regulatory enablement of crowd-sourced equity funding. The disconnect between publicly funded research and research users undermines the effectiveness of innovation and entrepreneurship, and must be resolved for the national good.

Other measures should be implemented in the medium term to facilitate the mobilization of large pools of private capital that are subject to the investment decisions of individuals. Among these are regulated pools created under the superannuation guarantee levy and held in self-managed funds. Enablement or incentive measures must take account of the diversity of individual investors; useful insights exist, as both types of measure have been tested and applied in comparable economies.

Inflows of overseas capital are not seen as a likely remedy for failure in Australia's ESECM. Experience to date is that inflows are not large, are inconsistent and are determined by many factors, of which specific enablement or incentive measures by Government will be only a part. Better understanding of the factors affecting capital inflows for early stage investment, including the shift from institutional to individual investors, is required before any policy response is proposed.

Entrepreneurial aspirations and engagement in entrepreneurship in Australia are not low by international standards, and are supported by a range of both government and private initiatives (though perversely undermined by existing government policy e.g. on employee share options). Entrepreneurs and early-stage businesses could be supported by better design and utilisation of procurement by government and by specific value-chain and export facilitation actions.

While this report is focused principally on capital needs of start-up and early-stage ventures, it needs to be complemented by further analysis of capital allocation for development and expansion stages, as investors' perception of follow-on capital risk is a material factor in their perceptions of early stage risk.

PURPOSE

This report is a response to the following questions:

1. What is the CA Board's perspective on the current state of access to capital for innovative start-ups in Australia, including:
 - weaknesses in the current system?
 - where should the Australian system be heading?
 - what levers can the Government apply to shape a more effective system?
2. What international comparisons are relevant?
 - should Australia seek international engagement to attract investment, including use of Austrade and the Advance Australia Network?
3. How can the Government improve Australian attitudes to entrepreneurship?

BACKGROUND

The report represents the views of non-executive Commercialisation Australia Board Members based on our collective expertise and experience in managing and investing in start-up and early-stage companies and in the commercialisation of innovation, and our various engagements over a long period in State and Commonwealth Government policy and programs to support innovation and commercialisation in Australia.

Given available time and resources, our response is necessarily qualitative, but there is a substantial evidence base that should be assembled to underpin a more formal exercise. In our concluding remarks we highlight some areas where data should be assembled.

QUESTION 1: ACCESS TO CAPITAL

1.1 “MARKET FAILURE”?

1. there is long-standing recognition that the market fails to allocate capital to early stage, technology-based and innovation intensive ventures in Australia.
2. in comparable economies (including but not limited to the USA, Canada, UK, European countries and Israel, which are those for which information is most available) there is also recognition of a similar failure, perhaps to a different extent and with less deleterious consequences. We know of no economy that does not experience this failure, and does not respond with measures to compensate and induce more effective allocation of capital to this segment of the capital market.
3. in other economies this is called “market failure” and we have used this terminology at times in this report, since the terminology is widely understood, has been widely used in public policy discussions in Australia, and facilitates the international comparisons we have been asked to make.
4. we acknowledge there may be technical economic arguments against applying the concept of “market failure” in the current context, but do not believe they should be used to distract attention from the substance of the views offered in this report.

1.2 WHAT SORT OF CAPITAL, FOR WHOM?

5. venture capital or risk capital is taken to be capital available to newly formed ventures (start-ups), early-stage companies seeking to take to market (to commercialise) new products or processes, and later-stage small-to-medium enterprises (SMEs) seeking rapid growth and significant market positions.
6. in particular, we focus on technology-based or innovation-intensive companies, where perceptions and sometimes mis-perceptions of risk lead to a failure of the capital markets to allocate capital to such ventures.

7. there are “gaps” in availability of capital at all stages – proof-of-concept, early stage commercialisation and early expansion and development – and perceptions of which gap is most difficult to address may be a reflection of personal experience.
8. here, we mainly deal with capital for start-up and early-stage companies, without implying that gaps in availability of follow-on capital for expansion and development are any less acutely felt or any less attributable to market failure.
9. we note that capital for such companies is predominantly provided as equity or quasi-equity investment – debt plays no major part in capitalising early stage ventures.
10. we use the term “early stage equity capital markets” (ESECM and thus ESEC) rather than “Venture Capital markets” to reflect (below) the changing nature of the market, with the emergence of alternative funding models to the familiar VC Funds model.

1.3 THE DECLINING ROLE OF VENTURE CAPITAL FUNDS

11. “Venture Capital”, represented by the familiar VC Funds model, and “venture capital”, represented by the questions put to us, are not synonymous.
12. the VC industry, built on a VC Fund model of raising capital principally from a “limited partner” universe of institutional investors (mutual funds, superannuation funds) and managing it through a firm of “general partners” in 10-year closed-end funds, represents the most visible and widely understood form of venture capital, but in almost all jurisdictions is not the predominant player in the provision of ESEC.
13. this is especially so in Australia at present: since 2008, the contribution of such VC Funds (the number of managers, capital raised, capital invested) has declined substantially. The industry has been returns-negative for two decades, perhaps not least as a consequence of the tech-wreck and GFC, and also its relative immaturity, and Australian VC Funds are now not a significant source of capital to new ventures.
14. there are widely voiced views in the investment community, which we broadly share because of our observations of dysfunction in the VC market for some time, that the VC Fund model is “broken” and needs to evolve and be complemented or replaced by other models for mobilizing and managing ESEC.
15. past Government response to perceived market failure in the ESECM has been largely directed towards the VC Fund mechanism (e.g. the IIF and PSF programs). With the recent decline in the sector, new VC funds with co-funding from the IIF Program have come to represent a large part of the overall VC fund activity. We do not argue a case that this response from Government should end, but conclude it needs to be revisited and considered alongside other possible policy responses (below).

1.4 NEW MODES FOR EARLY STAGE EQUITY CAPITAL MARKETS

16. new approaches to sourcing, mobilising and managing ESEC in other countries (e.g. in North America, UK and Europe), and apparently also in Australia, provide alternatives to the VC Fund approach; in effect, ESECMs are becoming more diverse.
17. in the long run, these new approaches are likely to be seen as complementary to the VC Funds approach, and not a replacements or complete substitutes for it.
18. the balance between individual and institutional sources of capital is changing with the former becoming more important and the latter presently playing a less systemically significant role:
 - a. institutional capital (industry and for-profit superannuation funds) has not yet shown significant re-engagement with the ESECM since reducing its commitments after 2008
 - b. corporate capital, which has a inconsistent record as a participant in ESECM (e.g. Lend Lease Ventures) other than as a strategic investor on a case-by-case basis, may become a larger source of capital (e.g. Westpac’s Reinventure fund)
 - c. individual investors, judging from evidence in comparable economies and to a lesser extent in Australia, come in many guises, from very high net-worth (HNW)

investors experienced in building new ventures, to syndicated HNW angel investors, to retail investors.

- d. (the term “angel” now embraces a very broad spectrum of investors).
- 19. the channels for mobilising and managing capital are also becoming more diverse, with investment vehicles and entities that eschew or significantly depart from the standard 10-year closed-end fund typical of VC Funds, and may include:
 - a. new pooled-fund arrangements
 - b. different or flexible time-frames, including open-ended funds
 - c. pledge models often favoured by syndicated angel funds
 - d. organisational linkages to accelerator and incubator initiatives
 - e. retail investor funds
 - f. crowd-sourced equity, debt or reward funds.
- 20. as examples of the consequences of the changing nature of ESECM, crowd-sourced funding (of all types, not limited to crowd-sourced equity funding) is estimated globally to have exceeded USD2.7 billion in 2012 and USD5 billion in 2013; in the US, angel funding (narrowly defined in a published data set as investments by angel groups and syndicates), in early-stage ventures exceeded USD1.1 billion in 2013.

1.5 HOW ARE THEY WORKING?

- 21. the efficacy in Australia of the shifts described above is yet to be fully demonstrated.
- 22. the early success of these new approaches in other comparable economies owes something to Government intervention, enablement or incentives, even in jurisdictions like the USA that benefit from a well established history of investor support for early-stage ventures.
- 23. the new activity and new players in Australia appear to have been successful in mobilising capital predominantly through a narrow focus on so-called “lean” start-ups that have relatively low capital requirements and are largely software-based, web-mediated and disruptive of existing businesses and business models. It is worth noting that this is not the domain of traditional VC Funds and is often not driven off traditional technology development.
- 24. however, major economically and socially important areas of innovation that are linked to the national R&D effort and have larger capital requirements and longer development cycles (e.g. biotechnology, medical devices, nanotechnology, new materials, new manufacturing, energy efficiency) remain denied of capital.
- 25. in summary, we consider there remains a significant under-allocation of capital to early stage ventures, to Australia’s national detriment, particularly for innovation-intensive enterprises with long development cycles and larger capital requirements.

1.6 WHAT LEVERS CAN THE GOVERNMENT APPLY?

- 26. Governments in general need to take account of the present economy-wide structural change (specifically, to a highly connected, increasingly service-based economy), and how it will influence the ways Australian companies innovate, grow and compete. This implies continuing change in how the ESECM will operate in future.
- 27. it also implies that Governments must recognise investment in innovation-intensive, technology-based companies as a critical element of our future productivity and competitiveness:
 - a. distance is no longer a barrier to economic activity (though it may be to investors – see below): globalisation, ubiquitous high-speed international data connectivity, and the growing importance of innovation in services and business models, means that many economic activities can be outsourced/done from a distance
 - b. this is a two-way street: if Australia (now a ~70+% service-based economy) does not have home-grown capacity to build innovative companies and service providers we will increasingly suffer from overseas competition.

- c. conversely, a superior national capacity to respond through innovation to offshore competition and disruption of businesses and business models will be a source of competitive advantage.
- 28. Government has policy levers and funding levers to pull in a number of portfolio areas, not just in industry innovation/tax/financial regulation. They include higher education, R&D administration, and trade and export facilitation, and possible actions are highlighted below.
- 29. in relation to the ESECM, future Government measures need to recognise the continuing existence of a market failure, and respond to the shifting nature of early stage equity capital – to the emergence of new sources of capital, new channels for mobilising and managing it, and the different motivations and drivers of investors, noting in particular that:
 - a. it is no longer a institutional investor/VC Fund game
 - b. individual investors, ranging from the highly organized “family offices” to ordinary Australians managing for their future financial independence, will be more significant sources of capital.
- 30. assets held by Australian HNW individuals and potentially available for investment reportedly are currently *ca* \$700 billion (overlap with the next dot-point is unclear).
- 31. in particular, approximately one-third (*ca* \$600 billion) of the relatively recently and rapidly created pool of superannuation savings is in self-managed funds and is subject to the investment decisions of individuals.
- 32. this highlights that Government interventions designed to address perceived market failure , by enabling investment or providing incentives for it, must be tailored to allow all types of investors to match their risk tolerance with investment opportunities, if the interventions are to achieve maximum effect.
- 33. our collective extensive experience in various State and Commonwealth Government programs puts us in an unique position to comment on the value of existing interventions. In particular:
 - a. the current R&D tax incentive and CA programs for early-stage companies operate in complementary ways that reinforce their respective contributions to an effectively operating ESECM
 - b. it is our unanimous and strong view that the combination of these programs is a very effective tool to support the growth of innovative companies. Their non-dilutive nature provides an important complement and incentive for equity-based investment funding.

1.7 SPECIFIC AREAS FOR GOVERNMENT ACTION

- 38. enable the effective issue of employee share options by start-up and early stage companies (and in doing so, acknowledge the distinction between such issues and those by large established companies) by removing the disadvantages created by their current tax treatment. This will materially affect investor perceptions of risk. (We acknowledge there now appears to be a certain level of political commitment to take this step).
- 39. simplify the requirements for investment vehicles for angel and other individual investors to provide flow-through tax-based incentives on both the capital and operating accounts (*cf* United Kingdom) to build, over time, a durable base of individual investor support for early-stage ventures.
- 40. re-examine regulatory and other constraints on accessing the >\$1.8 billion superannuation savings pool for ESEC investment, with particular emphasis on understanding the balance between risk of such investments and risk-mitigation opportunities presented by a balanced portfolio approach.
- 41. in particular, consider the beneficial consequences of enabling SMSFs to invest easily, with appropriate regulation of unacceptable risk, into the ESECM.
- 42. consider “safe harbour” provisions for trustees of superannuation funds of all types, even if as an interim measure, for investment in ESECM within regulated bounds. This

would act to complement efforts to overcome institutional risk-averse behaviours that arise from inadequate knowledge of ESECMs.

43. enable the involvement of small individual (“retail”) investors in the ESECM, by providing an appropriate regulatory environment and structures in which crowd-sourced equity funding can operate (we acknowledge, with reservations, the CAMAC review, and note recent expressions of political commitment to the concept).
44. introduce a national measure of “research impact” to encourage strong engagement between publicly funded R&D organisations and business, to ensure that the innovation capacity of Australian companies is enhanced by the results of R&D. We note that the evidence of low impact is well documented, and the need for such a measure is highlighted by the following mismatch:
 - a. the proportion of R&D done by publicly funded research organisations is much higher in Australia than that in many other comparable economies
 - b. the level of engagement between these organisations and business (users of research) is much lower than that in comparable economies.
45. ensure continuing support for export market development and market entry, areas where early stage companies have significant difficulty in building or accessing skills.
46. introduce procurement-based programs to support innovative small companies, similar to the US SBIR program (we note that SA and Victoria are trialing similar programs, and that Innovation Australia has recently made a submission to the Senate Enquiry on procurement matters).
47. ensure the continuity of the R&D tax incentive and CA as complementary mechanisms (to one another and prospectively to other initiatives by Government) to provide non-dilutive funding to support growth of innovative small companies.
48. introduce a long-overdue emphasis on stability, coupled with timely and competent performance evaluation, for any Government policies or programs that are established to support the operations of the ESECM in future. Avoid tinkering!

QUESTION 2: INTERNATIONAL LINKS

2.1 INTERNATIONAL COMPARISONS

49. in preceding discussion we have identified the following circumstances in ESECM in comparable economies as relevant to analysis of Australia’s ESECM and Government’s policy responses:
 - a. all comparable economies acknowledge either explicitly or implicitly that there is “market failure” (their widely used terminology) in ESECM
 - b. all respond with interventions that may be grant-, tax- or regulatory-based
 - c. the GFC affected ESECMs and, most visibly, VC Fund operations in all comparable economies and, 6 years on, most are yet to recover to the levels at which they operated pre-GFC.
 - d. in comparison with those economies, Australia had and has a relatively small, underdeveloped and immature VC Fund capacity which has proven to be less resilient than the sectors in other economies.
 - e. Australia it is displaying similar patterns in the emergence and operations of other components of the ESECM, but data and analyses are few.
50. we do not conclude that Australian investors inherently are more risk averse and therefore less disposed to invest in start-up and early stage companies than investors in comparable economies – for example we note the marked and largely unexplained contrast in the willingness of the Australian market to provide risk-capital to mining exploration or start-up ventures, substantially mediated by the public market.
51. but we do observe that this predisposition does not extend to technology-based and innovation-intensive ventures, where a private market is the norm.

2.2 ACCESSING INTERNATIONAL CAPITAL

52. we have a range of views on the ability of Australia to access international capital: the following are points on which we have consensus.
53. there is no reliable evidence that the vacuum in VC Fund activity in Australia, or the demonstrated availability of high quality investment opportunities in this country, will induce significant, regular flow of early stage capital from overseas-based VC Funds into Australia.
54. there also are examples of past initiatives to bring US VC firms into Australia, usually in partnership with Australian VC firms, but to our knowledge none has flourished.
55. however, we have experience of particular case-by-case approaches taken by overseas investors, and of relationship-based investments into early stage companies.
56. many of these investments, but not all, result in the relocation of the investee offshore, but we note this need not inevitably be so, particularly as Australian-domiciled companies become competitive in global marketplaces.
57. there is regular fact-finding, relationship-building and mandate-seeking in Australia by larger US-based private equity firms (e.g. Sequoia), but little evidence that this extends in any consistent way to US-based early stage investors.
58. an interesting example that may point the way to future developments is the current negotiation between the CSIRO and the Boston/London-based Omega superannuation fund manager to invest on a portfolio basis into bioscience and biotechnology opportunities.
59. we foresee that one of the principal benefits to be gained from greater involvement of overseas investors in the ESECM will be in improving the skills-base of Australian investment managers, leading to better future investment decisions. (It is reasonable to conclude that inadequate skills among investment managers contributed to the underperformance of the VC Funds sector over the last 20 years).
60. based on direct experience and relationships, we consider that Government incentives (e.g. tax breaks) may be attractive to prospective overseas investors but do not of themselves determine the willingness of overseas investors to invest in Australia. We consider that more detailed needs analysis would be helpful.
61. we do not yet understand how the shift from institutional to individual sources of capital in ESECMs will affect the inflow of overseas capital to Australia's ESECM. (Web-media articles report that Asian-based family offices may seek a wider exposure).
62. we agree that Austrade in many locations is a very helpful enabler and facilitator, and that structured relationships between Government incentive programs such as Commercialisation Australia and Austrade would be beneficial.
63. Advance Australia has significant profile but less capacity to provide similar services in a systematic or continuous way.

QUESTION 3: ENTREPRENEURSHIP

64. we consider that entrepreneurial aspirations and entrepreneurship are not lacking in Australia, and data from PwC give support to this view.
 - a. however, there are indications that entrepreneurial behaviour is not evenly spread, as some of Australia's industry sectors appear to be falling behind in global competitiveness, possibly reflecting a need for greater innovation.
 - b. for example, Australia is reportedly falling behind many countries, including France, Brasil and New Zealand, as a source for China's imports of agricultural products.
65. we also believe, with less authority, that Australian community attitudes to entrepreneurship are not unsupportive, and that the stigma that arose from corporate excesses in the late 1980s and early 1990s has washed out.
66. the "rise" of entrepreneurship may in part be due to the development of a lot of soft infrastructure to support entrepreneurs through education and networks, such as

mentorship schemes and bespoke training programs, which have become a very visible part of the ecosystem over the last 10-15 years.

67. support for entrepreneurship has also become greater, more diverse, and more effective through developments like:
 - a. small “skills and knowledge” grant support, e.g. from Commercialisation Australia and various complementary State programs
 - b. the widespread emergence of incubation and accelerator services, initially driven through Government programs (Commonwealth and State) but now increasingly privately driven.
68. Government has sent mixed messages about its support for and commitment to entrepreneurship (e.g. Treasury’s and ATO’s long negative stance on employee share options has undermined perceptions of Government support for entrepreneurship and enterprise creation/growth).
69. Government now has the opportunity to send a clear signal of its support for innovative new companies and entrepreneurship. This signal will be strengthened if it is seen as a coherent, cross-Government priority.
70. we consider that such a signal will also be picked up by mature companies, increasing their adoption of innovation in a quest for long-term competitiveness and sustainability.

DOCUMENTING AND UNDERSTANDING THE ESECM

72. we highlighted at the start that this report is based on our collective expertise and experience in investing in start-up and early-stage companies, commercialising innovation, and contributing to State and Commonwealth Government policy and programs.
73. our response to the questions asked of us is necessarily qualitative, but we have indicated that there is a substantial evidence base that should be assembled in the Department. In the following points we highlight some areas where this evidence base should be increased.
74. the changing nature of the ESECM should be documented in more detail by drawing on the data accumulated by the CA Program. We believe that, if the data are not captured in the database (as appears to be the case), then they should be extracted in a specifically designed primary research project. The data should reveal investors or capital sources before CA support, co-investment with CA funds, and to some extent follow-on investment, using the original applications, subsequent reports and the detailed knowledge of the Case Managers.
75. substantial information is available on the policy responses to the changing nature of ESECMs in comparable economies, but an overview would be helpful, and comparative description and analysis are required of the regulatory and incentive measures that have been introduced.
76. to complement the focus of this report on capital for start-up and early stage ventures, a similar review of impediments to the allocation of capital for later-stage ventures (e.g. development and expansion capital) is required. These are not disconnected problems:
 - a. we have highlighted that perceptions of risk by prospective investors in start-up and early stage ventures will be conditioned by their understanding of downstream capital risk e.g. to avoid the event of investees being “stranded”
 - b. for ventures that have long development cycles and/or are capital-intensive, Government incentives for longer duration commitment of private capital (e.g. for clinical trials) need further consideration. An understanding of approaches in comparable economies would be useful.
77. a needs analysis of prospective overseas investors in early stage ventures in Australia should be undertaken, and tested against experience of people familiar with the area.

end/