

Response to Treasury on Wholesale & Retail Clients



Australian Association of Angel Investors Limited
ACN 127 412 515
PO Box 2199, Toowong, Queensland 4066
Email: info@aaai.net.au Web: www.aaai.net.au

CONTENTS

Executive Summary	3
Overview	4
Background on the Early-Stage Case	4
Which Investors Need Protection?	6
Outline Proposal for Early-Stage Investments.....	6

EXECUTIVE SUMMARY

The Australian Association of Angel Investors (AAAI) is the national forum for the advancement of Angel investors and the professional development of its members' passion for investing in entrepreneurial success.

In considering the peculiar issues related to investments by private citizens in early-stage ventures the AAAI is the only persistent and national voice for both the Angel investors and the companies in which they invest.

The AAAI is focused on ensuring the availability of suitable capital to fund Australia's early-stage entrepreneurial ventures.

An outline proposal with regard to the definition of the Sophisticated Investor as it applies to the early-stage case needs to address the key problems of:

- a paucity of objective information;
- a lack of relevant transactional skills and knowledge in both investor and entrepreneur; and
- the scarcity of suitable, professional advice.

In the spirit of industry self-regulation, the AAAI proposes an exemption from retail investor status for individual investors who:

- have completed a training programme; and
- maintain that qualification through participation in a continuing professional development (CPD) programme.

Achieving accreditation under such a scheme should require a statutory declaration of financial capacity without setting a specific wealth test benchmark. Accreditation can also provide some recognition of prior experience but, experience alone will never be an adequate qualification for exemption.

An example of one such scheme is the AAAI Fellow programme for AAAI members. The AAAI emphasises that it fully expects this category of Sophisticated Investor exemption would be open to participants in any equivalent scheme which satisfies the government criteria set for the exemption.

This paper is provided in response to the consultation invited by the Treasury Options paper and the AAAI look forward to the opportunity to continue the dialogue on the most appropriate treatment to realise an effective and manageable protection regime for both the early-stage companies and the investors who support those companies.

OVERVIEW

In responding to the Future of Financial Advice Options paper on Wholesale and Retail Clients from the Treasury, the Australian Association of Angel Investors (AAAI) is focussed on a specific niche of the broader market and economy – early-stage businesses and the investors who support them. This early-stage niche is not explicitly considered in the options paper, yet is widely recognised internationally by government, academia and industry as a critical driver of innovation and wealth creation in the broader economy.

The AAAI is focused on meeting the peculiar needs of ensuring the availability of suitable capital to fund early-stage entrepreneurial ventures.

Government and corporations continue to fund primary research in Australia but, there are no institutional investors, such as private equity and venture capital funds, consistently funding development and commercialisation of early-stage businesses. The success of privately backed venture funds which do invest in early-stage opportunities is in stark contrast to the institutional and government backed funds that continue to lose money. However, successful, or unsuccessful managed funds are a well regulated source of capital which operates under the protections afforded by the Australian financial services license (AFSL).

The vast majority of investment to support the development of new technologies and commercial opportunities has traditionally been informal private investment. Such investment does not use fee-for-service money managers like venture and private equity fund managers. This private, informal investment activity is not subject to the Australian financial services licensing regime. Indeed, many of these investments fall outside the existing definitions of the legislation and would not happen at all if the constraints of the investor definitions were rigorously applied.

Early-stage investment is the essential funding to support a business from start-up through to sustainable operations. The so called and widely acknowledged 'funding gap' is the evidence of the lack of early-stage investment activity in the economy. Early-stage investors accept risk levels not usually tolerated by fund managers investing other people's money. Ensuring that early-stage investors are protected but, not inhibited is essential if we are to maintain access for early-stage companies to the capital they require to develop and grow.

The AAAI recognises the challenge of creating balance between legislation to protect citizens from unreasonable levels of investment risk and a legislative framework that encourages the availability of investment capital to support Australian businesses. Current exemptions from the retail investor definition under the legislation do not adequately serve the needs of early-stage companies. The AAAI presents a case to add or adapt an exemption for private early-stage investors; an exemption based on requirements for professional conduct supported by relevant education, experience and qualifications.

BACKGROUND ON THE EARLY-STAGE CASE

The ventures in question are typically pre-revenue, or pre-profit and will have the potential for rapid and significant value growth with the goal of realising a high value capital return through a liquidity event in around five years from investment. As is explored below, these ventures have characteristics not found in other types of business investments and, as such, require a regulatory regime that addresses the issues for both the investors and the companies raising funds.

The existing disclosure exemption for Sophisticated Investors, based entirely on a financial means test, can work effectively for public companies that are going concerns with conventional reporting of historical performance and forecasts of future performance. In such circumstances it is not unreasonable to assume that an individual with sufficient capital can purchase advice and that appropriate advice is widely available at prices that represent a very small proportion of the anticipated investment.

However, when considering investments in early-stage private companies a simple financial means test is insufficient. Indeed, in these circumstances the issue is not one of disclosure at all as there is generally very little objective information to disclose. Further, the management team/business

owners frequently lack the skills to properly present their investment opportunity and lack the financial resources to hire advice. This is the classic “catch-22” of an early-stage business.

Early-stage entrepreneurs frequently seek appropriately skilled and experienced individuals who can provide mentoring and guidance, a contribution of intellectual capital, in addition to the financial capital required to support the commercialisation of the business. This has become known as seeking “smart money”, while in contrast “dumb money” refers to investors who only deliver financial capital. There is a role for both types of investor but, they do not sensibly converge under a single protection regime.

In considering an investment opportunity in an early-stage company an appropriate investor is typically required to have more experience in making such investments and evaluating such companies than the business owners seeking the investment. Further, such investments are often for very modest amounts of money (less than \$100,000) so the economics of hiring advice are unlikely to work for the investor. The licensing and professional investor criteria in legislation do not adequately address the skills, expertise and experience requirements for advisors servicing early-stage transactions. So, assuming that relevant professional advice is readily available is an *absolutely false assumption*.

When considering the situation of investment in early-stage companies one needs to recognise the key problems of a paucity of objective information, a lack of relevant transactional skills and knowledge in both investor and entrepreneur, and the scarcity of suitable, professional advice.

The paucity of objective information is an inherent aspect of early-stage opportunities and is not susceptible to change through government intervention.

The lack of relevant transactional skills in early-stage business owners is a natural weakness for which government intervention can provide some support, such as the many Federal and State government programs that deliver information to entrepreneurs. However, the transient nature of an entrepreneur and the high rate of failure of new enterprises underline the reality that the transactional weakness cannot be fully addressed through the entrepreneur. By comparison, the investors are expected to have more business experience and more transactional experience as well as a conscious intent to pursue such investments. For the investors, government intervention through legislated standards such as the proposal below can effectively address the lack of transactional skills without creating systemic asymmetries in the negotiation of an investment.

The scarcity of suitable, professional advice is unlikely to change because the role for such advisers is simply not economic. Neither the companies nor the investors are ever likely to pay high enough fees on their very small transactions to sustain the advisers and the companies often face the “catch-22” of not having the funds to pay the fees without first securing the investment capital. This issue was partly addressed by the COMET programme and continues to be partially addressed by the Commercialisation Australia programmes but, realistically, this is a natural market failure for which there is no sustainable systemic response other than permanent government subsidy. Even long term government intervention is unlikely to work because it is unlikely to attract and retain the most appropriate practitioners. Consulting to companies with no money is not a sensible or sustainable business model. The advice is available but, the relevant expertise and experience rests mostly in a subset of the investor community.

The current Sophisticated Investor regime places the onus for compliance on the company raising the funds. The options paper in paragraph 2.9 presumes that the compliance burden lies with a licensed financial services provider but, this fails to recognise the lack of such advice as described above. In practice, most small transactions are undertaken personally by the directors of the company raising capital in direct engagement with the investors.

All of the problems identified in section 4 of the options paper relate to public markets, complex securities and other going-concern type business transactions. Not a single one is directly related to the challenges of early-stage businesses and their investors, which simply highlights the lack of visibility of these issues and the need for a more specific discussion about this space.

The AAAI is the one organisation in Australia best positioned and informed to participate in this discussion and bring the perspectives of both the investors and the early-stage companies.

WHICH INVESTORS NEED PROTECTION?

Knowledge is the primary differentiator between those investors who require protection and those who can afford a lower level of protection.

Which knowledge is relevant to being eligible to access higher risk investment opportunities depends largely on the nature of those investment opportunities.

An experienced stock market investor may well be considered to have the knowledge required to access investments in profitable, going concern businesses in the unlisted market. However, there is very limited correlation between experience investing in listed equities and the knowledge required to be a competent investor in an early-stage, high growth potential company.

Conversely, an investor experienced in investing in early-stage, high growth potential companies will not necessarily be knowledgeable about investing in infrastructure and major resources projects.

Any protection regime for early-stage investors in Australia will need to contemplate:

- investors acting as individuals;
- investors acting through their Self-Managed Super Funds;
- investors acting through investment trust structures;
- investors acting through closely held and widely held private companies (both special purpose investment companies and general operating companies that also make investments);
- investors acting through incorporated partnerships (both special purpose investment partnerships and general operating partnerships that also make investments); and

any other instances of investors acting through structures and vehicles not operated by a financial services licensee.

The AAAI can see merit in a number of exemptions to the retail investor classification for Sophisticated Investors where each exemption is intended to address a specific category of investor/investment risks. An exemption based solely on a financial means test may be appropriate for some of those categories of risk. However, unless the wealth benchmark for such a test is both simple and minimal it is likely to have the effect of excluding many investors who would otherwise be suitable and willing to contribute patient risk capital to early-stage ventures.

Where wealth measures are based on out-dated assumptions of personal wealth portfolios and acceptable levels of personal asset risk such measures are likely to prove ineffective.

Our society is changing. For example, for many of the Gen X, Gen Y and younger members of our society rising costs have put the traditional pattern of home ownership beyond their reach. However, that same change increases their available disposable cash assets at a time when those generations have a greater awareness of and interest in the entrepreneurial culture of start-up businesses.

Over regulation is as undesirable as no regulation. To find the balance in regards to the question of Sophisticated Investor exemptions requires testing each exemption category and proposal against broad economic interests of the community, practicality of implementation and ability to deliver efficient and effective governance.

OUTLINE PROPOSAL FOR EARLY-STAGE INVESTMENTS

The goal is to provide sufficient protection to companies to avoid them being victims of inappropriate or criminal investor behaviour. At the same time to provide sufficient protection to investors to avoid them being victims of fraudulent or deceptive behaviour.

This proposal only addresses individual investors and does not contemplate incorporated investors which may operate under the Australian Financial Services Licence (AFSL) regime, or under the

Australian Prudential Regulation Authority (APRA), or any investor governed by the rules of the Australian Stock Exchange Limited (ASX), or any other licensed Australian stock market.

In the spirit of industry self-regulation, the AAAI proposes an exemption from retail investor status for individual investors who have completed a training programme and who maintain that qualification through participation in a continuing professional development (CPD) programme. In achieving accreditation under such a scheme there will be some recognition of prior experience but, experience alone will never be an adequate qualification for exemption.

Prior experience and qualifications can be used to satisfy requirements such as competence in:

- understanding and interpreting financial reports;
- understanding and interpreting a business plan;
- understanding and recognising the protection and exploitation of intellectual property;
- understanding and valuing diversity;
- managing a team;
- negotiating and managing legally binding business relationships;
- operating as a non-executive director of a private business;
- designing and developing a product and/or service;
- conducting cross-cultural and international business; and

similar competencies that relate to the growth and operation of a business.

The training programme will focus on the specific knowledge that relates to being an investor in an early-stage company with the inherent challenges of limited information, limited influence and limited resources. The training programme must equip the investor with a thorough understanding of at least:

- the key elements for professional conduct as an early-stage investor;
- the peculiarities of early-stage investments;
- the key legal constraints within which an investor makes early-stage investments;
- the available legal structures for making such investments and guidance in their use;
- strategies for negotiating investments;
- the terms and conditions of investments and how to use them;
- what is appropriate due diligence and how to conduct due diligence for an early-stage investment;
- the character and behaviour of entrepreneurs;
- how to establish and maintain alignment of interests with entrepreneurs and co-investors;
- how to syndicate investments with other Angels;
- how to conduct cross-border Angel investments and syndications.

An example of one such scheme is the AAAI Fellow programme for AAAI members as described below. The AAAI emphasises that it fully expects this category of exemption would be open to participants in any equivalent scheme which satisfies the government criteria set for the exemption.

Table 1 AAAI Fellow Programme

Programme Element	Criteria
Fellow Status	AAAI Angel Member in good standing AAAI members are bound by the AAAI Code of Conduct Completion of the AAAI Introduction to Angel Investing Course Experience requirements: <ol style="list-style-type: none"> 1. Deal lead in structuring of an investment, undertaking due diligence, term sheet negotiation and ongoing management and involvement (measure – declaration and references to support having undertaken at least one of each) 2. Made at least one Angel investment 3. Exited at least one Angel investment

Programme Element	Criteria
Continuing Professional Development	Minimum of 15 CPD hours annually to maintain status. To include a minimum of 5 CPD hours from professional education activities and a minimum of 5 CPD hours from practical components.
	<hr/> Professional education activities (5 CPD) Must include at least one of each of the following: <ul style="list-style-type: none"> • National Conference (max credit of 3 CPD hours per day) • Courses/Workshops (AAAI) (max credit of 2 CPD hours each) • AAAI Affiliated Angel group member meetings with an education component (max credit of 2 CPD hours each)
	<hr/> Practical components (5 CPD) Must include each of the following: <ul style="list-style-type: none"> • Attendance at Angel screening sessions (at least 3 per year with credit of 1 CPD hour per session) • Attendance at Angel pitch sessions (at least 3 per year with credit of 1 CPD hour per session) Balance of hours a combination of the following: <ul style="list-style-type: none"> • Deal lead in structuring of an investment, or due diligence, or term sheet negotiation, or post-investment contributions (credit of 2 CPD hours per deal) • Invest in Angel deal (credit of 2 CPD hours per deal) • Exit Angel investment (credit of 2 CPD hours per deal) • Attendance at Angel networking events (credit of 0.5 CPD hours per event) <hr/>

The AAAI Angel Education Australia™ initiative is developing and delivering a series of seminars and workshops to provide effective, informative education that can be certified and substantiated as contributing to an individual's competence as an Angel investor in Australia.

The AEA™ course materials benefit from the AAAI collaboration with the leading Angel education organisations in North America and Europe. AAAI contributes elements of its course materials to the international standardisation of Angel education through its role as a charter member of the Board of the World Business Angels Association.

The AEA courses include:

1. Angel Investing an Overview
2. An Introduction To Angel Investing
3. Investment Ready: Evaluation, Valuation and Portfolio Strategy
4. Doing the Deal: Terms Sheets
5. Doing the Deal: Due Diligence
6. Doing the Deal: Shareholders' Agreements & Investing
7. Living the Deal: Portfolio Management
8. Living the Deal: Building Value
9. Living the Deal: Exit
10. All About Angel Groups

The following table describes some of the available modules in the AEA™ curriculum.

Table 2 AAAI Introduction to Angel Investing Course

Module	Description
Angel Investing an Overview	<p>A comprehensive overview of the Angel investing process. Originally developed for investors with limited or no Angel investment experience, it also provides good knowledge for entrepreneurial support professionals, university faculty and policy makers to assist their client entrepreneurs in the Angel investing process. This seminar is a balance of expert presentations, panel discussions and small group case studies.</p> <p>Format Full Day Workshop</p> <p>Highly interactive, featuring a series of PowerPoint presentations delivered by an experienced Angel investor, case studies, role play exercises for applying the concepts presented in the course and a number of panel discussions with expert Angel investors, lawyers, tax advisers and IP attorneys.</p> <p>Who Should Attend</p> <ul style="list-style-type: none"> • Aspiring Angel investors and Angel investors who want to bring structure and understanding to their investment processes. • Entrepreneurial support professionals, service providers and entrepreneurs. • Audiences who are interested in learning more about Angel investors and the elements of the Angel investment life cycle. <p>Workshop Leader Certified Angel Instructor</p> <p>Course Materials A workbook will be provided to each participant that includes presentation content, slides and exercise worksheets.</p>
An Introduction to Angel Investing	<p>A comprehensive introduction to Angel investing. Developed for investors with little or no Angel investment experience and for Angels new to the Angel group context. This workshop is also an effective introduction to Angel investors and how they operate for entrepreneurial support professionals, university faculty and policy makers. This seminar is a balance of expert presentations and panel discussions.</p> <p>Format Half Day Workshop</p> <p>Highly interactive, featuring a PowerPoint presentation delivered by an experienced Angel investor, self-assessment exercises and exercises for exploring the concepts presented in the course. A panel discussion with expert Angel investors, experienced entrepreneurs and early-stage business advisers.</p> <p>Who Should Attend</p> <ul style="list-style-type: none"> • Aspiring Angel investors and Angel investors, particularly those interested in joining, or who have recently joined an Angel group. • Entrepreneurial support professionals, early-stage business advisers and entrepreneurs. • Audiences who are interested in learning more about Angel investors and the nature of Angel groups. <p>Workshop Leader Certified Angel Instructor</p>

Module	Description
	<p>Course Materials</p> <p>A workbook will be provided to each participant that includes presentation content, slides and exercise worksheets.</p>
<p>Valuation & Portfolio Strategy</p>	<p>Valuation of pre-revenue companies is one of the most critical issues in the Angel investment process and valuation is inextricably linked with portfolio strategy. Questions addressed by this workshop include:</p> <ul style="list-style-type: none"> • What to consider when valuing a venture? • What can an Angel investor do to help make Angel-entrepreneur negotiations less contentious? • How to address the typical disconnect that occurs between an Angel and an entrepreneur? • What rules of thumb do Angels use when crafting or measuring their portfolios? • What insight into effective portfolio strategy can investors gain by exploring data from actual Angel portfolios? <p>Format</p> <p>Half Day Workshop</p> <p>Highly interactive, featuring a PowerPoint presentation delivered by an experienced Angel investor, video segments presented by two internationally renowned Angel investors, hands-on exercises for applying the concepts presented in the course and a panel discussion with expert Angel investors, lawyers and accountants.</p> <p>Who Should Attend</p> <ul style="list-style-type: none"> • Angel investors who have completed the Overview seminar or who have already made several Angel investments. • Entrepreneurial support professionals, service providers and entrepreneurs. • Audiences who are interested in learning more about establishing a pre-money valuation for seed/startup companies, the importance of the company scalability to Angel investors and the critical parameters for a successful Angel portfolio strategy. <p>Workshop Leader</p> <p>Certified Angel Instructor</p> <p>Course Materials</p> <p>A workbook will be provided to each participant that includes presentation content, slides and exercise worksheets.</p>
<p>Terms Sheet</p>	<p>Angel investing is high risk investing. Consequently certain safeguards are understandable and appropriate. This advanced workshop facilitates in-depth discussions of the terms and conditions commonly used by Angel investors in funding early stage ventures.</p> <p>Format</p> <p>Half Day Workshop</p> <p>This workshop is designed to be highly interactive for an audience of up to 50 participants. The format features an extensive PowerPoint presentation delivered by a terms sheet-savvy senior Angel investor, including Q&A.</p> <p>After a brief break, a panel comprised of experienced Angels and local experts (e.g. an early-stage transaction attorney and an early-stage M&A accountant) will lead a discussion on terms sheets and specific</p>

Module	Description
	<p>terms, drawing heavily on their experience to illustrate the discussion.</p> <p>Who Should Attend</p> <ul style="list-style-type: none">• Investors who have completed the full-day PAI seminar programs or have made five to ten angel investments.• Service providers and other entrepreneurial support professionals who are interested in learning more about the specifics of angel investing to help prepare their clients for equity funding. <p>Workshop Leader Certified Angel Instructor</p> <p>Course Materials A workbook will be provided to each participant that includes presentation content, slides and exercise worksheets.</p>