AUSTRALIAN CENTRE FOR FINANCIAL STUDIES

Level 46
525 Collins Street
Melbourne Vic 3000
Australia

The Secretary
Financial System Inquiry
GPO Box 89
Sydney NSW 2001

March 31, 2014

Re: Submission to the Financial System Inquiry

Dear Sir/Madam,

Please find attached a submission from the Australian Centre for Financial Studies (ACFS) responding to the call for submissions for the Financial System Inquiry. This submission provides the key findings from a recent report conducted by the Centre titled *Innovation in Victoria: Funding and Facilitating* that is relevant to the following sections of the terms of reference:

3.4. Changing organisational structures in the financial sector;

4.3. Foster dynamic and innovative financial service providers

6. The Inquiry will examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and provide observations that could inform the Tax Policy White Paper.

Key points raised in the reports relating to the specified sections of the terms of reference follow:

1. **Alternative sources of investment for Venture Capital (VC) Funds.** VC investments tend to be illiquid, have the potential for large losses on invested capital and do not have observable market prices. These characteristics make them an unlikely match for retirement fund investment. Further, only 0.03% of SMSFs meet the sophisticated investor requirement of having a minimum of $10 million dollars in assets, which limits this opportunity. Where Significant Investor Visas (SIVs) are concerned, while VC is a risky asset class with low risk adjusted returns, the $5 million investment required is well beyond the investable assets required to achieve sophisticated investor status. Based on the above points, it is suggested that consideration be given to including VC funds amongst the complying investments available to SIV applicants.
2. **VC Fund Business model.** The current VC fund business model is not conducive to generating the returns required of the volatile and illiquid asset class. Problems with the model include a misalignment of interests - too much reward generated from basic management fee and too little generated from performance based compensation, a shortage of VC funds with specialisation in key sectors and lack of VC fund desire to invest in B round funding. Alternative fee models, greater engagement with other suppliers of VC capital, fund of fund structures and mechanisms to increase liquidity may provide a more attractive investment proposition.

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3. **Alternative sources of early stage capital.** While there has been a reduction in capital flows to VC funds, recent times have seen a proliferation in alternative investors, vehicles and investment structures for early stage investments. These investment structures address a number of the weaknesses currently present in the Victorian VC model and may be able to fulfil the intermediation role traditionally played by VC funds. These include: 1) Angel Investors 2) Business Incubators 3) Corporate Venture Capital Funds 4) Crowd Sourced Equity Funding Platforms 5) Matching Platforms. Policy should seek to create an equal playing field between various early stage investment avenues and remove barriers to innovations that may improve access to and awareness of early-stage investment opportunities to sophisticated investors.
4. **Taxation alignment.** To create an even playing field between different investment methodologies, alignment of the tax incentives available through various VC fund structures and direct investment in early-stage high risk ventures like that conducted by angel investors and corporates may warrant consideration. Current financial incentives are provided in VCLP and ESVCLP structures but not for direct investment by individuals or corporations. Financial incentives for individual investors in start-up firms were recently introduced in the UK under the Seed Enterprise Investment Scheme (SEIS) and resulted in greater direct investment by individual high-net worth individuals in start-up firms. The taxation of stock options for firms with revenue below a defined threshold should also be reviewed.
5. **Online Platforms for Deal Flows.** The online platforms being developed in response to crowd sourced equity funding and the service developed by the Australian Small Scale Offerings Board could play an important role in raising local, national and potentially international awareness of early stage investment opportunities, building networks across the innovation ecosystem and increasing potential for syndicate investing as well as providing an additional avenue for raising capital. While the investment characteristics of early stage ventures typically do not make them appropriate investments for retail investors, platforms of this nature should be made available and promoted to sophisticated investors**.**

We would be happy to discuss the issues raised in the submission in more detail with Treasury if required.

Yours sincerely,

Deborah

Professor Deborah Ralston
Executive Director, ACFS