

Introduction

Scope and Structure of the Submission

This submission responds specifically to matters raised by the Financial System Inquiry's Interim Report in connection with:

- Funding for Startups and the SME sector; and
- Investor Protections;

and includes comments on A Framework for Superannuation Policy Development.

Credentials

The recommendations presented are based on policy-based analysis and importantly, the experience derived from the author's 43 years career operating across diverse facets of the financial system including positions of:

- Credit Manager and later Executive Director of a major fixed-interest securities house;
- Project leader for the introduction of Corporate Promissory Notes (Commercial Paper) and Currency Swaps;
- General Manager-Finance/Global Treasurer for 2 top-25 Listed Companies
- Strategic Planner and Deputy MD of an Australian subsidiary of an international bank;
- Director of a Financial planning Firm and CEO of a leading Asset Consultant;
- Executive Officer of the Commonwealth Government's Superannuation Schemes;
- Chair of the ASFA Best Practice Committee and drafter of the Best Practice Risk Papers;
- Initial Chair of the Regulatory Committee and drafter of the Industry's marketing guidelines for the AIMA Australia (Hedge Funds);
- Investment Consultant specialising in Portfolio and Risk Policy development and Private Equity including Venture Capital portfolio development;
- Co-founder of the Medical Research Commercialisation Fund and the Trans Tasman Commercialisation Fund; and
- Co-founder of the Australian Institute for Innovation.

A Personal Submission

The author is Chief Executive/Director of the Australian Institute for Innovation, a not-for-profit "think-tank" that seeks to inform the discussions of innovation policy and program development. While the submission is informed in relevant parts by the Institute's views, this is a personal submission.

Paul Cheever

Mobilising Capital For Startups and the SME Sector

Why do we block the flow of capital to emerging growth enterprises?

The Report notes the importance of SMEs including startups to the Australian economy¹ and addresses the topic of lending for SME's. However, lending is the metaphorical cart here, because the SME/startup horsepower derives, not from credit, but from the availability of equity capital. Startups rely on sweat and equity, while even revenue-generating and profitable SMEs require adequate equity capital to risk-manage their businesses and support borrowing applications. It follows that if we can mobilise equity capital into this sector, then competition will follow for lending and other financial products for those enterprises that demonstrate the successful application of their foundation equity capital.

The provision of startup/SME equity capital is not the province of the banking system but needs to flow from long-horizon sources in individually modest allocations across risk diversified portfolios (reference the Innovation Australia Board submission to the Inquiry, and the Australian Institute for Innovation's public response). Preferably this capital would be packaged together with development advice and go-to market support.

The natural source of this "patient" capital flow of investment is our superannuation capital pool. However, our superannuation pool is today almost totally ineffective in delivering equity funding to our startup and SME sector, notwithstanding that the preservation rules by definition create long-term investment horizons. The ideal source of such risk equity capital is from our larger superannuation funds, whose size supports such long-term risk capital allocations that are small to their portfolios yet would generate substantial capital to emerging growth enterprises.

What are the blockages that exist today to this mobilisation? This is a complex topic that is perhaps better dealt with through consultation rather written submission, so the comments here are intentionally succinct, offering points for reflection by the Committee rather than a comprehensive dissertation.

The main blockages fall into two policy buckets and one management related barrier, though itself with policy considerations. The policy blockages arise from the regulatory dictates of liquidity and cost reduction. The management issue is risk aversion, typically the personal risk aversion of trustees and managers rather than actual portfolio risk aversion, with the sole purpose test used as the "barrier".

¹ A conclusion reinforced by data evidencing that for more than three decades, startups have generated the **whole of the net job growth** in the US, with UK data reaching a similar conclusion. Reference: *Tech Starts: High-Technology Business Formation and Job Creation in the United States*, Ian Hathaway, August 2013 (Kauffman Foundation Research Series) <http://www.kauffman.org/>

Financial System Inquiry Submission – Paul Cheever

Within superannuation policy, liquidity is imposed as a critical dimension, but this demand for liquidity obviously impedes long-term investment. Liquidity policy needs to be revisited, especially in the context that the system's preservation rules and the tax structure both act to forestall any damaging "run on the bank" for the superannuation system as a whole.

We can step away from liquidity as a demand with no adverse effects, though still imposing the duty of care on funds to be "aware" of their position so as to "form a reasonable view that the fund would not have to enter into a forced liquidation of its assets, in a manner which could have an adverse impact on its members". The industry, with APRA and the RBA, should be encouraged to develop guidelines that then allow for long-term investment within a diversified portfolio. After all, even the Government recently convened a meeting with the larger funds about long-term investment into physical infrastructure.

Cost is often raised as a barrier to larger superannuation funds investing in the SME and startup sector, with fund executives expressing the claim that 'unless we can write a cheque for at least \$200 million, it is too expensive to administer and govern'.

Cost is a valid consideration, recognising that the Investment Cost Ratio of most venture and early stage growth private equity funds can be 20% or higher in the early years of such funds. And the need for portfolio diversification means potentially engaging in many relatively smaller arrangements, generating administrative costs.

But Government can and should play a role here to work with the larger funds to facilitate the development of, and provide operational funding for, an efficient collaborative infrastructure to flow investment capital into the Startup/SME sector, and which would include a better mobilisation of our startup and growth knowledge to support these emerging growth enterprises. The Australian Institute for Innovation has put a proposal to Government for such an approach.

The management barrier is that as the Report notes, historic venture returns have been poor when measured on a broad industry basis, and small firms are seen as inherently risky. The irony is that an industry which has the mantra that past returns are not indicative of future performance seems unable to apply itself to doing it better, instead choosing to do nothing.

In resisting startup/SME investment proposals, some superannuation executives claim the Sole Purpose Test implies that investment must be **assured** of profit to be undertaken. This is a selective interpretation, adopted for convenience to defend the lack of action, but it is nonetheless a barrier. So Australian venture/SME investment becomes a no-go zone, notwithstanding that superannuation investors willingly invest in venture funds overseas, and notwithstanding that portfolio theory premises a gain in value through, and current portfolios already incorporate, a mix of risks.

Alongside Government leadership to advocate for startup/SME investment, the regulatory framework needs to remove any barriers, legitimate or otherwise. **It is strongly recommend that the Inquiry advise Government to require APRA: to review the practices of superannuation funds related to investment for the Startup/SME sector; and to identify any obstacles with a view that their findings be documented in a Guidance Note describing what APRA would consider as prudent practice for startup/SME investment.**

Many large superannuation funds adopt ESG principles and report extensively on these in addition to their investment portfolio reporting. **It is further recommended that public-offer superannuation funds be required to also report on the impact of their investments on the Australian economy.**

Investor Protections

"Somebody Knew" and other Myopias

As a long-term practitioner within the financial markets, my experience of the many frauds or simply mis-described financial offerings in the marketplace, is that in each instance, someone knew of, or suspected, the problem. Most often, the problems were apparent to those at the coalface, from treasury dealing rooms to the research arms of the financial planning networks. So the question is why did this knowledge not trigger a more timely regulatory response?

Experience suggests that there is no recognised protocol for the market to advise the regulators of misleading or inappropriate conduct or product, and equally, the regulators appear not to have any protocol to systemically access the market's embedded supervision resources.

There are several factors influencing this relationship.

- I. Market participants who raise potential issues can be subject to defamation actions, or threats thereof, while of course, internal whistleblowers can simply be fired.
- II. The regulators appear similarly inhibited to undertake preliminary investigation in the absence of a clear breach. Of course, it may be that the regulators are limited by budget or organisation design, but given that such restrictions exist, it all the more supports a case for constituting more regular communication channels with the marketplace.

in this connection, the reference below that supported the establishment of the Takeovers Panel has resonance here.

Certainly, it was open to the Federal Parliament to conclude that the nature of takeovers disputes was such that they required, ordinarily, prompt resolution by decision-makers who enjoyed substantial commercial experience and could look not only at the letter of the Corporations Act but also at its spirit, and reach outcomes according to considerations of practicality, policy, economic impact, commercial and market factors and the public interest.

'Kirby J in Attorney-General of the Commonwealth of Australia v Alinta Limited & Ors [2008] HCA 2 (31 January 2008) at [45]'

The formation of a similar **Financial Product and Services Review Panel** would provide a bridge between the regulators and the marketplace, and a platform for merging formal regulatory activity with market self-supervision. This would give those with concerns a confidence that their concerns would be reviewed by market practitioners rather than bureaucrats alone (notwithstanding that such bureaucrats might be highly skilled in the formal laws and regulations).

Also on the topic of investor protections, the author joins other commentators in the opinion that the current interaction of real estate investment and SMSF sector

presents a risk to the system. The myopia of excluding real estate investment from the realm of investment product and financial service supervision results from applying a product definition to investment as opposed to a functional definition of any proposed activity in which a person expects to accrue a passive financial profit.

While real estate investment should be subject to the regulatory framework that applies to any other financial product or service, this is no doubt too complex to deal with in its ramifications of embedding this sector within the current AFSL legislation, and perhaps the better and faster path is simply to establish a restricted AFS Licence to apply to real estate investment sales. Such a Licence would mirror, as appropriate, the investor protections that apply to current financial products and services.

Perspective - The Two Superannuation Systems

Driven by legislation and tax incentive, the Superannuation pool is now Australia's major, and still growing, source of savings formation. But policy and regulatory discussion on superannuation is hindered by a lack of framework perspective.

The most useful framework for any discussion of the superannuation system is to recognise that it is two systems, not one. The most important system in a policy context is the Superannuation Guarantee Charge (SGC) pool, which is in effect our national pension program, while the "Voluntary" pool reflects a personal savings mechanism.

While several factors motivated the SGC system, it was in effect a policy decision to establish a universal, funded, national pension scheme. Furthermore, a key sub-policy decision in its design was that the management of this funded pension pool would be distributed so that the community would benefit by both a diversified approach to the investment management, and a level of competitive activity to drive the development of good practice and continuous improvement. Another critical sub-policy was that its governance would be balanced in employer and employee representation. It was also, and importantly, seen as mobilising a pool of domestic savings to support the economy, though this motivation has been largely ignored since in policy discussions, which have been overwhelming, and counter-productively obsessed with choice.

The benefits of adopting this SGC design are apparent when compared to the two major alternatives: an unfunded pay-as-you-go system from the public purse, or a funded system managed by a single government investment entity.

As our national pension scheme, this SGC system is not then a set of independent accounts but a collective of mutual obligation and benefit. In simple terms, what you do with your account impacts me, and moreover, has an intergenerational impact. It is this interdependence that should inform the system policy and regulatory decisions. The SGC sub-system is our collective sovereign wealth fund.

In contrast, the Voluntary pool, while it adds incrementally to our national savings base and the funds are generally applied to retirement income, is a subsidised savings system

Considering these two pools as separate systems, provides for a more coherent policy and regulatory analysis. This submission believes that the FSI should recommend that

Government set future policy around this framework and explore the separation of past flows.

Concluding Theme

All systems require optimisation around objectives operating under constraints, and this applies fully to the Financial System in the balance between the constraint of the integrity of prices and services being set within the internal dynamics of a “free market”, and the constraint that the system exists to serve the community good.

If we are concerned with having an effective capital market that supports our economic and even social aspirations, we need to adopt policies that encourage our capital markets to support this outcome, and this is particularly relevant to our SGC system. The organisations in the SGC system, whether profit or not-for-profit, are the beneficiaries of a government mandated flow of community savings. In this context, it is fair that we should expect a sense of community obligation to exist in return, be it in supporting our emerging growth companies or in insisting on the protection of our SGC pool.

The closing perspective here is to observe the typical example (2013 data) of one of our largest superannuation funds, with a an exposure to Australian startups of 0.05% (0.0005) of its portfolio at best, was at the same time comfortable to take the risk of holding over 12% of its portfolio in just 4 highly-correlated banks. The risk to the financial system and the economy is on both sides of this imbalance.