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Innovation Australia

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Committee Secretary
Financial System Inquiry
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By email: fsi@fsi.gov.au

Dear Mr Murray

Financial System Inquiry Interim Report

I refer to the Financial System Inquiry Interim Report released on 14 July 2014 which sets out the Panel's views on the objectives of the financial system and the principles that should guide its development.

Innovation Australia was pleased to have the opportunity to make a submission to the inquiry and also to participate in a number of subsequent teleconferences with the Principal Adviser to the Inquiry and Members of the Secretariat.

In our submission **(Attachment A)**, we had a specific focus on the significant issue of market failure in early stage and development capital in Australia and in particular access to finance for small and medium enterprises (SMEs).

We agree with the Inquiry's observation that small businesses pay a premium for loans in comparison to large businesses and that there are structural impediments for small and medium sized enterprises (SMEs) to access finance. These impediments include information asymmetries, regulation and taxation (p2 -43). We also agree that venture capital is constrained in Australia (p2-65) due to a number of factors including a poor history of returns, the relatively young and small scale of the Australian market. We note the Inquiry's comment that there are a range of possible options for consideration (p2- 67) that might address some of these constraints, including an SME finance database providing business level data to new and existing lenders; loan guarantees by government; examining potential for loan brokers; providing quarterly R&D tax credits; and improving the operation of the VCLP regime.

We largely concur with the sentiment of some submissions that argued for government to facilitate innovation through forward looking mechanisms to ensure the regulatory framework supports innovations while managing risks (p4-49) and that this could be achieved through a central mechanism or body for monitoring and advising Government on technology and innovation.

You are seeking views on whether specific areas in which Government or regulators need to facilitate innovation through regulation or coordinated action e.g. by facilitating development

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of central utilities; and ways to improve how regulators monitor or address emerging technological developments, for example, through adopting new technologies or mechanisms for industry intelligence gathering (p4-51).

We are disappointed that there does not seem to be an acknowledgement of the fact that the primary government involvement in the venture capital markets for the past two decades (co-investment vehicles and other support) has suddenly disappeared with nothing to replace these former vehicles. In our March submission (p7 – **Attachment A**), we referred to the IIF program and Government venture capital co-investment as a social good, with reasonable returns over the years. It is concerning that the program has, since our last submission, been effectively discontinued and with it any prospect of dealing with what we agreed in our March submission was the primary way we were dealing with market failure.

We also note the Inquiry's comments on the Corporations and Markets Advisory Committee (CAMAC) report on crowd sourced equity finance, and that you are seeking views on the need to introduce differentiated equity markets for SME's, and possible modification of other capital raising requirements (p2-94). The Board provided a submission to CAMAC's Review of Crowd Sourced Equity Funding which we attach for your reference (see **Attachment B**).

Whilst we acknowledge that the interim report is comprehensive, we believe that there are some important issues discussed in the Board's submission to the Inquiry which do not appear to be addressed in the interim report. For example, the need to maximise the patient capital of Australian superannuation (institutional, industry and self-managed super), by creating incentives that can drive more private investment in early stage and development investment. Funding for small innovation intensive firms typically offers a premium for funders who are prepared to sacrifice liquidity over the medium term. This makes superannuation (both institutional and self managed super funds) an ideal vehicle for such funding. However, partly to meet the prospect of beneficiaries switching between funds and to meet prudential concerns arising therefrom, superannuation trustees prize liquidity far more than is justified by the long-term nature of the underlying investment for beneficiaries. There may be room for worthwhile institutional development to address this problem.

In addition, consideration should be given to delivering the various tax concessions available via super in a way that drives investment in earlier stage, higher risk high value investments that typically provide multiple benefits to the economy and community in the form of new capabilities, knowhow and innovation. This should occur both for general funds – in a form that would facilitate expert intermediaries – but also for self managed super funds which are beginning to become vehicles for substantial 'angel' and other investment in high growth innovation.

Finally, Innovation Australia emphasises the critical importance of having consistency in government policies, particularly incentives designed to encourage businesses to innovate and to improve their productivity and growth trajectory. The constant churn in policies with the electoral cycle prevents the continual improvement of programs, and, more importantly encourages business to take any incentives offered as 'windfalls' which undermines the dominant purpose of the incentives, which is not to channel funds to firms that are already innovative, but to influence firms to become *more* innovative.

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We are happy to expand on matters raised in this letter or from our previous submission to CAMAC on crowd source funding and also hope far more of our additional views can be discussed, and we hope furthered in the Inquiry's final report to be released in November 2014.

Yours sincerely

Dr Nicholas Gruen
Chair
26 August 2014

Attachment A: Innovation Australia's Submission to the Financial System Inquiry 31 March 2014

Attachment B: Innovation Australia's Submission to CAMAC's Review of Crowd Sourced Equity Funding

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Attachment A

Innovation Australia Submission to the Financial System Inquiry

31 March 2014

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Innovation Australia

Australian Government
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Committee Secretary
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GPO Box 89
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By email: fsi@fsi.gov.au

Dear Mr Murray

Financial System Inquiry

I am writing to respond to the Financial System Inquiry, on behalf of Innovation Australia.

Innovation Australia provides the following comments principally to Terms of Reference 1.3 and 3.3, in this initial submission, but notes the relevance to other Terms of Reference focussed on regulation, the role of government, and impact on innovation and industry generally.

We have focussed specifically on the significant issue of market failure in early stage and development capital in Australia. A copy of the submission is provided for your consideration at **Attachment A**.

Innovation Australia would be very keen to meet with representatives of the Inquiry Committee to expand on the issues identified in the submission prior to the finalisation of the interim report.

A profile of Innovation Australia is provided at **Attachment B**

Yours sincerely

Nicholas Gruen
Chair
31 March 2014

Encl.
Attachment A: Submission
Attachment B: Innovation Australia Board Profile

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Attachment A

FINANCIAL SYSTEM INQUIRY
(Submission by Innovation Australia)

"Australia is falling behind as a lucrative environment to start new companies, due to the lack of accessibility to significant customers and funding, a World Economic Forum report says. The findings, based on a survey of more than 1000 early-stage companies globally, showed Australia scored an average of 53 per cent when judged on eight key criteria for encouraging start-ups in global economies.

Though local start-ups reported that accessible markets and funding were the most crucial aspects of starting a new company, the country scored just 69 per cent in those categories. By comparison, the United States scored above 90 per cent for markets and funding, with an average score of 77 per cent, the highest among economies rated in the report."

The Australian Financial Review 28 January 2014

Market Failure in Early Stage Equity Capital

There is long-standing and unresolved failure in capital markets in Australia to provide capital for new ventures, particularly in relation to technology-based and other innovation-intensive start-ups.

Past government response has been directed towards the VC Fund mechanism, with limited success (the industry has seen returns negative for two decades, perhaps not least as a consequence of the tech-wreck and GFC, its relative immaturity and also its lack of scale), and Australian VC Funds are currently not a significant source of capital to new ventures. It seems unlikely that this situation will induce significant flow of venture capital from overseas VC Funds.

Emerging new approaches to sourcing, managing and mobilising venture capital provide alternatives to the VC Fund approach particularly in current circumstances. However, the efficacy of the new approaches in Australia is yet to be fully demonstrated. Moreover, they appear to be narrowly focussed on low-capital "lean" start-ups that are software-based, web-mediated and disruptive of existing business models. Larger areas of more capital-intensive innovation (e.g. biotech, medtech, new materials, advanced manufacturing) remain starved of capital.

The early success of these new approaches in other comparable economies owes something to government intervention, enablement or incentives, underpinned but not obviated in a few cases (e.g. in USA) by a deeper and more established propensity to support early-stage ventures.

An efficient and effective future early stage equity capital market in Australia will depend on a deeper understanding of the changing nature of early stage capital and on the nature of the market failures, to determine what sort of policy may be appropriate to the circumstances and to the objective of ensuring sufficient capital is allocated efficiently to early-stage ventures.

More fundamentally, having an efficient and effective early-stage equity capital market depends on our recognising the national imperative to support the development of innovative businesses, in the interests of greater productivity, competitiveness and export.

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Development Finance

A disproportionate number of the jobs of tomorrow will be created within small to medium high growth firms seeking to expand rapidly – so called Gazelles. Funding such firms is a difficult endeavour for several reasons.

It is difficult, as such high growth firms do not typically have long established track records, and even if they did, rapid expansion may be risky for them. Financing in such circumstances is high risk and requires high levels of skill, both in building relationships and in understanding risk. Yet, though the task absorbs more capital than start up and venture capital, it is still a small fraction of the task of financing major corporates and household lending. This means it is not 'centre of mind' for large banks.

As a recent paper argued regarding the British economy:

> *Even a rushed 'emergency scheme' relationship-banking institution, set up by the Government, succeeded in lending to a sample of firms, 95 per cent of whom had been refused loans by high street banks, without any difference in loan default rates. The market does not self correct because the scale of current banking creates strong incentives for conformity to a single business model and substantial barriers to entry for new banks offering better services to SMEs. The subsidies given to large highly leveraged banks through implicit government guarantees…further constrains entry.*[1]

The Australian banking sector is configured similarly to the British banking sector – except that concentration is higher in Australia. In the IA Board's experience it is likewise not performing well regarding the provision of development finance.

Given the risks involved, equity and quasi-equity finance are also relevant to the question of supplying Australian Gazelles with adequate development finance. Here there has been more diversity than in banking. There are three major superannuation fund streams – Industry super, for-profit super and self-managed super funds (SMSFs). In each case however, development finance is a difficult market to serve, requiring specialist skills that may be difficult for the trustees to govern, and yet which should occupy only a relative small share of a properly balanced portfolio. In such circumstances development finance typically falls through the cracks.

A somewhat different set of issues arises for mid-market firms who are growing rapidly. In Australia the case is often made that while the nation has a proliferation of micro businesses and small SMEs, we lack the presence of a sizeable number of mid-size firms with the capacity to expand globally while anchoring their value adding activities at home. Ministers, business leaders and academics frequently raise the question "where is the next generation of Cochlears, Resmeds and CSLs coming from?"

During the 2012 Manufacturing Taskforce, the non-government members of the Taskforce ("the non-government members") considered what was required to "help more SME's grow into the global, mid-size firms Australia lacks".[2] Access to development or expansion capital was frequently nominated as an issue, particularly loans for rapidly expanding mid-market firms (or those breaking into the mid-market space) tooling up for new business, expanding off-shore through acquisitions or substantially increasing capacity at home to service domestic and export markets. Banks perception of risk and restrictive loan covenants were amongst the issues raised.

[1] Hutton, W. and Nightingale, P. 2011. The Discouraged Economy. London: The Work Foundation.
[2] PM's Manufacturing Taskforce: Report of the Non-Government Members August 2012 page 4.

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Similar issues are at the centre of the debate in the UK following the Rowlands Review and the establishment of the Business Growth Fund, the Growth Accelerator Program and other mechanisms to help finance high growth firms.[3]

Interim Report and Final Report

Innovation Australia request that the Financial System Inquiry in the development of its interim and final reports, thoroughly investigate and make recommendations taking into consideration the following points:

- The mechanisms for providing growth capital to new, early-stage and rapidly growing SMEs in Australia are deficient, particularly in relation to technology-based and other innovation intensive opportunities (this stands in marked and largely unexplained contrast to the skill, experience and willingness of the Australian market to provide risk-capital to mining exploration or start-up ventures).
- The "gaps" in availability of capital occur at proof-of-concept and early stage commercialisation stages as well as early expansion development finance, meaning that incipiently successful Australian innovations and ventures are confronted by a sequence of capital barriers well beyond those experienced in other comparable economies.
- Since 2008, the contribution of conventional Venture Capital Funds has declined substantially. It is not assumed that this circumstance of low VC Fund activity will not be remedied in future, but it is clear that, in current circumstances, broader views of venture capital are required.
- Investment in R&D intensive SMEs is highly cyclical. This is on its face a market failure. Whereas the cyclicality of some investments demonstrates the market working efficiently - for instance varying construction activity with the state of demand and supply of dwellings and interest costs – this is not true for R&D intensive stocks - the world will either want the new technology and service being development or not. This shows how VC and development capital tend to be an afterthought - pursued when the market is buoyant and full of optimism and rationalised in difficult times. There therefore needs to be some consideration of this in crafting interventions. We saw this in the wake of the GFC and took some limited and *ad hoc* steps to counteract it. It would be better to build such considerations into institutional design.
- There is no reliable evidence that the vacuum in VC Fund activity in Australia, and the demonstrated availability of high quality investment opportunities in this country, will induce significant flow of early stage capital from overseas markets into Australia.
- Sources of and channels for mobilising venture capital in other countries, and apparently also in Australia, are becoming more diverse.
- 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.
- In the circumstances where provision of venture capital currently appears to be adequate, it is often narrowly focussed on fast-moving, software-based and web-mediated innovation that is disruptive to existing businesses and business models.
- 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, new materials, new manufacturing, energy efficiency) continue to be starved of capital.

[3] The UK debate is canvassed in detail in R. Brown, C Mason and S. Mawson: Increasing the Vital 6 Percent" Designing Effective Public Policy to Support High Growth Firms NESTA Working Paper No. 14/01. As pointed out in the NESTA paper and in the Australian debate, there are many issues besides access to capital that feature in the underdevelopment of Australia's mid-market sector.

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- Past government policy interventions, like the Innovation Investment Fund (IIF), have recognised market failure in early stage capital markets in Australia, and sought solutions by supporting VC Funds or similar entities through co-investment (IIF commenced in 1998, with future funding depending on the upcoming budget). This seems an appropriate form of intervention as it 'crowds in' private endeavour, helping to develop the private capital market in appropriate directions, rather than 'crowding out' commercial funding by competing with it unfairly.
- More recently, governments have established mechanisms like Commercialisation Australia, which is proving successful in overcoming specific market failures and helping early stage ventures to bridge capital and knowledge gaps.
- Future measures need to recognise the continuing market failure, and respond to the shifting nature of early stage equity capital, the emergence of new sources of capital, new channels for mobilising and managing it, and the different motivations and drivers for investment.
- Unsurprisingly, given the level of risk, the majority of capital for early-stage ventures is equity or quasi-equity rather than debt though debt can be a useful adjunct to equity. This means that Australia's large pools of capital within its superannuation system should be a powerful resource; however, owing to a mix of market failures and regulatory settings this has not been the case.
- Australia has one of the largest savings pools in the world (>$1.8 trillion) in government-enforced saving superannuation (institutional, industry and self-managed super), meaning there is no shortage of capital, just a shortage of it being applied to early stage and development investment. The reasons are varied but there are a variety of incentives that could drive more private investment in this sector.
- With regard to institutional investors, there are many reasons why they have not allocated much capital (<0.5%) to venture capital. In addition to historical poor results, there are structural reasons (super funds are too big to write small cheques) and business reasons (asset consultants often advise against venture capital, partly due to lack of education on the sector), as well as a natural conservatism.
- The liquidity requirements of super funds make investing in venture capital difficult, given its long-term illiquid nature. However, an undue focus on liquidity results in a loss of diversification opportunities in funds that may be highly concentrated through comparatively high exposure to domestic equities.[4] Given that allocations to venture capital investment would remain a small share of total portfolios, there are opportunities for gain where funds trade-off very small losses in liquidity for higher returns.
- With regard to individual investors, experience in comparable economies shows that new sources of capital include individual investors with diverse characteristics, from very high net-worth (HNW) investors experienced in building new ventures, to syndicated HNW angel investors, to retail investors.
- Whether Australian individual investors will show a similar predilection for venture investing is unclear. On the one hand is evident enthusiasm for crowd-funding arts ventures; on the other are data showing that Australian HNW investors construct more conservative portfolios than counterparts in comparable economies.
- There are various structural and other barriers that prevent this capital flowing into early stage and expansion capital opportunities in significant quantities. Such barriers include regulatory and individual notions that such investment is 'high risk', when, however true that might be of investment in a single venture, it is less true of a portfolio of such investments and less true again when the riskiness of that portfolio can actually lower risk in a larger portfolio where it is not strongly correlated with the market generally.

[4] 61% of ASX earnings generated by 2 industries; 60% of ASX earnings generated by 10 companies. Source: FactSet 2011

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- New channels for mobilising and managing capital include new pooled-fund models, including syndicated angel funds, which may be organisationally linked to accelerator and incubator initiatives, retail investor funds, and crowd-sourced equity, debt or reward funds.
- The result of too little early stage and expansion capital is that many innovative opportunities are relocating to and seeking capital in overseas locations (and therefore moving economic activity and high quality jobs offshore), or “dying on the vine” for lack of capital.

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Attachment B

Innovation Australia Board Profile

Innovation Australia is an independent statutory body under the *Industry Research and Development Act 1986* (IR&D Act) to assist with the administration and oversight of the Australian Government's industry innovation and venture capital programs delivered by AusIndustry. Membership of the Board comprises leading Australian business figures with professional and technical expertise across a broad section of industries, technologies and capital markets. Established on 27 September 2007, Innovation Australia assumed the roles, responsibilities and powers of the two former Boards and carries responsibility for past decisions made by the IR&D and VCR Boards.

The IR&D Act promotes the development of Australian industry and aims to improve industry efficiency and international competitiveness by encouraging research and development, innovation and venture capital activities.

The Board also has functions conferred on it by the *Pooled Development Funds Act 1992* (PDF Act) and the *Venture Capital Act 2002* (VC Act) in relation to the administration of the venture capital programmes. The Board evaluates and advises Government on the operation of the IR&D Act, the PDF Act, the VC Act and the Commonwealth's income tax law as they operate in relation to those Acts.

In addition to the R&D Tax Incentive, the Board and its committees assists the government in the administration of two key business programs - Commercialisation Australia and the Innovation Investment Fund. These programs are aimed at commercialising innovative technologies and turning research into new products, service and processes.

R&D Tax Incentive

The R&D Tax Incentive is a targeted, easy to access, entitlement program that helps businesses offset some of the costs of doing R&D. The Program aims to help more businesses do R&D and innovate. It is a broad-based entitlement program. This means that it is open to firms of all sizes in all sectors who are conducting eligible R&D.

Commercialisation Australia

Commercialisation Australia (CA) is a competitive, merit-based assistance programme helping Australian companies and researchers convert their novel intellectual property (IP) into new products and services. CA offers both financial assistance and skilled resources to help build businesses from new IP.

CA assistance targets early stage commercialisation to build businesses that are market ready and attractive to investors. CA does not support basic research and development activities and therefore it complements, rather than duplicates, support available through the R&D Tax Incentive Program. CA is the only national programme operating in this space.

Innovation Investment Fund

The Australian Government’s Innovation Investment Fund (IIF) is a venture capital programme that supports 10 year innovation funds to develop high growth Australian companies to become globally competitive by commercialising the outcomes of Australia’s strong research capability. The Australian Government has supported venture capital through its IIF program since 1998. Over the three rounds the programme has licensed 17 fund managers and has supported over 135 new companies.

When finalised, IIF3 (since 2007) is expected to have injected $370 million (Government and private) of risk capital into the venture capital sector to fund the commercialisation of Australian R&D.

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Attachment B

Innovation Australia Submission to the Corporations and Markets Advisory Committee

29 November 2013

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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.

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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

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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

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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.

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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.

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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.

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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

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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

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- 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

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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.

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(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 uptodate, 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

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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

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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.

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(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

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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.

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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.

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(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.

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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.