White Paper

Equity Crowd Funding in Australia

November 2013

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Important Notice:

Information included in this paper is intended to be for guidance only and is not intended to be relied upon by potential issuers of securities or potential investors. We recommend professional advice is sought should you wish to raise funds in terms of the current legislation in Australia.

Contents

Glossary

AAAI	Australian Association of Angel Investors
ABS	Australian Bureau of Statistics
AFSL	Australian Financial Services License
ASSOB	Australian Small Scale Offerings Board
ASIC	Australian Securities and Investments Commission
AVCAL	Australian Private Equity & Venture Capital Association
CAMAC	the Australian Corporations and Markets Advisory Committee
CSEF	Crowd Sourced Equity Funding
PE	Private Equity
RBA	Reserve Bank of Australia
The Act	Corporations Act, 2001
VC	Venture Capital

1. Executive Summary

Small business is the back-bone of the Australian economy, and it has the ability, given the right conditions, to have a significant positive impact on the Australian economy.

Small business (0 to 19 employees) accounts for almost 50% of private sector industry employment and there were over 2.1 million actively trading businesses in Australia in 2011, the vast majority of which were small businesses and at any one time there are over half a million Australians involved in early stage entrepreneurial activity.

The problem that many of these small businesses and entrepreneurs face is a lack of access to capital to grow and develop their businesses. As a result less than 60% of small businesses manage to survive for any degree of time.

Many start-ups do not even try to source outside funding, possibly due to a perceived lack of available options.

Equity Crowd Funding is a means for small business to access capital by engaging with the crowd via social media to raise money in exchange for equity in the underlying business.

Currently equity crowd funding is illegal in Australia. A number of other jurisdictions around the world are considering or have passed new laws regulating equity crowd funding and Australia, via CAMAC, has taken the first steps in seeking feedback from the public in terms of how any equity crowd funding legislation should be structured.

There are a number of avenues currently available for small business in Australia to raise equity capital including:

- Angel Investors
- Venture Capital & Private Equity
- Prospectus or disclosure document
- Family & friends via personal offers

The reality is though that many of these avenues either have a low chance of success or come at significant cost and a significant investment in time.

At present the fund raising laws in Australia are bent towards investor protection and that is obviously an important characteristic that should not be fundamentally changed, but there needs to be a balance between investor protection and giving small business the ability to access capital in a cost effective and timely manner, i.e. equity crowd funding.

There seems to be a wide acceptance that the fund raising laws in Australia (and around the world) which in most cases have been in place for decades need to be amended to suit the current climate that we find ourselves in.

Our blueprint for a credible and viable equity crowd funding industry in Australia supports the amendment of the existing personal offers exemption included in the Corporations Act

Some of the key principles which we believe should be adopted and which are more fully detailed in section 9 include:

For Investors

- Limits on investment – we believe equity crowd funding should be open to all residents and there should be an investment limit of $5,000 pa. For Self-Managed Super Funds we suggest a limit of $10,000.
- Self-regulation and reporting – we recommend self-regulation of the investment limits by the investor via the ATO
- Tax relief –we recommend specific tax relief for investors in the form of a tax deduction on any equity crowd funding investment
- Accreditation – we would support an accreditation process whereby prior to investing an investor would be required to attend and pass a risk awareness workshop.
- Limit on potential investors – we suggest a limit on the number of potential investors of 400 (i.e. a maximum fund raising of $2 million per issuer)
- Legal interest in shares –we support the investor having full legal interest in the shares and not indirect beneficial interest via a managed investment scheme.
- Tag Along rights – we suggest that Tag-Along clauses are compulsory. This would force anybody making an offer for the shares of a controlling shareholder to make the same offer to all minority shareholders.
- Cooling off period –we suggest a cooling off period of 14 days

For Issuers

- Accreditation of directors – we believe that all directors of an issuer should be accredited (via formal training)
- New issues only – any issue of securities via an equity crowd funding process should be for the issue of new shares only
- Provisional Public Company – we suggest the creation of a new form of company called a Provisional Public Company which gives the issuer the flexibility to have multiple shareholders but not the related public company governance requirements. The intention would also be for an issuer to evolve into a full public company once certain criteria were met. Other potential attributes include:
    - A maximum of 400 shareholders
    - Only one type of share available
    - A limited disclosure document for fund raising purposes
    - No audit requirements unless turnover exceeds a certain pre-determined amount (we suggest $2 million)
- Solicitation & advertising – Issuers should have the ability to directly solicit investment from accredited investors

For Intermediaries

- Registration of intermediary – we recommend that all intermediaries be registered with ASIC but no requirement for an AFSL or being registered as a Responsible Entity
- Risk awareness – the intermediary should ensure that the investor is fully aware of the potential risks of investing in a small business start-up

- Investment advice – the intermediary should not be allowed to offer investment advice to any investor or issuer
- Solicitation – the intermediary should not be able to solicit investment, the role of the intermediary should simply be to facilitate the introduction of accredited investors with issuers
- Due diligence – The intermediary should be responsible for basic due diligence on the issuer
- Project eligibility – the intermediary should take reasonable care to ensure that any issuer listed on their platform does not Infringe any intellectual property rights amongst other things
- Access to accredited investors – The intermediary should ensure that only accredited investors have access to the investment opportunities on the platform

We welcome any feedback on this document, please send any questions and/or comments to “whitepaper@ipledg.com”

2. Background

Small business is the back-bone of the Australian economy, and it has the ability, given the right conditions, to have a significant positive impact on the Australian economy.

Unfortunately in recent years these conditions have deteriorated due to the global financial crisis which has put a lot of pressure on these small businesses, especially from a financing perspective as the main stream banks have tightened their credit policies making it very difficult for these small businesses to access capital to grow their business.

To highlight the impact of small business on the Australian economy reference is made to the Australian Small Business, Key Statistics & Analysis – December 2012, published by the Australian Government, Department of Industry, Innovation, Science, Research & Tertiary Education.

Some of the key findings of this report were as follows:

- In Australia, small business (defined as actively trading businesses with between 0 and 19 employees) make a significant contribution to the Australian economy, accounting for slightly less than one-half of private sector industry employment and contributing approximately one third of private sector industry value added in 2010–11.
- There were 2 132 412 actively trading businesses in Australia as at June 2011
- In 2010–11, micro businesses, other small businesses and medium businesses experienced barriers to innovation shown by 65.8 per cent, 58.8 per cent and 63.1 per cent respectively

Additional evidence from the Australian study of Entrepreneurial Emergence suggests that:

- Over half a million Australians are involved in early stage entrepreneurial activity at any point in time.
- Australian start-ups compare well with their American counterparts on indicators of quality.
- In terms of quality, Australian founders are less likely to be motivated by necessity or lack of alternatives, more likely to be growth oriented, more likely to emphasise research and development, and more likely to be based on young and/or sophisticated technologies

On the contrary, the Global Entrepreneurship Monitor (GEM) suggests that

- Australia has high rates—second only to the US among "innovation-driven economies"
- Australia has the highest proportion of start-ups motivated by "improvement-driven opportunity".

In terms of finance only one source, personal savings, is used by more than 50 per cent of all start-ups.

Despite frequent references to the '3 Fs'—friends, family and fools—most firms do not rely on such sources. Apart from credit card debt, even a major source such as bank funding is used only by a minority.

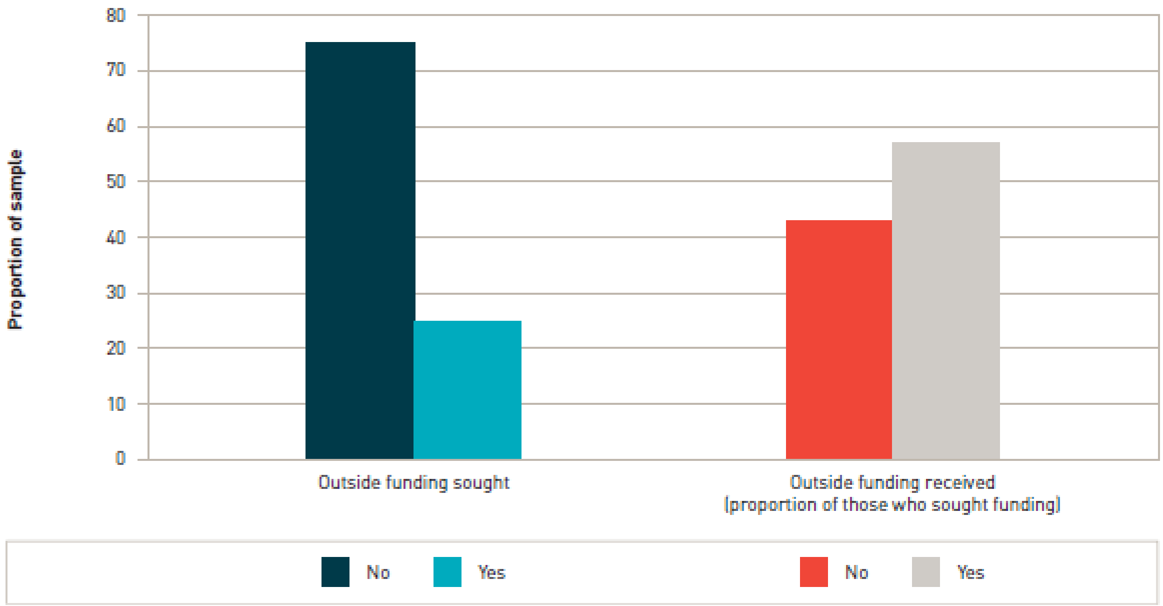
In a random sample, funding by business angels and venture capital firms is close to non-existent. This is quite different from the picture of "typical" start-ups from the business press or business school textbooks.

Table 2: Per cent of nascent and young firms using different sources of funding

Source	Not used		Minor source		Major source	
	NF	YF	NF	YF	NF	YF
Personal savings	13	25	15	24	72	51
Personal credit card	55	53	25	28	21	19
Money from another business that the founders' also own	85	96	6	2	9	2
Government grants	93	94	5	5	2	1
Delayed payment terms from suppliers	87	78	8	13	5	9
Advance payment from customers	86	78	9	14	5	8
Loans from family members	86	91	9	6	5	2
Loans from friends, employers or colleagues	95	96	4	3	1	1
Founders' personal secured-bank loans	83	84	4	6	12	11
Founders' other personal loans, overdraft or other credit facilities from a bank	85	84	9	9	6	6
Secured bank loans to the business itself	92	91	3	4	5	6
Other loans, overdraft or other credit facilities from a bank to the business itself	94	92	5	6	1	2
Loans from any other organisation to the business itself	96	94	3	3	1	2
Equity from family members	95	91	4	6	1	2
Equity from friends, employers or colleagues	98	99	1	1	1	0
Equity from other private investors ('business angels')	98	99	1	1	1	0
Equity from Venture Capital firms or any other organisations	100	100	(one case each among NF and YF, respectively)			

Note: NF = Nascent firm; YF = Young firm. Entries in per cent. Entries may not sum to 100 due to rounding. "Major" was defined as representing at least 20 per cent of total funding needs.

Figure 6: Seeking and receiving external funding (nascent firms only)

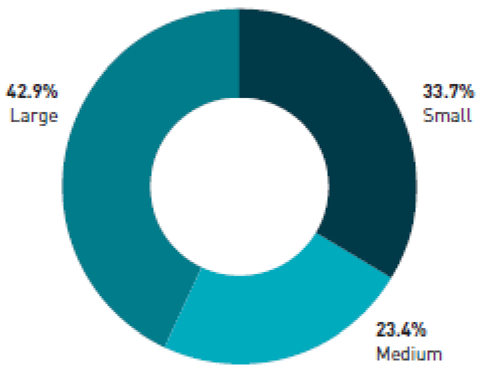


The graphs above indicate that many start-ups do not even try to source outside funding, possibly due to a perceived lack of options available or perhaps not wanting to rescind control of their firm.

a) Australian Bureau of Statistics

According to the ABS Small businesses make a significant contribution to the Australian economy, accounting for nearly one-half of private sector industry employment and contributing approximately one third of private sector industry value added in 2010–11.

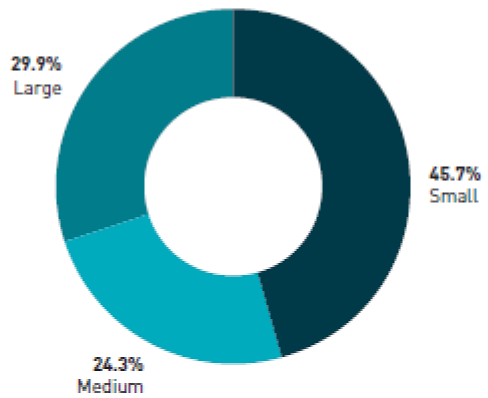
Figure 9: Contribution to private sector industry value added by business size, 2010–11



Data source: ABS Cat. No. 8155.0 and DIISRTE calculations.

Text description: see Appendix C.

Figure 11: Share of private sector employment by business size, at end June 2011

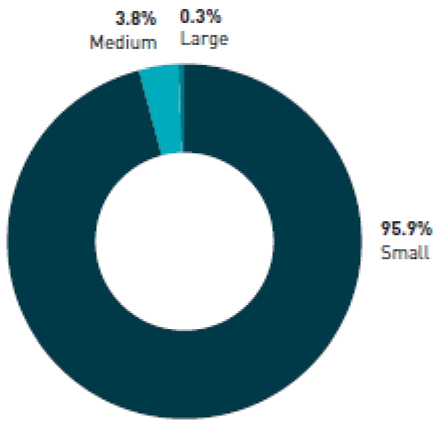


Data source: ABS Cat. No. 8155.0 and DIISRTE calculations.

Text description: see Appendix C.

The figure below shows that of the 2,1 million actively trading businesses in June 2011, almost 96 per cent were small businesses (over 2 million), 3.8 per cent were medium businesses and less than 1 per cent were large businesses.

Figure 16: Distribution of total business numbers by business size, June 2011



Data source: ABS Cat. No. 8165.0 and DIISRTE calculations.

The Australian Taxation Office (ATO) estimates that there were around 3 million micro entities in Australia at the start of the 2012–13 financial year, up from around 2.8 million micro entities at the start of the 2011–12 financial year. Micro entities are defined as having a turnover of equal to or more than $1 and less than $2 million in a financial year.

In relation to business finance, businesses were asked whether they had sought any debt and/or equity finance during 2010–11. The proportion of businesses seeking finance increased with each successive employment size range: from 15 per cent for firms employing 0–4 persons, to 37 per cent of firms employing more than 200 persons.

Both micro businesses (40 per cent) and other small businesses (45 per cent) reported short-term cash flow or liquidity as the most common reason for seeking finance. The second most common response from micro and other small businesses was to ensure survival of business at 35 and 37 per cent respectively.

Table 14 below shows the aggregate survival rates for the Australian economy as a whole and depicts the proportion of businesses that were operating in June 2007 and continued operating to June 2011. As can be seen from this table, the survival rate for small businesses is lower than for medium and large businesses

Table 14: Business "survival" rates by employment size between June 2007 to June 2011

	Number of businesses operating in June 2007	Number of businesses that continued to operate to June 2011	"Survival" rate (%)
Small (0–19)	1 985 822	1 185 997	59.7
Medium (20–199)	82 071	62 243	75.8
Large (200+)	5 900	4 386	74.3
Total	**2 073 793**	**1 252 626**	**60.4**

Data source: ABS Cat. No. 8165.0 and DIISRTE calculations.

b) Bank lending for small business

Small businesses access many sources of finance to assist their business. Sources of finance include family, friends, credit cards, mortgages and unsecured loans, to name a few.

The Reserve Bank of Australia hosted a small business finance roundtable in May 2012, to gain better understanding of how small businesses are financed. The roundtable, besides making other observations, noted that:

- Small businesses meet their funding needs using internal equity funding and existing debt facilities.
- Eighty per cent of small business loan applications are accepted while only a small fraction of businesses who seek venture capital funding are successful.
- Small businesses pay more, on average, for debt than both households and larger businesses. This is because smaller businesses are typically viewed as having more volatile revenue streams, make greater use of riskier forms of loan collateral, and make more use of unsecured debt products.
- The higher cost of small business debt facilities leads many smaller businesses to use household debt products to fund their business.
- Smaller businesses also make use of alternative sources of debt such as equipment and vehicle leasing.
- Other forms of finance for small businesses include debtor finance and debt funding from trade suppliers.

The RBA also reported that:

‘The strong links between small businesses and households also accords with the finding that while small businesses tend to have less debt than large businesses, households that own small businesses tend to have higher debt than other households. The personal nature of small businesses is often reflected in their financing arrangements, with financing evolving with the business. Initially, financing is predominantly tied to the owners’ personal situation. As the business develops, financing becomes more closely linked to the performance of the business.

c) Trends in small business access to finance

In its Submission to the Inquiry into Access for Small and Medium Business to Finance, the Reserve Bank of Australia, on 7 February 2011, reported that:

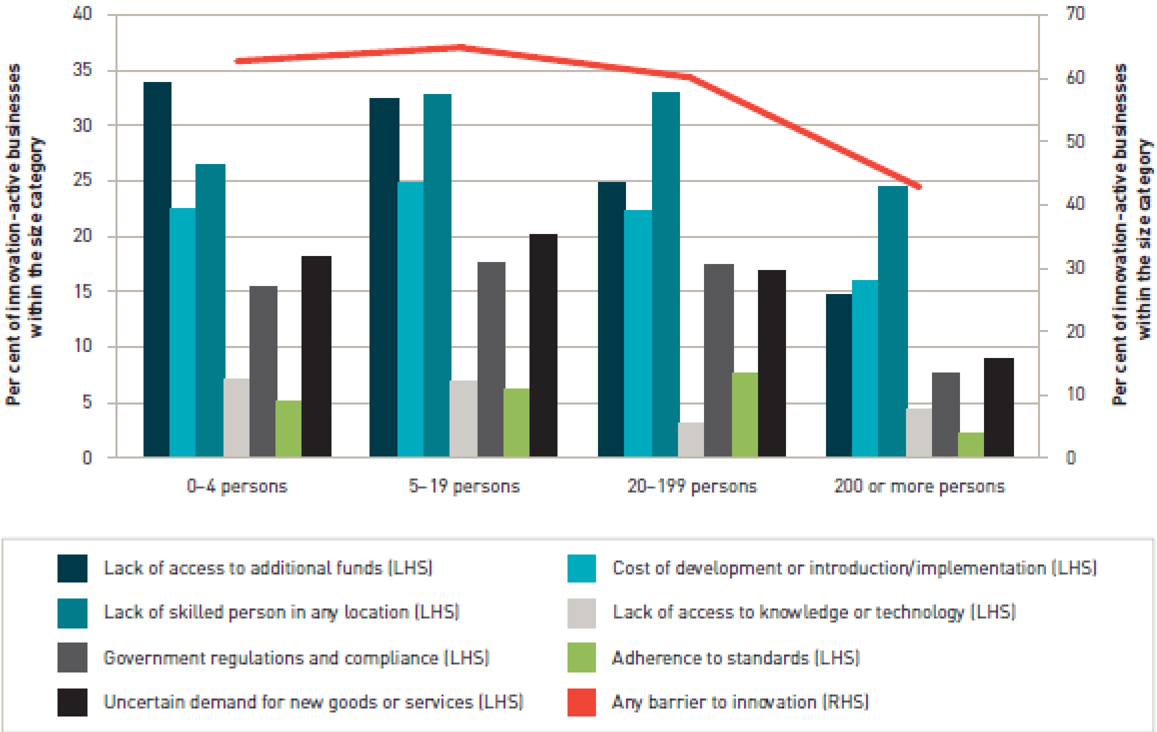
- Lending to small businesses has increased slightly over 2009 and 2010, after growing steadily over the decade prior. The slowdown reflects both reduced demand from businesses and a general tightening in banks’ lending standards. Small businesses in most industries have been able to access funding throughout the financial crisis, albeit on less favourable terms than previously.’
- ‘Higher funding costs and a reassessment of risk have resulted in an increase in the spread between the rates that lenders charge on business loans and the cash rate.’
- ‘Competition in the small business lending market eased following the onset of the financial crisis, but there are some early signs that competitive pressures are again beginning to intensify in some segments of the business lending market. This should continue as the economy continues to strengthen.’

The CPA Australia Asia-Pacific Small Business Survey 2011 found that only 30 per cent of businesses surveyed had a business loan at the time of the survey. According to the survey, 30 per cent of businesses needed additional funds in the year to October 2011, with the main reasons for requiring additional funding being to cover increasing expenses and business survival (41% each).

The survey also revealed that in 2011, a much higher percentage of business owners sought additional finance for business survival, purchasing assets and covering tax payments compared with the year before. On the other hand, the percentage of businesses seeking additional finance for business growth remained almost unchanged from 2010. This may reflect a shift in small business bank financing priorities from growth to survival. Of those businesses which reported requiring additional funding, 55 per cent obtained all or part

About a third of business seeking finance reported difficulty in accessing additional funding, with difficulty in finding a financier willing to provide funding to the business’ industry reported as the main reason.

Figure 33: Barriers to innovation, 2010–11[48]



Data source: ABS Cat. No. 8158.0, Data Cube 6, Table 1

3. Current Australian Environment for Equity raising

Equity fund raising in Australia can currently be secured from a number of avenues namely:

- Offers to the Public
- ASSOB
- Angel Investors
- Venture Capital & Private Equity

a) Offers to the Public

The Australian Corporations Act, 2001 (the Act) sets out the rules and procedures required to raise funds from the public via the issue of shares.

The relevant rules are contained in Chapter 6D of the Act and essentially state that a person cannot make an offer of securities (i.e. shares) to an investor until a disclosure document has been lodged with ASIC.

Some offers, as defined in s708 of the Act, can be classified as exempt and require no disclosure, such as:

- Personal offers (offers of less than $2m and no more than 20 investors in a 12 month period)
- Offers to sophisticated investors (defined as someone with net assets of >$2.5m or gross income for the last 2 years of at least $250k)
- Offers to professional investors (e.g. listed entities with assets of at least $10m)

Where none of these exemptions apply a proprietary company (i.e. a private company) is prohibited from raising any funds from investors in Australia. Where offers are received from outside Australia these rules do not apply but local rules (from where the offer is made) may be applicable.

Given the above, the opportunity for small private companies to raise funds from the public is very limited unless you know some wealthy and/or sophisticated investors. Certainly equity crowd funding (i.e. raising small amounts of investment from lots of people) would not be allowed unless the rules of Chapter 6D were followed.

Irrespective of whether an offer is exempt or not, the conduct of someone raising funds from the public could still be subject to other sections of the Act or common law, i.e. you cannot make false or misleading statements or engage in misleading or deceptive conduct.

For this reason most offers to the public (exempt or not) are contained in an information memorandum, the aim of which is to minimise risk for the issuer in case they are accused of misleading or deceptive behaviour. Although this is not a formal document required by the Act it is common practice and typically requires input from professional accountants and lawyers which can turn into fees of tens of thousands of dollars.

For non-exempt offers to the public a prospectus is required to be prepared and lodged with ASIC. This is a formal document containing pre-determined information and again typically involves input from accountants and lawyers.

For offers of less than $5m an offer information statement can be used which is a less onerous document in terms of content but again typically requires input from accountants and lawyers.

What we can conclude from the above is that the current legislation enables the raising of funds from the public but the cost of compliance and complexity and risk involved is high making it almost impossible for private companies to access the public for investment with the legislation in its current form.

The key is to find an alternative solution which balances investor protection (via various disclosure and/or statements from the directors) with minimising the cost of compliance in terms of preparation of documentation.

b) ASSOB

ASSOB operates under ASIC Class Order 02/273 which provides an exemption from the fundraising provisions of the Corporations Act for persons involved in making or calling attention to offers of securities through a business introduction service.

According to their website ASSOB is Australia's largest and most successful business introduction and matching platform for showcasing investment opportunities in high growth, unlisted Australian companies.

A wide range of businesses, from seed and start-up stage to award-winning and government granted companies, as well as more established growth and expanding companies have joined ASSOB seeking access to growth capital and a convenient forum to connect with potential investors and other stakeholders.

To join ASSOB, companies are not required to have a minimum company size, particular financial track record, proven profit trading history or shareholder spread.

ASSOB have raised ~$135m to date, but the class order limits investors to 20 accredited investors per annum and a maximum funding amount of $5m.

It costs a company $4,500 to list on the platform plus $400 per month to retain the listing, sponsor fees for investor documentation average $3,000 plus, with typical fees of $8,000 upwards.

There are also other fees to consider such as

- Trust account & Share register establishment fee of $1,250,

- Transaction fees of 2.5%
- Success fees of 8% of capital raised

Although ASSOB, operating under its class order, certainly makes it easier and cheaper for smaller companies to access capital it certainly requires improvement to enable smaller companies to access the capital markets more cheaply and to engage a wider cross section of the population.

c) Angel Investors

According to Wikipedia an Angel Investor is an affluent individual who provides capital for a business start-up, usually in exchange for ownership equity. According to the Australian Association of Angel Investors (AAAI, www.aaai.net.au):

- Australian Angel investors invested $1 billion in emerging businesses.
- These businesses generated 5,000 jobs.
- More than 50% of Angel investments were in seed and start-up companies.
- The most popular sectors for Angel investment were Life Sciences, Clean Technologies, Web Software and IT.
- Angel investors spend around 48 hours per month on Angel investment activities. Up to 20 hours is spent advising entrepreneurs seeking investment.
- There are now 12 Angel Groups across Australia. In 2006 there were only three.
- The average size of an Angel Capital investment in a round is between $350,000 – $400,000 in Australia.

From the above Angel Investing would certainly seem to be a viable source of capital for many businesses but consideration needs to be taken of the chances of success under Angel funding and also the consequences of bringing in an Angel investor.

The following data was gathered from Southern California's Tech Coast Angels (sourced via www.billpayne.com), showing that only 1 in 72 entrepreneurs (1.4%) who applied for funding were successful, broken down as follows:

- Pre-Screening: 1 in 4 deals proceeds to Screening
- Screening: 1 in 3 deals proceeds to Due diligence
- Due diligence: 1 in 3 deals proceeds to an Investment Meeting
- Investment Meeting: 1 in 2 deals raising money
- Overall: 1 in 72 companies who apply for funding are successful

So this would infer that the chances of finding and securing a deal with an Angel Investor are pretty slim. This makes sense when you consider that an Angel Investor is potentially investing a few hundred thousand dollars in a number of investments, 80% of which may not work, therefore they have to be strict in their investment screening process to try and earn a return on their investments.

Angel Investors apply a screening method to all of their potential investors and there is no reason why a similar process should not be used in the equity crowd funding process to enable potential investors to form a view of the company.

Typically this screening process would involve looking at the following issues:

- What is the value proposition for the business and for the investors
- How are you going to scale revenues and business value as fast as possible
- Ensure your business has a unique competitive position – something that indicates why you will succeed over anyone else
- Identify an exit strategy, e.g. trade sale or IPO
- Knowing how much money you are going to need to deliver the returns to investors

The management team is also one of the most important pieces of the puzzle for Angel Investors, the following information is extracted directly from the AAAI website:

"Angel Investors recognise that the founder and management team are the critical factors in delivering on outcomes in any business. There is a continual debate about whether to "bet on the horse or the jockey". For Angels it is about both. There must be a significant and unique value proposition that will give you a distinct competitive advantage. However the best technology in the world cannot be guaranteed to succeed without the passion and drive of the founder and the management team. Someone has to live that business and drive it forward. The investors will need to have confidence that founders and management can deliver on that and that they are prepared to develop a strong relationship based on trust. One key factor is whether the team is mentorable. If a founder is not prepared to listen and learn from experience, it is not likely to be a comfortable relationship and investors may walk away."

When it comes to equity crowd funding mentoring is not an option, it is assumed that the existing management team has the required skills, experience and drive to deliver on results. As a result there needs to be a consistent way to measure this to enable potential investors to gauge these management traits. Many of these can be assessed by discussions or investor presentations, interviews with management, background checks etc.

In conclusion although Angel Investing has an important role to play in finding and developing new businesses it also has a number of drawbacks, mainly in relation to your chances of securing investment.

d) Private Equity & Venture Capital

In Australia Private Equity & venture Capital is essentially an avenue for companies to secure funding for expansion capital rather than start-up capital.

According to the Australian Private Equity & Venture Capital Association (AVCAL - www.avcal.com.au) there are approximately 300 private equity & venture capital firms in Australia.

Over the last 10 years over $1.5bn has been invested in 250 companies. Considering there are over 1 million businesses in Australia, many thousands of which are looking for capital, this is not a high hit rate and indicates that the private equity and venture capital industry in Australia is more focused on companies that already have some substance to them with a track record of growth requiring expansion capital to take them to the next level.

As a result this form of funding is not really viable for small private companies looking to raise seed capital although it does have its place on the funding ladder.

4. US Overview

The US JOBS Act ("the Act") was signed into law on 5 April 2012, with an initial expectation that it would be implemented by the SEC on 1 January 2013.

The primary provisions of the Act were aimed at:

- Increasing the number of shareholders a company may have before being required to register its common stock with the SEC and become a public reporting company. Currently these requirements are applied when company assets reach $10 million and it has 500 shareholders. This would be altered so that the threshold is reached only if the company has 500 "unaccredited" shareholders, or 2,000 total shareholders, including both accredited and unaccredited.
- Provide a new exemption (subject to a number of conditions) from the requirement to register public offerings with the SEC. This exemption would allow use of the internet "funding portals" registered with the government. Currently the use of such portals in private placements is extremely limited. Included in these conditions is a yearly limit on the amount each person may invest in offerings of this type (linked to net worth or yearly income). The limits are $2,000 or 5% (whichever is greater) for people earning (or worth) up to $100,000, and $100,000 or 10% (whichever is less) for people earning (or worth) $100,000 or more. The aim of this exemption is to allow a form of crowd funding. The Act also allows for reviews of financial statements for offerings between $100,000 and $500,000, and audits of financial statements for offerings greater than $500,000 (with a maximum offering of $1million).
- Relieve emerging growth companies from certain regulatory and disclosure requirements (most notably the obligations imposed by Section 404 of the Sarbanes-Oxley Act and related rules and regulations) in the registration statement they originally file when they go public, and for a certain period after that.
- Lift the ban on "general solicitation" and advertising in specific kinds of private placements of securities, i.e. allowing the use of social media to promote offerings to the public.
- Raise the limit for offerings from $5 million to $50 million, which allows for larger fundraising efforts under this simplified regulation.

There are obviously concerns regarding the perceived lack of investment protection for investors, thereby exposing small and inexperienced investors to the prospect of fraud.

5. UK Overview

Crowd funding sites and peer-to-peer lenders in the UK have developed to help fill a gap left by reduced bank lending due to tougher capital rules and greater regulatory scrutiny.

The British government has pledged to lend £85 million through non-bank lenders, including peer-to-peer sites, as part of its efforts to help drive economic recovery by boosting funding for small businesses.

The Financial Conduct Authority has authorised (as an exemption from the United Kingdom prospectus provisions) some intermediaries to conduct crowd funding to investors who self-certify that they come within prescribed tests of being high net worth or sophisticated investors.

Given the restrictions around investors and their perceived sophistication when it comes to investing this has reduced the amount of regulation for issuers and intermediaries compared to other countries which are considering full equity crowd funding legislation.

Intermediaries are not obliged to conduct in-depth due diligence investigations on an issuer and only basic checks are performed.

The focus on the UK is therefore on informing potential sophisticated investors of the inherent risks involved in equity investment, i.e. limiting investment opportunities to high net worth individuals, which many perceive as unfair and not true “crowd” funding.

According to Reuters, the Financial Services Authority is currently working on additional rules for equity crowd funding and proposals could include caps on the amount an individual is allowed to invest as a percentage of their net worth, or a higher minimum investment level intended to deter those who can't afford to lose money currently rumoured to be £1,000.

a) Tax incentives

The other aspect of UK legislation which should not be overlooked is the tax incentives available for investors.

On 6 April 2012, the Seed Enterprise Investment Scheme (SEIS) was launched, with the goal to "stimulate entrepreneurship and kick start the economy."

Investments which qualify under SEIS allow significant tax incentives for investors purchasing equity the rationale being that investment in companies that are not listed on a stock exchange often carries a high risk and hence the tax relief is intended to offer some compensation for that risk.

6. Italy Overview

The Italian Government recently issued a decree legalising equity based crowd funding, with CONSOB (equivalent of SEC and ASIC) given the task of implementing the legislation. The aim of the crowd funding legislation is to help entrepreneurs get access to capital but appears to be focussed on high-tech innovative start-ups.

Criteria for eligibility includes:

- the company purpose should expressly include "development and commercialisation of high-tech value products or services"
- at least 51% of the company must be natural persons (not legal entities)
- no distribution of profits
- no more than 48 months in operation
- total value of yearly output should not exceed 5 million Euros (from the second year)

Interestingly the decree includes specific request to protect un-accredited investors. To that effect, professional investors and/or VCs will need to invest at least 5% in a start-up before equity is opened up to the crowd, and CONSOB will need to create protective measures for non-professional investors in the event that controlling shareholders yield their shares to a third party after the offer".

This is similar to a "Tag Along" clause, i.e. whereby a minority shareholder can tag along with any offer a majority shareholder receives for their shares. This could be an effective way of managing minority shareholder risk under equity crowd funding.

CONSOB are in the process of defining the specific legislation which is expected in the next couple of months.

7. New Zealand Overview

The Financial Markets Conduct Bill was announced in September 2013 and allows for online equity capital raising. This is effectively a re-write of Securities law in New Zealand and not specifically implemented to cater for equity crowd funding.

An intermediary will need to be registered with the Financial Markets Authority to be licensed as a 'prescribed intermediary service'.

Issuers wishing to utilise the services of a registered intermediary will be exempt from the normal requirements to register a product disclosure document.

There is a N$2 million limit on the amount each issuer can raise in any 12 month period which needs to be aggregated with any other amounts raised under the existing small scale personal offers 20/12 exception.

There are no limitations on who may invest through CSEF.

Draft regulations to support the Act will be released for consultation later in 2013 with the legislative provisions due to come into operation in April 2014.

8. CAMAC's Discussion Paper

On 10 September 2013, the Australian Corporations and Markets Advisory Committee (CAMAC) released its 'Crowd Sourced Equity Funding (CSEF) discussion paper' which sets out CAMAC's initial findings in relation to its independent review of the regulation of CSEF funding in Australia.

The CAMAC paper considers whether the current fundraising and licensing requirements should be adjusted to suit CSEF, or alternatively whether a specific set of rules and regulations for CSEF should be implemented.

CAMAC has identified a number of possible ways forward for CSEF in Australia, including:

- No change in existing regulations
- Liberalise the small scale personal offers exemption
- Limit CSEF exemptions to offers to sophisticated, experienced or professional investors
- Make specific changes to existing regulations for CSEF offers open to all investors
- Create a specific, self-contained statutory and compliance structure for CSEF open to all investors.

a) Small scale personal offers exemption

As detailed in section 3 (a), proprietary companies are prohibited from raising funds from a large number of investors unless they fall within the small scale personal offers exemption of the Corporations Act.

One possible amendment considered by CAMAC is an increase in the number of investors from the current limit of 20 as well as an adjustment to the total funds that each issuer can raise per year.

The current limit of 20 investors could barely be considered “crowd” funding and so for the regulation to meet the finance needs of small business this increase would have to be substantial.

This would, however, not get around the issue of the limit of 50 shareholders in a proprietary company and as a result additional changes may be required to amend shareholder caps for proprietary companies and additionally the level of regulation for proprietary companies versus public companies, e.g. audit requirements.

Public companies can also be exempted from the need to prepare a full prospectus if they fall within the exemptions of section 708 of the Corporations Act. Another option is raising funds via an offer information statement, which, although not a prospectus, is still a disclosure document required to be lodged with ASIC with audited account requirements and a cap of $10 million.

The Corporations Act also restricts advertising of public offers and again this is something that needs to be addressed by any new regulation as at the core of crowd funding is the ability to use social media such as Facebook to communicate and engage with the crowd and to solicit investment.

b) Sophisticated Investors

Currently a sophisticated investor is someone with $2.5m in net assets or gross income of at least $250,000. CAMAC considers whether CSEF issues should be limited to these sophisticated investors and also whether there should be a separate determination of a sophisticated investor in a CSEF context.

Should any new CSEF legislation be limited to the privileged few who are already independently wealthy or should the “crowd” decide which opportunities they want to back? At the end of the day it’s the “crowd” that decide whether a product or service is successful by consuming or using it so why shouldn’t the “crowd” have the ability to invest in what they perceive to be the next best thing since sliced bread.

Nobody should be able to lose their life savings on a single investment and so we would support caps on investment in CSEF issues but we believe everybody has the right to participate if they wish.

Perhaps the definition of sophistication is also misplaced, just because someone has wealth doesn’t necessarily make them sophisticated and the opposite is also true. Perhaps a better gauge of investment sophistication should be a test that anyone wanting to invest via CSEF must pass before being accredited? At a minimum this test could raise the awareness of the key investment risks for individuals and at least get them asking the right questions of the issuer.

c) Managed Investment Schemes

Another alternative to direct shareholding via CSEF is for individuals to hold an economic interest via a Managed Investment Scheme, essentially money is pooled by members of the scheme and invested in underlying securities.

These schemes are also regulated by the Corporations Act and require:

- registration with ASIC if there are more than 20 members
- a responsible entity to hold an Australian Financial Services License allowing it to operate a scheme
- the responsible entity to issue a product disclosure statement

CAMAC’s paper considers whether the regulation regarding Managed Investment Schemes could be adjusted to meet the requirements of CSEF.

The problem with these schemes is the cost of compliance for the intermediary, the requirement for a responsible entity and AFSL requires significant cost which undermines the purpose of equity crowd funding which is for small business to raise money from the crowd in a timely and cost effective manner.

d) Licensing

The CAMAC paper also addresses whether the current licensing requirements should be adjusted to allow intermediaries to operate. There could be specific requirements introduced to determine:

- How the level of risk disclosure is to be communicated to investors,
- The extent of background checks required to be made by the intermediary on the issuer
- The extent of due diligence required by the intermediary on the issuer, and
- How funds should be processed and distributed to the issuer

Submissions to CAMAC are due by 30 November 2013 and feedback is expected in the first quarter of 2014.

At the end of the day any CSEF laws need to balance quick access to low cost funding for small business with investor protection and ensuring a credible and viable population of intermediaries.

9. Recommendation

The rules for equity crowd funding in Australia are already in existence (almost) in the form of the personal offer exemption. As a result we believe that the most pragmatic approach to implementing equity crowd funding in Australia is to amend the existing legislation to expeditiously allow equity crowd funding.

Equity crowd funding is a relatively new concept and will evolve over time but trying to create new legislation for something that we don't fully understand yet will result in legislation that may not address the issue of access to capital for small business. It will also be a very time consuming process to draft new legislation rather than amending existing.

We believe the following principles and guidelines should be adopted in any amendments to the legislation.

a) Investors

- Limits on investment – we believe equity crowd funding should be open to all residents irrespective of whether they meet the existing "Sophistication" criteria. There should be reasonable limits on how much an individual can invest via equity crowd funding to ensure that nobody is at risk of losing a material portion of their wealth in one investment. We suggest that this limit should be a flat $5,000 maximum. For Self-Managed Super Funds we suggest a limit of $10,000.
- Self-regulation and reporting – In order to manage these limits there needs to be some kind of regulation and reporting requirements. This would be too onerous for an intermediary to manage and as a result the most practical approach is for individuals to self-regulate possibly using the ATO and annual tax returns process.
- Tax relief – to encourage equity crowd funding for small business we recommend specific tax relief for investors, this will also force individuals to report their investments via the ATO and hence self-regulate. Tax relief should take the form of a tax deduction for up to $5,000 invested via an eligible equity crowd funding project.
- Accreditation – It is important for investors to be fully aware of the risks of investing. We do not believe that wealth or income is a good gauge of sophistication. As a result we would support an accreditation process whereby prior to investing an investor would be required to attend and pass a risk awareness workshop.
- Limit on potential investors – we suggest a limit on the number of potential investors of 400 for a specific opportunity, at an investment limit of $5,000 each this equates to a maximum investment of $2 million in the issuer which we believe is sufficient. Given the limit of 50 shareholders in a proprietary company this may require specific laws regarding the type of company that can be established for equity crowd funding, i.e. a hybrid structure (Provisional Public – refer below) giving the flexibility of a public company but the compliance regime for proprietary companies.
- Legal interest in shares – we do not support the use of managed investment schemes to invest in start-ups or small business mainly due to the onerous registration requirements and ongoing AFSL and Responsible Entity requirements. As

a result we support the investor having full legal interest in the shares and not indirect beneficial interest via a managed investment scheme.

- Tag Along rights – to protect the interests of investors whilst the business is in Provisional Public status (refer below) we suggest that Tag-Along clauses are compulsory. This would force anybody making an offer for the shares of a controlling shareholder to make the same offer to all minority shareholders. This would ensure that individual investors are not left "holding the can" after the controlling shareholder has sold out.
- Cooling off period – the investor should have a reasonable time post the investment decision to change their mind, we suggest this cooling off period should be 14 days, long enough for an investor to fully consider the opportunity and associated risks but not too long so as to delay the issuer unreasonably.

b) Issuers

- Accreditation of directors – we believe that all directors of an issuer should be accredited (via formal training) to ensure they understand their fiduciary and other duties towards their shareholders.
- New issues only – any issue of securities via an equity crowd funding process should be for the issue of new shares only, i.e. not the sale of existing shares from existing shareholders
- Provisional Public Company – we suggest the creation of a new form of company called a Provisional Public Company specifically for use in equity crowd funding. The intention being that this type of company structure gives the issuer the flexibility to have multiple shareholders but not the related public company governance requirements. The intention would also be for an issuer to eventually evolve into a full public company once certain criteria in terms of revenue, profitability or total assets was met. In this way investors will have a potential exit strategy as the company grows and converts to a full public company. Other potential attributes of a Provisional Public Company include:
    - A maximum of 400 shareholders
    - Only one type of share available, i.e. all shareholders have the same voting rights and rights to dividends (this will avoid investor confusion and potentially misleading behaviour from the issuer)
    - A limited disclosure document for fund raising purposes which should include:
        - Description of business and business plan
        - Current financial statements (income statement and balance sheet)
        - Director and Officer details, skills, experience and remuneration details
        - How much funding is required and use of proceeds
        - Deadline to reach minimum subscription
        - Price of the shares supported by a valuation including details of how valuation was reached
        - Related party transactions

        - Future fund raising rounds expected and potential dilution of shareholding
    - No audit requirements unless turnover exceeds a certain pre-determined amount (we suggest $2 million) or unless a certain minimum % of shareholders request an audit. For issuers with turnover greater than $0.5 million but less than $2 million we suggest a formal review but not an audit and for turnover less than $0.5 million we suggest no audit or review requirements.
- Tag along clauses – as mentioned above under "investors" we believe that a tag along clause should be a standard mechanism for any equity crowd funding issue. This will ensure a majority shareholder cannot sell out leaving minorities with no exit strategy.
- Solicitation & advertising – Issuers should have the ability to directly solicit investment from accredited investors (i.e. those that have completed their equity crowd funding risk workshop) via all forms of media.

c) Intermediaries

- Registration of intermediary – we recommend that all intermediaries be registered with ASIC but that should be the extent of any regulation, i.e. no requirement for an AFSL or being registered as a Responsible Entity. Anything further than simple registration would be onerous and costly for the intermediary and such costs would ultimately be passed on to the issuer which would defeat the purpose of crowd funding being a low cost option for small business.
- Risk awareness – the intermediary should ensure that the investor is fully aware of the potential risks of investing in a small business start-up. Prior to approving any investment the investor should be forced to positively acknowledge that they are aware of the potential investment risks.
- Investment advice – the intermediary should not be allowed to offer investment advice to any investor or issuer
- Solicitation – the intermediary should not be able to solicit investment, the role of the intermediary should simply be to facilitate the introduction of accredited investors with issuers, ensuring the necessary laws and regulations are followed.
- Due diligence – The intermediary should be responsible for basic due diligence on the issuer including director background checks and IP and/or key asset ownership, full details of the due diligence findings should also be disclosed.
- Project eligibility – the intermediary should take reasonable care to ensure that any issuer listed on their platform does not:
    - Infringe any intellectual property rights
    - Breach any applicable laws
    - Be defamatory
    - Be obscene or offensive
- Access to accredited investors – The intermediary should ensure that only accredited investors (refer above) have access to the investment opportunities on the platform.
- Cooling off periods – the intermediary should ensure that any investor has a reasonable time to "cool-off" after making an investment decision.

10.Contact details

If you have any questions or suggestions on equity crowd funding and specifically this white paper then please feel free to send us an email to whitepaper@ipledg.com