Submission to CAMAC review of crowd sourced equity funding (CSEF)

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Credentials:

Kylie Hammond is founder and CEO of Board Portfolio www.boardportfolio.com and is authorised under ASIC Class Order 02/273 to deliver Business Introduction or Matching Services. Board Portfolio is accredited as a sponsor to ASSOB for capital raising services. Like ASSOB, Board Portfolio operates under section 708 of the Corporations Act (Cth.) 2001. This provides for (in certain circumstances) an issue of securities being made to certain types of investors without a disclosure statement and regulated promotion securities offers.

Roger Buckeridge is co-founder and director of Allen & Buckeridge Asset Management Limited (A&BAM), holder of AFS Licence #238128, for which he is the responsible officer and an authorised representative. A&BAM has operated as responsible entity for both registered and unregistered managed investment schemes since 2000 which have invested >$200 million in equity of early-stage technology-based businesses in Australia.

Structure of Submission:

After a summary and our principal comments and recommendations, we provide responses to the ten questions set out in section 7 of the Updated Discussion Paper of October 2013 (the "DP").

Summary

We agree with CAMAC's analysis of the differing positions of issuers, intermediaries and investors and we believe that CSEF has a high potential to stimulate business capital formation and create high value jobs in the Australian economy through:

- A simplified, less expensive but strongly regulated issuance regime
- Aggregation of many tens of thousands of pre-qualified Australian and overseas investors who are disposed to examine Australian equity and debt financing opportunities in small and medium size growing companies
- Development of Australian-based online platforms to intermediate cost effectively between such investors and offerors that have been vetted or qualified in some consistent and factual way.
- Platform economics that attract quality issuers to it because of timeliness and lower fee structures than private placements and major stock exchange listings.
- Platforms that assist potential offerors to acquire human resources that will bring them to an investment grade that will be acceptable to investors and warrant listing on the platform.

We support what ASSOB has achieved in this regard during the last several years, evolving a platform that requires high standards of disclosure and compliance from issuers without themselves providing investment advice. Board Portfolio collaborates closely with ASSOB to assist in upgrading of offeror boards and executive ranks so that they are of an acceptable standard to list on the ASSOB platform and attract investor interest. See www.assob.com.au/executive-equity.asp

Licensing of Intermediaries

In regard to platform operators, we submit that an online CSEF portal or platform should not be making a recommendation or statement of opinion. They are facilitators and not advisors. Thus portals or platforms should not themselves be required to hold an Australian Financial Services Licence. However this view is not supported by current ASIC guidance on CSEF (12-196MR ASIC guidance on crowd funding, 14 August 2012), which states:

> "In the circumstances that crowd funding involves an offer that meets the definition of a financial product, the owner of Australian-based websites that facilitate this crowd funding may be legally considered as the person making an offer to arrange for the issue that financial product. In these circumstances, a person must meet certain requirements under the Corporations Act:
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> - Hold or obtain an AFS licence with the appropriate licence authorisations or be an authorised representative of an AFS licence holder; and
> - If offering to arrange for issue of a financial product to retail investors or inviting them to apply for a financial product, give a Product Disclosure Statement (PDS) for the offer to the client."

Earlier, ASIC has said that:

> "'Financial product advice' is defined broadly in s766B of the *Corporations Act 2001*. Generally, financial product advice is a recommendation or statement of opinion (or a report or either) that:
>
> - Is intended to influence a person or persons in making a decision in relation to a financial product or class of products (including superannuation products); or
> - Could reasonably be regarded as being intended to have such an influence.
>
> When assessing whether a communication falls within this definition, we will consider the overall impression and the particular circumstances of a communication. *The giving of just factual information is not however regulated as advice.* Thus it will be a question of fact for each service provider as to the extent to which the information being provided by the service provider is intended to influence a person in making a decision in relation to a financial product. The answer to the question will revolve around the way in which the service provider engages with the people to whom information is provided about the securities that may be offered. An introduction service might also consider the extent to which Reg. 7.6.01(e) and (ea) may apply. These two exclusions operate to exempt from licensing people who refer a person to a financial services licensee. "

We are more comfortable with this earlier position, from the perspective of a platform or portal operator, who would prefer to operate the engine room and not be responsible for the content.

Section 3.3.1 of the DP suggests that an Australian Market Licence (AML) may be required for a CSEF portal/platform. We think that a CSEF portal is far from being a stock exchange like the ASX or Chi-X. The balance sheet resources required for an AML are almost certainly beyond the capacity of candidates to operate as CSEF intermediaries.

However some regulation of intermediaries is likely to build confidence and provide integrity and guard against fraud and scams. It is in the interest of the intermediary to self-police in this regard, as has been the experience of crowd funded rewards platforms, like Kickstarter and Pozible, which have developed algorithms to alert them to frauds and scams.

The DP suggests that a licensed CSEF platform should perform initial background and/or viability checks on issuers before including them on their website, as well as ongoing checks on issuers already on their website. The licences could also regulate how each intermediary website is to operate and how funds provided by investors are to be held prior to their being passed to the issuer. An intermediary must be an organisation of substance and be sufficiently capitalised and resourced to carry out its role.

We think that the market will demand that an intermediary carry out these functions and that an AML-like regime is not required.

Managed Investment Schemes

In Section 3.2.4 of the DP, managed investment scheme (MIS) structures are considered. A&BAM and its associates have raised and managed such schemes in Australia since 1997. CSEF schemes would likely need to be registered schemes and in our opinion and experience would need to be at least $50 million in committed funds for the management expense and compliance costs to be supportable. However, many individual investors do not wish to be in a large "blind pool" structure.

An approach, as the DP suggests, where a scheme could be structured so that investors can elect which from a number of projects they want to support, has considerable merit. They would then acquire a specific class of interests in the scheme for each project or enterprise chosen. Again, all equity acquired would be held by the RE, on trust for the investors who are scheme members.

We would envisage a CSEF platform having a member (or indeed many members) that holds an appropriate AFSL, which would offer such schemes to investors, who may also be individually accredited members of the platform. Some would be happy to be aggregated in this way, so long as they get to pick the investments that they wish to take a position in. In particular this might work for issuers who wish to retain proprietary company status and not convert to an unlisted public company until they have become more robust and proven in their business models. It is also likely to suit investors who do not wish to be individually accredited under existing sophisticated investor rules.

We think that the existing regulatory regime for licensing, disclosure and compliance for responsible entities of MIS is robust and appropriate to CSEF MIS, as described in Section 3.2.4 of the DP.

CSEF of proprietary companies

Section 3.2.4 also suggests:

> "A benefit of CSEF under a managed investment scheme arrangement to an issuer is that an issuer incorporated as a proprietary company could receive investor funds, but without the shareholder cap problem that would arise if investors themselves could acquire equity in the company in their own name. Also, as the scheme (not the proprietary company) would be making offers to investors of interests in the scheme, the prohibition on proprietary companies making public offers of their own securities would not apply."

Whilst this statement is true on the facts, in our experience using MIS structures is highly unlikely to satisfy the demand for small scale capital raisings in Australia. The Australian market experience is that the existing small scale personal offers s708 exemption, whereby an proprietary company issuer may make a personal equity investment offer to investors, provided that no more than $2 million is raised in any 12 month period from no more than 20 investors, but with no public solicitation, is too

restrictive. Not enough investors are available under these rules to fund proprietary companies in Australia.

We believe sufficient investors can be attracted to CSEF by selective changes to the law. We advocate an expansion of s708 rules to accommodate up to 100 investors in raisings of up to $5,000,000 in any 12 month period. This would require lifting of the shareholder cap for proprietary companies to at least 100 persons not including existing shareholders, directors, advisers and employees. Recognising that a proprietary company is generally prohibited from engaging in any public offer of its equity or other securities, under s113(3), there would need to be an exemption for offers made via a regulated or approved platform or portal, with processes and compliance rules such as have been developed by ASSOB, for example.

We recognise that ASIC Class Order 02/273 *Business Introduction and Matching Services* permits up to $5,000,000 to be raised in some circumstances, with the restrictions on advertising a small-scale offer also being relaxed. However the ceiling of 20 investors in any 12 month period needs to be substantially lifted to accommodate those investors who may meet tests for a sophisticated investor but wish to diversify their SME investment portfolio by making many investments in the $25,000 to $50,000 range. Many of BP's members are likely to fit this description.

Options for CSEF regulation

Section 7 of the DP sets out five options for consideration of what, if any, regulatory response might be made in Australia to CSEF:

- **Option 1**: no regulatory change
- **Option 2**: liberalising the small scale personal offers exemption from the fundraising provisions
- **Option 3**: confining CSEF exemptions to offers to a limited group of persons, such as sophisticated, experienced or professional investors
- **Option 4:** making targeted amendments to the existing regulatory structure for CSEF open to all investors
- **Option 5**: creating a self-contained statutory and compliance structure for CSEF open to all investors.

We favour Option 4, which includes Option 2 liberalisation.

Our comments to the specific questions set out on section 7.3 follow:

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, for the reasons set out above regarding unmet SME demand for equity and unsecured debt funding

Question 2 Should any such provision:

(i) Take the form of some variation of the small scale offering exemption?

Response: Yes, to 100 investors per 12 months per company for up to $5,000,000 per 12 months per offeror. 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?

Response: No. the current tests are too stringent for CSEF platforms. The approach should be similar to that emerging in the USA, where pre-qualification by platforms or by aggregators of investors through membership organisations like angel groups, can guard against over-commitment by retail investors.

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. 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: See above comments on MIS and lifting of the shareholder cap for proprietary companies who raise funds through an accredited CSEF platform**.**

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')

Response: no case has been made for exclusion of classes of investors. CSEF is all about liberalising access for investors to offerors

(ii) **Types of permitted securities:** what classes of securities of the issuer should be able to be offered through CSEF?

Response: all equity and equity-like instruments such as ordinary shares, preferred shares and convertible notes; and debt-like instruments such as debentures and secured interests in income streams. These are all proven instruments used by the venture capital investor community.

(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?

Response: see comments above. We think that the ceiling should be flexible but for an initial trial period $5,000,000 per issuer per 12 month period should be okay. The SEC's proposal for a $1,000,000 cap in the US context has been universally panned by the VC and CSEF community. This ceiling should apply to CSEF offers irrespective of whether the issuer is a proprietary or unlisted public company.

(iv) **Disclosure by the issuer to investors:** what disclosures should issuers have to provide to investors?

Response: an information memorandum or OIS similar to those currently permitted under the ASIC Class Order 02/273.

(v) **Controls on advertising by the issuer:** what controls, if any, should there be on advertising by an issuer?

Response: none other than existing consumer protection against false and misleading statements

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: See our comments above about intermediaries and MIS Res

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?

(b) What financial, human, technology and risk management capabilities should an intermediary have for carrying out its role

(c) What fair, orderly and transparent processes must the intermediary be required to have for its online platform

(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: See our above comments regarding an AML regime. We recognise that considerable thought must be given to this subject and welcome the opportunity to further consult with ASIC based upon our experiences in this market.

(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?

(b) What preliminary/ongoing due diligence checks should intermediaries be required to conduct on issuers and their management?

(c) What preliminary/ongoing due diligence checks should intermediaries be required to conduct on the business conducted by issuers?

(d) To what extent should intermediaries be held liable for investor losses resulting from misleading statements from issuers made on their websites?

(e) To what extent should intermediaries be held liable for investor losses resulting from their websites being used to defraud investors?

(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?

(g) What controls should be placed on issuers having access to funds raised through a CSEF portal

Response: There are many matters to be worked through on these topics. We think that many have been appropriately dealt with by ASSOB as it accumulated experience of many transactions during the last 5 years. Regarding intermediary liability (points d and e), a platform operator, similar to an Internet Service Provider, cannot be held liable for the acts of others who use their platform. It is in their interest to monitor and curate, as best they can, the integrity of offers made using their platform in order to build and retain investor trust. Question (f) is often raised. The CSEF platform must have a transparent fee structure that allows it to invest and build its business, whilst not having a financial bias towards one issuer versus another. It will be advisory businesses that bring issuers to the platform which earn fees based upon success of the fund-raising.

(iii) **Intermediary matters related to investors:** these matters include:

(a) What, if any, screening or vetting should intermediaries conduct on investors?

(b) What risk and other disclosures should intermediaries be required to make to investors?

(c) What measures should intermediaries be required to make to ensure that any investment limits are not breached?

(d) What controls should be placed on intermediaries offering investment advice to investors?

(e) Should controls be placed on intermediaries soliciting transactions on their websites?

(f) What controls should there be on intermediaries holding or managing investor funds?

(g) What facilities should intermediaries be required to provide to allow investors to communicate with issuers and with each other?

(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?

(i) What disclosure should be made about the commission and other fees that intermediaries may collect from funds raised?

(j) What, if any, additional services should intermediaries provide to enhance investor protection?

Response: We support the processes that ASSOB has developed in most of these matters. As we have said above, intermediaries should not provide investment advice to investors. They do have a key role in marketing offers once listed on their platform. All types of media and public solicitation must be permitted or the CSEF concept fails.

Investor funds should be held by a trustee or custodian independent of the platform operator, just as happens for registered and many unregistered MIS.

Complaints regarding performance by the intermediary of its legally permitted functions should be made under existing ACCC regulations.

(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?

(ii) The difference between legal and beneficial interests in shares?

(iv) Any classes of shares in the issuer and its implications for investors. A related question is whether disclosure, alone, would suffice.

Response: All offer memorandums or OIS prepared by issuers should address these matters. The intermediary would require these statements as part of its rules for listing on its platform but would not prepare them itself. This is a duty of the issuer. Generally the duty of the issuer is one of disclosure and the investor or the RE representing an MIS must satisfy himself that these matters are properly and fully explained.

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?

(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?

(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*.

(iv) **Risk acknowledgement by the investor:** should an investor be required to acknowledge the risks involved in CSEF?

(v) **Cancellation rights:** should an investor have some right of withdrawal after accepting a CSEF offer?

(vi) **Subsequent withdrawal rights (Italy only):** should an investor have some further withdrawal right subsequent to the offer?

(vii) **Resale restrictions:** should there be restrictions for some period on the on-sale of securities acquired through CSEF?

(viii) **Reporting:** what ongoing reporting should be made by the intermediary and/or issuers to investors in regards to their investment?

(ix) **Losses:** what recourse should investors have in relation to losses resulting from inadequate disclosure?

(x) **Remedies:** what remedies should investor have in relation to losses results from poor management of the enterprise they invest in?

(xi) **Any other matter?**

Response: Our view on points (i) through (vii) and (ix) and (x) is no or none. These are restrictions designed for failure of the CSEF policy objectives: removal of constraints on willing buyers and willing sellers of equity securities finding one another and entering into a transaction; and hence the creation of growth companies that in turn create value-adding jobs and contribute to national productivity. The market realities of risk and reward that pertain to all equity investing cannot be ameliorated by regulation, nor should they be. Regarding reporting, point (viii), it is the primary

responsibility of the issuer or the RE of a MIS to report to investors regarding the progress of their investment. Some intermediaries, and ASSOB is one such, require a company to be a public company to be listed, as that affords investors the legal protections of audits and continuous disclosure. We do advocate however that CSEF platforms accept proprietary companies, particularly in their early stages, which may need advisers recommended by the intermediary to assist them in satisfying disclosure and financial statements that will be mandatory as they transition to public company status.

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: We advocate incremental adjustments. CSEF has a valuable role to play as companies start-up and grow and graduate to full stock exchange listing or become established profitable and self-financing enterprises. However the regulatory and consumer protection laws applying to all retail investors and to fraudulent activity should be applicable to financing transactions along this whole spectrum.

Question 10 What, if any, other matters which come within the scope of this review might be considered?

Response: We look forward to further consultation with CAMAC in 2014.

Supplementary comment to submission to CAMAC's CSEF review

Authors: Kylie Hammond and Roger Buckeridge

29 November 2013

We wish to provide some recent experience in raising equity capital in Australia under the current small scale offerings regime.

There is a view expressed by some that today's raisings under the ASIC Class Order 02/273 and s708 regime are achieved mainly from "friends and family" and that investors unknown to the issuer are rarely attracted to subscribe to these offerings. Our experience is that this is not so and does not need to be the case.

What is required is a platform that is credible to its members and properly prepares offerings before they are allowed to use the platform. Its members will be individuals who are pre-qualified as being interested in taking small equity positions in early stage companies as part of a diversified portfolio approach to managing their own assets.

Many investor members registered with the platform will be interested in the opportunity to actively take an interest in the companies in which they invest, either directly or via a MIS (as described in our primary submission). This could include becoming non-executive directors or advisers to the boards and management of the investee enterprise, or it could involve having some process of regular access to the management and some information rights. We think that this type of investor is an ideal fit for young enterprises whose founders and directors may have very little practical experience in building successful businesses.

By way of example, we have recently (since July 2013) collaborated in privately raising over $500,000 in three months as the first step in a $2.8 million raising for a young company that is unprofitable and is recording less than $1 million revenue per annum. We assembled a group of strangers quickly, none of whom knew the company or each other. The process is still under way and we expect to finalise the raise within the next 6 months, on schedule. We will be happy to provide detailed commentary if and when we have an opportunity to meet with CAMAC in 2014.

In summary, our point here is that a successful CSEF intermediary will need to have a world-class capability to market to both investors and issuers, so that a broader investor cohort than friends and family is matched with each issuer. We know already from practical experience how to build the investor community, for solid issuer opportunities that are not necessarily associated with the celebrities, rewards or philanthropic goals that often are the feature of successful donation and rewards-based crowd-funded projects.