Dear John,

Re: Crowd sourced equity funding discussion paper

We welcome the opportunity to make our submission in relation to the crowd sourced equity funding ("**CSEF**") review process currently being undertaken by the Corporations and Markets Advisory Committee ("**CAMAC**"). By way of background, Pennam Partners is a Melbourne-based investment and corporate advisory house with, inter-alia, domestic and cross border mandates assisting firms in different business lifecycles (including with fundraising matter). Pennam Partners is/has been involved in the crowdfunding field. We are currently working with an established offshore CSEF platform intermediary to assess crowdfunding viability in different jurisdictions; we have previously undertaken an Australian survey in relation to crowdfunding; and we maintain a watching brief on crowdfunding developments offshore (for instance Italy).

The review process in Australia is timely given same has been/is being conducted in various offshore jurisdictions. Australia, through the CAMAC review, should be commended for giving serious consideration to a CSEF regime given the likely positive impact a CSEF regime would have on the financing landscape for Australian start-ups and for Australian innovation. As you may be aware, there is comparatively a limited pool of capital allocated to the venture capital asset class in Australia by institutional investors; this can be substantiated by the limited number of Australian-based venture capital funds. As a result, many Australian start-ups fail to source funding locally with a substantial start-up cohort looking at offshore markets to raise funds, which sometimes leads to the start-ups relocating to that offshore market. Secondly, venture capital funds do not generally make investment less than $3 million in an investee firm; this creates a gap at the smaller end of the venture capital funding spectrum. In addition, it is common knowledge that start-ups do not have the appropriate financial profile to seek bank funding given they are generally at pre-revenue stage, are likely to be asset-poor and cannot provide the adequate collateral; venture debt is currently not available in Australia. This means there are reasons other than a flawed business model that impede start-ups from raising the necessary funding they require. The inability to raise capital for a start-up business does not necessarily translate in that start-up being riskier compared to a start-up that managed to snare funding from a venture capital fund or companies that are listed on the Australian Securities Exchange (for instance mining exploration and biotechnology companies).

Many industries, including the financial industry, are being disrupted with the advent of sophisticated online technologies and social media. Disintermediation is starting to occur in the financial industry, which is providing companies with direct access to sources of capital while at the same time providing retail investors access to investment opportunities. For instance peer-to-peer lending is providing retail investors with the opportunity to participate in debt funding opportunities and earning higher interest rate compared to a bank/term deposit. Financial disintermediation is growing at an accelerated rate with the expectation that USD 5.1 bn[1] will be raised through crowdfunding platforms in 2013. However, there is an urgent need to review current regulatory regimes in place (including Australia) to ensure: 1) the regulatory regime caters for both intermediated and disintermediated funding mechanisms; 2) disintermediation does not produce higher and unnecessary investment risk due to a lack of adequate safeguards (e.g. appropriate disclosures and due diligence required); and 3) the compliance cost for the participants in a disintermediated marketplace is not excessive to achieve and maintain a properly regulated marketplace.

A: We have set-out below our views on the matters listed for consideration in the CSEF discussion paper.

1. Option 1: no regulatory change

[1] 2013 CF: The crowdfunding industry report

We are of the view that Option 1 should be discarded. Historically, Australia has a strong corporate regulatory regime with investors' protection being one of the foremost drivers behind such regime. With that in mind, we believe that appropriate regulatory changes can be drafted to accommodate CSEF in the financing landscape. In addition, Australia tends to be proactive with its legal and regulatory regime to keep pace with its counterparts and adjust such regime to address global event(s). For instance, section 254T of the Corporations Law was amended from a profitability test to a net assets test to deal with the aftermath of the global financial crisis.

2. Option 2: liberalising the small scale personal offers exemption from the fundraising provisions

Option 2 is the most preferred option and would allow for an expeditious tailoring of the regulatory regime to accommodate CSEF. We recommend the following:

- The number of investors that can participate per issuance should be increased but such increase should cater for proprietary companies. Proprietary companies will face undue burden if the investor threshold is raised to over 50 investors given they will have to convert to an unlisted public company prior to launching the CSEF campaign and at that particular stage they will not know whether they are going to exceed the 50 non-employee shareholders threshold. On that basis, we propose the following:

    - For a proprietary company undertaking a CSEF campaign, the total investors post the CSEF capital raising should be capped at 50 non-employee shareholders. This means the amount of investors that can participate in a CSEF raise will vary on a case by case basis and will depend on the existing non-employee shareholders a proprietary company has at the time of starting the CSEF campaign; and

    - In the case of a public company, the total investors that can participate should be capped at 100 investors. This gives some flexibility and allows a proprietary company to convert to an unlisted public company if they think they should be raising from a bigger pool of investors but also provides them with the opportunity to use CSEF for subsequent capital raising if they have already raised funding via CSEF in the form of a proprietary company;

- As it is currently the case with the 20/12/2 offer, sophisticated, professional and foreign investors should not be included in the investor threshold cap for a CSEF offer. That is, participation by sophisticated, professional and/or foreign investors should not deplete the cap but would be in addition to the investor threshold cap;

- The investment size per CSEF offer should be increased to $3 million. This will truly provide start-ups with an alternative fundraising conduit and may even create pressure for (foreign) venture capital funds looking into Australian inbound investments to revise their minimum investment outlay to compete for deal flows. Whilst the aim of CSEF is to raise funding from a large pool of investors with each contributing small amount of money, practically it is highly likely that sophisticated and/or professional investors will participate in a CSEF offer and will make comparatively significant investments. This should be taken into consideration when determining whether to increase the CSEF investment offer size;

- Consideration should be given to codifying ASIC Class Order 02/273 into the Corporations Act to provide certainty for CSEF intermediaries;

- CSEF intermediaries should explicitly be excluded from the requirement to hold an Australian Market Licence ("**AML**") to operate a CSEF platform. If there is a need to hold an AML to operate a CSEF platform, this will place undue pecuniary and compliance burden onto the CSEF intermediaries. This will invariably translate into higher cost for the CSEF intermediaries, which will ultimately be passed on to the issuers.

  However, to ensure CSEF intermediaries have the appropriate expertise, resources and can be held accountable, CSEF intermediaries should hold an Australian Financial Services Licence ("**AFSL**").

Operating via an AFSL will limit the amount of CSEF intermediaries and will, in theory, maintain an adequate level of competency; and

- It would be worthwhile to liaise with the Australian Investments and Securities Commission ("**ASIC**") in relation to the 20/12/2 offer (if the CAMAC has not already done so). ASIC can provide insights about the 20/12/2 offer, fraudulent offers registered and the amount of complaints. This should provide a fair idea on whether the 20/12/2 offer is the most appropriate platform to use for implementing a CSEF regime in Australia.

3. Option 3: Confining CSEF exemptions to offers to sophisticated, experienced or professional investors

We fail to see the merit in Option 3. Offers to sophisticated, experienced or professional investors already benefit from various carve-outs in relation to solicitation and provision of disclosure document, and confining CSEF offers to this group of investors will severely restrain the operation of a CSEF platform.

We opine that the test for sophisticated investors is adequate and none of the thresholds of the test should be lowered. Any modification will potentially have broader impact i.e. not only on CSEF related matters but also for other kind of investments.

4. Options 4 and 5

As aforementioned, any 'cherry picking' approaches should use the 20/12/2 offer regime as the starting point and build upon that regime to implement a CSEF regime. If a separate and new regime is considered to be the most appropriate option, then the CAMAC should consider the following:

- The CSEF regime should be limited to unlisted public companies;

- This will ensure a heightened oversight mechanism of the issuer with at least 3 directors sitting on the board and shareholders can benefit from additional protection under the Corporations Act;

- At the risk of stating the obvious, a CSEF issuer can use only one CSEF intermediary to raise funding during a CSEF campaign;

- Irrespective of whether a company is a public company or a proprietary company, if it is a CSEF issuer it will, mandatorily or willingly, be subject to comprehensive ongoing disclosure and auditing (or a process akin to auditing). This means the additional cost from an ongoing information disclosure and auditing/review process perspectives for using a public company will be minimal;

- To make the process cost-effective, a new disclosure document regime should be devised. A prospectus-lite regime should be developed and consideration should be given to offer information statement and how this can be tailored for smaller public capital raisings;

- Consideration should be given to the accounting reporting requirements and the requirements under the Australian Accounting Standards. The Australian Accounting Standard Board can be of assistance in clarifying whether CSEF issuers would be subject to reduced accounting disclosure requirements; and

- Consideration should be given to whether CSEF should be limited to start-ups only. The CAMAC should consider the outcomes of the employee share schemes and start-up companies consultation and whether recommendation has been made to define the term 'start-up'. The other alternative is to make sure that CSEF issuers do not carry on 'ineligible activities'. The term 'ineligible activities' can mirror the ones in the venture capital limited partnership and the early stage venture capital limited partnership regimes.

B: We have also addressed some of the queries that the CAMAC has raised in the discussion paper:

- **Q3 (iii):** It is our view that a CSEF model operating under a managed investment scheme will commercially not be feasible in Australia. We are aware of back to back arrangements undertaken overseas (such as Solar Mosaic, Funders Club and Angel List). Such arrangements would fall either under the managed investment scheme regime or the debenture regime in Australia. However, the requirement for a responsible entity or a debenture trustee (and the regulatory onus placed on these parties) to operate such arrangement will significantly impede the use of CSEF in Australia. From our experience, these arrangements are costly and as opposed to a company, the costs are recurring year in and year out.

- **Q4 (i):** Refer to the above.

- **Q4 (ii):** If a proprietary company is the issuer, then the CSEF issuer should have on issue only one class of securities for all of its shareholders. A public company should be able to have different classes of securities.

- **Q4 (iii):** There should be a ceiling of $3 million and that ceiling should not take into consideration sophisticated, professional and foreign investors but would include the small scale personal offers. Arguably, the small scale personal offers should be broadened to cater for CSEF offer and effectively making it one and only regime.

- **Q4 (iv):** Issuers should provide periodic reporting to investors in the form of year-end financial reporting together with continuous disclosure for material events. The continuous disclosure should be done electronically and can be done via a third party or through the CSEF platform.

- **Q4 (v):** Advertising should predominantly be done through the CSEF platform (and to its subscribers) with the issuer only able to communicate with its existing network only (similar to the 20/12/2 offer) outside of the CSEF platform.

- **Q4 (vi):** The existing laws (including defence) are adequate.

- **Q4 (vii):** Unless the CSEF intermediary is operating via an AML, electronic on-selling of existing securities or operating a secondary market should be banned. However, the CSEF intermediary should be able to operate a securities 'match-making' service to match buyers and sellers of companies that listed on that particular CSEF platform.

- **Q5:** CSEF intermediaries should operate via an AFSL and should be excluded from the requirement to hold an AML. Given funds will be held on trust (potentially by a third party), the financial capacity of the CSEF intermediary should not be of the upmost importance.

- **Q6 (i):** It is important to place some barriers to entry for CSEF intermediaries ensuring that CSEF does not get flooded with 'fly-by-night' intermediaries. However, undue burden should not be placed on CSEF intermediaries to make CSEF an unviable operation.

- **Q6 (ii):**

  a) This would depend on whether CSEF is limited to 'start-ups' only (term yet to be defined) or limited to companies not carrying on 'ineligible activities' (term yet to be defined);

  b) The due diligence undertaken by intermediaries should be limited to preliminary due diligence. The CSEF platform is not a market and therefore should not be carrying ongoing surveillance on past CSEF issuers unless they are providing a platform for continuous information disclosure to investors. A

process akin to Know Your Customer process should be designed and implemented by CSEF intermediaries, which would include at a minimum review of ASIC company extract, credit report, personal checks on directors, getting issuer to provide legal sign-off to ensure offer document is legally compliant and accountant sign-off for financial information included, and solvency statement by the directors of the issuer;

c) This onus should fall on investors;

d) To the extent that CSEF intermediaries have used their best endeavours to carry out due diligence on information provided, CSEF intermediaries should not be liable for investor losses resulting from misleading statements published on their websites;

e) To the extent that CSEF intermediaries have used their best endeavours to carry out due diligence on issuers, CSEF intermediaries should not be liable for fraudulent activities;

f) A CSEF intermediary should not have any financial interest in a CSEF issuer. All fees (including application fee and capital raising fee) should be disclosed in the offer document; and

g) Irrespective of whether it is an 'all or nothing' or 'keeping it all' CSEF campaign, issuers should only get access to the funds when the CSEF campaign period has ended and subsequent to the proposed cooling off period being over.

- **Q6 (iii):**

a) CSEF intermediaries should get evidence from subscribers of the CSEF platform about their investor status i.e. if they are sophisticated, professional or foreign investors. Otherwise, the investor will be considered as a retail investor (i.e. not sophisticated, not professional and not foreign investors);

b) Similar risk and disclosures contained in ASIC Class Order 02/273;

c) Any amount in excess of the (yet to be determined) investment threshold per CSEF issuance should be returned to the investors. This can be achieved given the funds will be placed on trust. We are of the view that there should be no investment threshold per investor but rather this should only be per CSEF issuer;

d) CSEF intermediaries should not provide any investment advice and this should be prominently displayed on the CSEF platform. In addition, CSEF intermediary should not participate in discussions on the CSEF platform except as a facilitator and moderator;

e) No;

f) CSEF intermediaries should not control or manage investor funds. It is recommended that a third party be used to operate the trust account;

g) As part of a CSEF campaign, a Q&A facility should be provided for the issuer and the potential investors. The Q&A facility can be accessed by all subscribers of the CSEF platform and the subscribers will have the option of corresponding privately or publicly with the issuer;

h) Complaint procedures and liability insurance should be disclosed in the financial services guide (on the proviso the CSEF intermediaries need to hold an AFSL). The financial services guide will be provided at the time of subscribing to the CSEF platform and also will be made available on the CSEF platform itself;

i) Disclosure on commission and other fees should be made in the offer document; and

j) CSEF intermediaries can operate an ongoing online disclosure facility where previous CSEF issuers can upload material and/or periodic disclosures for investors to have access to.

- **Q7 (iii):** Where a CSEF issuer is allowed to issue equity under different classes of shares, the CSEF issuer should disclose the rationale for the adoption different classes of shares and the implications of subscribing to the different classes of shares. Our view is that if a proprietary company is allowed to raise capital using CSEF, then the proprietary company should have one class of shares only.

- **Q8 (i):** No limitation should apply.

- **Q8 (ii):** No minimum threshold for sophisticated investor participation should apply. However, we note practically it is likely that there would be sophisticated investor that would participate in some of the CSEF issuances.

- **Q8 (iii):** No cap per investor should apply. Issuer linked caps and investor linked caps will be hard to monitor and police in practice.

- **Q8 (iv):** Yes, at the time of making an investment in a CSEF issuer.

- **Q8 (v):** Yes.

- **Q8 (vi):** No.

- **Q8 (vii):** No, resale restrictions should apply to founders and directors only.

- **Q8 (viii):** Financial reporting, material disclosures and solvency statement should be made by CSEF issuers.

- **Q8 (ix):** This would depend on which party contributed to the inadequate disclosure (for instance directors, lawyer and/or accountant).

- **Q8 (x):** This is part of the investment risk and there are existing remedies that may or may not be available (for instance directors' duties).

- **Q9:** Initially, this should be in the form of incremental adjustments to the existing provisions as aforementioned. This should allow for an expeditious implementation of a CSEF regime in Australia.

- **Q10:** Privacy policy (e.g. data security) and AASB-related matters should be considered concurrently but this would be outside of CAMAC's terms of reference.

If you want to discuss the contents herein or have any query, please contact me on 03 8635 1987 or via email on yanese@pennampartners.com. I look forward to continuing this discussion.

Yours sincerely

Yanese Chellapen
Director
Pennam Partners

[ELECTRONIC SUBMISSION]