Discussion paper for:	Australian Government. Corporations and Markets Advisory Committee
Topic	Crowd Sourced Equity Funding
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Background:

Tony Camphin is a Chartered Accountant and Australian Small Scale Offerings Board (ASSOB) sponsor working with a range of family and small to medium businesses to assist in corporate, business and strategic planning, professionalising management and the challenges facing these businesses trying to commercialise their operations be they start ups, scale ups and going concern business valuations.

The following comments are offered to the questions raised in the discussion paper dated September 2013.

Question 1 In principle, should any provision be made in the corporations legislation to accommodate or facilitate CSEF. if so, why, if not, why?

Question 2 Should any such provision:

(i) take the form of some variation of the small scale offering exemption and/or

(ii) confine CSEF to sophisticated, experienced and professional investors? If so, what, if any, change should be made to the test of a sophisticated investor in this context, or

(iii) adopt some other approach (such as discussed in Section 7.3, below).

- There should be changes made in the corporations legislation to facilitate CSEF based on the following reasons:
    - The level of regulations protecting investors is very restrictive and has given rise to the CSEF and investor incentives such as inexpensive gifts, trinkets etc.
    - Investors of amounts above say $1,000, I suggest, would rather have equity, they know they are taking a risk and don't really want a gift anyway.
    - The result is less financial support than would be available if equity was permitted.
- The level of funds raised under the CSEF model should be set at an amount that helps bridge the funding gap between an idea and being able to build a prototype or prepare a section 708 capital raising, IPO etc. Suggested upper level of say $500K.

Preparing an offer document and assisting in the raising of capital in compliance with Section 708 of the Corporations Act can cost anything up to $50K. While section 708 is designed to help target certain unsophisticated investors it is really more applicable to raising funds from overseas and sophisticated investors.

Because a potential investor is not independently wealthy doesn't mean they don't understand the market or cannot evaluate the risks associated with certain investments. If a $500K capital raising under section 708 were to rely on unsophisticated investors, under the 20/12 rule each would have to invest

$25K. If however the rule was 100/12, investments of $5K would be considered and this is far more palatable.

Restricting investors because they are not independently wealthy is somewhat an over precaution. Many an investor may have the knowledge to invest but are not be classified as wealthy why shouldn't they be at liberty to invest under section 708 in smaller amounts.

- Sophisticated investors should not be restricted to people who have money, educational standards and risk assessment tools have a role to play here.
- Methodologies such as Blue Ocean Strategy identify 6 areas of risk that face all early stage ventures and how they can be mitigated.
- In addition to considering the warnings and disclaimers incorporated in a Section 708 offer document consider including a profile of the areas of risks faced by the venture and how these are to be mitigated.

Question 3 In the CSEF context, what changes, if any, should be made, and for what reasons, to the regulation of:

(i) proprietary companies

(ii) public companies

(iii) managed investment schemes. In considering (c), 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?

- CSEF suits seed capital raising, once sufficient funds are available options present such as an offer document under section 708.
- The proprietary company structure is really not suitable for raising funds even under section 708, proprietary companies are better suited to existing alliance partners, family, friends and work associates. There need be no change for these entities in existing regulations.
- Public companies with the need of 3 directors and external audit are more suitable for raising capital, however the 20/12 rule imposes a number of shortcomings as eluded to above.

1. The current definition of a sophisticated investor assumes that if you don't have assets or a high paying job you are restricted in making investment decisions in start-ups and/or early stage ventures.
2. From discussions with (ASSOB) it appears the average investment in an ASSOB listed company is above $25,000, which is far too high for what is currently classed as an unsophisticated investor. As a result many good projects don't reach minimum subscription restricted by the 20/12 rule.
3. It is very difficult in Australia to raise funds for any early stage venture, high net worth (HNW) investors tend to be very unresponsive to early stage investment (see page 28 PWC report April 2013), as a result reaching minimum subscription for a section 708 capital raising is

difficult. A change to the 20/12 rule to say 100/12 rule would enable smaller investments from accredited investors.

One solution to the problem is redefine sophisticated/accredited investors to include those with the knowledge and ability to assess risk and not assume because an investor has neither $2.5 Million of net assets nor a $250K income they cannot assess an investment.

To address this problem, consideration should be given to the following:

1. The level of education a potential investor has and their ability to assess risk, which need not be linked to net worth or income levels.
2. Warnings tend to be general, not project specific and highlight the fact that early stage ventures are risky and investors should seek the advice of an expert.
3. The areas of risk are seldom addressed specifically in a methodical fashion. If this was done it would highlight even to the most unsophisticated investor, risks that they should be aware of.

Addressing Risk in CSEF.

Almost all CSEF ventures:

- Have limited funds,
- are challenging the status quo,
- target uncontested market space,
- developing some new and/or innovative technology,
- are seldom built around lowest cost strategies, their target is more likely to be directed at needs that is currently unmet.

Blue Ocean Strategy (BOS) is an example of a methodology that addresses the risks associated with establishing businesses in this uncontested market space and has been embraced by the Malaysian and Slovenian governments with great success in establishing innovative opportunities.

There 6 risks that need to be understood and addressed by potential investors in CSEF when assessing the possibility of success, they are:

1. Search risk: Does this specific opportunity look to make the competition irrelevant?
2. Planning Risk: Does the plan create and capture new opportunities?
3. Scale Risk: Does the opportunity unlock new demand, hence minimising scale risk?
4. Business Model Risk: Is there a viable business model that identifies the ability to produce and maintain profitability?
5. Organisational Risk: Does the offer identify how the leaders and managers overcome the key organisational and operational hurdles?
6. Management Risk: This deals with the team leadership and is associated with peoples attitudes and behaviours.

Managed Investment Schemes

These schemes have a role to play despite the failure of many agricultural/ horticultural schemes. The experience, competencies of and agreements with management need to be carefully reviewed and once again emphases on addressing risk and how it is being mitigated.

Question 4

What provision, if any, should be made for each of the following matters as they concern CSEF issuers:

(i) **types of issuer:** should there be restrictions on the classes of issuers permitted to employ CSEF (for instance, investment companies are excluded from the CSEF provisions of the US JOBS Act. In Italy, CSEF is confined to designated 'innovative start-ups')

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

(iii) **maximum funds that an issuer may raise:** should there be a ceiling, and if so what, on the funds that can be raised by each issuer in a particular period through CSEF. Should that ceiling include any funds raised under the small scale personal offers exemption

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

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

(vi) **liability of issuers:** in what circumstances should the directors or controllers of the issuer have liability in relation to CSEF. What defences to liability should apply

(vii) **ban on a secondary market:** should CSEF be limited to new issues, excluding on-selling of existing securities

(viii) **any other matter?**

Q4.

I. The types of issuers needs to be relatively broad, for example if an applicant has received an R & D grant then they should qualify in being able to raise CSEF. The US system is attractive, it broadens the scope and the ability to promote investment opportunities, however the accredited investor should be expanded to include less wealthy individuals who can demonstrate a degree of knowledge and the offer should highlight the risks and how they are addressed.

II. Ordinary Shares, Convertible Notes and Preference Shares

III. There should be a ceiling and a minimum subscription for all fund raisings.

IV. A brief description of the opportunity the management and relevance of the 6 risks addressed earlier and how they are mitigated.

V. Along the lines of the US model, which allows entrepreneurs to publicly advertise and market their company's investment opportunity of whatever size to accredited investors. (expand accredited to include educated/knowledgeable investors).

VI. Issuers need to be accountable for the truth and correctness of the information they provide the investors. The defences of a reasonable man need to apply.

VII. Secondary markets should be available once the initial capital raising has closed.

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?

1) The obligation to attest to the fame and character of the issuers and
2) the expanded accreditation of the investors.

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

(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

(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

(iv) **any other matter?**

Q6

I. Permitted types of intermediary

a. Yes Chartered Accountants, CPA and Lawyers in practice. Stock brokers and perhaps certified financial planners.

b. See (a.)

c. Guide as to information to be covered in the documentation, which covers the risk associated with the venture and how they are addressed if at all.

d. Possibly for disputes relating to misrepresentation.

II. Intermediary matters related to issuers

a. Should not be related to medications or cures for cancer etc. Citizenship programs, or matters related to immigration and exclude real estate ventures.

b. General enquiries that issuers are of good fame and character, check say 3 specific credible character references.

c. None unless responsibility is specified in the offer document.

d. None unless responsibility is specified in the offer document.

e. None unless it can be shown that the character checks were not properly undertaken or were falsified.

f. Financial associations with the issuer must be outlined in the offer document. Funds to be held in trust and only released when minimum subscription is reached. All investments to pass through the trust account.

g. Details of a register of members as specified in the offer document.

h. Information about complaints should be first to the issuer then the intermediary and finally ASIC, all procedures being detailed in the offer document.

i. Full disclosure in the offer document.

j. Web address for complaints.

III. Intermediary matters relating to investors

a. Intermediaries should ensure that the accredited investor is actually accredited.

b. See 6 risks detailed earlier.

c. Ensure that the funds are held in trust until minimum subscription is reached. There should be a cooling off period of say 5 days from receipt of funds.

d. Intermediaries should declare their interest and confirm that investors understand this.

e. No, provided there is full disclosure in the offer document.

f. Investments should be handled through a trust account of a third party and only released on the conditions in the offer document being met.

g. All fund raising amounts over $500 should be identified and in the event of minimum subscription not being reached refunded to the investor. For applications less than $500, these should be offset against fees of intermediaries and any balance to a charity identified in the offer document.

h. Website with a pro-forma in the offer document, which an investor can follow easily.

i. All fees and commission should be detailed in the offer document.

j. Web platform similar to ASSOB.

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

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

I. Yes the differences between various shares, convertible notes and debt should be detailed in the offer document.

II. Yes

III. Yes

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) **cooling off 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?**

I. No limitation
II. No
III. No
IV. General notice in the offer should be sufficient.
V. 5 days for amounts $500 and above.
VI. No just V. above.
VII. Resale restricted until offer closes.
VIII. Annual accounts and significant events notification on the web.
IX. As per unlisted public company.
X. No recourse unless fraud or misrepresentation.

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?

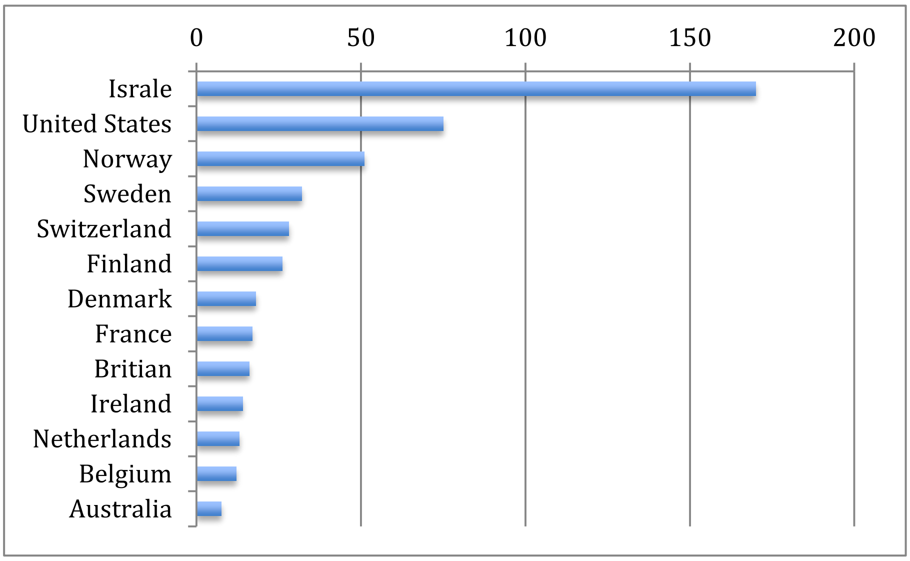
In the form of a self contained regulatory regime.

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

Please consider the problem that confronts early stage ventures and start-ups raising funds.

Australia is behind other developed nations when considering equity investment in venture capital. See the chart below taken from the PriceWaterhouseCoopers paper "The Starteup Economy, how to support tech start-ups and accelerate Australian innovation" commissioned by Google Australia April 2013[1];

VC per capita (2010 US $)



Australia at US$7.50 (FY10 & FY11 average), is at the bottom of the list.

Australia has a poor record in VC Investment and especially when compared to the number of patents granted. The following Graph shows that Australia can boast a world-class innovation pipeline for patents granted both per capita and as a % of GDP. But venture capital investments per capita are abysmal as is evident from the following graph:

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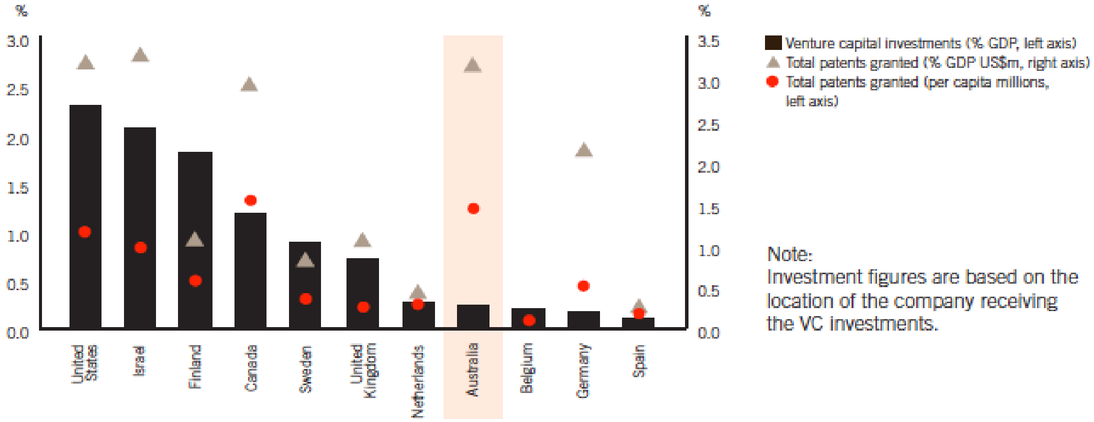
[1] *http://www.digitalpulse.pwc.com.au/wp-content/uploads/2013/04/PwC-Google-The-startup-economy-2013.pdf*

World-class innovation pipeline

Figure 2: VC investments vs. patents granted in selected OECD countries (2000 – 2011)
Sources: AVCAL, ThomsonONE, EIU, WIPO Statistics Database



The above snapshot shows Australia is great coming up with the innovative and patentable ideas but does not provide the environment for their development or commercialisation.

Commercialisation Australia is supposed to address this shortcoming however from my approaches (to date all unsuccessful) it is evident that you must have ticked a number of boxes, which include the following:

- Your idea/process must be patentable IP.
- You must demonstrate that you have exhausted all possible avenues of finance for the project.

This second point ensures that the whole process is a funding option for those ideas that couldn't get funding from the private sector (applicants are often referred to as second stringers).

Considering the first point it is in the DNA of those seeking to come up with innovative new ideas to get them patented. However, in the real world very few if any of these early stage operators can fund protection of such a patent. CA ignores being first to market unless you have something patentable.

The current Research and Development Grants offered by the Federal Government encourage this process and result in the siloing of good ideas as is evident in the earlier chart.

What is needed to compliment the R&D Grant is a Collaboration and Development Policy offering tax advantages for individuals or firms to fund smaller innovative under capitalised firms or ideas. This would take the emphases and financial drain away from R&D grants and focus attention on commercialisation of the many bright ideas that need capital.

Numerous small businesses wouldn't survive but for the R&D grant. If their IP was stolen it is doubtful if they could finance any challenge to stop the theft.

Collaboration & Development Policy in Australia

Discussion Points – Tony Camphin & Bruce Billson:

There is ample research here and abroad that points to the following:

- Some estimates put 95% of all patents commercialised, and only 3% as profitable. Also, Australian R&D is skewed away from being conducted within business, and towards being undertaken at Universities, ***suggesting it is more likely to be pure and academic research and less commercially focused***

- Australia lags significantly in attracting overseas investment and collaboration in R&D, suggesting we are not leveraging IP created overseas nor capital available from overseas, and we may be relying too much on home grown solutions and reinvention, or simply managing without innovation.

- Somewhere in the order of 70% of all innovation is not driven by new technology, but by the redeployment of existing technology or innovation in business models and processes. "Value Innovation" is the phrase that has been coined to define innovation that is not simply pure and academic (i.e. the use of technology for technology's sake), but has value to end-users. ***Suggesting that our academic approach to R&D will most likely focus on technology and overlook the broader pool of value innovations***

- "First to market" is often beaten by "first to monetise the market", which suggests our potentially more academic, less commercial focus on R&D is probably sub optimal for driving economic growth.

- R&D spending both by the private sector and government creates economically perverse behaviours such as hoarding IP (hiding it from competitors, buying and burying it to avoid it arising as a path to substitutes and alternatives, holding IP despite not having the resources to commercialise it). ***This suggests that policy should attempt to encourage organisations to free up and share IP, partially by providing greater practical protection from poaching***

- Companies already recognise the importance of collaboration and development and have commenced their own experiments in this area, unfunded by Government.

- Industries that receive large government subsidies and support often use this to prop up ailing and outmoded business models, maintain return on existing assets, upgrading capital and the retention of labour resources but in a declining industry, and generally fail to innovate themselves into sustainable new industries, business models and markets.

- There is a false view that small to medium business is the engine of ingenuity, creating new and disruptive innovations far in excess of "lazy and rigid" large businesses, ***when in fact most highly successful innovation comes about through collaboration between businesses of all sizes.***