



Law Council
OF AUSTRALIA

Business Law Section

Manager
Financial System Assessment Unit
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: csef@treasury.gov.au

6 February 2015

Dear Sir/Madam,

SME Business Law Committee – Submission in relation to Discussion Paper dated December 2014 on 'Crowd-sourced Equity Funding' (CSEF Discussion Paper)

Introduction

The Law Council of Australia is the peak national body representing the legal profession in Australia.

The Small and Medium Enterprise Business Law Committee of the Business Law Section of the Law Council of Australia (**SME Committee**) makes this submission in response to the Discussion Paper dated December 2014, released by Treasury.

The SME Committee has as its primary focus the consideration of legal and commercial issues affecting small businesses and medium enterprises (**SMEs**) in the development of national legal policy in that domain. Its membership is comprised of legal practitioners who are extensively involved in legal issues affecting SMEs.

Please note that the SME Committee's submission may differ from those made by other Committees of the Law Council because of our Committee members' perspectives and experiences as adviser to SMEs.

Other Submissions

The Corporations Committee of the Business Law Section of the Law Council of Australia (**Corporations Committee**) is also lodging a submission on the CSEF Discussion Paper.

On 12 November 2013 the Corporations Committee lodged with the Corporations and Markets Advisory Committee (**CAMAC**) a Submission (**the CAMAC Submission**) to the CAMAC Discussion Paper on CSEF of September 2013. A copy of that CAMAC

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Submission is attached to the submission from the Corporations Committee on the CSEF Discussion Paper.

The SME Committee concurs with the issues and suggestions raised in the CAMAC Submission and notes that Option 1: CAMAC Model in CSEF Discussion Paper substantially draws on the CAMAC Submission.

SME Committee Position

The SME Committee notes that fundraising on-line is also done through receipt of small gifts or donations to start ups and innovators or persons or entities with projects or causes that require monetary support. These gifts are not made in return for an issue of any equity (or debt) interest and it appears the donors are not concerned to participate in any success or growth of the enterprise, although some of these enterprises do provide the donors with a service or reward, such as an opportunity to meet the innovator or the receipt of a sample good or service.

Aside from such money raising enterprises having to ensure they are not misleading or deceptive with regard to consumers (donors) or fraudulent, there is currently no regulatory structure that applies to them because no equity or debt interests are issued to donors. As no interest issues to donors, the legislation on anti-hawking and disclosures does not apply.

Clearly there are opportunities for unscrupulous operators to take advantage of the generosity of consumers (donors) in this unregulated environment and the risk accepted by donors would be dependent on each donor's appetite and funding ability.

The SME Committee considers that this 'online donation' funding should also be looked at by the Productivity Commission given how accessible this method is both to willing donors and to unscrupulous operators.

With regard to CSEF, the SME Committee recognizes that in order for SME start ups and innovators to be able to access equity funding of small amounts from large numbers of investors, particularly through social media forums, which is the basis behind crowd-sourced funding, changes need to be made to the existing legislation, particularly to the Corporations Act 2001 (Cth).

The existing corporate legislation was drafted to provide regulatory relief for small numbers of investors through restricting the number of shareholders in proprietary companies to less than 50. Where there are more than 50 shareholders, which takes the entity into the public company domain, complex and costly disclosures are required to protect investors (subject to some carve outs which don't assist crowd sourced funding). Likewise, offers to large numbers of small value investors through a trust is also regulated by similar legislation that covers governance and disclosure requirements designed to protect investors.

Submission

In summary, the SME Committee supports Option 1: *CAMAC Model*, with minor variation, because it would allow funding for start ups and innovators in the SME sector while

requiring a minimum level of regulatory compliance and maintaining investor protection reflective of the relevant investment value risk.

The Committee prefers Option 1 to Option 2. It is concerned that as Option 2: *Regulatory Framework based on the New Zealand Model* would enable 'crowd' funding that is not limited to SME start ups and innovators, and does not impose caps or constraints on intermediary fees or investment, it may result in the focus on investor protection and investment value risk being lost.

The Committee considers that Option 3: *Status Quo*, as recognized under 1.1 '*Need for Innovation*', constrains SME start ups and innovators with current regulatory requirements, particularly with regard to investor disclosure, and thereby unaffordable costs.

In the following Submission responses, the SME Committee will be limiting its comments to those issues which it believes are relevant for SME businesses and for which the SME Committee has knowledge.

Responses

The SME Committee responds to the questions asked in the Discussion Paper as follows:

Section 1- Opportunities Presented By Crowd-Sourced Equity Funding (CSEF)

1. Is the main barrier to the use of CSEF in Australia a lack of a CSEF regulatory structure, or are there other barriers, such as a lack of sustainable investor demand?

Answer

As noted by Treasury and CAMAC, a major barrier in Australia to raising funds online from the 'crowd' for SME start ups and innovators is the regulatory regime under the Corporations Act, which:

- *limit proprietary companies to 50 investors,*
- *require costly disclosure materials that must be provided by public companies and managed investment schemes,*
- *limit the small scale personal offer exemption to 20 investors within 12 months*
- *provides for public offer fundraising through a managed investment scheme regime that is not appropriate for 'crowd' sourced funding.*

2. Do the existing mechanisms of the managed investment scheme regime and the small scale personal offer exemption sufficiently facilitate online offers of equity in small companies?

Answer

Neither the managed investment scheme regime nor the small scale personal offer exemption sufficiently facilitate online offers of equity in small companies for the regulatory constraint reasons set out in 1.

3. Other than the restrictions identified above in relation to limitations on proprietary companies, public company compliance requirements and disclosure, are there any other barriers to the use of CSEF in Australia?

Answer

Given that 'crowd' sourced funding has developed through social media forums and looks to attract large numbers of small value investors, the jurisdictional location of the platform hosting the 'issue' may prove challenging to regulate should an Australian connection not be apparent. Consequently, this may not prove so much to be a barrier to the use of CSEF, but rather a barrier to protections for Australian investors.

4. Should any CSEF regime focus on the financing needs of small businesses and start-ups only, or is there a broader fundraising role?

Answer

It is the Committee's view that a CSEF regime should only focus on the fundraising needs of small businesses start-ups and innovators because larger companies do not suffer the current regulatory and cost constraints as set out above given those constraints were put in place to regulate larger companies and protect investors who deal with them.

Section 4.1 Option 1: Regulatory Framework Based on the CAMAC Model

5. Do you consider that, compared to existing public company compliance costs, the exempt public company structure is necessary to facilitate CSEF in Australia?

Answer

The Committee believes the proposed exempt public company structure, with minor variation, is necessary to facilitate CSEF in Australia.

The alternative would be to establish a separate regulatory regime within the Corporations Act to specifically cater for the requirements of crowd sourced funding for SME start ups and innovators.

6. To what extent would the requirement for CSEF issuers to be a public company, including an exempt public company, and the associated compliance costs limit the attractiveness of CSEF for small businesses and start-ups?

Answer

The Committee considers this will depend on which regulatory compliance requirements for public companies are maintained for exempt public companies. So long as the CSEF regime only maintains those requirements necessary to ensure appropriate investor protection in light of investor value loss risk, compliance costs for the exempt public company itself should reduce so as to become viable compared with current compliance costs.

7. Compared to the status quo, are there risks that companies will use the exempt public company structure for regulatory arbitrage, and do these risks outweigh the benefits of the structure in facilitating CSEF?

Answer

In the Committee's view, so long as limits are imposed as proposed, even if companies use exempt public company structure for regulator arbitrage, the impact

would be minimal. Under Option 2 however, where no limits would be imposed, the impact of such risk could be material.

8. Do you consider that the proposed caps and thresholds related to issuers are set at an appropriate level? Should any of the caps be aligned to be consistent with each other, and if so, which ones and at what level?

Answer

The SME Committee considers the proposed caps and thresholds are appropriate to provide investor protection reflective of the value risk.

9. Do CAMAC's recommendations in relation to intermediary remuneration and investing in issuers present a significant barrier to intermediaries entering the CSEF market, or to companies seeking to raise relatively small amounts of funds using CSEF?

Answer

So long as payments to an intermediary, whether percentage based, fixed fee or taking an investment, are disclosed to potential investors, these should not, in the SME Committee's view, present any barrier to intermediaries entering the CSEF market, or to companies seeking to raise relatively small amounts of funds using CSEF.

10. Do the proposed investor caps adequately balance protecting investors and limiting investor choice, including maintaining investor confidence in CSEF and therefore its sustainability as a fundraising model?

Answer

The SME Committee considers that the proposed investor caps do adequately balance protecting investors and limiting investor choice, by limiting the investment value risk for the proposed 'crowd' investors and thereby should result in the maintenance of investor confidence in CSEF and therefore its sustainability as a fundraising model.

11. Are there any other elements of CAMAC's proposed model that result in an imbalance between facilitating the use of CSEF by issuers and maintaining an appropriate level of investor protection, or any other elements that should be included?

Answer

The SME Committee considers that intermediaries should not need to hold an Australian Financial Services Licence (AFSL) if they are not actively advising on or promoting fundraising for the SME start up or innovator. If the intermediary is merely an administration platform there should be no need for it to hold an AFSL.

Section 4.2 Option 2: Regulatory Framework Based on the New Zealand Model

12. Do you consider it is important that the Australian and New Zealand CSEF models are aligned? If so, is it necessary for this to be achieved through the implementation of similar CSEF frameworks, or would it be more appropriate for CSEF to be considered under the Trans-Tasman mutual recognition framework?

Answer

The Committee does not consider that Australia's regulatory regime for CSEF should be driven to mirror that of New Zealand. So long as Australia has a practical CSEF regime in place, Australian SME start ups and innovators will benefit. The New Zealand CSEF regime which enables 'crowd' funding not limited to SME start ups and innovators, and does not impose caps or constraints on intermediary fees or investment, does not provide the focus on investor protection and investment value risk that the CAMAC Option would do for Australian investors.

13. Do you consider that voluntary investor caps and requiring increased disclosure where investors contribute larger amounts of funds appropriately balances investor protection against investor choice and flexibility for issuers?

Answer

The Committee considers that voluntary investor caps and requiring increased disclosure where investors contribute larger amounts of funds does not appropriately balances investor protection against investor choice and flexibility for issuers. Once the investment value for each investor becomes large, the existing Corporations Act regulatory requirements should apply as the start up or innovation entity would not then be an SME.

14. What level of direction should there be on the amount of disclosure required for different voluntary investor caps?

Answer

In the SME Committee's view the amount of disclosures required should not differ between investor caps. The investor protection requirements should be the same and should be kept to the minimum required to enable an investor to be sufficiently informed to make a capped investment without being misled or deceived into doing so.

Section 4.3 – Option 3: Status Quo

15. How likely is it that the obstacles to CSEF that exist under the status quo would drive potential issuers, intermediaries and investors to move to jurisdictions that have implemented CSEF regimes?

Answer

In the Committee's opinion obstacles to CSEF that exist under the status quo would certainly drive potential issuers, intermediaries and investors to move to jurisdictions that have implemented CSEF regimes. Further, as 'crowd' sourced funding has developed through social media forums, the jurisdictional location of the platform hosting the 'issue' may not be Australia.

Section 5 – Questions Comparing Models

16. What are the costs and benefits of each of the three options discussed in this consultation paper?

Answer

The SME Committee is not in a position to comment on this question other than at a high level as done in other answers.

17. Are the estimated compliance costs for the CAMAC and New Zealand models presented in the appendix accurate?

Answer

The SME Committee is not in a position to comment on this question.

18. How many issuers, intermediaries and investors would be the expected take up online equity fundraising in Australia under the status quo, the CAMAC model and the New Zealand model?

Answer

The SME Committee is not in a position to comment on this question.

19. Are there particular elements of the New Zealand model that should be incorporated into the CAMAC model, or vice versa?

Answer

A major difference in the New Zealand model to that of CAMAC is that the New Zealand model does not restrict intermediaries as to the fees they can charge, including allowing them to charge a proportion of funds raised. The SME Committee observes that the risk in incorporating unrestricted fee arrangements for intermediaries in the CAMAC model for Australia is that less of the funds raised would end up with the SME start up or innovator, as intended by the 'crowd' investors, and more will end up with the intermediaries. The model would then not benefit SME start ups and innovators as much as is proposed.

20. Are there particular elements of models implemented in other jurisdictions that would be desirable to incorporate into any final CSEF framework?

Answer

The SME Business Law Committee is not in a position to comment on this question.

21. Do the issues outlined in this consultation paper also apply to crowd-sourced debt funding? Is there value in extending a CSEF regime to debt products?

Answer

In the Committee's opinion, for SME start ups and innovators there is little practical difference between equity funding and debt funding if the interest on the debt funding could be delayed until the company can afford to make repayments, in the same way as returns on capital are delayed. The difference in the funding type would need to be recognised by debt funding taking precedence on timing repayment to equity funding.

Issues outlined in this consultation paper can also be applied to crowd-sourced debt funding and the Committee thinks there would be value in looking to also extend a CSEF regime to debt products for SME start ups and innovators.

22. To what extent would the frameworks for equity proposed in this discussion paper be consistent with debt products?

Answer

The framework for equity funding proposed is, as set out, currently prima facie constrained by the regulatory requirements of the type of company equity is to be raised by. With debt funding from large numbers of small lenders through social media similar constraints to those applicable to public company equity funding would currently apply to the SME start up or innovator that is borrowing.

23. Would any of the options discussed in this paper, or any other issues, impede the development of a secondary market for CSEF securities?

Answer

In the SME Committee's view nothing proposed in the CESF Discussion paper would impede development of a secondary market for CSEF securities.

Further discussion

The SME Committee would be happy to discuss any aspect of this submission.

Please contact Coralie Kenny, the Chair of the SME Business Law Committee, on 0409 919 082 if you would like to do so.

Yours faithfully

A handwritten signature in black ink, appearing to read 'John Keeves', with a long horizontal flourish extending to the right.

John Keeves
Chairman, Business Law Section