CROWD SOURCED EQUITY FUNDING

Submission to the Consultation

February 2013

RESEARCH AUSTRALIA
AN ALLIANCE FOR DISCOVERIES IN HEALTH

ABOUT RESEARCH AUSTRALIA

Research Australia is an alliance of 160 members and supporters advocating for health and medical research in Australia. Research Australia's activities are funded by its members, donors and supporters from leading research organisations, academic institutions, philanthropy, community special interest groups, peak industry bodies, biotechnology and pharmaceutical companies, small businesses and corporate Australia. It reflects the views of its diverse membership and represents the interests of the broader community.

Research Australia's mission is to make health and medical research a higher priority for the nation. We have four goals that support this mission:

- A society that is well informed and values the benefits of health and medical research.
- Greater investment in health and medical research from all sources.
- Ensure Australia captures the benefits of health and medical research.
- Promote Australia's global position in health and medical research.

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INTRODUCTION

Research Australia welcomes the consultation on the development of an Australian regulatory framework for Crowd-sourced Equity Funding (CSEF).

Crowdfunding has been one of the most innovative developments of the last decade, and has allowed a range of projects to attract the financing they needed to succeed. Starting in the creative arts, the range of projects supported by crowdfunding has broadened in recent years. Perhaps one of the best examples of the potential of crowdfunding has been its use as a platform for the funding of university research projects, pioneered by Deakin University and Pozible in 2013.[1]

With crowdfunding in Australia currently restricted to providing non financial benefits, the move to equity funding of small businesses is an obvious next step. Research Australia considers that CSEF should be seen as a true hybrid of crowdfunding and equity raising. It is important to recognise that the origins of crowdfunding lie in social media rather than commerce and that this influences the character of CSEF. Research Australia expects that the majority of CSEF investors will be motivated primarily by the desire to support the goals of the business proposition (typically the development of a new product or service) rather than the opportunity to make a profitable investment. To this end, clear warnings about the generic risks of investing in small businesses are likely to be more effective than detailed disclosure about the nature of the company and the proposed investment.

Like crowdfunding, the advantage of CSEF for businesses lies in the opportunity to reach individuals who are supportive of their aims and objectives. For this reason, Research Australia believes that small companies seeking to develop medical devices and technologies could be significant beneficiaries from a CSEF model as the products they are seeking to develop are generally a public good and will find a significant pool of potential investors willing to support their development. This has important economic benefits, as a lack of capital for small innovative Australian companies has been identified as a barrier to Australian innovation.[2]

Research Australia is broadly supportive of the model proposed by the Corporation and Markets Advisor Committee (CAMAC). The responses to the questions raised in the Discussion Paper outline some proposed refinements to that model and identify some key questions that should be addressed.

CSEF is a new phenomenon globally and it is difficult to predict how it will develop. While it is possible to make assumptions about both the benefits and risks of the model, these will need to be tested against real experience. Research Australia recommends that the regulatory regime for CSEF be reviewed two years after

[1] http://www.pozible.com/collection/detail/53; http://www.deakin.edu.au/news/media-archives/2013-media-releases-archives/deakin-makes-research-pozible

[2] Australian Government, *Boosting the commercial returns from research,* October 2014, p.16

it is implemented, and proposes a number of areas for review in its response to specific questions. With such a review in mind, Research Australia has proposed a relatively conservative approach to CSEF initially. This submission provides an overview of Australian health and medical research, identifies Commonwealth government sources of funding and support, the role of State Governments, the importance of the H&MR research sector to the economy, and the role H&MR can play in assisting the Commission in its task of addressing waste and duplication in Commonwealth Government expenditure.

RESPONSES TO QUESTIONS

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?

Research Australia believes the main barrier is the lack of a CSEF regulatory structure.

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?

No. CSEF provides an opportunity to attract investment from a new group of potential investors that small businesses generally lack the resources to reach through the existing fundraising mechanisms. As noted in the introduction, Research Australia believes that the advantage of the CSEF model over traditional fundraising is the ability to reach a large pool of potential investors who are motivated primarily by a desire to see the proposed product or service delivered.

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?

Research Australia is not aware of any other barriers to the use of CSEF.

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

Research Australia submits that the main market for CSEF is small businesses and start-ups and that initially at least, CSEF should be limited to companies that meet these criteria.

<u>Post implementation review:</u> A broader fundraising role could be considered when the CSEF framework is reviewed after two years of operation.

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

Research Australia believes that the cost of compliance with the full public company requirements would be a significant disincentive to participation in CSEF, and that the proposed exemptions are an important element of the CSEF proposal.

RA believes that together with clear investor warnings and the $2500 investment cap, the exempt public company structure strikes a reasonable balance between investor protection and the regulatory burden on issuers.

<u>Post implementation review:</u> The extent to which the exempt public company structure has been a barrier to participation and the extent to which it has provided useful information and protection to investors should be considered when the CSEF framework is reviewed after two years of operation.

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?

Research Australia acknowledges that there are additional compliance costs associated with being an exempt public company rather than a private company, and that this will discourage some companies from using CSEF. Nonetheless Research Australia believes that these additional obligations are reasonable and strike an appropriate balance between facilitating equity funding of small businesses and the protection of unsophisticated retail investors.

<u>Post implementation review:</u> The extent to which the exempt public company structure has been a barrier to participation and the extent to which it has provided useful information and protection to investors should be considered when the CSEF framework is reviewed after two years of operation.

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?

Research Australia acknowledges that there are risks of regulatory arbitrage but that these are likely to be significantly mitigated by elements of the CSEF model such as the cap on the size of the company that can be an issuer and the amount of money that can be raised in a year.

<u>Post implementation review:</u> The extent to which the exempt public company structure has been abused should be considered when the CSEF framework is reviewed after two years of operation.

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?

Research Australia has no comment on whether the caps on issuers are set at an appropriate level.

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?

Research Australia has no comment on CAMAC's recommendations in relation to intermediary remuneration and investing in issuers.

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?

Research Australia acknowledges that there is an element of arbitrariness to the investor caps. However, the existence of the cap on the amount that an individual investor can invest in a single fundraising is an important investor protection and it is essential that the regulatory regime is simple to understand and administer. On balance, Research Australia supports a cap per investment. Research Australia has no specific view on what this cap should be, but submits that $2,500 seems to be low. If the aim is to prevent an individual from losing more money than he or she can afford to lose without suffering significant financial hardship (an 'unaffordable loss'), this objective could be achieved for the majority of potential investors with a higher cap than $2500.

Intermediaries should be obliged to put in place systems that enforce this cap at the account level and to put in place measures in relation to the identification of individuals and verification of identity to reasonably ensure that an individual cannot open more than one account.

In relation to the limit of $10,000 p.a. per investor across all CSEF investments, while this has a clear consumer protection element which Research Australia supports, we have reservations about whether this limit can be enforced in practice.

While it is reasonable to require an intermediary to limit the value of investments made from any one account in a 12 month period and to put in place measures to minimise the opportunity for an investor to create multiple accounts, this would not prevent a person having an account with more than one intermediary (and it would limit competition among intermediaries to crate such a limit). Effective enforcement of a $10,000 per annum per person limit would require real time monitoring of investments across multiple CSEF accounts with multiple intermediaries. This would be time and resource intensive for both the intermediaries and the regulator, and it is not currently clear that such a measure is warranted or even practical.

Research Australia proposes that intermediaries be required to take reasonable steps to prevent an individual investor creating multiple accounts. Research Australia also proposes that intermediaries be required to implement the $10,000 cap on investments in any rolling 12 month period from any account. Research Australia does not support imposing an investment cap of $10,000 per annum per investor because monitoring and enforcing such a cap will require disproportionate resources from the intermediaries and/or regulator.

If the individual investment cap of $2,500 is raised to a higher amount, Research Australia submits that the limit of $10,000 per investor per year should also be raised to maintain it at four times the individual investment cap.

Post implementation review: The extent to which:

- the investor caps restrict investment in issuers; and
- their effectiveness in preventing unaffordable losses to investors;

should be considered when the CSEF framework is reviewed after two years of operation.

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?

Minimum and Maximum targets

One of the key features of crowdsourcing that is not addressed in the discussion paper on CSEF (but is addressed in part by the CAMAC recommendations) is the setting of a target for fundraising. Research Australia believes that the creation of a minimum target, and the release of the funds by the intermediary to the issuer only when the minimum target has been attained, should be a feature of a CSEF model. While it has disadvantages for issuers a minimum target protects investors from the risk that an issuer is unable to raise sufficient funds to achieve the proposed purpose.

A maximum target is also worth considering, as there is a risk that an issuer could raise more funds than it can use productively and profitably. A maximum target could be required to be specified as a dollar amount. Alternatively a maximum target could be applied uniformly to all CSEF proposals as a percentage of the minimum target (eg.120%). In either case, the disclosure provided by the issuer should identify how any funds raised in addition to the minimum target will be utilised.

Intermediaries should be responsible for ensuring that funds below the minimum target and in excess of the maximum target are returned to the investor.

Communication between investors

While investor (and issuer) complaints about intermediaries will be subject to an alternative dispute resolution scheme, resolution of investor complaints will be subject to the normal legal processes. Intermediaries should be required to provide a forum in which investors are able to communicate with each other. Such a forum would enable issuers to share information and to co-operate in resolving common complaints and grievances with issuers. It would also facilitate a secondary market in CSEF equities- see the response at Q.23 below.

Cooling Off

CAMAC proposes a limited Cooling Off right of, for example, 5 days. This varies from the existing cooling off period provided by crowd funding sites where the cooling off period applies until the time the pledge reaches its threshold target.

Under current crowdfunding arrangements, the pledge amounts are only withdrawn from the individuals' accounts when the pledge reaches its threshold target. This approach has some significant advantages. The first is that there is only a very short period between the pledge being redeemed by the intermediary and the funds being transferred to the initiator of the campaign. This eliminates the risks and costs associated with intermediaries holding large amounts of money for extended periods 'on trust' for investors and issuers. It also avoids the accounting and transaction costs associated with refunding pledges when the threshold target is not met.

While not explicit, the CAMC proposal for a limited cooling off period implies that the funds will be drawn form the investor's account immediately the investment is made or at the end of the five day cooling off period. This approach means that intermediaries will be holding large amounts of funds on trust, raising questions about how these funds will be held and how the interest earned on the funds will be distributed. It also raises the question of who bears the transaction and administrative costs in the event that funds need to be returned to the investor under the cooling off period or if the minimum threshold is not met.

Research Australia recommends that the existing crowdfunding providers be consulted on their experience with crowdfunding pledges and whether the ability of individuals to withdraw their pledges up until the time the threshold is reached presents them with real difficulties in administering campaigns. If the current approach does not present major difficulties, Research Australia recommends that the same approach be adopted for CSEF.

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?

Research Australia considers that while it is desirable, it is not necessary that the models be aligned.

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?

No. CSEF is a hybrid of crowd funding and normal equity raising. It is likely that the CSEF investors will be motivated at least as much by the intended outcome (development of a new product etc.) as they will be by the desire for a return on their investment. In this context, there is significant scope for individuals to make poor investment decisions and to overcommit themselves with voluntary investor caps. Providing further and more detailed information is unlikely to be as useful as it would be to an investor that was purely motivated by a desire for a return on their investment.

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

Allowing different voluntary investor caps adds a level of complexity that does not appear to be warranted at this time. This could be a matter to be considered when the scheme is reviewed.

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?

Research Australia has no response to this question.

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

Research Australia has no response to this question.

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

Research Australia has no response to 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?

Research Australia has no response to this question.

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

Research Australia has no response to this question.

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

Research Australia has no response to 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?

Research Australia has no response to this question.

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

Research Australia has no response to this question.

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

Research Australia submits that the creation of a secondary market for CSEF securities is important to the long term success and sustainability of the model. While not addressed by the discussion paper, intermediaries should not be prohibited from creating a secondary market for CSEF securities or from facilitating the direct communication between CSEF investors.

CONCLUSION

Research Australia is pleased to have the opportunity to make this submission. We believe that CSEF has the potential to provide an important additional source of capital for innovative small companies, many of which are drawing on Australia's expertise in health and medical research.

While these investments are inherently high risk, the proposed scheme provides an opportunity to draw on the successful crowdfunding model to tap the retail investment market while limiting the potential risk to investors.

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