



Australian Private Equity &  
Venture Capital Association Limited

16 February 2015

Mr Kurt Hockey  
Manager  
Financial System Assessment Unit  
Financial System and Services Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Email: [csef@treasury.gov.au](mailto:csef@treasury.gov.au)

Dear Mr Hockey,

**Submission on Crowd-sourced Equity Funding Discussion Paper**

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the Government's announcement as part of the Industry Innovation and Competitiveness Agenda (II&CA) about the introduction of reforms to encourage crowd-sourced equity funding (CSEF) in Australia in order to provide startups with improved access to capital.

AVCAL is the national association representing the private equity and venture capital industries in Australia. Our members comprise most of the active private equity and venture capital firms in Australia. These firms provide capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies.

At the outset, it worth pointing out that AVCAL is supportive of the Government's plans to introduce a regulatory framework to facilitate the use of CSEF in Australia. The benefit to the broader economy of improving access to finance and capital for small business and startups is well documented. In the context of CSEF, it is apparent that other developed economies have already taken a number of steps to implement policy frameworks which support the use of crowd-sourced equity funding. Because of that, we believe it is vitally important that we remain focussed on positioning Australia to compete for the best entrepreneurial talent both domestically and from offshore.

In our view, the implementation of changes to facilitate the use of CSEF should be developed around a set of policy objectives which seek to deliver a simple and cost-efficient framework that successfully aligns the interests of startups and CSEF investors. Experience tells us that the success of an Australian CSEF will depend on whether or not the new regulatory framework strikes the right balance between competing market and regulatory interests.

Our recommendations on key aspects of the proposed new CSEF framework are outlined in the attached document. If you would like to discuss any aspect of this submission further, please do not hesitate to contact me or Dr Kar Mei Tang on 02 8243 7000.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Yasser El-Ansary", written over a horizontal line.

**Yasser El-Ansary**  
Chief Executive  
AVCAL

## **AVCAL SUBMISSION**

### **Discussion Paper on Crowd-sourced Equity Funding**

AVCAL welcomes the Government's recently announced proposals to introduce a regulatory framework to facilitate the use of CSEF in Australia. Boosting access to new funding and capital for small businesses and startups is something that we have been supportive of over many years.

As Treasury will be aware, other developed economies around the world have already implemented policy frameworks to support the use of CSEF, and because of that it is critically important that we remain focussed on positioning Australia to compete for the best entrepreneurial talent both domestically and from offshore. The implementation of an effective CSEF framework will play an important role in helping to improve Australia's entrepreneurial system which, when married with other key policy architecture, will drive a more innovative and dynamic economy for our long-term prosperity.

AVCAL's response to questions posed in the Discussion Paper, and recommendations on the design of the CSEF framework, are set out below.

#### **1. Need for a regulatory framework for CSEF**

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

Feedback from existing CSEF participants clearly indicates that the existing mechanisms of the managed investment scheme regime and the small scale personal offer exemption do not sufficiently facilitate online offers of equity in small companies.

AVCAL believes that Australia should remove unnecessary roadblocks to CSEF in Australia, such as restrictions on advertising an offer of securities and financial products by issuers seeking to raise funds through CSEF.

AVCAL recommends that the design of the regulatory framework must allow for CSEF to be economically feasible and a credible alternative to other sources of funding. It should take into account the current (albeit limited) experience of equity crowdfunding market in Australia and overseas on the likely composition, size and volume of the market. Companies that crowdfund usually raise \$1m or less. The average successful fundraising on overseas CSEF platforms is typically in the \$100k-\$200k range (e.g. Seedups (Ireland, US\$200k), GrowVC (US, US\$7k), Buzz Entrepreneur (US, US\$136k), and Crowdcube (UK, US\$250k)).<sup>1</sup> In Australia, ASSOBS records a slightly higher average fundraise of \$300k per company.

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<sup>1</sup> Ahlers, G., D. Cumming, C. Günther, D. Schweizer, Signaling in Equity Crowdfunding (December 2, 2013). Available at SSRN: <http://ssrn.com/abstract=2362340>.

For such typically small issue sizes, it is important that the CSEF legal framework does not add new layers of administrative complexity which leads to a significant cost burden for startups wishing to access capital this way. Achieving a balance between flexibility and consumer protection will be critical to the effectiveness of the new regime.

From a policy perspective, it is also important to recognise that the broadening the CSEF regime, while welcome, will complement but not fill the existing VC funding gap. This is because CSEF typically facilitates fundraising at similar levels to angel or micro-VC investors at the very earliest startup stages.

AVCAL data shows that the number of startups receiving funding rounds of under \$2m has increased in the last five years (from 47% to 58% all companies receiving VC funding). At the same time, however, the number receiving funding in the \$2-\$20m investment round size has declined. A critical gap in startup funding currently exists for funding rounds of between \$2m to \$20m.

The much smaller amounts typically raised through CSEF, given the experience in other markets and the projected limited size of the retail investor base, means that CSEF will typically be used by issuers at the earlier pre-seed/seed funding rounds of \$1m and under (although some startups may, depending on the circumstances, seek to raise higher amounts).

Nevertheless, AVCAL sees no compelling reason to limit the application of CSEF to small businesses and startups. In fact, it may be argued that both investors and issuers would benefit from the flexibility of allowing any private business seeking to raise capital through CSEF. In addition, this would obviate the need for defining what constitutes a “small business” or “startup” under the CSEF framework, as perceptions on these concepts vary widely.

## 2. Company structures to facilitate CSEF

### Questions

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

**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?**

**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?**

It is vital that the CSEF framework simplifies rather than adds to the administration and compliance costs for startups.

AVCAL is of the view that there is no need for a new “exempt public company” structure if the essential exemptions are made available for existing categories of incorporation. More specifically exemptions from the public company compliance requirements should be available for issuers who have more than 50 shareholders as a result of raising capital through a CSEF intermediary, without the need to change the issuer’s category of incorporation.

To ensure that these exemptions are aligned with the business’s size and growth stage, they could be set to automatically expire when, for example, the startup’s total capital exceeds a certain threshold.

### 3. Proposed caps and thresholds for issuers

#### Question

**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?**

CAMAC's proposed \$2m p.a. funding cap for issuers, while probably unlikely to be tested often, is nevertheless potentially a limiting factor which may impact the success and growth of the CSEF framework.

It is worth noting that some of the most successful CSEF fundraisings globally would have breached the proposed \$2m p.a. cap. The largest CSEF fundraising to date was by Borro, an asset-backed online lender, which raised US\$6m on Israeli CSEF intermediary OurCrowd in February 2015.

In addition, such a cap puts CSEF at a disadvantage given that no such caps exist for other means of crowdfunding, such as reward-based platforms like Pozible, Kickstarter or Indiegogo. There are also no equivalent buyer caps in these platforms, thus facilitating a wide range of funding opportunities.

In AVCAL's view, having an informed issuer base should also be regarded as an important part of ensuring the integrity and success of the CSEF framework. It is vital for issuers to be properly advised and made aware of their obligations in relation to their CSEF investor base. In particular, issuers need to be prepared to manage:

- **Shareholder agreements:** The startup needs to be clear on the kind of flexibility it needs to retain in order to ensure it is attractive to future investors. This includes determining whether it needs a shareholders agreement to deal with issues such as directorships, voting rights, and secondary trading of shares. For example, it may not be easy for an equity crowdfunded company to get future funding from angels, VC or PE funds or corporate investors if the original shareholders' agreement does not facilitate certain controlling rights being passed on to the new financial sponsor(s), 'drag-along' rights, or if there is already a very large and diverse shareholder base which may make it difficult for the new financial sponsor(s) to exercise its investment strategy. Therefore, it is important for issuers to take the appropriate steps to ensure their shareholder structures are set up to mitigate the risks of being deemed "uninvestable" by potential future investors.
- **Shareholder registers.** If there are a large number of shareholders, the startup will need to figure out how it will manage its share register and keep track of its shareholders over time.
- **Investor relations.** Are both issuers and investors clear on the reporting expectations under the reduced disclosure requirements? Even if investors have limited information rights, issuers should be prepared to receive inquiries from CSEF investors and devise a process around handling such inquiries.
- **Staff training.** Relevant startup employees may also need to receive the appropriate training on compliance with securities regulations, e.g. on insider trading and market manipulation.

### 4. Proposed requirements for intermediaries

#### Question

**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?**

The potential conflicts of interest arising from intermediaries' interests in issuers as noted in the CAMAC report are recognised and should be addressed.

However, in AVCAL's view there are also risks arising from not allowing intermediaries to have an interest in the issuers on their platforms. Having a financial interest in the issuer not only facilitates alignment of interests between the intermediary and issuer, but can potentially allow the platform offer its own unique value proposition to retail investors who wish to co-invest with professional investors.

In the US platforms such as AngelList offer investors the opportunity to co-invest in syndicates led by renowned angel investors. Such opportunities can be particularly valuable in early stage investing where access to information and industry knowledge are vital for successful investment in novel, high-risk ventures. They also allow non-professional investors the opportunity to access a professionally curated, diversified portfolio of CSEF investments.

In addition, crowdfunding platforms are themselves often backed by VCs.<sup>2</sup> The proposed restrictions on intermediaries investing in issuers, if extended to the intermediaries' shareholders, may mean that startups raising funds through CSEF will be disqualified from accepting investment from these VCs.

It should be noted that some of the most successful CSEF fundraisings have been part of larger syndicated investment rounds involving VCs and other professional investors. The largest CSEF round to date was backed by Israeli CSEF intermediary OurCrowd, which raised US\$6m of a US\$19.5m funding round for Borro, an asset-backed online lender. Other investors in that round included VC investors such as Rocket Internet AG, Canaan Partners and Augmentum Capital. One of Australia's most successful crowdfunded ventures, Ingogo, raised \$1.2m on VentureCrowd, out of a total \$9.1m funding round led by financial backers UBS and Canaccord Genuity.

## 5. Proposed investor caps

### Questions

**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?**

**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?**

**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?**

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

The CSEF regulatory framework should include appropriate safeguards for retail investors who participate in the market.

Adequate education and information flow is essential, as retail investors would typically lack access to the same information and sectoral know-how as professional investors.

In AVCAL's view, CSEF investor protection measures need to be effective and simple to administer. In addition to measures for investor protection in the event of fraud, investors need to be made aware of the risk-return characteristics of the issuer, and their rights as shareholders (which may vary across different platforms and issuers).

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<sup>2</sup> For example, crowdfunding platforms such as AngelList (notable investors include Atlas Venture, Google Ventures, Kleiner Perkins Caufield & Byers and Draper Fisher Jurvetson), CircleUp (Google Ventures, Union Square Ventures and Maveron), and many others.

In particular, investors should be made aware of the risks of investing in early-stage novel businesses, which typically have much higher failure and pivot rates than listed companies. This means that stellar returns are, by nature, relatively infrequent. For example, one US study demonstrates that the likelihood of a positive return on any early-stage “angel investment” is less than 50%.<sup>3</sup> In addition, in early stage investing typically only a small number of successful startups account for the majority of financial returns to investors.

Importantly, if there are restrictions on the amount and type of investments that an investor can participate in, these should not have the unintended consequence of preventing the investor from being diversified or prevented from co-investing with professional investors.

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<sup>3</sup> Wiltbank, R. and W. Boeker, *Returns to Angel Investors in Groups*, study sponsored by the Ewing Marion Kauffman Foundation and Angel Capital Education Foundation, Nov 2007.