Senate Standing Committees on Economics

Corporations Amendment (Crowd-sourced Funding) Bill 2015

Submission 5 February, 2016

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Introduction

This legislation is technology driven and not technology neutral. Because the Government wishes in a learning curve to legislate only for a narrow proportion of equity crowdfunding, ECF, it has excluded the provision of a crowdfunding service from the definition of a “managed investment scheme” even though it logically, as ASIC has indicated, would otherwise fall within this definition.

“Crowd” simply means “the public” so that in effect the raising of capital by the method under review is no different from the method of raising capital when corporations legislation was first enacted in Australia. The major difference is that “software as a service” or “SAS” and “cloud” technology has developed to such an extent that it is now feasible to have a more efficient digital system for raising capital than was hitherto possible under older technology. While the government has legislated in respect of technology on numerous occasions, it is preferable to consider any legislation from basic principles and then overlay those principles on the technology which is the subject of the legislation.

Section 703B

It is critically important from a productivity point of view and a technology exports point of view that existing means of raising capital from the public continue unabated. S703B is to emphasise the fact that ECF is to be a separate regime. Unfortunately, the legislation is not sufficiently discrete, integrating in some provisions and operating as a stand-alone piece of governance, with others.

Section 725A

It is critically important that the existing exemptions from disclosure documents be maintained. As noted which a separate regime is attempted, the legislation has not achieved a sufficient separation. This could be achieved by separately defining an “accredited investor” and a “consumer investor” instead of using the term “retail client” for the latter.

Section 734

Publishing is dealt with later and is a difficulty under this legislation.

Part 6D.3A

It is easier for the government to achieve its objective by having ECF as a separate part of Corporations Act 2001. This seems an appropriate manner of dealing with this area of regulation. This legislation is inconsistent in terms of nomenclature (see later). The term used should be “Equity crowdfunding”.

738A

There is no distinction here between public and proprietary companies. This gives flexibility. It is a mistake to keep providing different categories of corporation and to have different definitions in different legislation (eg small and large companies in income tax legislation). One can vary the requirements for a limited range of companies. It is however a mistake to require that a public company be incorporated as an ECF company.

Definitions

I consider it unhelpful to have relevant definitions scattered throughout Section 9 and also through Part6D.3A. The legislation would be far more coherent if all definitions were in Division 1 – Introduction.

Section 738C and 738D

In one sense these two sections constitute “the elephant in the room”. Firstly, most aspects of ECF have been considered save for the exact provisions which are to be in the ECF AFSL. A complete envelope in respect of ECF can only be provided if there is examination of the obligations of an ECF AFSL to see whether there are some obligations which are too onerous in the context of the scheme which is being proposed. Some of the obligations in respect of “public companies” have been reduced but the more difficult obligations to the totality of the scheme may well be in the AFSL. The Committee should find that the AFSL requirements for an ECF intermediary should be specified in the Regulation or at the least discussed in the context of the Bill and the Regulation.

Secondly, there is significant confusion in the existing legislation in the area of “financial products”, “financial services”, “retail clients” and “wholesale investors” not the least because “managed investment schemes” specifically utilises these terms. It would have been preferable to use the term “consumer client”, thereby allowing a comparison of the respective regimes. The implication is that there are some efficiencies from use of the term “retail client”, but I believe a careful analysis of the legislation suggests that this is not the case.

Section 738E

The Government has attempted to have the current amending legislation discrete and not to impact on section 708 exemptions which are currently being used. These exemptions and those in Class Order ASIC CO 273/2002 have been used satisfactorily for a number of years and had their genesis in Productivity Commission reports in the 90s. The Class Order is within the province of ASIC. This Class Order should in keeping with other fundraising provisions be amended. The Class Order is exempt from this legislation by omission. It would however be appropriate to have a provision to the effect that this ECF legislation operates independently of any Class Orders made by ASIC.

Section 738G

It is important to maintain the exemptions in paragraph 738G(2)(c), namely those in subsections 708(1) and (10). It would be appropriate however, to also exempt amounts raised under any class order respect of fundraising, made by ASIC. It is clear that Class Order ASIC CO 273/2002 needs to be amended and clarified. The Class Order, which requires no licence but a detailed procedure, purports to cover products and services, a number of subsections in section

708, managed investment schemes and to some extent retail and wholesale clients. The class order system is significant because it provides ASIC with powers not usually given to agents of the government, and because it enables in this particular case, anyone to play the role of the intermediary, provided they do not have an interest in the issuing company and provided they follow the procedures set out in the class order.

Section 738H

The requirement for “the company’s principal place of business” to be in Australia seems anomalous (738H(1)(b)). It is even unclear what it means. It would work against a start-up which for example, commenced in Australia but then had significant operations in Papua New Guinea such that its principal place of business is then located in that country. One wonders to why it is necessary that “a majority of the company’s directors… ordinarily reside in Australia” (738H (1)(c)). It should be sufficient that the issuer company by incorporation or registration as a foreign company subjects itself to the jurisdiction of the Corporations Act 2001. Would it matter, for example, if a company incorporated in Malaysia with mainly Malaysians resident directors, came to Australia to issue shares to investors. It is clear that once a company is on a platform, that investors may be in Australia or may be overseas. Australia needs to embrace the international environment as opposed to sheltering within the geographic confines of Australia’s boundaries. It is that type of thinking and the reliance on less intellectual products such as mining, agriculture and tourism, which has led to the balance of trade difficulties which we are currently facing.

The limitation in subparagraph 738H(2)(a)(i) as to “the value of the consolidated gross assets of the company and of all its related parties is less than $5,000,000” is also problematical. Typically a start-up may require a sum between $1,000,000 and $5,000,000 although some have managed to be cash positive and trading under $200,000. The difficulty is that the majority (that is 80%) of corporate assets which used to be physical or real estate are now intellectual property. It is conceivable that a company which is raising very little seed capital by issuing shares, has a high value because of the potential of the system it is using (that is, it is scalable, innovative and disruptive), the number of persons who are subscribing to its services or the value of its intellectual property. In this circumstance a relatively small amount of capital is being raised, and a small percentage of equity is being given to investors.

It also appears unfortunate to have a provision which limits “the consolidated annual revenue of the company and of all its related parties” to be less than $5,000,000 (738H(2)(b)). If the service being sold is highly technical and results in significant advantage to the customer it could be well worth $5,000,000 even though the start-up is in need of seed capital and has no history of trading. Similarly, a start-up could be selling equipment or apparatus which has a significant capital value to the purchaser which is of the order of $5,000,000. Thirdly the service or apparatus being sold may involve this start-up in a significant purchase itself of services or equipment. Because the $5,000,000 is a gross figure and does not take into account the cost of goods or services resold, it appears unnecessarily limiting.

Section 738J

To some extent the CSF offer document is the Information Memorandum normally provided to investors. Investors will normally react to the manner of its presentation and the information which is contained in it, this being some guide to investors of the quality of the management team and the care and detail which they take in presentation and therefore in other aspects of

their work. To the extent that the CSF offer document is template driven, there is less opportunity for investors to assess based on the core information which would otherwise be provided by the issuing company, when there was no strict specification as to the information to be provided. The draughtsman has intended to cover this aspect by providing that certain information must be contained in the offer document, meaning that other information can be included depending on the issuer's ability and perception of investor need. However the difficulties of misleading and deceptive conduct (as to which see later), mean that "less is more".

Section 738K

The words, "worded and presented" and "clear, concise and effective manner" refer more to syntax and grammar and organisation of thought than they do to the content of the words which goes more to "misleading and deceptive". To obtain a good result from investors clarity should necessarily be the objective, but it is useful to have the legislation draw attention to this aspect. Effectively it means that the information needs to be conveyed to persons who may not have a background in the service or technology which the issuing company is involved. It is effectively an obligation which rests both on the CSF intermediary and on the issuing company.

Section 738L

It is unnecessary and in fact confusing to refer to a "hosting arrangement" (subsection 738L(2)). This is because the word "hosting" simply refers to the ability of the entity which is providing the "software as a service" or "SAS" to provide the service. That is, the CSF intermediary may have its own computers or may be hosted on a third party computers, such as Amazon Web Services. It should be removed from the legislation in so far as it refers to the arrangement between the issuing company and the CSF intermediary. The legislation could simply provide "The agreement between the company and the CSF intermediary… ". As indicated, the preferable course is to have the definitions at the beginning of Part 6D.3A, Division I.

The usual methodology used for payment is that the platform requires investor registration either before or after the investor sees the assets which are being sold, in this case the issue of equity in new companies. Once the investor has created his "dashboard" he can then select the asset in which he wishes to invest, carry out his "due diligence", read and execute the required documentation, and then make payment by card or direct transfer to the intermediary. The intermediary then holds the moneys received on trust for the issuer company subject to the legislation and any agreement between the platform and the issuer company. As the platform must comply with the requirements of its AFSL, it is appropriate to provide that payments are received by that entity.

The whole area of advertising and publishing needs revisiting (see subsection 738L(4)). This is because the concepts which are enshrined in legislation had their genesis in print or email to individuals. Now however anything on the web is "published" and "advertised". This aspect is considered later.

It is appropriate to have maximum and minimum amounts (see subsection 738L(7) and (8)), although there are various models in non-equity crowdfunding (e.g. gifts and perks) sectors which have different requirements in this regard. This is because the CSF offer document or information memorandum will typically outline the business plan for which the funds are being raised. It is readily apparent, that the business plan may not be able to be fulfilled unless there is sufficient capital, i.e., if too little is raised. There is still risk for the investor because it is

possible to have either a narrow or a large spread between maximum and minimum to effectively negate this requirement. And an issuing company which deliberately specifies a low minimum may be significantly increasing investor risk, because there is insufficient capital to achieve the business model objectives defined by the management of the issuing company.

Section 738M

The consents required by directors and potential directors are important as are consents by persons who have made statements for the purpose of the CSF offer document or statements based on statements made by a person. However, this is another area where the requirements are more stringent than they are for prospectuses with the result that appropriate information may not be in the CSF offer document or this method of capital raising will not be used. A contrary argument is that if the bones of the concept are sufficiently attractive and there is insufficient detail, the investor can make his own enquiry of the issuing company.

Section 738N

It is appropriate to succinctly define when the offer is made, open, closed, suspended and complete. It is appropriate to specify a maximum period of three months and to provide that while the legislation is specific as to its requirements in respect of the status of the offer, that the issuing company can have further agreements with the CSF intermediary regarding the opening or closing or suspension et cetera of the offer. Again, it is inappropriate to use the term “hosting arrangement”.

Section 738Q

This is another provision where the obligations in respect of the CSF offer document are more onerous than prospectus compliance for an issue of shares by an unlisted or listed company.

Secondly, subsections 738Q(4) and (6) are extremely poorly drawn and difficult to interpret. For example, in section 738Q(6) should read:

> *If the responsible intermediary becomes aware that the CSF offer document is defective because it learns that a misleading or deceptive statement has been made, learns of a significant omission or a new circumstance has arisen or for some other reason, the CSF intermediary must remove the CSF offer document from the offer platform and either close or suspend the offer.*

I have earlier expressed the view that is inappropriate to have the Bill and Regulation without the requirements of the AFSL – the 3 documents are an interdependent package. Here we have a reference in subsection 738Q(7) to the CSF intermediary’s compliance manual which presumably is a subject covered by the AFSL. While it is readily apparent that the AFSL may vary depending on the applicant, the essential criteria for the AFSL should be the same across all applicants who are licensed.

Without giving public attention to the AFSL, there is a likelihood that the entities which will be applying for an AFSL are those entities which already hold an AFSL. That is, the equity crowdfunding compliance regime will simply be an extension of the AFSL which is already in place. This may have the consequence that the legislation does not create the watershed which is required, which is more likely to occur if disruptive, innovative companies become the CSF intermediaries.

Section 738T

The right to withdraw an application in paragraph 738T(b) is unclear in its wording. I suggest that withdrawal may be permitted by the responsible entity:

- in accordance with any agreement with the applicant;
- in accordance with the responsible intermediary's AFSL; or
- in any other circumstance allowed by the responsible intermediary.

Section 738U

the concept of a "misleading or deceptive statement" is problematical in the start-up context. One definition of a start-up is a company which is endeavouring to find its business model. A start-up usually is created on the basis of some hypothesis as to product or service and client or customer behaviour. Market research may indicate that the premises on which the start-up is operating need to be drastically changed or varied in a significant degree to make the start-up profitable and scalable. A major product Slack, is a case in point. Such a change is often referred to as a "pivot".

It can be seen that such change and direction, differing from an information memorandum or from a CSF offer document, could be labelled "misleading and deceptive", as the document postulates one direction and the investor finds that the company in which he is invested is now taking another direction. Yet it is in that investor's interest, that the pivot takes place and the new course is taken by the start-up. In addition, an investor must be taken to have understood that this is necessarily part and parcel of the environment in which start-ups operate. It may be incumbent on the start-up in this environment to stipulate that it has the right to change direction and that such change is not encompassed by the terms "misleading or deceptive". It is readily apparent that later series A or series B funding can be undertaken with more certainty than that which is possible with seed capital. The genesis of this legislation and indeed similar legislation around the world is however that the primary objective is seed capital, and that the failure of the start-up is not necessarily problematical from the entrepreneur's or the investor's point of view. I therefore recommend that there be some change to this section to reflect the importance of this issue.

Section 738ZG

When considering regulation, it is helpful with some provisions to contemplate a matrix as follows:

What is the activity being regulated	The publishing of advertisements for the issue of shares pursuant to a CSF offer on a CSF intermediary platform
What is the harm sought to be prevented	This is not clear. It appears to be an investor investing on the basis of a summary as opposed to the CSF offer document.
What does the regulation require	A blanket prohibition against advertising a CSF offer or publishing a statement which directly or indirectly refers to a CSF offer or is reasonably likely to induce people to apply for

	securities pursuant to a CSF offer subject to certain exceptions
Is there some other way in which such harm can be prevented	• other provisions with respect to the integrity of the intermediary platform, the integrity of the company issuer and the specification of both the procedure to be followed and the content of the CSF offer • the requirement to have the advertisement or statement have provision that “the application for the issue of shares pursuant to investment of money can only be carried out on the intermediary site pursuant to the CSF offer”
Does the regulation itself cause harm	The whole purpose of this regime is to make the marketplace more transparent and to make it easier for innovative companies to raise seed capital and easier for retail clients to have the opportunity to invest in innovation
Is the regulation appropriate given current technology	Current corporate technology is dependent upon digital operations, a critical aspect of which is interacting with the consumer, which occurs specifically with email contact and social media. Any limitation given this environment appears obtuse.
Is the regulation anachronistic	This regulation appears to have emerged on the back of print publishing and in an environment where electronic media was non-existent. It appears to have been maintained to no great advantage to either the supplier or the consumer.

In my opinion it would be far better to simplify this area by indicating advertisements could be placed wherever the issuing company or intermediate platform sees fit, with the caveat that application must be made in such a way that will indicate at the investor has read and understands the offer and is still willing to invest. The procedure to be followed when the investment is made appears to obviate the advertising restrictions in this form. It is akin to assuming a corporate can protect its information at its boundaries as opposed to appreciating that real protection is only obtained from encryption the information itself and providing special keys.

For this reason, the advertising provisions in Section 734 and 739 should be revisited.

Section 766F

Nomenclature is important in this legislation if only because there is some international uniformity which should be maintained. The labelling of the service as a “crowd-funding service” is clearly at odds with the title of this legislation which uses the term “crowd-sourced funding”. This latter term originated in the CAMAC Report and appears to be hubris. The word or words

internationally are “crowd funding” and “crowdfunding” with the latter now being accepted in most countries. In terms of differentiation from other types of crowdfunding, the term used is “equity crowdfunding”. There seems advantage in simplifying terminology and no advantage in having our own semantic regime. This definition and others should be together, in the one place. There should be uniformity of terminology in this legislation and the international use is to be preferred.

A submission earlier made on the Regulation is attached.

Andrew Macpherson

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5 February 2016

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Corporations Amendment (Crowd-Sourced Funding) Regulation 2015

Submissions on the exposure draft – Andrew Macpherson, Macpherson Greenleaf – 22 January 2016

1 Government Objectives

1.1 The objectives of the Commonwealth Government include:

- recognising that innovation and disruption are critical to productivity and seeking to provide a more complete productivity and innovation circle by providing for equity crowdfunding (i.e. meeting one of the deficiencies identified by the latest OECD ratings);
- enabling the Government to capture more information on raising seed capital in the private sector;
- creating an equity crowdfunding start point for further change in legislation based on experience obtained from this legislation’s operation; and
- to be seen to be taking some action in innovation and disruption by having some conservative legislation in place for the equity crowdfunding industry.

1.2 The exposure draft regulation is detailed and shows significant care by Treasury however:

- it is not at all clear that this legislation will make a substantial improvement in the ability of start-ups to raise seed capital or that as a result of this legislation the so-called “consumer” investor to be able to sensibly contribute to this up start-up space;

- exposure draft concentrates on the “ECF offer document” when in fact attention should have been also focused on the nature of the Australian Financial Services License AFSL to be obtained by the financial intermediary or cloud platform promoter of start-up companies.

1.3 The legislation presupposes:

- there will be a substantial increase in seed funding of start-up companies using the proposed legislation; and
- while the legislation provides risks for the consumer, that some consumers will be advantaged by being able to participate in investments previously mainly available to wealthy or “sophisticated” investors.

However, it appears from empirical evidence both in Australia and in New Zealand, that start-up companies can either more easily find the necessary capital by other methods if the start-up has any potential, and that there are insufficient quality start-ups wishing to use this methodology for raising finance to make a platform viable. This is when one considers the amount of capital necessary to obtain the AFSL, prepare and have running appropriate software and sufficient staff to attend to the research required by the draft Regulation.

Such platforms as emerge may assist Australia by providing a later stage investment platforms and competition for local and overseas start-ups which may otherwise have used overseas jurisdictions. It may also enable sensible use of a percentage of superannuation holdings, given the spread of investment which is possible by large funds.

2 Regulation 6D.3A.02 Contents of CSF offer document – Section 1: Risk warnings

2.1 Delete “very” from the second line of the second paragraph;

2.2 in the second paragraph delete the word “must” and insert the word “should”;

2.3 delete the sixth paragraph commencing “Even ……” and ending “…… money.”

The difficulty with this paragraph is that start-ups are all about an appropriate business model for the business or consumer market which they are intending to supply. This means that often start-ups, realising that their initial business model is flawed, are forced to “pivot” and change their business model to something which was not intended at the time the seed capital was originally raised. It can be seen therefore, that an investor could easily argue that the change meant that the initial business model was a “misleading statement”.

The whole point about the risk in start-ups is that they cannot demonstrate a track record of turnover and profitability and dividends for shareholders usually apparent with SMEs which have been successfully trading for a number of years. It can be seen that

this paragraph is therefore inappropriate in a "risk warning" context. One cannot assume risk and then complain if the risk inherent in the investment, results in events which one took into account when the investment was made.

3 Regulation 6D.3A.04 Contents of CSF offer document – Section 2: Information about the offering company

3.1 The requested information is appropriate and well set out in the correct order. However, there is insufficient emphasis on a key aspect of information available to investors. This is the extent to which any of the moneys raised are to be used to repay any debts of the company and in particular any debts owing to officers of the company, shareholders of the company, persons associated with either officers or shareholders of the company and the amount of such debts. The reference to "debt" in (1) (f) is insufficient for this purpose.

3.2 add the following provision to clause (1)

(g) a list of all debts owing by the offering company to officers or shareholders or persons associated with officers or shareholders, specifying in addition to those debts, whether the proceeds of monies to be raised by the proposed issue of shares are to be used in repayment of any of those debts.

This subject matter comprehensively covered in Section 3: Information about the offer (see clause (2)) save that there should be a description of relevant debts even if the proceeds are not to be used in repayment of those debts. It should also be listed for all officers and shareholders and not just those shareholders who meet specific criteria.

3.3 add the words "provided that there is an update of the consolidated statement of financial position to a date within 30 days of the date of the CSF offer document".

Under the existing provision accounts could be presented as part of the CSF offer document which were 11 months old.

4 Regulation 6D.3A.05 app contents of the CSF offer document – Section 3: Information about the offer

4.1 I consider that clause (2) is insufficiently clear and therefore have made the suggestion in 3.2 above.

5 Regulation 6D .3 A .06 Contents of the CSF offer document – Section 4: Information about investor rights

5.1 I make no comment on this section.

6 Regulation 6D.3A.10 Obligation of ESF intermediary relating to their platforms – applicant risk acknowledgement

6.1 Delete from clause (2) “and contains less information than a prospectus.”

These latter words contain the strongly incorrect inference that a prospectus is issued by an issuer company that has more substance than a start-up and therefore carries less risk and the strongly incorrect assumption that an information memorandum produced by the issuer company is necessarily less accurate and somehow inferior to a prospectus. Firstly, when a prospectus is issued there is no quality assessment by ASIC as to the quality of the issuing company or the document or the issue in question; ASIC simply ensures that the prospectus complies with the requirements in the Corporations Act 2001. Secondly, there are companies listed on the ASX which have been unable, because of their inferior quality, to raise capital privately and offers approved by ASIC which should never have been offered to the public. The document registration compliance, that is, the prospectus part of ASIC, is different from the “enforcement” side of ASIC. Prospectuses are issued which the enforcement side of ASIC would consider were inappropriate for consumer investment. A recent example is the Dick Smith prospectus and issue.

From clause (2)(a) delete “is risky” and insert the words “entails substantial risks”.

Internationally there is far greater use of the term “crowdfunding” than there is of the term “crowd funding” and Australia should adopt the same nomenclature. In addition, it is appropriate to use the term “equity crowdfunding” as used in this provision as opposed to the phrase “crowd-sourced funding”. This latter phrase is CAMAC hubris.

7 Regulation 6D.3A.11 Gatekeeper obligation of CSF intermediary – checks

7.1 Clause 1 – delete “starting to publish” and insert the word “publishing”.

7.2 Add a clause (5) as follows:

(5) The CSF intermediary must disclose or ensure there is disclosed in the offer document a description of any information which it is required to check under Regulation 6.3A.11 but which it has been unable to substantiate and verify.

Essentially the Government is outsourcing an ASIC approval process to the intermediary. It is inappropriate for the legislation to make the intermediary’s role far more onerous than ASIC has in respect of a prospectus. There is a subtle balance between protecting the consumer and creating an environment where risk can be assumed and met without significant disruption to the equity crowdfunding industry.

8 Regulation 6D .3 A .13 Obligation of CSF intermediary relating to their platforms – general CSF risk warning

8.1 In the statement in clause (2) delete "very" from the second line of the first paragraph, in the second paragraph delete the word "must" and insert the word "should" and delete paragraph 5.

The reasons for this change are set out in paragraphs 2.1, 2.2 and 2.3 above.

9 Omission from the Regulation

9.1 It is appropriate for Treasury to conduct a detailed examination of the AFSL process and the extent to which the AFSL requirements should have been altered or reduced for the intermediary company. This appears not to have been done.

Andrew Macpherson - **Macpherson Greenleaf -** 22 January 2016

22 January 2016

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Submissions on the exposure draft

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