ABSTRACT

Whilst a step in the right direction the bill is creating an unnecessary complexity and

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Senate Economics Legislation Committee
Inquiry into Corporations Amendment (Crowd-sourced Funding) Bill 2015 [Provisions]

Contents

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About this submission

We thank the Committee for the opportunity to make this submission to highlight the economic importance of having a strong and practical CSEF structure to resolve a major market failure in the area of small business funding.

We also thank the Committee for the opportunity to bring to the attention of Senators examples of the significant challenges that small businesses are facing in trying to access funding and how this impacting on economic growth and employment. This will highlight why the critical need for CSEF.

Our submission raises that CSEF is a digital disruptor to the fund raising market that can increase competition, drive down costs, create jobs and deliver greater returns to investors. However a fear based approach that over focuses on possible risks for investors has created a bloated structure that is inflexible, too costly for the businesses it was designed for and at the end of the day does not reduce the risk to investors.

We would like to see greater competition in the capital markets. There is a focus on intermediaries being the backbone of CSEF. However our concern is that this will create a scenario like the banking sector where depositors and borrowers do poorly and the banks as intermediaries have a license to print money due to their market control. We would like to see intermediary roles made thinner and more done to break up advisers, exchanges and other parties so that there is greater competition. We would like to see independence between parties and also to ensure there are no commissions between intermediary parties.

What we would like to see as an outcome of the Senate Inquiry would be to have a peeling back of some of the layers of proposed legislation to make it a far simpler model that will enable businesses looking to raise $250k - $1M to be able to afford to take up CSEF. They should not be disadvantaged in paying significant costs to meet a range of compliance requirements that deliver no benefit to anyone.

The objective of CSEF is to fund growth in the SME sector so as to grow jobs, grow GDP, grow tax revenue and grow exports. We would like to see the bill focus more on that objective than trying to wrap investors up in cotton wool and protect them from every imagined risk.

Yours, sincerely,

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Solutions4Strategy
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Failure to resolve the market failure of SME Funding that is holding back the economy

Whilst Senators will be aware there is a problem of funding to the SME sector, they may not be aware of the scale of the problem. I would like to highlight the following issues to put some context to why CSEF is so critical and why it so important to get it right rather than rush it through.

The following is an extract from the NSW Chamber of Commerce report on SME Access to Funding[1] that highlights the serious issue that is facing the SME sector.

> Failing to provide small business with adequate finance places a handbrake on the nation's innovation and, in turn, its productivity. In 2010-2011, there were approximately 760,000 innovating firms that identified as SMEs - in fact, small firms account for the largest share of innovating businesses by employment. Unfortunately, however, recent NSW Business Chamber research indicates that around 30% of SMEs felt that they had missed an opportunity due to a lack of credit.
>
> Lack of finance not only constrains small business innovation, it can force smaller firms to shed staff or worse, lead to a bankruptcy. Our research has identified that of SMEs rejected for a loan: around 55% felt that the rejection significantly constrained firm growth; around 21% felt that it significantly increased the chances of bankruptcy; and 18% had to lay off staff.

Australia is at the bottom of the list of OECD countries in innovation outcomes, despite the considerable investment and innovative capability of this country. The problem lies in the lack of funding available to commercialise innovation. This has to be urgently resolved.

We have been involved in looking at how to arrest the decline of lending to SME Business and the escalating cost of funding. I have attached a couple of infographs at the end of this document to highlight some of these issues, such as a 93% fall in business investment in relation to housing investment since 1990.

These figures are our best estimates from information we have collected from a number of sources, but we are challenged due to the lack of information collected by the RBA and ABS around SME lending that we could use to confirm the figures. The RBA is just not aware of the depth of the problem as they have not collected the level of information necessary to identify the market failure in SME funding. Whilst we cannot confirm the figures, we believe they are fairly representative of the problem small businesses are facing.

Below is a summary of the challenges that SMEs are facing.

- Banks do not want to deal with SME lending, they see it too small to bother with.
  - SME lending has become largely limited to mortgage backed finance.
  - The banks are reluctant to spend more than 15 minutes assessing a loan.
  - The banks have dumbed down their lending staff with little capability left to asses SME loans.
- Most banks do not want to deal with small businesses. Many of the foreign banks will not talk to them unless they have monthly revenues of several million.
  - There is a lack of competition, where deregulation has been at a cost to the SME Sector rather than benefiting them.
- Estimate $120B of loans are charged at 14% to 20% interest rates whilst the cash rate is at 2%
  - The RBA reduced rates to encourage businesses to borrow to invest in growth. This failed to happen because the banks did not pass on any rate cuts to SMEs over the last seven years.

[1] NSW Chamber of Commerce report "Small Business Access to Finance"

- $50B of SME cash flow is managed on credit cards, around $15B is on the business owner's personal credit card.
- Banks exaggerate risk to justify gouging. Bad debts are at a 20 year low at .5% of the loan book and this is not indicative of the high risk the banks are claiming.
  - The banks tell APRA a whole different story when it comes to allocating capital for risk.
- Mortgage backed business lending is no longer possible as we have a whole generation coming through with little or no equity in a home due to the high cost of housing.
- In 1990 $20 was invested in business to every $1 invested in housing. This is now down to a $1.40 to every dollar invested in housing. A 93% drop in investment in business.
- APRA requires banks to have three times the capital for a business loan than they do for a home loan which hurts SME lending.
  - The theory is that home loans are less risky, yet the GFC was caused by mortgage lending. In Australia with around 40% of homes being interest only, mortgage lending is a systemic risk, not SME Loans
  - Why are regulators creating such a problem for business finance? Why is there no ability to challenge APRAs logic that is hurting the economy?

As the Senators would appreciate, the market failure around small business lending is a major cause of continued flat economic growth and high unemployment. The gouging by the banks is so large that the amount of cash that they rip off from the SME sector could increase employment by 1.5%. If there is one positive thing that could come out of this inquiry and that would be greater public awareness of the level of gouging of small businesses by banks that is hurting our economy and costing jobs.

Even with CSEF available, there is still a need of an effective lending facility for SMEs to get to the stage of a CSEF fund raising. We would see that it is important that Government be more proactive in this matter instead of hiding behind a free market mantra. Either the Government sets up an SME Bank to resolve the market failure or else put more obligations on the banks to do more. We regard that any bank that has the privilege of a banking license has an obligation to service the SME sector and also should have the proper resources and facilities to provide unsecured loans to the SME Sector. We can no longer ignore this issue as it is a critical issue for the economy.

Equity as an alternative to lending is also failing

Instead of borrowing, companies have looked to equity fund raising. However they are faced with similar market failures in the small scale capital markets. In exploring to raise equity I was quoted that it would cost me $250K to raise a million dollars A quarter of what I raised would go to intermediaries and that is just not a sustainable model.

There is a lack of competition and a small group holds control over access to capital. I would like to quote a story of a young woman who after building her business to a million dollars revenue a year, decided to grow the business to another level. This is exactly what Australia wants to see entrepreneurs growing business and increasing employment. She went to a venture capitalists to raise the capital required. She turned down the offer as they demanded too much control and return for what was being invested. However the VC just turned around to her and laughed, saying that she will be back when she is close to bankruptcy. This is indicative of a market that lacks competition and where intermediaries can get away with what would not be acceptable in any other industries because they have too strong a control of the market.

70% of the workforce is employed by SMEs. (40% employees, 30% owners and partners in partnerships). The majority of innovations come from SMEs. Hence the quickest way to turn around the economy is to get small business growing and the quickest way to achieve this is to resolve the market failures around funding.

CSEF Focuses on Start-ups and Forgets other types of Businesses

The driver around the innovation statement and CSEF is to fund the start-up sector. Whilst there is a definite need for this, I would like to bring to the attention of senators a more important sector and that is the Mid-up sector.

I have coined this term to describe a sector that is forgotten by the economy and yet is a critical player to turning around the economy. Mid-ups are the next step up from start-ups. They have matured, developed products and have customers. However they are stuck in limbo, they cannot get funds to grow. They have consumed their funds to get their innovations to this point, but the banks are not interested in them, they are too small for venture capitalist and too mature for angel investors.

Start-ups will take several years to get going and have a high risk of failing. Mid-ups are ready to go, they have proven themselves, they can begin employing, exporting and growing as soon as they get funding. They will deliver an immediate return for investors. The Government needs to pay closer attention to this group of businesses as a way of accelerating economic growth immediately.

The problem with the proposed structure for CSEF is that it is developed with start-ups in mind, those unencumbered with a hodge podge of private investors and loans built up over the years. Taking this baggage and trying to convert it into a public unlisted company will be a nightmare that discourages this group of businesses from taking up CSEF. Yet this is where CSEF could achieve the greatest impact for the economy. It is also a group of businesses that are low risk for investors.

My recommendation for CSEF is to treat it as an instrument not a corporate structure. Then the instrument could be used in a variety of corporate structures including private companies, partnerships, co-operatives and mutuals. This could be a preference share in a private company or a cooperative capital unit in a non-for-profit co-operative.

Focus on perceived risk instead of economic benefit

In my discussions with Treasury, forefront in their thinking is how to avoid future newspaper headlines “Pensioners lose their retirement savings in …..”. Whilst we need to protect investors as much as we can when we can, it should not be to the detriment of achieving the objectives of the bill.

The risk adverse culture in Government is hijacking economic outcomes. Instead of looking at how to structure CSEF to ensure economic growth and jobs, the focus was to avoid the smallest likelihood of risk. In doing so regulation has created unnecessary red tape that pushes CSEF out of the reach of small businesses that it is intended for.

Ironically, the restrictions that have been added does little to protect investors. Hence we have a situation of imposed costs that does not protect investors and takes the process beyond the reach of many small businesses. There needs to be a better compromise in this bill to make it viable.

I would ask the Senators to raise the question, how much of the requirements for structures, disclosures and reporting really adds value. If you look at the Dick Smith Electronics scenario, all the disclosure statements and reporting that was supposed to protect shareholders were worthless.

Public Companies do not minimise risk

There is a belief that a public company structure has a number of processes in place to minimise risk exposure to investors. However the recent collapse of Dick Smith Electronics highlights the flaws in the system.

Within the first two weeks of January mom and dad investors in Public companies lost $100B of their savings directly or indirectly. Yet investors in private companies, co-operatives, partnerships and mutuals did not lose money like public shareholders. So why is there a fixation on the Public company structure as being the ideal model and why is CSEF restricted to this model?

CSEF is a disruptor that is breaking the mould of how capital raising is being done. We need to stop applying what may have worked for other forms of capital raising in the past and rethink what will work for this new structure.

Sophisticated Investor Rules are creating concentration risk for mom and dad investors

One of the challenges around CSEF is to allow unsophisticated investors the ability to invest in small businesses. Whilst the unsophisticated investor rules made sense over 50 years ago, today we have a more educated market who have to take more responsibilities for their own finances.

Why is Government interfering in how people invest their money? Not only is it a question of do mom and dad investors want that protection, it is also a problem that the rules are creating risk for mom and dad investors. Unsophisticated Investor rules means that mom and dad investors are exposed to concentration risk. They are basically limited to cash, Public Listed shares and housing, which is largely responsible for overheating these investment categories. It also leaves unsophisticated investors with a scenario of having all their eggs in a few baskets.

There needs to be a rethink of relaxing these rules to avoid mom and dad investors from losing their retirement income due to concentration risk. Wealthy investors are not restricted, so why should everyone else be restricted.

Federation of Risk is more important than restricting investments

CSEF is designed to have many small investments in many small companies. The key is that if a business does fail, the investor has only a small exposure to that failure. The newspaper headline disasters that Treasury was concerned to avoid, revolved around scenarios where investors had all their eggs in one basket. Crowd Sourced Funding does not allow this and is the key protection for investors. The other requirements around disclosure are less effective in protecting investors, but adds considerable cost.

This drive to protect investors from themselves has become so excessive, that the USA introduced the JOBS act to try and start removing the red tape restricting small business growth. The USA saw that it was critical to take the pressure off small business in order to grow jobs and the economy.

We would see that it is important that CSEF focuses on keeping investments to small parcels spread across multiple companies and keeps other disclosure and reporting requirements to the bare minimum.

Reporting requirements need to change

Many of the rules around disclosure and transparency is around ensuring the investor is well informed when investing large sums. The reality is that the majority of investors never read this information, anyway. The New Integrated Reporting Standards are being adopted as the traditional reporting and disclosure processes were shown to be lacking when the GFC hit. It is time to challenge the status quo and ask whether these requirements are really necessary or effective.

Whilst there needs to be some observance to ensure there are no scams, the key should be to reduce the reporting burden and shareholder obligations to the bare minimum on the basis that the size of investment is small. This will keep the compliance cost down for small businesses.

Summary

The bill is trying to work around unnecessary processes built in to protect investors from risk that is not really working in the first place. CSEF changes the direction from informing the investor to spreading risk where no investor is highly exposed to a scheme. CSEF should not be about adding a minimal approach to disclosure and reporting the public companies have, it should be about rethinking what will work. For instance digital information flow, strategy and strong corporate structures are more beneficial than a bulky prospectus.

Trying to manage restrictions that are already circumvented

Treasury in devising this bill has had to find ways to work around the private company limits of 20 shareholders a year and having to becoming a public company when exceeding 50 shareholders. The large numbers of small shareholders from a CSEF fund raising would obviously break these rules for a small business.

However this legislation has been circumvented for years. Companies are setting up trusts that are shareholders and then invite individual to become members of the trust instead of shareholders of the small business. By this method small businesses can have hundreds of shareholders without impacting the rules.

We have legislation going back 50 plus years that is no longer relevant nor effective. But instead of challenging the status quo and asking why the restrictions are still in place, we build legislation on top of legislation to get around rules that probably should not be there in the first place.

What is the logic behind these limits and if they are being circumvented, why not just remove them. Are they serving any purpose?

We are talking about being an innovative and creative nation, yet the first step is to start being innovative in the legislation we have and challenging it when it is no longer effective or meaningful.

CSEF is a digital disruptor to capital raising

Crowd sourced funding is a digital disruptor to the fund raising market that can create competition in a market that has lacked competition. One of the benefits has been to bypass the intermediaries who often have profited from their market control. PWC raised in a Crowd Funding seminar how investors and business owners wanted to bypass intermediaries and talk directly to each other. PWC identified that Crowd Sourced Funding was raising capital within a month or two, where in the past it was taking 12 months.

CSEF has an opportunity to disrupt the market and bring much needed change and competition

CSEF needs a new approach in how it is legislated, not something contrived from legacy legislation for legacy capital raising

As the Senators will have observed over the past couple years, Uber as a digital disruptor to the Taxi Industry is causing serious regulatory challenges as Governments try to apply legacy taxi rules to a totally different model. It is not that controls in the legacy taxi legislation are no longer valid, but it is more that they cannot be applied in the way they were applied in the past.

This is a concern we have with the current CSEF bill in that it is contrived from legacy fund raising legislation without taking into account its digital structures. For instance, in the past capital raising was done in Australia, the laws of Australia applied. With CSEF an investor could invest from Singapore across the internet, so how is the legislation applied. Foreign investment controls have failed to catch foreign investors breaking rules around existing housing, so how will it manage foreign investment in CSEF.

Digital Disruptors are about bypassing intermediaries

One of the great opportunities of CSEF is to bypass the intermediaries who have had so much control in the past. This is important in driving competition, driving down costs and accelerating how quickly funds are raised.

Whilst intermediaries do play a role, we believe that their involvement should be as thin as possible. We feel that CSEF has cemented the intermediaries' role as a dominant player rather than driving competition in the intermediaries sector. This undermines the benefits that CSEF can have in disrupting the market.

We believe that intermediaries' roles should be restricted to ensure competition. There should be independent roles of providing advice, publicising, exchanges and other parties. No intermediary should play more than one role and no commissions should be passed between parties.

The bill needs to put significant pressure on driving competition on parties involved in capital raising to make the sector more efficient, cost effective and more ethical.

Summary

There is a view that a business owner need to operate at a high level of compliance, governance and competence. In a perfect world, we would agree with this sentiment. However small business owners are human beings operating within a 24 hour day. They are one or two individuals who create something from scratch, market it, sell it, implement it, do the accounts and so on. In large companies this is done by multiple people. In small businesses it is all done by the owners.

Senate Economics Legislation Committee
Inquiry into Corporations Amendment (Crowd-sourced Funding) Bill 2015 [Provisions]

We are setting up a structure for people to fail. We set the bars too high, ask too much from individuals and create so many unnecessary costs that we are burning out too many businesses before they have the ability to grow. Not because they were bad ideas, but because we drown them in compliance.

Having some involvement in microfinance, I have seen villagers build a bakery from $300 where in Australia that would require closer to a $100K. Why is it so expensive to set up businesses in Australia?

The economy has seen sustained flat growth at a GDP level. Sure housing prices and the share markets have had some big highs, but now we are seeing the big lows. The reality is that we have to remove the burden from small business that is killing them and allow them to grow so that they can drive economic growth and create jobs.

Many that I talk to, say we have to have all these rules to prevent the schemers from scamming investors. However I point out two problems with this thinking

1. Why do we punish the 99% of honourable businesses for the actions of the 1% of rogues
2. All the rules in place at the moment have done little to stop the rogues from scamming investors anyway.

It is time to challenge the status quo and ask whether all the rules, restrictions and obligations created over the last century, still apply, are still effective and whether the negatives have exceeded the positives. CSEF is an opportunity to break through these barriers as a digital disruptor and allow Government to reinvent and revitalise the way businesses can fund growth without the excessive compliance burden.

The current bill will only benefit businesses looking to raise a million dollars of capital. The urgency for CSEF is not this market, but those trying to raise $200K to $800K. Whilst treasury is looking at how to adapt CSEF to fit those looking to raise small funds at some time in the future, the reality is the economy needs the bill to deal with this sector now.

I would ask that Senators push to have greater involvement of small businesses owners in the development of legislation such as CSEF right at the beginning. Despite the talent and expertise within Treasury, they just don't have the experience and knowledge of those that operate at the coal face. Those who have not experienced an environment of not being able to sleep at night worrying about how to pay salaries next month and operating on the smell of an oily rag cannot hope to understand the challenges faced by small business owners. By the time the consultation process occurred, too many decisions has already been made to be able to influence it.

Whilst CSEF is a step in the right direction, the current structure will not resolve the market failure that small businesses required to kick start growth and grow jobs. More has to be done to remove the compliance burden. I would also recommend shifting the thinking that this is a traditional share and think of it as a new form of digital share that would operate differently.

Finally I would urge the Senators to consider this as a digital disruptor that will shake up the capital markets and increase competition. I would ask the senators to minimise the role intermediaries have in the process to ensure greater competition occurs. The current bill creates a potential of building players who will gain a market control at the cost of competition.

Appendix

Invest in Working Capital, Invest in Innovation, Invest in Small Business

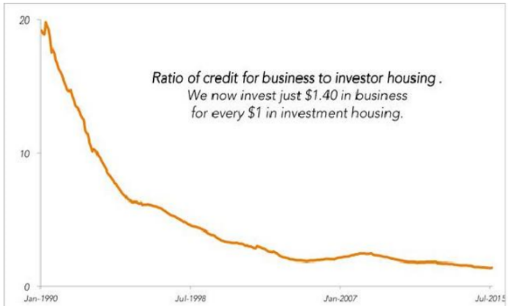
Invest in Working Capital not speculative asset swapping which is non-working capital

4% Share Purchases new working capital
(half of that went to banks to fund house loans)

6% property purchases new dwellings

Over 90% of investments go towards asset swapping at ever inflating prices

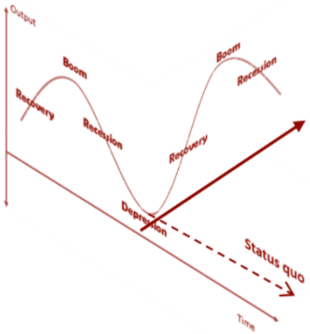
Investment in new business collapsing with housing boom



Funds under management
- 48% in housing
- 9% goes to SMEs

"Working Capital creates jobs, grows GDP – Speculative investment does not"

GFC is an Economic Pivot Point
New Growth is from New Innovative Businesses



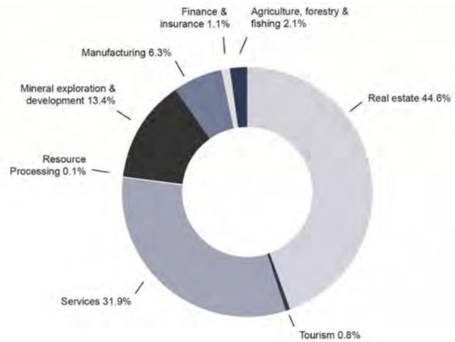
Policy Supports "old economy"

Policy Fails "new economy"

Lack of support for innovative SMES
(these are not start ups!!!)

Need "new economy" thinkers involved with policy making

Foreign Investment not in innovation, smart manufacturing & new economy businesses



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Senate Economics Legislation Committee
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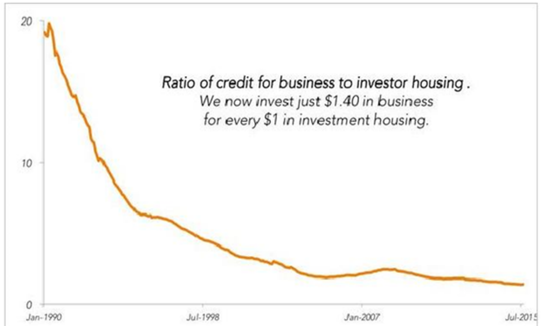

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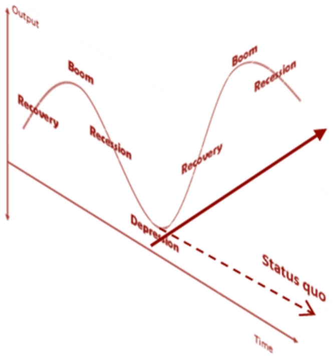

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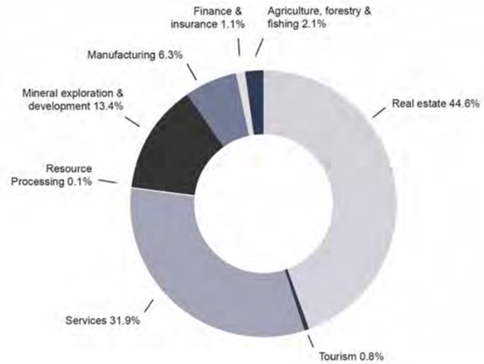

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