Australian Private Equity & Venture Capital Association Limited

31 March 2015

Mr David Crawford
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Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

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Dear David,

Financial System Inquiry Final Report

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to respond to the Financial System Inquiry's final report ("the Report"), released on 7 December 2014.

AVCAL is the national association that represents the Private Equity (PE) and Venture Capital (VC) industry in Australia, which manages over $25 billion in funds on behalf of domestic and offshore investors. These funds supply capital for early stage companies, later stage expansion capital, and capital for management buyouts of established companies.

The release of the Report heralded an important starting point in the mapping out of a blueprint for reform of the financial system over the next decade.

The final Report of the Financial System Inquiry involved two general themes which were of most direct relevance to AVCAL and its members: funding Australia's economy and boosting competition. The PE and VC industry represents an important component of both these themes. It not only provides Australian businesses with access to private capital. It also seeks to build better businesses by enhancing their productivity, to make them more successful, sustainable and internationally competitive.

Our specific comments, and associated recommendations, are set out in the attached submission.

We look forward to continuing to actively participate in the Government's work in relation to the Financial System Inquiry, and assisting in any way we can as part of the next steps of the implementation process.

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,

Yasser El-Ansary
Chief Executive

AVCAL SUBMISSION TO TREASURY ON THE FINANCIAL SYSTEM INQUIRY FINAL REPORT

FUNDING AUSTRALIA'S ECONOMY

One of the most significant challenges facing Australia today is how its financial system will support the next wave of economic growth through the expansion of the pool of capital available to invest in local businesses.

Australia needs to transition from a resources-driven economy to an innovation-driven one. There is a structural shift taking place across all traditional sectors of industry such as manufacturing, healthcare and retail as a result of technological advances and global competition.

The domestic economy is currently still relatively reliant on a few industries such as the mining sector which has represented disproportionally large share of GDP growth in recent years.[1] We need to diversify our sources of wealth and tax revenue by creating the right policy settings to allow new companies, new ideas and new entrepreneurs to thrive in Australia. We also urgently need to look at ways of increasing productivity where possible in businesses that are being challenged with declining value-add and consequently declining employment opportunities, while investing more in areas that generate both jobs and long-term growth (Figure 1).

However, financing the necessary new investment in innovation and productivity is not an activity that the traditional financial services industry is typically well equipped for. Figure 2 illustrates the distribution of companies by sector funded from the public equity markets, compared to those funded by PE. For example, ASX listings are dominated by Financials (comprising 45% of ASX market capitalisation) and Materials & Mining (16%), while PE tends to be a proportionately higher investor in the high-employing Healthcare (14% of the market value of Australian PE portfolios) and Consumer Goods & Services (19%) sectors. In fact, a number of stock exchange listings in these relatively under-represented sectors were successfully listed only after receiving VC or PE backing in their early stages.

Entrepreneurs and startups, and even small and medium-sized businesses, need equity partners to take them to the next level of development. However, such investments are inherently risky and require specialist expertise and careful due diligence, not to mention close governance and other forms of assistance such as advice and network connections as the businesses grow. Many are not able to access debt funding in any significant way, and few would be ready to list on the stock exchange as a means of raising capital.

It is therefore imperative that the Government’s response to the Financial System Inquiry identifies the key elements necessary for the financial system to meet the challenges in funding Australia’s economy going forward.

The VC industry plays an important role in channelling private capital to back innovative, high-growth Australian businesses that have the potential to become future market leaders in new fields. For example:

- Companies that have received VC backing in their early stages have total assets amounting to just 0.3% of GDP, but account for 10% of all business R&D expenditure in Australia.[2]
- There are only 500 companies in Australia that have received VC backing before, compared to 24,000 in the US. However, two of the 20 US FDA-approved drugs identified as "first-in-class" in 2012 came from Australian VC portfolios.
- Of the top 50 healthcare and biotech stocks on the ASX, one-third are VC-backed.
- Success stories include SEEK, which, 14 years after AMWIN Innovation Fund's original investment, which now has a market capitalisation of nearly $6b and is the largest online jobs-listing business in the world.[3]

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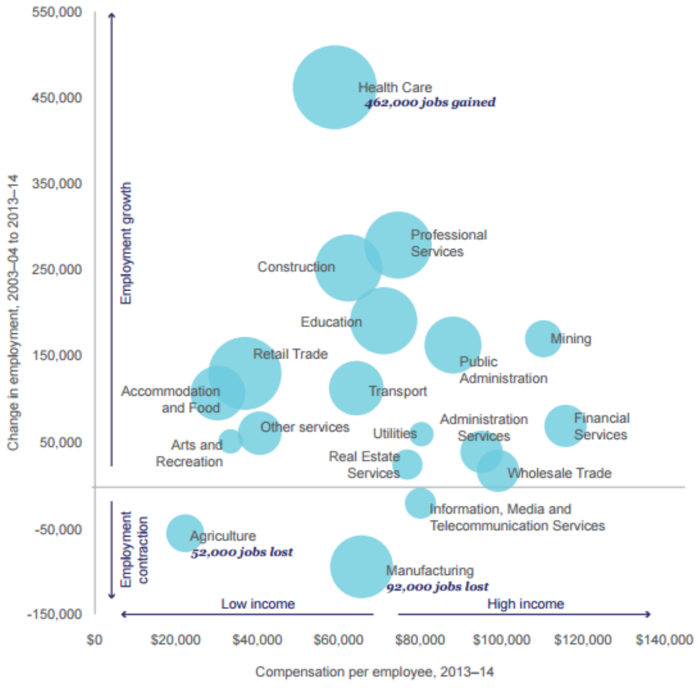
[1] Office of the Chief Economist, Department of Industry, *Australian Industry Report 2014*.
[2] Cumming & Johan (2012), *Venture's Economic Impact in Australia*.
[3] As of 27 March 2015.

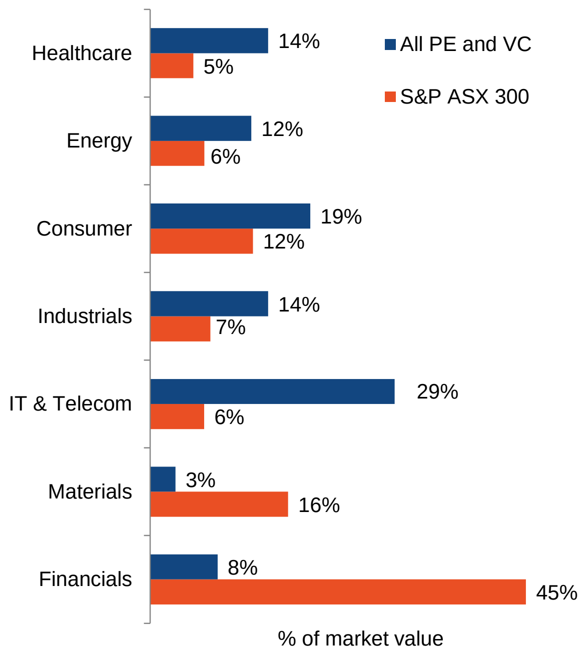
Figure 1: Change in employment (FY04 to FY14), employment and compensation per employee (FY14) by industry



Source: Office of the Chief Economist, Department of Industry, Australian Industry Report 2014.

Note: Industry names have been abbreviated, Utilities includes Electricity, Gas, Water & Waste Services.

Figure 2: Sectoral distribution of PE & VC investee companies in Australia vs ASX300 companies, by market value



Source: Cambridge Associates, as of 30 Sep 2014

The need for more efficient allocation of productive capital is not confined to early stage companies, but also extends to more established small to medium sized Australian businesses that are simply looking to grow further. PE plays a vital role in funding this growth. Deloitte Access Economics research shows that:[4]

- Businesses backed by PE investment have, on average, revenue growth of 11% p.a. and workforce growth of 28% p.a. in the first five years after the initial investment.
- The average PE-backed business in Australia has annual turnover of $195 million; pays $42 million in wages to 827 full-time equivalent employees; and contributes $77 million in direct value added to the nation's economy.
- In addition, PE-backed firms generate more revenue (an estimated $64 billion p.a.) than either the coal mining or the general insurance industries in Australia.
- Capital investments by PE funds help to support a total of more than 500,000 jobs and contribute over 4% to Australia's national economic output every year. This means that PE-backed businesses, on a collective basis, employ a larger workforce than either the automotive or banking industries.

[4] Deloitte Access Economics, *The Economic Contribution of Private Equity in Australia*, 2013.

The evidence, both from Australia and from around the world, unequivocally supports the fact that VC and PE investment plays a vital and important role within a robust financial system. This plays out not just through the intermediation of savings to productive investments, but also through the transformative effects of their investment model on businesses to create market leaders of the future.

However, the role of the industry as a conduit between private capital and investment-hungry businesses faces significant challenges. In particular, there is an increasingly urgent need to find a more efficient way to unlock access to capital to support a much greater level of PE and VC investment than is currently the case. AVCAL estimates that at least 30,000 businesses are missing out on PE investment currently, with the industry presently having the capacity to invest in only 1% of this potential pool of businesses. In Australia, PE currently accounts for only 5% of all mergers and acquisition activity and private placements. In the US and UK markets, the proportion is around 14%.

There are a number of roadblocks that will need to be considered and addressed for the industry to be able to effectively play its role in backing businesses to grow and prosper. In particular, the Government needs to:

1. Lift the value of the superannuation system and retirement incomes
2. Address tax distortions affecting financing to startups and SMEs, including:
    - Simplifying the tax rules for Venture Capital Limited Partnerships, and streamlining Government administration of the regime, to reduce barriers to fundraising; and
    - More flexible access to R&D tax offsets to help reduce firms' cash flow constraints, particularly for new ventures.
3. Introduce a regulatory framework to facilitate crowd-sourced equity funding
4. Improve collaboration between business, academia, consumers and government to improve innovation

AVCAL's response and recommendations to each of these issues are set out in further detail in the following sections.

SECTION 1 Lift the value of the superannuation system and retirement incomes

As the 2015 Intergenerational Report has shown, Australia has an ageing population which will be placing increasing pressure on the age pension. This will also create business succession planning challenges as business founders retire and finding suitable successors to take over becomes increasingly challenging.

An efficient superannuation system is critical to help Australia meet the economic challenges of an ageing population. The Inquiry states that, "while its importance for retirees and, to a lesser extent, taxpayers is self-evident, superannuation efficiency is also vital to sustaining long-term economic growth, given the system's increasing importance in funding Australia's prosperity. Australia's superannuation system has considerable strengths. However, the system lacks efficiency in a number of areas. The lack of clarity around the ultimate objective of superannuation policy contributes to ad hoc short-term policy making, which imposes unnecessary costs on superannuation funds and members, reduces long-term confidence in the system and impedes efficiency. The Inquiry believes the purpose of the superannuation system is to provide an individual with an income in retirement".

If the objective of superannuation is to provide retirement income to substitute or supplement the Age Pension, it is imperative that superannuation regulations do not present disincentives towards achieving that outcome.

In the context of the superannuation industry, an unintended consequence of policy and regulatory changes in recent years is increased (and problematic) focus on highly liquid, low-cost investment products in default super funds. Since the introduction of MySuper and increased focus on low-cost superannuation portfolios, there has been a shift by many superannuation funds to low-cost liquid asset classes, such as listed equities and fixed interest, to reduce their headline fees. However, whether this is the right direction towards achieving the long-term objective of easing reliance on the age pension is in question. Illiquid assets such as PE, property and infrastructure are not considered “low-fee” but have typically consistently delivered superior net returns to low-fee asset classes over the long-term.

The Inquiry also notes that, “In some cases, higher costs and fees may be in the interests of members. For example, alternative asset classes, such as infrastructure and other unlisted investments, tend to be more expensive to manage, but they may also diversify risks and offer higher after-fee returns for members. Submissions support this point”.

In fact, Rice Warner modelling shows that an allocation to PE and VC can enhance (within a diversified portfolio) the risk-adjusted long term retirement outcomes of superannuation members. Regular superannuation performance benchmarking analyses by Chant West have also consistently found that the best long-term performing super funds tend to have been helped by the returns-boosting effect of their PE investments.[5]

The long experience of US pension funds in this asset class provides a strong body of evidence on the consistency of long-term PE returns over multiple economic cycles. Of the US public pension funds that do invest in PE and VC, disclosures under the Freedom of Information Act show that their 10-year returns from this asset class have averaged 14% per annum compared to just 8% for the S&P500 Index.[6] Australian PE funds provide similarly competitive returns vis-à-vis the listed markets; however, due to the declining participation of superannuation funds in these funds, these gains are increasingly being realised by overseas pension funds and sovereign wealth funds rather than Australian retirees.[7]

In light of this evidence, it is incongruous that there has been a significant decline in the supply of Australian superannuation monies flowing to Australian PE and VC funds backing unlisted businesses and startups (Table 1).

Table 1: Superannuation funds held in Australian equities vs Australian PE and VC (FY05-14)

Financial Year	Total super fund assets under management (AUDm)	Total super funds held in Australian equities (AUDm)	% held in Australian equities	Total super funds committed to Australian PE and VC (AUDm)	% committed to Australian PE and VC
2004-05	709,035	287,828	41%	4,996	0.70%
2005-06	860,123	359,032	42%	6,337	0.74%
2006-07	1,129,632	485,159	43%	8,520	0.75%
2007-08	1,099,334	461,729	42%	9,700	0.88%
2008-09	1,025,498	410,636	40%	9,861	0.96%
2009-10	1,149,816	475,122	41%	10,429	0.91%
2010-11	1,285,998	552,989	43%	9,352	0.73%
2011-12	1,335,873	532,495	40%	9,452	0.71%
2012-13	1,546,115	625,615	40%	9,502	0.61%
2013-14	1,762,260	723,339	41%	8,492	0.48%

Sources: ABS 5655.0, 5678.0.

[5] See, for example, Chant West media releases “Super delivers the goods again in 2014” (20 Jan 2015), “Super funds hit double digits again in 2013/14”, (22 Jul 2014), “Super chalks up best returns in 16 years” (22 Jul 2013).
[6] Private Equity Growth Capital Council, Q3 2014 Performance Update.
[7] See, for example, AVCAL/Cambridge Associates Q3 2014 Performance Benchmarks.

The amount of capital invested by superannuation funds into Australian PE and VC funds equate to an estimated 1% of the total superannuation savings pool of $1.8 trillion.

The majority almost 70%) of MySuper funds do not invest in PE or VC, even though most have sufficient scale to do so. Of the funds that do invest in PE and VC, the weighted average allocation is 2% of total assets under management.[8] This is very small, with other markets such as the US reporting average allocations to the asset class at around 9%-10%.

AVCAL believes that Australia needs to address existing roadblocks which impede the effective deployment of superannuation capital into Australian businesses across the economy.

While fee competition is to be welcomed, AVCAL is of the view that a policy focus on reducing super fees at all costs detracts from the main objective of an effective superannuation framework. If not addressed, this could potentially lead Australia's superannuation policy in the wrong long-term direction to the detriment of future retirement outcomes.

Statistical reporting by regulators, product disclosures and member statements should be carefully considered so that to the extent possible they encourage members to focus on long-term outcomes.

A substantial amount of regulatory reform has gone into promoting the disclosure of fees and costs, and portfolio holdings. It is widely expected that the impending public reporting of fund-by-fund fee metrics, required of APRA under Stronger Super reforms, together with existing superannuation league tables widely used within the industry, will promote an environment where members increasingly use this data to inform their long-term superannuation choices.

In AVCAL's view, the metric which matters most is the member's account balance at retirement: the account balance made up of net contribution flows and net investment earnings. To this end, AVCAL recommends that the disclosure framework for MySuper should encourage members to focus on their net retirement income, rather than fees.

Product dashboards already require super funds to report long term returns (net of fees and costs). AVCAL believes that focusing members' attention on net returns is more meaningful than focusing on reducing headline fee metrics, which are reported in a manner which draws no link to the net returns figures.

Disclosures that inadvertently encourage members to make choices based on fees without due regard to net returns would be counterproductive. Reported fee metrics consolidate many different types of fees which may have different effects on member balances. For example, a high asset-based fee on a passive buy-and-hold investment would be a net drain on the member's balance over time, particularly if more cost-effective alternatives are available. But a high fee with a performance incentive on an actively managed, specialised investment class such as infrastructure or private equity that are aimed at delivering superior returns could – and often do – significantly augment the member's net balance on retirement.

Therefore, AVCAL believes that a more meaningful metric to focus on – consistent with the fundamental objectives of superannuation – would be to report regularly to the member his or her projected account balance at retirement, and projected retirement income stream.

Current required disclosures of fees and costs should be reviewed in consultation with the broader investment community. A diversified portfolio will have a diverse range of fee structures across different asset classes. Reducing a large number of complex fee structures into the single headline fee metric reported on product dashboards means that interpretation of that metric should be treated cautiously.

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[8] Rice Warner analysis.

AVCAL supports:

- Recommendation 9 for the Government to set a clear objective for the superannuation system to provide income in retirement to substitute or supplement the Age Pension, and to introduce a framework to facilitate the more efficient allocation of retirement savings to provide for higher and more enduring income in retirement. We also support the proposal for the introduction of a legislative mechanism to examine whether policy proposals are consistent with the objectives of the superannuation system.
- Recommendation 23 on removing regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.

AVCAL recommends that the disclosure settings for superannuation funds should be designed to encourage members to focus on their net retirement income, rather than fees (which may or may not have a material effect on their balances at retirement).

SECTION 2 Address tax distortions affecting financing to startups and SMEs

There are a range of tax measures that will need to be considered as part of the Government's Tax White Paper process, if not sooner, to address current roadblocks to effective fundraising by domestic PE and VC funds. The Report identifies and refers a number of existing tax distortions that prevent the efficient allocation of funds by the financial system to the Tax White Paper for further consideration. The Inquiry specifically identifies two tax issues for startups and innovative firms that, if better targeted, would facilitate innovation:

- Simplifying the tax rules for Venture Capital Limited Partnerships (VCLPs), and streamlining Government administration of the regime, to reduce barriers to fundraising; and
- More flexible access to R&D tax offsets to help reduce firms' cash flow constraints, particularly for new ventures.

2.1 Simplify the tax rules for VCLPs, and streamline Government administration of the regime, to reduce barriers to fundraising

A key reform which will produce a significant and immediate positive impact on the industry is the introduction of a minor legislative change to provide tax certainty to domestic investors in PE and VC funds using VCLPs.

The VCLP regime was introduced to enable venture funds to be structured as limited partnerships that can facilitate the pooling of capital into equity investments in risky startup and expanding Australian companies.

However, there is currently a critical area of tax uncertainty with respect of the VCLP regime which forces Australian PE and VC fund managers to offer investors a costly number of multi-entity funds whenever they conduct a new fundraising.

This area of tax uncertainty relates to whether investment gains to all domestic investors into a VCLP are consistently regarded as "capital gains" rather than revenue gains. This uncertainty became a particular concern following the Australian Taxation Office's (ATO's) views in Taxation Ruling TR 2010/21 stating that the type of investments commonly made through a VCLP may be taxed on revenue account for some investors.

This is particularly problematic as it has created an uneven playing field between different classes of investors in VCLPs. VCLPs continue to provide favourable and consistent tax treatment in relation to foreign investors (as they benefit from a full tax exemption for any investment gains) and complying superannuation funds (which benefit from statutory capital account treatment).

However, other domestic investors do not have similar certainty of tax treatment and therefore would typically only invest if the fund manager creates a new Australian Managed Investment Trust (MIT) structure, where they are able to make a capital account election to remove any potential uncertainty.

The result is that either this capital is foregone and invested elsewhere, or the fund manager has to engage advisors at considerable cost to establish multiple structures to accommodate a wide pool of investors.

Hence, Australian PE/VC fund managers typically have to establish domestic multi-entity funds when undertaking a local PE/VC fundraising. This allows investors the choice of committing their capital to either an Australian VCLP or one of a number of MITs, to allow for consistent tax treatment for all investors whereby the underlying investment is held on capital account.

The requirement for Australian domestic PE/VC fund managers to offer multi-entity fund platforms and to provide investors with a choice of vehicle, results in a duplication of fund establishment, administration and tax compliance costs. Based on conservative estimates, the additional setup costs associated with structuring around the current deficiencies is approximately $150,000 to $200,000 for each PE or VC fund which is established, and $80,000 or more on an ongoing and annual basis.

If these cost savings are extrapolated over the 50 or so Australian PE and VC fund managers that are currently actively investing and fundraising in Australia, the potential for red tape and cost reductions across the industry (and the approximately 500 businesses they back) is substantial. In addition, there are potential cost savings to Treasury, regulators and the ATO who are responsible for reviewing multiple regulatory filings and monitoring compliance.

The Financial System Inquiry Committee has clearly identified the current ambiguity and complexity in using VCLPs as a tax issue that distorts the efficient allocation of funding and risk in the economy. It has noted that simplifying the tax rules for VCLPs would reduce barriers to fundraising.

A number of other key stakeholders, including Innovation Australia which (together with the ATO) administers the VCLP regime on behalf of the Government, have also consistently expressed the view that the uncertainty associated with the capital/revenue distinction for domestic investors into VCLPs has greatly reduced the effectiveness of the VCLP regime.

In addition, the tax policy and integrity considerations associated with this proposed amendment have previously been reviewed at length by the Board of Taxation and Treasury. The Board of Taxation in its *Review of Taxation Arrangements under the Venture Capital Limited Partnership Regime* in June 2011 has also recommended the provision of deemed capital account treatment for all eligible domestic investors in VCLPs. However, the Government took the decision to not proceed with enacting this recommendation in December 2013, as part of a broader list of proposed legislative measures that would not be progressed further at that point.

Given that the economic impact of this long-running tax issue is now well understood, there is clearly a compelling case for the necessary changes to this area of the tax law to be made as quickly as possible. In our view, it should not be necessary to await the final direction of the Government's proposed Tax White Paper (due late 2016, with potential implementation schedules spanning 2017 and 2018), because during the period between now and then Australia stands to risk losing billions of dollars of capital investment into the growth and expansion of domestic businesses as a direct result of this tax uncertainty.

AVCAL recommends that the Government takes urgent steps to address the Inquiry's observations on the significant barrier to fundraising caused by existing tax uncertainty around VCLPs, by introducing the necessary legislative amendment (which various industry submissions have provided drafting examples of over the years) without further delay.

There are also a number of additional changes which can be made to simplify Government administration of the VCLP regime, which will help provide tax certainty and consistency with other areas of tax law, and reduce unnecessary red tape. These are set out below:

- VCLPs and Early Stage Venture Capital Limited Partnerships (ESVCLPs) can only hold a debt interest if it is a "permitted loan" (defined under the Venture Capital Act 2002 (VC Act) as legal form debt). There is no apparent rationale for this inconsistency with the broader definition of debt interests under Division 974. This means that instruments such as Redeemable Preferences Shares or Convertible Redeemable Preference Shares (which are debt interests for tax purposes and a common feature in VC investments) are not allowed under the existing ESVCLP and VCLP regime.

- The current VCLP legislation prevents "bolt-on" investment by the funds in existing portfolio companies or unit trusts (to support an acquisition for growth) from being eligible VC investments, except under very limited circumstances. This means that once a business is acquired by an ESVCLP or VCLP, there is limited scope for the acquired entity to make additional complementary acquisitions of third party targets on arms-length commercial terms. This is presumably an unintended, an unfortunately undesirable, outcome that require costly workarounds, such as forcing the investee company to undertake the acquisition by way of an asset deal which may lead to increased stamp duty costs (due to the transfer of business assets) and potentially makes the transaction structurally inefficient in respect of collapsing old corporate structures. In addition, it should be noted that no such restrictions exist in the MIT regime.

- Domestic PE and VC funds typically make investments using one or more clean-skin Australian special purpose companies to facilitate the acquisition. This is often a requirement imposed by lenders seeking to lend at the second or third tier of an acquisition structure (i.e. such that the shareholdings of the PE/VC fund are structurally subordinated to the bank debt). Subsection 118-425(11) of the ITAA 1997 sets out the framework which prima facie enables the use of a two-tier acquisition structure to acquire the ultimate target which meets the requirements to be an "eligible venture capital investment" (EVCI). However, there is currently uncertainty created by subsection 118-425(16) which appears to disqualify an investment through multiple holding companies as an EVCI at the time the first holding company becomes the head company of a consolidated or consolidatable group. This effectively nullifies subsection 118-425(11) as a multi-tier acquisition structure involving two or more Australian companies will generally always comprise a consolidatable group.

AVCAL recommends that the Government introduces the necessary reforms to:

- Harmonise the definition of "permitted" loans under the Venture Capital Act 2002 (VC Act) with other areas of the tax law;
- Remove current restrictions on VCLPs or Early Stage Venture Capital Limited Partnerships (ESVCLPs) undertaking additional share "bolt-on" acquisitions after the initial acquisition of an investee entity; and
- Remove uncertainty in relation to the use of two-tier acquisition structures.

2.2 More flexible access to R&D tax offsets to help reduce firms' cash flow constraints, particularly for new ventures

The Inquiry noted that for new ventures, access to quarterly R&D tax credits would help alleviate cash flow constraints, and referred this issue to the Tax White Paper process.

Early stage companies involved in developing new technologies often face cash-flow constraints because they require significant cash outlays in the early stages of the product life cycle.

Currently, these companies can access a 45% rebate on expenditure related to eligible research and development (R&D). The R&D tax regime has had a very significant positive impact in supporting domestic businesses investing in innovation.

It is also an important incentive for offshore investors to put money into Australian companies, and in attracting businesses from offshore to re-locate their R&D operations to Australia. This plays an important role in helping businesses to source adequate levels of capital investment in the knowledge that the regime will deliver long-term certainty to businesses that commit large allocations towards R&D activities.

In some cases, however, accessing the support that can be delivered by the existing R&D regime can effectively be delayed by up to 16 months, as businesses are typically required to wait until the point in time that they lodge their income tax return for the financial year, and then wait a further four months to secure the R&D rebate that they may be eligible for.

In addition, companies seeking to commercialise patents can miss out on the opportunity to derive premium earnings and returns on investment during the exclusive earning period for new patents.

The businesses that would gain the most out of this change are small, research-intensive enterprises with annual turnover under $20 million. These businesses typically have limited access to capital, but the R&D tax credit has been one measure that has been widely supported by those small businesses that invest heavily in R&D activities. The fiscal impact on the federal budget would appear to relate mostly to timing differences, and concerns regarding over or underpayment of credits can be addressed in much the same way as for quarterly GST or PAYG income tax payments.

In a global marketplace for capital and R&D investment, it is critically important to position Australia as an innovative 21st century economy and a 'knowledge nation'. Australia must continue to improve its policy settings in the R&D area, to ensure that we can continue to compete with other jurisdictions around the world.

AVCAL supports a move to quarterly R&D tax credits to alleviate the cash-flow constraints that these companies face. We do not believe that there is a significant fiscal cost associated with the introduction of these reforms to the R&D tax credit regime, but there will almost certainly be a very real and positive impact on the working capital of small innovative companies in Australia.

SECTION 3 Crowdfunding

AVCAL notes that the Government has already announced, as part of the Industry Innovation and Competitiveness Agenda (II&CA), plans to provide startups with improved access to capital by introducing a regulatory framework to facilitate the use of crowdsourced equity funding (CSEF) in Australia.

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. Other developed economies have already taken a number of steps to implement policy frameworks which support the use of CSEF. For these reasons, we believe it is vitally important that Australia's regulatory framework for capital raising remains abreast of these developments and developed further to allow the business sector to effectively compete for capital both domestically and from offshore.

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)).[9] In Australia, ASSOB records a slightly higher average fundraise of $300k per company.

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).

In AVCAL's view, having an informed issuer base should be regarded as an important part of ensuring the integrity and success of the CSEF framework. In view of the nascent nature of the retail CSEF environment globally and the fact that many startups and small businesses seeking capital this way may not be aware of all their options and obligations, it is vital for issuers to be properly advised and made aware of their obligations in relation to their CSEF investor base.

For example, the startup needs to be clear on the kind of capital structure and shareholder composition it needs 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. It may not be

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

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.

AVCAL supports Recommendation 18 for reforms to remove obstacles to SME financing, including a regulatory framework to facilitate both equity and debt crowdfunding. The CSEF framework 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.

SECTION 4 Collaboration between business, academia, consumers and government to improve innovation

AVCAL supports the overarching goal of ensuring that regulation keeps up with technological change.

In our view, Recommendation 14's proposal for the formation of a permanent public-private sector "Innovation Collaboration Committee" consisting of senior industry, Government, regulatory, academic and consumer representatives to enable effective policy and regulatory responses to innovation should be carefully thought out to see how it can deliver on its objectives without replicating existing mechanisms.

A high-level panel of senior industry and regulatory representatives is best positioned for driving and advising on innovation policy from a macroeconomic perspective, with a view to strategic longer-term outcomes. Such a committee would be useful in terms of blending the views of business, innovators and policymakers and providing valuable high-level guidance to policymakers.

However, many aspects of productive innovation often demand timely responses from Australian policymakers and regulators: responses that require a level of alacrity, resources and detail that high-level committees are often not well equipped for.

One area that is in need of policy coordination is at the operational level in terms of providing regulatory clarity and assistance to technological innovators and startups in understanding their legal and tax obligations. Startups typically do not have the resources to hire a range of specialist tax, legal and accounting advisors to help them navigate the regulations that they may need to comply with. This is a particular problem for startups that innovate in highly-regulated industries such as financial services, energy and healthcare. There are a range of possible regulatory issues associated with new areas of growth such as fintech, medtech, edtech, sportstech, big data, and other disruptive technologies.

The speed and certainty in relation to obtaining advice directly from the relevant authorities vary, particularly in relation to new technologies and business models. Some Government departments do have clear policies in place to provide guidance on technological innovation in their respective areas of jurisdiction, while many do not. In the latter case, working to an appropriate response often involves a high degree of uncertainty and delay. In addition, most regulatory authorities operate within the existing compliance framework rather than having an innovation development agenda. For many startups, determining their compliance obligations can become a prohibitively costly and lengthy exercise relative to the scale of their product offering.

While a single high-level committee can only draw representatives from a limited number of sectors and businesses, there needs to be a more inclusive and all-of-Government approach to facilitating more pro-innovation regulation.

AVCAL recommends the formation of a dedicated "Innovation Unit" within each major relevant Government department that is mandated not just to foster compliance with the existing rules but also to seek policy solutions to foster industry innovation. This may be a single point of contact or a multidisciplinary team that is tasked with:

- Engaging closely with their customers and industry to identify regulatory issues emerging from new technologies and innovation;
- Identifying areas where the regulatory framework needs to adapt to enable such innovation where it is in the interests of consumers and other key stakeholders; and
- Providing clear, transparent and consistent information on areas of regulatory uncertainty.

This concept is similar to the premise behind the UK Financial Conduct Authority's (FCA) Project Innovate, which provides a central point of contact for fintech businesses operating in the UK seeking regulatory transparency and support.

It calls for a structure that is made up of sufficiently senior operational executives, and which is capable of liaising with other parts of Government as needed (such as the ATO and ASIC), so that it can stay across cross-regulatory issues that have an impact on innovation development. This would help move the current regulatory and policymaking system beyond the current model of agencies operating in silos and allow the Government's customers – those seeking regulatory clarity and information – to be able to access the specific information and advice they need in a timely manner, and also allow them to provide feedback and policy input directly to the agencies involved.

Issues with wider-reaching policy or systemic implications could be referred to a higher-level team or committee (or the high-level Innovation Collaboration Committee), which is then responsible for providing advice and guidance on the policy response to these particular issues.