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5 February 2016

Committee Secretariat
Senate Standing Committees on Economics
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CANBERRA ACT 2600

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Dear Sir/Madam,

Submission on the Corporations Amendment (Crowd-sourced Funding) Bill 2015

Thank you for the opportunity to provide a submission on the Corporations Amendment (Crowd-sourced Funding) Bill 2015 ("the Bill").

We are very supportive of the Government's initiative of introducing a crowd-sourced funding ("CSF") regime in Australia. However, in our view, the proposed rules fall well short of providing a viable regime. The significant restrictions proposed for eligible participants (customers) and eligible securities (products) under the regime will ultimately result in very limited demand for the regime. Accordingly, we believe that it will be difficult for CSF platform operators to create platforms that will (from a business perspective) be economically viable.

We have included a number of suggestions in this submission that we believe would help to address this concern. We do not believe that significant amendments would be required to cater for these recommendations. Further, we believe the integrity of the regime can still be maintained by making these modifications.

We would be happy to discuss the issues raised in this submission with you at any time. Please contact me

Yours sincerely

A M KOKKINOS
Executive Director

About Pitcher Partners

1.1 Pitcher Partners is an accounting firm that specialises in providing advice and services to entities in the middle market. We are one of the largest accounting firms in Australia specialising in this market and have expert knowledge in the regulatory requirements for small business operators.

1.2 As a part of our business, we specialist in assisting firms in establishing crowd source funding ("CSF"), peer-to-peer ("P2P") lending and market place lending ("MPL") platforms. We have worked with numerous legal firms and professionals and have helped in the establishment of a large number of managed investment trusts currently operating both debt and equity CSF platforms (both retail and wholesale) as well as providing assistance in the establishment of crowd funding facilitation platforms under the current ASIC Class Order CO 02/273 ("ASIC CO").

1.3 Our client base have a keen interest in the creation and operation of CSF platforms. Our client base (being entities in the middle market) would also be the main target customer base for these platforms (i.e. that would qualify as eligible CSF companies).

1.4 Accordingly, we believe we are well placed to make a submission as to the proposed legislation dealing with the proposed CSF regime.

1.5 The following sections outline some of our main concerns with the proposed regime as currently drafted in the Bill and the draft regulations released by Treasury titled the Corporations Amendment (Crowd-Sourced Funding) Regulation 2015 ("the Draft Regulations")).

Allowing redeemable preference shares to be offered

1.6 The new CSF regime is proposed to be limited to ordinary shares per the Draft Regulations. We request that this be expanded to include redeemable preference shares.

1.7 Our concern with ordinary share capital is that it is a form of long term finance that is not always very attractive to private groups seeking short term funding and finance at the start-up and expansion phase. There are significant complexities that relate to ordinary share capital that do not attach to other forms of equity.

1.8 For example, returning share capital or performing a buy-back of ordinary shares under the Corporations Act, as compared to repaying debt or redeeming preference shares. Furthermore, to the extent that different rights are attached to different classes of shares, ordinary shares often require shareholder agreements.

1.9 In our view, many small business operators will be reluctant to offer ordinary share capital to unknown investors. We believe that this limitation will inevitably reduce the overall market for the CSF platform operators.

1.10 While we understand the reasons for not including debt securities within the regime (at this stage), we believe that an appropriate compromise would be to allow redeemable preference shares to be an eligible security under the regime. These securities have the protection of being share capital under the Corporations Act. However, for income tax and accounting purposes, these securities are generally considered to be debt capital. Accordingly, offering these securities under the CSF regime will (in our view) provides greater flexibility for a small business looking to obtain finance, while maintaining appropriate protections as required under the Corporations Act.

1.11 By way of example, consider a small business seeking capital for a period of five years to assist in expansion. The small business could offer ordinary share capital, however restrictions may make it difficult to redeem or repay the share capital in the future. Alternatively, the company could issue redeemable preference shares with a cumulative preference dividend coupon (akin to interest). Not only would this form of investment be attractive to investors (as it offers preference distributions and is treated as share capital under the Corporations Act), but it would also be a form of "quasi debt financing" that can be more readily accessed by a small company.

1.12 In our view, this would greatly increase the demand for the new CSF regime, while also offering the same levels of protection as currently contained in the Bill and the Draft Regulations. We therefore believe that the CSF regime be expanded to accommodate redeemable preference shares.

Recommendation 1: We recommend that the Draft Regulations be expanded to allow redeemable preference shares to be considered an eligible security for the purpose of subsection 738G(1).

Ensuring the viability of CSF platforms by expanding the customer base

1.13 We highlight that new CSF platforms will only be created if they can be economically viable (i.e. will at least allow operators to generate a profit and remain in business).

1.14 The Bill and Regulations currently provide a very limited market place for target companies, being newly created public companies that are tagged as eligible CSF companies. This means that a new CSF operator (competing against other new CSF operators) would have a zero customer base to begin with (in terms of target companies once the legislation is introduced). It would also mean that it would take a substantial amount of time before there is a credible target market to ensure that the operators can become profitable.

1.15 In our view, this appears to be a very limiting way of trying to introduce a new regime aimed at supporting new and innovative markets.

1.16 We therefore believe that it is important to consider the ability for private companies to be introduced (in some form) as eligible CSF companies under the CSF regime. Please refer to our Recommendation 5 which highlights items for your consideration. In simple

terms, private companies could be included within the regime, or could be given the opportunity to convert to eligible CSF companies.

1.17 Per the ATO most recent statistics released, there are over 850,000 companies in Australia. Of this, there are more than 780,000 private companies with a turnover of $2 million or less ("Micro Companies"). Furthermore, there are more than 830,000 private companies with a turnover of less than $10 million. Accordingly, opening the regime to private companies would at least provide a good customer base.

Recommendation 2: To ensure that CSF platform are economically viable, it is important to consider expanding the customer base of the proposed regime to existing and future private companies.

Allowing private companies to access finance

1.18 It has long been acknowledged that small business face significant barriers to traditional finance. Accordingly to the Financial System Inquiry Final Report in 2014, "[t]here are structural impediments for small- and medium-sized enterprises to access finance. These impediments include information asymmetries, regulation and taxation."

1.19 Recently, the Banjo Small Business Survey[1] reported 80 per cent of small business entities will likely be approved for an alternative finance loan, compared to approximately one in five from a traditional bank. Indicatively, for every 10 small business entities applying for bank funding, two were successful, one was unsuccessful and seven chose not to apply for various reasons including cost and collateral requirements.

1.20 While access to alternative financing is growing, it currently accounts for around 3% of financing used by small business. This equates to $7.5 billion of the market of approximately $247 billion.

1.21 It is therefore evident that alternative financing is easier for small business to access. However, unless appropriate access is provided to private companies under the CSF regime, the new CSF regime will do little to help address this issue and support the middle market.

1.22 We believe that both Recommendation 1 and Recommendation 2 will help to address this issue by: (a) opening the regime to debt-like hybrid financing; and (b) opening the regime to be accessible by private companies.

Recommendation 3: To help improve access to finance for small business, it is important to expand the CSF regime to cover items in both Recommendation 1 and Recommendation 2.

[1] Published by Banjo, being one of the first market place lending platforms established in Australia.

Compliance requirements for an eligible CSF company

1.23 We are significantly concerned with the requirement that an eligible CSF company is to be a public company (s.738H). This would mean that small businesses that seek to access the regime (which would otherwise operate as private companies) would be required to significantly increase their compliance requirements. This would be the case even if small amounts of CSF capital is raised.

1.24 In particular, we are concerned that the compliance reductions provided to an eligible CSF company (e.g. AGM, audit and reporting) are very small and are very short term in nature. That is, the limited compliance savings offered only apply for the first five years (paragraph 738ZI(c)). Furthermore, the audit exemption (section 301) only applies if the eligible CSF has raised less than $1 million from a platform at any time (on a cumulative basis). The costs of an external audit are significant and (in addition) would also require the company to incur significant costs on hiring specialist staff to deal with the audit. Accordingly, a small company would face high costs and compliance if it were to enter the CSF regime.

1.25 Finally, to be an eligible CSF company, the company must have gross assets of less than $5 million and gross annual turnover of less than this amount. Accordingly, only start-ups are likely to be able to access the new regime.

1.26 This can be compared to a company looking to raise finance from a current CSF platform operating an ASIC Class Order CO 02/273 exemption model. These platforms do not have any of these requirements and can also allow a private company to raise up to $5 million (e.g. ASSOB). While the Bill will be offered to retail clients, given the investment $10,000 limit, we believe that the compliance requirements are not proportionate.

1.27 We request that consideration be given to whether an eligible CSF company could (instead) be subject to the requirements of a "review" rather than an "audit". That is, if a company met the definition of an appropriately defined "eligible CSF company", the Bill could instead require that the eligible CSF company comply with a review process during the period which the company meets the definition of being an eligible CSF company.

1.28 An audit review is covered by the requirements of section 309 of the Corporations Act. According to ASRE 2410:

> "The objective of the auditor is to plan and perform the review to enable the auditor to express a conclusion whether, on the basis of the review, anything has come to the auditor's attention that causes the auditor to believe that the financial report, or complete set of financial statements, is (are) not prepared, in all material respects, in accordance with the applicable financial reporting framework. (ASRE 2410.4)"

1.29 In our view, requiring a review to be conducted of an eligible CSF company would provide a middle ground for reducing compliance costs for entities seeking to raise

finance through a CSF model. Instead, we believe that the limited benefits of raising small amounts of finance will be offset by significant audit and regulatory costs under the current proposals.

1.30 Accordingly, we believe that the number of companies that seek finance from a CSF platform is likely to be less than expected unless compliance costs associated with becoming a public company can be reduced.

Recommendation 4: We recommend that consideration be given to replacing any audit requirement of an eligible CSF company with a "review" requirement. We also recommend relaxing the five year requirement.

Requirement to be a public company

1.31 If the "audit review" requirements proposed above were accepted, an eligible CSF company would not need to be a public company.

1.32 Instead, we believe that it would be acceptable to allow a form of private company to meet the definition of eligible CSF company.

1.33 That is, it would be possible to extend the definition of an eligible CSF company to include a proprietory company that would otherwise meet the conditions in section 45A(2), but for breaching the 50 shareholder test due to shareholders having subscribed via a CSF platform. To the extent that the test is breached, it should only be so due to equity raised via a CSF platform. Such an entity would also be defined as an eligible CSF company.

1.34 In such a case, the company would continue to be treated as a private company. The additional compliance that would be placed on the private company would simply be an "audit review", which would occur semi-annually.

1.35 Given that investors would only invest $10,000 each in the private company, we do not believe this proposal would be unreasonable. It would also allow for the CSF model to be accessed by appropriate private company groups, with the added protection of an audit review (resulting in lower compliance costs).

1.36 This would also allow an extension of the platform to companies with $25 million of turnover and $12.5 million of assets. It would also extend to entities that have been in existence for more than 5 years. In our view, this would be a more appropriately targeted model for "small business".

1.37 If this recommendation is not accepted, we believe it is imperative for the regime to allow private companies to be able to convert into public companies that are eligible CSF companies (without having to start a new company). Not only would this address issues with the viability of the regime (i.e. due to the small expected customer base), but would also provide small business with an option to be able to seek finance from this alternative source without having to establish a new company and incur significant

restructuring costs (which would likely outweigh the benefits of raising finance under the CSF regime).

Recommendation 5: We believe it is imperative that the regime allow private company access by allowing them to either: (a) qualify as eligible CSF companies; or (b) convert to eligible CSF companies.

Ability to invest in other securities or schemes

1.38 Proposed section 738G(1)(e) will prohibit an eligible CSF company to be able to invest in securities or interests in other entities or schemes. This is a practically difficult requirement to satisfy in almost all capital raisings. We believe that this requirement is a drafting error that needs to be corrected.

1.39 Essentially if the eligible CSF company is a holding company, then it will "on lend" such funds to a subsidiary entity (via equity or debt). Accordingly, on the current wording it could potentially breach this condition. The same would occur if the eligible CSF company is the "finance entity" of a newly established group.

1.40 We do not believe that a limitation to this extent is the intention of the provisions, as this would make the provisions potentially limited in almost all cases (as most new groups operate via a holding company or raised finance using a finance company). Accordingly, we believe that the test should be modified to make it clear. For example, the following underlined change could be made to clarify this issue:

> (e) the funds sought to be raised by the offer are not intended by the company to be used, to any extent, by the company or a related party of the company, to invest in securities or interests in other entities or schemes <u>(other than in the company or a related party of the company)</u>;

1.41 We believe that this minor proposed change to this test could help clarify the operation of this provision. We note that safeguards are already provided in respect of this proposed amendment through the requirement contained in proposed s.738G(2)(b), which looks at the sum of all amounts raised by the company and related parties.

Recommendation 6: We recommend that a drafting amendment be made so than an eligible CSF company is not prohibited from using funds raised from investing in subsidiary entities or related parties. Without such an amendment, we believe that the current provisions will give rise to significant practical difficulties.

Newly created entities versus existing entities

1.42 We are unsure why the provisions would seek to discriminate against companies that are already in existence (per section 738ZI).

1.43 That is, why the provision specifically would require one to identify that they will seek to raise CSF upon registration of the company and also limit access to concessions for entities that are less than 5 years old. We see no reason why this should be the case.

1.44 The proposed restrictions will mean that a group that is already in existence will need to either form a new entity or group, or seek to restructure from a private company to a public company.

1.45 We are unclear why the Government would seek to include this additional compliance burden, basically requiring a group to restructure to obtain access to the regime. We are also unsure why the Government would seek to exclude existing entities. Again, as outlined earlier, we believe that private companies could be included within the definition of an eligible CSF company. We therefore request consideration of this aspect of the Bill.

Recommendation 7: We do not support the requirement that new CSF companies must be newly created (and tagged as a CSF entity on registration) in order to obtain access to the regime. This will unnecessarily limit those entities that can apply for CSF and would also result in significant and unnecessary complexity in restructuring old groups into a new company (i.e. if they were to seek access to funding under the new CSF regime).

Size of the entity

1.46 The $5 million revenue and assets test proposed in section 738H (being a combined test), coupled with 5 year requirement in proposed section 738ZI, will mean that the CSF platform will only be available to very small start-up companies. As outlined earlier, this will place a significant limitation on the CSF platform.

1.47 This will mean that an entity with high turnover (but small margin and small asset base) could be excluded from the regime. It would also mean that a capital intensive start-up (with low turnover) could also be excluded from the regime.

1.48 We have outlined earlier that we believe that private companies should be allowed to access to the regime. The test for a private company (i.e. $25 million of turnover and $12.5 million of assets) are (in our view) far more appropriate for identifying small business entities as compared to the thresholds provided in the Bill. The Bill targets what would be regarded as micro business, rather than small business.

1.49 In our view, it is those businesses that are at the cusp of $5 million turnover of $5 million of net assets that will greatly need the additional finance to grow and expand. Accordingly, we believe that the regime is targeted at the very small end of the scale rather than appropriately targeting the middle market.

1.50 Furthermore, we are unsure why the two tests in section 738H(2) would not be alternative tests and why they need to be a combined test. That is, to the extent that an entity either has gross assets of less than $5 million or gross revenue of less than $5

million, this would indicate that the entity is "small". We highlight that the definition of a small business in the Income Tax Act uses these tests in the alternative, whereby s.152-10(c) provides that an entity is a small business if it either meets the turnover test (subpara (i)) or the asset test (subpara (ii)).

1.51 We therefore recommend that appropriate consideration be given to the size of the relevant entity as contained in the Bill.

Recommendation 8: We recommend that either the regime be expanded to private companies, or that the asset and turnover threshold tests in section 738H(2) be considered "alternative" tests rather than "combined" tests.