THE ENTREPRENEUR v THE FINANCIER

DR DAVID MILLHOUSE
HONORARY ADJUNCT SENIOR RESEARCH FELLOW
FACULTY OF LAW
BOND UNIVERSITY

The boxing match

It is little wonder that only a small proportion of investment proposals ever successfully attract venture capital. The relationship between entrepreneurs and investors and bankers can sometimes be likened to the relationship between contestants in a boxing match, entering the ring from opposite corners, both adamant they are up against opponents, not potential allies, from the very first bell. But it doesn't have to be that way.[1] Neither should entrepreneurs behave as Oliver Twist, forever asking for more gruel. You are selling valuable securities, in Australia usually in the form of company shares or units in a trust. This requires legal documentation.

That immediately results in another boxing match: who should advise and guide you legally? And what are your commercial arrangements to be with your legal adviser since there is limited capital? Valuable securities in start-ups normally rely upon intangible assets in the form of intellectual property, both identifiable in the form of patents and trademarks, but often without physical form. From an Australian perspective, the identity of the property, its ownership and its valuation immediately trigger considerations of capital taxation. Legal advice is often directed at the corporate form rather than the taxation consequences of the start-up, or indeed, strategy. Form must follow function. Entities should not be established until this is resolved.

Both boxing matches require successful outcomes: the raising of capital is an entrepreneurial endeavour and usually the primary focus of the entrepreneur. Implementation is equally important and severely wealth destroying if not properly planned.

A tough sell…

The success rate of entrepreneurs pitched to venture capitalists ('VC''s) is approximately one tenth of one percent (0.12%). More recent data increases this to c.1.2%.[2] Typically, there is a 20-minute initial window to get the story across. Powerpoint in darkened rooms is a deal killer. VC's make a considerable investment in deal flow generation — time is of the essence.

Clearly there are a lot of frustrated entrepreneurs out there. So, do they have their head in the clouds or are VCs particularly ruthless? The relationship between entrepreneurs and VCs is often characterized by erroneous expectation on both sides. This author explains the reasons for this large disparity in deal-flow versus investible deals in Australia.[3]

You get the tension in Australia between the short-term orientation of the VCs and the longer-term needs of the entrepreneurs. The reality is that if you want to build a corporation as an entrepreneur, you really need to give yourself a ten-year horizon. And a problem with financing in Australia, is that almost every

[1] *Australian Anthill* (2004) 5, 22–26.
[2] Matthew Drummond & Jemima White, 'Adventures', *The Australian Financial Review Magazine* (Sydney, December 2020) 28–31.
[3] See, David Millhouse, 'Equity Capital Raising and Usage', corpbuilders™ *Venture Capital Training* (Webinar 1, 2013) Section 1.12 <www.millhouse.co>.

fund is a closed end fund, which means that the investments made by VC's are typically much shorter in duration.

The tragedy of the commons: entrepreneurship is not a zero-sum game

Change lies at the heart of entrepreneurship. The entrepreneur perceives new profit-making possibilities and alternative ways of doing things — the entrepreneur has a vested interest in change.[4] These abilities constitute non-identifiable intangible assets and have great value reflected in the entrepreneurs' equity in the start-up. 'The input of entrepreneurship cannot be measured or manufactured in any obvious way.'[5] It does result in shareholder value. '[t]hose responsible for marketing technologically innovative products and services are involved in the dynamic and uncertain process of creating markets.'[6] Without these qualities, there is no 'deal flow' for the VC to invest in. No capital deployment. No wealth generation. This is the common objective that obsoletes the boxing match paradigm.

A meeting of minds

Entrepreneurs should not view venture capital as risk capital. Venture capital is not there to be lost. It is there to earn a return. In Australia, we still have this paradigm that if someone has a good idea, somebody else's money should fund it. There is no value in an idea. The history of returns in Australian venture capital is written in red ink. The value is in the entrepreneur building a listable public corporation from it. That is a rare skill set, often not one possessed by founders. A major role of a venture capitalist is to add value, not only from capital supply, but also from the supply of expertise. This often comes by director appointments (which can be problematic) but also by the provision of contracted management services. Functional skills requirements will change in a venture backed investment which grows rapidly.

A lack of empathy can certainly buttress the clash of heads mentality. Will you travel economy long distance, share a hotel room, and still remain trusted colleagues afterwards? But transforming the relationship between entrepreneurs and financiers into a meeting of minds is about fate and fortune as well as hard work. A good idea and a good investment are two very different species. Confluence of minds is often a matter of style and value sets. These can make or destroy small organisations. 'It is all very well for the cello to play out of tune in a Tchaikovsky symphony; that fault in a string quartet is disastrous. In small companies there is just no room for personality clashes or style misfits.'[7] Venture capital investment is thus more than capital: it is about a shared vision between those with very different histories, functional skills, and behaviours. Successful entrepreneurs exhibit superb judgement in building commonality of objective and cohesion in implementation from disparate resources.

Venture capital in Australia: a brief history

A nascent venture capital industry developed in Australia in the early 1980's using Managed Investment Companies as licensed tax preferred vehicles. Competition and a new awareness of what is possible led to equities market investment in university research projects, technical innovation, and the establishment and growth of entrepreneurial technically based business enterprises which facilitated the renewal of Australian manufacturing. Many universities created spin-off commercialisation and seed financing entities specifically to capitalise on new found financing freedoms. Many now have accelerators or incubators of some form. In Germany, UnternehmerTUM (Technical University of Munich) and the vibrant start-up sector in Berlin are modern examples. At Bond, the Transformer is a cross-faculty accelerator.

Public sector agencies, including the Commonwealth Scientific Industrial Research Organisation ('CSIRO') followed. Reform generated excitement and enabled entrepreneurship. This was the era of the 'industry plan' designed to modernise sectors of the economy. It was the era of Science and Technology Ministers at

---

[4] D G Millhouse, 'Leadership in innovation: exploiting the global market' (March 1988) *Industry & Higher Education* 4.
[5] Ibid 5.
[6] Raymond W Smilor, 'A controversial assumption: and an entrepreneurial dream' (1987) *High Tech Marketing Review* 1(1) 5—6.
[7] Third Technical Innovation and Entrepreneurship Symposium, 'Developing the Entrepreneurial Organisation' (September 1988) Utah Innovation Foundation, IC2 Institute UT Austin, UniQuest Limited University of Queensland.

the Commonwealth and in the Australian States wanting to emulate Harold Wilson's 'White Hot Technological Revolution' of 1960's United Kingdom, albeit two decades later. More kindly, it was the emulation of Stanford University and Silicon Valley, the MIT corridor in Boston, Utah Innovation Foundation, and IC[2] at University of Texas Austin which provided the role models for what could be achieved. This latter linkage led directly to Bond's participation in Moot Corp™ from 1989 onwards. These examples have a long genesis in the United States leading to the birth of its modern venture capital industry in the 1980's.

In 1990's Australia, a second generation of venture capital investment had much greater scope and scale in consumer, business and industrial finance. Licensed MIC's were replaced by tax preferred Pooled Development Funds ('PDF'), and later, Industry Innovation Funds ('IIF') with additional tax preferred support for research and development investments. This tax preferred support created a new venture sector using leveraged R&D Syndications promoted by several major financial institutions. The leverage of 'core' technology valuations were later subjected to regulatory review and litigation. Such financial products often commence their life being only available on a 'wholesale' basis to professional and sophisticated investors but found their way to 'retail' and unsophisticated investors through the market mechanism of financial advice.[8] These were mainly structured as commercial trusts in Australia under the guise of Managed Investment Schemes ('MIS') rather than the international norm of limited liability partnerships with general and limited partners. One consequence is a reduced flow of foreign investment capital into Australian venture capital firms, particularly at the smaller end of the market. This is where much of the deal-flow demand is to be found, with large numbers of start-ups purportedly unable to find equity investors. It is also the source of market failure arguments, including demand for a crowd-sourcing funding regime.

In practice, capital supply is not the limiting factor. The deal flow and matching ecosystems are reasonably mature. They feed an Australian venture capital industry that has a surplus of investible funds. Many experienced venture capitalists argue that quality 'deal flow' is in short supply in Australia and they have difficulty in deploying their committed capital. Aggregate capital availability data indicates that this appears to be the case presently. Retail investors do have opportunities to deploy both private and SMSF capital into venture capital and private equity using registered and unregistered management investment schemes.

The legal framework

The financial adviser

Intermediaries are commonly used in financing start-ups in superannuation and non-superannuation environments. Financial advice and financial product advice are defined terms, and the use of the term 'financial adviser' is restricted by the application of the educational standards in FASEA Code of Ethics.[9] These standards apply from 1st January 2021. Firms providing financial advice to retail investors are required to hold an AFSL and have a statutory best interest duty to the client,[10] and much broader fiduciary-like best interest obligations to the investor.[11] Their duty is not to the start-up.

Type of security issuance

Whilst many start-ups are equity funded, many are quasi-equity funded or debt funded. A loan is a financial product.[12]

---

[8] David G Millhouse, 'A business and legal analysis of the systemic failures in the Australian financial products and financial services sectors: have weaknesses in corporate governance law contributed to this cyclical failure and are there legal solutions?' (PhD thesis, Bond University, 2018).

[9] Financial Adviser Standards and Ethics Authority, a Commonwealth Statutory body.

[10] *Corporations Act 2001* (Cth) s 961.

[11] *Corporations Amendment (Professional Standards of Financial Advisers) Act* 2017 (Cth); *Corporations Act 2001* (Cth) s 921U(2)(b). See also, David G Millhouse, Best Interest Duties of Financial Advisers — More Law, More Confusion (2020) *Enterprise Governance eJournal*, Centre for Commercial Law, Bond University.

[12] *ASIC v Secure Investments Pty Ltd (No 2)* [2020] FCA 1463.

Design and Distribution of Financial Products

The issuers of financial products and their advisers (being 'regulated person[s]') are subject to new law to commence on the 5th October 2021.[13] This DDO legislation amends the *Corporations Act*, the *ASIC Act* and the *National Consumer Credit Protection Act*. In short, all financial products, including investment products, around which modern life exists.

Its product intervention powers have been in place since 6 April 2019. The intent is to apply tests of appropriateness, target market fitness, and marketing conduct. Investment contracts (being 'regulated sale[s]') are voidable, can be void *ab initio*.[14] Civil penalties apply.[15] There is some subjectivity — '[i]n considering whether a financial product has resulted in, or is likely to result significant detriment to retail clients…'[16] Whilst the legislation is directed at 'retail' investor protection, is uses the broader term 'financial consumer' in both its design and distribution[17] and product intervention powers.[18] Financial product issuers need not have breached fund raising law to trigger a DDO intervention and there is no ASIC obligation to act confidentially.

Investor typology

Australia already had overlapping investor typologies with definitions scattered through the *Corporations Act.* Both DDO and FASEA have re-interpreted and broadened the scope of 'retail' investor. This can significantly impact the distribution of investment products.

Australia now has four differing overlays of investor typology continuing its tradition of 'obscure and convoluted' legislation.[19] Some parts of the regulatory framework only apply if the client is a retail client [or investor].[20] This requires holistic reform — investor typology does not always reflect their competencies.[21] 'Professional',[22] 'sophisticated',[23] 'wholesale' (being not retail),[24] 'retail'[25] overlap. Separately, FASEA[26] introduced further confusion into the retail/wholesale investor typology. Its Code of Ethics extends the interpretation of retail investor to include financial comprehension[27] and applies to 'relevant providers'[28] not only to traditionally termed financial advisers.[29] A person 'may be a retail client

---

[13] *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (Cth); *Corporations Act 2001* (Cth) pt 7.8A. See also, David G Millhouse, Directors & Officers — Strategic Leadership or Bondage? (2020) *Enterprise Governance eJournal*, Centre for Commercial Law, Bond University.

[14] *Corporations Act 2001* (Cth) ss 994M,Q.

[15] Ibid s 1023Q.

[16] Ibid s 1023E(1).

[17] Ibid s 760A(aa).

[18] *National Consumer Credit Protection Act 2009* (Cth) s 301E.

[19] Pamela Hanrahan, 'Legal Framework for the Provision of Financial Advice and Sale of Financial Products to Australian Households' *Royal Commission in the Banking, Superannuation, and Financial Services Industry* (Background Paper 7) 13 citing *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] FCAFC 50 [152]–[153].

[20] Ibid 21 [2.4].

[21] See, eg, David Millhouse, *Corporate Governance in Non-Bank Financial Entities* (2019, LexisNexis Butterworths) 194 [4.17]—[4.30].

[22] *Corporations Act 2001* (Cth) s 9 reg 7.6.02AE.

[23] Ibid ss 708(8), 761GA.

[24] Ibid ss 761G(4), 761G(7)(c)(ca), reg 7.128.02AB.

[25] See, eg, *Corporations Act 2001* (Cth) ss 738D, 760A(a), 761A, 761G, 761GA, 994A(1), 1012E.

[26] *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* (Cth).

[27] David G Millhouse, 'Best Interest Duties of Financial advisers — More Law, More Confusion' (2020) *Enterprise Governance eJournal*, Centre for Commercial Law, Bond University 11.

[28] *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* (Cth) s 910A.

[29] A relevant provider can be any person or entity licensed and engaged in transactional personal advice to FASEA's interpretation of retail client. It could include stockbrokers, accountants, mortgage brokers, and sales representatives. See especially FASEA, *Financial Planners and Advisers Code of Ethics* (Guidance FG002, 2019) 6.

for some purposes and a wholesale client for others.'[30] A SMSF trustee director may be retail, but the SMSF is not. Similarly, the interface with the non-FASEA financial advice provisions[31] has bizarre consequences.

> [This] new law [s 961] applies to some financial services firms who are not fiduciaries with respect to the giving of that advice at general law. However, because of the narrow definition of retail client [when s 961B was enacted], many financial advisers who are fiduciaries … are not subject to the new law.[32]

However, later interpretations of retail client will change this. The DDO legislation adds further complexity in extending NCCPA consumer protection provisions more broadly in securities issuance for capital raisings.

Extreme care will therefore be required in the offer and issuance of securities directly or indirectly to investors. Traditional assumptions are obsolete. Some industry participants have proposed an investor accreditation and educational qualification process echoing that which appliies to financial advisers.

Resolving these definitional issues should be a task for the ALRC[33] in its quest for Hayne inspired corporate law simplification.

***Corporation Act* s 708 (1)—(21)**

The *Corporations Act* has since 2000 accommodated venture investing by private 'retail' investors and others facilitating small capital raisings without a prospectus.[34] Section 708 allows issuers to raise funds from a handful of investors without the usual (and expensive) product disclosure requirements being met. Securities or equities issued under s 708 also can be offered by a financial services licensee, subject to FASEA and DDO constraints. The licensee must be satisfied that the investor is experienced enough to be able to assess the merits of the offer and the value of the securities. Other s 708 subsections have different and additional excluded offer provisions.

Traditionally, a 'sophisticated investor' is someone who has a certificate from a qualified accountant, stating they have net assets of $2.5 million and/or that her gross income for the past two financial years has been at least $250,000 a year. This is still the case in that section, but now heavily limited by the application of the FASEA and DDO tests. The assumption that 'sophisticated investors' were wise enough to judge the wisdom of an investment without the assistance of additional disclosures or advice is no longer the case.

Under s 708(1) a disclosure document is not required if a person makes a personal offer of equities or securities and up to 20 or fewer persons accept those offers in any 12-month period. No more than $2 million can be raised in this way in any one year. The exemption applies to personal offers only. Issuers cannot make an offer to the retail market as a whole — then issuers need a proper disclosure document. The 12-month period commences on the date of the issuance of the securities to the first accepting investor. These personal offers cannot be advertised.

Class Order 02/273 et seq

Similarly, ASIC Class Order 02/273 exemption for business introduction and matching services, introduced in 2002, was designed to conditionally facilitate small scale capital raisings. It has facilitated a multiplicity of Angel investor groupings, for instance, the *Clean Tech Angels Network* and *Melbourne Angels*, with the Australian Association of Angel Investors being one industry lobby group. There are others including the RegTech Association for emerging regulatory technology companies. This class order not only facilitated angel groups (in the pre-internet age) but also a rich ecosystem of pitch meetings, university accelerators, competitions and introduction agencies.

---

[30] Hanrahan, (n 19) 22 [2.4].

[31] *Corporations Act 2001* (Cth) s 961B.

[32] Hanrahan, 'The relationship between equitable and statutory "best interests" obligations in financial services law' (2013) 46(1) *Journal of Equity* 7 para [V]. See also, Millhouse, (n 21) 234—235 [5.66].

[33] Australian Law Reform Commission.

[34] *Corporations Act 2001* (Cth) s 708.

Class Order 02/273 (which was issued by ASIC under s 741(1)(a)) is part of the government's encouragement of small and medium businesses. This exemption is provided for offers of securities through a Business Introduction Service. These Business Introduction Services are defined as businesses — such as a business of fundraising broker — that have as one of their objects the promotion of investment in SMBs.

CO 02/273 provided relief from the need to hold an AFSL to operate a matching service and from certain fund raising provisions of the *Corporations Act* applying to the issuer, seller, endorser, and publisher of securities or interests in respect of disclosure, advertising and selling of securities or interests in a company or managed investment scheme. If the matching service operator provides anything other than 'matching', then they are required to hold an AFSL.

ASIC has preserved the legal intent of this class order until 1st April 2022,[35] during which time, there is proposed to be a review and consultation period on the original policy settings. There are five important exemptions which apply to the operators of these angel matching services. Of these, the third exemption limits capital raisings to $5.0m million in total until one year after the last of offers of securities have been made.[36] This can be in addition to regulated offers (excluding s 708 offers) under the *Corporations Act*. Notably, it is the quantum of offers of securities rather than acceptances of offers.

Some argued that these measures were not enough and more needed to be done to widen the pool of potential investors.[37] Crowdsourcing platforms are similar to angel investing in online mode, requiring, as in small scale capital raisings, an issuer, a platform, and a 'crowd'. The *Corporations Amendment (Crowd-sourced Funding) Act*[38] is an addition to the traditional channels of capital raising, including those composing the 'crowd'. It seeks to open the door to limited public offers. There is an 'issuer cap' of $5.0 million and a limit on the per-investor subscription. The issuer cap includes all amounts raised pursuant to other capital raising options, including s 708(1) or (10) in the preceding 12-months period. In this case, it is offers, not acceptances of offers. Corporate crowd funding offers can only be undertaken by the issuance of shares in an audited (with an audit threshold of A$1.0 million) public company with three directors.[39]

There are many examples in comparative jurisdictions. These include Seedrs (UK), Crowdcube (UK), and Snowball Effect (NZ). These platforms have the attributes of a business matching services and should be licensed to operate accordingly. Arguably, there was no need for separate legislation. Indeed, it is more restrictive than the combination of s 708 and CO 02/273, requiring a public company structure

Despite its fashionability, crowdsourcing should not be an unregulated free-for-all based on specious market failure arguments. It is in fact a virtual online angel network (arguably with less financially literate users) and should be regulated accordingly. Regulation in a non-prudential market conduct environment does not prevent loss of capital. It should however provide the basis on which a new cohort of investors can practice their investing skills. It is these skills in seeking new opportunities, sourcing value creating entrepreneurs, and identification of risk which mitigates loss of capital. Otherwise caveat emptor leading to loss of capital leads directly to an inability to finance an entrepreneurial society. This has already occurred in Australia with foregone GDP growth rate (assuming GDP measures all economic activity) estimated to be some 20% p.a.[40] These economic consequences are significant nationally and for the individuals concerned. Crowdsourcing may be fashionable, but it is not new, it is not a panacea, and should be viewed as an extension of the capital markets infrastructure and regulated accordingly.

---

[35] Australian Securities and Investments Commission, *Corporations (Repeal and Transitional) Instrument* (2017.186, 22 March 2019).
[36] Ibid 3(b)(ii).
[37] Jason Zein, 'Filling the capital gap: The financing case for crowdsourced equity funding in Australia' (2014) 25 *Journal of Banking and Finance Law and Practice* 102.
[38] *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth).
[39] This was later amended by the *Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Act 2018* (Cth) to facilitate fund raising, primarily for philanthropic purposes, by Australian proprietary companies. Two directors are required. The audit threshold applies if the company raises A$3.0 million or more. Crowd-sourced proprietary companies can be converted to public companies.
[40] Millhouse, (n 8) ch 3.

Australian start-ups and SME's have a long history of attracting financing. Some of these have become global brands with internationally significant market capitalisations. Prominent examples include Cochlear, Atlassian, NUIX, Resmed, and CSL. There are thousands of others in all industries. Examples applying s 708 include an international funds manager ($4.0 million),[41] an electronics manufacturer for the electricity distribution network ($500,000, later $3.5 million),[42] later being acquired by a TSX listed company, a national retail food franchise ($4.5 million),[43] a NSW winery and wine distribution business ($2.5 million),[44] and an international business education entity (2*$500,000, later $1.05 million).[45] Examples under ASIC CO 02/273 include wineries, manufacturers, and investment businesses, some in regional areas.

Ten common mistakes of entrepreneurs: traps to avoid in selling your deal

Not knowing the game: Imagine sailing around the world solo with no sailing experience? Most founders attempt a corporate version of such an expedition. You need to build a scaleable, publicly listable corporation, often on a multi-country basis.

Undercapitalisation: most entrepreneurs look for capital to finance technical and engineering needs. Few compute (preferably in a detailed capitalisation plan) the investment required in marketing, brand development, business development, intellectual property development and protection, and human capital. The capital need is typically 8 times the technical capital requirement. To prevent undue dilution of founder equity, this is sourced differently, at different times, and importantly at different prices: hence the need for a capitalisation plan.

Selling skills: building a listable corporation requires selling skills of a high order to a large number of stakeholder groups. This is the key skill of the chief executive. Functional executives need to support the CEO, but often cannot supplant that person. Investors worldwide focus on the identity of the CEO whose only tasks should be to visualise, lead others and sell the investment dream to investors. They require the CEO and the company to acknowledge the true role of a CEO.

The J Curve and conservative projections: Spreadsheets and powerpoint in darkened warm rooms are deal killers. Financial forecasts should be realistic, achievable and based on well researched facts. So-called conservative projections are as unbelievably bad as geometric excel formulas without a factual basis. These are usually not dreams: they are the hallmark of lazy or non-existent research.

First mover advantage: Rare indeed. It is more common than not that someone has or is already doing what you propose. Research is the key.

10% of the market: Market share projections should not be of the 'if we get 10% of the market' variety. They need to be based in believable quantitative research. These projections feed directly into your capitalisation plan and pre and post money valuations. They also directly affect your personal credibility and your ability to attract venture capital at all.

Competition: There will always be competition. Admit it, plan for it, and raise the capital to address it.

Global aspirations: A great aspiration, but most markets are not global. They are highly segmented, often internationally, usually with different pricing, distribution channels, and political influences. Focus on those segments you have capital to target as at least the runner up to market leaders.

Engaging others: Style and culture are very important attributes. Diffusion of an 'unhealthy culture'[46] is a common problem in financial institutions and companies. A style manual is an essential tool in brand

---

[41] *Corporations Act 2001* (Cth) ss 708(8), 708(11).
[42] *Corporations Act 2001* (Cth) s 708(1).
[43] *Corporations Act 2001* (Cth) ss 708(11), 708(12).
[44] *Corporations Act 2001* (Cth) ss 708(11), 708(12).
[45] *Corporations Act 2001* (Cth) ss 708 (1), 708 (11).
[46] Millhouse, (n 8).

building. Personal branding (eg Steve Jobs, Richard Branson) is equally important. Most people like to believe in their leader: this comes with responsibility as CEO to set and enforce style and culture.

Attacking walled cities (apologies to Sun Tzu): Venture capital does not fund cannon fodder: it funds the innovative and agile. You are not Napoleon in 1812 or the German Wehrmacht of 1941.

Ten common venture capitalist mistakes: select your investor wisely

Small funds and the ability to provide follow-on financing: Investment is usually not a one-off event. The CEO's of almost all growth companies require ongoing access to capital. Almost all Australian venture funds are closed end funds, meaning they are restricted in accessing new capital and may face significant dilution if they cannot provide follow on financing. This is a common trap for funds managers. Your capitalisation plan will determine how much capital is required, for what purpose, its timing and its price. Yes capital requires a return, but this is not a constant. Small funds may only finance part of the journey.

Duration of the fund: closed end Australian funds are typically of 10 year duration with the ability to extend for a further 2 years. To extract the most equity value uplift means investing early in the life cycle of the fund. Similarly, for the entrepreneur, a forced divestment by a key funding shareholder as a result of late cycle investing can destroy value.

Portfolio overstretch: Too many investments, especially by a small fund, leads quickly to venture management overstretch and an inability to properly fund each of the portfolio companies.

Emulation of the United States model: Portfolio diversification to ostensibly reduce risk has not had a happy history in Australia: the historical returns have been poor in both venture capital and private equity. The venture model in a smallish economy with limited supplies of venture capital and limited exit opportunities requires focus on making every investment a success, not a small proportion of a portfolio, or reliance on a 'star'. This paradigm leads to a top decile fund performance history, without which investors should keep away.

Exit options: Both the venture capitalist and the entrepreneur should be focussed on ultimate exit. This aligns the interest of the parties. Australia has comparatively limited exit options. It does not have the deep capital markets of the United States, and it does not have the extremely well developed corporate venturing market of Europe, particularly in Germany, Switzerland, and France. The capitalisation plan should provide for the transaction costs of exit in these markets. Different and superior exit pricing can also be achieved.

Leverage: venture capital funds should not be leveraged – they are equity. Private equity funds are normally leveraged but the debt servicing costs have been known to wreck the underlying investments. The Germans have a great word for this scenario – Heuschrecken (locusts).

Type of security: There is a tension between the entrepreneurs need for equity and the venture capital need for return of capital. Many of the securities issued by companies to meet this need (and the investment contracts that accompany them) are actually hybrids structured as equity but with debt like features. This can be value destroying over the life of the capitalisation plan since future investors will either decline or require remediation. This can be costly and in Australia have adverse capital gains tax consequences.

Pre-emption, anti-dilution and subordination clauses: These are two sides of the same coin in many respects. It is common that future investors will require earlier investors (and the entrepreneur) to have lesser rights to the economic results. ie earlier investors rights are subordinated to the demands of future investors. Earlier investors use pre-emption and anti-dilution clauses, but if they cannot provide the necessary capital, the company becomes starved of capital. This can lead quickly to insolvency.

Financial models are not businesses: the key to any successful venture investment is the ability of the management. Without the entrepreneurship of the CEO and the implementation ability of the supporting team there may be nothing, despite what excel purports to tell you.

Board appointments: these are not career progressions for the professional staff of the venture capitalist. A board has to be multi-skilled, industry and market knowledgeable, well connected, cohesive, and match the style and culture of the organisation. Many board appointments do not have these attributes. Neither can

they be nominee directors in any meaningful sense. Supporting technical and professional skills are readily available from the venture capitalist or from third parties by contract.

The Law matters: A note to Canberra

If Australia is serious about becoming an 'agile and innovative' economy generating rising post-Covid real living standards, then a **re-emphasis on entrepreneurship**, its rewards, its capital taxation and insightful strategic reform of financial regulation are essential preconditions.[47] Presently, these are either missing or at best misunderstood, mired in the politicisation of the debate. Consequently, Australia's best export is its entrepreneurs — for which the country earns no return. Australia:

> needs a system that evades the risk aversion that has become common practice and returns to our roots as an entrepreneurial community breaking new barriers. In the 21st century regulation needs to avoid paternalism without completely abandoning prudent protection of interest.[48]

The present Crowd Sourced Equity Funding ('CSEF') statute[49] for corporate capital raising is paternalist. It giveth and it taketh away. What is required is a modernisation of s 708 and a permanent continuation of ASIC CO 02/273.

Modernisation of s 708 needs to at least include indexation of the $2.0 million limit, preferably to $5.0 million and an increase in the 12-month cap of 20 securities issuances to 50. Section 708(1) would evolve to a 5/50/12 rather than the present 2/20/12 provision. It would then be consistent with the shareholder cap for proprietary companies and with the $5.0 million limits on fund raising under CO 02/273 and crowdfunding. Further consistency in the application of offers and acceptances provisions is also required. It should also be consistent with proposed reform by this author of the MIS provisions of Part 5C of the *Corporations Act* in respect of unregistered MIS.[50] These provisions would provide a practical and modern legal infrastructure without the limitations of the CSEF statute.

Before further lobbying ensues, start-ups should be wary of the 'politics of investment'[51] — managing 50 often inexperienced and over optimistic shareholders is a task in itself. There is no compelling reason in a start-up to increase the number of new investor issuance beyond 50. Thereafter, other provisions of the *Corporations Act* should apply, including statutory migration to unlisted public company status and its enhanced compliance framework. Most investments require follow up finance. Incoming investors will not wish to negotiate with hordes of earlier very small investors, especially in the absence of a shareholders agreement, this being the norm in crowdfunding raises. Directors should be careful with their strategy. Whilst traditional legal impediments have generated a demand for crowdsourcing, it is not necessarily a panacea.

---

[47] See especially, David G. Millhouse, W[h]ither Australia? Will Parliament Act? (2020) 14(2) *Law and Financial Markets Review* 84–101.

[48] Australian Association of Angel Investors, *Equity Crowdfunding; Response to the Treasury Consultation Paper* (2015).

[49] See above n 38.

[50] Millhouse, (n 8).

[51] Paul Niederer, 'Small Scale Equity Offerings ARE Equity Crowdfunding Raises!' (2014) <http://paulniederer.com>.