AVCAL

Australian Private Equity &
Venture Capital Association Limited

Financial System Inquiry

Submission Two

April 2014

AVCAL Australian Private Equity & Venture Capital Association Limited

28 April 2014

Mr David Murray AO
Chair, Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

By email: fsi@fsi.gov.au

Dear Mr Murray,

Supplementary submission to the Financial System Inquiry

On 2 April 2014, the Australian Private Equity & Venture Capital Association Limited (AVCAL) had an opportunity to meet with the Secretariat to the Financial System Inquiry (FSI) to our discuss views on a range of specific issues relevant to the private equity and venture capital marketplace in Australia.

In our discussion, we canvassed a number of policy and regulatory factors that act as 'roadblocks' on the capacity of the Private Equity (PE) and Venture Capital (VC) industry to increase its contribution to the future growth and expansion of Australian businesses within our economy. We thought that it would be helpful to the FSI Panel for us to put forward a supplementary submission to reinforce our views on some of those specific issues.

There are a number of areas where we believe policy reforms could help to catalyse economic growth from business investment via PE and VC funds. A number of these areas of policy have been the subject of ongoing discussions between AVCAL and the Government in the past few years. Given the broad terms of reference for the FSI, we believe that these issues should be considered during the course of the Inquiry's deliberations this year.

The key reform areas fall into the three broad categories set out below:

1. **Addressing impediments to domestic investment in Australian businesses**
   - 1.1 Consistent tax treatment for domestic investors in VCLPs
   - 1.2 Better alignment of Stronger Super regulatory environment with the core objectives of superannuation

2. **Encouraging foreign investment in Australian businesses**
   - 2.1 Flow-through Collective Investment Vehicles (CIVs)
   - 2.2 Expansion of complying investments under the Significant Investor Visa programme

3. **Policy settings to facilitate long-term innovation funding**
   - 3.1 Modernise the Innovation Investment Fund programme
   - 3.2 Introduce R&D quarterly tax credits for early stage companies
   - 3.3 Reform of the Employee Share Schemes tax framework for early stage companies
   - 3.4 Strengthen the nexus between publicly-funded research and economic outcomes

SECTION 1: ADDRESSING IMPEDIMENTS TO DOMESTIC INVESTMENT IN AUSTRALIAN BUSINESSES

1.1 Consistent tax treatment for domestic investors in VCLPs

In 2011, the Board of Taxation (BoT) completed a comprehensive review into the current taxation arrangements under the Venture Capital Limited Partnership (VCLP) regime, and as part of that, examine whether the current rules are delivering on the original policy objectives. Amongst other things, the BoT recommended that that deemed capital account treatment should apply to eligible domestic partners on gains or profits made by a VCLP on the disposal of eligible investments. This recommendation was made on the basis of the BoT's assessment of how the current VCLP regime could be amended in order to facilitate more direct investment into Australian businesses by PE and VC funds.

The previous government had made a decision (following the BoT's recommendation) to proceed with amendments that would introduce consistency as between the tax treatment of different classes of domestic and offshore investors into VCLPs.

However, the current Government reversed this decision in December 2013, and decided not to proceed with this reform. AVCAL's view at that time, and still at this point, is that the Government had missed an opportunity to implement reforms that would assist in facilitating greater investment into mid-market Australian businesses through PE and VC funds. AVCAL believes that the Government should continue the implementation of the BoT's recommended reforms, which will improve the capacity of the current VCLP regime to deliver on the original policy objectives that were set by the Coalition Government when this structure was first introduced back in 2002. To the best of our understanding, AVCAL does not believe that the implementation of these reforms would carry a significant revenue cost to the federal budget position.[1]

In AVCAL's assessment, further investment into mid-market businesses is being held back as a direct result of the current inconsistency in the tax rules that apply to different classes of domestic investors in VCLPs. As the legislation currently stands, foreign investors have certainty in respect of capital account tax treatment, but a similar level of certainty does not currently exist for all domestic investors. Feedback from AVCAL members over many years has consistently highlighted that the present capital/revenue account tax uncertainty is the issue of greatest concern within the VCLP regime, and a significant impediment to domestic fundraising. These conclusions were largely echoed by the BoT in their 2011 report.

A consistent and clearly defined VCLP tax regime will encourage private domestic investors to invest in unlisted mid-market Australian businesses with high growth potential, which will ultimately lead to greater employment growth across a wide variety of industry sectors. A more efficient VCLP regime would also support the objectives of the FSI, and the broader Government agenda, of seeking to give businesses the certainty and confidence they need to innovate and adapt to globally competitive markets.

1.2 Better alignment of *Stronger Super* regulatory environment with core objectives of superannuation

AVCAL supports the objectives of MySuper, which broadly are to "deliver a better deal for all default fund members, including through improving the simplicity, transparency and comparability of superannuation products".[2]

---

[1] Any perceived risk to the revenue associated with AVCAL's recommendations should be more than offset by increased taxation receipts from bigger and more profitable portfolio companies, and more productive workforces. The assessment of the Deputy Governor of the RBA, Mr Battellino, noted in the Senate Report on the review of private equity in 2007, was that: "[the] conclusion would be that really on a macro scale shifts in the patterns of financing probably do not have a big overall impact on the tax base."

[2] The Treasury, MySuper Consultation Working Group, Issues paper on defining MySuper (March 2011).

In practice, however, existing policy drivers limit the extent of performance-based competition because the focus on high liquidity and low fees means that there is a limited range of assets and allocation ranges that super funds will typically invest in, in order to keep their implementation and compliance costs down.

However, there is a strong body of evidence that shows that effective asset allocation decisions are critical to long-term net returns (see for example the Myners Report, 2001), and make a bigger difference than fees (DCIIA, 2013).[3] Policies on fee structures and reporting need to recognise that there are both productive and unproductive components of investment costs. For instance, some fees can be explicitly associated with superior net returns for members (particularly performance fees), compared to lower-fee products.

AVCAL believes that it is vital that the regulatory environment for default super funds should act as an *enabler* rather than a *driver* of asset allocation decisions. For this to happen:

- There will need to be more informed public policy dialogue on 'superannuation adequacy', focusing on the net returns to superannuants when they retire. In the same way that a country cannot tax its way to prosperity, a pension system cannot bargain its way to long-term wealth. The growing dominance of low-cost superannuation, if coupled with an inadequate policy and regulatory focus on promoting the importance of net returns, will challenge the superannuation system's ability to deliver its fundamental objectives of providing an adequate level of retirement income for superannuants, relieving pressure on Government-funded support such as the age pension, and increasing national savings to create a pool of patient capital to be invested as decided by fiduciary trustees.[4]

- More information will need to be made available to superannuants to explain the role played by fees and overall net returns in determining their level of retirement income, and help improve awareness and financial literacy on the drivers of long-term superannuation outcomes. This will also aid in broadening access to capital by the small business sector, which employs almost half of workers in the private non-financial sector and is the driving force behind the Australian economy.[5]

Given the ever-increasing significance of the role played by Australia's superannuation savings pool, AVCAL believes that it would be appropriate for the FSI to consider whether recent reforms to the policy and regulatory framework should be re-assessed. AVCAL believes that a close examination of the downstream implications of recent reforms is warranted, given the long-term opportunities – and consequences – which exist in relation to the exponential rate of growth in the nation's aggregate superannuation savings over time.

SECTION 2: ENCOURAGING FOREIGN INVESTMENT IN AUSTRALIAN BUSINESSES

2.1 Flow-through Collective Investment Vehicles (CIVs)

The 2010 report *'Australia as a Financial Centre'* (the Johnson Report), recommended "that the Treasurer request the BoT to review the scope for providing a broader range of tax flow-through collective investment vehicles". The Johnson Report found there were strong indicators that if Australia had access to a broader set of appropriate vehicles to sell into Asia that were taxed on a flow-through basis, more collective funds vehicles would likely be managed and administered out of Australia.

The BoT's review of the tax arrangements applying to CIVs was completed in December 2011 but the report, and the Government's response, has to date not yet been released. The considerable delay between reporting

[3] "Institutional Investment in the United Kingdom: A Review" (the Myners Report to HM Treasury, March 2001), Defined Contribution Institutional Investment Association (DCIIA), "Is it time to diversify DC risk with alternative investments?" (May 2013).
[4] *Charter of Superannuation Adequacy and Sustainability (2013).*
[5] RBA, "Small Business: An Economic Overview" (May 2012).

and public release is a concern pointed to in Parliament by the current Government (when in Opposition), in March 2013.[6]

AVCAL believes that the outcomes of this review are important because the CIV of choice domestically, apart from VCLPs, remains a managed investment scheme taking the legal form of a trust. Currently some features of Managed Investment Trust (MIT) tax framework put Australia's funds management sector at a competitive disadvantage in terms of managing funds for offshore clients who have greater certainty of flow-through tax treatment through other international CIVs of choice such as limited partnerships and limited liability companies. These shortcomings and uncertainties should be addressed, in consultation with industry, as part of the Government's ongoing review of the MIT tax framework.

These reforms are also important to Australia's future capacity to attract foreign investment into our economy. In view of this, AVCAL recommends that the FSI encourage the Government to:

- release the BoT's review of CIVs, together with its response to the report;
- provide legislative certainty for the retention of character and source for investors in MITs, and address other areas of the MIT tax framework to allow these vehicles to operate in as similar a fashion as possible to how international CIVs are taxed in other jurisdictions; and
- prioritise, as part of the proposed Tax White Paper which will be prepared in the course of the next two years, the implementation of policies that will support Australia's capacity to attract capital from domestic and international investors through a globally competitive environment for collective investment management activities.

2.2 Expansion of complying investments under the Significant Investor Visa (SIV) programme

The current SIV regime requires applicants to invest at least $5 million into one or more 'complying investments'. The current list of eligible 'complying investments' include direct investment into Australian proprietary companies, and bonds, investment in managed funds investing in companies expected to be listed within 12 months on an Australian Stock Exchange, but do not include investment in Australian PE and VC funds.

This inconsistency means that SIV holders do not have the opportunity to invest in Australian businesses through professionally managed PE and VC funds, which are among the most developed and well-regarded in the Asia-Pacific region.

AVCAL believes that the categories of 'complying investments' for the purpose of the SIV be further expanded to include the PE and VC asset classes. This will give greater flexibility to fund managers to tailor SIV compliant funds to meet investors' risk-reward appetites, while at the same time boosting unlisted Australian businesses' access to capital.

At the time of writing, there is a policy review process that is being carried out by the Department of Immigration and Border Protection to examine the merits of targeted reforms to the existing SIV regime to enhance its effectiveness in attracting offshore investment into Australia. AVCAL has put forward a submission to the Department (as part of that consultation process) setting out the case for a broader list of 'complying investments'. We believe the FSI should monitor this process and assess the opportunity to put forward further recommendations for reform, where appropriate.

[6] Senate Notice Paper No.143 – 14/5/2013; Orders of the Senate, Senator Mathias Cormann

SECTION 3: POLICY SETTINGS TO FACILITATE LONG-TERM INNOVATION FUNDING

With other countries such as the US, UK, Canada and Singapore forging ahead in building their innovation ecosystems, it is important that Australia does not lose this opportunity to send a signal that it truly is 'open for business' and that it is actively seeking to attract and retain the best and the brightest businesses in our economy.

The FSI Chair has indicated, on a number of occasions in the recent past, an interest in examining how Australia 'can foster a more dynamic VC marketplace' to support innovation investment within our economy.

In AVCAL's view, a more dynamic VC marketplace can be achieved if a concerted effort is made to address barriers to private investment in new ideas, reduce red tape and prohibitive tax policies which are inconsistent with global norms, and through the correction of market failures in capital formation for emerging new ventures.

Above all, an improved VC environment will be helped by a focus on consistency and long-term thinking in relation to the nation's innovation policy framework. Investment in new ventures and ideas is inherently high-risk and requires long-term commitment on the part of both the investors and business builders in order to take the venture from inception, to maturity. Consistency in the long-term approach to innovation policy settings is therefore a critical ingredient in helping to provide industry participants with the necessary confidence required to support investment in the domestic innovation ecosystem.

3.1 Modernise the Innovation Investment Fund programme

The Innovation Investment Fund (IIF) was originally a Coalition Government initiative implemented in the early 2000s to develop the pool of Australian VC fund managers and to develop high-growth Australian companies to become globally competitive by commercialising the outcomes of Australia's strong research capability. The programme has played a key role in providing early stage capital to market leading companies such as www.seek.com.au, which is today the largest online jobs-listings business in the world.

However, to date the goal of developing a self-sustaining VC industry has not yet been achieved, contributing to the migration of Australian entrepreneurs to overseas markets where funding is more readily available, and a more supportive policy environment exists. This market failure can be ascribed to a combination of factors including the onset of the global financial crisis, the withdrawal of superannuation funds from investing in VC, and the intermittent and insufficient distribution of the funds in subsequent rounds of the IIF programme over recent years. These factors have led to a "stop-start" approach (with a bias towards more *'stop'* than *'start'*) to financing Australian start-ups over the years, and the inability of local VCs to scale up to meaningfully participate in later-stage investment rounds in tandem with their investees' rapid growth.

In terms of budget impact, the administered capital provided through the IIF has no impact on the Government's fiscal balance. The Government receives an equity share in these investments and has the opportunity to participate in any profits from the funds invested.

In view of this, we recommend that the FSI consider the role of the Government in the context of:

- committing to a new $350 million investment round commencing in 2014;
- establishing a long-term innovation investment programme to address the shortcomings of an intermittent approach to such funding;
- recycling of all profit, capital and interest accruing to the Government from current IIF investments into an ongoing and self-sustaining programme of targeted investment into innovative Australian businesses; and

- an expansion of funding allocation to the IIF to allow the programme objectives to be fulfilled. Even though proceeds are recycled through the Revolving Fund, these returns will take many years to crystallise and it is important that the cycle of supporting innovation remains unbroken so that Australia does not lose the momentum gained by building up the early stage investment sector only to have it falter at later stage VC investment.

In addition, AVCAL believes that there are specific aspects of the programme that can be improved to allow it to more effectively deliver on its policy objective of developing globally competitive high-growth companies in Australia. Our recommendations are summarised below:

3.1.1 Introducing a priority return of capital to private investors

Currently returns on investment go back to both the Government and private investors, with capital and interest being returned first on a pro-rata basis and then any profits shared by the Government and private investors on a 1:9 basis.

Feedback from private investors, particularly institutional Limited Partners (LPs), such as superannuation funds, consistently indicates that a prioritised return to private LPs would be a significant factor in whether or not they would invest in an IIF fund.

This is not a capital guarantee for private investors, and if the fund performs well there will be no impact on the Government's ability to recover its capital over the fund's lifetime. If private investors received their capital back first (or even on an 80/20 ratio) followed by a catch-up for the Government, this would allow them a higher chance of a positive IRR (which is particularly important to institutional investors that need to report regularly on their returns on investment).

3.1.2 Restoring the 2:1 matching requirement

Revising the current 1:1 matching ratio back to the original 2:1 ratio of Government funds to be matched by private sector funds would be an important step in making the programme more attractive to private sector investors. The 2:1 ratio was a key element of Rounds 1 and 2 of the IIF, which included the most successful IIF fund to date with results exceeding many of the most successful VC funds in the US.[7]

Regardless of the matching ratio or priority of returns, the net impact on the Government fiscal balance will be zero as the administered capital provided through the IIF involves the acquisition of financial assets. In addition, unlike most other Australian Government support programmes, the IIF returns money to the Government (to the Revolving Fund and consolidated revenue) from the divestment of fund manager portfolios. The returns reduce the cost to the government and facilitate the re-use of capital into productive investments.

3.1.3 Increasing the revenue and investment caps for eligible investments

The average annual revenue limit for investees at the time of investment needs to be increased from $5 million – a threshold which has remained unchanged since the programme began in 1997 – to accommodate not just the effects of inflation over the past 17 years, but also to provide more flexibility in allowing IIF funds to invest in legitimate early stage companies that do not meet this requirement. It may be appropriate, for example, for the Government to consider aligning this with the eligibility criteria for the 45% R&D refundable tax offset, which

[7] A 2:1 matching ratio is not uncommon in public programmes aimed at developing high-impact investments with correspondingly high levels of risk being borne by the investor. For example, the US Government's US$1 billion Impact Investment Fund under its Start-up Nation initiative provides up to a 2:1 match to private capital to target "impact" investments.

classifies eligible entities as those with an aggregated turnover of less than $20 million p.a. Raising this threshold will enable the funds to invest more effectively to take advantage of promising opportunities than they are able to under the current framework.

In addition, the Government should consider replacing the maximum allowable investment for eligible investee companies from $15 million with a higher cap, as this current amount will soon be too small to suit early stage investments, particularly when factors such as inflation and a growing economy are taken into account.

3.1.4 Reducing red tape and compliance costs

The requirements for IIF licensees are very rigorous and, over time, have imposed a growing compliance burden on the funds involved. For example, legal documentation for IIF funds now typically runs to over 200 pages that fund managers and private investors need to obtain legal advice on.

The costs of compliance are demonstrably more time-consuming, complex, and costly compared to compliance with the standard documentation (commonly around 60-pages in length) for most VC and PE funds that most sophisticated wholesale investors are accustomed to. AVCAL recommends that consideration be given to amending the following aspects of the IIF governing documents which are costly and commercially difficult to satisfy, and replacing them with more flexible structures that will not sacrifice the integrity of the programme:

(i) Replacing the Supervisory Board with an Investment Advisory Committee;
(ii) Replace the requirements limiting the fund manager's investment discretion with a more flexible approach;
(iii) Allow for flexibility in the choice of collective investment vehicle suited to the investors' tax circumstances;
(iv) Remove the requirement for annual audits of investee companies irrespective of size; and
(v) Simplifying the standard governing documents.

3.1.5 Encouraging foreign investment in Australian VC through the IIF programme

With many local institutional investors such as superannuation funds having moved away from investing in Australian venture capital (or having never invested in this category in any significant way to start with), matching private sector funding will increasingly need to come from other sources such as high net worth (HNW) individuals and offshore investors. The pool of HNWs in Australia who are able and willing to invest in a significant way in VC funds is highly concentrated. Offshore investors will become an increasingly important source of matching funding, which means that taking steps to ensure that the programme is attractive to them will be key to its long-term effectiveness and sustainability.

Some targeted liberalisation of the existing IIF rules will greatly help make the programme more attractive to foreign investors, and to foster foreign linkages. These include:

(i) Relaxing the requirement for the fund to invest in an ‘Australian Pty Ltd’ company, and to have the majority of its assets and intellectual property in Australia, or all expenditure in Australia. If the concern is that the foreign investees will benefit at the expense of Australian interests, the Government may wish to consider a selective broadening of eligible investments to include matching investments in specific markets with a similar legislative framework (e.g. New Zealand) or strategic trade partner (e.g. China) as a first step, and review its performance over time to see if the policy objectives are being met. For example, IIF funds that raise a significant amount of matching capital from a foreign government-owned investment entity such as the NZVIF should have the flexibility to make reciprocal investments into New Zealand as well as Australian entities; and

(ii) Allowing Significant Investor Visa (SIV) applicants to invest in IIF funds as an eligible investment for fulfilling the visa requirement.

3.1.6 Reform of the IIF licensee selection process

The current selection process for IIF licensees should be made more flexible to allow for a greater number of genuinely competitive proposals to be considered. Instead of prescribing a set of rules for applicants to comply with, the Government may wish to consider providing broad terms of reference for applicants and allow managers to be more flexible with their fund structures, and pitch their best bids in a competitive process. The selection committee can then select from a wider range of proposals that all have the potential to meet the stated policy objectives, while being suitably structured for the fund's specific investment focus and investors. This will result in as larger number of interesting and different ideas, and by not ruling out certain structures from the outset will allow managers to tap a wider pool of potential investors than the programme would otherwise attract.

Manager selection should continue to be based on merit (regardless of whether the manager can be considered "experienced" or "new") and the manager's ability to attract matching capital from private sources should be the test of whether the manager is suitably qualified to apply for a license.

In addition, the fund manager selection process needs to be completed in a more transparent manner, and within a specified limited timeframe, to minimise uncertainty for private investors while awaiting the outcome of the selection process. The longer the selection process, the higher the opportunity cost incurred by private investors when they could be opting to deploy their capital elsewhere.

3.2 Introduce R&D quarterly tax credits for early stage companies

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 regime has had very a significant positive impact on serving to support domestic businesses investing in innovation, as well as attracting businesses from offshore to re-locate their R&D operations to Australia. The regime 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 will often commit large allocations towards R&D activities. Stability and certainty in relation to the operation of the R&D system is therefore a fundamental driver of realising the policy objectives of the regime.

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 a practical sense, companies businesses 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.

A move to quarterly R&D tax credits would alleviate some of the cash-flow constraints that these companies face. 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 R&D tax credit, and the proposal to allow for quarterly payments to eligible businesses, is also an important incentive for offshore investors to put money into Australian companies. 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.

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. While there is a perceived risk in relation to the difficulty of clawing back overpayment of credit due to the risk profile of these early stage companies, integrity rules similar to those used for the GST and income tax can be put in place to mitigate the risk. More generally, the risk profile of these companies is not dissimilar to many other SMEs, which are a vital part of the Australian business landscape.

AVCAL does 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.

3.3 Reform of the Employee Share Scheme tax framework for early stage companies

Early stage companies seeking to attract the best talent are often starved of cash, and therefore turn to offering shares or share options in the business as a form of compensation to employees. These schemes also act as powerful incentives to employees to commit to the future success of the venture.

The current legislation on employee share option plans (ESOP) and employee share schemes (ESS) came into effect in July 2009. Under these rules, gains are assessed as ordinary income and can be taxed prior to the gains being realised.

These ESOP and ESS arrangements offer a far less attractive environment in which start-ups can operate and retain highly skilled employees. Valuable human capital continues to move from Australia's tech hubs to the Silicon Valley and other jurisdictions for lack of a best-practice innovation ecosystem (along with the requisite policy settings) in Australia.

AVCAL's position is that employees of start-ups who receive benefits under ESOPs and ESSs should only be taxed when a realisation event occurs, and this should only be on capital account. The approach should also be simple and low cost; and utilise an appropriate definition of 'start-up companies'.

In AVCAL's view such a regime would represent an appropriate balance between protection of the revenue, creating incentives for employees to work in Australian start-ups and reducing cost and complexity. Ultimately, reforming current ESOP and ESS rules would pay dividends to the Australian economy in years to come as more capital and talent is attracted to our shores.

The Government should accelerate the implementation of reforms to un-wind the negative impact of past changes to the tax rules in this area, and to help to drive greater investment in start-up businesses in Australia. There is a Government-led inquiry into potential reforms to the employee share scheme rules for start-ups already underway at the moment (led by the Department of the Treasury). Further details are available in AVCAL's submission to the Government's January 2014 consultation paper on 'Employee Share Schemes and Start-Ups' (see http://www.avcal.com.au/documents/item/781).

3.4 Strengthen the nexus between publicly-funded research and economic outcomes

Private capital can be more effectively deployed into early stage companies and innovation if there is a productive, collaborative and aligned relationship between the business and academic sectors in Australia. This will allow Australia to harvest greater economic and productivity benefits from the public funding of R&D in universities and research centres. It will also help reduce the number of missed economic opportunities from viable but non-commercialised research.

To address impediments that limit the amount of collaboration between business and universities and publicly funded research agencies, some suggestions for further consideration by the Government include:

- Better alignment of publicly funded research with Government initiatives supporting commercialisation;
- Fine-tuning of incentives for publicly-funded researchers to collaborate to commercialise their research; and
- Greater business sector input in the strategic allocation of university research funding.

3.4.1 Better alignment of publicly funded research with Government initiatives supporting commercialisation

The Government currently spends around $9 billion each year in supporting science, research and innovation, of which $2.8 billion (an amount which exceeds the size of the entire domestic VC industry in Australia) is spent on university research funding.[8] To date, very little of this investment has led to a commercialised result. In the ten years to June 2013, the Australian VC industry was able to invest only $154 million per annum (on average) in early stage companies, and this amount has been declining in recent years.

Reflecting the low priority given to the translation of publicly funded research to commercial outcomes, total Government support for commercialisation amounted to only $0.2 billion (or 2% of the federal budget allocation for research and innovation) in 2012.[9]

To this end, the FSI should consider how the Government can better align the national research and commercialisation agendas to ensure that they provide the correct balance between the pipeline of R&D and the capacity of investment to commercialise that research. To this end, the Government ought to examine the optimal size of commercialisation programmes (such as the Innovation Investment Fund programme), and how supporting structures such as the ES/VCLP regime can be improved to facilitate this alignment on a more effective basis going forward.

3.4.2 Fine-tuning of incentives for publicly-funded researchers to collaborate to commercialise their research

Often, working in academia and embarking on the commercialisation journey are treated as mutually exclusive options for researchers in Australia. There are often few economic (or career) incentives for researchers to invest their time and resources in working on high-risk, early stage start-ups with long-dated payoffs.

Commercialisation also typically occupies only a very small place on the list of priorities for many Australian universities. Widely-followed university rankings and key performance indicators typically focus on research citations, teaching quality and research grants obtained, as key drivers of what constitutes a ‘top ranking’ university.

In addition, the competitive research grants programme tends to focus on publications as a key performance indicator of research outputs, with no clear distinction between the value of publications and conference presentations vis-à-vis more capital-intensive commercialisation outcomes.[10]

To address these structural impediments to taking public-funded innovation to the market, it would be helpful in our view for the Government to consider incorporating into the national research agenda a stronger emphasis on a project's potential commercial impact under its selection criteria and reporting process.

---

[8] Australian Government, Science, Research and Innovation Budget Tables: 2013-14
[9] Australian Government, 2012 National Research Investment Plan.
[10] The ARC's principles on Performance Evidence classify research outputs as the following: "In addition to standard academic publications, research outputs can include grey literature, consultancy reports or reviews, patents and policy advice, competitive grants and other research support, higher degree student completions, major exhibitions, compositions or performances, plant breeding rights, registered designs, invited keynote and speaker addresses and other professional activities and contributions to the research field."

For example, it may wish to examine fine-tuning the selection criteria, reporting template and funding envelope of existing research grant programmes to better align funding with desired outcomes. The Government may, for example, consider setting aside a predetermined proportion of existing competitive research funding to high-potential, game-changing technologies with a clear commercialisation pathway.

In addition, reform of the ESOP/ESS tax framework will also help better define the potential upside opportunity to founder/researchers, and remove a significant barrier which currently acts as a disincentive to them investing their time and resources into bringing their innovations to the market.

3.4.3 Greater business sector input in the strategic allocation of university research funding

Currently there are several bodies that oversee the strategic priorities and allocation of higher education research funding in Australia, but the business sector has relatively little direct representation in this process.

For example, the Australian Research Council (ARC) is a statutory agency that advises the Government on research matters, and its mission is to deliver policy and programmes that advance Australian research and innovation globally and benefit the community. Its current Advisory Council comprises seven academic representatives and only two business representatives.

That notwithstanding, there appears to be a notable lack of business representation in the composition of the ARC College of Experts, which assesses and ranks ARC grant applications.

This is anomalous given that an improved level of collaboration between business and academia is widely considered to be an important objective of publicly funded research. There are no business representatives among the 159 members of the ARC College of Experts. For example, the ARC College of Experts in Engineering, Mathematics and Informatics has 41 members, of which 40 are university academics and one from the Defence Science and Technology Organisation. By contrast, the United Kingdom's ARC-equivalent body, the Engineering and Physical Sciences Research Council, comprises 18 members including an independent entrepreneur, and representatives from businesses such as Microsoft, Procter & Gamble, IBM and Arup, to name a few.

While it is recognised that there will always be a number of important areas of research that do not carry a clear commercial motivation, such as areas of work that enrich Australia and its community in a wide variety of other ways, it should be recognised that the current lack of alignment between business and academia will continue to diverge unless we take the opportunity to arrest the decline as a matter of priority.

The FSI should look at the opportunity for the Government to consider modernising the composition of the various committees that oversee research funding in order to ensure that appropriate private sector input is taken into account to facilitate the effective and productive allocation of what is a very significant overall amount of public funding to the academic research sector.

****

If you would like to discuss any aspect of this supplementary 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