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Submission from Arnold Bloch Leibler

Draft Legislation: Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017

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1 Introduction

1.1 This submission has been prepared by Arnold Bloch Leibler in response to the Australian Government's request for feedback on draft legislation, released as part of the 2017-18 Budget, to extend crowd-sourced equity funding (**CSF**) to proprietary companies.

1.2 We consider that the draft legislation is a significant step forward in expanding the funding options available to start-up companies and other small-to-medium sized enterprises. The increased ability of proprietary companies to raise capital will assist in fostering innovation and entrepreneurialism in Australia. The legislation also reduces the competitive disadvantage faced by Australian companies, given that companies in other jurisdictions, such as New Zealand and the United Kingdom, are already allowed to raise capital under a CSF offering.

1.3 Permitting a certain level of public investment in proprietary companies increases the capital sources available to proprietary companies. However, it also carries risk for less sophisticated shareholders, particularly in light of the fact that proprietary companies have less comprehensive corporate governance requirements compared to public companies. Given that a proprietary company will cease to be closely-held following a CSF offer, the information asymmetry will likely increase after the offer. The Government has therefore sought to ensure that greater transparency and accountability is provided as a means to protect CSF shareholders.

1.4 The draft legislation takes into account this need to strike a balance between maintaining the structural benefits of proprietary companies while also ensuring that CSF shareholders, and their interests, are sufficiently protected. While the draft legislation aims to take into account the interests of both the managers of proprietary companies and their CSF shareholders, we consider that certain issues under the legislation need to be addressed to truly create a fair balance and make CSF a viable financing alternative for proprietary companies. Any uncertainty in the CSF regime will ultimately deter companies from using CSF as an alternate source of capital raising.

2 Proposed amendment to shareholder cap for proprietary companies

2.1 Currently, under section 113(1) of the *Corporations Act 2001* (Cth) (**Act**) a proprietary company may only have 50 non-employee shareholders (**50 Member Cap**). If the number of shareholders in the company increases above this cap, then the company must convert to a public company.

2.2 The draft legislation proposes to amend this section to exclude CSF shareholders (as well as employee shareholders) from the 50 Member Cap for proprietary companies. The proposed definition of a CSF shareholder of a proprietary company is "*an entity that holds one or more securities of the company as the result of being issued with the securities pursuant to a CSF offer by the company.*"

2.3 The purpose of this amendment is to ensure that a proprietary company's ability to use the CSF regime is not limited.[1] Without this amendment there is little incentive for proprietary companies to raise capital under a CSF offer if they wish to remain as a proprietary company, as most would exceed the 50 Member Cap on making the CSF offer. Under the proposed legislation a proprietary company can have a much larger number of CSF shareholders and still remain a proprietary company, provided the number of non-employee shareholders does not exceed the statutory limit.

[1] Draft Explanatory Memorandum, Corporations Amendment (Crowd-sourced funding for Proprietary Companies) 2017 Bill 8 [1.15].

2.4 However, it is only the person who receives securities "as a result of" the issuing of shares under the CSF offer" that is excluded from the 50 Member Cap. Any transferee of those shares will be included in the 50 Member Cap. Given each CSF shareholder can only commit a maximum of $10,000 in a 12-month period, the 50 Member Cap could be breached relatively quickly once shares start to be transferred following a CSF offer.[2]

2.5 For the purposes of the 50 Member Cap, the proposed approach is too restrictive. It captures the transfer of shares to a related entity of the CSF shareholder, not only a transfer to a third party. As example 1.1 in the draft Explanatory Memorandum demonstrates, where the initial CSF shareholder transfers her shares to a person entirely unrelated to her, due to her dissatisfaction with the company's management, the purchaser is counted for the purposes of the 50 Member Cap. However, where the CSF shareholder is merely restructuring their affairs, this should not impact the 50 Member Cap. A transfer to a related entity does not have the same effect in terms of ownership passing to a person entirely removed from the initial CSF offer.

2.6 In our submission a transfer of shares from a CSF shareholder to a related entity should not be counted towards the 50 Member Cap. This change supports the legislative purpose in that it will allow the proprietary company to raise capital utilising a CSF offer while remaining a proprietary company. The legislative purpose could be frustrated if a proprietary company is forced to transition to a public company due to some of its CSF shareholders reorganising their affairs. This has the potential to occur under the current draft legislation.

2.7 In order to provide certainty to the company in determining whether the transferee is to be counted for the purposes of the 50 Member Cap, the company should be entitled to rely on a certificate from the CSF shareholder confirming that the transferee is a related entity of the CSF shareholder.

3 Transitioning between company types

3.1 As a preliminary point, we agree that additional corporate governance obligations are necessary for a proprietary company that utilises the CSF regime given the company would cease to be closely-held. Imposing these additional obligations beyond what is normally required for a proprietary company will however result in compliance costs that a proprietary company would not otherwise incur. These costs are intended to be lower than the costs that would be incurred if the company converted to a public company.[3]

3.2 Given that this is the legislature's intention, we consider that the draft legislation does not fully support this outcome. This is due to the risk that a proprietary company undertaking a CSF offer may be forced to convert to a public company (and therefore bear the additional costs associated with being a public company) because of events beyond the control of the company.

3.3 As noted in section 2, proprietary companies may easily breach the 50 Member Cap following a CSF offer due to transfers of shares by CSF shareholders. By way of example, if a company sought to raise the maximum amount permitted, being $5 million, with each investor committing $10,000, this would result in the company having 500 CSF shareholders in addition to any existing members. The company would breach the 50 Member Cap if only 10% of its CSF shareholders were to transfer their shares. Whether a CSF shareholder transfers their shares is ultimately outside the control of the company. However, under the legislation as currently proposed, where there is sufficient trading in the CSF shares the company will be forced to convert to a public company when that is not its desire or intention.

[2] *Corporations Act 2001* (Cth) s 738ZC(1).
[3] above n 1, 3.

3.4 This is unfair to the proprietary company as it will lose the financial and structural benefits of remaining a proprietary company as a result of the actions of certain of its CSF shareholders and not through its own actions or as a result of a decision made by its board of directors. This could occur at a time when the company has raised no further capital and may not be in a position to bear the additional costs of becoming a public company. It may force the company to raise additional capital at a time that is not advantageous leading to an unnecessary dilution of the existing shareholders, including the CSF shareholders.

3.5 Unfairness may also result from the fact that the changes to the governance structure may alter commercial outcomes for the company and its shareholders. For example, a shareholder holding more than 20% of the shares in the company may have invested time and money in making an offer to smaller shareholders. The shareholder may however be compelled to withdraw this offer upon conversion to a public company, given that the takeover provisions in Chapter 6 of the Act would come into effect upon conversion.

3.6 We agree that, following the raising of capital under a CSF offer, a proprietary company should not be able to remain as a proprietary company indefinitely even though its shareholder base changes. Nonetheless, the current draft of the legislation does not allow the company to entirely control the timing of the conversion. The decision to convert to a public company is one for the board of the company and should not be dictated solely by the actions of its shareholders.

3.7 In order to avoid this unintended consequence we consider that further conditions should be required to be satisfied before a proprietary company must convert to a public company. In our submission, once the 50 Member Cap is exceeded due to the transfer of shares by CSF shareholders, the company should then only be required to convert to a public company if:

(a) it has undertaken a further capital raising that has increased the number of non-employee shareholders; or

(b) a designated period (say two years) has elapsed from the date on which the company first exceeded the 50 Member Cap.

3.8 The purpose of the draft legislation is to allow proprietary companies to benefit from the CSF regime without the burden of converting to a public company. This strengthens the argument for the conversion to a public company to take place at a time of the company's choosing instead of being triggered solely by the actions of its shareholders. The introduction of these additional conditions allows for a gradual and controlled transition between company types, rather than the company being in a situation where it is unexpectedly forced to convert to a public company and having to then comply with the additional regulatory burdens and costs. Easing companies through this conversion, which is arguably inevitable once CSF offers are made, will help make the CSF regime more attractive to proprietary companies and increase its use by proprietary companies.

4 Corporate governance on converting to a public company

4.1 The corporate governance obligations of a public company are significantly greater than those of a proprietary company, even a proprietary company under the proposed CSF regime.

4.2 The *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) created corporate governance concessions for new public companies and for proprietary companies that converted to become public companies in order to be eligible to make a CSF offer. These companies are eligible to comply with the limited corporate governance requirements provided they meet the eligibility requirements in section 738ZI of the Act. The concessions included that eligible companies:

(a) have no obligation to hold an AGM;

(b) are able to provide shareholders with financial reports via a website; and

(c) are not required to appoint an auditor unless more than $1 million is raised from all CSF offers ever made by the company.[4]

4.3 The draft legislation restricts the availability of these concessions to companies that either registered as a public company or converted to a public company in order to be eligible for the CSF regime prior to this draft legislation being enacted. As a result, a proprietary company that converts to a public company after this date would not seem to be eligible to benefit from these concessions.

4.4 We disagree that the corporate governance concessions are no longer required solely because proprietary companies are not required to convert to access the CSF regime.[5]

4.5 In our submission there should be transitional corporate governance concessions for a proprietary company with one or more CSF shareholders that is required to convert to a public company (**CSF Converted Company**). We propose that the corporate governance concessions originally provided by the *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) should be extended to CSF Converted Companies. We acknowledge that a CSF Converted Company cannot benefit from these concessions indefinitely and should eventually be required to comply with the normal obligations and reporting requirements of a public company. We propose that a CSF Converted Company may only benefit from these concessions for a nominated period, say up to five years, following its conversion date.

5 Legislation by regulation

5.1 We note that the eligibility requirements for the CSF regime may be prescribed by regulations.[6] While we are comfortable with this process and agree that the government needs to be able to intervene quickly if necessary, we are concerned that determining eligibility partially through regulations has the ability to make the CSF regime uncertain for companies investing time and money to use it, and for the CSF intermediaries who build the platforms from which CSF offers can be made.

5.2 Any regulations enacted for the purpose of the CSF regime should not have retrospective application. Companies will plan their structures and undertake capital raisings based upon the law as it stands at the relevant time. It would be unfair to alter the law retrospectively as companies cannot prepare for this.

5.3 There are also issues if the regulations have immediate effect upon enactment. Uncertainty about the application of the regime will undermine confidence in utilising the CSF regime to raise capital. We submit that any regulations enacted pursuant to the CSF regime should allow for a suitable transitionary period in order to enable companies seeking to make a CSF offer, and the CSF intermediaries, to adjust their offerings accordingly.

6 The Exit arrangement trigger

6.1 The draft legislation proposes to exempt proprietary companies undertaking a CSF offer from the takeover provisions in Chapter 6 of the Act. Overall we agree with this proposal,

[4] *Corporations Act 2001* (Cth) ss 250N(5), 250N(6), s 301(5) and s 314(1AF).
[5] above n 1, 16 [1.57].
[6] ibid 7 [1.10].

given that compliance with the takeover provisions will inhibit the funding opportunities available to proprietary companies and undermine the ultimate purpose of undertaking a CSF offer.

6.2 We are concerned that the current definition of appropriate CSF exit arrangements which must be included in a company's constitution to benefit from the takeover exemption is too restrictive. The current draft provides that the constitution must include a provision whereby a person who acquires a relevant interest in voting shares that increases the person's voting power above 40% must offer to purchase all other securities in the company on the same terms as their own acquisition within 31 days (**Exit Offer**).

6.3 The importation of the concepts of "relevant interest" and "voting power" into the proprietary company environment appears, in the first instance, to be a sensible way to set the trigger for the Exit Offer.

6.4 However, it is typical for the constitution or the shareholders agreement of a proprietary company to provide for the following arrangements:

(a) pre-emptive rights - under which the remaining shareholders have the right to acquire the shares of a selling shareholder;

(b) drag-along rights - under which the majority can compel the minority to sell their shares along with the majority as part of a sale transaction; and

(c) tag-along rights - under which the minority can compel the majority to allow the minority to sell their shares along with the majority as part of a sale transaction.

6.5 As the pre-emptive rights and the drag-along rights are likely to confer on shareholders the "power to control the exercise of a power to dispose of the shares" held by the other shareholders it may well be the case that the controlling shareholder holds a "relevant interest" and therefore "voting power" in 100% of the shares in the company from the outset. This is the case even though the controlling shareholder can only physically vote the shares attaching to its own shareholding.

6.6 We note that section 609(8) of the Act provides that a member of a company does not have a relevant interest in the company's securities by virtue of the inclusion in the company's constitution of pre-emptive rights on the transfer of securities. This provision only applies if the pre-emptive rights are given to all members on the same terms.

6.7 Section 609(8) has limited application. It only applies to pre-emptive rights and not to drag-along rights. In addition, it is more commonplace for a proprietary company to include pre-emptive rights in a shareholders agreement, rather than in the company's constitution. Given this, and notwithstanding the operation of section 609(8), it will still be possible for a controlling shareholder to have a "relevant interest" and "voting power" in 100% of the shares in the company from the time that the controlling shareholder first invests in the company. The Exit Offer would therefore be unable to be invoked at the time that the controlling shareholder's shareholding increases to the point that the number of its shares exceeds 40%.

6.8 To avoid this outcome, we submit that the concept of "relevant interest" for the purposes of the definition of "appropriate CSF exit arrangements" should be amended to exclude a "relevant interest" arising as a consequence of the exit arrangements provided for in the company's constitution or shareholders agreement.

7 The Exit Offer arrangement

7.1 As currently drafted the Exit Offer must come from the person who acquires the relevant interest in the voting shares that increases the person's voting power in the company. We consider that such a requirement is particularly undesirable in the context of start-up companies. The founders of the company may wish to limit the level of control that equity investors are able to gain.

7.2 By way of example, say that the founders have established a start-up company. Following a CSF offer they have raised further capital from a venture capital fund. As a result, the founders have retained 40% of the shares in the company, the venture capital fund holds a 36% interest in the company and the CSF shareholders hold the remaining 24%. Following the exercise of options that were granted to the venture capital fund, and which are expiring, the venture capital fund's shareholding will increase to 41%. Under the proposed legislation, upon the exercise of the options, the venture capital fund would be required to offer to buy all the other securities in the company at the same price and on the same terms as it will acquire additional shares on the exercise of the options. If all the CSF shareholders decide to sell their shares under this offer, the venture capital fund would then gain effective control of the company to the detriment of the founders. While this exit arrangement ensures minority shareholders are given the opportunity to exit the company on favourable terms, it may be undesirable to the founders.

7.3 Consequently, we submit that the CSF exit arrangements should allow any person to make the offer to acquire the remaining securities in the company if a person's voting power increases above 40%, not only the person whose voting power increases. Defining the exit arrangement in this manner does not prejudice or displace minority shareholders. They still have the same opportunity to participate in the exit arrangement. The only difference is that other remaining shareholders, including the founders, could participate in the making of the offer and control of the company would not be impacted as a result.

8 Conclusion

8.1 We support the introduction of the new legislation.

8.2 In our submission, the Bill should be amended to allow for:

(a) the exclusion of transfers to related persons by a CSF shareholder from the 50 Member Cap;

(b) a more controlled process for a proprietary company to convert to a public company through:

(i) requiring conditions to be satisfied in addition to exceeding the 50 Member Cap before a proprietary company must convert to a public company; and

(ii) extending the corporate governance concessions under the *Corporations Amendment (Crowd-sourced Funding) Act 2017* (Cth) to CSF Converted Companies;

(c) the "relevant interest" definition to work appropriately in relation to an Exit Offer, given that a proprietary company may have a shareholders agreement and may impose drag-along rights as well as pre-emptive rights on shareholders; and

(d) the Exit Offer to be capable of being made by any shareholder, not only the shareholder whose voting power exceeds 40%.

8.3 We also recommend that changes to the CSF regime regulations should provide suitable transitionary periods before becoming effective to ensure certainty.

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