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Dear Sir or Madam

Consultation Paper *Facilitating crowd-sourced equity funding and reducing compliance costs for small businesses*

I am writing on behalf of the Australian Securities & Investments Commission (**ASIC**) to provide comments on the Government's Consultation Paper (**CP**) *Facilitating crowd sourced equity funding and reducing compliance costs for small businesses*.

Crowd-sourced equity funding framework for public companies

ASIC's main interest in the regulation of crowd-sourced equity fundraising (**CSEF**) for small businesses and start-ups is to ensure the appropriate balance between public companies' effective use of CSEF and the need for investors to be confident and informed. As we noted in our submission dated 6 February 2015 in response to Treasury's Discussion Paper *Crowd Sourced Equity Funding*, confident and well-informed investors are more likely to continue to participate in CSEF, which is important in ensuring CSEF becomes a sustainable funding option for businesses in the long term.

Crowd-sourced equity fundraising has the potential to significantly impact the way in which equity fundraising is carried out in Australia. For instance, approximately 25% of companies listed on ASX have a market capitalisation of less than $5 million and 36% have a market capitalisation of less than $10 million, which demonstrates the potential disruptive impact the proposals may have on traditional equity fundraising methods. As you would appreciate, CSEF investors' access to information about their investment and their ability to exit their investment will be far less than would be the case than if the investment was made in a listed company.

It is with this background that we have made some comments below concerning the CSEF framework for public companies, although no specific questions have been asked in the CP.

Investor risk

CSEF by small businesses and start-ups is a very high risk form of investment[1]. ASIC therefore supports the Government's proposed CSEF model for public companies incorporating annual investment caps for retail investors. It is also important that retail investors will be provided with a risk warning and required to complete a risk acknowledgement statement. We note that intermediaries will have a key role to pay in ensuring the investment opportunity offered to investors via their CSEF platform is not simply a scam. ASIC agrees that these are appropriate features for a high risk form of fundraising and help focus investors on whether they are comfortable with the risks involved in the CSEF investment.

Eligibility test and funding cap

We consider that the fundraising cap should be set at a level that does not give rise to a significant risk of regulatory arbitrage. On this basis we suggest that the fundraising cap of $5 million should be reduced by the company's assets and $5 million should be the maximum that a company can raise using CSEF (i.e. not an annual cap). If the fundraising cap is not reduced by the company's current assets, small businesses will likely need to compete for CSEF with relatively large, well-resourced companies.

We further note that the CSEF limits of regimes in other jurisdictions, including United States of America, New Zealand and United Kingdom, have set a lower fundraising cap.

New public company exemptions

The Government's CSEF framework proposes giving newly registered or converted public companies relief from a number of regulatory obligations, which is not a feature of international models. ASIC is concerned about the proposal to provide an exemption from the requirement to prepare audited financial statements when the amount raised is less than $1 million. ASIC considers that companies who engage in public fundraising should be required to prepare audited financial statements in order to provide appropriate accountability to investors. Small listed companies, many of which are similar size or smaller than the public companies eligible to use the proposed CSEF model, accept the need for audited accounts as consistent with accessing public equity funding.

We also note that the CSEF regimes in other jurisdictions have not given companies exemptions from corporate governance requirements.

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[1] In a review of crowd funding for the International Organisation of Securities Commissions, Kirby and Worner (2014) estimated that the risk of default and/or investment failure in CSEF ventures was around 50%. Cited in *Business Set-Up, Transfer and Closure*, draft report by the Productivity Commission, May 2015.

We are concerned that if the exemptions are introduced, they will lead to inconsistent reporting by public companies. There will be a higher obligation on a company that does not raise funds through CSEF than one that does raise funds. This creates a risk of regulatory arbitrage and investor confusion.

Platforms restricted to primary offers

ASIC believes that it is important that CSEF platforms are restricted to primary offers and not extended to secondary trading under the proposed CSEF framework. That is, all secondary trading should occur on a licensed financial market, the typical requirements of which ensure sufficient information to support secondary trading, and other investor protection requirements. As an observation, meeting the obligations of a current licensed financial market under the current regulatory requirements would likely be prohibitive for CSEF platform intermediaries. For that reason, we think there is an important need for a more graduated markets licensing regime to be developed.

Anti-avoidance mechanisms

We recommend that anti-avoidance provisions be included in the regime to ensure that the fundraising and audit exemptions are not misused. For example, these mechanisms could aim to ensure that non-eligible public companies do not incorporate new subsidiaries to take advantage of the exemptions for newly created public companies. It may also be useful for ASIC to be given powers to determine the regime and exemptions cannot be used in certain ways. This would be similar to a power the New Zealand Financial Markets Authority has over their CSEF regime.

Foreign businesses use of CSEF

We note that the Government's proposed CSEF framework is restricted to public companies incorporated in Australia. ASIC has identified an increasing trend of foreign-based businesses raising funds from Australian investors via Australian incorporated entities but with a foreign operating company. If these types of entities were able to utilise the CSEF regime, that funding would be used to support a business that was primarily located offshore. The Government may wish to consider whether that is consistent with the intent of the CSEF regime. If it is not, eligibility criteria could restrict the regime to companies that solely or predominantly carry on, or propose to carry on, business in Australia.

Increasing flexibility in capital raising activity for small proprietary companies

ASIC considers there is no commercial or legal imperative for changing the well-established distinction between proprietary and public companies. Public companies are permitted to raise funds from the public because they are subject to more corporate governance, transparency and financial reporting requirements. A proprietary company who wishes to seek funds from public investors can convert to a public company with relative ease, the main requirement being a shareholders' special resolution.

ASIC also queries whether proprietary companies have difficulty raising funds due to lack of investor appetite rather than compliance with legal requirements. The Productivity Commission's draft report *Business Set-up, Transfer and Closure* published in May 2015 provides detailed commentary on new businesses' access to finance. The draft report states 'Discussions that the Commission has had with a range of stakeholders during the course of this inquiry suggests that in many of the cases where finance could not be obtained, the organisation lacked a viable business case or was unable to demonstrate it to a reasonable level of detail. (at page 110)'. The report also stated:

> *A business with unproven, limited or volatile revenue streams is unlikely to be viewed as an attractive investment by either debt or equity financiers.....Given the nature of new businesses – which are often founded using unproven business models, with limited assets and by owners with limited business experience – there will always be a proportion of new businesses that find it difficult to access finance. Indeed, that such businesses are not successful in obtaining external finance does not suggest that there are problems with the finance system, but rather that investors are engaging in a rational consideration of the risks, costs and benefits involved with financing each new business" (at pages 121-122)*

Appropriateness of the shareholder limit

Q.1 *Should the law be amended to increase the permitted number of non-employee shareholders in a proprietary company and what would be the appropriate limit?*

As indicated in the CP, the principle of proprietary companies being closely held underpins the entire regulatory framework for proprietary companies. In this context, ASIC considers that 50 non-employee shareholders is the appropriate limit for proprietary companies. In this regard, we note that:

- more than 50 shareholders is the test for whether an unlisted public company is subject to Chapter 6's takeover regime: s602(a)(i); and
- an entity will be a disclosing entity if it has issued securities under a disclosure document and securities in that class have been held by 100 or more persons at all times since the issue: s111AF.

We note that the Parliamentary Joint Committee on Corporations and Financial Services (**PJC**) considered increasing the shareholder limit for proprietary companies in 2008 and concluded that there was no need for an increase. Also one of the recommendations of the PJC 2012 report on *Family Business In Australia* was that Treasury should consult with representatives of the family business sector about the effect of s113.

Q.2 *What are the benefits and risks? For example, would raising the limit expose risks to shareholder protection?*

Proprietary companies are subject to less corporate governance and transparency requirements on the basis that they are closely held. If the permitted number of shareholders is increased, there is a risk that the larger number of non-employee shareholders will not have the protections and information they need.

The proposal also involves a risk of regulatory arbitrage due to the higher ongoing regulatory obligations imposed on public companies.

Another disadvantage of increasing the shareholder cap for proprietary companies is that it changes the basis on which existing shareholders have invested (i.e. that the number of non-employee shareholders will be no more than 50 and there is some protection against them being excessively diluted). If the permitted number is increased, consideration might be given to precluding existing proprietary companies from increasing their non-employee shareholders above 50 without a special resolution (similar to the requirement for a change of company type).

Q.3(a) *Have there been changes to market practice or the broader operating environment such that shareholders and investors now have greater access to management or information about a company's performance?*

Email, internet and social media make it easier and more cost effective for management to communicate with shareholders but do not compel them to do so. Stakeholders have the ability to obtain credit reports and other data about entities but this can be time consuming and there are costs involved.

Q3(b) *What are the ways by which management now remains accountable to shareholders or shareholders otherwise have access to information about a company?*

We have attached Infosheet 188 *Disputes about your rights as a proprietary company shareholder*, which provides some information relevant to this question.

Directors of proprietary companies are subject to directors' duties in Ch 2D but shareholders of public companies have more rights. Public companies are subject to enhanced corporate governance arrangements, including:

- restrictions on related party transactions (Ch 2E);
- financial reporting requirements (see Ch 2M – which does not apply to proprietary companies other than large proprietary companies);
- restrictions on directors voting on matters of personal interest (s195);
- special rules for the appointment and removal of directors (s201E and s249H(3);
- a requirement for at least 3 directors, 2 of whom are resident in Australia (s201A(2); and
- a requirement to hold an AGM (250N).

Q.4 *If the shareholder limit were increased, how should the law treat public companies which become eligible to be registered as proprietary companies but have issued shares under a disclosure document?*

A company with securities issued under a disclosure document would remain a disclosing entity if the securities have been held at all times by 100 or more persons: s111AF. This is appropriate to minimise regulatory arbitrage and promote the transparency that the disclosing entity provisions are based on.

Small-scale offering exemption

Q.5 *Should the law be amended to increase the 20 investor limit and/ or the $2 million cap? What would be an appropriate limit? Should the $2 million cap be linked to increase in line with the consumer price index (CPI)?*

If CSEF were not extended to proprietary companies, ASIC supports increasing the $2 million cap in s708(1)(b) to $3 million and then in line with CPI over time. The $3 million figure would approximately reflect CPI increases since the exception was introduced.

Q.6 *What are the benefits and risks of increasing the 20 investor limit and/ or the $2 million cap? Who would benefit or bear the risk? Could there be unintended consequences from altering these limits, for example in terms of the definition of a sophisticated investor?*

Increasing cap in line with CPI appears to be a logical update in accordance with the broader economy. It would also be logical to apply consistent changes in s1012E.

Q.7 *Could other exceptions to the requirement to issue a disclosure document provide benefits to small proprietary companies if amended?*

ASIC considers that current exemptions in s708 are appropriate for proprietary companies but their use of the small-scale offerings exemption could be facilitated as an alternate to extending CSEF:

- The small-scale offering exemption is restricted to personal offers. In order to be a personal offer, the offer may only be accepted by the person to whom it is made: s708(2)(a). This requirement could be amended to make it clear that associated persons might invest, for example, a family company.

- A personal offer includes an offer to a person who is likely to be interested in the offer having regard to the person's statements or actions which indicate they are interested in offers of that kind: s708(2)(b)(iii). CSEF intermediaries could facilitate fundraising by proprietary companies by providing a database of investors who are interested in investing in proprietary companies under the small scale offering exemption[2]. Intermediaries could

[2] Subject to retail investors providing the intermediary with appropriate risk acknowledgement.

also host profiles of proprietary companies seeking investors, subject to similar obligations contained in the Government's model for CSEF by public companies.

Q.8 *Would increasing the shareholder limit for proprietary companies and/ or expanding the small scale offering exemption to the disclosure requirements provide small proprietary companies with sufficient additional flexibility to raise capital?*

Expanding the small-scale offering exemption as indicated in our answers to Questions 5 – 7 would give small proprietary companies appropriate additional flexibility to raise capital. In this regard, we note that the Productivity Commission's draft report on business start-ups stated that the regulations around equity raising by private companies and the related disclosure requirements were not raised as an issue by participants to their inquiry (at page 143).

Extending crowd-sourced equity funding to proprietary companies

ASIC has concerns about extending CSEF to proprietary companies beyond the measures outlined in our answer to Question 7. Permitting proprietary companies to engage in CSEF is likely to have the effect of distorting the long understood and accepted distinction between proprietary and public companies. This may not be either necessary or desirable. As a general proposition it would be preferable for companies which engage in public fundraising in whatever form to be public companies, with appropriate accountability to their shareholders.

Q. 11 *Should any increase in the shareholder limit solely for proprietary companies using CSEF be temporary, based on time and size limits? What are the benefits and risks of this approach?*

and

Q. 12 *If permitted to access CSEF, should proprietary companies using CSEF be subject to additional transparency obligations when raising funds via CSEF?*

Temporary changes to shareholder limits and transparency obligations to facilitate CSEF will likely introduce unnecessary complexity. Reducing shareholder numbers is also likely to be costly.

If CSEF is extended to proprietary companies, there should be a permanent increase to the permitted number of shareholders (subject to the requirement for a special resolution, as referred to in our answer to Question 2). Companies who elect to have an increased number of shareholders should be subject to enhanced transparency obligations until they would be eligible to convert back to a small proprietary company with no more than 50 non-employee shareholders

Q. 13 *Do you consider that an annual fundraising cap of $5 million, and eligibility caps of $5 million in annual turnover and gross assets are appropriate for proprietary companies using CSEF? If not, what do you consider would be appropriate fundraising caps and eligibility criteria?*

ASIC has concerns about extending CSEF to proprietary companies beyond the measures outlined in our answer to Question 7.

Q. 14 *Are there any other elements of the CSEF framework for public companies that should be amended if proprietary companies were permitted to use CSEF?*

ASIC considers that if CSEF is introduced for proprietary companies, the limit should be the same as applicable under the small-scale offering exemption and those companies should be subject to the same corporate governance and financial reporting requirements as public companies using CSEF.

Reducing compliance costs for small proprietary companies

The solvency resolution

Q. 15 *Should the requirement to make a solvency resolution be removed or modified? Is there a more effective way to remind directors of their obligations? For example, would aligning the timing of the resolution with tax or other obligations with fixed timing reduce the regulatory burden?*

ASIC would be concerned with removing the important requirement for directors of small proprietary companies to pass a solvency resolution if the company is not lodging a financial report. This requires directors to turn their mind to the solvency question and is likely to be important from a behavioural economics perspective. Operating any company solvently is fundamental to running a business and insolvent trading could have significant adverse impact on creditors, customers and suppliers.

Q. 16 *What is the extent of the burden imposed on small proprietary companies to make the resolution in terms of time and/ or financial cost?*

The obligation to pass a solvency resolution once per year is not onerous, especially given that directors should be regularly monitoring the company's financial position in order to properly run their business and also to comply with s588G. The requirements also do not appear to be resulting in widespread compliance problems. According to ASIC lodgements in 2014-2015 there were only 73 instances where companies failed to pass a solvency declaration and a further 64 instances where the company indicated it was not solvent.

Q. 17 *What is the value to directors of the annual solvency resolution in reminding them of their ongoing solvency obligations?*

The requirement to pass a solvency resolution focusses the directors' attention on the company's solvency. It is a very important pro-active obligation that helps to protect the company's creditors, many of whom will be small businesses.

Q. 18 (a) *Would removing the requirement to make a solvency resolution be likely to increase rates of insolvency or business failure among small proprietary companies? Would unsecured creditors be exposed to increased risk? Are there other risks associated with removing the requirement?*

There is a risk that removing the requirement to pass a solvency resolution will increase the rate of insolvency and also that insolvencies will go undetected for a longer period of time, causing greater hardship to creditors. Given the requirement is not onerous, ASIC questions whether these are risks worth taking.

Q.18(b) *Could the risks be mitigated adequately by ASIC reminding directors periodically (say, annually) of their duty to prevent insolvent trading by the company? Are there other ways to mitigate the risks?*

ASIC does not consider the risks involved would be effectively mitigated by periodic reminders. ASIC considers it is more effective for directors to take the pro-active step of passing a solvency resolution rather than simply receiving a reminder from ASIC regarding compliance with s588G.

Maintaining a share register

Q. 21 *Should the requirement to maintain a share register be removed for small proprietary companies with up to 20 shareholders given ASIC's records duplicate the information in share register of such companies?*

It is consistent with international requirements for companies to maintain a register of members (save in a few instances where bearer shares continue to be permitted - a practice now widely eschewed essentially because of tax avoidance and money laundering implications). We are not aware of any instance where the burden has been, in effect, transferred to a public agency. It is in the interests of companies to maintain proper records of who their members are; and what interests they hold. In these circumstances, the requirement to maintain registers is not unreasonable or unnecessary.

The share register that companies maintain under s168 currently forms the evidentiary basis of share ownership: s176. Replacing the company's share register with the ASIC register would shift that evidentiary basis to a database not controlled by the company (i.e. it would depend on the company's lodgement of documents regarding its share capital and ASIC's processing and maintenance of the register). In addition, currently members can inspect the company's share register without charge under s173(2) whereas charges are incurred for access to shareholder information from ASIC's register under the *Corporations (Fees) Regulations 2001*.

Completing and Lodging Prescribed Forms with Regulator / Other Compliance Costs

As noted in the CP, ASIC is working to remove or amend forms that are redundant or have low regulatory value. We also invited feedback on the removal of these forms as part of Report 391: *ASIC's deregulatory initiatives*. Feedback was generally positive and urged further progress on

making forms available digitally, and making digital forms more responsive. ASIC is progressing these suggestions where possible within existing resources. Many of the amendments we identified require law reform and those suggestions have already been provided to Treasury.

ASIC also sought feedback more generally on unnecessary red tape. There were no areas or measures identified in submissions that were particularly relevant to small proprietary companies.

Conclusion

ASIC strongly supports the Government's efforts to increase fundraising options for public companies and reduce regulation for proprietary companies, subject to ensuring investors in our markets remain confident and informed. We look forward to further working on these important initiatives.

Yours sincerely

John Price
Commissioner
Australian Securities and Investments Commission

ASIC
Australian Securities & Investments Commission

INFORMATION SHEET 188

Disputes about your rights as a proprietary company shareholder (member)

This information sheet explains what you can do if you have a dispute about your rights as a shareholder (member) of a company. These disputes include concerns about holding company meetings and access to company information.

What are disputes about your rights as a company shareholder (member)?

If you own shares in a proprietary company (i.e. one that has 'P/L' or 'Pty Ltd' at the end of its name) you have certain rights, including the right to get information about the operation of the company and the right to request the company hold meetings of members (subject to certain conditions). If the company fails to provide this information or if it doesn't hold general meetings, it can lead to a dispute between the company (and its directors) and members.

Disputes about your rights as a company shareholder can involve:

- accessing the company register
- lack of general meetings
- the company acting contrary to the interests of its members
- company members bringing legal action against the directors.

A company's constitution sets out the obligations and rights of the company, its officeholders (including directors) and members. In that way, the constitution works like a contract. A breach of contract is not a criminal matter. The contract is enforceable through private action taken by the parties to the contract (in this case, the constitution) with disputes being resolved either between the parties involved or, failing that, by the court.

The law also grants rights to members – for example, the right to inspect the company register free of charge and obtain copies of it and, in certain circumstances, the right to request directors hold a meeting of members of the company.

Information sheets provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

What you should do

If you would like to resolve a dispute about your rights, there are a number of options available to you.

Contact the company	Write to the company outlining your concerns and ask for the information that you are entitled to as a member. The following actions may be open to you: • Members with at least 5% of the votes in a small proprietary company may give the company a written direction to prepare a financial report and directors' report and send them to all members. • Members with at least 5% of the votes, or the support of 100 members who are entitled to vote, may give the company notice of a resolution they propose to move at a general meeting. • A member can ask the company to distribute a statement to all members. That statement must be about a matter that can be considered at a general meeting. • Directors of the company must call and hold a general meeting if requested by members with at least 5% of the votes that may be cast at the meeting. The request must in writing, signed by the members making the request and state any proposed resolutions. The directors must call the meeting within 21 days after the request is given to the company, and the company must hold the meeting no later than two months after the request is given.
Seek legal advice	If you have contacted the company to try to resolve the matter and remain dissatisfied with their response, you can also talk to a legal adviser about what you should do next to enforce your rights as a member. If you are unsure about how to access legal advice, contact the Law Society in your state or territory.
Apply for a court order	In some serious cases, if members feel that the directors are not performing their duty to the company, they can start legal action on behalf of the company. To do this you need to contact the court. A court can also make orders requiring the company to act in accordance with its constitution, or to prevent a company from acting in a way that prejudices the members. You should always get legal advice before you start an action in court.

ASIC and disputes about your rights as a company shareholder (member)

ASIC does not get involved in disputes about the running of proprietary companies.

These disputes generally relate to private legal rights of individuals and do not affect consumers or investors in the broader community. For this reason, our role in helping you resolve a dispute is limited to suggesting the best course of action to address your concerns.

Failure by the directors of a proprietary company to comply with a request from members with 5% of the votes is not an offence, but it is something that a court can order a company to comply with. ASIC cannot prosecute the company or its directors for failing to comply with such requests, given it is not an offence.

Where can I get more information?

- For information about our role, see www.asic.gov.au/our-role.
- For information about the laws we manage, see www.asic.gov.au/legislation.
- Download copies of information sheets at www.asic.gov.au/infosheets.

Important notice

Please note that this information sheet is a summary giving you basic information about a particular topic. It does not cover the whole of the relevant law regarding that topic, and it is not a substitute for professional advice. You should also note that because this information sheet avoids legal language wherever possible, it might include some generalisations about the application of the law. Some provisions of the law referred to have exceptions or important qualifications. In most cases your particular circumstances must be taken into account when determining how the law applies to you.