MARQUE

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Manager
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Dear Sir / Madam

Submission on consultation for extending crowd-sourced equity funding to proprietary companies

We welcome the invitation to make submissions on the release of exposure draft legislation intended to extend crowd-sourced equity funding to proprietary companies.

1. Terms of reference

The Government has released for public consultation draft legislation and associated explanatory materials to extend crowd-sourced equity funding (**CSEF**) to proprietary companies. These changes are being progressed as part of the 2017-2018 budget.

The Government has already passed legislation that will establish a CSEF regime for public companies, commencing 29 September 2017. The draft legislation and subject of this public consultation intends to amend the Corporations Act 2001 to include proprietary companies.

2. Who we are

Marque Lawyers is a commercial law firm that aims to do law differently. Our purpose is to redefine the law firm as a collaboration of exceptional (and exceptionally happy) lawyers dedicated to using the power of the law for positive change – for ourselves, our clients and society.

We (being Giselle and Felicia) work in the corporate team at Marque doing anything from capital raising for start-ups to IPOs and large merger and acquisition transactions.

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3. General

3.1 Overview

As new forms of capital raising become increasingly popular, so too does the need to modernise the law. We recognise that CSEF is not a new phenomenon and that these changes are long overdue. It is however crucial that the changes are considered carefully given the high risks involved in permitting large scale offerings to retail investors.

CSEF is generally used for startups and young businesses. Typically, companies use an online portal or intermediary which enables a diverse group of investors (including retail investors) to fund companies in return for equity. Unlike other forms of capital raising usually used for startups and young businesses, CSEF (in particular) allows retail investors to participate in investment opportunities, something which is typically reserved for friends and family of the founders (through the small scale offering exemption) or professional and sophisticated investors.

3.2 The balance

The real crux of the issue is about striking the right balance between investor protections and corporate opportunity.

Typically, when a company makes a large scale offering of its shares to investors (which a proprietary company is prohibited from doing), it is required to produce a heavily regulated disclosure document (usually a prospectus), which is then provided to investors in order for the investors to make an educated decision on whether or not to invest. These disclosure documents can be extremely costly, usually involve extensive financial disclosure, and a thorough due diligence process requiring substantial time and resources.

Due to the limited resources available to start-ups (and the fact they are normally proprietary companies), they are typically restricted to seeking investment from a limited pool of investors that don’t require such disclosure documents.

The push for CSEF has always therefore been about giving young businesses access to a larger pool of investors (and in particular retail investors) without requiring the same level of disclosure as is ordinarily required in a prospectus. The other push for CSEF is that it allows retail investors to invest in companies at an earlier stage than they would normally get access to (an IPO normally being the first point most retail investors have the chance to invest), and therefore have a greater share in the potential growth of that company.

In contrast, allowing young businesses (which statistics show have a higher rate of failure than mature businesses) to offer its shares to less sophisticated investors without having to disclose the same amount of information means that investors are less informed about their potential investment and are therefore at risk of losing the money they invest.

3.3 Corporations Amendment (Crowd-sourced Funding) Act 2017 (**Act**)

In March, the Government created a framework for public companies to use CSEF. The Act gives regulatory relief to public unlisted companies which would otherwise be required to comply with heavy regulatory burdens normally associated with being a public company.

The Act does attempt to juxtaposition investor protections with corporate opportunity by providing maximum investment thresholds and modified disclosure requirements.

In particular, the legislation allows public companies with an annual turnover or gross assets of up to $25 million to use CSEF. These companies can raise up to $5 million a year and investors can invest up to $10,000 a year per company with no limit on the number of companies they invest in.

3.4 Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 (**Bill**)

The biggest grievance after the Act was passed was that it did not apply to proprietary companies. It meant that the Act excluded 99.7% of registered companies in Australia. The current Bill proposes to extend the CSEF regime to proprietary companies. This is of course great news for start-ups. It does however re-introduce the question of adequate disclosure considering the volume of companies that can now use the regime.

Overall we are comfortable with the Bill and believe that it provides a necessary extension of the CSEF regime to proprietary companies, we do however have two comments that we wish to seek clarification on:

(a) how will the 50-member limit be dealt with when CSF shareholders on-sell their shares to non-CSF shareholders; and

(b) how is the change to paragraph 738ZI(a) intended to work— we understand that reporting relief will now only apply to public companies incorporated or converted before the Act comes into force.

These two points are addressed in turn in sections 4 and 5 below respectively.

4. Maximum shareholder threshold subsection 113(1)

The draft legislation proposes to exclude “CSF shareholders” from being counted towards the 50-member limit that currently applies to proprietary companies under the Corporations Act. This change is crucial in overcoming the regulatory roadblocks that currently restrict proprietary companies from participating in CSEF.

The added definition of “CSF shareholder” defines it as “an entity that holds one or more securities of the company as the result of being issued with the securities pursuant to a CSEF offer by the company”.

We are concerned with what happens when CSF shareholders on-sell their shares to non-CSF shareholders. Once a CSF shareholder sells their shares, that new shareholder will no longer be a CSF shareholder for the purposes of section 113 and may tip the shareholder limit past the 50-member limit, resulting in the company breaching the Corporations Act. Given that CSEF is intended to reach a large number of investors, when these investors start selling their shares, it will result in a large number of proprietary companies in the market with hundreds (if not thousands) of non-CSF shareholders.

The explanatory memorandum contemplates this scenario but does not consider the effect on the company. In example 1.1, Hannah invests $5,000 to acquire 5,000 shares as part of a CSEF offer by Kavas Pty Ltd. After a few months, Hannah is dissatisfied with the management of Kavas Pty Ltd and transfers all 5,000 shares to Nelson. Although these shares were originally purchased as part of a CSEF offer, Nelson will not be a CSF shareholder of Kavas Pty Ltd as he did not acquire the shares through the CSF offer himself. As Nelson is not a CSF shareholder, he will not be excluded from the 50 non-employee shareholder cap under section 113(1). If Nelson is not excluded from the cap, then his membership could tip the company over the 50-member limit. We expect that this situation will be quite common and unavoidable for most proprietary companies engaging in CSEF.

Under section 165 of the Corporations Act, ASIC may direct companies who contravene section 113 to convert from a proprietary company to a public company. Is the intention to force companies to convert after the on-sale of CSF shares or will ASIC be given the power to provide relief to companies who have engaged in a CSEF raise?

We also note that section 707(3), which requires disclosure if shares are sold within 12 months of their issue, will not apply to CSF shareholders. This means that CSF shareholders will be able to on-sell their shares in an indirect issue (potentially to other unsophisticated investors) without any disclosure. This could have adverse effects considering the initial disclosure requirements in CSEF are already limited and the on-sale doesn’t require any disclosure (particularly relevant when selling to mum and dad investors). This, though, is the situation applicable to public companies using a CSEF offer as well, so not particular to the Bill.

5. Paragraph 738ZI(a) and reporting relief

The Act and the Bill have two very different intentions applicable to each entity type – the Act gives reporting relief to public companies whereas the Bill provides extra reporting requirements for private companies.

Paragraph 738Z(a) of the Act currently provides a list of companies eligible for limited governance requirements (this includes public companies, converted companies etc) The Bill is aiming to repeal this section and replace it with companies that:

(a) were registered as a public company limited by shares under Part 2A.2 in response to an application lodged under section 117 before the eligibility end day; or

(b) were converted from a proprietary company to a public company limited by shares under Part 2B.7 in response to an application lodged under section 163 before the eligibility end day,

(eligibility day means he day the Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Act 2017 25 commences).

Effectively, the new paragraph 738ZI(a) will limit governance and reporting relief to public companies that have been incorporated or have converted before the Bill is enacted. This means that public unlisted companies who incorporate after the Bill becomes law will no longer receive the same governance relief provided in the Act.

Our concern is that the intention of the Bill has not been adequately represented. Is the intention to limit the use of the CSEF regime to proprietary companies only (considering reporting relief will no longer be given to public unlisted companies)?If this is the case, we recommend that the Act and the Bill be cross referenced for consistency so that certain relief is not left only available to a small number of public companies that were incorporated or converted before the Bill has been enacted.

For example, public companies incorporated or converted before the Bill is enacted are exempt from section 314AB – requiring companies to notify members of their options for receiving reports. This is because the new section 314(1AF) of the Act allows eligible companies (being those listed in 738ZI(a)) to make financial reports accessible on their websites whereas proprietary companies (engaging in CSEF) have not been granted this same relief.

Overall we are comfortable with the Bill and believe that it provides a necessary extension of the CSEF regime to proprietary companies.

While we do harbour a sense of scepticism that the current CSEF regime provides adequate protections for investors we welcome this extension. We do hope for further clarity on the membership limit and confirmation that all companies using the regime will have the same reporting requirements (and relief). We encourage the progression and movement towards making CSEF accessible to the start-up community and hope that our submissions provide some assistance.

Yours sincerely

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