TREASURY CONSULTATION PAPER – ANOTHER STEP TOWARDS CROWD-SOURCED EQUITY FUNDING

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Australia Capital Markets and Consumer Financial Services Alert

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BACKGROUND

On 4 August 2015, the Treasury of the Australian Government released a consultation paper, facilitating crowd-sourced equity funding and reducing compliance costs (Consultation Paper). This follows the previous discussion paper released by treasury in December 2014.

The Consultation Paper outlines key elements of the government's crowd-sourced equity funding (CSEF) framework for public companies. Further details of the government's CSEF framework for public companies will be available in draft legislation released for public comment later in the year. The introduction of legislation to parliament is expected to follow in the Spring sitting period.

The Consultation Paper also seeks feedback on whether proprietary companies should be able to access CSEF and outlines a potential model.

The Consultation Paper will be open for public comment, with submissions due by Monday 31 August 2015. The government will consider stakeholder feedback before making decisions on whether to proceed with CSEF for proprietary companies.

CROWD-SOURCED EQUITY FUNDING FRAMEWORK FOR PUBLIC COMPANIES

Issues for Issuers

From an issuer's perspective, the key elements of the government's proposed CSEF framework are:

- Issuers must be incorporated as a public company in Australia. The proposed framework excludes foreign incorporated companies from accessing the Australian CSEF framework. No such restriction exists under the New Zealand CSEF framework.
- Relief from certain public company compliance costs will be available to newly registered or converted public companies. Reliefs include:
  - exemptions from disclosing entity rules

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  - allowing annual reports to be provided online only
  - exemption from holding an annual general meeting
  - exemptions from the need to appoint an auditor and have financial accounts audited, subject to a cap of AUD1 million raised from CSEF or under a disclosure exemption.
- Exemptions will be available for a period of up to five years, subject to annual turnover and a gross assets threshold of AUD5 million (excepting the audit exemption).
- CSEF is limited to certain small enterprises that have not raised funds under existing public offer arrangements.
- An issuer may raise up to AUD5 million in any 12 month period, inclusive of any raisings under the small scale offerings exception, but excluding funds raised under existing prospectus exemptions for wholesale/sophisticated investors.
- An issuer can only issue fully paid ordinary shares per CSEF offer. All shares in a particular CSEF offer must have the same price and terms and conditions. Therefore, the proposed framework appears to exclude the issue of preference shares and convertible equity securities, such as convertible notes, but it remains unclear if a CSEF offer can provide that the ordinary shares have no voting rights.
- Reduced disclosure requirements, including a tailored CSEF disclosure document. Required disclosures will relate to:
  - facts about the company and its structure, including financial statements
  - facts about the CSEF raising
  - mandatory risk warnings.

Issues for Intermediaries

From an intermediary's perspective, the key elements of the government's proposed CSEF framework are:

- An intermediary must hold an Australian Financial Services Licence (AFSL). The proposed framework does not create a separate CSEF category of licence as has been done in New Zealand.
- There are no restrictions on fee structures. However, fees paid by an issuer must be disclosed. Previously, the Corporations and Markets Advisory Committee (CAMAC) model proposed in June 2014 prohibited intermediaries from being remunerated according to the amount of funds raised.
- An intermediary is permitted to invest in issuers using their platform. However, details of any investments must be disclosed.
- An intermediary is prohibited from providing investment advice and lending to CSEF investors.
- An intermediary must undertake prescribed checks on the issuer.
- An intermediary must provide generic risk warnings to investors.

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- The Consultation Paper is silent on:
  - whether or not secondary sales of CSEF issued shares are expressly prohibited (except within current exemptions)
  - whether an intermediary's platform may facilitate or be involved in the secondary sales of any CSEF issued shares.

Any intermediaries seeking to facilitate secondary sales must be very mindful of the current disclosure and advertising restrictions, and licensing requirements if a financial market is operated and in light of the current regulatory guidance provided by the Australian Securities and Investments Commission (ASIC) in *ASIC RG 172: Australia market licences: Australian operators*.

ASIC Class Order 02/273: *Business Introduction and Matching Services* facilitates an intermediary introducing potential investors to small scale issuers by providing relief from certain obligations under the *Corporations Act 2001 (Cth)* (Act). This Class Order is scheduled to sunset on 1 April 2017. The Consultation Paper provides that intermediary facilitation of any small scale offers following an introduction would need to comply with relevant regulatory requirements, "which may include an ASFL or Australian Market Licence".

Issues for Investors

From an investor's perspective, the key elements of the government's proposed CSEF framework are:

- There are no investment caps for sophisticated investors. There are, however, investment caps for retail investors of:
  - AUD10,000 per offer per 12 month period
  - AUD25,000 in aggregate CSEF investment per 12 month period, self certified by investors.
- Intermediaries would be responsible for monitoring compliance for investments made via their platform.
- Investors would have to sign risk acknowledgement statements prior to investment, including that:
  - investing in early stage companies is risky and the investor may lose the entirety of their investment
  - investors may not be able to sell their shares
  - the value of the investment may be diluted over time
  - investors have complied with the investor caps.
- Unconditional right to withdraw for five days after accepting offer.
- Additional rights in relation to 'material adverse changes' during the offer period.

Significantly, the proposed CSEF Australian model imposes mandatory investment caps, whereas in New Zealand investment caps are voluntary for investors.

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SHOULD LAWS BE AMENDED TO INCREASE FLEXIBILITY IN CAPITAL RAISING BY A PROPRIETARY COMPANY?

Currently, the Act restricts proprietary companies by limiting the number of non-employee shareholders to 50 and restricts a proprietary company from offering shares to the public, except in limited circumstances. A proprietary company is classified as small if it meets at least two of the following criteria:

- the company's consolidated revenue for the financial year is less than AUD25 million
- the value of the company's consolidated gross assets at the end of the financial year is less than AUD12.5 million
- the company has fewer than 50 employees at the end of the financial year.

The Consultation Paper seeks consultation on two key questions and related issues which currently restrict proprietary companies from raising capital through a crowd-sourced equity model:

1. Should the current 50 non-employee shareholder limit be increased to enable a proprietary company to raise funds from a larger base and what would be the appropriate limit?
2. Should the law be amended to increase the 20 investor limit and/or the AUD2 million cap? What would be an appropriate limit? Should the AUD2 million cap be linked to increase in line with the consumer price index (CPI)?

The Consultation Paper seeks industry submissions on whether increasing the shareholder limit for proprietary companies and/or expanding the small scale offerings exception to the disclosure requirements would provide small proprietary companies with sufficient additional flexibility to raise capital.

Prior commentary has considered that in order to facilitate crowd-sourced equity funding and not restrict its use to public companies, it is necessary to remove the shareholder cap of no more than 50 non-employee shareholders for issuers. It has been noted that the takeovers provisions of the Act should only apply if the CSEF funded company has more than, say, 500 shareholders or a certain level of revenue.

A POTENTIAL CSEF MODEL FOR PROPRIETARY COMPANIES?

The Consultation Paper makes clear that the government will evaluate stakeholder feedback before making a final decision on whether to extend CSEF to proprietary companies.

Even if CSEF is not extended to proprietary companies, there may be flow on benefits to private companies as a wider pool of investors investing in CSEF. Offers may be identified and become accessible to private companies if they fall within the personal offer category given some previous contact or connection with the company.

The Consultation Paper asks for feedback on the following and related questions:

- Should proprietary companies be able to access CSEF? If so, should the shareholder limit be changed specifically for proprietary companies using CSEF?
- Should any increase in the shareholder limit solely for proprietary companies using CSEF be temporary, based on time and size limits?

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- If permitted to access CSEF, should proprietary companies using CSEF be subject to additional transparency obligations when raising funds via CSEF?
- Whether an annual fundraising cap of AUD5 million, and eligibility caps of AUD5 million in annual turnover and gross assets are appropriate for proprietary companies using CSEF?

The Consultation Paper notes that an alternative approach would be to impose a lower cap for proprietary companies, such as AUD1 million, in recognition of their lower corporate governance and disclosure obligations.

The Consultation Paper also suggests that to address concerns that small CSEF investors may lack ongoing access to information about the company and its performance, additional transparency obligations similar to those applying under the public company CSEF regime could be placed on proprietary companies using CSEF, including:

- a requirement for financial and directors' reports to be prepared and made available to shareholders online
  and/or
- a requirement to appoint an auditor and have financial statements audited once the company has reached certain thresholds, such as raising AUD1 million from CSEF or from other offers that do not need disclosure under Chapter 6D of the Act.

Industry commentary on the venture capital gap and examples of how the CSEF model is working in overseas jurisdictions would suggest that it is precisely small proprietary companies and early stage ventures that have not yet been groomed to a public company status that seek to access the benefits of raising capital through crowd-funding models.

Consultation Regulatory Framework for Small Proprietary Companies

The Consultation Paper also asks if there are unnecessary compliance costs for proprietary companies, such as in the requirement for a director to make an annual solvency resolution, maintain a share register and notify ASIC of changes in share register.

Interestingly, one of the questions is whether the requirement to maintain a share register should be removed for small proprietary companies with up to 20 shareholders, given that ASIC's records duplicate the information in the share register of such companies.

CONCLUDING COMMENTS

The Consultation Paper does not yet resolve the critical question for industry. That is, whether a regulatory framework for CSEF should, and will be limited, to certain small enterprises using an exempt public company status (as was originally proposed by CAMAC) or whether the regulatory framework should be open to both public and proprietary companies and not be limited to small enterprises, as is the case in New Zealand.

Industry will need to await the draft legislation for further details of the key elements, such as the extent of due diligence checks, financial statements and content of the CSEF disclosure requirements. However, the proposed

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CSEF framework certainly gives a green light to the use of CSEF by Australian public companies. Companies and intermediaries alike can begin preparing for this new mode of capital raising.

Please contact us if you would like assistance in preparing submissions on the questions raised in the Consultation Paper or require advice on getting ready for a CSEF model and any capital raising and licensing issues posed by crowd-sourced equity funding.

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