Dr. Yongqiang Li
Research Fellow,
Governance Research Program
College of Law and Justice
Victoria University

Level 1, 256 Queen Street
College of Law and Justice
Victoria University
PO BOX 14428 MELBOURNE
VICTORIA 8001 AUSTRALIA
Phone: 61 433 138 668
Email: Yongqiang.Li@vu.edu.au
vu.edu.au

31 Aug 15

General Manager
Financial System and Services Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Hon. Minister Billson,

Re: Facilitating crowd-sourced equity funding (CSEF) and reducing compliance costs for small businesses

Based on our response to the consultation questions, the following recommendations are provided for further policy reform on small business regulation and their accessing to CSEF:

1. Developing a streamlined legal small business definition for regulatory compliance purpose. The legal definition specified in Corporations Act 2001(Cth) s45A should be adopted for data collection and administration. Li (2014) finds out that the Australian Bureau of Statistics (ABS) definition of small and medium-sized entreprises and the legal definition of small proprietary companies are generally consistent in non-service related industries.
2. Developing a risk-based responsive regulatory system for non-listed small businesses
   The 'one size fits all' regulatory model should be reformed to take into account the resource constraints and capacity of small businesses to meet regulatory requirements. Rather, a risk-based responsive regulatory system should be established for non-listed small businesses (Armstrong et al. 2011; Li 2014).
3. Further efforts should be devoted to cutting the red-tape of small businesses, in particular, extra regulatory compliance requirements incurred by regulatory reforms.
4. Thinking outside the box: introducing the public limited companies model
5. Cash flow and payment collection issues: potential options such as establishing an independent clearing house, or commercial papers to be convertiable for line of credits
6. Re-regulating professionals such as lawyers, accountants, financial advisers and consultants who serve small businesses.

Yours sincerely,

Dr. Yongqiang Li
Professor Anona Armstrong AM
Professor Andrew Clarke
College of Law and Justice, Victoria University
Contact emails: Yongqiang.Li@vu.edu.au ; Anona.Armstrong@vu.edu.au ; Andrew.Clarke@vu.edu.au

Consultation questions		Our response
Appropriateness of the shareholder limit		
1	Should the law be amended to increase the permitted number of non-employee shareholders in a proprietary company and what would be an appropriate limit? Or do companies with more than 50 non-employee shareholders have a sufficiently diverse ownership base with limited access to information or ability to influence the affairs of the company to justify the greater governance requirements currently placed on them?	The number of shareholders should not be the only criteria to determine whether a company is a public or a proprietary. Rather, a risk-based approach should be adopted, which should take into account a suite of factors such as the industry, age of the business, development stage and business size. Li (2014, Chapter 8) has suggested that a cluster analysis approach should be applied to separate the businesses into three groups given that risk profiles, namely high-risk, intermediate risk and low risk. Then constraints should be designed in a way which is responsive to the small businesses characteristics and their risk profile. The number of shareholders is not the problem. The right problem is about representation of the shareholders and how governance mechanisms such as proxy voting and board independence are set up to curb the agency costs.
2	What are the benefits and risks? For example, would raising the limit expose risks to shareholder protection?	The benefits are that raising the number of shareholders may potential enlarge the pool of funding for the businesses and may increase the speed of business expansion. However, it is contingent on the business development stage and strategic directions. If shareholders are not active, increasing numbers may have little impact on shareholder protection. Hence, the problem here is again about shareholder protection, rather than number of shareholders.
3	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? What are the ways by which management now remains accountable to shareholders or shareholders otherwise have access to information about a company?	The governance problem in small businesses is normally not that of owner-manager, but more of conflicts among stakeholders and conflicts between majority and minority shareholding. Most of the small businesses are family businesses in Australia, the conflicts of stakeholders, in particular between family controlling shareholders and the non-family stakeholders, eg. Principal-principal problem (Peng 2011), may incur additional costs to the businesses. Information asymmetry is a major problem. However, it is very difficult to make small businesses to disclose all the information, due to the availability of such information, the capacity of owners to deal with such information and the cost of making the information available. Companies should organise frequent events to communicate key decisions and progresses. However, shareholders should also be made accountable

		for their liabilities. On average, the holding period for shareholders nowadays is less than one year. Should the shareholders be rewarded if they stay longer with the company? If they churn for the sake of share prices, is full information necessary for them? Probably not.
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?	Companies should have the discretion to choose whether they go public or proprietary. Proprietary is a very generous and loose term. An alternative classification, which may be a better option, is to classify companies as either close form or public companies, enabling the transfer between these two forms.
Small scale offerings and other exceptions to the disclosure requirements		
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)?	The cap should be industry specific and risk-based. The current requirement is essentially limiting one investor to invest $100,000 on average to a company. However, it is necessary to find out how many companies are able to tap into a $2 million cap. It is also necessary to find out what are the transaction sizes of investment in different industries. Another issue is that the current small business offering market is not competitive and the transaction costs are very high, which precludes the small businesses from accessing it.
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?	Again, it depends on the industry and the type of companies. It is necessary to work out what types of companies are in need of $2 million cap.
7	Could other exceptions to the requirement to issue a disclosure document provide benefits to small proprietary companies if amended?	Not really. This can be easily done by better educating lawyers.
Increasing flexibility in capital raising		
8	Would increasing the shareholder limit for proprietary companies and/or expanding the small scale offerings exception to the disclosure requirements	It may increase the size of funding. However, it can hardly change the nature of the funding for small businesses, unless the private insurance market is mature enough to absorb the investment risks.

	provide small proprietary companies with sufficient additional flexibility to raise capital?	
Crowd-sourced equity funding		
9	Should proprietary companies be able to access CSEF? What are the implications for the corporate law framework of permitting proprietary companies to do so?	Yes. Why disadvantage them? The implications are that they may have to incur additional compliance costs and they may not be able to manage the additional funding properly. However, CSEF can serve as a mechanism to improve the competitiveness of the market.
10	If the shareholder limit is not changed for all proprietary companies, should proprietary companies be able to access CSEF? If so, should the shareholder limit be changed specifically for proprietary companies using CSEF? What are the benefits and risks of this approach? Would the benefits outweigh the additional complexity of increasing the shareholder limit for a subset of proprietary companies? If the shareholder limit were to be increased only for proprietary companies using CSEF, is 100 non-employee shareholders an appropriate cap?	No. It should be consistent to all the companies. No companies should be left behind. A systematic responsive approach has to be developed.
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? If the increased shareholder limit is temporary, what arrangements should apply when a company is	CSEF is aiming to serve as a complement to the traditional banking system. If this is the case, then proprietary companies will eventually be the long-term beneficiaries for the CSEF. Increasing the shareholder number is just creating an extra problem to solve another problem.

	no longer eligible for the higher shareholder limit (owing either to the expiry of the time limit or exceeding the caps on company size)? Should it be required to convert to a public company? Or should it have the option to conform with the general proprietary company obligations, including the non-employee shareholder limit?	
12	If permitted to access CSEF, should proprietary companies using CSEF be subject to additional transparency obligations when raising funds via CSEF? Do you agree with the proposals for annual reporting and audit? Should these be implemented by requiring proprietary companies that have used CSEF to comply with the obligations of large proprietary companies? Should any other obligations apply? Given the Government has committed to introducing a CSEF framework for public companies that will include certain reporting exemptions, what are the benefits of permitting proprietary companies to use CSEF when they would be subject to additional transparency obligations? Do you agree that these obligations should be permanent?	Yes. CSEF should be rested on transparency and stricter obligations. In this regard, media, general public and regulators can work together. Formal auditing and reporting may be necessary as long as it does not incur substantial accounting costs. Such obligations toward transparency have to be permanent. However, a responsive regulatory regime should be adopted, meaning that the companies which have good governance systems may face less checks, but those which are not transparent and have internal issues may face frequent checks and potentially penalty for wrongdoings.

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?	It depends on the industry, size of the business and business development prospects. Solid evidence has to be established to investigate such issues. However, little research is available on this matter.
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?	The small businesses normally lack the capacity to deal with regulatory changes. Hence, the regulation of professions who serve the small businesses is necessary.
Making an annual solvency resolution		
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?	Yes, it should be removed. The directors may not be competent enough to understand what a solvency resolution is. However, their accountants and lawyers should know. Hence, rather than making it a directors' liability, assign it to the professionals.
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 cost is unclear. However, according to Li et al. (2010), the small businesses bear regulatory compliance costs between $3,000 – $12,000 depending on the size of the businesses, on top of their usual expenses on the professionals.
17	What is the value to directors of the annual solvency resolution in reminding them of their ongoing solvency obligations?	It may potentially increase the directors' awareness of the cash flow management situation in the organisation. However, it may not create substantial effect given that the solvency is a flow issue, not a stock one.
18	Would removing the requirement to make a solvency resolution be likely to increase rates of insolvency or business failure among small	May possibly leads to more failure in that cash flow management is one of the major reasons for the small business failure. The unsecured creditors will be exposed to risk anyway, regardless of whether solvency resolution is in place. The protection for investors is minimal.

	proprietary companies? Would unsecured creditors be exposed to increased risk? Are there other risks associated with removing the requirement? 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?	
Maintaining a share register		
19	What is the extent of the burden imposed on small proprietary companies to establish and maintain a share register, in terms of time and/or financial cost?	Not necessary a huge burden as long as the lawyers and accountants do not over-charge.
20	What is the value to small proprietary companies of maintaining a share register? Would companies need to maintain similar records even if the law did not require them to?	Depending on how many hours lawyers and accountants factor into this work. It may well be between $400-$1,000.
21	Should the requirement to maintain a share register 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?	Yes, it should. For small shareholding companies, their operation is not that different from 'close-form' partnerships, hence the shareholding registration may not be necessary for them.
22	If the requirement were removed for small proprietary companies with up to 20 shareholders: how could share ownership be transferred? Could transfer take effect via a different	The removal of the shareholder number threshold can facilitate the private ordering, meaning that the shareholders may use standardised contracts or internal mechanisms to make the transfer happen, hence reducing unnecessary costs.

	mechanism, such as on notification to ASIC or on acknowledgment from the company? how would shareholders be able to ascertain the identity of the other shareholders of a company? Would it be reasonable to require shareholders to obtain the information from ASIC (including paying the required fee)? Are there other situations or circumstances where small proprietary companies with up to 20 shareholders need to have an up-to-date share register?	
23	Alternatively, should the requirement for small proprietary companies to maintain a share register be modified? If so, how? For example, should small proprietary companies with up to 20 shareholders continue to retain a share register but no longer be required to notify ASIC each time shareholder details change?	Small companies must document the changes and make them available upon the request of ASIC, but they do not necessarily need to lodge it.
24	Would removing/modifying the requirement to maintain a share register be likely to increase the risk of minority shareholder or property rights disputes for small proprietary companies? Are there other risks associated with removing the requirement?	No. Refer to the principle of Freedom of contract.
Facilitating the execution of documents		
25	Does the current law cause problems and/or increase compliance costs	It may cause difficulties for directors in case of conflicts of interest.

	for sole director/no secretary companies and their counterparties in executing documents? What is the extent of the burden imposed on sole director/no secretary small proprietary companies in terms of time and/or financial cost?	
26	Is it appropriate to amend the law to specify that a company with a sole director and no company secretary may execute a document without using a common seal if the document is signed by the director or with a company seal if the fixing of the seal is witnessed by the director? Are there any risks associated with this approach? Are there any alternative approaches?	No, the director is accountable for the decision. Hence, it is not that risky.
27	Is there an issue regarding split execution? What is the extent of the burden imposed on small proprietary companies in terms of time and/or financial cost? What are the benefits and risks of specifying in the law that split execution is acceptable?	It may incur extra cost for small businesses.
28	Is there an issue regarding the execution of deeds by foreign companies? What is the extent of the burden imposed on small proprietary companies in terms of time and/or financial cost? Should the UK approach be adopted in the Corporations Act? Should a similar approach be taken to other bodies	No issue.

	corporate? What are the benefits and risks?	
Completing and lodging forms with the regulator		
29	Could any forms which are used by small proprietary companies and prescribed by the Corporations Act or Corporations Regulations be removed, amended or streamlined to reduce the compliance burden? How much time/money would it save you?	Finer level online tools should be introduced by the ATO and ASIC to help small business document their transactions and automatize reporting.
Other ways to reduce compliance costs		
30	Are there any other requirements under the Corporations Act which impose unnecessary compliance burdens on small proprietary companies? What is the extent of the burden in terms of time and/or financial cost? How could the burden be reduced?	Use of Replaceable Rules and Overdrafts. Li and colleagues (2011) found out that some companies have neither a Constitution nor a Replaceable Rules. The internal control has been loosely defined and has yet to be properly regulated. However, internal control plays a very important role in the day to day operations of small businesses. Documentation is another burden. It will be useful if the ASIC and ATO has a one stop shop for all the regulatory compliance requirements.

Reference:
Anona, Armstrong, Yongqiang, Li, Andrew, Clarke, et al. (2011) Developing a Responsive Regulatory System for Australia's Small Corporations. Governance Program, Victoria Law School, Melbourne, Australia, ISBN: 978-1-86272-692-5.
Yongqiang Li (2014) Governance, Regulation and Performance of Non-listed Small Corporations in Australia:A Structural Equation Modelling Approach. Victoria University PhD Thesis.
Peng, Mike (2013). Global strategy. Cengage learning.