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THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

Corporations amendment (crowd-sourced funding for proprietary companies) bill 2017

EXPLANATORY MEMORANDUM

Only the approving Minister needs to be on the front cover. Please delete the non‑approving Ministers name

(Circulated by authority of the  
Treasurer, the Hon Scott Morrison MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

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| --- | --- |
| Abbreviation | Definition |
| CSF | Crowd-sourced funding |
| ASIC | Australian Securities and Investments Commission |
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General outline and financial impact

## Overview

Crowd-sourced funding (CSF) is an emerging form of funding that allows entrepreneurs to raise funds from a large number of investors. Legislation to create a CSEF framework for public companies will commence on 29 September 2017. Extending the CSF framework to proprietary companies will allow these companies to access an alternative form of finance with additional obligations that will protect investors.

Date of effect: The amendments will commence the day after the end of the period of six months after Royal Assent.

## Summary of regulation impact statement

### Regulation impact on business

Impact: This Bill will extend the CSF regime to proprietary companies, making a new funding source available for small businesses, whilst maintaining adequate investor protections through additional obligations on companies. These obligations are expected to have compliance costs for proprietary companies that use CSF; however these costs will be lower for CSF proprietary companies than if the company were to transition to public company type under the current regime.

Main points:

* This measure extends upon the *Corporations Amendment (Crowd-sourced Funding) Act 2017* to enable proprietary companies to access CSF without transitioning to public company status.
* Three models are discussed in the regulation impact statement – a model extending CSF to proprietary companies without additional obligations, a model extending CSF to proprietary companies with additional obligations; and the status quo where proprietary companies may transition to public company model.
* The model in the Bill is the extension to proprietary companies with additional obligations which balances the structural benefit of the proprietary company structure with certain obligations that increase shareholder protection.
* The regulation impact statement details the findings of the consultation paper released in August 2015 which canvassed extending CSF to proprietary companies in addition to industry roundtables conducted in late 2016 specifically regarding the regime’s extension to proprietary companies.
* The framework of *Corporations Amendment (Crowd-sourced Funding) Act 2017* will be extended through this Bill and associated regulations. The Government and the Australian Securities and Investments Commission (ASIC) will continue to monitor the regime after its extension to proprietary companies.

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1. Extending the crowd-sourced funding regime to proprietary companies

## Outline of chapter

* 1. This Chapter provides an overview of the Corporations Amendment (Crowd-sourced funding for proprietary companies) Bill 2017.
  2. Unless otherwise stated, all references in this Chapter relate to the *Corporations Act 2001* (the Act)*.*

### Context of amendments

### Policy background

* 1. Crowd-sourced funding (CSF) is an innovative type of fundraising, typically online, that allows a large number of individuals to make small financial contributions towards a company, in exchange for an equity stake in the company. Legislation will commence on 29 September 2017 to introduce a CSF regulatory framework for public companies, although with some transitional arrangements for proprietary companies who transition to public company status in order to issue CSF offers.
  2. Access to finance is crucial for innovative new businesses, as they can incur costly research and development in the early stages of a business at a time when there may be little or no revenue flowing in. Bank loans with immediate regular payments may not be suitable if they can even be approved. So equity finance such as CSF is often a preferable type of funding for innovative and early stage companies and the investors in those companies.
  3. Currently proprietary companies are unable to have more than 50 shareholders or make a public offer. Extending CSF to proprietary companies will enable small and innovative business types easier access to the capital they need to succeed.
  4. Acknowledging that CSF proprietary companies will no longer be closely held, these companies will be subject obligations designed to increase shareholder engagement and mitigate the occurrence of fraud. The obligations for CSF proprietary companies include: a minimum of two directors; financial reporting in accordance with accounting standards; audit requirements; restrictions on related party transactions and minimum shareholder rights to participate in exit events.
  5. These additional company obligations will help to ensure the sustainability of the CSF regime and give investors’ confidence in the market by ensuring companies meet a minimum standard and that investors have some basic information available to them.

## Summary of new law

* 1. The amendments extend the CSF regime to proprietary companies by:
* expanding the eligibility for the CSF regime in section 738H to proprietary companies that meet eligibility requirements;
* adding special investor protection provisions for proprietary companies accessing the CSF regime; and
* removing the temporary corporate governance concessions in the Corporations Amendment (Crowd-sourced Funding) Act 2017 for proprietary companies that convert to or register as public companies to access the CSF regime.

Comparison of key features of new law and current law

|  |  |
| --- | --- |
| New law | Current law |
| Proprietary companies that meet the eligibility requirements will be able to access the CSF regime | Only public companies can access the CSF regime |
| Proprietary companies that have CSF shareholders will have to prepare annual financial and directors’ reports in accordance with accounting standards | Small proprietary companies are generally not required to provide annual financial and directors’ reports unless directed |
| Proprietary companies that raise more than $1 million from CSF offers will have to have their financial statements audited | Small proprietary companies are generally not required to have their financial statements audited unless directed |
| Proprietary companies that have CSF shareholders will be subject to the related party transaction rules in Chapter 2E | Proprietary companies are not subject to the related party transaction rules in Chapter 2E |
| Proprietary companies that have CSF shareholders will not breach the takeovers rules if their constitutions contain appropriate CSF exit arrangements that are complied with | Proprietary companies with more than 50 shareholders are subject to the takeovers rules in Chapter 6 |
| Proprietary companies that make a CSF offer will have to include details about the offer and the shareholders as part of their company registers |  |

## Detailed explanation of new law

* 1. The amendments in schedule 1 of the Bill extend the CSF regime in Part 6D.3A of the Act to proprietary companies that meet certain eligibility requirements. As proprietary companies that use the CSF regime will be fundraising from the public, they will be required to adhere to additional reporting requirements and governance standards that will foster greater accountability and better decision making.

*Extending the CSF regime to proprietary companies*

* 1. Paragraph 738H(1)(a) of the Act is amended to extend the CSF regime in Part 6D.3A to proprietary companies. The amendment will allow a proprietary company to use CSF if it has a minimum of two directors and meets any other requirements that are specified in the regulations. [Schedule 1, item 39, paragraph 738H(1)(a)].
  2. Proprietary companies will be required to have at least two directors before they are able to use the CSF regime as this will provide greater transparency, more robust decision-making and greater certainty around succession planning.
  3. The regulations may also prescribe other eligibility requirements. It is appropriate to have the power to prescribe other eligibility requirements in the regulations so that the Government can quickly intervene to protect investors if required.
  4. The existing proprietary company framework in the Act provides for streamlined regulation for closely held companies. As proprietary companies that use CSF will be accessing public funding, these amendments provide for additional reporting and governance regulations to protect investors. Despite these additional requirements, it is possible that the CSF regime for proprietary companies will develop in a manner that creates risks for investors that would not be suitable. If this occurs, it is necessary for the Government to be able to intervene quickly to prescribe additional eligibility requirements that proprietary companies may have to satisfy before accessing the CSF regime, thereby maintaining an effective level of investor protection. It is appropriate for these requirements to be prescribed in the regulations as the Government may need to intervene quickly and as the regulations would be subject to disallowance, there would still be an appropriate level of parliamentary scrutiny.
  5. Proprietary companies are currently prohibited from engaging in any activity that requires disclosure to investors under Chapter 6D except to existing shareholders and the employees of a company. As CSF is a fundraising activity that requires disclosure to investors, subsection 113(3) of the Act is being amended so that proprietary companies are allowed to make CSF offers (which is defined in section 738B of the Act). [Schedule 1, item 6, subsection 113(3)]
  6. To allow proprietary companies to effectively use the CSF regime, the existing shareholder cap which provides that a proprietary company cannot have more than 50 non-employee shareholders is being amended so that CSF shareholders are not counted as part of the cap. Without this change, a proprietary company would only be permitted to have 50 non‑employee shareholders, severely limiting its ability to use the CSF regime. [Schedule 1, item 5, subsection 113(1)]
  7. A CSF shareholder is defined in section 9 as a person (legal or natural) that holds one or more securities in a company that was issued as part of a CSF offer by the company. [Schedule 1, item 1, section 9]
  8. A person will therefore only be a CSF shareholder if they purchase the securities as part of a CSF offer. If the securities are sold or transferred in any other way, the new holders of those securities will no longer be CSF shareholders.

**Example 1.1**

Hannah invested $5,000 to acquire 5,000 shares as part of a CSF 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 CSF 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).

* 1. Once a proprietary company makes a CSF offer, it will be required to maintain at least 2 directors as long as it has CSF shareholders. This is consistent with the requirement for a proprietary company to have at least two directors to make a CSF offer and will provide greater transparency, more robust decision-making and greater certainty around succession planning. A majority of the directors will also have to ordinarily reside in Australia. [Schedule 1, item 14, subsection 201A(1A)]
  2. The obligation to have at least the two directors exists as long as the company has a CSF shareholder. If all of the shares issued pursuant to a CSF offer are later sold, otherwise transferred or bought back by the company, the company will no longer have any CSF shareholders and will no longer be required to have the second director.

*Additional reporting obligations for proprietary companies that have CSF shareholders*

* 1. A proprietary company that makes a CSF offer will be required to include additional information as part of its company register. This information must be maintained on the company’s register while the company has CSF shareholders. The additional information to be maintained on the register includes the:
* date of each issue of shares as part of a CSF offer;
* number of shares issued as part of each CSF offer;
* shares issued to each member of the company as part of each CSF offer; and
* date on which each person ceases to be a CSF shareholder of the company for a particular share in the company.

[Schedule 1, item 11, subsection 169(6)AA]

* 1. Proprietary companies that make CSF offers are being required to maintain this information as part their registers so that they have an appropriate record of the securities issued pursuant to CSF offers and that they are aware of the number of CSF shareholders in the company at any given point in time. It is essential for these companies to be able identify if they have any CSF shareholders because they will be subject to additional reporting and governance obligations while this is the case (for example, the requirement to have a minimum of two directors outlined above).
  2. As proprietary companies that make CSF offers are taking funding from the public, it is important for ASIC to be able to identify the companies that have CSF shareholders and provide appropriate supervision. Proprietary companies that make CSF offers will therefore have additional obligation to report to ASIC once they make a CSF offer.
  3. As such, where a company makes changes to its register because it has issued shares as part of a CSF offer, the company will also be required to notify ASIC of the change to its register. [Schedule 1, item 12, paragraph 178A(1)(b)]
  4. As part of the new notification requirements, the company will also have to inform ASIC if it:
* starts to have CSF shareholders; or
* stops having CSF shareholders.

[Schedule 1, item 13, subsection 178C(1)]

* 1. These new reporting requirements will help ASIC track the proprietary companies that are subject to additional requirements because they have CSF shareholders.
  2. In addition, where a proprietary company issues new shares, it will be required to notify ASIC if the issuance of those shares results in the company having a CSF shareholder. [Schedule 1, item 15, subsection 254X(1)]
  3. Similarly, where a proprietary company cancels any of its shares, it will have to notify ASIC if the cancellation results in the company ceasing to have CSF shareholders. [Schedule 1, item 16, subsection 254Y(1)]

*Financial reporting obligations for proprietary companies that make CSF offers*

* 1. Under section 292, a small proprietary company would normally only have to prepare annual financial and directors’ reports if it is directed to by its shareholders (under section 293) or ASIC (under section 294), or in some cases where it is controlled by a foreign company. This is not appropriate where the company makes a CSF offer as the company will be accessing funding from the public and these shareholders should have access to ongoing information on the company’s progress. Unlike most investors in proprietary companies, who generally have connections to the company’s management and are therefore expected to be able to access information on the company as required, CSF shareholders will generally not have a connection to management and therefore have less ability to obtain the required information on the company.
  2. As such, to ensure that the individuals who invest their money into proprietary companies through a CSF offer have access to information about their investment in the company, subsection 292(2) is amended to require proprietary companies to prepare annual financial and directors’ reports while they have CSF shareholders. [Schedule 1, item 19, paragraph 292(2)(c)]
  3. Requiring proprietary companies that have CSF shareholders to prepare annual financial and directors’ reports will build investor confidence in the CSF regime, allowing the market to become established and then grow. It will also allow investors to monitor progress of the companies and make informed decisions on issues they can vote on. The requirement will also establish a minimum standard, ensuring that only companies that are willing to be transparent with their investors are able to access the regime.
  4. The financial and directors’ reports that are prepared will have to be provided to members in accordance with section 314 and must be provided to ASIC under section 319. There is no requirement for the company to make the reports public but they can elect to do so if they wish to.
  5. The obligation to prepare the financial reports and directors’ reports will apply from the financial year in which the proprietary company first starts to have a CSF shareholder (which can only occur once the company has completed a CSF offer) and will apply in relation to every future financial year in which the company still has a CSF shareholder. The financial reports prepared must comply with accounting standards.
  6. As a result of the requirement for these companies to prepare annual financial and directors’ reports, there are a number of consequential amendments required in relation to the current reporting exemptions available for small proprietary companies.
* First, small proprietary companies that prepare annual financial and directors’ reports in response to a shareholder direction under section 293 or a direction by ASIC under section 294 will have to lodge these reports with ASIC if they have CSF shareholders. [Schedule 1, item 23, paragraph 319(2)(a)]
* Second, subsection 298(3) is amended to clarify that the exemption from preparing a directors’ report for a small proprietary company will not apply if the company has a CSF shareholder. [Schedule 1, item 21, subsection 298(3)]
* Third, subsection 296(1A) is amended to require a small proprietary company that has a CSF shareholder to ensure its financial reports comply with accounting standards even if it is prepared in response to a shareholder direction under section 293 and the direction provides that the report need not be in accordance with accounting standards. [Schedule 1, item 20, subsection 296(1A)]
  1. Proprietary companies are generally not required to have their financial reports audited. While this is appropriate for closely held companies relying on private funds it is not appropriate for companies that have public investment. As such, proprietary companies that raise more than $1 million from CSF offers will be required to have their annual financial reports audited. [Schedule 1, item 22, paragraph 301(2)(a)]
  2. As a result of this requirement, the overview of auditing obligations in section 285 is amended to also provide that small proprietary companies that raise more than $1 million from CSF offers must have their financial statements audited. [Schedule 1, items 17 and 18, subsection 285(1) (cell at table item 3, column headed ‘comments’)]
  3. Once a proprietary company raises more than $1 million from CSF offers, its directors will have to ensure there is an auditor appointed from one month after the $1 million was raised until the company stops having CSF shareholders. If the company later makes another CSF offer, the obligation to have an auditor will again apply from within one month of that offer being made. [Schedule 1,item 27 section 325 and item 28, subsection 325(2)]
  4. Directors who are under this obligation are required to do everything reasonable to comply with it. However, where there is a vacancy in the office of the auditor, the obligation to have an auditor appointed will not apply for a one month period from when the vacancy arose. This will allow the directors the time necessary to appoint a replacement auditor. [Schedule 1, item 25, subsections 325(3) and (4)]
  5. Directors that do not do everything reasonable to comply with the requirement to have an auditor appointed to a company during the periods it has raised $1 million from CSF offers and it ceasing to have CSF shareholders will be liable for 25 penalty units or imprisonment for six months or both. This is appropriate as it is the identical penalty that applies to directors of a public company that breach their equivalent obligations. [Schedule 1, item 44, schedule 3 (table item 1116KM)]
  6. Where a proprietary company has raised more than $1 million from CSF offers but does not appoint an auditor as required above, the company must notify ASIC no later than seven days after the end of the 30 day period that the company’s directors have failed to appoint the auditor. Once the company does this, ASIC is required to appoint an auditor as soon as practicable. This requirement is the equivalent to the existing requirement in relation to public companies that do not appoint an auditor as required. Where ASIC appoints an auditor for a proprietary company that raises more than $1 million from CSF offers in this way, the auditor will hold office until the company’s next general meeting. [Schedule 1, item 29, section 327E ( heading) item 30, subsection 327E(1) and item 31, subsection 327E(6)]
  7. Similarly, ASIC’s power to appoint an auditor to a public company where one is not appointed as required under the Act is extended to apply to proprietary companies with CSF shareholders that have raised more than $1million from CSF offers. Where this occurs in relation to a proprietary company, the auditor will hold office until the company’s next general meeting. [Schedule 1, item 32, section 327F (heading); item 33, subsection 327F(1); item 34, paragraph 327F(1)(a); item 35, subsection 327F(2) and item 36, section 327G (heading)]
  8. Proprietary companies that have raised more than $1 million from CSF offers and have CSF shareholders will be subject to the existing rules that ensure independence between a company and its auditors. This is to protect against any conflicts of interest arising and is appropriate as it only applies to companies that have taken $1 million from the public through CSF offers. [Schedule 1, item 24, subsection 324CH(1) (table items 1 to 9) and item 25, subsection 324CH(3A)]
  9. Similarly, the existing rules that prevent an auditor from becoming a director of an entity they audited for a two year period is extended to also apply in relation to a proprietary company that has raised more than $1 million from CSF offers and has CSF shareholders. [Schedule 1, item 26, paragraphs 324CI(e), 324CJ(e) and 324CK(e)]

*Restrictions on related party transactions*

* 1. Since proprietary companies that use CSF are relying on public funding, they will be subject to restrictions on related party transactions to protect investors. Having these additional restrictions will ensure that individual investors have appropriate protection and will also help build confidence in the CSF regime as more investors participate in CSF offers.
  2. To protect investors against fraud and bias arising as a result of transactions with related parties, proprietary companies that have CSF shareholders will be subject to the existing related party transaction rules and penalties under Chapter 2E. [Schedule 1, item 43, section 738ZK]
  3. The application of Chapter 2E to proprietary companies that have CSF shareholders provides shareholders with protections where funds are transferred to any related parties through uncommercial transactions without shareholder approval. This will provide investors with confidence that they have access to the existing related party transaction remedies where funds are transferred to a related party for non-commercial purposes without shareholder approval.
  4. The restrictions are however not too onerous (in the context of companies that have accessed funding from the public through a reduced disclosure fundraising regime) as the transactions are still permissible if they are on commercial terms at arm’s length or if the shareholders provide consent.

*Takeovers of proprietary companies that have CSF Shareholders*

* 1. Proprietary companies that use CSF would generally be subject to the takeover rules in Chapter 6 as they are likely to have more than 50 shareholders. These provisions are complex and would inhibit funding and other exit opportunities for proprietary companies that use CSF as they apply in relation to the acquisition of control beyond 20 per cent of a company’s voting stock.
  2. This is contrary to the objectives of proprietary companies that use CSF as they may be positioning for a takeover or to become listed in the future. The shareholders of these companies that invest as part of CSF offers also do so in the expectation that, if the company is successful, they will benefit from a payout as part of an exit event.
  3. As such, a proprietary company that has CSF shareholders will be exempt from the takeover rules in Chapter 6 if the company’s constitution provides a minimum level of protection for investors to participate in an exit event. [Schedule 1, item 38, section 611 (table item 19A)]
  4. The exemption only applies to the acquisition of shares where the constitution of a proprietary company that has CSF shareholders provides for an appropriate minimum level of protection for investors to participate in an exit event and a person acquiring a relevant interest adheres to provisions in the constitution. If the company’s constitution does not contain an appropriate minimum level of protection then the existing takeover rules will apply. Where the constitution does provide for an appropriate level of protection but someone acquires a relevant interest that does not comply with the provisions in the company’s constitution that acquisition will not fall under the exemption and the acquirer of the interest will be in breach of the existing offences under the takeovers rules.
  5. To qualify for the exemption, a CSF company must include as part of its constitution a provision that requires someone who acquires more than 40 per cent of the voting shares in the company to offer to purchase all other securities in the company on the same terms within 31 days. The provision must require the purchaser to offer to acquire all of the voting shares on offer but it will be up to each shareholder if they wish to sell on the terms offered. [Schedule 1, item 1, section 9]
  6. Proprietary companies that have CSF shareholders are likely to have a large number of individual shareholders and it would be possible for someone to obtain effective control of the company by holding under 50 per cent of the voting stock. As such, by requiring someone who acquires more than 40 per cent of the voting stock to offer to buy out all remaining shareholders, CSF investors will be able take part in an exit event (if they choose to). These arrangements will reduce the chance of a future purchaser acquiring control of a company and later disadvantaging the company’s CSF shareholders.
  7. As companies will need to amend their constitutions to provide for the minimum exit arrangement, section 140 is being amended so that all shareholders are bound by the provision regardless of whether it was incorporated before or after they became a shareholder of the company. [Schedule 1, item 10, section 140]
  8. Members of a proprietary company with CSF shareholders that have appropriate CSF exit arrangements in their constitution will not be considered to have a relevant interest in the voting shares of the company merely because of the exit arrangements in the company’s constitution. Without this provision, every shareholder would have a relevant interest in every share in the company and every sale of shares would trigger the CSF exist arrangement in the company’s constitution. [Schedule 1, item 37, subsection 609(8A)]
  9. Similarly, agreements that are conditional on a person complying with appropriate CSF exit arrangements for a proprietary company with CSF shareholders will not create an interest in securities until the relevant conditions are satisfied. This will enable parties to reach conditional agreements relating to the sale of shares in a proprietary company that has CSF shareholders without it creating an interest in the company’ securities. The interest will only be triggered when all of the conditions are satisfied and the purchaser acquires the securities (in compliance with the CSF exit arrangements). [Schedule 1, item 37, paragraphs 609(8)(8B) and (8C)]
  10. The existing obligation under subsection 117(3) that public companies that have constitutions lodge a copy of the constitution with ASIC is being extended to also apply to proprietary companies that have a constitution at the time of registration that contains appropriate CSF exit arrangements. [Schedule 1, item 7, subsection 117(3)]
  11. Similarly, a proprietary company that includes or removes CSF exit arrangements from its constitution will be required to lodge a copy of the constitution with ASIC within 14 days of the special resolution approving the inclusion or removal of the relevant provisions into the company’s constitution. [Schedule 1, item 8, subsection136(5) and item 9, subsection 136(5A)]
  12. These provisions will ensure that ASIC is aware of the companies that have appropriate CSF exit arrangements in their constitutions and regulate them appropriately. Without this notification, it would not be apparent to ASIC if a proprietary company with CSF shareholders was subject to the normal takeover rules of if they were complying with the CSF exist arrangements in their constitution.

*Removal of the corporate governance concessions for new public companies and proprietary companies that convert to access the CSF regime*

* 1. The *Corporations Amendment (Crowd-Sourced Funding) Act 2017* provided for a number of corporate governance and reporting concessions for new public companies and proprietary companies that convert to access the CSF regime. These concessions were provided to facilitate proprietary companies converting to public companies in order to access CSF. As the amendments in this Bill will allow proprietary companies to use CSF without having to convert, the corporate governance concessions are no longer required.
  2. As such, section 738ZI is amended so that the corporate governance concessions are not available to public companies that incorporate, or proprietary companies that convert, after the commencement of these amendments (which will be six months after Royal Assent). [Schedule 1, item 40, section 738ZI; item 41, paragraph 738ZI(1)(a) and item 42, subsection 738ZI(2)]

## Consequential amendments

* 1. The small business guide in Part 1.5 of the Act is being updated to explain that the cap on the number of non-employee shareholders a proprietary company can have does not include any shareholders who have invested in the company as part of a CSF offer. [Schedule 1, item 2, paragraph 2.1 of the small business guide in part 1.5]
  2. Similarly, the small business guide in Part 1.5 of the Act is updated to explain that the prohibition on proprietary companies engaging in fundraising activity does not extend to raising funds under a CSF offer. [Schedule 1, item 3, paragraph 2.1 of the small business guide in part 1.5]
  3. Part 1.5 of the small business guide is also updated to reflect the fact that proprietary companies will have to prepare annual financial and directors’ reports if they have CSF shareholders. [Schedule 1, item 4, paragraph 10.3 of the small business guide in part 1.5]

## Application and transitional provisions

* 1. The amendments take effect six months after receiving Royal Assent.

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