Comments on Exposure Draft and EM issued 9 May 2017 re Corporations Amendment (Crowd-sourced Funding for Proprietary Companies) Bill 2017 ("CSF")

Submitted 6 June 2017

by

Australian Equity Crowdfunding Pty Ltd

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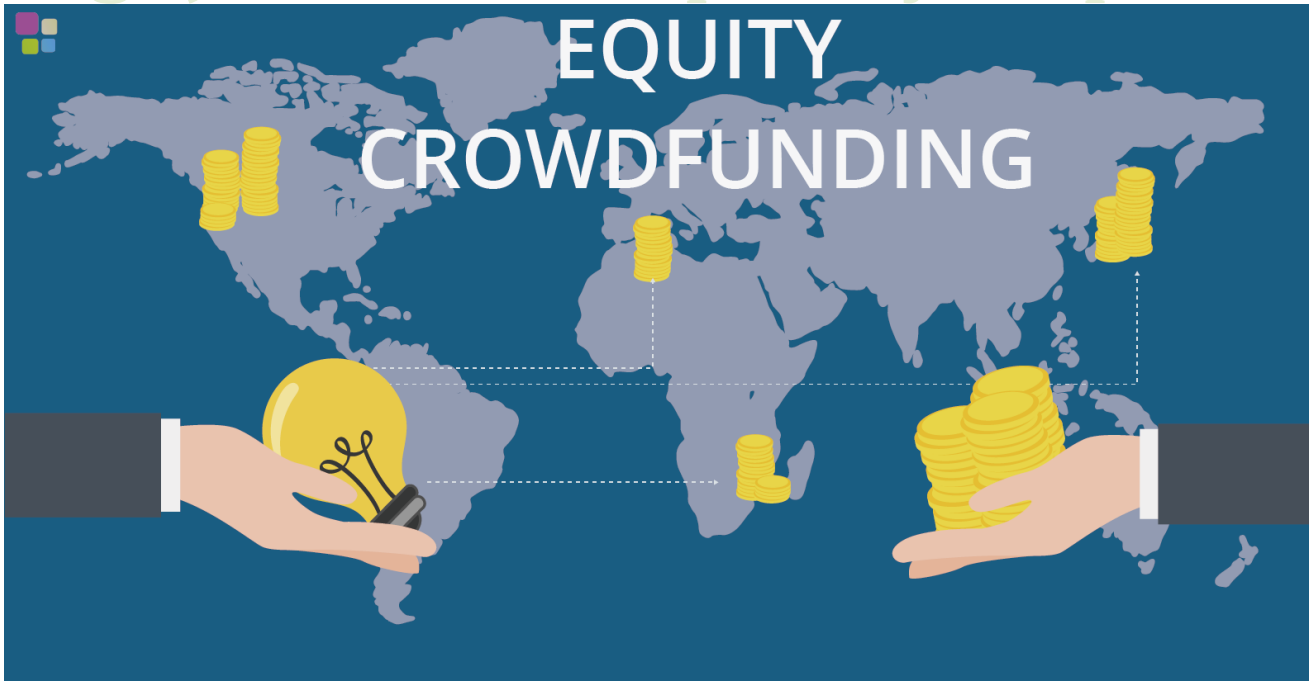
Pursuant to an invitation to comment from Treasury



This paper is provided in response to a request by Treasury on extending Crowd-sourced Equity Funding (CSEF) to proprietary companies. These changes are being progressed as part of the 2017-2018 Budget.

Submissions are due by 6 June 2017.

As an experienced, full service early stage funding group with a large retail investor base, we are well placed and keenly interested to see the best CSEF model deployed in Australia. We have spent a great deal of time evaluating CSEF platforms around the world and have responded to all Treasury feedback requests, attended the RoundTable meetings in Sydney, input into the CAMAC paper and recommendation 18 from the Financial System Inquiry Final Report. We have also had several discussions with Treasury officials.

We intend to apply for an Intermediary status with an AFSL to operate a CSEF platform once we complete our funding portals and internal documentation. We are working with companies now to see them "CSEF-ready" and we are also speaking at seminars on CSEF.

Our observations thus far are that most of the CSEF-aspirant companies approaching us are happy to convert to public status and progress through the CSEF regime stipulated in the Corporations Amendment (Crowd-sourced Funding) Act 2017. Most aspiring high growth early stage companies recognise that the CSEF funding round may be an early stage (seed) funding and they will most likely require additional funding via further issues and enlarging their shareholder register further and hence best to be in the optimal (public unlisted) structure early in their corporate life with comprehensive Constitution etc. Some have ASX aspirations. As a result, building a solid foundation as a public unlisted company is a prudent course of action for these companies.

Nevertheless, we are amendable to seeing CSEF applied to Pty Ltd companies and the EM and ED on extending CSEF to Pty Ltd companies captures most issues. We have outlined some thoughts / recommendations for your consideration – nothing substantive and we trust our notes are of use.

We acknowledge the input to this submission from our strategic alliance partners, retail investors and SME's we are assisting and we look forward to progress in this area in due course.

Signed by the authors being Directors of Australian Equity Crowdfunding Pty Ltd and Fat Hen Ventures Pty Ltd this 6th day of June 2017,

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Shareholder rights

The draft legislation aims to amend the Corporations Act 2001 to extend the CSF regime to proprietary companies to improve access to finance for start-ups and innovative small businesses. The proposed amendments are designed to remove the need for proprietary companies to transition to a public company aimed at reducing cost of compliance.

It is our view that emerging Pty Ltd companies will view a CSF round as an early stage round (i.e. just after family and friends) aimed at funding areas such as proof of concept, IP protection, prototyping, or pre-market launch and it is critical this round is built on solid foundations to set the company up for its future – involving most likely larger capital rounds with an increasing shareholder base and elevated profile.

Often these emerging companies have not been through an external "CSF Offer" process before and they will need guidance and help to ensure their structure is CSF investor friendly. Ideally their accountant or the Intermediary will be able to help these companies but as often they are short on funds (hence the CSF round requirement) they may have limited means to access the right advice and produce a fully compliant CSF Offer document.

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 will be amended such 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)]

Because the CSF Offer can only be for an issue of ordinary fully paid shares it is vital that CSF shareholders clearly understand their rights as encapsulated in a well written Constitution and succinctly summarised in the CSF Offer document.

We believe companies may need some help with a "sample Constitution" and we recommend ASIC as part of their Innovation Hub commitment and guidance, make available on their web site an Example Constitution with notations at each relevant paragraph to assist CSF-aspirant Pty Ltd companies to understand the shareholder rights as external investors in a high-risk venture.

We are mindful of CSF shareholders being adversely affected particularly where a company may have on issue:

- Convertible notes
- Preference shares
- Incentive options to the value creators who often draw minimal salary and see executive shares / options vesting over time / KPI's as attractive
- Loans without clear coupon or repayment periods or security
- Founder/s owns majority of company with likely related party dimension

The above instruments can complicate and possibly circumvent the interest of the ordinary f/p CSF shareholders and we strongly recommend full details of these instruments are clearly spelt out in any CSF Offer document and the Risk section in particular. We are still awaiting the Regs for the CSF regime and look forward with interest to these to ensure there is a full disclosure about anything that could impact the CSF shareholders position.

We believe that IF a Pty Ltd company makes a CSF Offer and Issue then while CSF shares remain on issue that any future issue or offers of ordinary shares provides CSF shareholders with equal rights to participate in ANY proposed issue of ordinary shares. Essentially the CSF Pty Ltd company needs to do a rights issue rather than place shares with a non-existing shareholder possibly on more attractive terms than the CSF Offer was made.

One of the key concessions to CSF companies under the proposed Bill is in relation to takeovers. Currently, a Pty Ltd company with more than 50 non-employee shareholders is subject to the takeover rules in Chapter 6 of the *Corporations Act*. The proposed Bill recognises that these complex rules may be contrary to the objectives of start-ups who are often disrupting the markets and positioning for a takeover or to become listed in the future.

Accordingly, the Bill provides an exemption from Chapter 6 where the CSF company includes a provision in its constitution that requires a person who acquires more than 40% 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 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.

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 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]*

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. As companies will need to amend their constitutions to provide for the minimum exit arrangement, section 140 is intended to be 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]*

Our observations here include:

a) *A 40% or more figure seems somewhat arbitrary but we are happy in essence with the thrust of the mechanism provided there is anti-avoidance mechanisms to ensure where people acting in concert who may collectively trigger 40% or more are caught under the proposed Section*
b) *It is useful to note that there may be ordinary non-CSF shares on issue so the 40% applies to ALL voting shares on issue at that time*
c) *Effectively it means CSF shareholders have a tag along at a 40% of total voting share trigger*
d) *We would not want to see companies try to circumvent CSF shareholders by issuing non-voting shares or non-ordinary shares etc to get around this tag-along trigger*

more shareholders
more comfort required re audit

Audit

The Bill proposes that 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)]

We have always strongly advocated that companies (Pty Ltd or Public) raising ANY funds via a CSF Offer should be audited. It makes no difference in our opinion, and based on detailed discussions with hundreds of potential CSF investors, if a company raises $500,000 or $2m from the public (retail and wholesale investors). For the relatively low cost of an audit it should be done by ANY CSF recipients no matter how much they raise to provide a safeguard and comfort around the CSF Issuer company.

This is particularly so where the company has been a small proprietary company lacking adoption of accounting standards, management and owners often one and the same and accounting systems that are very basic. Many of these companies have no understanding of director responsibilities to external non-involved shareholders and the audit is one way of at least having a watch dog to guard the interest of CSF and other external shareholders who are often unable to secure information about the normal operation of the company at any time.

When a company takes money from non-involved external retail and wholesale investors who may not have any influence over information dissemination etc we believe there is a HIGH risk to investors by not having an audit. It is illogical to say " *just because a company is raising $750k the audit costs (say $7.5k) are too prohibitive so we exempt them from an audit*." The CSF Offeror needs to cost into its cash flow requirements an audit and if it means a few extra thousand in the raising, we firmly believe this is an essential line item for any company taking on board public investor funds.

Peace of mind and good governance dictates an audit should be performed and notwithstanding the exemption to $1m, we will be recommending companies we advise be audited for ANY CSF raising in any event. Such pro-active action actually helps the company to raise its capital.

Other matters

Maintenance of a more comprehensive company register

We support the proposal that a proprietary company making a CSF offer 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]

It is essential for these companies to be able identify if they have any CSF shareholders given they will be subject to additional reporting and governance obligations while this is the case.

The register should be available at no cost to CSF shareholders and available on ASIC's database for a fee to non-CSF shareholders of that company. We would advocate that for CSF companies with more than 100 shareholders, then an external registry must be engaged to ensure the time and integrity of the register is maintained given such matters are often not a priority to a small technology based team of people and they are most likely to overlook diligence in maintaining the registers.

P**roduction of financial and directors' reports**

subsection 292(2) is to be 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)]

We concur that requiring proprietary companies that have CSF shareholders to prepare annual financial and directors' reports as this 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.

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. The financial reports prepared must comply with accounting standards.

The adoption of Accounting Standards is very important to CSF companies given historically their financial statements are more "tax based" and often not completed until 6 months or more after the end of the financial period.

We strongly advocate that ANY financial information contained in the CSF Offer document has to be cast or recast in a table where the company shows its results from full compliance with Accounting Standards otherwise the readers may not be able to make an informed investment assessment by reading the historical financial information presented in the CSF Offer.

As a result of the requirement for these companies to prepare annual financial and directors' reports, there are a number of consequential amendments that will be required in relation to the current reporting exemptions available for small proprietary companies.

We assume the annual financial report will include:

Document	Section of the Corporations Act
Statement of financial position as at the end of the year (if consolidated accounts are not required by accounting standards)	295(2) and 296(1)
Statement of profit or loss and other comprehensive income for the year (if consolidated accounts are not required by accounting standards)	295(2) and 296(1)
Statement of cash flows for the year (if consolidated accounts are not required by accounting standards)	295(2) and 296(1)
Statement of changes in equity if consolidated accounts are not required by accounting standards)	295(2) and 296(1)
Consolidated financial statements, if required by accounting standards	295(2) and 296(1)
Notes to financial statements (disclosure required by the *Corporations Regulations 2001*, notes required by the accounting standards, and any other information necessary to give a true and fair view)	295(3)
Directors' declaration that the financial statements comply with accounting standards, give a true and fair view, there are reasonable grounds to believe the company/scheme/entity will be able to pay its debts, the financial statements have been made in accordance with the Corporations Act	295(4)
Directors' report, including the auditor's independence declaration	298-300A

We would also impress on directors of CSF companies that the above is a minimum and IF any major favourable or unfavourable event occurs during a reporting period, they are obligated to release such material information to the shareholders promptly. Likewise, for any proposed transfers of shares, the directors should approve such transfer and should any unreported adverse or positive material information be known to the directors and not shareholders then the directors should have an obligation to make such information known to the shareholders to avoid an uninformed market for such transfers of shares – particularly as these shares would then become non-CSF shares.

the related party transaction restrictions in Chapter 2E of the *Corporations Act* will apply to a company with CSF shareholders

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]

The application of Chapter 2E to proprietary companies that have CSF shareholders is aimed at providing 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.

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.

Given that related party transactions can be common in such thinly managed / owned companies we recommend the shareholder approval be forthcoming from only independent shareholders being CSF shareholders **and any other "outside"** shareholders. Also, all related parties must be disclosed in the CSF Offer document and the quantum of payments etc and ANY material departure from this disclosure or new related party transactions must be approved by all non-related shareholders.

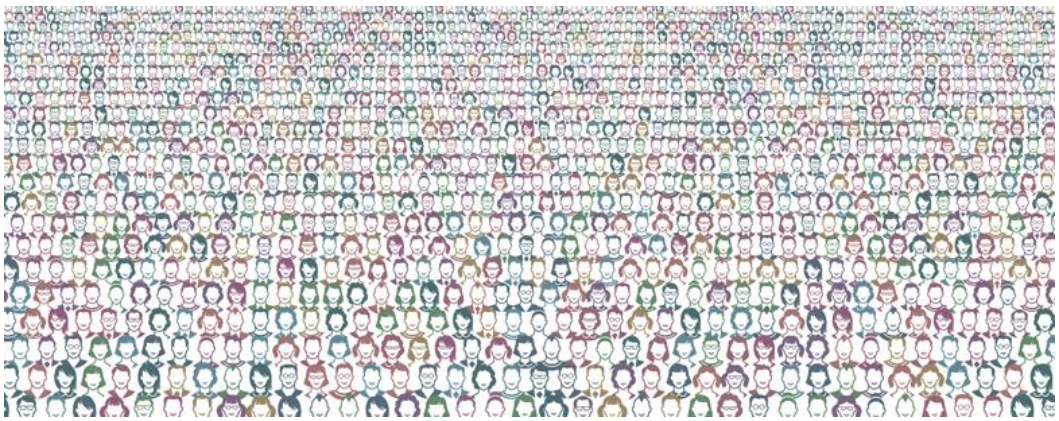
We suggest it should be a special resolution.

Directors

It is proposed that 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 is designed to 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)]. 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.

We would recommend that the Constitution be worded such that where CSF shareholders have subscribed at least 25% of the total paid up capital of the company, then CSF shareholders have an entitlement to appoint one director to the board of the CSF company. Our experience has shown that Pty Ltd companies often still run the company post equity raise as though it is their own private company and the small combined shareholders (i.e. minority) and often ignored, or worst case, prejudiced often not by design but by naivety about the minor shareholder group rights – who in many cases actually subscribe for the majority of the cash to fund the company.

Given this reality, we believe this requirement in the Constitution would lead to greater transparency, more robust decision-making and greater certainty around succession planning.



Crowding into Pty Ltd companies - the right way

Conclusion

We trust these comments assist in your efforts to finetune the Pty Ltd extension.

If you require anything further please contact the writers anytime,
Yours sincerely

X

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