



The Institute of Public Accountants



IPA INSTITUTE OF PUBLIC
ACCOUNTANTS
Partnership beyond numbers

**Corporations Amendment
(Crowd-Sourced Funding For
Proprietary Companies) Bill 2017**

June 2017

IPA - Deakin SME Research Centre

The Institute of Public Accountants (IPA) is one of the three legally recognised professional accounting bodies in Australia. The IPA has been in operation for over 90 years and has grown rapidly in recent years to represent more than 35,000 members and students in Australia and in more than 80 countries. The IPA has offices around Australia and in London, Beijing, Shanghai, Guangzhou and Kuala Lumpur. It also has a range of partnerships with other global accounting bodies. The IPA is a full member of the International Federation of Accountants and has almost 4,000 individual accounting practices in its network, generating in excess of \$2.1 billion in accounting services fees annually. The IPA's unique proposition is that it is for *small business*; providing personal, practical and valued services to its members and their clients/employers. More than 75 per cent of IPA members work directly in or with small business every day. The IPA has a proud record of innovation and was recognised in 2012 by *BRW* as one of Australia's top 20 most innovative companies.

In 2013, the IPA partnered with Deakin University to form the IPA Deakin SME Research Partnership, a first in Australia. This partnership has grown and evolved into the IPA assisting Deakin University in establishing the IPA-Deakin SME Research Centre in 2016. The goal of the Centre is to bring together practitioner insights with cutting edge SME academic research, to provide informed comment for substantive policy development.

The IPA-Deakin SME Research Centre comprises:

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Along with our report below, we have attached (in full), our previous submission to government on crowd-sourced funding (July 2015), as we believe it has considerable information relevant to the current debate. The aforementioned submission was prepared by Professor George Tanewski from the IPA-Deakin SME Research Centre, Deakin Business School, Deakin University. The report has been publicly cited in several publications by different bodies, including the Australian Productivity Commission. Other contributors to the 2015 report include; Professor Gordon Murray (Exeter University, UK); along with Professor Marc Cowling (Brighton Business School, UK).

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6 June 2017

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Dear Sir/Madam

***Corporations Amendment (Crowd-Sourced Funding) for proprietary Companies) Bill 2017
Extending the Crowd-Sourced Funding Regime to Proprietary Companies***

The IPA-Deakin SME Research Centre (IPSR) is pleased to submit our comments to the proposed legislation intended to extend the crowd-sourced funding regime to proprietary companies in Australia. We also commend the Government for recognising the need to provide for an important alternative source of funding for entrepreneurs and for small to medium enterprises generally.

The IPSR is a joint initiative of the Institute of Public Accountants and Deakin University. It exists to increase the awareness by government and the community more generally on issues related to individuals and small to medium businesses by contributing to policy debates, particularly as they affect our membership.

If you have any queries or wish to discuss our submission in greater detail then please don't hesitate to contact Vicki Stylianou (vicki.stylianou@publicaccountants.org.au or mob. 0419 942 733).

Yours faithfully



Vicki Stylianou
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1. Introduction -Crowd-Sourced Funding Legislation (existing and proposed)

Recently enacted CSF legislation

After many years of discussion and debate, as well as several ‘false’ starts, Australia finally passed legislation allowing public companies to access crowd-sourced funding (CSF), effectively, as from September this year. Further to our submission to Government in 2015, the IPA strongly supports the amendments to the *Corporations Act 2001* which will now allow eligible start-ups greater access to a relatively new form of finance which, in the words of one commentator, ‘will democratise the funding of start-ups’ (Blanding, 2013). Moreover, the IPA further supports the reduced compliance and disclosure provisions within the amendments relieving unlisted public companies from significant regulatory burdens over a five year period. The passing of the new laws is a quantum leap forward for this form of funding and will position Australia alongside several other countries that have already adopted and embraced similar laws and financing regimes, such as for example, the USA, the UK, Canada, and New Zealand along with a host of other European countries. The IPA trusts that the new legislation will change the funding landscape not only for start-ups, but also for established companies that meet the eligibility criteria. To meet the eligibility criteria, a public company must earn less than \$25 million in annual revenue and have less than \$25 million in gross assets. Some of the other features of the changes which the IPA fully endorses, and would be of interest to our members and their clients, are briefly listed below:

- An eligible company can raise up to a maximum of \$5 million in any 12 month period.
- An eligible company can accept offers from retail investors (with a maximum holding of \$10,000 per company for each investor in any 12 month period). A retail investor could be any member of the public, and typically could well include the so-called ‘*mum and dad*’ investors.
- Any offers to invest in a CSF offer must be made via a CSF intermediary. The intermediary must hold a current Australian Financial Services Licence along with authorisation to conduct CSF offers.
- Investor protections
 - Cooling-off period of 5 days
 - Prohibition of financial assistance for investment in a CSF
 - Accepting risk acknowledgement prior to lodgement of application for shares
 - Civil and criminal liability for defective offer documents
- Concessions for unlisted public companies

- No holding of an AGM
- Ability to provide required reports online
- No need to appoint an auditor if CSF offer is less than \$1

Proposed CSF legislation

Notwithstanding IPA's support (and related commentary) for the recently enacted legislation above, the IPA does acknowledge that in their current form, the new laws have the consequential effect of restraining a more predominant corporate form, and perhaps a form more representative of new entrepreneurs and start-ups in Australia. We refer of course, to the proprietary company form. And so, given recent parliamentary endeavours, we are delighted that similar, yet more measured provisions are now being proposed by government via The *Corporations Amendment (Crowd-Sourced Funding for Proprietary Companies)* Bill 2017 (CSF Bill). These proposed changes address one of the major criticisms of the new laws which prevented private companies from participating and enjoying the benefits of engaging in CSF offers. As the law currently stands, due to the well embedded '50-member' restriction, the only mechanism which would allow existing proprietary companies to partake in CSF activities, is to firstly morph from a proprietary company to a public company and then be eligible to engage in CSF activities (assuming of course, that all of the other eligibility criteria set out in the legislation are met, for example revenue and asset monetary thresholds). Moreover, any new start-ups that wish to reap the benefits of the new CSF regime, would first need to register as a public company, a decision on structural form, which in many cases may not be appropriate in the early stages of developing a new business.

As with the new CSF laws relating to public companies, the IPA fully endorses the proposed measures, with some minor exceptions detailed in commentary below. For the benefit of our membership, we would like to reiterate our understanding of the proposed laws in the current bill and explanatory memorandum, and comment according to the major features of the proposed changes.

2. What the changes will mean for proprietary companies

As briefly mentioned above, the CSF Bill will extend the current CSF funding regime applicable to public companies, to proprietary companies that meet the eligibility criteria

which are basically the same as those for a public company making a CSF offer (except that in the case of a proprietary company, the company must have at least two directors).

Commentary on eligibility – revenue and asset thresholds

We note that to be eligible to make a CSF offer, a company must satisfy a number of criteria, including having less than \$25 million in gross consolidated assets, or \$25 million in consolidated annual revenue at the ‘*test time*’. We assume that test time means, the time that the offer is made. This being the case, we ask whether the criteria are ongoing, that is, will they need to continue to be met after the offer? For example, will there be any consequences in terms of continued eligibility if the thresholds are exceeded after the CSF offer? Perhaps this issue requires clarification.

Commentary on funding

The amendments will bring along with them, significant benefits that will flow from bridging the ‘capital gap’ faced by countless young and emerging start-ups in the Australian economy. As explained by one author, Zein, (2013) “*Australia’s success rate in funding and commercialising innovation lags behind most other advanced economies, [and] addressing the lack of funding for start-ups is critical because it is these firms that drive the economic transformation needed to respond to new challenges and requirements of a dynamic global economy*”. The IPA wholeheartedly supports this view and again, commends the government for taking the initiative to extend the current CSF regime to proprietary companies. Indeed since the decommissioning of the Australian Secondary Board Stock Market several decades ago, which specifically catered for young and emerging firms, it appears that start-ups in Australia have had very few avenues for adequate long-term funding and in this respect have relied on funding sources that may have been the right choice in their particular circumstances and stage of development. Many have turned to going public only to find the route considerably expensive, often fraught with significant regulatory burdens, as well as lack of investor interest, see, particularly Mroczkowski, (2008). Mroczkowski (2003), also documents the considerable discounting (*underpricing*) that occurs for SME firms that engage in an Initial Public Offering (IPO), particularly those with a short trading history. Considerable underpricing is often at the expense of the entrepreneurial firm founders as the academic literature shows that the share price for promising IPOs will climb well above initial price in the first 20 days post listing, see for example, Rock (1986), at which time there is a sell-off period in which initial buyers reap considerable gains. The other avenue of funding that has some appeal is venture capital, but often this form of financing, means agreeing to significant covenants and constraints for entrepreneurs, and maybe rightly so, as some evidence suggests that up to 75 per cent of venture-backed start-ups fail; see, Ghosh, (2012).

It has been the experience of IPA members and their clients that a significant source of funding for SMS's has traditionally been an over-reliance on funding from private sources such as family members and friends, and for many firms this is a wise choice where these funds are available and with no overwhelming restrictions. For most SME's however, private funding is not readily accessible, see Mroczkowski, (2008).

Commentary of directorships (ie minimum of two directors)

Nothing has come to our attention that would cause us to object to these amendments except where otherwise elsewhere identified in this response.

Commentary of residency of directors (ie majority of directors required to be resident in Australia)

Except to the extent that in circumstances where there are only two directors, determining what constitutes a majority would be somewhat difficult if not possible, nothing further has come to our attention that would cause us to object to these amendments.

3. Cap of 50 non-employee shareholders

Default trigger to public company form

From our understanding of the proposed amendments, the existing cap of 50 non-employee shareholders will not include shareholdings that arise from a CSF offer, in which case first time acquirers of CSF shares will not trigger the current default provisions in the law requiring a proprietary company to convert to a public company. The IPA has no issue with these amendments as they relate to initial buyers of CSF shares. However, we are concerned with the amendments as they relate to secondary buyers who lose the CSF status and are counted among the existing shareholding that is subject to the 50 non-employee shareholders cap. Our concerns relate to our members and their clients, many of whom either directly or through various inter-posed entities, have already reached the cap of 50 members or are close to it. Consider for example, instances where family firms with several families and their generations of offspring are shareholders and who are looming toward a membership of 50. A sudden sell-off or transfer of shares by initial purchasers to secondary buyers might result in a breach of the cap thus resulting in a mandatory conversion to a public company. This in itself might bring with it unintended and undesirable circumstances for the original 'private' group of shareholders. We believe that this area of the proposed laws needs further examination and consideration, particularly whether it would be plausible, for at least the first 5-year period, to consider all acquirers, including secondary acquirers, as qualifying CSF shareholders, and thus not form part of the cap.

4. Composition of shareholding

In addition to our comments above, we note the commentary in the Explanatory Memorandum that the new CSF regime for proprietary companies will in effect create two classes of shareholders and possibly another class for secondary buyers. We acknowledge that the class or classes of shareholders not forming part of the original (closely held) holdings will thus not have the same access to information as those in the closely held group, ie upon which to make informed judgement as to the status of their investment inter alia. Accordingly, the typical situation articulated in the literature as a separation of ownership and control will occur and therefore the need for protection for these groups of shareholders is warranted. The IPA has no issue with these additional protections and measures, particularly the additional reporting and governance regulations as discussed further below. Our concerns are more with the rights of the new shareholder group(s). Nothing has come to our attention within the bill or the explanatory memorandum for us to assume that the normal provisions of the law relating to all companies will not equally apply to CSF shareholders. Accordingly, we would expect their rights and entitlements to be the same as a result of being in a separate class of shareholding. For example;

- The right to expect the full application of the law with respect to the fiduciary duties of directors as they currently apply to all shareholders
- The rights to dividends assuming the criteria within the Act are satisfied
- The right to attend meetings if and when called
- The right to receive financial reports, and so on.

As is sometimes the case with legislation, proposed amendments make reference to additional requirements that may be specified in the regulations and accompanying schedules from time-to-time, and often without providing additional information. For example, within the Corporations Amendment (Crowd-Sourced Funding) Act 2017, No 17, 2017, applicable to public companies, s738F(3), s738G(f), and s738ZJ are typical examples of citations relating to regulations dealing with further detail. While we understand that regulations and schedules are required to bring effect to the operational and more perfunctory aspects of the law, the IPA believes that more detailed explanations within the explanatory memorandum on specific practical issues (such as for example, CSF shareholder rights, and processes that may impact those rights [for example the basis upon which an intermediary allocates shares to particular offerees]), would help stakeholders better understand the rationale for the various measures proposed, as well as their potential impact. Moreover, we maintain that more information is better than less and accordingly sets the platform for meaningful debate and the enactment of good laws. While we commend the Government's efforts in providing a valuable and much needed avenue of funding for SME's and the like, without further information of how the new laws will play out in practice, we fear that the new laws could provide fertile ground for

potential disputes between the closely held group of shareholders and the CSF shareholders. At the extreme, it would be almost akin to the majority v. the minority dilemma that has plagued corporate law; it would seem, for centuries.

5. \$10,000 cap per investor per company in any one year

Except to confirm our support for an excellent mechanism to mitigate/cap risk exposure for retail investors, particularly *mum and dad* investors, we have no further comment on the proposed amendments.

6. 5-Day cooling off period

While we understand the concept of a cooling off period as another form of added protection for retail investors, we are not quite comfortable as to the need for such protection, particularly given that Australia almost stands alone as a country that has adopted this form of protection. Unlike expensive motor vehicles and real estate, where the need for a cooling off period or similar regime is arguably warranted, for example, where an acquirer gets '*cold feet*' for whatever reason (such as for example not having enough time to properly assess the purchase and/or feeling a little pressure from all the sales hype), an investment in a CSF offer has already significant protections in place not only in terms of the \$10,000 cap per investor, but also the significant *checks and balances* placed on intermediaries. Moreover, one would expect that a person intending to invest in a CSF offer, would take advantage of the significant time period (up to three months), to undertake appropriate due diligence measures to ensure the appropriateness of the investment in terms of the investors personal circumstances (often described as the '*clientele effect*' in the finance literature). The IPA also has concerns that the 5-day window where an investor can withdraw from an offer after the offer closes, could potentially lead to market manipulation. A good example is the where a group of investors known to each other (and have made significant investments in the offer via different vehicles and associates) can band together and withdraw from an investment thus possibly changing the outcome of the offer. While this would be highly unlikely, it is possible and as such, could have a significant negative impact (Dias, 2017).

7. Offer platform

The IPA has no major issues with the detailed provisions relating to the offer platform via licensed intermediaries. Our only concerns relate to our earlier comments regarding the need for more information on the practical aspects of the legislation relating to offers. Moreover we, eagerly await the release of the forthcoming details in the regulations relating to the minimum information required to be included in a CSF offer document.

8. Additional reporting obligations

Financial

The requirement to comply with accounting standards when preparing a financial report is an important governance measure which the IPA fully supports. We note however, that proposed compliance requirements will be a major gear shift for some companies not currently required to comply with accounting standards, and in this respect, perhaps some form of reduced disclosure regime may warrant further consideration.

Registers

Nothing has come to our attention that would cause us to object to these amendments except where otherwise elsewhere identified in this response.

Related parties

The requirement to comply with Chapter 2E of the Corporations Act, which applies to related parties, is an important governance measure which the IPA fully supports. We note however, that the proposed compliance requirement will be a major burden for companies not currently required to comply with related party restrictions and disclosures. This is particularly so for proprietary companies, many of which are fraught with complex structures often involving an intricate web of personal and business relationships.

Audits – CSF offers greater than \$1 million

Except to confirm our support for an excellent mechanism of corporate governance which will provide credibility to the financial statements, we have limited further commentary on the proposed amendments. Our only concern is the significant cost burden that a financial audit will place on proprietary companies.

9. Chapter 6 Exemptions

Nothing has come to our attention that would cause us to object to these amendments except where otherwise elsewhere identified in this response.

10. Defective offers

Nothing has come to our attention that would cause us to object to these amendments except where otherwise elsewhere identified in this response.

11. General comments

Public company governance concessions

Unlisted companies choosing to adopt the CSF public company model will have concessions for a period of five years that relate to the holding of an AGM, an option to post reports online, and the removal of the requirement to appoint an auditor unless the company engages in a CSF offer of greater than \$1 million. The IPA is concerned that after the initial five-year period, the concession will presumably be removed, in which case the remaining structure, along with all of the compliance burdens, may not be what was initially planned or desired.

Further funding pressure on the regulator

Our final comment relates to the enormous work that will no doubt be required by ASIC to continue to monitor the activities of companies undertaking the crowd sourced funding route, along with the activities of their intermediaries and their respective offer platforms. We fear that ASIC's already under-resourced monitoring and surveillance/compliance activities will be further stretched requiring even more funding from the public purse.

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