
Crowd-sourced equity funding a reality for Australian companies

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Authors: James Delesclefs, Manoj Santiago, Sarah Hickey, Latika Sharma, Henry Goodwin, Lisa Dounis

In brief

Australian companies now have more options when it comes to fundraising, following legislative changes around crowd-sourced equity funding (**CSF**).

Effective from 29 September 2017, the *Corporations Amendment (Crowd-Sourced Funding) Act 2017 (Cth)* (**CSF Act**) allows companies to raise capital from a large number of investors through an online platform run by an intermediary. The framework for CSF in Australia follows some international jurisdictions which already have a CSF regime in place, including New Zealand, the United Kingdom and the United States of America.

Currently, chapter 6D of the *Corporations Act 2001 (Cth)* (**Corporations Act**) provides that a company is prohibited (subject to certain exemptions) from offering securities for issue or for sale to the public without the required disclosure to investors.

The CSF Act strives to balance supporting investment, reducing compliance costs and maintaining appropriate investor protection. In this article, we outline some of the key features of the new CSF regime, as well as provide an update on further changes proposed by the Federal Government with respect to CSF for proprietary companies, and discuss initial coin offerings (**ICO**) which are another form of alternative fundraising gaining momentum in Australia and internationally.

In detail

Key features of the CSF Act

The CSF Act introduces a legislative framework and regime whereby CSF may be undertaken by Australian *public* companies under certain circumstances, provided the requisite criteria set out in the CSF Act (and summarised below) are met.

Eligibility requirements for companies undertaking crowd-sourced equity funding

To be eligible to make a CSF offer, a company must be an **Eligible CSF Company**. An Eligible CSF Company will, at the time of making the offer:

- be registered as, or be converted to, an unlisted public company limited by shares.¹ Related parties of the Eligible CSF Company cannot be listed either;
- have gross assets and annual revenue each *less than* AUD25 million at the time when the company makes the CSF offer. These limits include the assets and turnover of related parties of the Eligible CSF Company;
- have its principal place of business and a majority of its directors ordinarily reside in Australia; and
- not have a substantial purpose of investing in securities or interests in other entities or schemes. This restriction also applies to related parties.

A CSF offer must also comply with the **Issuer Cap**, meaning that the *sum* of the following must not exceed AUD5 million:

- the maximum amount sought to be raised by the new CSF offer;
- all amounts raised through previous CSF offers, made by the Eligible CSF Company or its related parties in the 12 months before the new CSF offer; and
- all amounts raised through certain chapter 6D exemptions², by the Eligible CSF Company or its related parties, in the 12 months before the new CSF offer.

In addition to the CSF offer meeting the requirements of the Issuer Cap, it will need to expressly state that the offer is made under the CSF regime, and be an offer for the issue of fully-paid ordinary shares in the Eligible CSF Company. The funds raised via a CSF offer may not be used to invest in other companies, entities or schemes or be used as a loan to related parties.

Temporary Concessions

For those companies undertaking CSF either as a newly registered public company or a proprietary company which converts to a public company, the CSF Act provides some temporary exemptions from compliance with certain corporate governance and reporting requirements that would normally be required by a public company.

The exemptions are available for up to five years after registration as, or conversion to, a public company. They include an exemption to the requirement to:

- hold an annual general meeting (**AGM**);
- appoint an auditor and the requirement for financial reports to be audited; and
- distribute hard copies or electronic copies of annual reports to shareholders.

To qualify for the exemptions, the entity must meet the requirements set out below at the time of registration as, or conversion to, a public company, and at the end of each financial year in which it seeks to rely on the exemptions. At those times, it:

- must become or convert to a public company on or after 29 September 2017;

¹ ASIC has been accepting applications for registration for public companies wanting to participate in the CSF regime and for those proprietary companies wanting to convert from 29 September 2017.

² Subsections 708(1) or (10) of the Corporations Act.

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- intend to make a CSF offer within the next 12 months;
 - be eligible to make a CSF offer;
 - successfully complete a CSF offer within 12 months; and
 - not offer any securities that need disclosure under Chapter 6D.2 of the Corporations Act, since it started accessing the concessions.

The temporary concessions will cease to apply at the earlier of five years from the date of registration, or conversion, or when the entity no longer meets all of the requirements set out above.

To be eligible for the audit concession, the entity must meet the above requirements *and* have raised less than AUD1 million from all CSF offers. If the entity exceeds that limit, it will need to appoint an auditor, but will remain eligible for the AGM and annual report exemptions if it continues to meet the above requirements.

Companies nearing the threshold of the exemption for audit and reporting requirements are advised to be prepared. Issues such as the consistency of accounting standards and reporting requirements with financial information supplied in previous offer documents will be important factors for the entity to consider once the temporary concessions no longer apply to that entity.

How to make a CSF offer

The key requirement for an Eligible CSF Company to make a CSF offer is to engage with a CSF intermediary *and* prepare the CSF offer document.

The CSF intermediary

The CSF intermediary will play a significant role in the CSF regime. The intermediary will operate and host the online platform through which Eligible CSF Companies are able to publish a CSF offer document, and investors can participate in a CSF offer and make an investment.

In addition to operating the online platform, the CSF intermediary will have a number of obligations under the CSF Act, including some 'gatekeeper obligations', such as being required to:

- perform checks on the Eligible CSF Company, its directors and the CSF offer document;
- perform checks on investors, including assessing whether an investor is a retail client;
- hold investor money on trust;
- provide an application facility and communication facility;
- prominently display the CSF general risk warning and cooling off rights (for retail investors) and the fees that the CSF intermediary is charging the Eligible CSF Company making the offer; and
- review and consider whether a CSF offer will need to be suspended or closed in certain circumstances (for example, where the CSF offer document is defective).

Licensing requirements

A CSF intermediary will be required to hold an Australian Financial Services License (**AFSL**), permitting it to engage in a 'crowd-funding service' and to operate a crowd-funding platform.

The crowd-funding service is a new financial service and the AFSL obligations under the Corporations Act continue to apply to CSF intermediaries authorised to provide a crowd-funding service.

From 29 September 2017, the Australian Securities and Investments Commission (**ASIC**) has been accepting applications for those entities that wish to operate as CSF intermediaries. If the CSF intermediary is intending on using the crowd-sourced funding platform to facilitate a secondary trading of CSF shares, whereby crowdfunding investors can trade their CSF shares with other investors who also hold CSF shares, then the intermediary will also need an Australian market licence.³

The CSF offer document

The CSF Act and the accompanying regulations set out the minimum information that is required to be included in a CSF offer document. Those requirements comprise the following information about the Eligible CSF Company:

- information about the company, including its business, organisational structure and risk factors;
- a general risk warning;
- the capital structure of the company;
- the company's financial information;
- information about investor rights; and
- information about the offer, including intended use of the funds raised.

ASIC has provided a CSF offer document template as an appendix to the Regulatory Guide 261 *Crowd-sourced funding: Guide for public companies* to assist those Eligible CSF Companies with the format and detail required for the CSF offer document.

The retail investor

The CSF Act provides certain safeguards for retail investors. These include:

- retail investors can only invest a maximum of AUD10,000 through a CSF offer by the same company via the same CSF intermediary in any 12-month period;
- an unconditional cooling off period of up to five business days after submitting an application to reconsider their investment and the opportunity to withdraw their application;
- a general risk warning statement, using specified wording required by law, must be provided to retail investors in the CSF offer document and on the CSF intermediary's platform; and
- retail investors must acknowledge that they have read and understood the general risk warning before applying for shares under a CSF offer.

These mechanisms seek to protect retail investors, especially in light of the comparatively reduced disclosure requirements of CSF offers.

Proprietary Company Regime

In response to the market's reaction to the CSF Act (which requires companies to be *public*), the Federal Government announced in this year's Federal Budget its plan to extend CSF to proprietary companies. The *Corporations Amendment (Crowd-sourced funding for Proprietary Companies) Bill 2017 (CSF Proprietary Bill)* was introduced to the House of Representatives on 14 September 2017. The CSF

³ ASIC released Consultation Paper 293 (Consultation Paper) and Regulatory Guide 172 (Regulatory Guide) to deal with AML exemptions in light of the CSF Act. In this consultation paper ASIC sets out a proposal to implement a new "two-tiered" market licensing regime to complement the CSF Act, and how it may impact some CSF intermediaries.

Proprietary Bill extends the CSF regime to Australian proprietary companies without the need for those companies to convert to a public company.

Set out in the table below is a summary of the key differences between the requirements for undertaking CSF under the CSF Act, and the regime proposed under the CSF Proprietary Bill for proprietary companies. Notably, no changes are proposed to the criteria for the CSF offer, the CSF offer document, CSF intermediary, licensing requirements and many others in the regime under the CSF Proprietary Bill.

CSF Act	CSF Proprietary Bill
Eligible CSF Company must be a public company, or a proprietary company that converts to a public company.	<ul style="list-style-type: none"> • No requirement to convert to a public company. • A proprietary company must have at least two directors and a majority of the directors will also have to ordinarily reside in Australia. • A proprietary company may have a maximum of 50 non-employee shareholders, but CSF shareholders will not count towards this cap.
<p>Reduced reporting obligations for those entities that meet the criteria set out above, including:</p> <ul style="list-style-type: none"> • the entity is only required to provide financial reports to shareholders online; and • the entity is not required to have its financial statements audited until more than AUD1 million has been raised from CSF offers or other offers requiring disclosure. 	<ul style="list-style-type: none"> • Currently small proprietary companies are not required to prepare financial and directors' reports unless they are directed to do so. However, under the CSF Proprietary Bill: <ul style="list-style-type: none"> ○ proprietary companies that have CSF shareholders will have to prepare annual financial and directors' reports in accordance with accounting standards; and ○ proprietary companies that raise AUD3 million or more from CSF offers are required to have their financial statements audited. Early engagement with an auditor will assist in ensuring accounting policies, governance and controls can withstand an audit process. • Proprietary companies that make a CSF offer will have to include details about the offer and the shareholders as part of their company register, and will also need to notify ASIC of these details.
<p>Other temporary concessions for eligible entities that register as, or convert to, a public company include an exemption to the requirement to:</p> <ul style="list-style-type: none"> • hold an AGM; and • the appointment of an auditor until more than AUD1 million has been raised from CSF offers or other offers requiring disclosure. 	<p>If the CSF Proprietary Bill passes:</p> <ul style="list-style-type: none"> • public CSF companies will lose the AGM exemption;* • the audit concession threshold for public CSF companies will increase from AUD1 million to AUD3 million or more from CSF offers (in line with the limit proposed for proprietary companies under the CSF Proprietary Bill);* and • both public and proprietary companies will only have to distribute their annual reports online. <p><i>*Companies that convert into public CSF companies before the CSF Proprietary Bill comes into effect will retain eligibility for the concessions on a grandfathered basis.</i></p>

Notably, both public companies and proprietary companies that have CSF shareholders will be subject to the related party transaction rules in Chapter 2E of the Corporations Act. Currently, the protections available under Chapter 2E are only available to public company members. This means that CSF shareholders of a proprietary company will have the benefit of the protections where funds are transferred to any related parties through uncommercial transactions without shareholder approval.

Furthermore, proprietary companies that have CSF shareholders will be exempt from the takeover rules in Chapter 6 of the Corporations Act. Given that a proprietary company which undertakes a CSF is likely to exceed 50 shareholders, the exemption should allow proprietary companies more flexibility for exit and sale opportunities without the need to comply with the takeover rules. This is provided that the entity meets any of the conditions which are set out in the regulations from time to time.

Initial Coin Offerings (token raisings)

An Initial Coin Offering (**ICO**) is an alternative form of fundraising for companies, and provides another option for investment. An ICO is a method used by businesses or individuals to raise funds from a large pool of investors through the internet, and is most prominently used by technology start-ups that are using distributed ledger (i.e. 'blockchain') technology.

Generally, an ICO process operates by allowing investors to purchase tokens using cryptocurrencies, such as Bitcoin or Ethereum, through a platform on the internet. The nature of the 'token' that is issued to the investor varies greatly, but most ICO digital tokens do not come with ownership, voting rights, or even a promise to share in future profits. Tokens may only give the investor access to the platform or service which the company has provided or in the particular project that the company is developing.

An ICO and the terms under which digital tokens are acquired by an investor vary, and the ICO can be used for a number of different types of projects to raise funds. An ICO has been described as similar to an initial public offering (**IPO**) process. However, the two are very different in practice and vary significantly with respect to legislative protections, so it is important to not conflate the two concepts. ICOs usually do not offer any legal rights and protections, nor claims to any underlying assets, unlike shares in an IPO (which is highly regulated through recognised stock exchanges).

As with other innovation and digital technology, it is moving faster than any regulator would like given the high risk to investors. Some countries have responded to ICOs with concern (e.g. China and South Korea, which have both banned ICOs for the time being), whereas other countries have embraced ICOs (e.g. Switzerland). One of the major concerns is that token raises are not complying with regulatory rules for the issue of securities (in particular as they relate to retail investors). It is for this reason that more recent token raisings tend to involve a token other than an equity or debt right in respect of the issuing company.

While there is no specific regulation for ICOs in Australia, ASIC has released an information sheet (INFO 225) giving some guidance on the potential application of the Corporations Act to the offering of ICOs. Importantly, it really depends on the terms of the offer of the ICO and the way the ICO is structured as to whether that particular ICO will be subject to compliance under the rules of the Corporations Act. Most relevantly, the ICO may be bound by the disclosure regime under Chapter 6D of the Corporations Act and, if the ICO is considered to be a managed investment scheme, it will be subject to Chapter 7 of the Corporations Act.

There is also limited guidance on the taxation implications of token raisings for issuers and investors. As many token raisings approximate a pre-sale of goods or services, the proceeds may be taxable for the issuer. Equally, there are open questions as to whether the supply of the token is a taxable supply. The answers to both questions are highly dependent on the nature of the token and the particular investment. Parties entering into a token raising transaction should exercise caution and seek independent tax advice.

As ICOs are not separately legislated for, they will be bound to comply with the current funding regime provisions under the Corporations Act. By contrast, the CSF Act *amends* the Corporations Act to create a regulatory regime for those companies undertaking CSF.

International experience

United Kingdom

Crowd-sourced funding has become an increasingly popular, and at times alternative, way to fund businesses in the UK both in the debt (so called 'peer-to-peer') and equity sphere, often taking the place of venture capital or small private equity investment. Crowd-sourced funding is conducted through a variety of online platforms which are authorised and regulated by the Financial Conduct Authority (**FCA**), and is open to any company in the UK through these platforms (the act of arranging deals or communicating investments in securities is the act that requires FCA regulation and authorisation).

The platform itself has to accept and approve the company to participate in its own platform, and as an entity that is regulated by the FCA, they have their own responsibility to ensure the company is suitable. They also conduct their own due diligence (e.g. to ensure statements made are correct) and have their own rules and requirements in relation to the companies that participate in crowd-sourced funding (e.g. usually related to fairness across all shareholders with rights set out in the articles of association rather than shareholders agreement).

Reports suggest that in the past six years (when crowd-sourced funding really started in the UK), as an industry, over GBP500 million of equity has been raised and GBP4.2 billion of debt raised.

Singapore

There is no specific crowd-sourced funding legislation in Singapore. *The Securities and Futures Act (Cap. 289)* (**SFA**) governs securities offerings, including equity-based crowd funding. Platforms facilitating crowd-sourced equity funding are required to hold a Capital Markets Services License under the SFA. Issuers are required, under the SFA, to issue a prospectus, subject to an exemption for 'small offers' under SGD5 million.

The SFA framework was updated following consultation in 2016 with the aim of improving access to crowd-sourced equity funding for early stage companies and SMEs, whilst enhancing safeguards for investors. The key changes following the consultation include:

- simplification and reduction of pre-qualification checks for investors (including for retail investors);
- lowering of the capital requirements and removal of the security deposit for platforms servicing accredited and institutional investors; and
- guidance issued providing clarity for platforms to publicise their services.

ICO experience in Singapore

Since the China ICO ban in September 2017, the financial regulator in Singapore, the Monetary Authority of Singapore, has re-iterated that it does not wish to regulate cryptocurrencies, in favour of focusing on the legitimacy of activities surrounding cryptocurrencies. The regulator will continue to assess ICOs on a case-by-case basis under the SFA securities framework and has acknowledged the existence of ICOs that issue coins or tokens that do not resemble securities under the SFA.

The takeaway

The CSF Act is a welcome new reform to allow for alternative fund raising for Australian companies, however we anticipate it will have a slow up-take in the market given that the Federal Government has now introduced the CSF Proprietary Bill.

It is important that if you are considering engaging in or undertaking any form of crowd-sourced funding activities to get professional advice upfront. PwC provides legal, tax, accounting, audit and assurance advisory in tandem with our market experts in the Emerging Companies and Venture Capital team.

For more information, please contact the PwC Emerging Companies and Venture Capital team.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

James Delesclefs
Legal, Sydney
+61 (2) 8266 2320
james.delesclefs@pwc.com

Manoj Santiago
Emerging Companies, Sydney
+61 (2) 8266 4494
manoj.santiago@pwc.com

Sarah Hickey
Tax, Sydney
+61 (2) 8266 1050
sarah.a.hickey@pwc.com

Henry Goodwin
Legal, Singapore
+65 6340 3815
henry.dn.goodwin@pwclegal.com.sg

Latika Sharma
Legal, United Kingdom
+44 (0) 20 7212 1574
latika.sharma@uk.pwc.com

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