Fundraising: Section 708
Exceptions To The Mandatory Disclosure Requirement

Benedict Sheehy*

I Introduction

Australia's securities regulation has undergone dramatic changes in recent years. One significant part of that revamping has been an increased focus on the business and economic aspects of law, an aspect of which has examined the fundraising process.[1] The legislature has made mandatory disclosure a mainstay of its securities regime. The idea behind disclosure is twofold: firstly, to ensure appropriate investor confidence, and secondly, to reduce information costs associated with making necessary inquiries.

These two specific purposes support a broader economic philosophy, namely promoting the efficient allocation of resources in the market by ensuring that the better projects attract funding and that suboptimal projects do not attract more funding than they merit. Mandatory disclosure permits investors to distinguish more easily between investments, which results in the disclosure of flaws and a more appropriate allocation of funds. This, in turn, should promote greater investment activity and hence, economic growth.

The legislature recognizes, however, that the disclosure regime may not be appropriate for all situations. Accordingly, the legislature has

* B.Th., M.A., LL.B., M.A., LL.M., Lecturer in the School of Law, University of Newcastle, NSW. An earlier version of this paper appeared as "Exceptions to the Disclosure Requirements in Australian Company Law" (2004) 10 Company and Securities Law Bulletin 84. The author would like to thank Dr. Keith Fletcher of the University of Queensland whose guidance in the area has been most valuable.

1 Commonwealth of Australia, Commonwealth Law Economic Reform Program, Proposals for Reform: Paper No. 2: *Fundraising: Capital Raising Initiatives to Build Enterprise and Employment* (1997).

created 15 specific exceptions[2] to mandatory disclosure in s 708 of the *Corporations Act* (Cth). In essence, these exceptions can be reduced to three broad exceptions to the mandatory disclosure regime:[3] small scale offerings, sophisticated investors and related investors. This paper examines the appropriateness of these exceptions with respect to the Commonwealth Law Economic Reform Program ('CLERP') philosophy. This paper is not an effort to provide an analysis of the economic outcomes of the exemption; rather, it focuses attention on some of the critical policy considerations and in particular, the non-economic or balancing objectives of CLERP.

II Small Scale Offerings: s 708(1)

Pursuant to subsection 708(1), small scale offerings are not subject to mandatory disclosure. Section 708(1) is made up of two rules: s 708(1)(a) – there may not be more than twenty investors who purchase securities, and s 708(1)(b) – sales may not exceed $2 million in any 12 month period. To access this exception, the offers must be 'personal offers'. That is, the offering can be accepted only by the person to whom it is made,[4] and offers may be made only to people likely to be interested.[5] To meet the interest criteria of s 708(2)(a), the offeror and investor must have been previously in contact,[6] known professionally or through some other connection, or by statements or actions by the potential investor indicating an interest in such offers.[7]

A The 2/12 Caps

The rationale for this small scale exception is that compliance costs associated with the mandatory disclosure regime in a small scale offering may be excessive. Accordingly, where a fundraiser needs no more than $2 million in a 12 month period, the legislature deems the mandatory disclosure regime too costly relative to the benefit achieved through fundraising.

---

2 One can count the exceptions in different ways depending on whether each criteria is counted differently, or the general situation is analyzed. Fifteen is the number in H Ford, R Austin, I Ramsay, *Ford's Principles of Corporations Law* (11th ed, 2003) [22.130] pp 946. The other situations (offers to associated people, dividend reinvestment plans, offers to current holders of securities, transfers for no consideration, options for no consideration, compromises, takeovers, exempt bodies including public bodies) are justified prima facie. Therefore, this paper will focus on the three most contentious exceptions.

3 The other exceptions not addressed in this paper are ones between commercial entities more or less in the normal course of business.

4 s 708(2)(a)

5 s 708(2)(b).

6 s 708(2)(b)(i)

7 s 708(2)(b)(iii).

Permitting smaller fundraising without mandatory disclosure meets the CLERP objective of being "practicable and cost-effective"[8] for the fundraiser. The questionable aspect is whether it meets the CLERP objective of placing investors "in a position to make more confident assessments about securities without undertaking their own costly inquiries."[9] More particularly, does having the ceiling on investment combined with the relationship criteria meet the objective of investor protection? While the 2/12 caps may limit the amount of overall loss of capital in the market they are clearly designed to limit fundraisers' access to the exception, not investor protection. We turn next to the second part of this exception, the relationship criterion which addresses the investor protection concern.

B The Relationship Criterion: Personal and Interested

Subsection 708(2) restricts distribution to people who have particular relationships to the fund raising body. Subsection 708(2)(a) essentially restricts the use of market intermediaries who may wish to sell the securities to clients by making personal acceptance mandatory. While this restriction may restrict general public access it may not produce the sought after effect, as without a market intermediary financial advisor, it would appear less likely that an investor will be able to assess the investment.

The next restriction, subsection 708(2)(b), appears to further the objective of limiting access of the general investing public. This section further limits offers to "a person likely to be interested in the offer" and appears to limit offers to people who have some type of contact or people interested in investing. The legislature appears to be proceeding from the assumption that (1) some form of social inhibition is at work to restrain fundraisers from abusing their associates, and (2) that specialized investors/people interested in investing in non-mandatory disclosure investments can take care of themselves.

Social inhibitions may have various forms and sources. Such general inhibitions against lying and stealing would be clear and simple examples of the inhibitions the legislature may have had in mind. Such inhibitions are more likely to be activated by social relationships, such as those which may occur between investors who are in regular contact with fund raisers. Given the pervasiveness of questionable fund raisers and questionable products, reliance on social inhibitions may not be a satisfactory policy.

Further, it is not clear that the personal contacts or supposed social inhibitions either work or help evaluate or minimize the risk. Thus, in terms of minimizing the risk to investors, particularly where these

---

[8] CLERP above, n 1, 9.
[9] Ibid.

investors are private individuals and not institutional investors, this provision may not be adequately aligned with CLERP objectives.

While the legislature's assumptions concerning the knowledge of the specialized investors may be correct – certainly an investor experienced in a particular business can evaluate information (as a geologist interested in a mining investment, for example, would review preliminary drill sample reports) – it does not address the more crucial concern that mandatory disclosure assists investors in distinguishing between good and bad investments. As CLERP's authors put it; 'Promoters of bad products are unlikely to disclose their flaws'.[10]

Regardless of the knowledge of a potential investor, there are always flaws which any fundraiser wishes to disguise. As the insider, the fundraiser has the best means of disguising the flaw while the outsider-investor, without access to information, is in the worst position of being able to find out about the flaw.

The idea that potential investors who show interest are in some way protected from questionable fundraisers or projects is not very credible. The connection-interest criteria do not serve to ensure investors receive appropriate disclosure for an investment decision. Thus, while this exception does meet the economic reality of the expensive mandatory disclosure regime for Small-to-Medium-Enterprises ('SME's), it fails to ensure adequate investor protection.

Perhaps a better solution to this information problem can be drawn from elsewhere. In certain instances, law places a different disclosure standard on the seller. For example, in insurance contracts, the law departs from *caveat emptor* to place an obligation on the seller to advise forthrightly about defects; failure to do so may void the underlying contract. Some such obligation, using CLERP's "material information" standard would better serve the CLERP objectives of protecting the investor without adding the excessive costs associated with a full prospectus under the mandatory regime. Alternatively, these small scale funding situations are ideal for angel investors, and perhaps certain mandatory shareholder agreements with terms dealing with control over management decisions or representation on the board of directors, or other common protections would be a more appropriate way of balancing the CLERP concerns in small scale offerings.

III Sophisticated Investor: s 708(8)

The sophisticated investor exception has a better rationale. The basic requirements for this exception to apply are: a minimum investment requirement of $500,000,[11] or a certificate by a qualified accountant

---

[10] Above, n 1, 9.
[11] s 708(8)(a)–(b).

that the potential investor has a substantial net worth[12] or a substantial annual income[13] as determined by the regulations, to s 708(8)(c)-(d). The reasoning here appears to be that a loss of the proposed investment by such investors would not put them into a position from which they could not recover. The general sense of this exception is extended by permitting sales through Financial Services Licensees with certain criteria,[14] and sales to Professional Investors.[15]

The basic question is: what advantages does a high level of wealth – whether in terms of high net worth or high income – grant the would be investor so as to vitiate the need for mandatory disclosure? The discussion here focuses on private individuals who may access this exception. Although the more common use of the exception is by institutional investors, the rationale may yet apply, particularly where fraud is involved.[16]

The legislature has assumed that the wealthy, having been savvy enough to have amassed their wealth are well-equipped enough to protect it. As Baxt *et al* write, the wealthy are 'sufficiently sophisticated, and having sufficient incentive and ability to obtain information, not to require the protection of the mandatory disclosure regime'.[17] The wealthy are in a better financial position to be able to pay professional advisors to assess the value of the proposed investment.

While the issue of the cost of gathering and evaluating information can be more readily addressed by a wealthy investor, it does not remove necessarily the need for mandatory disclosure. This is so because the legislature's assumptions are not necessarily true. For example, a superannuated farm couple could find themselves with the assets needed to qualify for the exception; however, their ability to assess the investment is likely relatively poor. Furthermore, being in a superannuated situation, the couple would certainly not be in a position to recover from a poor investment. Again, given the existence of unscrupulous fundraisers (or simply the unlucky outcome of some investments) a loss could irreparably harm this couple, regardless of their initial wealth. Perhaps a better approach to permitting the wealthy to take these risks would be to set the criteria as a percentage of an individual's net worth or income that can be invested without the mandatory disclosure. While not addressing directly the need for disclosure, this criterion may be a better measure of ability to deal with the risk of loss, which is ultimately the issue of disclosure and the basis for this exception.

---

12 Assets of $2.5 million. Corporations Regulations 6D.2.03 Regulations cited in Ford, above n 1, 953.

13 Annual income of $250,000 6D.2.03 cited in Ford, above, n 1 954.

14 s 708(10).

15 s 708(11).

16 See for example, M. Morrison, "Rush to judgment: the lynching of Arthur Andersen & Co." (2004) 15(3) Critical Perspectives on Accounting, 335-375, indicating that it may be very difficult to obtain appropriate disclosure of financial information even for sophisticated investors.

17 R Baxt, A Black and P Hanrahan, *Securities and Financial Services Law*, (6th ed, 2003) 61.

IV. Associated Parties: s 708(12)

Investments between associated parties may be made for a variety of economic and non-economic reasons, and the need for (and nature of) needed disclosure will vary accordingly. Where the exception applies to transactions between corporate entities or parties involved in management, the exception appears well justified. It permits people with access to information to make decisions freely about investment and funding.

Where investment decisions are made by non-managers or for non-economic reasons (such as wanting to see one's relatives succeed in a business venture), disclosure may become even more critical. Such objectives still require disclosure because as a project that may have a more limited chance of success, the ability to understand and assess the risk becomes even more important. To see relatives fail, or operate a marginal business, or to understand how less-advantaged people are planning to go about their business can permit a more knowledgeable person to assist, or alternatively, make a better decision about the amount he or she is willing to commit to the project, or the rate of return necessary to take on the risk.

V Conclusion

Disclosure as mandated and interpreted by the courts is prohibitively expensive for many SME's. Accordingly, SME's require some exceptions to the mandatory disclosure requirements of the *Corporations Act* (Cth). Whether the current exceptions meet the needs of SME's while appropriately addressing the needs of investors is questionable, and as such, aspects of the exceptions seem hard to justify. None of the exceptions appear to be fully compatible with CLERP's objective of placing "investors in a position to make confident assessments about securities," efficient disclosure and resultant appropriate allocation of market resources.

Perhaps a better intermediary position could have been reached. For example, mandatory disclosure of two years audited financial statements could certainly be done without being overly burdensome on the SME or the investor. In all likelihood, any lending institution would require as much for a loan, so why not provide the same level of protection for a private investor who is likely to put more at risk? Or alternatively, why not provide mandatory security, guarantees or shareholder agreements terms as suggested previously?

There is a more important, underlying question concerning the utility of mandatory disclosure documentation: does it really help inform investors? Ramsay's survey indicates that most investors have difficulty understanding prospectuses[18] and that even many professional

[18] I Ramsay, "Use of Prospectuses by Investors and Professional Advisers," (2004) 22 *Company & Securities Law Journal*, 151.

investment advisors find them difficult to read.[19] It would seem fair to say that the mandatory disclosure regime has moved away from producing useful, readable information for investors in favour of creating documents aimed at compliance with technical legal requirements.

Given this reality, it is hard to make much of a case for the mandatory disclosure requirements at least as they stand and hence criticize the exceptions. From this perspective, compliance with disclosure does not necessarily put the investor in a dramatically better position. Perhaps by forcing disclosure, the legislature may have forced fundraisers to be more conscientious about bringing better products to market instead of just trying to sell whatever appears available on a given day. The reality from this brief review would appear to be that neither the disclosure nor the exceptions hit their marks. Further empirical research examining the economic aspects of the exemptions and their effectives may well prove useful.

---

19 Ibid.