Facilitating capital raising for corporate Australia

A speech by Belinda Gibson, Commissioner ASIC, to the Corporate Finance World Australia 2009 conference, 10 November 2009

Introduction

My theme today is "Facilitating Capital Raising for Corporate Australia". I wish to focus on a number of issues within this topic. Broadly speaking, I will comment on how Australia has fared in terms of raising capital in the wake of the GFC and the capital raising methods being used. I will then provide some insights on issues that ASIC is focusing on going forward including:

- early leakage of information about a prospective raising;
- the overall quality of disclosure to the market in annual reports, and
- the meaning of "clear, concise and effective", particularly now the capital markets are opening again to Initial Public Offerings (IPOs).

Raising capital in difficult economic conditions

Australian companies have responded to the GFC by raising capital to restore balance sheets. It is a testament to the strength of Australia's companies and their leadership, and to the strength of the capital markets, that Australian businesses have been able to raise $119.9 bn by equity issues between July 2008 and September 2009 and $77.1 bn since January this year.

This record equity capital raising has allowed companies to repay debt and has undoubtedly helped to forestall foreclosures and promote credit growth through the Australian banking sector.

Approaches to capital raisings

In times of high stock market volatility, such as that experienced in the last 18 months, companies needed to act quickly to avail themselves of market opportunities. The decision to proceed on a particular day was often dictated by overnight prices, particularly on Wall Street. This necessitated access to the wholesale institutional markets – both because they had the funds and research to respond within hours and because companies could meet the disclosure requirements of the *Corporations Act 2001* in a short time frame.

The directors of a company must decide what means of capital raising is in the best interests of the company as a whole, at the relevant time. Does the urgency of more capital, in a climate of uncertainty about whether debt will be refinanced or the capital markets will reopen again for a new equity raising, outweigh the diluting impact on existing shareholders? Directors must balance the absolute fairness of a pro rata offering amongst shareholders against the discount offered and the risks of completion.

There are a variety of means to raise capital, which require different disclosure to the market, and which have varying lead times to complete. Let me briefly describe the various capital raising options:

<u>Placements and share purchase plans</u>

Placements involve raising capital by issuing shares to specific investors. Generally, the offer is to institutional or sophisticated investors, not to all shareholders. If this is the case, there is no need to issue a formal prospectus. Companies will issue a "cleansing statement" to the investors and the market confirming the market is fully informed, in terms of continuous disclosure.

A share purchase plan (SPP) enables listed companies to raise new equity capital from existing shareholders. Relief from the prospectus requirements of the Corporations Act is provided for these offers where the amount that may be invested by each investor in a 12 month period under the plan is limited to $15,000. Generally the SPP is offered as a supplement to the institutional placement, at the same discount to market price. It is a means of rebalancing shareholder interests, though in some respects a rather crude means.

Rights issues

Another option is for companies to undertake rights issues. As you know, this is where existing shareholders are offered an opportunity to subscribe for further shares on a pro rata basis. Listed companies are not required to prepare and lodge a full prospectus provided certain conditions set out in the Corporations Act (s708AA) are satisfied. One condition is that the "cleansing statement" is issued.

Rights issues can be renounceable or non renounceable. Renounceable rights can be sold (generally on the secondary market, and often by a bookbuild organised by the company). Non renounceable rights issues must be either taken up or forfeited. Where a shareholder does not have the funds to take up their entitlement under a non renounceable rights issue, their shareholding is diluted with no compensating cash payment.

In the 2008-09 year, non renounceable issues by ASX 300 companies had an average discount to market of 18.1%, while renounceable issues had an average discount of 11.3%. This perhaps reflects the underlying financial position of the issuers concerned. The vast proportion of issues were non renounceable.

Recently we have seen companies introducing variations to the traditional rights issue structure with a view to raising funds faster and with greater certainty. An accelerated rights issue is where an offer is made to institutional investors, followed by an offer to retail investors. This is also referred to as a "Jumbo" structure.

Another form of accelerated rights issue is the accelerated renounceable entitlement offer (AREO) structure. Again, an AREO involves making an offer to institutional investors before retail investors. The key difference is that any rights not taken up under the institutional offer are offered under a bookbuild immediately following the institutional offer. A similar process occurs for the retail offer and a second bookbuild occurs at the end of the retail offer.

We have just seen the emergence of Simultaneous Accelerated Renounceable Entitlement Offers (SAREO). SAREOs are designed to ensure that retail investors get the same price as institutions for their renounced rights. There is only one bookbuild which is undertaken at the end of the retail offer for all renounced rights.

Where does this leave us?

The placement to the wholesale market is the quickest and simplest route. Rights issues take longer (at least 40 days) and require more disclosure.

In the last 12 months placements by ASX 200 entities attracted an average discount of 10.2% to the price seven days before the offer was announced against a rights issue average discount of 20.6%. (I will explain the relevance of the seven day measure later in this talk.)

In the 2008-09 year, placements accounted for 43.4% of all capital raised ($38.2bn). SPPs raised another 4.3% ($3.8bn), and rights issues accounted for 32.4% ($28.5bn). There were 192 SPPs in the financial year, 42 by large firms. If all their shareholders had taken up the SPP offer, $37.6bn could have been raised, but in fact only $3.4bn was raised. This reflects the caution of retail investors during that difficult period. Interestingly, dividend reinvestment plans continued to operate during the year and $15.0bn was raised across all companies (or 17% of all capital raised).

ASIC took steps early in 2009 to facilitate companies giving retail shareholders access to placements at the same discount offered to institutions. The purpose was to minimise the diluting effect of significant raisings at a steep discount to historically low prices. First, we expanded the availability of share purchase plans, which now permit offerings of up to $15,000 in value to existing shareholders without additional disclosure. Secondly, we expanded the scope for rights issues with just a "cleansing statement" confirming that the market is fully informed at the time of offer. We also adjusted relief to facilitate underwriting by parties associated with an entity, subject to an override that there is no prospect of unacceptable change of control.

There is no legal requirement that new shares must be offered first to shareholders, unlike in the UK which is exploring Jumbos to solve a problem. The main formal restriction on capital raisings is in the ASX Listing Rules – very broadly, only 15% of equity can be raised in any year without shareholder approval, except by a pro rata offering. However, directors are obliged to have regard to the interests of the company as a whole and this includes having due regard to the diluting impact on existing shareholders.

We are now seeing an easing of the financial crisis and less need for urgent capital injections. In that context, ASIC will continue to closely monitor market developments in relation to how companies deal with the issue of diluting the holdings of existing shareholders, to see if law reform is required. Our preference would be to leave the selection of capital raising methods with the board of directors, who are best placed to judge the capital needs of the company against the (un)fairness of diluting shareholders.

Leakage

A current area of concern for ASIC is the possible early leakage of information about a prospective raising that appears to presage a share price decline in advance of an announcement. That of course can distort the timing and ultimate success of the fundraising and more fundamentally can cause significant disruption to the market in the company's securities.

This problem has been particularly pronounced over the last year. It is why we measured the discount offered in capital raisings to the price seven days before the announcement. While price falls in that seven day period may have been the result of the volatile market conditions at the time, it has also raised concerns around the practices of market participants in handling confidential information.

ASIC has responded by not only pursuing a series of investigations into particular leaks, but also by commencing a project to examine market practices in handling confidential information. Over the last eight months we have met with many companies and their advisers to find out what systems they have to protect confidential information prior to the announcement of price sensitive transactions such as a fundraising or an M&A transaction.

As a result of this work, ASIC believes there needs to be greater focus and control over how confidential information is handled by companies both within their own organisations and externally with advisers and other service providers. We are now in the process of compiling a set of best practice guidelines for the handling of confidential information. Our objective in releasing best practice guidelines in this area is to encourage better practices across the market and ensure leaks of confidential information, and thus the potential for insider trading, are reduced to the maximum extent possible. These will be published for consultation in December 2009, and we will welcome market input on them.

One of the issues we will include in these guidelines concerns sounding the market prior to a capital raising. The discussions we have conducted have revealed that practices for soundings in the Australian market vary, but some are lax indeed.

While ASIC understands that the necessity of obtaining direct market feedback from potential or existing investors in some circumstances, it is vital that confidentiality is maintained when soundings are conducted.

The formal process of bringing an institution "over the wall" has been abbreviated, often to the point of being inadequate. It is critical that banks and brokers sharpen their practices.

Pre sounding should be a formal process that is well understood by the issuing company, their investment bankers and the institutions involved. The bankers should inform the company when they need to pre sound the market, give their client specific details of the soundings they propose to conduct and should obtain their prior approval to do so. There must be formal acknowledgments of confidentiality and "no trade" undertakings before any information is conveyed and written confirmation afterwards that binds the institution to those confidentiality obligations.

Soundings should ordinarily be done when the market is closed. A trading halt may be necessary. It is up to companies to insist proper processes are adopted by their bankers.

Disclosure to the market

In the middle of the annual report season it is timely for the corporate community to consider the overall quality of disclosure to the market. The Corporations Act sets out a comprehensive disclosure regime from the IPO, through the annual reports, to the material that shareholders must be given when there is a company transforming event such as a takeover or related party dealing. The continuous disclosure regime sits over these formal documents.

Over the past year, we have seen large amounts of equity capital raised in the Australian market. The circumstances in which a comprehensive prospectus is required by a listed company in order to raise further equity capital have over time reduced considerably. I have already referred to ongoing relief that ASIC has granted this year to allow more rights issues and share purchase plans to be made without a prospectus. It is therefore important that companies effectively communicate with investors via ongoing disclosure obligations.

The assumption of the regime is that the annual reports (which cover the business description, and also the historical financial performance in the audited accounts) are a comprehensive update from year to year, displacing the IPO document in terms of providing relevant and current information for investors. Are today's annual reports useful disclosure documents for an investor in the company, or just promotional material covering the statutory requirements?

If a company wishes to serve its investors well, it should aim to provide an annual report which communicates effectively with investors rather than just ticks all the required boxes and includes some attractive graphics. The annual report is the once a year opportunity a company has to take stock of its position and report back to its investors. It is the opportunity to articulate its forward strategy to investors in a comprehensive manner. Some investors who read annual reports would be surprised to discover that the annual report should contain for instance:

- a review of operations during the year;
- details of significant changes to the company's state of affairs and principal activities; and
- reference to likely developments in the company's operations in future financial years (s299).

The information provided in relation to these matters is sometimes so formulaic that it communicates very little to the reader. The analysts briefings to investors released with the annual results are often more informative in this regard.

While continuous disclosure is important, by its very nature it is piecemeal. It can be difficult for investors to form a complete view of an entity on the basis of continuous disclosure releases of varying importance. Our regime can only work effectively if financial reports and in particular the annual report provide an opportunity for investors take stock of the company as a whole. It has a prospectus like function for investors who are trying to decide whether to buy, sell or hold shares in the company. This is reinforced by the additional content for listed companies required by s299A, the terms of which are close to those of the prospectus content requirements set out in s710:

The directors' report for a company ... that is a listed public company must ... contain information that members of the company would reasonably require to make an informed assessment of:

(a) the operations of the entity reported on;

(b) the financial position of the entity; and

(c) the entity's business strategies and its prospects for future financial years.

Meaning of clear concise and effective

The corporate community must also engage with the meaning of "clear, concise and effective", particularly now the capital markets are opening again to IPOs. The prospectus is intended to tell investors everything they reasonably require to make an investment decision. They are intended to be read, and understood, by both retail and institutional investors.

Are today's prospectus and public disclosure documents too long and too focused on promotion? Are the risks of investing plain enough and sufficiently near the front to be read and understood? Is the prospectus another "tick the box" exercise where persons responsible for the business have little engagement with the document?

Sometimes the investor slide pack is needed.

Readability of a prospectus is key for investors. This is what the legal requirement of clear, concise and effective is aimed at. In many cases the length of a document can present problems. But short documents can suffer from problems too, particularly if poorly presented and worded. Investors need sign posts to navigate their way through information. The words are part of this solution but design and layout are also other factors that can assist.

ASIC will be providing more guidance to the market on this question in the next 12 months.

Conclusion

Let me briefly recap and close.

Australian companies have successfully used a range of capital raising methods to respond to the GFC by restoring balance sheets. This is to the enormous credit of our corporations and capital markets.

ASIC is mindful of the obligation of companies to have regard to the interests of the company as a whole, which includes having due regard to the diluting impact on existing shareholders, and will continue to monitor market developments to see how this issue is dealt with and whether law reform is needed.

Some other specific issues that ASIC is focusing on in this space include:

- the early leakage of information about a prospective raising;
- the overall quality of disclosure to the market in annual reports, and
- the meaning of "clear, concise and effective", particularly now the capital markets are opening again to IPOs.

Thank you and I welcome any questions from the floor.

