ASIC

Australian Securities & Investments Commission

CONSULTATION PAPER 32

Secondary sales of securities that require disclosure under s707(3) and (4)

December 2001

What this issues paper is about

1. This paper identifies and ask for comment about issues in the interpretation of s707(3) and s707(4) of the *Corporations Act 2001* ("the amended provisions") as amended by the *Financial Services Reform Act 2001* (the "FSR Act") with effect from 11 March 2002. The amended provisions set out when disclosure under Part 6D.2 of the *Corporations Act 2001* (the "Act") will be required for secondary sales of securities within 12 months of their issue.

2. ASIC invites comment from participants in the securities industry and other interested persons on the issues, interpretative discussion and possible options for relief canvassed in this paper.

3. ASIC is contemplating class order relief from the amended provisions for the secondary sale of securities in some circumstances including:

(a) where there is an adequately informed market. For example, securities in a class of quoted securities of a listed company where the issuer has provided the information of the kind required by a s713 prospectus to the market; and

(b) where relief is necessary to avoid an unintended operation of the amended provisions. This might occur if the rationale for a current statutory exemption or an ASIC exemption from part 6D.2 disclosure available for the initial issue extends to secondary sales. Examples of such situations may include dividend re-investments under s708(13) or ASIC relief for share purchase plans under CO 00/194.

4. None of the views and proposed relief set out in the paper should be construed as final ASIC policy.

Contents

Purpose of this issues paper

Issues and possible options

1. This paper identifies a number of issues about the scope of the amended provisions and possible approaches ASIC may adopt to address those issues. In particular, ASIC seeks comments on whether:

(a) it has identified the issues correctly and comprehensively;

(b) the possible approaches for addressing those issues provide practical solutions without lessening the level of consumer protection intended by the disclosure provisions in the Corporations Act; and

(c) there are other issues and possible approaches that should be considered.

2. ASIC is seeking this information so it can identify what, if any, relief is warranted from the requirements in the amended provisions. This is not, and should not be taken as, an indication that ASIC is prepared to provide relief from those requirements.

Background

3. When the FSR Act comes in to operation from 11 March 2002, the amended provisions will apply to regulate the on-sale of securities within 12 months of their issue. Securities in this context includes shares, debentures and legal or equitable rights or interests relating to a share or debenture. The amended provisions are designed to address some of the problems associated with the operation of the current provisions in s707(3) and s707(4) of the Act ("the current provisions"). Similar provisions in regard to the secondary sale of financial products other than securities will also be introduced when the FSR Act commences (see s1012C of the FSR Act). Therefore, the considerations raised here are equally relevant to the on-sale of other financial products (such as interests in managed investment schemes).

4. Like their predecessors, former s1030 and s1030(1A) of the Corporations Law, the current provisions are designed to address the possible avoidance of prospectus disclosure by issuers through the use of various exemptions available from such disclosure. The way the current provisions were intended to operate was discussed in some detail in the Parliamentary Joint Committee Report on the Corporate Law Economic Reform Program Bill (CLERP Bill) issued in May 1999 and also in the Explanatory Memorandum to that Bill. Although the current provisions strengthened the anti-avoidance effect of the former s1030, some issues have arisen that impact upon their effectiveness.

5. While the amended provisions address these issues, they may make on-sale after a placement problematic in some cases. ASIC notes the comments in the Parliamentary Joint Committee Report on the CLERP Bill that ASIC might provide relief from the anti-avoidance provision in s707(3) in appropriate cases. In determining whether relief is appropriate ASIC will have regard to the intent of the provisions.

Submissions sought on relevant issues

ASIC invites submissions on the following issues

6. We seek your views on the following issues:

   (a) Do you agree with our interpretation of the amended provisions? Are there other issues relating to these amended provisions? (see paragraphs 20-22)

   (b) Do you agree with ASIC's general approach to granting relief from the amended provisions? (see paragraphs 24-38)

   (c) Do you think that the kind of relief we suggest is practical and workable? (see paragraphs 41 - 45 for the types of relief)

   (d) Do you think that there are other circumstances in which relief should be granted from the amended provisions?

   (e) Are there alternative regulatory approaches to addressing issues that arise in relation to the operation of the amended provisions? If so, what are they and why should they be adopted?

   (f) Is there any reason we should not adopt a consistent approach for financial products other than securities covered by s1012C of the Act (as amended by the FSR Act)?

7. More detailed questions are also set out in paragraphs 23, 39 and 40, 46-52 and 56-58.

8. Submissions addressing these and any other relevant issues will be used by ASIC to help it decide whether there is a need, and a sound policy and legal basis for granting any relief.

Your comments

Comments are due by 1 February 2002 and should be sent to:

Dhammika Amukotuwa
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You can also contact Dhammika Amukotuwa on 03 9280 3395 for further information about this issues paper.

Interpretative discussion

The scope of the amended provisions

The amended provisions

9. The amended provisions are:

> 707(3) An offer of a body's securities for sale within 12 months after their issue needs disclosure to investors under this Part if:
>
> (a) the body issued the securities without disclosure to investors under this Part; and
>
> (b) either:
>
> (i) the body issued the securities with the purpose of the person to whom they were issued selling or transferring the securities, or granting, issuing or transferring interests in, or options over, them; or
>
> (ii) the person to whom the securities were issued acquired them with the purpose of selling or transferring the securities, or granting, issuing or transferring interests in, or options over, them;
>
> and section 708 does not say otherwise.
>
> 707(4) For the purposes of subsection (3):
>
> (a) securities are taken to be:
>
> (i) issued with the purpose referred to in subparagraph (3)(b)(i); or
>
> (ii) acquired with the purpose referred to in subparagraph (3)(b)(ii);
>
> if there are reasonable grounds for concluding that the securities were issued or acquired with that purpose (whether or not there may have been other purposes for the issue or acquisition); and
>
> (b) without limiting paragraph (a), securities are taken to be:
>
> (i) issued with the purpose referred to in subparagraph (3)(b)(i); or
>
> (ii) acquired with the purpose referred to in subparagraph (3)(b)(ii);
>
> if any of the securities are subsequently sold, or offered for sale, within 12 months after issue, unless it is proved that the circumstances of the issue and the subsequent sale or offer are not such as to give rise to reasonable grounds for concluding that the securities were issued or acquired with that purpose.

How do the amended provisions change the current provisions?

10. The amended provisions change the regulation of the secondary sale of securities within 12 months of their issue by expanding and clarifying some aspects of the scope of the provisions and by refining how the presumption relating to purpose operates.

11. Under the current provisions, a secondary sale of securities within 12 months of their issue requires disclosure under Part 6D.2 of the Corporations Act if three conditions are met:

(a) the issuer issued securities without disclosure to investors under Part 6D.2;

(b) the issuer issued the securities with the purpose of the person to whom the securities were issued selling or transferring them or granting, issuing or transferring interests in, or options or warrants over those securities; and

(c) section 708 does not say otherwise (ie the secondary sale does not come within any of the exemptions under s708).

12. The amended provisions resolve key issues that have arisen in the current provisions in a number of ways.

13. If the purpose of the on-sale is the acquirer's (rather than the issuer's), the current provisions do not apply. As a result, an investor who subscribes for securities as a sophisticated or professional investor for the purpose of on-sale can, under the current provisions, on-sell within 12 months of the initial issue those securities to retail investors without disclosure under Part 6D.2.

14. The problem is exacerbated in the case of debenture issues. This is because generally the trustee and trust deed requirements, which form a key retail investor protection aspect of regulation under the Corporations Act, also do not apply if Part 6D.2 disclosure is not required.

15. The amended provisions close this gap by extending the concept of purpose to cover the purpose of the acquirer. This means that it is sufficient to establish that either the issuer issued the securities or the acquirer under the initial issue acquired them for the purpose of on-sale within 12 months. In either of these cases disclosure under Part 6D.2 is required for the on-sale unless exempt under s708.

16. Under the current provisions, it is uncertain whether the relevant purpose must be the sole or dominant purpose of the issuer when issuing the securities for the Part 6D.2 disclosure requirements to apply. The amended provisions resolve this uncertainty by expressly providing that it is enough if the securities were issued or acquired for the purpose of on-sale, even if there are other purposes for the issue or acquisition.

17. Under the current provisions, unless the contrary is proved, a body is taken to issue securities for the purpose of on-sale if the securities are subsequently sold or offered for sale within 12 months of their issue. Under the amended provisions, if securities are sold or offered for sale within 12 months of their issue, they are presumed to have been issued or acquired for the purpose of re-sale. This presumption can be overcome by proving that the circumstances of the issue and subsequent sale or offer do not give rise to reasonable grounds for that conclusion. As a result, under the amended provisions, the test for whether the securities were issued or acquired for the prohibited purpose becomes an objective one.

General interpretation of the amended provisions

18. Under the amended provisions a disclosure document under Part 6D.2 is required for a secondary sale of securities if all the following conditions are met:

(a) the issuer issued the securities without disclosure to investors under Part 6D.2;

(b) there are reasonable grounds for concluding that the issuer issued the securities, or the person to whom the securities were issued acquired them, with the purpose of selling or transferring them, or granting, issuing or transferring interests in, or options over them; and

(c) a subsequent sale or transfer occurs within 12 months of the issue of securities in circumstances where none of the exemptions under s708 applies to the sale or transfer.

19. Under the above requirements, the purpose must be present *at the time of* the issue or acquisition of securities from the issuer without disclosure under Part 6D.2. The purpose can be that of either the issuer or the acquirer. As a result, if one of them is reasonably taken to have had the necessary purpose, it is not necessary that the other party too should act for a similar purpose. Where the purpose exists at the time of the issue, (ie either on the part of the issuer or the subscriber), then a re-sale of any of those securities within 12 months of their initial issue and without the benefit of any s708 exemptions requires disclosure under Part 6D.2. This is the case even if the subsequent sale to retail investors is by a person who was not the initial subscriber.

20. For example, a placement of securities to an investor (the first investor) of an amount in excess of $500,000 does not need disclosure under s708(8) even if the relevant purpose exists. The first investor can offer the securities for sale to another person (the second investor) without a disclosure document provided that the offer is made under an exemption in s708. If the second investor offers the securities for sale within 12 months of their initial issue to a third person (the retail investor) and a s708 exemption is not available, the second investor must prepare a disclosure document for that sale. This is so even though no disclosure document was required for the issue to the first investor and the on-sale to the second investor.

21. This construction is consistent with the ordinary and literal meaning of the amended provisions. It is a result of the extension of the relevant purpose to the acquirer of securities under the amended provisions. This construction is also consistent with the objective of removing inappropriate incentives for acquirers of securities to circumvent the disclosure requirements under Part 6D.2.

22. A possible alternative construction is that s707(3) only prohibits on-sale to retail investors within 12 months of the issue of securities by the subscriber to the initial issue and not any re-sale by a person who acquires those securities directly or indirectly from the subscriber. Some support for such a construction of the current provisions can be derived from the reasoning in *Re Timor Sea Petroleum NL* (2000) 35 ACSR 186. However, such a construction would enable the obvious anti-avoidance purpose of the amended provisions to be readily defeated, and we therefore do not consider it can be accepted.

23. We seek your views on whether you agree with the above interpretation of the amended provisions. If you do not agree, please explain why.

Possible relief from the amended provisions

ASIC's general policy on granting relief from the amended provisions

24. ASIC considers that relief from the amended provisions may be justified if the overall purpose of the disclosure requirements and the legislative intent of the amended provisions are not undermined. The underlying purpose of the amended provisions and the current provisions has not changed. Their intent is to ensure that retail investors purchasing the issuer's securities have the benefit of disclosure under Part 6D.2. Accordingly, the issue of securities to an institutional investor to whom the issuer does not have to provide disclosure under Part 6D.2 should not be a means of allowing that investor to on-sell the securities to retail investors within 12 months of the initial issue without full disclosure.

25. However, the anti-avoidance mechanism in the amended provisions is not designed to prevent legitimate market practices such as placements of securities in an existing quoted class. A placement of this kind is often commercially more convenient because it is quicker and less costly than an issue to retail investors requiring full disclosure under Part 6D.2. A balance is needed between these commercial considerations and the need to minimise the risks of abuse of provisions designed to protect the interests of retail consumers.

26. The amended provisions strikes this balance by the rebuttable presumption mechanism set out in s707(4). These provisions make it more difficult to circumvent the disclosure obligations under Part 6D.2 where retail investors are the ultimate acquirers.

27. In ASIC's view, relief from the amended provisions may be warranted:

(a) where there is an adequately informed market; and

(b) to overcome an unintended consequence of the amended provisions.

Adequately informed market

28. Relief may be appropriate if retail investors to whom securities are offered for sale within 12 months of their issue are directly provided with the benefits of disclosure by a means other than disclosure under Part 6D.2.

29. ASIC's role is to administer the legislation consistently with the underlying objectives of the provisions. In the case of the amended provisions, the legislative intent is to ensure that retail investors have the benefit of disclosure under Part 6D.2 where securities are issued for the purpose of on-sale within 12 months of their issue. Therefore, ASIC has to ensure that any exemptions available for institutional placements without Part 6D.2 disclosure does not provide a means by which retail investors' access to such disclosure can be avoided.

Unintended consequences

30. Relief may also be warranted if the effect of the amended provisions is an unintended consequence, rather than part of the purpose, of the operation of those provisions. For example, ASIC can use its exemption and modification powers to

relieve an issuer from its disclosure obligations under Part 6D.2. It may intend that secondary sales to retail investors following the exempt issue should also be exempt from the disclosure requirements under Part 6D.2. Issuer relief of this kind would require ASIC to be satisfied that compliance with the Part 6D.2 obligations is not warranted because of other considerations. These may include the benefits of another form of disclosure regulation, the small size of the offering or other means by which investors receive adequate information.

31. In these cases, it is reasonably likely that the circumstances that warrant the exemption for the issuer will generally also extend to a secondary sale by the acquirer. Not to allow relief for the secondary sale following an exempt issue would, in such circumstances, be an unintended operation of the current provisions and would justify ASIC extending relief to that secondary sale.

32. A similar unintended effect may arise where subsequent sales to retail investors follow an issue of securities that does not require Part 6D.2 disclosure because it falls under one of the various current statutory exemptions. Those exemptions are based on considerations such as that adequate information is available from other sources, or that disclosure under Part 6D.2 would not be appropriate given the scale or nature of the offer. Examples are the current exemptions available for dividend re-investment and bonus share plans (s708(13)(a)), compromises or arrangements (s708(17)) and scrip takeover bids (s708(18)).

33. In such cases, the persons to whom securities are issued may not necessarily take up securities for the purpose of on-sale within 12 months. However, the amended provisions apply generally to any secondary sales by such persons if they occur within 12 months of the date of issue and there has not been disclosure under Part 6D.2, even if this is because of an exemption under s708.

34. Where the original exemption from Part 6D.2 is premised on factors such as the availability of adequate information, or that disclosure under Part 6D.2 would not be appropriate given the scale or nature of the offer, those considerations might equally apply to any secondary sales. In those cases, we would consider the application of the current provisions as an unintended effect that warrants relief.

35. If ASIC provides relief from the amended provisions on the basis that adequate information is otherwise available to retail investors or other policy considerations, it may also consider whether existing shareholder interests are unduly affected by any proposed relief. By doing so, ASIC maintains its role of administering the Act in accordance with its underlying policy objectives.

Possible policy guidance

36. We are considering the need for further policy guidance to promote certainty for market participants as to the type of evidence that we will consider as sufficient to rebut the presumption created by s707(4).

37. For the amended provisions to apply either the issuer or subscriber must have the required purpose. If the issuer of securities and the initial subscriber give written warranties to each other that the issue and the acquisition are not for the purpose of on-sale within 12 months of the issue without Part 6D.2 disclosure, it may be an indication

that the securities were not issued and acquired for the relevant purpose. However, this will not be the case if there are other circumstances that negate the effect of the warranties. Examples of circumstances that may negate the effect of such warranties include:

(a) the application for quotation of the securities immediately after their initial issue;

(b) the issuer and subscriber being related paries; or

(c) where consideration for the issue of securities is not fully paid for by the subscriber.

38. We also note that such warranties would be subject to the prohibition against misleading and deceptive conduct in s1041H of the FSR Act and the requirement that statements about future matters have reasonable grounds – sees 769C.

39. Do you agree with ASIC's general policy basis for granting relief from the amended provisions? Are there other policy grounds that justify ASIC relief? If so what are they and why should relief be provided on those grounds?

40. Do you agree with the policy guidance described in paragraphs 36 – 38? If not, what are your reasons? Do you think that it is useful to give such policy guidance?

Specific types of relief

41. There may be a number of scenarios that fall within the general policy described above. We set out below two detailed situations that in our opinion would fall within the general policy. This is to highlight how the general considerations we describe above would apply in practice. While we think that these kinds of situations would most likely warrant class order relief, it does not mean that in other circumstances, individual relief will not be available. The two examples involve the secondary sale of securities:

(a) of listed disclosing entities in an adequately informed market; and

(b) offered under ASIC relief for small offers to existing shareholder of listed companies.

Adequately informed market

42. ASIC considers that relief from the amended provisions is warranted to permit the secondary sale of securities of a listed disclosing entity to retail investors where all of the following conditions are met:

(a) the issuer is a listed company;

(b) securities are in a class of quoted securities of the issuer;

(c) the class of securities has been continuously quoted for the 12 months prior to the date of the secondary sale; and

(d) the issuer lodges with ASX at the time of the issue of securities information of the kind that would be required under s713(2) and s713(5) if a s713 prospectus had been issued.

43. Where all these conditions are met, retail investors buying the securities pursuant to a secondary sale or offer would be doing so in an adequately informed market. Their interests would not be adversely affected by the lack of disclosure under Part 6D.2 of the amended provisions. The proposed condition requiring the issuer to lodge a disclosure document with ASX is not unduly onerous because they are already subject to the continuous disclosure regime. Note that this relief will not be required if relief is available to secondary sales following an issue under a statutory or ASIC exemption where the grounds of the initial exemption is to extend to the secondary sale – see paragraph 30.

44. In our view, class order relief from the amended provisions is not warranted for secondary sales of securities that are:

(a) not securities of a class which is continuously quoted;

(b) securities of unlisted disclosing entities; or

(c) securities of non-disclosing entities.

45. We exclude these securities from the proposed scope of relief from the amended provisions because they cannot be offered through the s713 disclosure mechanism. It would therefore be inappropriate to exempt them from Chapter 6D on the basis that providing s713 information would be sufficient.

46. Do you agree that we should provide class order relief from the amended provisions for the secondary sale of securities in a class of continuously quoted securities of a listed entity?

47. Do you think any of the conditions proposed are not warranted?

48. Are there other conditions we should impose on this relief, for example to confine it to cases where issuers and acquirers of securities have declared that they have no present intentions of on-selling within 12 months of the issue?

49. Are there reasons why it would be impractical for issuers providing the information to market to be subject to the prospectus liability regime?

50. If a placement would exceed 15% of issued capital, should it be a condition of relief that shareholders be given the choice of a rights issue or a placement in a separate resolution?

51. Do you agree with excluding the other types of secondary sales mentioned in paragraph 44 from this relief? If not, what are your reasons?

52. Are there other considerations that we should take into account in providing the proposed relief or excluding from the proposed relief for the other identified classes of secondary sales in paragraph 44?

Secondary sale of shares offered under ASIC relief for small offers to shareholder of listed companies

53. This is an example of where ASIC may be prepared to provide relief from the amended provisions to remove their possible unintended effects. ASIC provides relief from the Part 6D.2 disclosure to enable listed companies to make small offers of shares to existing shareholders under share purchase plans (see Class Order relief CO 00/194). Under this relief, listed companies can issue shares up to the value of $3,000 to existing shareholders if, among other things, those securities are in a class of securities quoted on ASX and remains continuously quoted within the last 12 months. A key policy basis for this relief is that the cost of requiring a full prospectus for such an issue is not warranted where existing shareholders only invest quite small amounts. In cases of that kind, the cost of full compliance with Part 6D.2 disclosure would be disproportionate to the benefit.

54. Investors who take up parcels of securities not exceeding $3000 under ASIC share purchase plan relief are not in the same position as institutional investors taking up large placements. Subjecting them to Part 6D.2 disclosure for any on-sale of those securities is an unintended consequence that warrants exemption from the amended provisions.

55. Similar considerations apply to extending relief from the amended provisions to other cases where ASIC provides relief from the disclosure requirements under Part 6D.2 to issuers. Other examples include the relief provided for employee share schemes.

56. Do you agree with ASIC's rationale for proposing relief in the above circumstances to avoid unintended application of the amended provisions? If not, what are your reasons?

57. Are there other cases that would warrant similar relief? If so, what are they and why should relief be provided?

58. Are there other considerations that ASIC should take into account in this context?

Key terms

59. In this issues paper, a reference to:

“Act” means the *Corporations Act 2001*;

“ASIC” means the Australian Securities and Investments Commission;

“amended provisions” means s707(3) and (4) of the Corporations Act 2001 after the commencement of the FSR Act;

“current provisions" means s707(3) and (4) of the Corporations Act 2001 before the commencement of the FSR Act;

"The FSR Act" means the Financial Services Reform Act 2001.