CONSULTATION PAPER 312

Stub equity in control transactions

June 2019

About this paper

This consultation paper seeks feedback on our proposal to address concerns about certain offers of ‘stub equity’ scrip consideration in control transactions.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Document history

This paper was issued on 4 June 2019 and is based on the Corporations Act as at the date of issue.

Disclaimer

The proposals, explanations and examples in this paper do not constitute legal advice. They are also at a preliminary stage only. Our conclusions and views may change as a result of the comments we receive or as other circumstances change.

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The consultation process

You are invited to comment on the proposals in this paper, which are only an indication of the approach we may take and are not our final policy.

As well as responding to the specific proposals and questions, we also ask you to describe any alternative approaches you think would achieve our objectives.

We are keen to fully understand and assess the financial and other impacts of our proposals and any alternative approaches. Therefore, we ask you to comment on:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

Where possible, we are seeking both quantitative and qualitative information.

We are also keen to hear from you on any other issues you consider important.

Your comments will help us develop our policy on offers of stub equity in control transactions. In particular, any information about compliance costs, impacts on competition and other impacts, costs and benefits will be taken into account if we prepare a Regulation Impact Statement: see Section C, 'Regulatory and financial impact'.

Making a submission

You may choose to remain anonymous or use an alias when making a submission. However, if you do remain anonymous we will not be able to contact you to discuss your submission should we need to.

Please note we will not treat your submission as confidential unless you specifically request that we treat the whole or part of it (such as any personal or financial information) as confidential.

Please refer to our privacy policy for more information about how we handle personal information, your rights to seek access to and correct personal information, and your right to complain about breaches of privacy by ASIC.

Comments should be sent by 17 July 2019 to:

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What will happen next?

Stage 1	4 June 2019	ASIC consultation paper released
Stage 2	17 July 2019	Comments due on the consultation paper
Stage 3	October–November 2019	Consultation response and legislative instrument (if any) released

A Background

Key points

Certain offers of stub equity made to investors in connection with control transactions may avoid important protections in the Corporations Act.

We propose to modify the operation of the takeover and fundraising provisions to address concerns with stub equity offers.

Offers of 'stub equity' scrip consideration in control transactions

1 We are concerned about recent control transactions where the consideration offered includes stub equity in:

(a) proprietary companies; or

(b) other issuers where certain investors are required to hold that scrip through custody arrangements.

2 Offers of this kind have been made to a large and diverse group of securityholders, including retail investors.

3 Under the law, proprietary companies are required to be closely held and are prohibited from making general public offers of their shares under a prospectus. By structuring control transactions to avoid these restrictions, retail investors who accept scrip consideration miss out on the disclosure and governance protections that apply to public companies, but from which proprietary companies are exempt.

4 As foreshadowed in 18-376MR *ASIC to consult on measures to restrict offers to retail investors of stub-equity in proprietary companies*, we are proposing a new legislative instrument to modify the disclosure exemptions in s708(17) and (18) so they do not apply to offers of securities in proprietary companies. As discussed further at proposal B1, this has the effect of preventing these kinds of offers being made to retail investors in control transactions. However, in many circumstances it will still allow offers of stub equity to be made to persons who may be able to rely on another disclosure exemption in s708, such as management and institutional investors in the target.

5 Since the publication of 18-376MR, we have also observed control transactions offering stub equity in public companies on terms that require certain investors to hold that scrip through a custodian. This structure may maintain the investor protections and rights flowing from public company

status. However, it can still have the effect that the issuer does not become subject to the takeovers regime in Ch 6 or to the disclosing entity provisions—depriving holders of the protections provided by those provisions. Further, the mandatory custody arrangements would mean there is no barrier to the issuer subsequently converting to a proprietary company, leading to the issues set out at paragraph 3 above.

6 In response, we propose that the new legislative instrument should also modify the operation of the relevant exemptions in s611 relating to takeover bids and schemes of arrangement so that they do not apply where:

(a) scrip is offered as consideration; and

(b) that scrip must be registered in the name of a custodian on terms that would enable:

   (i) the issuer to avoid (to the extent they would otherwise apply) Ch 6 or the disclosing entity provisions; or

   (ii) the subsequent conversion of the issuer to a proprietary company despite there being, in substance, more than 50 investors in the company.

B Proposed new legislative instrument

Key points

We are proposing to address concerns with the use of stub equity and 'mandatory custody arrangements' by modifying the operation of the Corporations Act.

Our proposed modification seeks to address potential avoidance of the proprietary company, takeover and disclosing entity provisions.

Offers of securities in proprietary companies

Proposal

B1 We propose to make a new legislative instrument modifying Ch 6D so that the disclosure exemptions in s708(17) and (18) do not apply to offers of securities in proprietary companies.

Your feedback:

B1Q1 Do you agree with our proposal to prevent offers of stub equity in proprietary companies to retail investors under the exemptions for control transactions? If not, why not?

B1Q2 Do you have any comments on the form of the proposed legislative instrument in so far as it modifies Ch 6D?

See the draft ASIC Corporations (Stub Equity in Control Transactions) Instrument 2019/XX at Attachment 1 on the consultation paper webpage under CP 312.

Rationale

7 Ordinarily, proprietary companies must have no more than 50 non-employee shareholders and are prohibited from fundraising activities which would require disclosure to investors under a prospectus or other disclosure document: s113(1) and (3).

8 Since 2016, a number of control transactions using a scheme of arrangement have offered the choice of scrip consideration in a proprietary company. Scheme companies will often have thousands of shareholders—including a large subset of retail shareholders.

9 Because of the broadly drafted disclosure exception in s708(17)—which is designed to facilitate offers of scrip consideration in schemes generally—s113(3) and Ch 6D do not operate to prevent proprietary company scrip offers through a scheme of arrangement. Outside a takeover bid or scheme of arrangement, offers on such a wide scale would generally be prohibited.

10 One recent scheme offered shareholders not only the option to elect to receive scrip consideration but also to subscribe for additional shares in the proprietary issuer by contributing additional funds. The issuer relied on a broad construction of an ‘arrangement’ under Pt 5.1 to argue the offer formed part of the scheme, and therefore fell within the exception in s708(17). The offer was made in that case directly to over 3,300 potential investors, and indirectly to many more given it was open to any on-market purchaser of scheme company shares during the election period to participate. Such an offer could not have otherwise been made by the proprietary issuer.

11 Bidders and acquirers are able to avoid the ordinary prohibitions and consequences of an issuer accumulating investors as a result of offers to a large number of persons by keeping the number of shareholders on the issuer’s register artificially below 50 through the use of custodian arrangements.

12 While both the offers of scrip and the use of custodian arrangements are technically legal, we are concerned that they are contrary to what we consider is the clear intent and function of s113. Their effect is that members who once held shares in what is typically an ASX-listed public company are offered an investment leaving them with limited rights in a proprietary company which, by design, is subject to a lower standard of governance and disclosure.

13 This is so regardless of whether the offerees are provided with adequate disclosure about these consequences in connection with their decision to invest. The premise of s113(3) is that proprietary companies are not an appropriate vehicle for general public offerings to a large number of investors—irrespective of whether prospectus disclosure or equivalent is provided. Further, based on our past experience we consider reliance on disclosure has its limitations as an effective form of investor protection in these kinds of circumstances.

14 It is important that investors in widely held companies are afforded the safeguards that the law explicitly contemplates for shareholders of public companies, and from which ordinary proprietary companies are exempt, including:

(a) restrictions on related party transactions under Ch 2E;

(b) restrictions on conflicted directors voting under s195;

(c) rules for the appointment and removal of directors under s201E and 249H(3);

(d) Australian residency requirements for directors under s201A(2);

(e) a requirement to hold annual general meetings under s250N; and

(f) periodic financial reporting obligations under Ch 2M.

15 Additional protections are required when shares are widely held compared to a closely held company. In a widely held company, there may not be the same degree of knowledge, oversight and involvement by shareholders.

16 In our view, offering scrip in proprietary companies under schemes of arrangement to more than 50 target securityholders, including through the actual or contemplated use of custodian or nominee arrangements, is contrary to the clear legislative intent of s113 and the limitations placed on proprietary companies.

17 ASIC's concerns are not addressed merely because, having offered the option of scrip in a proprietary issuer under a control transaction, there were limited elections for scrip such that post-transaction the issuer will have fewer than 50 members. As discussed at paragraph 8, the target may have thousands of shareholders, who are in substance a subset of the public, and absent the exception in s708(17), the offer of that scrip would be fundraising activity prohibited by s113(3).

18 Similar policy concerns apply to offers of scrip in proprietary companies under a takeover bid as they do to offers under a scheme of arrangement. Accordingly, we propose that our instrument should extend to both s708(17) and (18).

19 This proposal does not prevent offers of proprietary company scrip being made where other exceptions in s708 apply—such as offers limited to sophisticated and professional investors. Offerors will however need to be mindful of:

(a) the limits on making different offers under an off-market takeover bid—such as the requirement that all offers are the same: s619(1); and

(b) the implications of offering different consideration under a scheme of arrangement—such as the likelihood those who will receive the proprietary company scrip will need to vote in a separate class.

Offers of securities incorporating mandatory custody or securityholder arrangements

Proposal

B2 We also propose to modify Ch 6 so that the exceptions in items 1–4 (takeover bids) and 17 (schemes of arrangement) of s611 are not available where securities are offered as consideration on terms (including terms in the constitution of the issuer) that require that scrip to be held by a custodian and/or subject to a securityholder agreement or similar arrangement, where doing so results in the issuer avoiding the application of:

(a) the shareholder limit in s113(1);

(b) s606; or

(c) the disclosing entity provisions in Pt 1.2A.

See the draft ASIC Corporations (Stub Equity in Control Transactions) Instrument 2019/XX at Attachment 1 on the consultation paper webpage under CP 312.

Your feedback:

B2Q1 Do you agree with our proposal to prevent offers of stub equity where the terms of the offer require that scrip to be held by a custodian or subject to an agreement that avoids:

(a) the application of the takeover bid provisions in Ch 6 or the disclosing entity provisions in Pt 1.2A; or

(b) the 50 non-employee shareholder limit in s113(1)?

If not, why not?

B2Q2 Should particular types of custodian arrangement or securityholder agreement be excluded from the proposal? If so, please explain why.

B2Q3 Are there any modifications to the proposal which may address unintended consequences of restricting the use of mandatory custodian arrangements and securityholder agreements in this way? Could these be addressed by including further modifications or individual relief?

B2Q4 Do you have any other comments on the form of the proposed legislative instrument in so far as it modifies Ch 6?

Rationale

20 Offers of securities under a control transaction can also raise concerns where receipt of the securities is conditional upon, or compels, entry into particular custody arrangements or securityholder agreements. Such arrangements may operate to defeat certain investor protections which legally depend on the number of members or registered holders there are in an issuer including:

(a) the disclosing entity provisions; and

(b) the takeover provisions.

The disclosing entity provisions

21 Ordinarily, where a body offers securities as consideration under a scheme of arrangement or an off-market takeover bid, and as a result those securities are held by 100 or more people:

(a) those securities are 'ED securities': s111AG;

(b) the body is a 'disclosing entity': s111AC; and

(c) the body becomes subject to periodic and continuous disclosure obligations, known as the 'disclosing entity provisions': s111AO, 111AP and 111AR.

Note: In the case of a scheme of arrangement the consideration securities will become ED securities only where either: (a) securities in the same class as the consideration securities are already ED securities; or (b) securities of the scheme company are already ED securities (e.g. where the scheme company is listed on a prescribed financial market): s111AG(2)(b).

22 The provisions commonly apply to offers of scrip in Australian bodies under a takeover or scheme. In the case of foreign bodies, as the 100-member test depends on the number of securityholders included, or entitled to be included, in a register kept under the Corporations Act, a foreign body offering shares will generally not become a disclosing entity as a result of offers under a takeover bid or scheme: see s111AH and Regulatory Guide 95 *Disclosing entity provisions relief* (RG 95) at RG 95.11A(b).

Note: A general exemption from the disclosing entity provisions also applies if a foreign body is admitted to the ASX as an exempt foreign entity: reg 1.2A.01 of the Corporations Regulations.

23 The additional requirements that apply to issuers that are disclosing entities include:

(a) if the issuer is incorporated or formed in Australia—the preparation of financial statements and reports for half years as well as full financial years under Ch 2M; and

(b) the requirement to provide continuous disclosure of material information under s675.

24 The disclosing entity provisions were enacted to 'ensure that enhanced disclosure obligations will apply to entities in which members of the public invest (disclosing entities) to enable informed decisions to be made about the allocation of investment funds'. Consistent with this objective the provisions apply to listed entities and entities in which there is significant investor interest as determined by reference to the ultimate result of an offer of securities by the entity.

Note: See the explanatory memorandum to the Corporate Law Reform Bill 1993, paragraphs 3–4.

25 The policy underlying the provisions was articulated by the Minister for Administrative Services in the second reading speech in relation to an earlier draft of the provisions in the Corporate Law Reform Bill 1992 (No. 2):

> Effective and soundly based action by shareholders is enhanced if they have access to all material information about their companies.
>
> However, the importance of adequate disclosure goes beyond this. An effective disclosure system will often be a significant inhibition on questionable corporate conduct. Knowledge that such conduct will be quickly exposed to the glare of publicity, as well as criticism by

> shareholders and the financial press, makes it less likely to occur in the first place.
>
> In essence, a well-informed market leads to greater investor confidence and in turn to a greater willingness to invest in Australian business.

The takeover provisions

26 The takeover provisions in Ch 6 apply to both listed and unlisted Australian companies as well as listed registered managed investment schemes. They seek to ensure, among other things, that takeovers of entities that are widely held take place in an efficient, competitive and informed market and that target holders are treated equally: s602.

27 The prohibitions in s606(1) and (2)—which underpin the general operation of the protections in Ch 6—apply to unlisted companies only if they have more than 50 members. The membership of a company is determined by reference to entries on the register of members: s231(b) and 606(3).

ASIC's avoidance concerns

28 As noted at paragraph 8, a scheme company may have many thousands of shareholders. Where scrip in a body is offered as consideration, it may be offered on terms that require:

(a) that certain accepting holders (e.g. all retail holders, or all existing holders of the target other than specified institutions) have that scrip registered in the name of a custodian, rather than holding the scrip directly; and/or

(b) that accepting holders agree to be bound by the terms of a securityholder agreement.

29 The terms of such securityholder agreements vary significantly, but may:

(a) modify the rights of certain groups of securityholders (e.g. by excluding relatively small holders from participation in future offers of securities or limiting the types of resolution on which small holders can vote);

(b) include tag-along and drag-along rights designed to facilitate the sale of 100% of the securities to a third party if a major investor wishes to exit their investment through a trade sale or public market transaction;

(c) limit the ability or circumstances in which a holder may dispose of their securities; or

(d) limit the ability of those holders whose securities are held in custody to call for them to be registered directly and held in their own name (mandatory custody arrangements).

30 While terms such as those described in paragraph 29(a)–(c) above may themselves raise fairness concerns as between different groups of holders, for present purposes we are particularly concerned with mandatory custody

arrangements of the kind described in paragraph 29(d). If an investor is forced to hold their investment in an unlisted Australian company through a mandatory custody arrangement they may not become 'members' for the purposes of the 50-member threshold in the takeover provisions.

31 Further, while the mandatory custody arrangements may be expressed to be a bare trust, the right of holders to call for the securities in an issuer to be registered directly may be fettered to such an extent it is arguable that they are not entitled to be so registered, and therefore do not 'hold' those securities for the purposes of the relevant disclosing entity provisions: s111AH(1)(b).

32 In the case of the disclosing entity provisions, even where more than 100 target securityholders elect to receive scrip consideration, most will hold that scrip through a custodian. As a result, fewer than 100 people will hold the securities offered as consideration, and the issuer will not become a disclosing entity. This is despite the fact that those securityholders, as investors, have the same interest in receiving the information about their investment in the entity, and other protections afforded by the disclosing entity provisions, that they would have if they held their interest directly on the entity's register.

33 Similarly, if the issuer is an unlisted Australian company—while the company will be, in substance, widely held, the protections of Ch 6 will not apply.

34 While the use of both custodian arrangements and securityholder agreements may be legal, we are concerned that the structure of such transactions enables avoidance of these important investor protections.

35 This is so irrespective of whether the securityholders are provided with adequate disclosure in connection with their decision to invest. It is not intended that an offeror may contract out of these statutory protections and we do not think it is consistent with the purpose of the provisions that they are readily avoided through the use of mandatory custody arrangements. ASIC's proposal seeks to ensure the provisions apply in accordance with their underlying policy and are not circumvented by structuring that avoids important shareholder protections.

Form of modification

36 Our proposed legislative instrument modifies the operation of the exemptions in items 1–4 and 17 of s611 so that they do not apply where scrip is offered under a takeover bid or scheme of arrangement that must be registered in the name of a custodian on terms that would avoid:

(a) Ch 6;

(b) the disclosing entity provisions; or

(c) the 50 non-employee shareholder limit in s113(1).

37 The modification also addresses concerns that a mandatory custody arrangement or shareholder agreement may be used to avoid the proposed prohibition in proposal B1 by making offers through a public company that are taken up by or on behalf of 50 or more target securityholders and subsequently converting the public company to a proprietary company.

38 We acknowledge that in some control transactions certain holders, such as management and institutional investors, may wish to retain their economic exposure to the target's business post-transaction and accept that stub equity can be one way to achieve this.

39 Our proposed modifications are not intended to prohibit such arrangements—only to ensure that if stub equity is offered it does not involve investors forgoing substantive protections under Australian law which they would otherwise enjoy absent the transaction structures of concern.

40 The proposed modification should not prevent, for example:

(a) offers being made to all target securityholders of scrip in:

- (i) a listed body;
- (ii) a body in respect of which none of the relevant protections under Australian law (i.e. the disclosing entity, takeover or proprietary company provisions) would in any event apply regardless of the take-up of the offer (e.g. an unlisted foreign body); or
- (iii) an unlisted public company provided:
  - (A) the disclosing entity provisions will apply to the company if the offer is taken up by more than 100 investors;
  - (B) the takeover provisions will apply to acquisitions of interests in the company if the offer is taken up by more than 50 investors; and
  - (C) the company will have more than 50 non-employee shareholders (as that term is defined in s113(1)) if the offer is taken up by more than 50 non-employee investors;

(b) offers of proprietary company scrip that are able to be made due to other disclosure exemptions in s708 (subject to the limits on, and consequences of, making different offers under the takeover and scheme of arrangement provisions); or

(c) agreeing with those parties who wish to retain their exposure to the target to jointly acquire the target—noting that where the combined interests of the parties exceeds the 20% threshold in s606(1), ASIC joint bid or scheme relief may be required in accordance with our policy in Section M of Regulatory Guide 9 *Takeover bids* (RG 9).

41 In circumstances where our proposed instrument would prevent a transaction that does not give rise to the policy concerns discussed above, we may consider granting individual relief from the proposed provisions.

C Regulatory and financial impact

42 In developing the proposals in this paper, we have carefully considered their regulatory and financial impact. On the information currently available to us we think they will strike an appropriate balance between:

(a) ensuring investor protections under Australian law are maintained when securities are offered to a large number of retail securityholders in connection with control transactions; and

(b) retaining an appropriate level of flexibility in the consideration that may be offered under these transactions.

43 Before settling on a final policy, we will comply with the Australian Government's regulatory impact analysis (RIA) requirements by:

(a) considering all feasible options, including examining the likely impacts of the range of alternative options which could meet our policy objectives;

(b) if regulatory options are under consideration, notifying the Office of Best Practice Regulation (OBPR); and

(c) if our proposed option has more than minor or machinery impact on business or the not-for-profit sector, preparing a Regulation Impact Statement (RIS).

44 All RISs are submitted to the OBPR for approval before we make any final decision. Without an approved RIS, ASIC is unable to give relief or make any other form of regulation, including issuing a regulatory guide that contains regulation.

45 To ensure that we are in a position to properly complete any required RIS, please give us as much information as you can about our proposals or any alternative approaches, including:

(a) the likely compliance costs;

(b) the likely effect on competition; and

(c) other impacts, costs and benefits.

See 'The consultation process', p. 4.

Key terms

Term	Meaning in this document
ASIC	Australian Securities and Investments Commission
Ch 6 (for example)	A chapter of the Corporations Act (in this example numbered 6)
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
Corporations Regulations	Corporations Regulations 2001
disclosing entity	Has the meaning given by s111AC of the Corporations Act
disclosing entity provisions	The provisions of Pt 1.2A, Ch 2M and Ch 6CA of the Corporations Act as they define, or apply to, disclosing entities
holder	A holder of securities
issuer	A body or managed investment scheme that issues securities
proprietary company	A type of company registered as a proprietary company under the Corporations Act as defined in s112(1) of the Corporations Act
Pt 5.1 (for example)	A Part of the Corporations Act (in this example numbered 5.1)
public company	A type of company registered as a public company under the Corporations Act as defined in s112(1) of the Corporations Act
s606 (for example)	A section of the Corporations Act (in this example numbered 606).
scheme acquirer	A person who will acquire a controlling interest in an entity under the terms of a scheme of arrangement
scheme or scheme of arrangement	A compromise or arrangement under Pt 5.1 of the Corporations Act
stub equity	Unlisted securities or interests offered in connection with a control transaction that: • enable offerees continued economic exposure to the performance of the underlying business of the body or other entity in which they are invested (such as shares in a bid vehicle); and • are offered as an alternative to another form of consideration (such as cash) that does not provide the same exposure

List of proposals and questions

Proposal	Your feedback
B1 We propose to make a new legislative instrument modifying Ch 6D so that the disclosure exemptions in s708(17) and (18) do not apply to offers of securities in proprietary companies.	B1Q1 Do you agree with our proposal to prevent offers of stub equity in proprietary companies to retail investors under the exemptions for control transactions? If not, why not? B1Q2 Do you have any comments on the form of the proposed legislative instrument in so far as it modifies Ch 6D?
B2 We also propose to modify Ch 6 so that the exceptions in items 1–4 (takeover bids) and 17 (schemes of arrangement) of s611 are not available where securities are offered as consideration on terms (including terms in the constitution of the issuer) that require that scrip to be held by a custodian and/or subject to a securityholder agreement or similar arrangement, where doing so results in the issuer avoiding the application of: (a) the shareholder limit in s113(1); (b) s606; or (c) the disclosing entity provisions in Pt 1.2A.	B2Q1 Do you agree with our proposal to prevent offers of stub equity where the terms of the offer require that scrip to be held by a custodian or subject to an agreement that avoids: (a) the application of the takeover bid provisions in Ch 6 or the disclosing entity provisions in Pt 1.2A; or (b) the 50 non-employee shareholder limit in s113(1)? If not, why not? B2Q2 Should particular types of custodian arrangement or securityholder agreement be excluded from the proposal? If so, please explain why. B2Q3 Are there any modifications to the proposal which may address unintended consequences of restricting the use of mandatory custodian arrangements and securityholder agreements in this way? Could these be addressed by including further modifications or individual relief? B2Q4 Do you have any other comments on the form of the proposed legislative instrument in so far as it modifies Ch 6?