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Dear Kim

Submission in response to Consultation Paper 312: Stub equity in control transactions

This submission is made by the Australian Public M&A and Private Equity teams at Allen & Overy in response to ASIC's Consultation Paper 312: Stub equity in control transactions (**Consultation Paper**).

We do not support the Consultation Paper's proposals to effectively limit the use of proprietary companies and nominee arrangements in connection with a stub equity alternative under a scheme of arrangement or takeover and for that reason do not support the issue of the draft instrument.

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?

No. We do not support ASIC's proposal to make a new legislative instrument modifying Chapter 6D so that the disclosure exemptions in sections 708(17) and (18) do not apply to offers of securities in proprietary companies.

- **Issue is one of adequate disclosure not structure**: We consider that the matter is an issue of disclosure (which we consider to be adequately addressed in the current regime) rather than the legal form or structure of the stub equity vehicle or its ownership structure. That said, ASIC could provide further guidance to market participants in Regulatory Guides 9 and 60 regarding the expected level of disclosure for offers of stub equity under schemes of arrangement and takeover bids (eg risks associated with ownership, differences between private and public companies etc).

- **No requirement for target shareholders to take stub equity**:
  - We believe that the type of investment vehicle is legitimately a matter for the sponsors to propose and for the investors to decide to take up or not in their discretion. There is no compulsion for them to accept the stub equity and indeed they will have a cash alternative typically at a significant premium to the prevailing market price, which the target directors have recommended and the independent expert has concluded is in target shareholders best interests.

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- ASIC appears to be approaching the issue based on the rights that the target investors will lose relative to their holding in a listed vehicle. Under the scheme the rights that they are losing is the forced transfer of their shares in consideration for their choice of cash (with its attendant certainty of value) or the stub equity.

- **No evidence of harm**: As noted above and based on available information, it appears from precedent transactions that:

  - shareholders are provided with a choice of consideration in addition to their choice as to whether to approve the takeover;

  - the disclosure provided to shareholders is extensive and addresses the risks associated with holding shares in an unlisted private vehicle;

  - target directors have, to date, only recommended that shareholders elect to take the cash alternative; and

  - there does not appear to be any evidence that shareholders who have chosen to acquire shares in a stub equity vehicle have been disadvantaged by the structure of that vehicle nor that they have been misled by the disclosure materials.

  Accordingly, it is not clear what harm it is that ASIC is seeking to protect against.

- **Stub equity proposals should not be considered a form of fundraising**:

  - We do not consider that the standard stub equity proposal should be considered as a form of fundraising activity. The sponsors are fully committed to acquire the target for 100% cash. The private equity sponsors would ordinarily prefer that the minimum election condition under the stub equity proposal is not satisfied so that they can acquire 100% of the target and not have to consider at all the on-going interests of the target shareholders who have elected to roll their investment.

  - The stub equity alternative merely enables target shareholders to roll, based on prospectus-style disclosure[1], their existing investment into the stub equity vehicle to retain their existing exposure to the underlying asset in an unlisted private equity vehicle. Aside from the one example you have referenced in which target shareholders were given the opportunity to top up their investment, there is no new money being provided.

- **Potential adverse consequences of the relief**:

  - *Discouragement of stub equity alternatives* – Stub equity vehicles were never intended to be a mere unlisted version of the listed public company but part and parcel of a public to private proposal. Stub equity proposals were designed to overcome issues where target investors may have had different views on value of the target (or time to deliver value) or otherwise have required on-going exposure to the underlying asset. The synergies associated with private ownership may not be able to be achieved to the extent that ASIC in essence retrofits public company requirements which restrict the ability to strip out the costs associated with the ASX listing and restructure the underlying company in accordance with the investment thesis. Imposing increased burdens on bidders in the manner contemplated by ASIC in the Consultation Paper would likely either:

[1] While stub equity proposals can be implemented through a takeover, the strong desire to get to 100% has meant that they have invariably been implemented through a scheme with its all or nothing outcome. There are also potential issues with limits on the stub equity and as to whether that could amount to a prohibited maximum acceptance condition.

  - discourage the use of the stub equity, make the costs of running the stub equity vehicle more expensive or provide unwarranted complexity to the stub equity vehicle (having regard to matters such as the application of the takeovers regime); and/or

  - limit the offering of stub equity to non-retail investors,

  each of which may in turn have the consequence of precluding the making or the consummation of public M&A deals in Australia.

- *Inconsistency with the Eggleston principles –* As noted above, we are not aware of the supposed harm which has been caused by any of the private equity proposals to date and believe that the effect of the proposed instruments would in many ways be inconsistent or give rise to inconsistencies with the Eggleston principles, for example:

  - the instrument would effectively exclude retail shareholders from being able to participate in the bid vehicle going forward contrary to the equality principle in section 602(c); and

  - if stub equity structures become unviable to the extent that sponsors elect not to even put a public-to-private proposal to particular companies due to the specific investment objectives of its shareholders, then the effect of the instrument will be to reduce competition in the market for control for that entity, which is contrary to section 602(a).

- *Potential non-availability of CGT roll-over relief* – Providing a roll opportunity to some but not all investors may create a range of issues such as potential non-availability of CGT roll-over relief, joint bid relief issues if the rolled shareholders and the bidder were to have a greater than 20% stake, and the potential to create different scheme classes which would reduce deal certainty.

- *Class creation issues* – While we note ASIC's comment that it would not have a difficulty with structuring the stub equity proposal so that the stub equity was only available to (some or all) non-retail investors, that would potentially have the attendant result of creating separate classes in a scheme context with the attendant consequences of increasing the effective voting threshold (and reducing the size of an effective veto) as the 75% by value and 50% by number thresholds would need to be passed for each class. This would impose a real cost to prospective bidders in making their acquisition proposal far less certain, reducing their confidence and likelihood to bid in this manner. Further, as noted by Santow J in *Re NRMA Ltd* (2000) 33 ACSR 595 at 617, there ought to be tendency against unnecessary multiplication of classes as this has the potential to lead to inconvenience and artificiality and to give an effective veto right to a small group of shareholders:

  > "the 'shifting' or 'fracturing' of classes into smaller groups can undermine the objective of obtaining decision by a large majority, by giving one group an effective veto over the wishes of the majority. That itself can be oppressive.

- **No general requirement for all substantial entities in Australia to operate in a public company structure**:

  - While the stub equity vehicle may be a substantial entity in its own right post implementation, we do not consider that there is a general requirement for substantial entities to all be held in a public company structure. Such a proposition would cut across a myriad of valid commercial arrangements from private equity to large family companies etc which may in fact be a large proprietary company (a concept recognised under the Corporations Act). Indeed most

domestic private equity and other unlisted alternative investments are held through managed investment or trust structures which have no greater rights (indeed frequently less) than those offered under most stub equity proposals even when offered to retail investors.

  - Furthermore, we believe that the increased use of proprietary companies incorporated under the Corporations Act since 2016 is to be encouraged not discouraged. Prior to that time sponsors had looked to use vehicles in jurisdictions such as Bermuda or the Cayman Islands with lower governance standards that Australian proprietary companies. It also raised more challenging issues in enforcing those governance rights when the bid vehicle was incorporated in such external jurisdictions.

- **Benefits of public company structure are overstated**: We consider the protections provided under the Corporations Act to public company shareholders as compared to private company shareholders to be overstated. Specifically:

  - *Related party provisions (Chapter 2E)* – we consider it is open for the shareholders agreement to prescribe its own regime for managing related party transactions.

  - *Restrictions of director's voting (section 195)* – section 195 is typically considerably narrower than the provisions under the shareholders agreement as section 195 is predicated on the existence of a material personal interest;

  - *Appointment and removal of directors (sections 201E and 249H(3))* – the public company structure may in fact bring lesser rights to the minority stub equity holders as with a greater than 50% interest the sponsor would have the power to remove and replace any director (subject to any specific class rights) rather than having a constitution which may set out some appropriate minority protections (eg shareholders holding more than x% have the right to appoint and remove a director).

  - *Residency requirement for directors (section 201A(2))* – any benefit arising from the Australian residency requirement for public companies is marginal given the capacity to obtain resident Australian director services and the fact that the expectation of directors in respect of the performance of their duties is agnostic to the residency or citizenship of any director. It is just potentially an additional cost.

  - *AGM requirement (section 250N)* - the merits of AGMs in the listed public company space is being significantly questioned. There is a considerable cost associated with an AGM with little corresponding benefit. Indeed if the stub equity vehicle were a managed investment scheme there would be no requirement for an AGM as section 250N does not apply to it. There are many significant managed investment schemes that do not hold an AGM although some agree to do so voluntarily.

  - *Periodic financial reporting obligations under Chapter 2M* – the only entities that are permitted to not prepare and file a financial report and directors' report are small proprietary companies who (1) have not been directed to so by ASIC or shareholders holding at least 5% of the votes; (2) were not controlled by a foreign company for all or part of the year; and (3) do not have one or more 'crowd-sourced funding' shareholders. Accordingly, it would appear to us that most stub equity vehicles may find themselves in a position whereby they need to comply with the financial reporting provisions of Chapter 2M, including by reason of having been directed to do so by ASIC or its shareholders.

- **No need to read section 708(17) or (18) down**: Schemes of arrangement and the combined package of a bidders statement and target statement have always been considered to provide for equivalent level of disclosure to a prospectus to allow informed decision making whether in the context of a scrip bid, a

demerger or a stub-equity proposal. We submit, there is no valid basis for carving out from this well recognised exception. In this regard we note that ASIC acknowledges the primacy of the provisions of section 708(17) in Regulatory Guide 60 at [66] but nonetheless notes its expectation that disclosure in the explanatory statement for a scrip takeover type scheme should meet the requirements of a bidder's statement for a scrip takeover bid. Further, we do not see the regulatory benefit in the proposals as the sponsor offering the stub equity alternative could merely incorporate the scheme booklet within the prospectus 'by reference' under section 712. While this may provide ASIC some additional process powers, we submit that it makes no substantive change as the takeover or scheme is already subject to substantially equivalent disclosure which is already subject to review by ASIC.

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

For the reasons set out above and below we do not support the proposed form of the instrument.

We also consider that there may be a real issue as to whether the issue of such an instrument may be beyond the power of ASIC under sections 655A and 741 on account of the fact that ASIC has not demonstrated any harm or disadvantage that has been suffered by market participants.

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?

No, for the reasons set out above and the additional matters below.

- **Other recognised vehicles with more than 50 members are not subject to the takeover rules**: We do not consider ASIC's concerns about the non-application of the takeover rules to warrant the issue of the draft class order. As noted in a line of cases since *Re Bank of Adelaide* (1979) 4 ACLR 393 the Courts have held that Chapter 6 is not a regulatory Mount Everest. ASIC's Regulatory Guide 60 also supports this proposition. If the stub equity vehicle was a managed investment scheme, or if the stub equity vehicle was a foreign incorporated company, Chapter 6 would have no application to the acquisition of interests in such vehicles. While there may be some disadvantages with the use of such vehicles, such as the non-applicability of CGT roll-over relief, the fact that these vehicles can be used clearly indicates that the ASIC focus should be on the quality of the disclosure rather than the form of the stub equity vehicle. Indeed, if ASIC's premise was correct, to achieve parity of regulatory treatment (which we do not consider to be the case) it ought to consider some form of class order to extend Chapter 6 to unlisted managed investment schemes with more than 50 members (which would have a material impact on the funds management industry). It would also seemingly restrict the offering of securities in offshore entities which may or may not have their own Chapter 6 equivalent. In essence target shareholders through a scheme vote with a higher voting threshold than a section 611, item 7 resolution are voting to ensure that the takeover rules ought not apply to the stub equity vehicle.

- **The takeover rules applying to a stub equity vehicle may have significant and adverse consequences**:

  - The application of the takeover provisions to an unlisted stub equity vehicle may significantly alter the rights that the sponsors may appropriately seek and which would be available for other unlisted alternate investments. Specifically, typical rights such as drag rights, tag rights, good leaver/bad leaver provisions (to the extent relevant), director appointment rights, special majority veto rights in addition to pre-emptive rights may have the effect that each member of the stub equity vehicle had a relevant interest in 100% of the shares in the stub equity vehicle (see *Darvall v North Sydney Brick & Tile Co Ltd* (1988) 6 ACLC 154) and each member may

be taken to be an associate or each other, thus giving rise to potential unintended consequences under Chapter 6.

– While the Corporations Act exempts a relevant interest arising from pre-emptive rights in the company's constitution it does not exclude a broader category of rights or rights in a shareholders agreement. The net result is that either these types of rights may need to be removed or the company face the considerable difficulties associated with this outcome; for example, if a new shareholder was introduced as a result of requiring new capital or transferring outside of the initial shareholders and the incoming shareholder's voting power increased from 0 to 100% that would either require shareholder approval or ASIC relief. This would impose a significant limit on the activities of the stub equity vehicle and the ability of it and its shareholders to respond to changes in market dynamics.

– Moreover, drag and tag rights serve the useful purpose of enabling the sponsors to ensure a clean and timely exit for all shareholders at the relevant investment horizon date. Such ability is seen as a fundamental necessity for the structuring of private equity investors.

- **Disclosure is considered adequate for foreign company shares**: In circumstances where a bidder proposes to issue shares (or derivative interests in shares) in a foreign registered company, for example under a foreign scrip bid or a redomiciliation effected via scheme of arrangement, ASIC appears to accept the adequacy of the risk disclosure in scheme booklets regarding the rights attaching to such foreign shares. Moreover, in respect of redomiciliations to offshore financial centres (eg Bermuda and Cayman Islands), where there are no statutory takeover protections available to holders of shares in those entities and, absent the inclusion of takeover restrictions within the entities articles (which has not been a prerequisite of either ASIC or the Courts in those schemes), shareholders will not be entitled to the benefit of any takeover threshold prohibition or mandatory bid threshold. As such, the question remains as to why 'disclosure' is not considered an adequate cure for the risks associated with holding shares in a private company, when it is clearly considered as such in respect of foreign scrip consideration.

- **Nominee structures are not unacceptable**: Nominee structures have been used for a considerable period to manage compliance with the 50 shareholder threshold. This has ranged from using nominees for employee incentive schemes or management equity plans to stay below 50 members or other structures such as the holding of all of the shares in Virgin International on behalf of relevant Virgin Australia shareholders on a record date. In essence it is no different than in the funds space to having multiple levels of feeder funds.

- **Disclosing entity provisions**: We consider that the supposed benefit of disclosure through these provisions is overstated as there will be no listed or liquid market for shares in the stub equity vehicle and hence the test for disclosure (ie a material effect on price or value) is harder to test. We would be interested in the empirical research indicating the average number of disclosures per annum by such unlisted disclosing entities. We suspect the number would be small.

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

All types of arrangements and agreement ought to be excluded for the reasons set out above.

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

Not applicable, for the reasons set out above.

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

Not applicable, for the reasons set out above.

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If you should have any questions or comments on the above submission, please do not hesitate to contact either Michael or James.

Yours sincerely

[*Sent electronically*]

Michael Parshall
Partner

[*Sent electronically*]

James Nicholls
Counsel