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Submission in response to ASIC's consultation paper on stub equity in control transactions

1 Overview

We refer to ASIC Consultation Paper 312 (**CP312**), dated 4 June 2019, which proposes to address offers of 'stub equity' scrip consideration in control transactions. We are pleased to provide this submission and thank ASIC for the opportunity to provide our comments.

The views expressed in this submission are the views of the authors only. They do not necessarily represent the views of our clients.

In summary, for the reasons below, we do not agree with ASIC's proposals in CP312 and urge ASIC not to implement any of them. At a minimum, we encourage ASIC not to restrict the use of Australian public companies with a custodian structure.

In our view, the proposals, if implemented, would have a negative regulatory, financial and economic impact, that is, to:

(a) deprive retail shareholders of a valuable investment opportunity, in circumstances where there is adequate disclosure, shareholders understand the risks and make an informed choice – *ASIC has long accepted that shareholders can make an informed choice based on disclosure on, for example, accepting foreign scrip consideration outside of the stub equity context. This should be no different*;

(b) drive an increase in using foreign domiciled issuers (such as the Cayman Islands and Bermuda) for stub equity – this is less protective for shareholders as these companies do not provide shareholders with the familiarity of investing in an Australian entity and some of the safeguards of an Australian company (in particular Australia public company safeguards); and

(c) potentially make Australia an unattractive jurisdiction for buyers looking to deploy capital (in particular private equity buyers), due to the increased complexity of a buyer's exit and overall costs of pursuing a control transaction.

We also query ASIC's ability to make an instrument of the nature contemplated. In particular:

(a) on one view, neither s655A nor s741 should be taken to empower ASIC to issue a purely restrictive instrument, such as the instrument proposed which prevents offers of stub equity in Australian public companies with a custodian arrangement, where the offer would otherwise be legal under the Corporations Act; and

(b) ASIC is required to consider the purpose of Chapter 6 in deciding to make a declaration under s655A – in our view, there are aspects of ASIC's proposals which are inconsistent with the purpose, for example:

  (1) the restrictions having the effect of potentially depriving shareholders (including retail shareholders) of a reasonable and equal opportunity to participate in the potential benefits of electing stub equity; and

  (2) by effectively prohibiting certain types of stub equity offers, it offends against the efficient, competitive and informed market principle as it restricts the sorts of transactions that can be done.

We set out further detail on each of these matters below. Each of the points above responds to questions B1Q1 and B2Q1 generally. As we do not agree with ASIC's proposals, we have not commented specifically on questions B1Q2 or B2Q2-Q4.

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2 Depriving retail shareholders of a valuable investment opportunity

Reduced incentive for bidders to offer stub equity depriving retail shareholders of choice

Stub equity deals are favoured by private equity bidders or acquirers as they provide flexibility in the ownership structure, a potential reduction in the funding required for the acquisition and a mechanism for the bidder to exit smoothly from its investment after a period. These incentives to offer stub equity would be reduced if ASIC's proposals are implemented as they would result in:

- bidders having less flexibility in the type of stub equity they can offer; and
- increased costs and complexity, during their period of ownership of the target as well as on any potential exit, particularly if the takeover rules or disclosing entity provisions apply to the stub equity vehicle.

Accordingly, the impact of ASIC's proposals is that bidders could be discouraged from offering stub equity or otherwise choose to exclude retail shareholders from the stub equity opportunity.

In either case, retail shareholders will be deprived of a valuable commercial opportunity to retain an economic interest in the target and share in the upside of private equity ownership. Relevantly, shareholders are not forced to take the stub equity – they can always opt to take cash consideration (and, in the vast majority of examples, do) – ASIC's proposals deprive them of this choice. Shareholders make this choice on a fully informed basis with knowledge of all material risks.

In addition, shareholders who elect to take up the stub equity will have the rights afforded to them under the relevant shareholders agreement / constitution for the stub equity vehicle. While it is up to bidders to put forward the terms of these documents, and for shareholders to consider if they are acceptable in the shareholders' individual circumstances, these agreements often contain drag and tag rights (allowing minority shareholders to participate in an exit of a major shareholder) and also certain information rights for shareholders.

Shareholders are fully informed and understand the risks

ASIC's view in CP312 is that, even if shareholders are provided with adequate disclosure (e.g. equivalent to prospectus level disclosure) in connection with their decision to take up the stub equity, that is insufficient. We disagree.

Shareholders make informed choices on the basis of disclosure in all control transactions. For example, in general foreign scrip control transactions (even outside the stub equity context), the bidder makes a wide offer to target shareholders of shares in a foreign company which is:

- not governed under the Corporations Act;
- may have very different (and often less) protections than those available in an Australian company; and
- may not have any takeover protections.

ASIC accepts in that context that provided shareholders are provided with adequate disclosure and understand the differences between the Australian listed scrip they hold and what they are being offered, they are able to make an informed decision as to whether to accept the foreign scrip. Why should it be any different for disclosure in the stub equity context?

In addition, with proper disclosure, the law has long recognised that shareholders can opt out of the protections under Chapter 6 – see, for example, s611, item 7. ASIC's proposal flies in the face of that principle and the adverse impact on an exit transaction where

Chapter 6 applies is another reason for bidders to avoid use of an Australian incorporated vehicle (and potentially drive them to foreign domiciled vehicles, as described in section 3 below).

From our analysis of stub equity transactions over the last 10 years, the take-up by retail shareholders of the stub equity is very low, evidencing that disclosure is an effective means for retail shareholders to understand the relative merits of a cash versus stub option. It is likely that only those who wish to take the risks associated with stub equity (in return for potential returns down the track) take up this option. This shows that ASIC's concerns are addressed through full disclosure, without creating the unequal access issues which may arise on ASIC's proposals.

We also are not aware of any specific instances where a retail shareholder has suffered harm as a result of electing the stub equity – in those circumstances, ASIC's proposal seems to be excessive and indeed deprive retail shareholders of choice.

3 Drive bidders to use foreign domiciled issuers for stub equity

Prior to 2011, most stub equity deals involved non-Australian stub equity vehicles, usually incorporated in low regulation countries such as Bermuda or the Cayman Islands. However, more recently, we have seen an increase in the use of unlisted Australian companies. This was a positive development for shareholders, particularly retail shareholders, who generally prefer the familiarity of an Australian stub vehicle to a foreign vehicle.

Unfortunately, in light of ASIC's proposal, we are already seeing live time in the market – as a direct consequence of ASIC announcing this consultation process – bidders moving back to foreign domiciled issuers – often selected for their lack of regulation and minority protections – as the stub equity vehicle. This situation is unfortunate for Australian retail investors who may well prefer to hold a beneficial interest in an Australian vehicle through a custodian over a direct interest in a foreign vehicle. It would generally suit the bidder, the target board and shareholders to instead use an Australian public company structure, with a custodian if the number of shareholders in the stub vehicle would otherwise exceed 50. All shareholders would have better protection and the structure would be less costly, meaning less value leakage for shareholders electing to receive stub equity. We query whether there may be adverse tax effects for Australia in driving bidders to use these offshore vehicles. There does not appear to be any form of stakeholder which benefits from ASIC's proposed new policy. Every category of stakeholder seems to be adversely affected.

It is a perverse outcome that ASIC's proposals, in particular proposal B2, which prevents the offer of stub equity in a public company with a custodian, would potentially deprive shareholders of certain safeguards of an Australian public company (such as restrictions on related party transactions, conflicted directors voting, rules for appointment and removal of directors, the requirement to have Australian resident directors, AGMs and periodic financial reporting).

4 Potentially make Australia an unattractive jurisdiction for buyers

As described above, ASIC's proposals, if implemented, would result in:

- bidders having less flexibility in the type of stub equity it can offer; and
- if a bidder used an Australian public company as the stub equity vehicle, increased costs and complexity, during their period of ownership of the target as well as on any potential exit, particularly if the takeover rules or disclosing entity provisions apply to the stub equity vehicle.

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These factors potentially make Australia an unattractive jurisdiction for buyers, in particular private equity buyers, looking for flexibility in ownership structure and a mechanism for the buyer to exit smoothly from its investment.

While it is too early to tell, this could have an unintended consequence of reducing the amount of capital invested in Australia.

5 ASIC's ability to make the instrument under s655A

We also query ASIC's ability to make an instrument of the nature contemplated.

On one view, neither s655A nor s741 should be taken to empower ASIC to issue a purely restrictive instrument, such as the instrument proposed which prevents offers of stub equity in Australian public companies with a custodian arrangement, where the offer would otherwise be legal under the Corporations Act.

The proposed instrument is at risk of being potentially found invalid due to repugnancy to or inconsistency with the Corporations Act because it purports to prohibit transactions that the Corporations Act specifically permits.

The provisions under which the proposed instrument would be made can be contrasted to other ASIC powers in the Corporations Act which expressly contemplate that an effect of an ASIC instrument may be to render an offence conduct that would not have been an offence (provided certain procedural requirements are met), and may accordingly be properly construed more narrowly.

There is also a risk that the proposed instrument is construed in such a way that a bidder could elect to simply comply with the Corporations Act and not seek to 'rely' on the proposed instrument. ASIC instruments more commonly provide a benefit on a conditional basis, and there would be myriad examples of persons who had the benefit of the instrument choosing to comply with the unmodified law rather than taking advantage of the instrument.

ASIC is also required to consider the purpose of Chapter 6, as set out in s602, in deciding to make a declaration under s655A. In our view:

- there is nothing about the offer of stub equity in a proprietary company or a public company with a custodian, as part of a takeover (or indeed a scheme), that is inconsistent with s602; and
- indeed, the stub equity scheme or takeover takes place in an efficient, competitive and informed market, shareholders are given sufficient disclosure, and critically, stub equity is offered to all shareholders so they have a reasonable and equal opportunity to participate in any benefits accruing to holders.

There is no policy reason for modifying this current position under the law. Rather, in our view, there are aspects of ASIC's proposals, to change the current position under the law, which are inconsistent with the purpose in s602 and accordingly should not be made. For example:

- for the reasons described in section 2 above, ASIC's proposed restrictions have the effect of potentially depriving shareholders (especially retail shareholders) of a reasonable and equal opportunity to participate in the potential benefits of electing stub equity; and
- by effectively prohibiting certain types of stub equity offers, it offends against the efficient competitive and informed market principle as it restricts the sorts of transactions that can be done.

6 Suggested approach

We think the better approach for ASIC to address its concerns is for ASIC to consult with the market to establish some clear guidelines for disclosure in stub equity deals, which could be put into the relevant Regulatory Guide. This would include guidelines concerning:

- prominent disclosure as to whether or not shareholders can elect to take all cash consideration instead of stub equity;
- whether or not the directors recommend shareholders elect to receive stub equity;
- clear disclosure of the risks of stub equity;
- clear disclosure of the differences from the rights as a holder of listed shares; and
- a preference that any election form is only available to shareholder on request to avoid inadvertent elections.

We think that a sensible set of guidelines could quickly be developed which would protect shareholders without diminishing the current rights of more sophisticated investors or creating the concerns we have described above. ASIC would then have achieved its regulatory goals. We would be happy to join a working group for this purpose.

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