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17 July 2019

To Kim Demarte
Senior Specialist - Mergers & Acquisitions
Corporations
Australian Securities and Investments Commission
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Dear Mr Demarte

Consultation Paper 312 (*Stub equity in control transactions*)

We refer to Consultation Paper 312 (*Stub equity in control transactions*) dated June 2019 ("**Paper**"). We are pleased to provide the following submissions and commentary on the matters raised in the Paper.

1 Background

Since 2011, bidders in Australian control transactions for publicly listed entities (particularly, private equity sponsors) have increasingly been required to respond to the commercial need, driven predominantly by target boards and management, to offer target shareholders scrip in private, unlisted bid vehicles (so called "stub equity").

Historically, the nature of the stub equity vehicle and its country of incorporation has varied. Early forms of stub equity vehicles used in Australia comprised offshore entities incorporated in jurisdictions such as Bermuda and Cayman Islands. In more recent times, the market has shifted to offers of stub equity in Australian proprietary companies or Australian unlisted public companies. This shift, in our view, has been largely driven by target and target shareholder familiarity with these structures, the statutory protections afforded to them under Australian law and a reduced administrative burden from maintaining an offshore holding domicile.

The onshore structures have consistently incorporated the following features:

(a) (**custodian arrangement**) a custodian or nominee arrangement whereby target shareholders who elect to receive stub equity also agree to have their holding held via a professional custodian or nominee; and

(b) (**shareholder agreement**) target shareholders who elect to receive stub equity also agree to be bound by a shareholders' agreement which regulates how the stub equity vehicle is governed and how the stub equity can be traded (including customary "drag" and "tag" arrangements).

There are a variety of reasons why these features are important and legitimate commercial considerations for bidders (including private equity sponsors) who wish to privatise a company and manage its business in a private forum. For private equity sponsors in particular, their investment proposals are generally premised on the ability to achieve an unimpeded exit of their investments over a 3-5 year timeframe. They also want to ensure that the shareholder register does not become too unwieldy to manage and that the rights of target shareholders rolling into the stub equity vehicle are able to be appropriately tailored having regard to the private context in which the underlying business will be managed.

Additional commercial drivers[1] include:

(a) (**roll management**) encouraging and enabling management shareholders to roll over into the stub equity vehicle through the opportunity to participate in the future economic performance of the privatised entity;

(b) (**tax rollover relief**) enabling target shareholders to potentially claim scrip-for-scrip capital gains tax rollover relief in respect of the stub equity component offered;

(c) (**reduce in cash outlay**) reducing the amount of cash required by the bidder for the acquisition; and/or

(d) (**allow target shareholders to maintain their exposure**) allowing target shareholders the chance to continue their exposure to the underlying asset if they believe that it is in their commercial interests to do so[2].

2 Use of stub equity in Australian control transactions

We have identified 12 Australian control transactions announced since 2011 where stub equity has been offered ("**Stub Equity Transactions**"). Details of the Stub Equity Transactions are set out in the schedule to this submission.

In relation to the Stub Equity Transactions, we note that:

(a) (**vehicle used**) the stub equity offered was either:

  (i) securities in an unlisted Australian managed investment scheme;

  (ii) shares in an unlisted Australian public company;

  (iii) shares in an Australian proprietary company;

  (iv) shares in a Cayman unlisted company; or

  (v) retained equity in the target;

(b) (**cash alternative**) in all but two, all shareholders were offered an all cash alternative to the stub equity. The two examples where an all cash alternative was not offered to all target shareholders were the RCF acquisition of Ausenco Group Ltd and the SR Residential

[1] These drivers may emanate from target boards, management and/or bidders.

[2] This analysis will likely include the alternative risk-weighted returns that would otherwise be achieved by a target shareholder if the after tax capital realised was reinvested in one or more other investments.

acquisition of Simonds Group Ltd. However, in both these transactions, the specific target shareholders not being offered a cash alternative comprised management, substantial shareholders and/or associates of the relevant bidder who had agreed separate contractual arrangements with the relevant bidder outside of the scheme process to retain their shares. All other target shareholders were offered cash in a parallel scheme process from which the specific target shareholders were excluded;

(c) (**director recommendation**) the target directors either:

(i) provided no recommendation in relation to the stub equity offer - the most common position taken by target directors; or

(ii) recommended against the stub equity offer – this has only happened once in the recent Brookfield Capital Partners privatisation of Healthscope Limited.

(d) (**minimum election achievement**) 10 of the 12 transactions were implemented, and of those there were 8 instances where stub equity was issued (i.e. because any applicable minimum scrip election threshold was reached); and

(e) (**number of stub acceptances**) where the minimum scrip election threshold was reached, acceptances have averaged around 56 participants per transaction. To put that into perspective, those participants represented about 1 per cent of the approximately 30,000 aggregate securityholders in those targets. While data is not publicly available in relation to the composition of the stub equity participants, based on our experience we believe a material proportion comprise sophisticated investors and/or target management.

3 Stub equity in other comparable jurisdictions

3.1 Regulation in foreign jurisdictions

We have considered the following instruments that regulate public company takeovers in the United Kingdom, Hong Kong, the United States, New Zealand and Canada:

(a) *The Takeover Code* (United Kingdom);

(b) *The Codes on Takeovers and Mergers and Share Buy-backs* (Hong Kong);

(c) *US Securities Exchange Act 1934* (United States) and *Delaware General Corporation Law 203* (Delaware being the most common jurisdiction of incorporation for public companies in the United States);

(d) *Takeovers Act 1993* and *Takeovers Regulation 2000* (New Zealand); and

(e) *Multilateral Instrument 62-104: Take-Over Bids and Issuer Bids* (Canada).

3.2 Key underlying principles

In the context of offers of scrip consideration in public takeovers, the regulatory position in each of the above foreign jurisdictions is broadly aligned and embody the following underlying principles:

(a) consideration may consist of cash, scrip or a combination of cash and scrip (although in Hong Kong and the United Kingdom, there are certain circumstances such as mandatory offers where a cash alternative must be offered to target shareholders);

(b) each offer must be made on the same terms and provide the same consideration for all securities belonging to the same class of securities under the offer;

(c) there is no additional restriction or requirement on the form or type of scrip consideration that may be offered; and

(d) there may be registration requirements[3] and mandated disclosure requirements for offers of scrip consideration, such as prospectus-level disclosure.

Significantly, in each of the above foreign jurisdictions, the form or type of scrip consideration that may be offered under a public takeover offer is not restricted – it is simply a commercial matter to be determined by the bidder in the structuring of its offer. In this context, ASIC's proposed changes, if implemented, would:

(a) put Australia's regulatory position well out of step with (and in our view, behind) the regulatory positions in the above foreign jurisdictions; and

(b) in our view, inhibit the competitive market for control transactions in Australia.

4 Proposed new legislative instrument

4.1 Introduction

As noted in the Paper, the new legislative instrument ASIC is proposing to issue ("**Proposed Instrument**") will mean that:

(a) the disclosure exemptions in section 708(17) and (18) of the Corporations Act will not apply to offers of securities in proprietary companies; and

(b) the exemptions in section 611 of the Corporations Act relating to takeover bids and schemes of arrangement will not apply where:

(i) scrip is offered as consideration; and

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

A. the issuer to avoid (to the extent they would otherwise apply) Chapter 6 of the Corporations Act or the disclosing entity provisions of the Corporations Act; or

B. the subsequent conversion of the issuer to a proprietary company despite there being, in substance, more than 50 inventors in the company.

In the balance of these submissions we address the Proposed Instrument as it concerns paragraph (b) above. While we do not consider that the proposed modification referenced in paragraph (a) is necessary, our primary concern with the Proposed Instrument is the proposed modification referenced in paragraph (b).

4.2 Rationale for the Proposed Instrument

We understand the central objective ASIC is trying to achieve with the Proposed Instrument is to restrict stub equity offers being made to "retail investors" as part of Australian control transactions.[4]

[3] If a non-US company uses its own shares as consideration to acquire a public company in the US, the bidder is subject to the registration requirements of the *US Securities Act 1933*, unless an exemption applies.

ASIC is particularly concerned that stub equity offers involving Australian companies can, under the current law, be structured so as to require that the scrip be held under custodian and shareholder arrangements described above and thereby avoid:

(a) the application of the provisions in Chapter 6 of the Corporations Act or the disclosing entity provisions in Part 1.2A of the Corporations Act ("**Protections**"); or

(b) the limit of 50 non-employee shareholder in section 113(1) of the Corporations Act.

4.3 The current regime

While there is no doubt that in some circumstances an investor will only make an investment if it is able to enjoy the Protections, there are many circumstances where an investor will voluntarily forgo them.

In making an election to receive scrip as part of a stub equity offer, an investor will have the benefit of either a scheme booklet or bidder's statement which will explain in detail:

(a) the terms applicable to the stub equity, including the terms of any applicable custodian or shareholder arrangement; and

(b) the comparative rights and other protections that will be available to securityholders that elect to receive the sub equity as compared to the rights and other protections currently available as a securityholder in the target, including that the investors will not have the benefit of the Protections.

Given:

(a) all target securityholders in recent stub equity offers have been offered a "default" all-cash alternative to the stub equity[5]; and

(b) the actual take up of the scrip election in the Stub Equity Transactions has been very low (representing about 1% of the total available target shareholder base),

the only reasonable conclusion that can be drawn is that the current regulatory regime for Australian control transactions for publicly listed entities (as it relates to stub equity offers) is working very effectively. The evidence strongly indicates that Target shareholders are heeding the recommended position of their target directors and/or fully understanding the risk disclosures associated with electing a stub equity alternative.

Additionally, we are not aware of any actual evidence to date of real grievances expressed by those who have elected a stub offering. If such evidence does in fact exist, we believe it should be disclosed publicly by ASIC and examined as part of this consultation process.

4.4 Negative impact of the Proposed Instrument

We consider that the Proposed Instrument is likely to have two material negative consequences.

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[4] ASIC, '19-127MR ASIC consults on proposals to maintain investor protections by restricting retail offers of 'stub-equity' in control transactions' <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-127mr-asic-consults-on-proposals-to-maintain-investor-protections-by-restricting-retail-offers-of-stub-equity-in-control-transactions/>.

[5] There were two examples where certain management, substantial shareholders and/or associates of the relevant bidder entered into separate contractual arrangements with the relevant bidder outside of the scheme process to retain their shares.

(a) (**foreign stub vehicles as the alternative**) First, it will drive bidders to use foreign holding vehicles not otherwise subject to ASIC's purview. For example, bidders may return to using Bermudan or Cayman Island holding vehicles which provide even less protection to securityholders as compared to what would be available to a securityholder in an Australian company subject to a custodian or nominee arrangement.

The use of foreign holding vehicles will also be less understandable and more unfamiliar to target shareholders who will have the unenviable (and potentially costly) task of considering and assessing the application of foreign laws to any stub equity holding they wish to take. In our view, this cannot be the optimal outcome from a policy perspective.

Finally, it is worth noting that the Australian experience in control transactions with such foreign vehicles has, on occasions, engendered quite a deal of negative shareholder reaction. The 2013 takeover of Miclyn Offshore Express, a Bermudan ASX-listed company, is one such example. As the target company was not subject to Australian laws, two major shareholders with an aggregate holding of 59.2% in the target were able to enter into a cooperation agreement under which they agreed to grant each other rights and restrictions over their target shares and nominee director appointment rights and to generally work together in respect of their investments in the target to achieve a "positive outcome". These major shareholders subsequently decided to make a privatisation offer for the target at a price below a recent price they had paid for an additional stake in the target and under which they would be able to vote their target shares in favour of the offer. Minority shareholders expressed concern that they were effectively being "squeezed out" in an inequitable change of control transaction at an offer price below the prevailing market value for target shares. Interestingly, it was reported at the time that ASX and ASIC were of the view that so long as Bermudian companies explained to shareholders that they have less protection in a control transaction than they would if the company was incorporated in Australia, it was up to investors to make sure they understand the risks[6]. So, while simple disclosure of such risks in an offshore vehicle context appears to be accepted by our regulators, it does not appear now to enjoy the same regulatory acceptance if an Australian holding vehicle is being used in a privatisation. This is curious, to say the least.

(b) (**chilling competitive forces**) Secondly, private equity sponsors (being the main proponents of stub equity offers in Australian control transactions) do not instinctively gravitate to stub equity offers, however they will consider them when it makes sense from a competitive perspective. This will often arise after initial interactions with a target board (keen to extract additional "benefits" for their securityholders) or having regard to likely preferences for key target securityholders (who might prefer to retain exposure to the underlying investment), or even to assist management roll their securities and incentives over in a tax effective manner. Therefore, there are commercial drivers external to the bidder for such offers to be made. There is a real risk that the Proposed Instrument will effectively chill the active participation of the private equity

[6] Ben Butler, 'Beautiful Bermuda, but investors told to tread with caution in the case of offshore listings', Sydney Morning Herald (online, 25 May 2013 <https://www.smh.com.au/business/beautiful-bermuda-but-investors-told-to-tread-with-caution-in-the-case-of-offshore-listings-20130524-2k6u3.html>.

sponsors in our public markets if they are unable to effectively respond to these external competitive forces.

4.5 An alternative approach

Our opinion remains firmly that the current regime for Australian control transactions for publicly listed entities (as it relates to stub equity offers) is currently working well and does not require amendment. We have seen no evidence of material grievances being expressed by those that have elected to accept a stub equity offer. Target shareholders are clearly being cautious in their preparedness to elect into stub equity offers and those that do so appear predominantly to be sophisticated investors and/or target management. We therefore consider there does not currently exist any sound basis for the changes proposed under the Proposed Instrument, particularly given the negative consequences that we believe will flow from the changes.

However, if notwithstanding the above, ASIC can demonstrate with actual evidence that there are real and legitimate issues being experienced by those who have accepted into a stub equity holding or a serious regulatory failing that is being exploited to the obvious disadvantage of the market or its participant shareholders, then we consider that ASIC should better target its approach to achieve its central objective. For example, rather than inserting the proposed section 615A set out in the Proposed Instrument, the Corporations Act could be modified as follows[7]:

(a) section 411 should be modified to provide that where stub equity is offered under a scheme of arrangement, that fact alone will not require the creation of a separate class provided that:

  (i) the stub equity is only available to management and institutional shareholders and must be accompanied by a default all cash alternative that all shareholders are entitled to accept; and

  (ii) the Australian holding vehicle used is an Australian public company and must remain a public company while there exist any holders of stub equity, unless the Corporations Act procedure to change the form of the vehicle is followed and, separately, persons holding at least 75% of the stub equity originally offered also agree to the change in company form; and

(b) modifying section 619 to provide that if the consideration for an off-market takeover bid includes an offer of stub equity:

  (i) that offer of stub equity can only be available to management and institutional shareholders and must be accompanied by a default all cash alternative that all shareholders are entitled to accept; and

  (ii) the Australian holding vehicle used is an Australian public company and must remain a public company while there exist any holders of stub equity, unless the Corporations Act procedure to change the form of the vehicle is followed and, separately, persons holding

[7] We appreciate that while ASIC has the power under section 655A to modify section 619, there is no equivalent power for section 411. Therefore, to implement this alternative approach it would be necessary for push for parliament to pass legislation on the issue.

at least 75% of the stub equity originally offered also agree to the change in company form.

In each of the above cases it should in our view still to be permissible to use the custodian or nominee arrangement described above.

To be clear, we consider the alternative approach would still be a retrograde step relative to the current regulatory position. In our view, ASIC should only implement the alternative approach if, among other considerations:

(a) it is entirely comfortable that the implementation of the alternative approach will not have a chilling effect on the willingness or capacity of bidders to propose competitive control transactions. As has long been recognised:

(i) takeovers are an integral part of the operation of equity markets and in turn the Australian economy; and

(ii) the benefits of takeovers, or the prospect of takeovers, to shareholders, the corporate sector and the economy include improved corporate efficiency and enhanced management discipline, leading ultimately to greater wealth creation; and[8]

(b) it is satisfied that the alternative approach is not inconsistent with equality principle set out in section 602(c) of the Corporations Act.

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To summarise:

- We do not see any sound case to alter the current regulatory framework governing stub equity offers. The evidence we have seen suggests strongly that the take up of such offers is very low and those accepting are aware of the arrangements they will be accepting in a private context.
- We do not support the changes set out in the Proposed Instrument. We consider that as framed they will likely have negative impacts for target shareholders of Australian companies and, more generally, for the competitive market for control transactions in Australia.
- if ASIC nonetheless considers that changes are required, then a more focused (and less inhibiting) approach needs to be taken to limit the likely negative impacts of the changes.

The views expressed in this submission do not necessarily represent the views of all King & Wood Mallesons partners and employees or of our clients.

We would be pleased to discuss these points further if that would be useful for you.

[8] CLERP Paper No 4, 'Takeovers – Corporation control: a better environment for productive investment' (April 1997), page 7.

Yours sincerely

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Schedule - Use of stub equity in Australian control transactions

Transaction	Year	Transaction structure	Bidder	Target securities	Stub equity offered	Who was offered stub equity?	Minimum scrip election achieved?	How many target shareholders / securityholders participated in the stub equity offer?	Total number of target shareholders / securityholders	Percentage of target shareholders / securityholders
Horizon Roads privatisation of ConnectEast Group	2011	Scheme of arrangement	Horizon Roads Consortium (CP2, APG CIC, KPS and others)	Units in ConnectEast Group	Securities in an unlisted Australian managed investment scheme	All target shareholders (other than ineligible foreign shareholders)	No	Not applicable - minimum scrip election not achieved	19,329	Not applicable
CHAMP privatisation of oOh!media Group Ltd	2011	Scheme of arrangement	CHAMP	Shares in oOh!media Group Ltd	Shares in a Cayman unlisted company	All target securityholders (other than ineligible foreign securityholders)	Yes	Unknown	959	Unknown
REA privatisation of iProperty Group Ltd	2015	Scheme of arrangement	REA Group Ltd	Shares in iProperty Group Ltd	Shares in an unlisted Australian public company	All target securityholders (other than ineligible foreign securityholders)	Yes	Unknown	4,957	Unknown
PEP acquisition of Patties Foods Ltd	2016	Scheme of arrangement	Pacific Equity Partners	Shares in Patties Foods Ltd	Shares in a new private unlisted Australian holding company	All target securityholders (other than ineligible foreign securityholders)	Yes	119	5,054	2.35%
RCF acquisition of Ausenco Group Ltd	2016	Scheme of arrangement	Resources Capital Funds	Shares in Ausenco Group Ltd	Retained equity in the target	Certain "committed shareholders"	Not applicable	10	5,263	0.19%
SR Residential acquisition of Simonds Group Ltd	2016	Scheme of arrangement	Simonds Family Office Pty Ltd and Roche Holdings Pty Ltd, joint holders of SR Residential Pty Ltd	Shares in Simonds Group Ltd	Retained equity in the target	Shareholders connected with the Simonds family	No - transaction did not proceed	7	862	0.81%

Transaction	Year	Transaction structure	Bidder	Target securities	Stub equity offered	Who was offered stub equity?	Minimum scrip election achieved?	How many target shareholders / securityholders participated in the stub equity offer?	Total number of target shareholders / securityholders	Percentage of target shareholders / securityholders
KKR Credit privatisation of Pepper Group	2017	Scheme of arrangement	KKR Credit Advisors	Shares in Pepper Group Limited	Either shares in a private Australian company or, in certain circumstances, retention of target share	All target securityholders (other than ineligible foreign securityholders)	Yes	70	566	12.37%
Blackstone privatisation of AMA Group Ltd	2018	Scheme of arrangement / demerger	Blackstone	Shares in the remaining AMA Group after the Demerger (holding company of Panel Business)	Shares in a private Australian company, Queen TopCo Pty Ltd	All target securityholders (other than ineligible foreign securityholders)	No - transaction did not proceed	Not applicable - transaction did not proceed	2,226	Not applicable
Wattle Hill RHC Fund privatisation of Capilano Honey Limited	2018	Scheme of arrangement	Wattle Hill RHC Fund and ROC Capital Pty Ltd	Shares in Capilano Honey Limited	Shares in a private Australian company Bravo HoldCo Pty Ltd	All target securityholders (other than ineligible foreign securityholders)	Yes	83	4,289	1.94%
Affinity Equity Partners Ltd privatisation of Scottish Pacific Group Limited	2018	Scheme of Arrangement	Affinity Equity Partners Ltd	Shares in Scottish Pacific Group Limited	Shares in a private Australian company (SME Capital Holdings Pty Ltd)	Management shareholders	N/A	10	1,559	0.64%
TPG privatisation of Greencross Limited	2018	Scheme of Arrangement	TPG Capital Asia and TPG Growth	Shares in Greencross Limited	Shares in a private Australian company (Vermont Aus Holdco Pty Ltd)	All target securityholders (other than ineligible foreign securityholders)	Yes	41	12,887	0.32%
Brookfield Capital Partners privatisation of Healthscope Limited	2019	Scheme of Arrangement and Takeover (conditional on Scheme failing)	VIG Bidco Pty Ltd	Shares in Healthscope Limited	Shares in a public Australian company (VIG Topco Limited)	All target securityholders (other than ineligible foreign securityholders)	No	Not applicable - minimum scrip election not achieved	31,795	Not applicable

Please note that in this schedule:

- all amounts are in Australian dollars;
- the reference to “year” is the calendar year in which the Implementation Agreement (or equivalent document) was entered into; and
- the total number of target shareholders is sourced from DatAnalysis and reflects the number of target shareholders as set out in the target's last Annual Report before implementation of the transaction.