MinterEllison

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BY EMAIL

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Dear Sirs

Submissions in response to consultation paper 312 on stub equity in control transactions

We refer to ASIC Consultation Paper 312: Stub equity in control transactions (**Consultation Paper**) inviting feedback on ASIC's proposal to address concerns about certain offers of 'stub equity' scrip consideration in control transactions. MinterEllison thanks ASIC for the opportunity to make these submissions.

MinterEllison's position is that all shareholders should have a choice as to whether to accept proprietary company scrip consideration as part of a control transaction, provided the risks are clearly disclosed.

MinterEllison considers that ASIC's proposal is more appropriately dealt with by Parliament making appropriate amendments to the Corporations Act, if Parliament agrees with ASIC that there is an issue.

We set out below in Part A MinterEllison's submissions on important preliminary matters regarding ASIC's approach to consultation.

We set out below in Part B MinterEllison's responses to the specific questions posed by ASIC in the Consultation Paper.

Please note that the views expressed in these submissions do not represent the views of MinterEllison's clients.

Part A – Appropriateness of ASIC's approach to public consultation in this instance

Summary

- We query the appropriateness of ASIC's approach to public consultation in this instance.
- We encourage ASIC to adopt a policy position that ASIC will not propose to make individual instruments modifying Chapter 6 of the *Corporations Act 2001* (Cth) (**Corporations Act**) to reflect a policy position that has not been subject of *prior* public consultation.

Explanation

On 13 December 2018, ASIC published media release 18-376MR in which ASIC stated that if any offers of proprietary scrip consideration were proposed as part of control transactions after the date of that media release, but prior to the conclusion of ASIC's future public consultation, ASIC "*may consider making individual instruments modifying s708 to similar effect*".[1]

That media release was published some six months before ASIC commenced its public consultation on 4 June 2019.

We appreciate that in media release 18-376MR ASIC did not expressly prohibit offers of stub equity as part of control transactions. However, the reality is that this statement had a practical outcome that was, in effect, a defacto prohibition on further offers of stub equity as part of control transactions, before ASIC's public consolation had even started.

At the time ASIC released 18-376MR, MinterEllison was advising a number of potential bidders who were contemplating stub equity structures as part a potential control transaction – in each such case the potential bidder declined to proceed with the stub equity structure as to do so would have been costly and would have had unclear prospects of success – it would have required the potential bidder to make costly submissions on the appropriateness of such an instrument well before the transaction was certain.

This practical outcome should demonstrate to ASIC the inappropriateness of proposing to make individual instruments modifying Chapter 6 of the Corporations Act to reflect a significant change of policy position that has not been subject of *prior* public consultation. Such an approach risks having a chilling effect on the market. We submit that such an impact is inappropriate.

Proposing to modify the law before public consultation takes place also risks creating a perception that such consultation is not genuine. This perception can arise even if ASIC only proposes to make such modifications on a case-by-case basis, and subject to the opportunity to make individual submissions. We submit that this risk should be avoided, as any such perception can lead to a longer-term undermining of the relevant policy position.

The fact that ASIC was permitted to take this approach by the scope of ASIC's powers under Part 6C.3 of the Corporations Act highlights a genuine concern we have with the current drafting of Part 6C.3 of the Corporations Act. The problem is that Part 6C.3 of the Corporations Act does not require ASIC to consult the public *prior* to modifying the Corporations Act, even where such modification would impact a broad cross-section of market participants.

It is helpful to contrast the position under Part 6C.3 of the Corporations Act with ASIC's powers to make rules under Division 3 of Part 7.5B of the Corporations Act. ASIC is not permitted to make a rule under Division 3 of Part 7.5B of the Corporations Act unless ASIC has consulted the public about the proposed rule. Whilst we appreciate that Part 7.5B of the Corporations Act is concerned with the regulation of financial benchmarks, which because of their nature are relied on by a broad section of the public, therefore requiring public consultation before changes are met, we consider that modifications under Part 6C.3 of the Corporations Act that affect broad classes of people are analogous, particularly where ASIC's changed policy position is more restrictive than what the legislation allows.

We submit that it is appropriate for ASIC to adopt a formal policy position that applies an equivalent approach to an exercise of ASIC's powers under Part 6C.3 of the Corporations Act as applies under Division 3 of Part 7.5B of the Corporations Act. That is, ASIC should adopt a policy position that it will not modify Chapter 6 of the Corporations Act, even on an interim basis, to reflect a policy position that has

[1] We note that ASIC excluded the offer of stub equity under the Greencross Limited scheme of arrangement from this treatment on the basis that we understand it was 'grandfathered' by ASIC.

not been subject of *prior* public consultation. The only exceptions should relate to genuinely urgent cases or where ASIC is acting to rectify in a facilitative manner a clear anomaly that restricts the conduct of market participants in an inappropriate manner or in a manner contrary to the principles in section 602 of the Corporations Act.

Part B – Responses to list of questions

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?

Summary

- We do not agree with ASIC's proposal, because we do not consider that there exists a clear policy or legislative intent that companies offering stub equity under control transactions must offer the various protections that ASIC considers important for widely held companies.

- Given the absence of any clear policy or legislative intent, we submit that it is a matter for Parliament to consider and, if thought fit, enact any amendments to the Corporations Act to give effect to ASIC's proposal.

Explanation

ASIC appears to accept that, where stub equity in a proprietary company is offered under a scheme of arrangement, the requirement to comply with ASIC Regulatory Guide 60 and s636(1)(g) of the Corporations Act means that retail investors will receive the same disclosures that would be required to be included in a prospectus under Chapter 6D of the Corporations Act. That is, from a disclosure perspective, retail shareholders are in exactly the same position that they would have been in if a prospectus had been issued.

ASIC's position is that, despite the equivalence of disclosure, offers of stub equity in proprietary companies to retail investors should not be allowed under the exemptions for control transactions because proprietary companies are not an appropriate vehicle for general public offerings to a large number of investors. ASIC argues that there is an existing policy underpinning s113 of the Corporations Act that investors in widely held companies must be afforded the safeguards that the law explicitly contemplates for shareholders of public companies.

We submit that, in order to assess ASIC's claim that offers of equity in proprietary companies under the exemptions for control transactions offends the public policy inherent in s113 of the Corporations Act, that policy must be identified with clarity.

ASIC states in the Consultation Paper at [16] that offers of scrip in proprietary companies under schemes of arrangement is contrary to the "*clear legislative intent of s113 and the limitations placed on proprietary companies*". Paragraphs [12] to [18] of the Consultation Paper repeatedly refer to the existence of such "*policy*", "*legislative intent*", and "*intent and function*". If that were correct, then evidence of that policy and intent should be clearly identifiable by reference to, for example the origins and rationale for antecedent legislation and commentary on analogous provisions overseas.

We submit that ASIC has not been able to point to any evidence that such a policy or intent exists, or indeed what the precise terms of such policy are:

(a) The terms of s113 of the Corporations Act plainly do not operate to introduce any such policy or intent considerations. Indeed, if ASIC's position were true, the Corporations Act would provide that only Australian public companies can offer shares to persons in Australia – but it does not and schemes have been approved where the consideration comprises shares in a foreign company where the safeguards that the law contemplates for shareholders of Australian public companies (such as the application of Chapter 6 of the Corporations Act and in the case of listed Australian companies, substantial holding disclosure) do not apply.

(b) Paragraphs [12] to [18] of the Consultation Paper do not refer to any external sources to support ASIC's claims that such policy or intent exists. There is no explanatory memorandum or second reading speech, either in relation to section 113 of the Corporations Act or its Australian or overseas antecedents, that supports the proposition that such policy or intent exists. There is no case law that supports the proposition that such policy or intent exists. The reality is that these

are merely statements of ASIC's own current view, apparently formed for the first time sometime *after* the KKR/Pepper scheme of arrangement.

(c) ASIC's submissions to the Court in *Capilano Honey Limited (No 2)* [2018] FCA 1925 argued that the existence of such a policy is evidenced by the fact that recent amendments to the Corporations Act to allow for crowd sourced funding require companies who do so to provide investors some of the reporting and related party protections that are otherwise features of public companies. However, the Court in *Capilano* did not accept this, and instead held at [75](1) that the fact that Parliament did not prescribe that a public company must be used without exception indicates that the public policy considerations are more complex and flexible than ASIC suggests.

The Court has held that s113 of the Corporations Act, together with s708(17) and s708(18) of the Corporations Act, permit the offer of securities of a proprietary company as part of a control transaction. Given the absence of any clear policy or legislative intent that investors in widely held companies must be afforded the safeguards of a public company, we submit that it is a matter for Parliament to consider and, if it thinks fit, to enact any amendments to the Corporations Act to give effect to ASIC's proposal. It should not be the case that ASIC's view of what should be the policy of or legislative intent of these provisions should apply in the absence of clear evidence of Parliament's own policy or intent.

We also query the perceived need to make the modifications proposed in order to protect investors. There have been over 400 schemes of arrangement to take-private ASX listed entities completed since 2001. The use of the exemption under s708(17) of the Corporations Act therefore amounts to less than 0.5% of those schemes of arrangement completed since 2001.

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

No.

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?

Summary

- We do not agree with ASIC's proposal, because we do not consider that there exists a clear policy that companies offering stub equity in control transactions must be subject to the disclosing entity provisions and to the takeover provisions.

- Given the absence of any clear policy, we submit that it is a matter for Parliament to consider and, if it thinks fit, enact any amendments to the Corporations Act to give effect to ASIC's proposal.

Explanation

ASIC's position is that offers of stub equity in control transactions that employ custody or securityholder arrangements should not be entitled to rely on the exceptions in items 1-4 (takeover bids) and 17 (schemes of arrangement) of s611 of the Corporations Act because such arrangements avoid the application to that company of:

(a) the disclosing entity provisions; and

(a) the takeover provisions.

In respect of the disclosing entity provisions, ASIC argues that there is an existing policy underpinning the disclosing entity provisions that mean that these provisions must apply to all widely-held companies. ASIC cites as evidence of this policy:

(a) paragraphs 3 – 4 of the explanatory memorandum to the Corporate Law Reform Bill 1993; and

(b) the second reading speech in relation to an earlier draft of the provisions in the Corporate Law Reform Bill 1992 (No. 2).

ASIC argues that those external sources are evidence that the enhanced disclosure obligations in the disclosing entity provisions are intended to apply to all entities in which members of the public invest.

The reality is that those external sources explain the reason why the disclosing entity provisions are beneficial to investors in the entities to which those obligations apply. Importantly, those external sources do not state that Parliament intended that the disclosing entity provisions must necessarily apply to all entities in which members of the public invest. This is the critical failure in ASIC's argument.

The reality is that if Parliament had intended to give effect to a policy that all entities in which members of the public invest must have the benefit of the disclosing entity provisions, then the Corporations Act would have provided that only a public company whose securities are held (or will be held) by 100 or more people may offer its securities to persons in Australia. But the Corporations Act does not do so, and has never done so. For example, the Corporations Act permits offer of securities by foreign issuers, including issuers whose domestic legislation does not provide investors with equivalent protections found in the disclosing entity provisions.

In respect of the takeover provisions, ASIC argues that the takeover provisions should be made to apply in accordance with what ASIC describes as "*their underlying policy*".

That is, ASIC argues that there is an existing policy underpinning the takeover provisions that mean that companies should not be allowed to avoid the application of those provisions by using custody or securityholder arrangements. At [34] of the Consultation Paper, ASIC concedes that using custody or securityholder arrangements "*may be legal*" but states that ASIC is concerned that it "*enables avoidance of these important investor protections"*.

We submit that, in order to assess ASIC's claim that there is an "*underlying policy*" that means that offerors of stub equity should not be entitled to avoid the application of the takeover provisions by using custody or securityholder arrangements, that policy must be identified with clarity.

We submit that ASIC has not been able to provide any evidence that any such policy exists, or indeed what the precise terms of such policy are:

(a) The reality is that there is no 'anti-avoidance' provision (either express or implied) in the takeover provisions, and there has never been one. Indeed, the opposite is true – the Courts have consistently held that the takeover provisions do not have to be followed in all cases, just because they are there. Bryson J stated in *Nicron Resources Ltd v Catto* (1992) ACSR 219 at 235 that (in determining if a takeover offer should be preferred to a scheme of arrangement):

"*Chapter 6 procedure is not to be followed merely because it is there. It is not Mount Everest*."

(b) The Consultation Paper does not refer to any external sources to support ASIC's claims that an 'anti-avoidance' policy exists in respect of the takeover provisions. There is no explanatory memorandum or second reading speech that supports the proposition that such policy exists. There is no case law that supports the proposition that such policy exists. The reality is that these are merely statements of ASIC's own view.

What ASIC's proposal is saying is that ASIC considers that the disclosing entity provisions and the takeover provisions must be made to apply to offerors of stub equity, even though there is no legal requirement to do so, in order that the protections offered under those provisions apply.

The true position is that explained by the Court in *Capilano* at [75](1), namely that the public policy considerations relevant to mandatory custody arrangements are more complex and flexible. Those public policy considerations are not necessarily furthered by simply mandating that the disclosing entity provisions and the takeover provisions must be made to apply to offerors of stub equity.

Further, we disagree with ASIC's view that no amount of disclosure is adequate if the protections offered under the disclosing entity provisions and the takeover provisions do not apply. Shareholders who are offered stub equity through mandatory custody arrangements are being offered a commercial opportunity to share in the upside of private ownership, which some might regard as valuable to them. In circumstances where the consequences of the disclosing entity provisions and the takeover provisions not applying due to mandatory custody arrangements are disclosed to those shareholders in very clear terms, we do not see what public policy is served by denying shareholders the valuable commercial opportunity that a stub equity proposal seeks to offer them. Indeed, there are benefits to private ownership that are simply not available in the public domain. That is after all why private equity firms engage in 'take-private' transactions – they see an opportunity to drive value out of a target acquisition that often cannot be realised by the target itself while in public ownership.

In particular, we are very concerned by ASIC's proposal because we consider this to be an example of ASIC attempting to make new law where the law does not currently apply, rather than attempting to clarify its operation. We consider that this role is properly reserved for Parliament. As such, we submit that it is a matter for Parliament to consider any amendments to the Corporations Act to give effect to ASIC's proposal. It cannot be the case that ASIC's view of what the law should be can apply in the absence of clear evidence of Parliament's own policy or intent.

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

We consider that, should Parliament consider it appropriate to exclude custodian arrangements or securityholder agreements from the exceptions in items 1-4 (takeover bids) and 17 (schemes of arrangement) of s611 of the Corporations Act, then it should only apply to offerors who are proprietary companies. That is, the use of custodian arrangements or securityholder agreements by public companies should be allowed.

In those circumstances, we consider this is appropriate because the use of a public company would import the various safeguards that the law provides for shareholders of public companies.

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?

We consider that there will be many consequences of restricting the use of mandatory custodian arrangements and securityholder agreements in this way which cannot practically be addressed by including further modifications or individual relief.

One key consequence will be a potential chilling effect on offers of stub equity by private equity backed bidders. We submit that this an unfair outcome. This outcome has the potential to inappropriately tilt the playing field in the competition for control of Australian listed companies in favour of non-private equity bidders, which we submit is itself contrary to the principles that the competition for control take place in an efficient, competitive and informed market, ie. in a manner where there is regulatory neutrality as between different acquirers. That is, denying one group of bidders a transaction structure that is inherently suited to their business model takes that group of bidders out of the market for corporate control. Ultimately, this outcome can only be prejudicial to shareholders of target companies who will miss out on the very real benefits that such enhanced competition would have brought them.

Another key consequence will be that private equity backed bidders may be forced to deploy overseas based transaction structures in order to offer stub equity. That is, they will likely use companies located in arguably lower regulation jurisdictions such as Bermuda and the Cayman Islands. We do not see how this can be of any benefit to Australian shareholders.

There will be other consequences. This is because restricting the use of mandatory custodian arrangements and securityholder agreements in this way is a blunt instrument in comparison to the current interaction between s611, s708 and s113 of the Corporations Act which the Court in *Capilano* described as "*complex and flexible*". The problem is that we do not know what those consequences are yet because, given the complexity of these provisions, it is difficult to predict. This uncertainty is itself a key negative consequence because potential bidders need clarity in determining their transaction structures.

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

No.

Yours faithfully
MinterEllison

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