REPORT 669

Response to submissions on CP 312 Stub equity in control transactions

September 2020

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 312 *Stub equity in control transactions* (CP 312) and details our responses to those issues.

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.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see:

- Regulatory Guide 9 *Takeover bids* (RG 9); and
- Regulatory Guide 60 *Schemes of arrangement* (RG 60).

Contents

A Overview/consultation process

1 In Consultation Paper 312 *Stub equity in control transactions* (CP 312), we consulted on our proposal to address concerns about certain offers of 'stub equity' scrip consideration in control transactions.

> Note: 'Stub equity' refers to 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.

2 In CP 312, we proposed a new legislative instrument to modify:

(a) Ch 6D so that disclosure exemptions in s708(17) and (18) of the *Corporations Act 2001* (Corporations Act) do not apply to offers of securities in proprietary companies (Modification 1); and

(b) Ch 6 so that the exemptions in items 1–4 (takeover bids) and 17 (schemes of arrangement) of s611 are not available where securities are offered as consideration on terms that require the securities 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:

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

(ii) s606; or

(iii) the disclosing entity provisions in Pt 1.2A

(Modification 2).

> Note 1: In this report, references to chapters (Chs), parts (Pts) and sections (s) are to the Corporations Act, unless otherwise specified.

> Note 2: In this report, references to 'scheme' or 'scheme of arrangement' mean a compromise or arrangement under Pt 5.1.

3 This report highlights the key issues that arose out of the submissions received on CP 312 and our responses to those issues.

4 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 312. We have limited the report to the key issues.

5 We received 12 non-confidential responses to CP 312. Respondents included the legal community and relevant industry bodies. We are grateful to the respondents for taking the time to send us their comments. We are also grateful to individuals who provided feedback and discussed specific issues with us during the consultation process.

6 For a full list of the non-confidential respondents to CP 312, see the appendix. Copies of those submissions are currently on the CP 312 page on the ASIC website.

Responses to consultation

7 One respondent supported our proposals pointing to:

(a) the range of financial literacy among, and time restraints on, retail securityholders for whom 'investing is not a full-time occupation';

(b) the difficulty in conveying the degree of illiquidity of stub equity to retail securityholders; and

(c) the fact that stub equity is generally not an appropriate choice for retail securityholders and its offer artificially collapses the two classes of investors in order to secure voting approval (i.e. retail securityholders for whom stub equity is not an appropriate choice, and non-retail securityholders for whom stub equity may be an appropriate choice).

8 The balance of respondents did not support our proposals. Some of these respondents expressed greater concern with Modification 2 in so far as it would restrict use of a custodian by a public company.

B Key issues and our response

Key points

After considering the submissions to CP 312, we have executed ASIC Corporations (Stub Equity in Control Transactions) Instrument 2020/734. The instrument:

- includes Modification 1 which prevents offers of proprietary company securities through the disclosure exemptions in s708(17) and (18); and
- does not include Modification 2 in the form described in CP 312.

This means that bidders may make stub equity offers using a public company with mandatory custodial arrangements but are not permitted to make offers using a proprietary company in this manner.

Our decision was reached after balancing appropriate investor protection with the ability for retail investors to fully participate in an offer and the ongoing regulatory costs to bidders.

However, we have concerns about the ability to circumvent the intent of Modification 1 by, for example, making stub equity offers through a public company with mandatory custodial arrangements, and converting to a proprietary company after the control transaction.

To address this concern, the instrument includes a requirement for the custodial arrangements to include provisions that mean the arrangements will cease if the public company applies to ASIC to change to a proprietary company at a time when it has more than 50 non-employee beneficial owners.

Disclosure to shareholders

We also consider that it would be better practice for:

- experts to include a valuation and opinion on the scrip consideration; and
- directors to include a recommendation on the scrip consideration.

Should ASIC adopt Modification 1 (Offers of securities in proprietary companies)?

Policy

9 In CP 312, we stated:

> 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 …

> 15 Additional protections are required when shares are widely held ... In a widely held company, there may not be the same degree of knowledge, oversight or 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.

10 One respondent did not object to ASIC requiring offers of stub equity to be via an unlisted public company if the disclosure exemptions in s708(17) and (18) were available to a public company regardless of whether a custodial or nominee arrangement was used.

11 One respondent acknowledged the tension in the policy which underpins:

(a) the restriction on proprietary companies being involved in an offer which requires a prospectus; and

(b) the prospectus exemptions for any securities offered as consideration in a control transaction.

12 One respondent did not agree with our position, and referred to the comments of Farrell J in *Capilano Honey Limited, in the matter of Capilano Honey Limited (No 2)* [2018] FCA 1925 at [75]:

> 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's submissions suggest.

13 Most respondents did not specifically address this issue.

Harm

14 Several respondents stated that we had overstated the risks and harms associated with offers of stub equity. They argued that:

(a) private equity seeks to maximise value of the businesses in which it invests (the inference being that the interests of private equity and other investors are aligned);

(b) the uptake of scrip has, to date, been low;

(c) the scrip is not compulsory—there is a cash alternative which the target directors have recommended, and which the independent expert has concluded is in target securityholders' best interests;

(d) target securityholders who accept the scrip have rights under the relevant securityholder agreement (which includes drag-along and tag-along rights); and

(e) there is no evidence of:

(i) harm;

(ii) target securityholders being disadvantaged by the choice of stub equity vehicle; and/or

(iii) target securityholders being misled by the disclosure materials.

Disclosure

15 In CP 312, we stated that our concerns were not addressed through disclosure.

16 Several respondents disagreed with our position. They argued that:

(a) target securityholders have the benefit of prospectus-level disclosure which has been reviewed by ASIC (and in the case of a scheme, the Court) which would clearly disclose:

(i) the terms, including the terms of the mandatory custodial arrangements and securityholder agreement;

(ii) the rights and protections which will be available to target securityholders who elect to receive scrip, compared with the rights and protections currently available; and

(iii) the risks; and

(b) target securityholders make informed decisions with disclosure in all control transactions, and if ASIC accepts that target securityholders can make an informed decision:

(i) to accept an offer of foreign scrip (which does not offer the rights or protections in the Corporations Act, including those available in a public company); or

(ii) about a change in control via item 7 of s611,

it should follow that target securityholders can make an informed decision to accept securities which will not be subject to Ch 6 and the provisions of Pt 1.2A, Ch 2M and Ch 6CA (together referred to as the 'disclosing entity provisions').

17 Other respondents suggested that we consult with a view to releasing disclosure guidelines for stub equity.

Negative effects

18 In CP 312, we stated that our proposals were not intended to prohibit stub equity arrangements—only to ensure that if stub equity is offered it does not involve investors forgoing substantive protections under Australian law. We stated that the proposals would not prevent:

(a) limited offers of proprietary company scrip that can be made due to other disclosure exemptions in s708;

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

(i) a listed body;

(ii) a body in respect of which none of the protections under Australian law would apply (e.g. an unlisted foreign body); or

(iii) an unlisted public company provided:

(A) the disclosing entity provisions will apply 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; or

(c) agreeing with those parties who wish to retain their exposure to the target to jointly acquire the target.

19 Nonetheless, many respondents were concerned that our proposals could have negative consequences for investors and/or the Australian market. However, these consequences appear to have been premised on the combined effect of Modification 1 and Modification 2, rather than the isolated effect of Modification 1.

20 They stated that our proposals may:

(a) cause bidders to exclude retail securityholders from the offer of stub equity, depriving them of the opportunity to invest alongside private equity and to benefit from the 'value-creating process';

(b) discourage bidders from offering stub equity in control transactions;

(c) encourage bidders (pointing to the most recent offer of stub equity as evidence) to revert to using stub equity vehicles incorporated in foreign, low-regulation jurisdictions which are less familiar to securityholders and offer fewer rights and protections; and

(d) discourage bidders from proceeding with control transactions altogether and/or make Australia less attractive for foreign capital investment.

Follow-on consultation

21 We held further discussions with a sample of respondents to better understand their submissions. These discussions indicated that the major objection for bidders to our proposals was the application of the takeover provisions in Ch 6 to any future sale of the stub equity company because it would increase complexity on exit and impede a timely exit.

22 These practitioners indicated that if we implemented Modification 1 only, it may increase the likelihood of bidders preferring to use Australian public companies with mandatory custodial arrangements over foreign companies going forward.

ASIC's response

We continue to have concerns about offers of proprietary company securities through schemes of arrangement and takeovers, including through the actual or contemplated use of custodial or nominee arrangements.

Proprietary companies are subject to a reduced level of regulation because they are intended to be closely held. Outside a scheme of arrangement and takeover, offers of proprietary company securities on such a wide scale would generally not be permitted.

Mandatory custodial arrangements facilitate offers of proprietary company securities by keeping the number of shareholders artificially below 50. We are concerned that these offers deprive target securityholders (in particular, retail securityholders) of rights and benefits that would be available to them in a public company.

Although the submissions suggest limited evidence of harm, the offer of proprietary company securities in control transactions is a reasonably new practice and potential harms may not manifest for some time.

While it is possible that Modification 1 may result in an increase in the use of foreign company vehicles, that risk may have been overstated in the submissions and influenced by the scope of our consultation which also contemplated restricting the use of custodial arrangements by public companies.

On balance, we consider that Modification 1 is an appropriate, proactive measure to uphold the intent and function of s113 and rights and protections of retail securityholders.

We will consider, and may provide, individual relief to permit offers of proprietary company securities on a case-by-case basis if it is in the interests of target securityholders to do so.

Should ASIC adopt Modification 2 (Offers of securities incorporating mandatory custodial or securityholder arrangements)?

Policy and avoidance

23 In CP 312, we expressed our concern that the custodial arrangements and securityholder agreements in stub equity offers may be used to enable avoidance of:

(a) the investor protections in Ch 6 and the disclosing entity provisions; and

(b) the proposed prohibition in Modification 1 (by making offers through a public company that are taken up by 50 or more target securityholders, and subsequently converting the public company to a proprietary company).

24 Many of the respondents argued that:

(a) there is no underlying policy that Ch 6 and the disclosing entity provisions must be made to apply to offers of stub equity;

(b) Ch 6 does not apply in all cases (e.g. it does not apply to acquisitions of interests in a managed investment scheme or to a foreign incorporated company), and the fact that it does not apply does not necessarily equate to 'avoidance' in the manner contemplated in s411(17)(a);

(c) Ch 6 and the disclosing entity provisions would increase costs and complexity (both during ownership and upon exit); and

(d) as a result of the securityholder agreement, all securityholders are likely to have a relevant interest in 100% of the securities, and Ch 6 would have unintended consequences for any incoming securityholders (going from 0% to 100%) and for all securityholders upon exit.

25 In addition, it was stated that Modification 2 was inconsistent with the purposes of Ch 6 because it may have the effect of:

(a) reducing the competition in the market for control of entities (contrary to s602(a)); and

(b) depriving target securityholders (including retail securityholders) of a reasonable and equal opportunity to participate in benefits which might accrue through stub equity (contrary to s602(c)).

Harm, disclosure and negative effects

26 The same submissions concerning harm and disclosure also applied to Modification 2 (see paragraphs 14 to 17).

27 It appears to us that the submissions about negative effects (see paragraphs 19 to 20) were premised heavily on Modification 2—in particular, the submissions that bidders may resort to using foreign incorporated stub equity vehicles.

ASIC's response

The considerations surrounding Modification 2 have been finely balanced for ASIC.

With the benefit of submissions, we acknowledge that the application of Ch 6 and the disclosing entity provisions may give rise to nuanced considerations in the context of stub equity.

At this time, and absent other concerns, we do not intend to pursue Modification 2. This decision was reached after balancing the interests of retail investors and bidders.

However, we continue to have concerns that bidders may (to the detriment of retail investors) circumvent Modification 1 by, for example, making offers through a public company with mandatory custodial arrangements and converting to a proprietary company after the control transaction (at a time when it has more than 50 non-employee beneficial shareholders).

To address this concern, we have modified Ch 6 so that where consideration includes securities in a public company held under mandatory custodial arrangements, items 1–4 and 17 in s611 only apply if the custodial arrangements contain 'conversion and termination provisions'.

'Conversion and termination provisions' are provisions to the effect that, if the public company applies to change to a proprietary company at a time when it has more than 50 non-employee beneficial owners:

- the custodial arrangement will terminate once the change of type takes effect; and
- the beneficial owners will be registered as securityholders of the securities.

We will continue to monitor stub equity offers and may raise questions where we have concerns.

Submissions about ASIC's process in CP 312

28 Some respondents made submissions about the process undertaken in connection with CP 312.

29 Some respondents raised concerns that the proposals (in particular Modification 2) amounted to law reform and should not be implemented via an ASIC legislative instrument.

30 One respondent stated that ASIC's Media Release (18-376MR) *ASIC to consult on measures to restrict offers to retail investors of stub-equity in proprietary companies* (13 December 2018) had the effect of a de facto prohibition on future offers of stub equity prior to consultation. In this media release, we stated:

> Where control transactions involving the offer of proprietary scrip consideration are announced after the date of this media release, but prior to the conclusion of the above consultation, ASIC may consider making individual instruments modifying s708 to similar effect. Before making such an instrument, affected parties will be afforded procedural fairness …

ASIC's response

We undertook an internal assessment and analysis which led to the position outlined in its media release of 13 December 2018 and the proposals in CP 312.

Our assessment of whether to proceed with the proposals continued throughout the consultation, a process which among other things led to our decision not to proceed with Modification 2.

The decisions set out in this paper are the outcome of our assessment, and also reflect our conclusion that the changes are appropriate for a legislative instrument given the scope of ASIC's powers.

Should ASIC provide disclosure guidance?

31 Several submissions raised the prospect of disclosure guidance to address our concerns with stub equity (see paragraph 17).

32 We do not consider that disclosure is the appropriate or complete solution to the concerns outlined in CP 312. Disclosure has its limitations and is often not well understood by investors.

Note: See Report 632 *Disclosure: Why it shouldn't be the default* (REP 632).

33 However, we have identified discrete areas that could be improved through disclosure to enhance investor decision making. For example, in our reviews of disclosure in this area we have noted:

(a) the independent expert's opinion was based on the cash consideration only and stated that if the expert had given their opinion on a transaction which only offered the scrip consideration, they would have concluded that the deal was not fair. This limitation was not prominently disclosed in the scheme booklet and only some independent experts included a valuation of the scrip consideration which illustrated the unfairness; and

(b) the directors' recommendation that shareholders vote in favour of the scheme is based on the cash consideration, often expressly stating that they 'make no recommendation in relation to the scrip consideration'. This limitation was also not prominently disclosed in the scheme booklet and, more importantly, the absence of a recommendation makes it difficult for target securityholders (particularly retail securityholders) to decide between the cash and scrip consideration.

34 We consider that it would be better practice for:

(a) the expert to include a valuation and opinion on the scrip;

(b) the directors to include a recommendation on the scrip consideration; and

(c) both (a) and (b) to be clearly and prominently disclosed in the scheme booklet.

ASIC's response

We will:

- continue to monitor stub equity offers; and
- raise concerns with deficient disclosure in independent expert opinions and directors' recommendations.

Appendix 1: List of non-confidential respondents

- Allens
- Allen & Overy
- Andromeda Partners Pty Ltd
- Australian Shareholders Association
- Australian Financial Markets Association (AFMA)
- Australian Investment Council
- Gilbert + Tobin
- Herbert Smith Freehills
- King & Wood Mallesons
- Law Council of Australia – Business Law Section
- MinterEllison
- National Stock Exchange of Australia