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Dear Diane,

Rather than provide a point by point response to the consultation questions, we have elected to broadly respond to major themes in ASX's recent Consultation Paper in relation to admission requirments. Our response has two main themes. First, the proposed changes to admission requirments will disadvantage small firms. Second, the proposed changes to admission requirments are inconsistent with national priorities of innovation, entrepreneurialism and establishing a viable Australian presence in the new economy. In terms of the structure of our response, we firstly provide some background in terms of a short overview of relevant empirical studies on the impact of regulation on small firms. We then consider the likely winners and losers from the proposal before detailing and addressing some more specific aspects of the proposed key changes.

Background

We see the ASX as a unique institution playing three important roles in the economy. As a regulator, it sets and enforces listing rules governing listed entities. As a profit-maximising company, it strives to enhance its reputation and efficient functioning of its operations. As a market place, it plays a critical role in facilitating capital formation and reallocation through organized trading of securities of listed entities. At times these roles may conflict with one another and the latest proposed 'updating ASX's admission requirements for listed entities' is a prime example. Essentially we interpret the proposed changes to the listing requirements as an attempt to stamp out small participants (micro-cap start-up companies) in order to 'protect' public investors at large and enhance the reputation of ASX as a premium exchange for quality issuers. In doing so, however, the ASX may be running the risk of not fulfilling its third important role of facilitating the formation and reallocation of risky capital. This is particularly relevant in an economy with a reliance on the mining sector and aspirations of becoming more R&D and technology oriented.

What does the academic literature say about the impact of regulation on small firms?

There is a significant body of academic literature examining the impact of regulation on firms. Overall, studies find that imposing regulation on markets has the effect of benefitting large

firms at the expense of small firms. Neumann and Nelson (1982) undertake a study of the differential impact of safety regulation on firms of different sizes following the implementation of the Coal Mine Health and Safety Act of 1969. They find that competition was reduced following the implementation of the Act, with small firms exiting the coal industry. Pashigian (1984) considers the effects of environmental regulation on plants with various sizes by examining the influence of the 1970 Clean Air Act in the US and finds small companies are comparatively worse off under the Act. Bartel and Thomas (1987) find evidence of predation through regulation in their study of the Occupational Safety and Health Administration and the Environmental Protection Agency. They find larger unionised companies benefit at the expense of smaller firms. Thomas (1990) investigates the effects of the US Food and Drug Administration (FDA) on the productivity of pharmaceutical companies. Small firms are shown to suffer significant reductions in research productivity as a result of FDA regulations. In summary, there are numerous studies published in top US journals suggesting small firms are worse off when regulation is increased.

Who are the winners from this package of proposals?

- *Venture capital industry*. One winner will be the Venture Capital (VC) industry since no longer will the public equity markets be available as a source of financing for small firms. This will enable the VC industry to generate monopoly rents from small firm financing, resulting in a fall in the number of successful projects financed. It is important to understand the Australian VC industry remains very small and has not been active in the capital formation phase for micro-cap companies. The risk is following these proposals the initial public offering (IPO) and backdoor listing (BDL) options will not be available for many micro-cap firms. If the VC industry does not step in to fill the void, risk capital availability for the micro-cap sector may effectively disappear.
- *Administrators and receivers*. Professional firms involved in providing services to the 'winding up' process, such as administrators (recievers and liquidators), will benefit from greater rates of firm failure for the listed shell companies as a result of the curtailment of the BDL market and closure of this funding route for micro-cap entities.
- *The ASX*. The ASX considers its reputation might benefit from constraining the presence of increasing numbers of micro-cap listings who have higher idiosynchractic risk. However, it should be noted that high risk investors are typically sophisticated and understand the risk-return trade-off.

Who are the losers from this package of proposals?

- *Stockbrokers*. In the long run, stockbrokers will be worse-off from a reduced number of IPOs and BDLs and lower trading volumes. Lower brokerage revenues may result in layoffs, particularly in small boutique brokerage houses specializing in the mining and high-tech industries.
- *Analysts*. In the long run, analysts will have a smaller pool of companies from which to differentiate themselves from their competitors in terms of forecast accuracy. It is likely there will be analyst job losses as a result of these measures owing to the lower brokerage revenue pool.
- *Entrepeneurs*. The proposed admission requirements will have negative effect on the number of IPO and BDL deals done in Australia. It is likely there will be many

projects currently able to be financed through IPOs and BDL's that will (if the proposals are enshrined) remain unfunded.

- *Shareholders of listed shells*. Shell shareholders will be worse-off. The prices of listed shells typically contain an option premium reflecting the distribution of positive net present value investment outcomes under a BDL scenario. Shareholders of listed shells will not only lose this premium, but face much higher probabilities of firm failure, delisting and winding up.
- *IPO and BDL market participants*. The tightening of asset test requirements (the working capital requirments and increase in the market capitalization threshold) will result in lower numbers of IPOs and BDLs.
- *Public investors*. Investors seeking to hold a balanced portfolio of risk will have their high risk preference options truncated.
- *Auditors*. Auditors will be worse-off from increased firm failure and corresponding reductions in audit and advisory fees.
- *Other professional services firms*. Apart from auditors, other professional services firms, such as investment banks, lawyers and consulting firms, will be worse-off from a reduction in BDL and IPO deal flow.
- *Extractive and high-tech industries*. The supply of shells predominates (especially recently) from the extractive industries. In times of low commodity prices, this important avenue for industry capital reallocation into R&D and high-tech companies will be curtailed. The tightening of the listing requirements will likely result in a crimping of mining IPO activity and high-tech BDL transactions. The medium term impact of these proposals would likely entail a material reduction in Australian mining exploration expenditure, with associated implications for ore-body discoveries and mine developments. This could have long-run implications for economic growth in the Australian economy owing to the importance of our world-class mining industry in terms of capital investment and export revenue generation.
- *The ASX*. In the long-run, the ASX will lose from a lower number of listings (listing fees), lower turnover from a diminished pool of listed entities leading to lower ASX profitability. The shuttering of the BDL market may result in more corporate failure in the short run as existing listed shells have no option but to enter administration when funding opportunities are curtailed, with corresponding short-run negative reputation effects to the ASX.
- *The Australian national interest*. To the extent that Australia aspires to become a more innovative and creative country in terms of business entreneurship, these proposals are completely at odds with the new national direction espoused by Prime Minister Malcolm Turnbull.

In summary, there are both supply-side and demand-side arguments supporting the existence of vibrant IPO and BDL markets. 'Says Law' suggests supply creates its own demand, with an efficient market using price as a clearing mechanism in the economy. The price mechanism is clearly working in relation to capital reallocation between industries in the Australian economy as evidenced by shell recycling. According to SNL Metals (9/06/2016), there were 66 backdoor listings completed on the ASX in the first 4 months of 2016. In other words, BDLs are becoming an increasingly important form of capital raising for micro-cap companies. This is especially the case during a period of depressed commodity prices. The

fact that 35 out of the 66 shells being utilized for BDLs have come from the mining industry is a strong indication the process of mining shell recycling during the commodity price cycle needs to be as seemsless as possible to enable efficient capital reallocation across industries.

Feedback on specific consultation questions

1. Do you support the introduction of a 20% minimum free float requirement? If not, why not and would you support a different minimum free float requirement?

We do not support the proposed 20% minimum free float requirement. Any rules-based approach has inherent limitations (and costs). The ASX is effectively doubling the free float requirement. This will be particularly detrimental to smaller IPO and BDL transactions, which typically do not raise a large amount of capital when going public and rely on seasoned offerings in the aftermarket. Because of the need for control and valuation considerations, high-tech issuers are also likely to have a low free float. The 20% minimum requirement is particularly problematic when combined with the proposed changes to definitions of free float and non-affiliated security holders (see response to Question 2 below). We suggest retaining the current 10% minimum free float requirement.

2. Do you have any comments on the proposed definitions of "free float" and "non-affiliated security holder" for the purpose of the proposed minimum free float requirement? Do you see any issues with excluding shares that are subject to voluntary escrow from the definition of "free float"?

The proposed definitions will tighten the definition of free float to those shares (unrestricted and not subject to voluntary escrow) held by non-affiliated holders (not related parties, an associate of a related party, or a person whose relationship with the entity could be deemed by ASX as an affiliate) instead of just non-related parties or trustees. This will effectively reduce the number of shares available in the calculation of free float, resulting in a drop in the free float percentage. This change will have the same detrimental effect as the proposed increase in the minimum free float requirement from 10% to 20%. Given not all BDL transactions involve capital raisings, this change in definitions will have a particularly adverse impact on firms seeking an admission to ASX via the backdoor.

3. Do you support the proposed changes to the spread test? If not, what element or elements of the changes do you not support, and what are your reasons?

The ASX proposes to require 200 security holders if the entity has a free float of less than A$50 million, or 100 security holders if the entity has a free float of A$50 million or more; and each security holder counted towards spread must hold a parcel of securities with a value of at least A$5,000. Effectively the ASX is looking to increase the parcel size to be considered a participant in the spread test from $2,000 to $5,000.

We do not support this proposal as investors in securities with high idiosynchratic risk diversify their risk by obtaining shareholdings (often small shareholdings) in large numbers of stocks with high risk profiles. This is possible where parcel sizes are $2,000, but much more difficult where the minimum parcel size is $5,000. Investors in high-risk start-up companies may treat their shareholdings as lottery tickets (i.e., with an average negative return but a non-zero probability of getting an extreme positive return). Investors may be willing to invest $2,000 in the shares of such a company (and thus counted towards the spread test under the

existing requirement) but not necessarily $5,000. Thus, setting a parcel size of $5,000 would have adverse effect on the ability of start-up issuers meeting proposed spread requirements.

4. Do you support the increase in the last year's profit element of the profit test? If not, please provide your reasons.

We are indifferent to this proposal as it is unlikely to have a significant impact on those firms meeting the profit test.

5. Do you support the increase in the net tangible assets and market capitalisation elements of the assets test? If not, please provide your reasons.

We do not support the proposed increases in the net tangible assets and market capitalization elements of the asset test as these would have detrimental effects on start-up companies going public. In our experience, most mining and high-tech IPOs and BDLs do not meet the existing size threshold in terms of market capitalization of $10 million. Therefore, doubling the market capitalization size threshold to $20 million will further put this threshold out of reach.

The real problem is the proposal to increase the net tangible assets threshold from $3 million to $5 million. This was already increased from $2 million to $3 million in 2012, which was then a 50% increase with a further 67% increase now proposed. Potentially this means the net tangible assets requirements are lifted from $2 million to $5 million in four years. Most likely, this measure would decimate the BDL market and severely curtail the mining IPO market. It would likely mean mining IPOs would become rare in Australia absent a highly favourable commodity price setting.

6. Do you think it is appropriate to extend the minimum requirement for $1.5 million working capital after deducting the first year's budgeted administration costs and costs of acquiring any assets (to the extent that those costs will be met out of working capital) to all entities admitted under the assets test? If not, please provide your reasons.

For entities admitted under the proposed $5 million net tangible assets requirement, it makes no sense to extend the working capital (current assets minus current liabilities) requirements to all firms, since working capital is highly correlated with both net tangible assets and total assets for most small IPO's and BDL's.

7. Do you think it is appropriate to maintain a fixed minimum $1.5 million working capital requirement in addition to a requirement for the entity admitted under the assets test to make a statement that it has sufficient working capital to meet its stated objectives? If you think the fixed working capital requirement should be a different amount, please tell us the amount and explain why.

We think requiring entities admitted under the assets test to maintain a fixed minimum working capital of $1.5 million is too rigid and unnecessarily onerous. Depending on their business plans and cash burn rates, different entities may have different working capital requirements. We think statements from entities and their professional advisers confirming there is sufficient working capital to meet their stated business objectives would suffice.

8. Do you support the proposed requirement for entities admitted under the assets test to provide 3 full financial years of audited accounts, unless ASX approves otherwise? If not,

please provide your reasons and describe what, if any, alternative approach you consider should be taken by ASX in order to meet the objectives of the proposed change.

We oppose an across-the-board requirement for 3 full years of audited accounts for entities admitted under the assets test. The proposed changes may bias successful listings against firms with shorter lives, such as tech start-ups and mining IPOs and BDLs towards firms with operational histories. Imposing 3 full financial years of audited accounts doesn't make much sense for a mineral explorer whose pre-listing activity consists of tenement pegging. In addition, mining exploration firms often form quickly to take advantage of favourable swings in commodity prices. For similar reasons, high-tech firms in many cases do not have material operational histories. This suggests the utility of pre-capital raising financial statements of many micro-caps listing may be marginal (See also our response to Question 9 below).

9. ASX has proposed that it will generally accept less than 3 years of audited accounts for an assets test entity (or an entity or business to be acquired by the entity) only in the circumstances where ASIC will accept less than 3 full years of accounts in a disclosure document, as explained in Part F of ASIC Regulatory Guide 228 (RG 228). Simultaneously with the release of this consultation paper, ASIC has released a consultation paper seeking comments on proposed changes to RG 228 setting out these circumstances. Are there additional circumstances where you consider ASX should be prepared to accept less than 3 years of audited accounts to those outlined in ASIC's consultation paper on RG 228?

Provided ASIC is willing to relieve entities under the assets test not having an operating history (e.g., a mining tenement or a technology IP) from the requirement of 3 full years of audited accounts and ASX is prepared to follow suit, we do not oppose to this change.

10. ASX has also proposed that it will only accept the types of modified opinion, emphasis of matter or other matter paragraph in accounts lodged with a listing application that ASIC will accept in a disclosure document, as explained in Part F of RG 228. Are there additional types of modified opinion, emphasis of matter or other matter paragraph that you consider ASX should be prepared to accept to those outlined in ASIC's consultation paper on RG 228?

We do not have specific comments regarding this question.

11. Do you agree with the list of overseas home exchanges proposed in section 2.1 of Guidance Note 4 (ie the main boards of Deutsche Borse, EuroNext (Amsterdam), EuroNext (Brissels), EuroNext (Paris), HKSE, JSE, LSE, SGX, TSE (Tokyo), TSX (Toronto), NASDAQ, NYSE and NZX) as being ones generally acceptable for an ASX Foreign Exempt listing? Are there any of these exchanges you would delete from this list? Are there any other exchanges you would add to this list?

We have no specific comments on these proposals.

12. Do you agree with the introduction of a further window for admission for ASX Foreign Exempt listings allowing them to be admitted to ASX if their market capitalisation is at least $2,000 million? If not, what threshold (if any) do you think would be appropriate?

We have no specific comments on these proposals.

13. Are there any specific issues or concerns that you can identify that would result from ASX removing the current requirements for foreign entities listed on ASX to maintain certificated registers in Australia?

We have no specific comments on this issue.

14. Do you believe the transition date of 1 September 2016 that ASX proposes for the introduction of the new admission rules is appropriate? If you think it should be sooner or later, please explain why?

We don't consider the timeline proposed is appropriate. The timeline proposed is harsh on 'in process' IPO's and BDL's which typically take a long period of time to execute. On the basis of the evidence to date in 2016, it would mean that there are currently many BDL transactions in play with the risk of BDL cramming in the period leading up to the transition date of 1 September 2016. If the ASX wishes to push forward with its admission requirement proposals, a far more reasonable implementation date would be the average period of time taken to undertake a BDL. This would allow 'in process' BDLs and IPOs to clear without rendering existing effort from participants a sunk cost. Our research on BDLs indicates this period is approximately 6 months on average. Thus a 6-month period should be provided so market participants considering a BDL have adequate time to adjust to the new playing field. Perhaps 1 January 2017 would be a more practical commencement date.

15. Do you have any other comments on the issues discussed in this paper or the proposed listing rule and Guidance Note changes?

<u>No secondary board in Australia</u>
Prior to raising the bar for small entities going public (IPO or BDL) it is worth considering the funding gap that exists in the capital markets for mining exploration and high-tech start-up companies. It is understandable the ASX aims to boost its international reputation by allowing only entities having a successful track record or large asset base to list. However, unlike many exchanges in other jurisdictions, there is no secondary board in Australia where start-up and emerging companies can obtain capital. Setting too high a bar for listing requirements (especially under the assets test) will make the funding situation even worse and be detrimental to the development of these emerging companies.

<u>Suspension of trading for listed shell during BDL transactions</u>
Based on our own research on backdoor listings (Brown, Ferguson and Lam 2010, 2013; Ferguson and Lam, 2015), we see the recent move by the ASX to have listed shells shares suspensed once they make a disclosure regarding a proposed BDL transaction as a significant step backward in facilitating price discovery in an informed market. In the past, listed shells were only required to be suspended after shareholders have approved the proposed transaction in a general meeting but not before. This way, shareholders of listed shells would have the opportunity and time to rebalance their positions and other investors would be able to take positions in the shares of the shells. This would enable a reallocation of risk among investors, which is Pareto optimal. Through trading, the market is kept informed with the ASX only needing to ensure the flow of information through the continuous disclosure requirements. If listed shells are mandatorily suspended upon the announcement of a proposed BDL transaction, shareholders are placed in a disadvantaged situation (being unable to trade). The recent move by ASX would have the effect of discouraging listed shells from participating in BDL transactions, subjecting them to higher risks of being placed under administration or

receivership. We consider shell recycling of listed entities through BDL's is 'efficient' benefiting both the shareholders of listed shells and entities seeking a listing status. We thus oppose this recent move and suggest previous practice of requiring a suspension upon shareholder approval of a pending BDL is preferable.

Sincerely,

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