Australian Shareholders' Association

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AUSTRALIAN SHAREHOLDERS' ASSOCIATION SUBMISSION TO ASX CONSULTATION PAPER REVERSE TAKEOVERS - SHAREHOLDER APPROVAL REQUIREMENTS FOR LISTED COMPANY MERGERS

Dear Mr Hobourn

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. The ASA is an independent not-for-profit organisation funded by and operating in the interests of its members, primarily individual and retail investors, self-managed superannuation fund (SMSF) trustees and investors generally seeking ASA's representation and support. ASA also represents those investors and shareholders who are not members, but follow the ASA through various means, as our relevance extends to the broader investor community.

Since the ROC Oil transaction in 2014, ASA has raised this matter on several occasions with the ASX and ASIC, as well as with affected companies directly, including in relation to the Novion/Federation Centres merger, the Amcom/Vocus Communications merger and M2 Group's proposed bid for iiNet. We are pleased to submit our response to the ASX consultation paper.

We note that the consultation paper refers generally to 'shareholder approval' and the 'issue of securities'. Our response assumes that the proposed rule will cover scrip takeovers and schemes involving the issue of shares, stapled securities, units and other interests.

Response to consultation questions

1. **Do you think there is a gap in the Australian regulatory framework that warrants a change from the status quo? Do you consider that there are characteristics of the Australian market which justify a different approach to other jurisdictions (taking into account factors such as other sources of financing)?**

Yes, we believe that there is a gap in the Australian regulatory framework. Protection of bidder shareholders against dilution of their investment and control rights is an important issue for a well-functioning securities market and must be acknowledged in our regulatory framework.

We do not consider that the characteristics of the Australian market are sufficiently unusual to warrant different rules from overseas exchanges. Our view is that the ASX must maintain global corporate governance best practices if it is to stay internationally competitive.

There is a fundamental inequality and unfairness in permitting transactions where one company acquires another company via a scheme of arrangement involving the issue of shares in the bidder, but only shareholders in the target are given an opportunity to vote on the transactions, irrespective of their relative sizes. Shareholders in the bidder, who will have their shareholdings significantly diluted by the transaction and will be investors in a company of a different scale and/or nature, do not get a say.

As ASX correctly identifies, the Corporations Act provisions in relation to the conduct of takeover bids and schemes of arrangement are primarily focussed on the impact on control rather than the dilution of shareholders. Accordingly, the Corporations Act generally does not impose restrictions on the issue of securities and we doubt that there would be sufficient Government interest in amending the Act to include a regime to protect the interests of bidder shareholders in this case or to rectify the inequality between bidder and target shareholders in schemes of arrangement involving the issuance of shares.

The ASX Listing Rules contains a number of rules which appear to be aimed at protecting the rights of shareholders, whilst providing for and maintaining a competitive and efficient market for listed entities. However, excessive focus on the latter point leads to the result that, in their current form, these rules are insufficiently broad to protect the rights of bidder shareholders in this scenario:

- Listing Rule 7.1: this prevents a company from issuing more than 15% of its issued capital in 12 months without the approval of its shareholders. The rule is clearly aimed at preventing dilution to existing shareholders. The exceptions to the rule are limited and include pro-rata offers to shareholders, which provide shareholders an opportunity to participate in capital raisings, thus minimising any dilution to their holdings.

- Listing Rule 11.1: this rule gives ASX discretion to require shareholder approval if an entity proposes to make a "significant change" to the "nature or scale" of its activities.

We understand from the ASX Consultation Paper that exceptions 5 and 6 of Listing Rule 7.2 relating to takeovers and schemes are intended to avoid putting a listed bidder at a significant disadvantage to an unlisted bidder in a contested takeover situation. Our view is that it is highly likely that shareholders (especially retail shareholders) would be hesitant to accept shares in an unlisted bidder (or even a bidder listed overseas) because of the lack of a liquid or easily accessible market in those shares and accordingly, the perceived disadvantage would be marginal. We concede that a listed or unlisted bidder offering solely cash does have advantages over scrip bids, but that is a separate point and applies in any event.

ASX notes that the original policy intention of Listing Rule 11.1 was to regulate back door listings and ASX is reluctant to exercise its discretion in other circumstances, including reverse takeovers. We accept this position but our view is that reverse takeovers are a material issue, which is not covered currently by the Listing Rules and unfortunately receive media attention only where there is a substantial shareholder on the register opposing the transaction. It is a matter which warrants ASX's intervention to update its regulatory position, in order to maintain a fair balance between the interests of issuers, shareholders and other market participants.

Further, we have seen from the Canadian experience that the introduction of the shareholder approval requirement has not resulted in any visible decrease in M&A activity. In fact, mergermarket reports that in 2010, the year following the Canadian change, M&A activity was up 19% from 2009, with the energy, mining and utilities sectors being the most active sector accounting for 65.7% of all Canadian deals.

In relation to the arguments in favour of maintaining the status quo, we have the following comments:

- *Reverse takeovers are relatively uncommon and are often supported by shareholders.*

  We agree that "reverse takeovers" have been relatively uncommon in Australia, in the traditional sense of the term, being where the target shareholders acquire the majority ownership of the company. Nonetheless, there have been a number of reverse takeovers in 2015, including:

  - Federation Centres bid for Novion Property Group: under the scheme, Novion shareholders received 0.8225 new Federation securities for each Novion security, giving the target shareholders about 64% of the combined entity
  - Vocus Communications bid for Amcom Communications: under the scheme, Amcom shareholders received 0.4614 Vocus shares for each Amcom share, giving the target shareholders 51.7% of the combined entity
  - Vocus Communications bid for M2 Communications (scheme meeting scheduled for January 2016): under the scheme, M2 shareholders received 1.625 Vocus shares for each M2 share, giving the target shareholders about 56% of the combined entity

  In addition to these transactions, we have seen other examples where existing shareholders were heavily diluted by the transaction (albeit not strictly being a "reverse takeover"), or would have been if the transaction had been successful:

  - Programmed Maintenance Services bid for Skilled Group: under the scheme, Skilled shareholders received 0.5032 Programmed shares and 25¢ for every Skilled share, with the result that each set of shareholders owning 50% of the combined entity
  - Woodside Petroleum bid for Oil Search (bid withdrawn): under the proposed scheme, Oil Search shareholders were to receive 0.25 Woodside shares for every Oil Search share, with the result that the target's shareholders would own 31.7% of the combined entity

- M2 Communications bid for iiNet (bid unsuccessful): under the proposed scheme, iiNet shareholders were to receive 0.803 M2 shares for every iiNet share, plus a special dividend of 75 cents, with the result that target shareholders would own approximately 42% of the combined entity
- Beach Energy bid for Drillsearch Energy (bid underway): under the proposed scheme, Drillsearch shareholders are to receive 1.35 Beach shares for every Drillsearch share, giving the target shareholders approximately 30% of the combined entity if the transaction succeeds. We understand Beach has sought a waiver from Listing Rule 10.1 for the transaction which removed the need for Beach shareholder approval and that an in-principle waiver has been granted.

The above transactions were all announced in 2015 and relate only to the companies that the ASA monitors. As ASA monitors approximately the largest 200 of the Australian listed entities, it is likely that there are others which we are not aware of.

We see this trend as likely to continue if the Listing Rules' status quo is retained.

The ASX asserts that, other than in the case of ROC Oil and Gloucester Coal, these transactions are generally "uncontested" and often supported by shareholders ((presumably of the target). Target shareholders almost always receive a significant premium for their shares and a holding in a substantially larger combined entity in these transactions, so the fact that the transactions receive overwhelming support from target shareholders at the scheme meeting is unsurprising.

Transactions such as ROC Oil and Whitehaven Coal tend to encounter resistance and media attention where there is a substantial shareholder on the bidder's register who is opposed to the transaction. Where there is not such a shareholder, it is unlikely that smaller shareholders opposed to the transaction will be in a position to rally large-scale support to stop the transaction from proceeding.

In fact, what we have noted is that immediately after the announcement of the takeover in the case of M2 Communications and Oil Search, their share prices increased sharply whilst the bidder's share price fell.

- *Potential negative impact on competition in the market for corporate control*

  Many leading overseas exchanges have rules relating to the number of shares which can be issued as a percentage of issued capital. Arguments relating to a possible disruption to the market for corporate control are, in our view, placing too great an emphasis on "protecting" Australian listed companies against foreign bidders, private bidders and large or mature companies. A number of factors favouring Australian listed companies must be noted:

- foreign bidders have an additional hurdle of review by the Treasurer under the Foreign Acquisitions and Takeovers Act, hence an additional element of uncertainty, delay and risk;

- foreign bidders offering scrip consideration will likely have requirements for shareholder approval in their home exchanges. Furthermore, Australian shareholders are less likely to favour taking shares in a foreign bidder over a domestic bidder, due to the added complications relating to holding shares in a foreign entity;

- private bidders are more likely to offer cash consideration, rather than shares, since as mentioned earlier, shareholders do not favour shares in a private company.

As an example, in the recent acquisition of David Jones by South African listed Woolworths, approval was required from bidder shareholders because of South African rules. In that transaction, we do not believe there is evidence to suggest that the prospects of a successful bid (whether by Woolworths, or another party) were adversely affected by the time, complications and uncertainty introduced by the requirement for bidder shareholder approval. Conversely, if a bid offers a fair value proposition to both bidder and target shareholders, the risks of not receiving shareholder approval ought to be low.

- *Increased costs associated with shareholder approval requirements.*

  We agree that the introduction of the bidder shareholder approval requirement may lead to some additional costs. The additional costs will include the cost of preparing and holding shareholder meetings, as well as additional fees to legal advisers. As we outline later, we are of the view that bidders should be required to prepare an independent expert's report for the benefit of its shareholders as well. Deal protection measures and break fees are a common feature of these transactions and we are comfortable that the 1% cap on the break fee provides a suitable upward limit on such costs.

  ASX's comments regarding impact on shareholder value if transactions are not undertaken at all or are restructured in a less efficient manner are hypothetical only. It is difficult to assess the extent of these risks and, as mentioned earlier, what we have seen is that immediately after the announcement of these transactions, the bidder's share price falls which may be reflective of the value to bidder shareholders.

  We believe that the identified potential additional costs of requiring bidder shareholder approval would not be material in the context of an acquisition. The benefit of protecting a fundamental right of shareholders, in our view, greatly outweighs the additional costs associated with the proposal.

- *Role of the board in decision making vs rights of shareholders*

  We do not dispute that the board of a company has the authority to manage the company, other than in respect of certain limited matters reserved for shareholders. However, as the

Toronto Stock Exchange noted in its Request for Comments in 2009 (when it proposed an amendment to its rules), securityholders of the acquirer should have the opportunity to approve acquisitions which may significantly alter their investment and control rights through dilution. TSX did not believe that seeking shareholder approval in such instances was inconsistent with the exercise of directors' fiduciary duties.

We agree. A decision which materially affects all shareholders' rights and value is sufficiently material so as to be taken to the shareholders for a vote. Further, there is an inequality and unfairness in schemes of arrangement where only target shareholders are able to vote whereas the bidder's shareholders' rights are impacted in a similar way.

2. **Do you agree with the implementation of a shareholder approval requirement for issues of securities in excess of 100% of existing capital as consideration for a merger? If not, why not? If you consider an alternative threshold would be more appropriate, what would that threshold be? Are there any alternative indicia you consider should be taken into account?**

Our view is that the suggested 100% threshold is much too high. A threshold of 100% would not strike an appropriate balance between the business interests of ASX listed companies and protecting the fundamental rights of shareholders, as it would be heavily weighted towards the former.

The table in Appendix A of the Consultation Paper shows that a number of international exchanges impose shareholder approval requirements on bidders for scrip based acquisitions that result in dilution of greater than 20 to 30%. This has been the case for many years. ASA believes that the Australian market *should* have a bright line threshold and that 20% to 25% is appropriate. The ASX paper does not offer any argument for proposing a significantly higher threshold than other exchanges.

It may be argued that the ASX should take into account the size and nature of ASX listed issuers. In fact, when the TSX consulted regarding its proposed amendments in 2007 and 2009, it determined that despite the differences in nature and size of its constituents from those in the main US markets, and its stated views during the consultation period that a 50% threshold was appropriate, a 25% threshold was more appropriate. This was after extensive and well documented consultation.

We do not believe that there are other indicia that should be taken into account. Other factors such as the premium paid for a target, are subject to a number of influences and are therefore difficult to objectively incorporate into a bright line test.

3. **If a shareholder approval requirement is implemented, do you think it should also be applied to other issues of securities in excess of 100% that are used to fund cash consideration for a takeover or scheme of arrangement? For example, rights issues under listing rule 7.2 exception 1?**

Yes, we would support such a rule, otherwise this could result in companies structuring transactions in this way to avoid shareholder approval, when the outcome is essentially the same. We do receive some comfort, however, that shareholders may be able to mitigate the dilutive effects of the share issue by participating in the capital raising, but for various reasons, this may not always be possible.

An issue of securities in excess of 100% is a significant decision that changes the scale (and possible the nature) of the business. As an example, we have seen recently where Slater & Gordon issued $1.1 billion of securities via a pro-rata renounceable rights issue to fund the UK acquisition of Quindell under an exception to Listing Rule 7.1. While not a takeover or scheme of arrangement, the transaction has seen the company's share price fall from highs of $7.5 to lows in the 50 cent range. Slater & Gordon shareholders were not given a chance to vote on the acquisition but have now seen their shares drop significantly. Please note that we show this only as one unfortunate example, not as the foundation of our argument.

4. **Do you agree that, if a shareholder approval requirement is implemented, it should be a "bright line" test rather than a discretionary test?**

Yes. A discretionary test would leave too much ambiguity and uncertainty as to when approval would be required. In our view, this would likely lead to higher legal and compliance costs for companies as well as an unnecessarily higher administrative burden for the ASX. A bright line test would be easier to understand and apply.

5. **Do you think the proposal would have a material impact on the ability of ASX listed entities to compete effectively in the market for corporate control? Do you think any particular sectors of the Australian market would be more significantly affected than others?**

No. See comments under question 1.

We have not seen any evidence in other jurisdictions which suggests that the introduction of a shareholder approval requirement has reduced the ability of listed entities on those exchanges to compete for corporate control. Indeed the TSX specifically asked for comment on the same question and referred to the Australian listed market; it concluded that the answer was "no".

It is possible that the proposal may affect smaller issuers and resource-based issuers more than others, as they may prefer to preserve cash for exploration and development purposes, and therefore offer securities rather than cash. However the prevalence of such companies in the ASX and the perceived impact on those companies is not sufficient to warrant different rules from overseas exchanges.

6. **Do you think that the proposal would lead to transactions being structured to avoid security-holder approval? If so, how might this be done and what would be the consequences of such restructuring?**

That is possible. Companies may feel that there is more uncertainty regarding the transaction and therefore look to finance acquisitions with cash or a mix of cash and shares. As contemplated in one of the earlier questions, companies may also decide to conduct a capital raising at the same time of an acquisition to fund the acquisition.

These alternatives are all permitted avenues of acquiring control under the Corporations Act. Deal structuring is a critical part of every transaction, so we do not feel that ASX should be reluctant to introduce rules on a basis that it may result in transactions structured differently.

7. **What do you consider may be the direct and indirect costs of the consultation proposal? Do you those costs outweigh the potential benefits? If so, please provide the basis for that view? Are there any characteristics of Australian shareholder approval requirements that may make it more difficult to obtain shareholder approval than other jurisdictions?**

See comments under question 1.

We are not aware of any characteristics of the Australian shareholder approval requirements that may make it materially more difficult to obtain shareholder approval than other jurisdictions. We note that the current approval requirements for schemes of arrangement are 50% of voting target shareholders (by number) and 75% of voted shares. The proposed rule canvassed in the ASX's paper is to require approval by majority of bidder shareholders, which is a significant easier threshold. Our view is that this difference will still produce an inequality between the rights of bidder and target shareholders in a scheme of arrangement, although the proposal is a substantial improvement over the status quo. We appreciate that ASX is attempting to strike a balance between the interests of the entities involved and their shareholders.

8. **Would such a requirement make transactions more difficult to complete? If so, how? What are the potential timing and disclosure implications of requiring shareholder approval for reverse takeovers?**

We recognise that requiring shareholder approval is an additional step in the process which may result in greater uncertainty. It will also require additional disclosure to bidder shareholders. However, we do not believe that a shareholder approval requirement will make transactions significantly more difficult to complete.

We do not feel the timing implications of the additional disclosure would be great, especially as schemes of arrangement already have reasonably lengthy timetables and they, and off market scrip bids, are usually subject to a number of conditions, including regulatory approvals, which tend to introduce uncertainty and delays.

9. **If a shareholder approval requirement is implemented, do you consider any changes to the standard voting exclusions or disclosure requirements would be required? For example, should target shareholders who also hold shares in the bidder be permitted to**

vote, subject to the usual exclusions for interested or related parties? Should an independent expert's report be required?

We have no issue with target shareholders who also hold shares in the bidder being permitted to vote, subject to the usual exclusions for interested or related parties. An independent expert's report should be required where bidder shareholder approval is required, as it will provide information to assist bidder shareholders with their voting decision.

10. Are there any other consequential amendments to the listing rules which would be required?

None that we are aware of.

11. Do you think such a proposal would have an impact on the willingness of issuers to list, or remain listed, on ASX? Alternatively, do you consider failure to implement any changes would impact on the willingness of investors to invest in entities listed on ASX?

No, we cannot see how the proposal would have any material impact on the willingness of issuers to list, or remain listed, on ASX. This is particularly the case as other overseas exchanges already have significantly tougher rules regarding the issuance of shares than what ASX is proposing. These rules have operated for many years, with no apparent adverse effect to market efficiency.

In contrast, we believe that failing to implement the changes would impact the willingness of investors to invest in ASX listed entities as a result of the lack of adequate shareholder protections. It would also mean that ASX will continue to be out of line with its offshore counterparts for no good reason. The TSX undertook a public consultation in 2009 and has had rules in place since then. We commend the TSX consultation process and the degree of detail published throughout its investigations. It is time that the ASX took action.

12. Are there any additional considerations which should be taken into account?

None.

Yours faithfully

Diana D'Ambra
Chairman, Australian Shareholders' Association