CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

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To whom it may concern

Strengthening Australia's equity capital markets: ASX proposals and consultation

CSA is the peak body for over 7,000 governance and risk professionals. It is the leading independent authority on best practice in board and organisational governance and risk management. Our accredited and internationally recognised education and training offerings are focused on giving governance and risk practitioners the skills they need to improve their organisations' performance and are 'first-choice' options for those intent on pursuing a C-suite career. CSA has unrivalled depth and expertise as an independent influencer and commentator on governance and risk management thinking and behaviour in Australia.

Company secretaries have primary responsibility in listed companies to deal with the Australian Securities Exchange (ASX) and interpret and implement the listing rules. Our Members deal on a day-to-day basis with ASX and have a thorough working knowledge of the operations of the markets, the needs of investors and the listing rules, as well as compliance with the Corporations Act (the Act).

CSA welcomes the consultation paper *Strengthening Australia's equity capital markets: ASX proposals and consultation* (the consultation paper) setting out proposals to increase the capital raising limit for mid to small caps to 25 per cent, subject to additional disclosure requirements and shareholder approval.

1 & 4. Do you support an increase in the capital raising limit for mid to small caps? Do you support the proposed investor protections:

- ***12-month shareholder mandate***
- ***additional disclosure***
- ***maximum 25 per cent discount to market price for the additional 10 per cent.***

CSA supports an increase in the capital raising limit for mid to small caps. CSA also supports the proposed investor protections, although we recommend that consideration be given to a special resolution being required to seek shareholder approval of the increased limit.

CSA agrees that mid to small caps have limited access to venture capital and debt funding, particularly at early stages in their life cycle. They need to raise funds in a cost-effective manner while balancing shareholder rights.

It is difficult for entities to forecast how successful a rights issue will be. A rights issue is an expensive means of raising capital, yet it comes with no guarantee that demand from existing shareholders will meet the capital needs of the entity. Moreover, in small to medium-size companies, the size of the shareholder base may not make a rights issue a viable means of raising capital.

Companies therefore need access to other forms of capital raising, such as institutional placements, where the investment bank approaches clients (generally institutions) and takes a significant risk in underwriting the offer. This risk accounts for the discount offered. There may also be circumstances where a company needs to move very quickly to take advantage of an opportunity arising, such as an acquisition, within a time frame that would negate raising the capital from all shareholders. In such circumstances, a placement may be the most appropriate form of capital raising. However, capital raising through placements dilute the holdings of other shareholders, particularly smaller retail ones.

It is important, therefore, that safeguards are put in place to protect shareholder rights when raising capital other than through a rights issue. As noted by the Australian Shareholders Association (ASA) in its paper, *Equitable Treatment of Shareholders in Capital Raising*:

> Boards have a duty to consider the interests of all shareholders when assessing their capital raising choices and to communicate the reasons for their decisions to shareholders. In addition to communicating the reasons for capital raising decisions, the ASA would like to see boards voluntarily disclose the individual particulars of institutional placements; when those share placements have not been made more widely available. In the view of the ASA by disclosing these details, it aids transparency and allows shareholders to form a view of the appropriateness of the board's decision making process.

CSA is of the view that the additional investor protections set out in the consultation paper offer the appropriate safeguards, although we do have some concerns with the disclosure of scenario testing and question how voting exclusions may operate when shareholder approval is being sought.

First, shareholder approval must be sought to issue 10 per cent of issued capital at a maximum 25 per cent discount to market price — this is in addition to the 15 per cent permitted under listing rule 7.1. Shareholders are therefore required to provide their board with a mandate to raise capital by offering a discount. This mandate is for a period of 12 months only. If shareholders are not happy to offer this mandate to the company, they can reject the resolution.

CSA notes that shareholders could impose a lower limit than the maximum 25 per cent discount when their approval is sought. Shareholders may wish to provide their board with the flexibility to raise capital quickly by offering a discount, but set a limit to the discount, which is lower than the 25 per cent maximum.

However, given the potential for dilution of existing shareholders, **CSA recommends** that consideration could be given to the resolution to approve the additional 10 per cent of placement capacity being a special resolution requiring 75 per cent of the vote to pass. This would ensure that the approval provided to boards to raise capital through placements is a significant shareholder mandate.

Notwithstanding this, CSA notes that other listing rules governing major corporate decisions are ordinary resolutions, requiring only 50 per cent of the vote to pass.

Second, the additional disclosure requirements attached to increasing the capital raising limit requires boards to disclose to the market:

- details of the dilution to the existing shareholders caused by the issue

- the reasons for undertaking a placement rather than a pro rata rights issue or other type of issue in which existing shareholders would have been eligible to participate
- details of the entity's allocation policy for the issue and the process by which the board determined it
- details of any underwriting arrangements, including any fees payable to the underwriter.

CSA is of the view that these additional disclosure requirements attached to the exercise of the authority provided by shareholders to undertake capital raising at discount ensure that boards must consider:

- if the capital raising leads to an inequitable dilution of existing shareholders without any compensating benefit to the entity (and therefore the shareholders)
- if another form of capital raising could be undertaken.

CSA notes that the additional disclosure requirements address the concerns set out by the ASA in its paper, *Equitable Treatment of Shareholders in Capital Raising*, which states that:

> 3.1. In the interest of transparency, where a company has undertaken a placement, ASA expects it to disclose to the market the following information:
>
> > 3.1.1. The name of the recipient(s) and the number and percentage of issued capital issued to each recipient of more than 5% of the total placement.
> > 3.1.2. The names of any advisors/ underwriters involved in the placement, a brief description of the work carried out and the total fees paid to each advisor/underwriter.
> > 3.1.3. A detailed explanation about what alternative methods of capital raising were explored and why the chosen method was preferred.

The ASX consultation paper includes draft amendments to the listing rule requiring companies to disclose the potential dilution of existing shareholders on the basis of at least three different assumed issue prices and values, including at least one example that assumes that the price of ordinary securities has fallen by at least 50 per cent.

CSA supports companies having to scenario test the impact on shareholders of any increase in the capital raising limit and the disclosure requirement to provide shareholders with sufficient information on which to base their voting decision. However, CSA is of the view that disclosure of the worst-case scenario (the price of ordinary securities falling by at least 50 per cent) may result in shareholders automatically rejecting the resolution to increase the capital raising limit. CSA does not suggest that negative impact scenarios should be avoided, but believes that disclosure of the absolute worst-case scenario will counter the intent of the listing rule amendment proposals. Furthermore, CSA notes that directors are required to make full and honest disclosure, and a worst-case scenario could be misleading.

CSA also queries how voting exclusions may operate. We note that the proposals are consistent with the current rule, but that with the potential for the transaction to be implemented within 12 months, it may be difficult/impossible to determine who will participate. For example, if the company undertakes a placement, any shareholder who participates cannot at the same time participate in a rights issue.

Comparison with other jurisdictions

CSA is aware that the ASA paper makes reference to the UK capital raising regime, stating that:

> UK listed companies are legally required to offer shares to existing shareholders on a pro-rata basis, on equal or more favourable terms, before the shares can be offered to anyone else. As a result, rights issues have become the most common method of raising equity in the UK.

However, the ASA paper does not provide a full context for this statement. For example, the average discount on rights issues in the UK could be as high as 45 per cent. The Financial Services Authority, the key regulator in the UK, issued its *Report to HM Treasury on the implementation of the recommendations of the Rights Issue Review Group* in April 2010. The Group was established 2008 to review the equity capital raising process and recommend how it could be made more efficient and orderly, as there were concerns about market orderliness and the time taken for some fundraisings to be completed. The Taskforce looked at the Australian model for capital raising as part of its review of how to improve the capital raising regime.

The ASA paper also states that ‘A renounceable pro-rata entitlement offer should be the preferred starting option for any listed company seeking additional equity funding. ... Where capital is required quickly, the company can accelerate the institutional component of the offer, using an accelerated rights issue’. We note that the UK Report found there was little appetite for adopting an accelerated pre-emptive offer model in the UK.

2. Do you agree that A$300 million is an appropriate threshold for identifying mid to small caps?

CSA agrees that A$300 million is an appropriate threshold for identifying mid to small caps.

However, **CSA recommends** that this threshold be reviewed periodically, say every five years, as it is a threshold that can be too high or low depending on economic cycles.

CSA would be concerned with any proposal to identify mid to small cap listed entities requiring the flexibility to raise capital more quickly and efficiently by industry type. The consultation paper points to the preponderance of resource sector companies in its current identification of mid to small caps listed on the Australian Securities Exchange (ASX). Other commentary on the consultation paper has noted that the companies most in need of the flexibility of capital raising proposed in the consultation paper are exploration and life science groups. However, CSA is of the view that ‘life science groups’ is a broad term encompassing not only speculative investment entities but also classic industrial companies. Indeed, ASX’s website includes the following companies under the banner ‘life science groups’:

- agriculture
- diagnostics
- veterinary and medical
- manufacturing
- environment
- biotechnology.

CSA is of the view that the requirement to seek shareholder approval of the capacity to issue 10 per cent of issued capital at a maximum 25 per cent discount to market price, in addition to the 15 per cent permitted under listing rule 7.1, ensures that shareholders are in a position to determine if the entity in which they invest is of a type to require this form of capital raising flexibility.

The consultation paper notes that ASX will determine an entity’s market capitalisation and publish a list twice a year of which entities are eligible to seek a shareholder mandate under the proposed listing rule amendments.

CSA is concerned that a list published on the general ASX website may not provide sufficient visibility to shareholders, particularly retail shareholders, as to whether the companies in which they invest are eligible for the increase in the capital raising limit.

CSA recommends that ASX place a marker on each relevant company web page on the ASX website, so that investors can clearly ascertain if the company in which they invest is eligible for the increase in the capital raising limit.

CSA would also be concerned if companies marginally above the A$300 million threshold were granted waivers in relation to capital raising limits. The use of waivers in such circumstances could see larger companies gradually brought within the increased limit as precedents were created. CSA notes that discipline is required by ASX in maintaining the threshold.

CSA's support for the amendments to the listing rules to allow mid to small caps more flexibility to raise capital is not support for a second listing rule regime for such companies in general. Our support for the changes as set out in the consultation paper cannot be read as support for a number of changes that would effectively lead to a second board and second set of listing rules.

Admission requirements draft listing rules

CSA has no comment on this section of the consultation paper.

Conclusion

CSA supports an increase in the capital raising limit for mid to small caps. CSA also supports the proposed investor protections, and A$300 million as an appropriate threshold for identifying mid to small caps.

CSA believes the changes could be strengthened if the resolution to approve the additional 10 per cent of placement capacity is a special resolution requiring 75 per cent of the vote to pass, to ensure that the approval provided to boards to raise capital through placements is indeed a shareholder mandate. However, given that other listing rules governing major corporate decisions are ordinary resolutions, requiring only 50 per cent of the vote to pass, this may not be appropriate.

CSA also recommends that the threshold of A$300 million be reviewed periodically and ASX place a marker on each relevant company web page on the ASX website, so that investors can clearly ascertain if the company in which they invest is eligible for the increase in the capital raising limit.

We have drawn on our Members' experience in our submission.

Yours sincerely

Tm Sheehy
CHIEF EXECUTIVE