



ASIC
Australian Securities &
Investments Commission

Explanatory Statement

ASIC Corporations (Stub Equity in Control Transactions) Instrument 2020/734

This is the Explanatory Statement for *ASIC Corporations (Stub Equity in Control Transactions) Instrument 2020/734*.

The Explanatory Statement is approved by the Australian Securities and Investments Commission (*ASIC*).

Summary

1. *ASIC Corporations (Stub Equity in Control Transactions) Instrument 2020/734* (the **instrument**) affects the operation of the takeovers and fundraising laws in Chapters 6 and 6D of the *Corporations Act 2001* (the **Act**) to address an emerging mischief that ASIC has observed in control transactions involving the offer of shares in a proprietary company and mandatory custodial arrangements.
2. Bidders and acquirers have been able to avoid the ordinary prohibitions and consequences of accumulating investors as a result of offers to a large number of investors, and keep the number of shareholders on the issuer's register artificially below 50 through the use of mandatory custodial arrangements.

Purpose of the instrument

3. 'Stub equity' typically consists of securities or interests in an unlisted bid or holding vehicle that provides offerees the option to retain continued economic exposure to the performance of the underlying business of an entity as an alternative to another form of consideration (such as cash) that does not provide the same exposure.
4. Proprietary companies are required to be closely held and are prohibited from making offers of their securities under a disclosure document. Ordinarily, proprietary companies must have no more than 50 non-employee shareholders and are prohibited from activities which would require disclosure to investors under Chapter 6D: see section 113 of the Act. However, broadly drafted disclosure exemptions in subsections 708(17) and (18) of the Act do not prevent offers of proprietary company scrip through a scheme of arrangement or a takeover, even though outside of these control transactions, offers of proprietary company scrip on such a wide scale would generally not be permitted.
5. ASIC has observed a number of recent stub equity control transactions where:

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- (a) the consideration offered to all holders includes securities in a proprietary company; and
 - (b) the securities are offered on terms which require certain accepting holders (e.g. all retail holders, or all existing holders of the target other than specified institutions) to have those securities registered in the name of a custodian, rather than holding the securities directly.
 6. Offers of this kind have been made to a large and diverse group of shareholders, including retail investors. By structuring control transactions in this way, issuers keep the number of holders on the issuer's register artificially below 50, and retail investors who accept scrip consideration do not receive the disclosure and governance protections that apply to public companies and which do not apply to proprietary companies. Proprietary companies are subject to a lower standard of governance and regulation than public companies because they are closely-held with no offers to the general public usually permitted.
 7. ASIC is concerned that offering proprietary company scrip under a scheme of arrangement or takeover bid to more than 50 shareholders, including through the actual or contemplated use of custodian or nominee arrangements, is contrary to the legislative intent of section 113 of the Act and the limitations on proprietary companies. The overall effect of these offers is to deprive retail investors in what are, in substance, widely-held companies, of rights and protections that would be available to them in a public company.
 8. The purpose of this instrument is to create a regulatory environment where retail investors in, what are in substance, widely-held companies, benefit from the higher levels of regulation available in public companies.

Consultation

9. In June 2019, ASIC consulted on a broader proposal in Consultation Paper 312: *Stub equity in control transactions* (CP 312) to:
 - (a) prevent offers of stub equity in proprietary companies to retail investors in schemes of arrangement and takeovers (by modifying Chapter 6D of the Act); and
 - (b) prevent offers of stub equity where the terms of the offer require the securities to be held under mandatory custodial arrangements that avoid the application of the takeover provisions in Chapter 6, the disclosing entity provisions in Part 1.2A, or the 50 non-employee shareholder limit in subsection 113(1) of the Act (by modifying Chapter 6 of the Act).
10. Submissions to CP 312 closed on 17 July 2019. ASIC received 12 non-confidential responses to CP 312. Respondents included the legal community and relevant industry bodies. One respondent agreed with ASIC's proposal. The majority of respondents disagreed with ASIC's proposal. Some expressed greater concern with the proposed Chapter 6 modification, insofar as it would restrict use of a custodian by a public company.

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11. Report 669 *Response to submissions on CP 312 Stub equity in control transactions* outlines the key issues that arose out of the submissions received on CP 312 and details our responses to those issues.
 12. ASIC was particularly interested in the feedback that its proposal might encourage the use of foreign stub equity vehicles. ASIC undertook subsequent targeted consultation which indicated that the application of Chapter 6 was the real deal-breaker and that bidders could prefer public companies with mandatory custodial arrangements over foreign vehicles for a range of commercial reasons.
 13. Following consultation, ASIC has decided to proceed with:
 - (a) the Chapter 6D modification as contemplated in CP 312 — to prevent offers of stub equity in proprietary companies to retail investors under the exemptions for control transactions;
 - (b) an *alternative* Chapter 6 modification — to limit the circumstances in which mandatory custodial arrangements can be used to convert from a public company to a proprietary company if there are more than 50 non-employee beneficial owners.
 14. In ASIC's view, this decision balances:
 - (a) the commercial needs of bidders;
 - (b) the remaining protections available to retail investors in public companies and subject to mandatory custodial arrangements (including, but not limited to, tag along and drag along rights); and
 - (c) the will of retail investors following the control transaction.

Operation of the instrument

15. The instrument affects the operation of Chapter 6D (fundraising) by modifying the disclosure exemptions in subsections 708(17) and (18) (which deal with schemes of arrangement and takeovers) so that those exemptions do not apply to offers of securities in proprietary companies. This has the effect of discouraging these kinds of stub equity offers being made to retail investors in schemes of arrangement and takeovers.
16. The instrument also affects the operation of Chapter 6 (takeovers) by the addition of new section 615A of the Act which affects the exemptions in items 1 to 4 (takeover bids) and 17 (schemes of arrangement) in the table in section 611 so that if the consideration offered includes securities in a public company held under mandatory custodial arrangements, those exemptions only apply if the custodial arrangements include 'conversion and termination provisions' which can only be amended by a special resolution of the beneficial owners.

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17. 'Conversion and termination provisions' are provisions to the effect that, if a public company applies to change to a proprietary company at a time when it has more than 50 non-employee beneficial owners:
 - (a) the custodial arrangement will terminate; and
 - (b) the beneficial owners will be registered as holders of the securities.
 18. This instrument commences on the day after it is registered on the Federal Register of Legislation.

Sunset date

19. The instrument will cease in accordance with section 50 of the *Legislation Act 2003*, the purpose of which is to ensure legislative instruments are kept up to date and only remain in force for so long as they are needed.
20. The purpose of the instrument is set out in paragraphs 3 to 8 of this Explanatory Statement. Transaction structures observed by ASIC may continue to be utilised in the absence of the modifications in the instrument and may continue to deprive retail investors of rights and protections that might otherwise be available to them. Accordingly, ASIC considers that the modifications which seek to prevent the erosion of retail investor rights and protections should continue for as long as the *Legislation Act 2003* permits.

Legislative instrument and primary legislation

21. The subject matter and policy implemented by this instrument is more appropriate for a legislative instrument rather than primary legislation because:
 - (a) the instrument utilises powers given by Parliament to ASIC that allow ASIC to modify or affect the operation of Chapters 6 and 6D to provide a tailored and flexible regulatory environment that is fit for purpose for certain kinds of fundraising activities and control transactions; and
 - (b) the matters contained in the instrument are a specific amendment designed to ensure the application of primary legislation remained flexible to adapt to market developments and applies in a way consistent with the intended policy and the enabling provisions in the primary legislation.

Legislative authority

22. The instrument is made under sections 655A and 741 of the Act.
23. Subsection 655A(1) of the Act provides that ASIC may declare that Chapter 6 of the Act applies to all persons as if specific provisions were omitted, modified or varied, as specified in the declaration.
24. Subsection 741(1) of the Act provides that ASIC may declare that Chapter 6D of the Act applies to all persons as if specified provisions were omitted, modified or varied, as specified in the declaration.

25. The instrument is a disallowable legislative instrument.

Statement of Compatibility with Human Rights

26. The Explanatory Statement for a disallowable legislative instrument must contain a Statement of Compatibility with Human Rights under subsection 9(1) of the *Human Rights (Parliamentary Scrutiny) Act 2011*. A Statement of Compatibility with Human Rights is in the Attachment.

Statement of Compatibility with Human Rights

This Statement of Compatibility with Human Rights is prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

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Overview

1. *ASIC Corporations (Stub Equity in Control Transactions) Instrument 2020/734* affects the operation of the takeovers and fundraising laws in Chapters 6 and 6D of the *Corporations Act 2001* to address an emerging mischief that ASIC has observed in control transactions involving the offer of shares in a proprietary company and mandatory custodial arrangements.
2. The purpose of this instrument is to create a regulatory environment where retail investors in, what are in substance, widely-held companies, benefit from the higher levels of regulation available in public companies.
3. The instrument prevents offers of stub equity in proprietary companies to retail investors under the exemptions for control transactions, and limits the circumstances in which mandatory custodial arrangements can be used to convert from a public company to a proprietary company if there are more than 50 non-employee beneficial owners.

Assessment of human rights implications

4. This instrument does not engage any of the applicable rights or freedoms.

Conclusion

5. This instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.