OWNERSHIP MATTERS

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Mr Richard Murphy
General Manager, Capital Markets
ASX Limited

Email: regulatorypolicy@asx.com.au

RE: Submission on proposed changes to placement capacity for mid to small cap entities

Dear Mr Murphy,

Thank you for the opportunity to comment on the ASX's proposed changes to ASX Listing Rule 7 for entities with a market capitalisation below $300 million. Ownership Matters (OM) is an Australian owned governance advisory firm serving institutional investors that was formed in 2011.

OM's submission addresses the ASX's proposal to allow mid to small cap entities (as defined by ASX being those entities with a market capitalisation of below $300 million) to seek shareholder approval by ordinary resolution to increase their placement capacity over a 12 month period from 15 percent to 25 percent (with the increased capacity of 10 percent subject to a maximum discount of 25 percent to the market price). OM does **NOT** support the proposed 'placement mandate' for the following reasons:

- The proposal interferes with the market for corporate control and would increase the capacity for investors in sub $300 million entities to be substantially diluted against their will.
- ASX has presented minimal evidence that the change is required.
- The proposed changes appear to have been driven by the ASX's commercial imperatives.
- The existing Listing Rule regime, and the proposed changes, does not provide sufficient protection against abusive non-pro rata share issues to related parties, major shareholders and other parties with significant influence over a listed entity.

Our submission will address each of these points in turn.

Control and dilution implications: Under the current ASX Listing Rules the largest shareholding that a listed company is able to allocate to a single individual in a 12 month period (without prior specific shareholder approval) is 13 percent on a fully diluted basis.[1] A

[1]In certain circumstances – such as in connection with an underwritten entitlement offer conducted together with a placement – a single investor is able to attain a shareholding above this level by underwriting the rights issue without shareholder approval in what is in effect a single capital raising. This occurred, for example, at Abacus Property Group at the beginning of 2009 when Kirsh Group emerged with a 27 percent securityholding. In this submission 'shares' and 'company' will be used to refer to all listed entities.

shareholding of this size confers substantial influence to a single investor and the capacity to block any on- or off-market takeover offer under the Corporations Act but is well below the level of 20 percent voting power identified under Australian law and accounting standards as conferring influence akin to control.[2] Under the proposed changes to the Listing Rules a company would be able to seek approval to issue shares under the placement mandate and the following day issue shares equivalent to 20 percent of shares on issue on a fully diluted basis to a single shareholder.

This would allow the board of a listed company to confer significant influence, to a single party without specific shareholder approval at a discount of more than 25 percent (as only the shares issued under the placement mandate are subject to a limitation on the maximum discount). That significant influence includes the capacity to effectively block a takeover via a scheme of arrangement, as scheme meetings can be defeated by 25 percent of shareholders who vote, and 'voter turnout' in schemes is rarely in excess of 80 percent of shares on issue. Under present regulation a single party could only achieve a shareholding of 20 percent in a single day (without shareholder approval) through a placement in conjunction with the purchase of shares on market and such a purchase is likely to have a substantial impact on market price of the listed company's shares.

The present regime allows a board of a listed company to dilute shareholders without their consent – to effectively reduce their ownership stake in the company – by up to 15 percent over any rolling 12 month period and this level cannot be exceeded unless an offer is made on a preemptive rights basis or after receiving shareholder approval for a proposed issue of shares. The ASX proposal would increase the capacity for shareholder dilution subject to the passage of a single, ordinary resolution every 12 months with no requirement to identify the specific purpose, price or likely recipients of any placement and with no meaningful restrictions from voting on the approval resolution (see below for a discussion of the shortcomings of investor protections under the placement mandate proposal).

The regulatory framework for listed companies in Australia sets the bar deliberately high for the acquisition of a shareholder's property without their consent: the compulsory acquisition threshold under an off-market or on-market takeover offer is 90 percent ownership and a special resolution and a majority of shareholders voting is required under a scheme of arrangement. The proposed placement mandate would however increase the capacity to effectively reduce a shareholder's ownership interest by ordinary resolution with potential beneficiaries (including management) able to vote on the resolution.

Lack of evidence in support of the proposal: The consultation document presented by the ASX in support of the proposed placement mandate presents almost no empirical evidence in support of the proposal. The paper cites consultations that the ASX had in 2005 with 87 senior executives from mid to small cap companies, a survey of small cap executives and their advisers also in 2005 and since March 2011 "one-on-one meetings with brokers, listed companies and boutique fund managers in Melbourne and Perth" and roundtable meetings "with attendees from brokers, listed companies, investors and industry bodies" in Perth, Sydney and Brisbane. The ASX has concluded from these discussions,

[2] Section 606 of the Corporations Act prohibits acquisitions above 20 percent without making a takeover offer outside of a listed of specified exemptions while AASB 128 states at paragraph 5 that "if an entity holds, directly or indirectly (eg through subsidiaries), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case."

which appear to have been largely with management of small to mid cap companies and service providers to these companies, that the changes would be welcomed, citing four quotes from anonymous sources as representative of the feedback it received. It also notes 80 percent of respondents to its 2005 survey favoured a relaxation of capital raising rules.

The belief by mid to small cap company executives, directors and their service providers that shareholders should have fewer property rights is not, in OM's opinion, persuasive evidence that shareholders' property rights should be reduced.

Further, it is apparent from an earlier ASX paper, *Omnibus Listing Rule Amendments,* released in December 2007 that the consultations in 2005 were in respect to capital raising proposals for companies with a market capitalisation of $100 million or lower, which it defined as 'SME's, and not the $300 million limit that is the subject of this consultation.[3] If this is the case, it is disingenuous to present the results of a consultation on a materially lower market capitalisation as evidence for change.

The feedback from the most recent consultations as summarised in the paper was that the existing 15 percent limit on placements over a 12 month period without shareholder approval imposed a "high financial and opportunity cost" for companies forced to go to shareholders for approval multiple times in a year. The ASX provides no data on the costs of such meetings nor does it quantify the number of mid to small companies that were required to seek shareholder approval multiple times in a single year solely in order to raise capital, although OM notes it is relatively common for mid to smaller listed companies to convene general meetings outside of the usual AGM cycle solely for the sole purpose of approving remunerated related resolutions for directors. In these cases the cost of holding a general meeting does not appear to act as a deterrent.[4]

In order to properly assess on a cost-benefit basis the ASX's proposal, investors require:

- The actual costs of convening shareholder meetings solely to approve placements ;
- Examples of opportunities unable to be acted on due to the need to seek shareholder approval to raise capital; and
- The number of meetings convened ***solely*** to raise capital (and not comply with the related party provisions of the Listing Rules or Corporations Act provisions).

The only empirical data cited by ASX in support of its proposal is a review of 244 general meetings **including AGMs** in 2011 held by 200 mid to small caps which included capital raising related resolutions. ASX notes only one proposal to raise capital at these 244 meetings was rejected and that where "security holder approval of placements is routinely obtained by mid to small caps, ASX listing rules may be imposing an unnecessary regulatory burden". This data provides no support for the ASX's proposals as:

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[3] It is also apparent from the 2007 paper that the placement mandate in this proposal was proposed for entities with a market capitalisation of $100 million or less based on ASX's own empirical analysis which showed that entities with a market capitalisation of over $100 million generally found the placement capacity under ASX Listing Rule 7.1 to be adequate. See paragraph 3.14 of the consultation document.

[4] As an example, Ampella Mining in February 2011 convened a general meeting to approve a new incentive plan (and elect a recently appointed director); Samson Oil & Gas on 30 May 2012 will hold a general meeting purely to approve various items related to executive and director pay; Mirabela Nickel on 17 August 2011 held a general meeting for the sole purpose of approving an equity grant under an incentive plan to its CEO.

- It is not clear how many of the 244 general meetings were AGMs; as it involved a survey of 200 entities throughout 2011 it is possible that more than half of the meetings were AGMs and so minimal costs in terms of additional meetings may have been imposed as a result of ASX Listing Rule 7.1.
- Investor support for resolutions seeking approval (or ratification) of specific share issues at specific prices for specific purposes does not indicate investors would be prepared to allow directors the capacity to issue shares effectively at any price to any person for any purpose over a 12 month period.[5]

In assessing the proposal it should also be noted that this is the fourth attempt by ASX in the past 15 years to increase the placement capacity of listed companies: The 1997 and 1998 changes which increased the placement limit from 10 percent to 15 percent, first for small mining companies and then for all listed entities; the abandoned 2003 attempt to lift placement capacity to 20 percent for all entities and allow companies to seek approval for an unlimited annual general placement mandate and the abandoned proposal in 2007 to permit a placement mandate of 10 percent in addition to the 15 percent available under ASX Listing Rule 7.1 for entities with market capitalisation of under $100 million.

A review of the last change to the capital raising rules, in 1997 and 1998, indicates that the key driver of the amount of capital sought by listed companies is the amount they are able to raise without shareholder approval. This study indicates that the increase in the limit on placements under the Listing Rules in 1997 and 1998 led to an increase in dilutionary placements up to the limit above which shareholder approval was required and had no discernible impact in the number of placements for which shareholder approval was required.[6] This past experience suggests the current proposal will provide minimal benefit to listed companies in terms of reduced costs from the need to convene shareholder meetings but additional costs to shareholders in terms of dilution.

The current proposal also notes other exchanges around the world have regimes that provide greater capacity for boards to dilute shareholders without their consent. ASX however provides no evidence as to how the existence of these other regimes may be damaging entities already listed on ASX or if ASX listed companies are delisting from ASX and seeking additional listings on these foreign exchanges solely in order to enjoy easier access to capital (as opposed to the other potential benefits of a listing in another jurisdiction such as a larger pool of investors or to secure a listing that reflects a company's geographical location).

Potential conflicts: Past proposed Listing Rule changes have been conducted by the ASX's Compliance (formerly Market Integrity or Regulatory) division. From the information available in the consultation paper, market announcements and press coverage of the proposal and comments made by ASX's new CEO, it appears the ASX's commercial division has had a significant influence on the preparation of this proposal. For example, in an earnings update to the market on 3 May 2012 in a slide detailing the sources of its revenue from listed entities, the ASX noted among the key measures being taken to "improve Listings franchise" were proposals offering "small to mid-caps … improved

[5] The discount limit relates to the market price at the time the placement occurs and not at the time the placement mandate is approved by shareholders so the discount to the price at the time of approval is inherently uncertain.

[6] HW Chan & R Brown, 'Rights issues versus placements in Australia: Regulation or choice?'. *Company & Securities Law Journal*, August 2004, Vol. 22, No. 5, pp. 301-312.

flexibility". Similarly, the ASX's new CEO has been reported as saying the proposals are designed to improve the services ASX offers to Western Australian based listed entities and followed "talks with Perth-based mining executives and brokers".[7]

The ASX has a clear duty to deliver returns to its shareholders but given its role as the supervisor of listed companies this creates a potential conflict of interest and the possibility, given ASX's near monopoly status in Australia and the domestic asset allocation bias of most Australian institutions, that it will seek to maximise returns by removing 'impediments' to capital raising at the expense of the rights of shareholders. This potential conflict has historically been dealt with through the separation of the supervisory and commercial functions. The apparent involvement of the commercial division in preparation of the current proposal is concerning given the lack of evidence presented in the consultation paper and the failure to consult investor industry groups in advance.

Problems with proposal and existing regime: The ASX proposed placement mandate relies on three key protections – the ASX's related party regime, the requirement for shareholder approval of the mandate by ordinary resolution and the discount limitation. The protections offered are however insufficient given the potential dilution and control risks the proposal carries.

- **Related party:** The ASX's current related party rules are materially weaker than those in peer exchanges such as Singapore and Hong Kong and contain substantial gaps, especially in relation to share issues to substantial shareholders and persons in a position of influence. Under the current related party rules relating to asset transfers, a person with a holding of 10 percent is defined as a related party unless the transaction involves an issue of shares for cash.[8] This means that a 10 percent or greater shareholder who is not personally represented on the board (ie. if they are represented on the board by employees or directors rather than the controlling party him/herself) can receive a placement (including one not open to other shareholders) or a disproportionate share of a placement without prior shareholder approval. This has occurred at large and small listed companies in recent years. In May 2010 Cash Converters International (which is included in the indicative list of companies able to seek the placement mandate under the ASX's proposal) made a placement to its 29.8 percent shareholder EZCORP after it expressed interest in increasing its stake in the company up to the limit set by the Corporations Act. The placement allowed EZCORP, without shareholder approval, to increase its position to 32.8 percent essentially at market price without having to acquire shares on market and risk increasing the cost of acquisition given the illiquidity of the company's shares.[9]

- Similarly, persons who have agreed to take up a position of influence over a listed company (such as a directorship) are able to receive favourable equity allocations without shareholder approval through a provision that exempts them from the definition of related parties under the Corporations Act.[10] It was this provision that allowed Berkeley Resources to allocate shares equivalent to 2.9 percent of shares

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[7] *The Australian Financial Review*, 'ASX reforms have West in mind', 4 April 2012.
[8] ASX Listing Rules 10.1.3 & 10.3.
[9] Cash Converters International, 'EZCORP Inc Subscribes Further Funds to Accelerate Growth', ASX announcement, 19 May 2010.
[10] ASX Listing Rule 10.12, exception 6; see section 228(6) of the Corporations Act.

on issue at a slight discount to the market price to two incoming directors in connection with their appointment without shareholder approval (with the placement occurring the day they were appointed), and to also allocate 5 million options to these two men at a premium to the market price, representing additional potential dilution of almost 3 percent.[11]

- **Shareholder approval mechanism:** Approval is required by an ordinary resolution which in OM's opinion is an insufficiently demanding threshold given the potential danger to shareholders that the placement mandate presents. By comparison, in recognition of the dangers of potential dilution UK law requires disapplication of preemptive rights to be approved by a special resolution.

- The 'protection' afforded by the current proposal is also reduced by lack of an effective voting exclusion provision. Listing Rule 14.11.1 specifies voting exclusions on shareholder resolutions. A literal reading of the rule suggests that shareholders that 'may participate' in placements will have their votes excluded on resolutions seeking approvals under the placement mandate. However the ASX endorses the existing market practice in relation to 'advance' approvals of placements where participants have not yet been determined under Listing Rule 7.1 whereby the votes of potential participants are included in these vote counts. The Federal Court has recently endorsed the ASX's position,[12] meaning that the class of shareholders who stand to benefit most from abandoning preemptive rights can increase an entity's capacity to do so. This would persist in the revised Rule 7.1A.

- **Discount limitation:** The proposal stipulates that any issue under the placement mandate must occur at a discount of no greater than 25 percent to the "average market price" over the 15 trading days prior to issue. In the ASX Rules, market price is defined as the closing price for a trade via the ASX's platform. The discount limitation therefore is highly capable of being manipulated as it relates to the average price of 15 individual trades; the lack of liquidity in trading of many smaller companies' shares exacerbates the potential for manipulation and dilution.

The proposal is also flawed in its intended application to a group of companies with a market capitalisation of less than $300 million identified and disclosed by ASX in May and November of each year. ASX is likely to come under considerable pressure from entities just above the cut-off point at the time they are holding a general meeting to grant waivers to permit them to seek a placement mandate and the static nature of the 'approved' list means that companies that suffer a substantial decline in their share price and who fall under the $300 million limit between May and November will not be eligible for the mandate.

In general the application of the proposal to all entities below a market capitalisation of $300 million is flawed given the general intent of the proposal appears to be aimed at assisting small, Perth based, resources companies with potentially substantial capital needs to raise additional equity capital. The proposed category includes many stable operating companies with minimal need for urgent additional capital. It is not clear why ASX has

[11] Berkeley Resources Limited, 'Board changes and share placement', ASX announcement, 26 April 2012.

[12] Stratford Sun Limited v OM Holdings Limited [2011] FCA 1275

chosen to adopt such a general group when it appears the proposal is designed to accommodate those entities subject to the JORC Code which are also required to file quarterly cash flow statements under ASX Listing Rule 4.

If the ASX proposes to proceed with the placement mandate – which OM opposes – it should be amended as follows in order to protect the property rights of shareholders:

- Approval of the mandate should be required by special resolution with related parties and shareholders with board representation prohibited from voting.
- The placement mandate should be available to a narrower group, such as those entities required to file quarterly cash flow statements and who are subject to Chapter 5 of the ASX Listing Rules (or entities with a much lower market capitalisation, say $100 million – the figure on which the ASX 2007 proposal and the 2005 consultations were based).
- The market price used to determine the maximum permissible discount should be better defined.

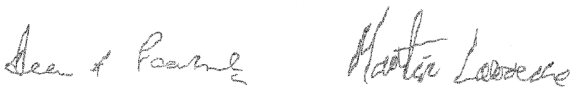
OM notes the proposed new form of Appendix 3B which would require placement mandate companies to disclose their remaining placement capacity under Listing Rule 7.1 and proposed new rule 7.1A should also be extended to apply to all companies so shareholders are able, whenever new capital is issued, to determine the potential dilution risk at that point in time under ASX Listing Rule 7.1.

In summary:

- OM opposes the proposed placement mandate under Listing Rule 7.1A.
- The proposal reduces shareholders' property rights and there is insufficient evidence presented as to why it is required.
- The proposal has the potential to interfere with the market for corporate control.

OM does not accept that the needs of investors, the ultimate owners of listed companies, are best served by reducing their capacity to protect themselves from dilution or changes of control that benefit insiders and intermediaries. A company that chooses to list on ASX in order to obtain investor capital does so with the knowledge that this access to capital entails certain limits which primarily exist to enable shareholders to protect their property.

Yours sincerely,



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Ownership Matters Pty Ltd

CC: Belinda Gibson, Australian Securities & Investments Commission

CC: Bernie Ripoll MP, Parliamentary Secretary to the Treasurer