Reverse Takeovers

Consultation on Shareholder Approval Requirements for Listed Company Mergers

CONSULTATION PAPER 10 NOVEMBER 2015

ASX

Invitation to comment

ASX is seeking submissions on Reverse Takeovers - Shareholder Approval Requirements for Listed Company Mergers by 17 December 2015. Submissions should be sent to:

E regulatorypolicy@asx.com.au

Office of General Counsel ASX Limited 20 Bridge Street Sydney NSW 2000

Attention: Gary Hobourn

ASX prefers to receive submissions in electronic form. Submissions not marked as 'confidential' will be made publicly available on ASX's website.

If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly in your submission.

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1. Introduction

1.1. Overview

The term "reverse takeover' refers to a takeover where a bidder acquires a larger target company offering its shares as consideration. This typically results in the target's shareholders between them acquiring majority ownership of the bidder, the reverse of what would ordinarily happen in a "standard" takeover, where the bidder and its shareholders acquire majority ownership of the target.

Under the current regulatory framework in Australia, neither the Corporations Act nor the ASX listing rules require bidder shareholder approval for a reverse takeover[1]. In particular, the ASX listing rules contain specific exceptions from the general listing rule 7.1 restriction on issues of shares in excess of 15% without shareholder approval for shares issued as consideration for a takeover or scheme regardless of the size of the issue.

ASX has received representations from some investor and corporate governance groups that there is a gap in the regulatory framework for reverse takeovers in Australia. This relates to the fact that in a reverse takeover, the bidder shareholders do not have a say in whether the transaction proceeds, even though they are effectively in the position of "target" shareholders. By contrast, the target shareholders do have a say through their right to accept or reject the offer (in the case of an off-market takeover offer) or to vote on the scheme proposal (in the case of a scheme of arrangement), even though they are effectively in the position of "bidder" shareholders.

For example, concerns were expressed about the lack of bidder shareholder approval for reverse takeovers in connection with the 2014 scrip offer by Roc Oil for the larger listed Horizon Oil[2]. Similar concerns were expressed around the proposed reverse takeover of Gloucester Coal by Whitehaven Resources in 2009[3]. More recently, however, the bid by Federation Centres for Novion, which resulted in the target shareholders owning approximately 64% of Federation Centres, proceeded without adverse commentary.

Differing views have been expressed to ASX on the regulatory framework for reverse takeovers including:

- shareholders should have a say in matters that will significantly dilute their ownership interests or otherwise transform the nature of the entity in which they are owners
- the ASX listing rules are out of line with other international exchanges (including London, New York, Hong Kong, Singapore and Toronto) which require shareholder approval for such transactions
- reverse takeovers are a long accepted form of control transaction in Australia and no regulatory reform is required.

[1] This assumes there are no extenuating circumstances which would result in a need for approvals under other provisions of the Corporations Act or the ASX Listing Rules such as related party transactions.
[2] This transaction would have resulted in the target's (Horizon) shareholders owning nearly 60% of the bidder (Roc Oil).
[3] This transaction would have resulted in the target's (Whitehaven) shareholders owning nearly 67% of the bidder (Gloucester Coal).

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Given these widely differing views, ASX is seeking feedback from stakeholders (including investors, issuers, corporate advisers and industry representative and advisory bodies) about the issues raised by these types of transactions.

This paper outlines:

- the current regulatory framework for reverse takeovers
- a consultation option for potential amendments to the ASX listing rules which would impose a shareholder approval requirement under listing rule 7.1 where the bidder issues shares in excess of 100% of its existing share capital as consideration for an acquisition by way of takeover or scheme
- some of the implications for reverse takeovers in the event of a change to the regulatory framework.

ASX is outlining its consultation option to facilitate discussion with stakeholders. ASX will take into account feedback in determining whether any amendments to the listing rules are warranted. ASX expects that there is likely to be a significant divergence of views amongst stakeholders in relation to this issue. Recognising this, ASX considers that any proposed changes to the regulatory framework must strike an appropriate balance between:

- any regulatory benefits (in terms of investor protections) relative to the size and nature of the perceived problem and any additional costs or market inefficiencies that may arise as a result of any change
- ensuring listed companies can continue to compete effectively in the market for corporate control
- not unduly interfering with the role of the Board as the primary decision maker in relation to corporate activity.

ASX has also engaged with, and will continue to engage with, ASIC and the Takeovers Panel in relation to the regulatory framework for reverse takeovers. ASIC supports this consultation process.

1.2. Next steps

ASX requests interested stakeholders to submit written responses to this consultation paper by 17 December 2015. ASX has posed a number of questions for consultation as set out in Annexure A. ASX prefers to receive written responses in the tabular form set out in Annexure A in pdf or word format.

ASX would welcome the opportunity to discuss this consultation paper with interested parties. Please contact Ms Janine Ryan (Janine.ryan@asx.com.au) if you would like discuss this matter.

ASX will consider the feedback received in determining whether there is a case for amendments to the listing rules in relation to reverse takeovers. ASX will publish a response to consultation. If the outcome of the consultation process is to pursue changes to the listing rules, an exposure draft will be released for public comment.

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2. Current regulatory framework for reverse takeovers

2.1. Summary

Takeovers and schemes of arrangements in Australia are governed by the Corporations Act and, where the bidder or target is listed, the ASX listing rules.

Neither the Corporations Act nor the ASX listing rules generally require bidder shareholder approval for reverse takeovers[4].

Further detail of the regulatory framework for takeovers and schemes in Australia as it applies to reverse takeovers is set out below.

2.2. Corporations Act

The Corporations Act contains the primary obligations in relation to the conduct of takeover bids and schemes of arrangement in Australia. Takeover bids are governed by Chapter 6 of the Corporations Act and schemes of arrangement are governed by section 411. These provisions are primarily focussed on the impact of takeovers and schemes on control of an entity, rather than dilution of existing shareholders, and as such do not generally require a bidder to obtain shareholder approval to offer its shares as the consideration under a takeover or scheme of arrangement, regardless of the number of shares issued. This is consistent with the Corporations Act generally, which does not impose restrictions on issues of securities other than in limited circumstances.

2.3. Listing Rules

The ASX listing rules regulate the circumstances in which share issues by listed entities require shareholder approval. Listing rule 7.1 requires shareholder approval for issues of securities in excess of 15% of an entity's existing capital over a 12 month period unless an exception applies.

ASX listing rule 7.2, exception 5 provides an exception from this requirement for securities issued under an off-market bid or scheme of arrangement under the Corporations Act. Therefore, shareholder approval is not required under the Listing Rules for a bidder who issues securities as consideration for an acquisition under a takeover bid or scheme of arrangement regardless of the number of shares issued. ASX listing rule 7.2, exception 6 provides a further exception for an issue of securities to fund the cash consideration for a takeover or scheme of arrangement if the terms of the issue are disclosed in the merger documents. The policy underlying these exceptions is that the imposition of a requirement for shareholder approval would put a listed bidder at a significant disadvantage to a non-listed bidder in a contested takeover situation.

ASX listing rule 11.1 gives ASX discretion to require shareholder approval if an entity proposes to make a "significant change" to the "nature or scale" of its activities. Guidance Note 12[5] notes that this listing rule was

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[4] This assumes there are no extenuating circumstances which would result in a need for approvals under other provisions of the Corporations Act or the ASX Listing Rules such as related party transactions.
[5] http://www.asx.com.au/documents/rules/gn12_changes_to_activities.pdf

originally inserted primarily to regulate “back door listings”. ASX does not treat a transaction between two listed entities as a back door listing and while it can exercise its discretion in other circumstances, it is generally reluctant to do so unless there are clear and compelling policy reasons to justify that course of action. As such, listing rule 11.1 would not generally apply to a reverse takeover between two listed entities. The Guidance Note sets out the considerations reflected in this policy position which primarily relate to:

- the general corporate law principle that responsibility and authority to manage the business of an entity and make decisions on its behalf rests with the directors other than in respect of matters reserved to the shareholders under the constitution, the Corporations Act and the listing rules
- the additional transaction costs, delays and uncertainties that may arise and which, in some cases, may threaten the transaction’s viability or success.

2.4. Discretionary powers of the Takeovers Panel and ASIC

The Takeovers Panel and ASIC have certain discretionary powers in relation to takeovers generally, including reverse takeovers. Under the Corporations Act, these discretionary powers are primarily focussed on issues relating to control of an entity rather than dilution of existing shareholders.

Takeovers Panel

Section 657A of the Act enables the Takeovers Panel to make a declaration of unacceptable circumstances in relation to a transaction having regard, among other things, to effect of the transaction on control of a company or to the principles set out in section 602.

Under these provisions, the Takeovers Panel would have jurisdiction to make a declaration in relation to a reverse takeover (including where it is being undertaken by a scheme of arrangement) if it gave rise to unacceptable circumstances.

The Takeovers Panel has only considered whether a reverse takeover gives rise to unacceptable circumstances once, in relation to the Gloucester Coal/Whitehaven transaction in 2009.

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Case study: Gloucester Coal and Whitehaven

Gloucester Coal and Whitehaven were ASX listed companies. In February 2009, they announced that they had agreed to merge. The merger was to be implemented by the smaller Gloucester Coal making a takeover bid to acquire all the shares in the larger Whitehaven in consideration for shares in Gloucester Coal. If successful, Whitehaven shareholders would have held approximately 67% of the shares in Gloucester Coal after the takeover.

Noble Group owned or controlled approximately 21.7% of the Gloucester Coal shares. As a result of the transaction being structured as a bid by Gloucester Coal for Whitehaven, Noble Group did not have a right to vote on the proposal.

Noble Group applied to the Panel for a declaration of unacceptable circumstances. The Initial Panel in the Gloucester Coal case made a declaration of unacceptable circumstances and ordered Gloucester to obtain shareholder approval for the merger on the basis that its existing shareholders were being denied the ability to consider very significant changes in control of the company and the opportunity to consider an alternative proposal by Noble Group. This decision was based on the Whitehaven directors and their associates holding approximately 74% of the shares in Whitehaven and that they would hold approximately 51% of the total shares in Gloucester after the merger.

Gloucester and Whitehaven sought a review of that decision. The Review Panel found, based on different information in relation to the shareholdings in Whitehaven, that the post-merger shareholdings did not result in a change in control or an effect on control that was of a sufficient nature or scale to give rise to unacceptable circumstances. Accordingly, the Review Panel found that Gloucester shareholder approval was not required. The Review Panel considered that neither the potential for two shareholdings above 20% in Gloucester Coal or the dilution of Noble Group's existing 21.7% holding in the company to 7% gave rise to unacceptable circumstances in that particular case. Implicitly, the fact that unassociated Whitehaven shareholders would hold approximately 67% of Gloucester Coal of itself was also insufficient to warrant a declaration of unacceptable circumstances.

The Review Panel did, however, form the view that the restrictive arrangements entered into between Gloucester Coal and Whitehaven gave rise to unacceptable circumstances because directors were excluded from considering a superior proposal and this fetter on their discretion was inconsistent with their fiduciary obligations.

Following the final Gloucester Coal decision, the Takeovers Panel consulted on whether the market required specific guidance in relation to reverse takeovers. The Panel subsequently issued a revised Guidance Note 1[6] which noted the following on reverse takeovers:

- a change of control, or a material effect on control, by an issue of shares as consideration for a bid, that either disenfranchises shareholders or does not meet the policy of Chapter 6 (even if it strictly it satisfies item 4 of section 611) may give rise to unacceptable circumstances
- a reverse takeover may also offend the principles in sections 602(a) and (c). It may "lock up" the bidder and adversely affect competition. The Panel takes into account whether the transaction is subject to the approval of bidder shareholders and/or is subject to a condition that allows a superior proposal to be considered by those shareholders.

ASIC

ASIC Regulatory Guide 60 (Schemes of Arrangement) sets out ASIC's view in relation to reverse takeovers undertaken by way of a scheme of arrangement. This guidance [7] was also revised after the Gloucester Coal decision. In the new guidance, ASIC noted that "a scheme results in a reverse takeover if:

a) consideration for the members of the company proposing the scheme (the target company) is shares in the offeror company; and

b) the scheme results in a change in control of the offeror company or has a material effect on control of the offeror company."

ASIC further noted that:

> "We encourage any person proposing a scheme that will result in a member in the scheme company obtaining voting power in the offeror company of more than 20% to consult with us very early in the planning stage. We will consider such schemes on a case-by-case basis to determine if they result in a change in control of the offeror company, or have a material effect on control of the offeror company and therefore whether they result in a reverse takeover. We will monitor this area and, if it becomes necessary, will consider providing further guidance in the future."

Based on current guidance, dilution of existing bidder shareholders through a reverse takeover may not of itself trigger a requirement for shareholder approval unless there is a broader change in, or material effect on control. This position is driven by the Corporations Act's focus on acquisition of control rather than dilution of existing shareholders. However, the Takeovers Panel has left the door open to require shareholder approval for reverse takeovers if the particular circumstances give rise to unacceptable circumstances.

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[6] http://www.takeovers.gov.au/content/Guidance_Notes/Current/downloads/GN01_2010.pdf
[7] http://download.asic.gov.au/media/1239045/rg60-published-22-september-2011.pdf

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2.5. International comparison

A high level summary of the shareholder approval requirements imposed on bidders for scrip for scrip acquisitions by major international exchanges is set out in Annexure A. In summary, a number of international exchanges (including LSE, TSX, SGX and HKex) impose shareholder approval requirements on bidders for scrip-based acquisitions that result in dilution of greater than 20% -30%.

This analysis does not consider how other aspects of the local regulatory framework (including securities regulation and timing and disclosure requirements for shareholders) may impact on such transactions, either directly or in concert with the relevant listing rules.

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3. Potential options

ASX has considered a number of potential options in response to the requests for ASX to consider this issue including:

- maintain the status quo
- require shareholder approval of scrip takeovers and schemes based on the level of dilution
- require shareholder approval for scrip takeovers based on their impact on control or other discretionary criteria.

ASX observes that a case can be made for maintaining the status quo including:

- the limited occurrences when this issue has arisen in the Australian market. As far as ASX is aware, there are, at most, only a few of these types of transactions in any year and most of these are uncontested. There have only been 2 examples in the past 7 years of reverse takeovers where concerns have been raised. In neither of these cases was the transaction successful as a counter-bidder emerged to make a superior offer
- the primacy of the Corporations Act takeover provisions, which permit reverse takeovers without requiring bidder shareholder approval and guidance from the Takeovers Panel and ASIC, the two key regulators of takeovers in Australia, that they will not generally impose a requirement for bidder shareholder approval for reverse takeovers except where there is a change in or material effect on control
- the costs and disadvantages to bidders who must obtain shareholder approval relative to others as discussed further below.

ASX would appreciate feedback from stakeholders on their view about the nature and extent of the problem and whether it warrants consideration of changes to the listing rules.

For the purpose of this consultation, if the feedback received is that a problem exists and there is sufficient impetus for regulatory reform, for the reasons set out below, ASX is outlining a consultation proposal based on dilution which would require a bidder to seek shareholder approval where there is scrip for scrip offer and the issue of new securities exceeds 100% of the bidder's existing share capital. This policy change would be achieved by an additional carve-out from listing rule 7.2, exception 5 where the securities to be issued to target shareholders exceed 100% of existing capital. For consistency, ASX considers that an equivalent carve-out should also be applied to listing rule 7.2, exception 6, which provides an exception for issues of securities to fund cash consideration for takeovers and schemes[8].

As with existing listing rule 7.1 approvals, approval would be by majority vote of bidder shareholders. ASX would appreciate feedback on whether changes to existing voting exclusions or disclosure requirements for listing rule 7.1 approvals should be made.

ASX considers that this option represents the best balance between the interests of the entities involved and their shareholders.

[8] This would not prohibit rights issues to fund the cash consideration for an acquisition which fall within the exception in listing rule 7.1, exception 1.

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In formulating this proposal for consultation, ASX has taken into a number of factors including:

- **the nature of the perceived regulatory gap that ASX has been asked to consider** – the consultation proposal addresses the main concern expressed by investor and corporate governance groups in relation to reverse scrip takeovers of smaller companies by larger companies (i.e. that they are being significantly diluted, with the result that the bidder becomes majority owned by the target's shareholders). Preliminary informal soundings with corporate governance groups have been broadly supportive of a shareholder approval requirement where securities issued as consideration would exceed 100% of existing capital. While some other international exchanges impose a lower threshold at which shareholder approval is required, ASX has not identified any significant momentum for a broader change in shareholder approval requirements for acquisitions that result in a lower level of dilution. ASX also observes that while a small number of reverse takeovers in the ASX market have attracted adverse comment, reverse takeovers are relatively uncommon and are often supported by shareholders.
- **the regulation of public company takeovers and schemes** – control transactions in Australia are primarily governed by the Corporations Act. Issues relating to the impact of a transaction on control of the bidder are, and in ASX's view should continue to be, determined in accordance with the Corporations Act under the supervision of ASIC and the Takeovers Panel. ASX does not consider it appropriate for the ASX listing rules to override the specific legislative intent reflected in the Corporations Act provisions relating to takeovers and schemes, which do not require bidder shareholder approval for scrip bids.
- **the rationale for reverse takeovers** - ASX notes that there may be valid reasons for implementing reverse takeovers including avoiding triggering change of control, pre-emptive rights or similar provisions in relation to key assets of the bidder and avoiding adverse taxation implications. Commentators have noted that, even where a reverse takeover may be structured to circumvent a blocking stake (generally a significant but non-controlling stake), the interests of the holder of the blocking stake should not automatically prevail over the interests of the broader group of shareholders in the entity in encouraging transactions that may create shareholder value.
- **minimising any potential negative impact on competition in the market for corporate control** – it is imperative that Australian listed companies can continue to compete effectively in the increasingly globalised market for corporate control. The prospects of a successful bid in a competitive environment may be adversely affected by the significant time, complications and uncertainty introduced by a requirement for bidder shareholder approval. Those bidders who may have a competitive advantage include foreign or other private bidders who are not subject to shareholder approval, larger companies, mature companies with cash reserves or the ability to access debt or bridge financing, and financial players (including private equity funds) who can provide cash consideration. The requirement for shareholder approval may also affect the flexibility of a bidder to revise deal terms in the context of a competitive bid, placing them at a strategic disadvantage. Conversely, commentators have noted that foreign bidders who are subject to shareholder approval requirements have been able to compete successfully in the market for corporate control in Australia and so a shareholder approval requirement of itself would not necessarily prevent such transactions proceeding.

  Small to mid-cap companies and the resources sector, each of which form a significant part of the ASX market, may be disproportionately affected. For example, resources companies accounted for the majority of reverse takeovers that occurred in recent years. These companies tend to engage in significant acquisitions relative to their size and often have limited access to cash flow, debt funding and private placements, particularly in the early stages of their life cycle. This was recognised with the increase in placement capacity to 25% for small to mid-cap companies in 2012. The flexibility of, and other innovations in, Australia's capital raising regime made Australia one of the most effective capital markets in the world during the GFC relative to other jurisdictions with more restrictive requirements. This flexibility is important given the range of companies listed on ASX and supports the adoption of a more flexible approach to reverse takeovers than may apply in other jurisdictions.

- **ensuring the benefits of the proposal outweigh the increased costs** - the imposition of shareholder approval requirements is likely to lead to an increase in direct and indirect costs of undertaking acquisitions. Some of the potential additional costs that have been identified include costs of preparing and holding shareholder meetings, potential demand for higher consideration to reflect greater deal uncertainty and reverse break fees or other deal protection measures to reflect greater deal risk. In addition, in some cases, shareholder approval requirements may result in deals not being undertaken at all, with the consequential impact on shareholder value. Deals may also be restructured in a manner that may be less efficient for shareholders (including greater reliance on cash or debt financing or use of expensive bridge financing).

- **preserving the primary role of the board in decision making whilst protecting the rights of shareholder** – under Australian corporate law, the board is vested with the authority to manage the company (other than in respect of the limited matters specifically reserved to shareholders). The directors also have statutory and common law duties to act in the best interests of the company. Shareholder's rights with respect to decisions made by the board include their right to appoint and remove directors and to pursue remedies such as breach of directors' duties.

  ASX considers that the role of the board as primary decision maker is fundamental to the efficient management of public companies and should not be lightly undermined.

  It has also been noted that security holders do not have access to the same information as the board, are not bound by statutory or common law duties and may have divergent interests which are not necessarily consistent with the best interests of the company. This may be particularly relevant where there is a substantial shareholder of the bidder who is opposed to the reverse takeover for reasons unconnected with the best interests of other shareholders.

- **providing certainty to the market in relation to when listing rule approval is required for a reverse takeover -** the proposal provides a bright-line test which provides certainty for the market on the circumstances in which shareholder approval under the Listing Rules would be required. This will assist issuers and their advisers in structuring transactions. ASX notes that reverse takeovers would remain subject to the discretionary powers of the Takeovers Panel and ASIC in relation to the impact of reverse takeovers on control of the bidder.

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Annexure A – Questions for consultation

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

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Question
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?
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?
8. 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?
9. Are there any other consequential amendments to the listing rules which would be required?
10. 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?
11. Are there any additional considerations which should be taken into account?

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Annexure B – International comparison of shareholder approval requirements for scrip issues

Jurisdiction/exchange	% at which approval required
AIM	N/A
Canada - TSX	25%
HKEx	25%
JSE	30%
Nasdaq	20%
New Zealand	N/A
Singapore -SGX	20%
UK – LSE (premium listing)	25%
US-NYSE	20%

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