



18 July 2005

To: Public for consultation
SUBJECT: Panel's policy on rights issues

Overview

1. Over the last two years, more than 10 matters have come before the Panel challenging the acceptability of rights issues which had an effect, or potential effect, on control of a company.¹ All of these rights issues have sought to rely on the exceptions in item 10 or item 13 of section 611 of the Corporations Act 2001 (**Act**) from the 20% takeovers threshold in section 606(1) of the Act.
2. The exceptions in item 10 and item 13 of section 611 are two of the gateways through the takeovers regulation of Chapter 6. The applications which have come to the Panel are representative of long standing concerns that these exceptions may be open to abuse. Since the days of the NCSC and the Companies Code, regulators and the market have been concerned about the potential for rights issues being structured and used as a way of effecting a control change without having to comply with the provisions which would normally regulate control transactions.
3. In some cases which have come before the Panel, it has found that rights issues which fell within the exceptions in item 10 or item 13 constituted unacceptable circumstances. A very wide range of issues have been raised as possibly contributing to the rights issues constituting unacceptable circumstances.
4. The Panel is concerned to ensure that any guidance it publishes does not interfere inappropriately with the very large number of rights issues which companies conduct which have very little potential effect on control. Similarly, the Panel does not wish to harm the shareholders of small cap companies for whom rights issues, often with potentially significant control effects, may be essential elements of their funding and survival, by eliminating rights issues from the capital management tools of their directors.
5. This Issues Paper sets out, and seeks public comment on, the underlying principles which it is proposed will form the foundation of a guidance note regarding when the Panel is likely to consider that a rights issue which has an effect on control of a company constitutes unacceptable circumstances.

¹ The propositions in this Issues Paper are intended to apply equally to rights issues undertaken by managed investment schemes. In such instances references to shares include interests and references to shareholders include interest holders.

6. In this Issues Paper, unless the context otherwise requires:
- (a) references to effects on, or increases in, control of a company should be taken to be references to acquisitions of shares which would increase a person's voting power above 20%, or increase the voting power of a person whose voting power is more than 20% (but less than 90%);
 - (b) references to companies should be taken to be references to listed companies, unlisted companies with more than 50 shareholders and listed managed investment schemes; and
 - (c) references to sections should be taken to be references to section of the Corporations Act (*Cth*) 2001.

Timetable/Process

7. The body of this Issue Paper comprises a series of propositions, followed by questions relating to those propositions.
8. Submissions are sought in response to the propositions and the questions by 5.00 pm on Friday, 30 September 2005.
9. Please send submissions to the Panel, attention Jason Lang (Tel: (03) 9655 3560; Email: jason.lang@takeovers.gov.au), Nigel Morris (Tel: (03) 9655 3501; Email: nigel.morris@takeovers.gov.au) and George Durbridge (Tel: (03) 9655 3553; Email: george.durbridge@takeovers.gov.au).
10. **The propositions outlined in this Issues Paper do not represent settled Panel policy.** The questions are intended merely to be prompts for discussion and are not exhaustive of the issues that the propositions may raise. You should feel free to address only selected questions, make general submissions that address an issue as a whole rather than the individual questions, or raise other issues that you consider relevant to the Panel in formulating a guidance note in regard to unacceptable circumstances in the context of control effects of rights issues.
11. Following receipt of public submissions in regard to this Issues Paper, the Panel will prepare a draft Guidance Note based on the propositions contained in this paper and considering the submissions received. The draft Guidance Note will be circulated for public comment before being finalised and released. It is Panel policy to review Guidance Notes periodically after they have been issued.
12. The Panel's policy is that all submissions received may be posted on the Panel's website, or otherwise made public, unless the person making the submissions specifically requests that they be confidential.

Background

13. A "rights issue" is an issue of new shares to existing shareholders² of a company in proportion to their existing holdings. A rights issue is offered to all

² Certain shareholders with overseas addresses may be excluded: section 615.

existing shareholders individually and may be rejected, accepted in full or (in a typical rights issue) accepted in part by each shareholder. Rights issues may be renounceable or non-renounceable. In a renounceable rights issue the rights can be traded if there is a market for them (renounceability is discussed in more detail below).

14. Rights issues are frequently underwritten. The role of the underwriter is to guarantee that the funds sought by the company will be raised. The agreement between the underwriter and the company is set out in a formal underwriting agreement. Typical terms of an underwriting require the underwriter to subscribe for any shares offered but not taken up by shareholders. The underwriting agreement will normally enable the underwriter to terminate its obligations in defined circumstances. A sub-underwriter in turn underwrites the obligations of the main underwriter; the underwriter passes its risk to the sub-underwriter by requiring the sub-underwriter to subscribe for or purchase a portion of the shares for which the underwriter is obliged to subscribe in the event of a shortfall. Underwriters and sub-underwriters may be financial institutions, stock-brokers, major shareholders of the company or other related or unrelated parties. The Panel's guidance will cover both non-underwritten and underwritten rights issues.
15. A rights issue may result in a shareholder³ or underwriter acquiring or increasing control in the company.
16. Section 611, item 10 provides an exception from the prohibition in section 606 on persons acquiring control of a company for persons who would otherwise breach that prohibition as a result of participating in a rights issue. Item 10 excepts:

An acquisition that results from an issue of securities that satisfies all of the following conditions:

- (a) a company offers to issue securities in a particular class;*
- (b) offers are made to every person who holds securities in that class to issue them with the percentage of the securities to be issued that is the same as the percentage of the securities in that class that they hold before the issue;*
- (c) all of those persons have a reasonable opportunity to accept the offers made to them;*
- (d) agreements to issue are not entered into until a specified time for acceptances of offers has closed;*
- (e) the terms of all the offers are the same.*

³ A shareholder who subscribes for shares under the rights issue may increase its voting power if the issue is not fully subscribed for and it is not fully underwritten, or where that shareholder is also an underwriter or sub-underwriter.

This extends to an acquisition by a person as underwriter to the issue or sub-underwriter.

17. For underwriters of rights issues, item 13 of section 611 provides an additional and similar exception where the rights issue is offered under a prospectus. Item 13 excepts:

An acquisition that results from an issue under a disclosure document of securities in the company in which the acquisition is made if:

- (a) the issue is to a person as underwriter to the issue or sub-underwriter; and*
- (b) the disclosure document disclosed the effect that the acquisition would have on the person's voting power in the company.*

18. By relying on these exceptions, shareholders who subscribe for shares under a non-underwritten rights issue and a person who subscribes for shares as underwriter or sub-underwriter to the rights issue, may acquire voting power beyond the takeover threshold and may therefore acquire, or consolidate, control of a company without breaching section 606.
19. The propositions set out in the remainder of this Paper represent the Panel's preliminary views on what factors the Panel should take into account in deciding whether the circumstances surrounding a rights issue are likely to constitute unacceptable circumstances. The Panel seeks comments on its preliminary views as well as on the questions which it is specifically asking.
20. For the purposes of these propositions and questions, it is assumed that the relevant company has undertaken a rights issue which is capable of leading to an effect on control of the company, item 10 or item 13 of section 611 is sought to be relied on, and a party with an interest has sought a declaration of unacceptable circumstances from the Panel.

Central proposition - presumption in favour of acceptability

21. The Panel commences from the following propositions:
- (a) companies are entitled to manage their capital in a range of ways; most rights issues will not have any control issues;
 - (b) the fact that control of a company is affected by a rights issue does not of itself constitute unacceptable circumstances;
 - (c) informed, rational shareholders who have reasonable and equal opportunities to participate in any benefits which flow from a rights issue may choose not to participate in a rights issue, with consequent control effects on their company;
 - (d) shareholders who invest in a company do so in the knowledge they may be diluted in the event of non-participation in a capital raising; and
 - (e) where there is a potential for a rights issue to affect control of a company, its directors should carefully consider all available options to mitigate the

control effect of the issue, and consider taking professional advice on these options.

22. The Panel does not wish to narrow inappropriately the scope of an exception inserted by the legislature. Therefore, if a rights issue is structured so as to fall within the exceptions in item 10 or item 13 of section 611 of the Act, there will be a rebuttable presumption that it is not unacceptable.
23. However, where the circumstances and terms of a rights issue suggest that the rights issue may affect control of the company in an unacceptable manner, the Panel may declare unacceptable circumstances to exist. The Panel's guidance will indicate those factors which are likely to increase the risk of scrutiny of a rights issue and which may tend to move the onus of proof onto the proponents of the rights issue. What follows is a discussion of those factors which may incline the Panel to declare that a rights issue constitutes unacceptable circumstances where it technically comes within the exemptions in item 10 or item 13 of section 611.
24. The Panel decision in *InvestorInfo* [2004] ATP 06 sets out a list of factors and circumstances surrounding a rights issue which may be relevant to the determination whether the structure of a rights issue created unacceptable circumstances. That list is set out in Annexure A to this Issues Paper. The list was not intended to be exhaustive, the elements on the list were not given any sort of structure, weighting or prioritisation, nor was any element necessarily likely to be relevant to any given rights issue circumstances. In part because of the lack of specification in the *InvestorInfo* list, the Panel wishes to be of more assistance in the guidance that it will provide to the market going forward.
25. The Panel is not primarily concerned with the motive of the company (or underwriter) in undertaking (or underwriting) the rights issue, but with whether the rights issue is likely to affect control of the company more than is reasonably necessary for fundraising purposes. Where, however, the Panel finds (from direct or circumstantial evidence, including the structure of the offer) that the rights issue has been structured for the purpose of affecting control of the company, it will be less ready to accept the company's judgement that a rights issue was an appropriate method of raising the required funds or that aspects of the structure of the issue such as price, timing and renounceability were in fact reasonably necessary for fundraising purposes.
26. Where a rights issue may affect control of the company, the board has a heightened onus to take the steps it reasonably can to minimise the potential for that to occur. A board's failure to do so, and to demonstrate that it has done so, may make the Panel less ready to accept the board's judgement as to the matters set out in paragraph 25 above.
27. It must be noted that the Panel in formulating its guidance is unlikely to identify a single test to determine whether a rights issue will give rise to unacceptable circumstances and this question will always depend to a significant degree on the facts of the matter before the Panel. However, the responses to the issues identified below will enable the Panel to formulate a

Guidance Note setting out its approach as to the circumstances in which there is an *increased risk* of such a declaration.

28. The Panel is concerned to ensure that rights issues are not used to avoid the prohibition in section 606 by abuse of the exceptions in item 10 and item 13 of section 611. Therefore, any steps which a company takes to reduce the likelihood of control being affected by a rights issue will limit the opportunities for complainants to present a case that the rights issue constitutes unacceptable circumstances and therefore reduce the likelihood of scrutiny by the Panel.

Questions on central proposition:

Starting premise

- (a) Are the Panel's starting premises reasonable?
- (b) Is there a general perception, or actual evidence that rights issues are sometimes used in order to effect changes of control?
- (c) Do these perceptions and practices (if they exist) materially reduce the confidence of investors in the Australian market and the efficiency and competitiveness of the market for control of Australian companies?
- (d) Is it possible to set out criteria for what kinds of companies are most at risk of unacceptable rights issues?

Purpose

- (e) Should the underlying "purpose" or "motive" of a company undertaking a rights issue be made more relevant in the Panel's considerations?
- (f) Where the Panel infers from communications or circumstances that a rights issue was undertaken with the intent of effecting a change in control, should the Panel find that unacceptable circumstances exist?
- (g) If a rights issue which appears to be intended to effect a change of control amounts to unacceptable circumstances, is it because such a rights issue detracts from an efficient, competitive and informed market?
- (h) Does the actual outcome of the rights issue (in terms of funds raised from shareholders, effect on control etc) affect the analysis in the previous questions?

Factors bearing upon unacceptability

Need for funding and form of fundraising

29. A rights issue which is brought before the Panel will be liable to a higher level of scrutiny by the Panel and carry an increased risk of a declaration of unacceptable circumstances if:
- (a) it results in no readily discernible benefit to the company;
 - (b) the company has no compelling need for funds; and
 - (c) it leads to an effect on control of the company.

30. The exception from the takeover prohibition in item 10 of section 611 was included as a necessary paring back of the regulation of control transactions to allow a company in need of funding to raise capital by way of a rights issue.
31. The Panel considers that the short time frame within which it is required to conduct proceedings, and the detailed forensic accounting required in many cases, mean it is often not possible to establish definitively the financial need of a company or the board's motives in promoting the issue. Therefore, the Panel considers that it should not normally second guess the judgement of directors based on grounds that appear on their face to be reasonable, that their company requires the funds sought in the rights issue, the raising of those funds will be of benefit to shareholders and that the rights issue was an appropriate mechanism.
32. The Panel proposes that the onus for demonstrating that there is, or was, no need for funds or that a rights issue was not an appropriate mechanism for raising those funds should generally, therefore, fall on the party seeking to challenge the rights issue. However, that onus is likely to shift onto the directors if:
- (a) the directors' assessment of the need for funds or that the rights issue was an appropriate mechanism is not supported by rational reasons (which would include advice received by directors from the company's professional advisers); or
 - (b) there are cogent arguments against the purported purpose which the directors fail to rebut.

Questions on need for funding and form of fundraising:

Need for Funding

- (a) Should the Panel take the need for funding into account when considering whether or not a rights issue constitutes unacceptable circumstances?
- (b) Is the Panel's approach to assessing a company's need for funds appropriate, or does it make it too easy for companies to justify the rights issue, and too hard for complainants to mount a case without access to internal company information?

Form of Fundraising

- (c) Should the Panel consider whether or not other methods of fundraising may have been more appropriate than the rights issue?
- (d) Should the Panel apply the similar onus test to this issue as it does in relation to the need for funding i.e. not override directors' decisions unless clearly wrong or unable to rebut cogent evidence against them?
- (e) What criteria should the Panel use to assess whether or not a rights issue was an appropriate way to raise funds?

Structure of rights issue

33. In undertaking a rights issues, a company and, if the rights issue is underwritten, the underwriter must decide on structural matters, such as the price at which new shares are offered, the number of shares offered and whether the issue will be renounceable. These factors cannot be considered in isolation from each other and the Panel will look at the structure of the rights issue as a whole in deciding whether that structure may give rise to unacceptable circumstances.
34. For example, the desirability of making a rights issue renounceable may depend on the price set for new shares; and the desirability of having a rights issue with a higher discount may depend on whether the rights issue is renounceable. The acceptability of pricing and renounceability may also depend on other factors, such as the liquidity of the relevant shares and whether the underwriter is a related party. In regard to the number of shares issued and the consequent issue ratio, those figures will usually be a function of the amount required to be raised and the issue price determined by the board, in consultation with an underwriter (if any).
35. Therefore, when it looks at the structure of a rights issue the Panel will look at whether the rights issue has been structured, as a whole, to minimise as far as possible any unnecessary effect on a change of control of the company. Set out below is a discussion of the most important structural issues – pricing and renounceability – the Panel will look to in determining whether unacceptable circumstances exist in relation to the structure of the rights issue, and how they relate to each other and other elements of a rights issue.

Pricing

36. The Panel considers that the price at which new shares are offered under a rights issue may be a relevant factor in determining whether the control effects of the rights issue are unnecessary and constitute unacceptable circumstances. However, the impact of the price on the decisions to be made by shareholders whether to take up the rights offer depends on other factors, such as the size of the rights issue compared to the company's existing share capital, whether or not the rights issue is renounceable and the effect on the prospects of the company if the rights issue succeeds.
37. Pricing is a difficult issue and is perhaps more likely than other issues to be dependent on the circumstances of the particular rights issue. The Panel notes that there are potentially both advantages and detriments for shareholders in a rights issue which is highly discounted, and in the same way there are both advantages and detriments for shareholders in a rights issue which is priced more closely to the market price of the securities. The Panel also notes that the requirements of commercial underwriters will materially influence directors' pricing decisions. Therefore the Panel is unlikely to be able to give firm guidance as to what level of pricing directors should choose and will be acceptable or unacceptable. Rather, the Panel will expect directors to consider the issues carefully and choose a level of pricing that they consider most likely

to minimise unnecessary potential effects of the rights issue on control of the company. The discussion which follows expands upon some of the issues for consideration in directors' pricing decisions.

Listed vs unlisted

38. The question of pricing is more easily considered in relation to liquid, listed securities, because there will be a market price against which to compare the issue price for the rights. For unlisted securities, illiquid listed securities and listed securities with a volatile market price, there may not be a readily accessible price comparison.

Low discount

39. It is argued that a rights issue which is priced more closely to the market price of the securities provides less incentive for the rights issue to be taken up by all shareholders and, therefore, may increase the likelihood of control becoming concentrated with an underwriter or other participating major shareholder.⁴ The price may be set at a level which makes the issue attractive only to a shareholder or underwriter who wishes to acquire control.

High discount

40. A rights issue which is offered at a high discount will have the advantage, from a control perspective, of being attractive to shareholders to take up (in order to gain the benefit of the discount) and thus is likely to reduce a shortfall flowing to an underwriter. In a renounceable rights issue an issue at a higher discount is likely to facilitate an active market for the rights, also reducing the control effects of the issue.
41. On the other hand, a rights issue priced at a large discount may involve value being transferred from pre-existing shares to the newly issued shares, and have an adverse effect on shareholders who elect not to participate.
42. The larger the discount the more shares must be issued to raise a given amount of funds (that is, the rights issue ratio increases). Accordingly, in a fully underwritten rights issue, for a given amount to be raised shareholders will be required to pay the same aggregate amount to maintain their voting power irrespective of the price offered. However, shareholders who do not participate, and cannot sell their rights, will face a greater depletion of value the higher the discount offered.
43. Therefore, a higher discount will involve a greater transfer of value to the underwriter if the issue is underwritten and there is a shortfall. If the issue is not underwritten, the transfer of value is from those shareholders who do not take up their rights to those who do.

⁴ In *InvestorInfo* [2004] ATP 06 at paragraph [38(c)], it was stated that the attractiveness of the pricing of the rights issue was a relevant factor because a significant discount to market will indicate that the issuer is seeking to attract shareholders to exercise their rights (in the *InvestorInfo* case the securities were to be listed and the rights issue was renounceable).

44. If the issue is renounceable, a shareholder who does not wish to subscribe may seek to sell their rights and the value of the rights should (at least partially) compensate for the corresponding diminution of value of their existing shares.

Large issue

45. If the amount of funds required by the company to be raised is large in comparison to the value of the company (requiring a very large issue ratio), the price at which new shares are offered will be less relevant. This follows from the fact that the existing assets of the company (which would form the basis of the value of the existing shares, and hence the reference value against which a discount would be measured) will comprise a smaller proportion of the value of the company following the completion of the rights issue. However, a company undertaking such a large rights issue may have a greater hurdle to overcome in demonstrating its need for those funds and may require shareholder approval, for example under the Listing Rules.

Managed investment schemes

46. Managed investment schemes are subject to a requirement to have set out in their constitution “adequate provision for the consideration that is to be paid to acquire an interest in the scheme” (section 601GA(1)). This is effectively a restriction on the discretion of the responsible entity to set an issue price at the time of an issue of interests. ASIC Class Order CO 05/26 provides an exception from this rule, allowing responsible entities to independently set the issue price in certain cases, including a rights issue.
47. However, the rights issue exemption in this instrument does not apply where the underwriter is an associate of the responsible entity (“associates” for this purpose including related bodies corporate of, and persons acting in concert with, the responsible entity). As such, a responsible entity wishing to undertake a rights issue underwritten by a related body corporate may need to apply to ASIC to relief to allow it to set its issue price.

Renounceability

48. A rights issue is “renounceable” if the right of each shareholder to subscribe for their entitlement may be transferred to a third party (who need not be another shareholder). Due to the limited market for rights in unlisted companies, renounceable rights issues are generally only undertaken by listed companies. Acquirers of these rights may subsequently exercise them to acquire shares in the company. On-market trading of rights may occur under a renounceable rights issue if the rights are quoted. The entitlements of shareholders under a non-renounceable rights issue cannot be transferred.
49. Subject to the rights having a value and demand existing for the rights, renounceability should lead to a higher likelihood of the rights being exercised. This in turn would reduce the flow-through to an underwriter of those shares not taken up by the original shareholders. A shortfall facility or similar dispersion facility, such as a back-end bookbuild, may also reduce the flow-

through to the underwriter or sub-underwriters (these are discussed in more detail below).

50. A rights issue which is non-renounceable is likely to limit the pool of potential applicants. This is likely to increase the likelihood of control becoming concentrated with an underwriter or other participating major shareholder and increase the likelihood of the rights issue constituting unacceptable circumstances.
51. In addition, given that there is no relevant exception from section 606 for the buyers of rights who then exercise them, those buyers are less likely to acquire or increase control of the company by buying and exercising renounceable rights, therefore a renounceable rights issue is less likely to constitute unacceptable circumstances.
52. The ability to sell renounceable rights makes it easier for shareholders to access the benefits of a rights issue and assist in ensuring equality and reasonableness of opportunity per section 602(c) of the Act. Where a market for rights is unlikely (for example, because the company is not listed, or the stock is illiquid) or making the rights issue renounceable is unreasonably costly or time consuming,⁵ it may be appropriate for the Panel to consider non-renounceability of a rights issue not to be significant.
53. On the basis of the above issues, the Panel proposes to adopt the position that a rights issue by a listed company which is non-renounceable is likely to carry an increased risk of scrutiny by the Panel where the rights issue leads to an effect on control of the company.

Questions on structure of rights issue:

Pricing

- (a) Is the proposition true that undertaking a rights issue at a small, or no, discount to market price (for listed securities) is likely to discourage shareholder participation and result in more shares going to the underwriter in an underwritten issue or increasing the control of a participating major shareholder in a non underwritten issue, particularly where the securities are illiquid?
- (b) If the above proposition is true, should the Panel provide guidance to the effect that a rights issue with a higher discount is less likely to constitute unacceptable circumstances, and a market value or premium rights issue will receive more scrutiny? Or, in similar vein, should the Panel provide guidance to the effect that a rights issues which affects control should be priced so that the rights have a significant value?

⁵ These arguments were raised in *Stericorp Limited* [2005] ATP 11.

- (c) Is a small discount more likely to discourage existing shareholders taking up their rights in a company whose securities are illiquid? Is this therefore an indicator of greater risk of unacceptable circumstances?
- (d) Based on the discussion outlined above, what factors may be relevant to determining when an issue price for shares contributes to the existence of unacceptable circumstances?
- (e) Should the Panel be less willing to scrutinise the pricing of a rights issue where the issue is underwritten by a professional underwriter, on the basis that the price of such a rights issue is usually determined by the underwriter and such an underwriter is unlikely to be interested in control of the company and will be seeking to minimise the shortfall for which it is obliged to subscribe?
- (f) Should this proposition depend on whether any sub underwriters are related to the company or its shareholders?
- (g) Should the Panel apply guidance which encourages shares to be offered at a discount, in a company which is not listed? If so, should the Panel require such a company to determine the value of its shares and state that value in the prospectus for the rights issue? How should the company determine the price?
- (h) Should the Panel treat high discounts as positive factors (because of their tendency to encourage shareholders to take up their rights and reduce flow through to an underwriter) or negative factors (because of the consequent flow of value from existing shares to the new shares) in assessing rights issues before it? Is the answer different for renounceable and non-renounceable rights issues?
- (i) In the case of listed companies, does making the rights issue renounceable adequately compensate non-participating shareholders for the diminution in the value of their existing shares, by allowing those shareholders to sell their rights on the market? If so, does renounceability remove the potential for high discounts to be problematic in listed companies?
- (j) Should the Panel set indicative figures for discounts it considers acceptable?

Renounceability

- (k) Should the Panel provide guidance to the effect that renounceable rights issues are less likely to constitute unacceptable circumstances and non-renounceable rights issues more likely?
- (l) Or should the Panel make a stronger statement to the effect that where there would be no impediment to a market in rights trading, the Panel would expect the rights issue to be renounceable?
- (m) Or should the Panel say that the onus will be on the directors of a company to explain why the rights issue was not made renounceable?

- (n) Are there good reasons why a company may not wish its rights issue to be renounceable?
- (o) What issues should the Panel accept as reasonable bases for not making a rights issue renounceable:
 - (i) there is unlikely to be a market for rights because the company is not listed;
 - (ii) there is unlikely to be a market for rights because the market for the securities of the company is very illiquid;
 - (iii) making the rights issue renounceable will be unreasonably costly or time consuming;
 - (iv) any other bases?
- (p) How should the Panel deal with unlisted companies whose shareholders will not be able readily to trade their rights?

Underwritten rights issues

54. The second limb of the exception in item 10 of section 611 relates to “*an acquisition by a person as underwriter to the issue or sub-underwriter*”. An underwriter or sub-underwriter to a rights issue may acquire control of the company by relying on this exception. Where a prospectus has been lodged in relation to the rights issue, an underwriter may also rely on the exception in item 13 of section 611. In the case of a fully underwritten rights issue, the only person whose voting power can increase is the underwriter’s.⁶
55. Almost all of the rights issues which have been the subject of complaints to the Panel have involved an underwriter or sub-underwriter, and in most cases, an underwriter who has been related to the company, its directors or a major shareholder.
56. A company may engage a professional underwriter (that is, a person who underwrites in the normal course of their business), or a major shareholder, related party or some other party, to underwrite its rights issue.
57. In general, a professional underwriter seeks to earn fees from underwriting, or profit from the on-sale of shortfall shares, and not to hold shares in the company it has underwritten to control or run that company. The Panel accepts that because of the nature of the risk which underwriters bear, there will be circumstances where underwriters (or sub-underwriters) are required to subscribe for shares pursuant to an underwriting agreement and cannot readily on-sell those shares. Therefore, blanket statements or rules in relation to the acceptability of all underwriting situations are very difficult.

⁶ However, where there is a shortfall facility, applicants under that facility, or where the rights issue is renounceable, purchasers of those rights who exercise their rights, may also increase their voting power.

58. The Panel accepts that for many companies whose nature, size and market following are likely to necessitate rights issues which may have control effects, a related party or major shareholder is likely to be the only realistic source of underwriting. While underwriting by a related party is not, of itself unacceptable, a company using a related party underwriter should recognise that this will likely cause greater scrutiny of the acceptability of the rights issue if control of the company is, or may be, affected and increased risk of a declaration of unacceptable circumstances.
59. The Panel also considers it likely that a professional underwriter is less likely to have any interest in obtaining control of the company. Therefore, the failure by directors to properly canvass professional underwriters, or seek out alternatives to a related party underwriter, may increase the likelihood of a rights issue and associated underwriting constituting unacceptable circumstances.
60. Sub-underwriting may have the same effect as underwriting in regard to control of the company and will receive the same level of scrutiny. On that basis, the concerns raised in relation to underwriters (especially related party underwriters) will also apply to sub-underwriters. Using several non-associated professional sub-underwriters (and hence decreasing the likelihood of control passing to any one of them) is likely to reduce the force of any inference that the rights issue is likely to affect control.
61. Informed approval by non-associated shareholders of the rights issue and underwriting or sub-underwriting by related parties would safeguard any consequent share acquisitions.
62. The Panel notes also the difficulties faced by a managed investment scheme undertaking a rights issue underwritten by a related entity referred to in paragraphs 46 and 47 above.

Questions on underwritten rights issues:

- (a) In setting out guidance as to when a rights issue and associated underwriting will constitute unacceptable circumstances, should the Panel attempt to define what arrangements will and will not constitute underwriting for the purposes of the policy of the item 10 and 13 exceptions?
- (b) Are there consistently applicable criteria as to when the Panel should accept that a related party (for example a company's major shareholder) was effectively the only person likely to provide commercially viable underwriting to a rights issue?
- (c) Given the increased potential for unacceptable circumstances to occur where a related party acts as underwriter for a significant rights issue, should the Panel place the onus onto the company and the underwriter in these circumstances to demonstrate why the arrangement would not constitute unacceptable circumstances?
- (d) What criteria should the Panel consider in deciding whether or not the circumstances are unacceptable?

- (e) Under what circumstances, if any, should it be necessary to avoid circumstances being unacceptable, for shareholder approval for a rights issue:
 - (i) which is underwritten by a person who is a major shareholder or related party?
 - (ii) at a nil or low discount?
 - (iii) where share funding is not essential?
- (f) Are there other transactions (additional to shortfall facilities, discussed below) which cause difficulties in assessing whether an arrangement is an "underwriting"? If so, how should these be dealt with?

Shortfall facilities and other methods of dispersing a shortfall

Effect on dispersing control

63. Recently, companies have adopted a number of strategies to deal with a shortfall in a rights issue rather than require the underwriter to subscribe for the initial shortfall. This may reduce the risk for the underwriter, and thus the fee payable by the company to the underwriter. Relevantly to the Panel's consideration, adopting such a strategy may also reduce the risk of the underwriter, or a major shareholder, acquiring or increasing control of the company. Two of the currently used strategies "shortfall facilities" and "back end book builds" are described below.
64. A "shortfall facility" in the context of a rights issue is a facility which allows shareholders⁷ to subscribe for any shares not taken up by other shareholders under the rights issue. Where the rights issue is underwritten, this participation will usually be in advance of determining the shortfall available to the underwriter.
65. A "back-end bookbuild" is a bookbuild conducted in respect of the shortfall in a rights issue (a "bookbuild" being an offer of securities to investors - typically institutions - for which bids are sought from the investors and the allotments and issue price are determined based on those bids). A back-end bookbuild is another method of dispersing the rights not taken up under a rights issue widely and minimising the chance of the issue having a control effect.
66. A dispersion strategy, such as a shortfall facility or back-end bookbuild, is not a necessary element of a rights issue which seeks to rely on item 10 or item 13. However, given its potential to mitigate the control effects of a rights issue by facilitating take up by shareholders or other investors of any shortfall shares

⁷ In the Panel's experience, shortfall facilities have usually only been offered to existing shareholders of the company, and in some cases only to shareholders who have subscribed for their rights. However, the Panel does not see any particular reason why participation in a shortfall facility could not be offered to persons other than shareholders. The Panel's initial presumption is that acquisitions under a shortfall facility, whether by existing shareholders or other persons, would not attract the benefit of the item 10 exception.

offered under a rights issue (rather than the shortfall flowing through to an underwriter or sub-underwriter), the inclusion of a dispersion strategy may assist in avoiding an inference that may otherwise arise that the rights issue is being undertaken to allow an underwriter or major shareholder to acquire control.

Ability to acquire control by use of a dispersion strategy

67. A question in relation to shortfall facilities which has been put in some Panel proceedings, is whether a person is able to rely on the exception in item 10 or 13 to protect an acquisition under a shortfall facility which would otherwise cause them to breach section 606 – this turns on whether that person can be considered to be an underwriter and thereby rely on the second limb of item 10 or item 13.
68. It is the Panel's view that such a person is *not* an underwriter. An "underwriter" is someone who facilitates the making of a capital raising by contractually committing to the company to subscribe for the shortfall *prior to the offer being made*.
69. As a shortfall facility can only be accepted after the rights issue has been launched and is, therefore, a matter at the option of the shareholders providing the company with no certainty of funding, it does not appear to the Panel that participants could be underwriters. (Note, however, that the item 10 and item 13 exceptions being unavailable does not render shortfall facilities futile – these facilities may still be used to disperse the shortfall among participating shareholders who do not in so doing breach the thresholds in section 606.) The Panel believes its views set out above on whether a person who acquires shares under a shortfall facility can be considered to be an underwriter should apply equally to persons who participate in other kinds of dispersion strategies, such as a back-end bookbuild.

Questions on dispersion strategies:

- (a) Should the Panel assess a dispersion strategy as a mitigating factor in circumstances where the Panel might otherwise be minded to declare that a rights issue constituted unacceptable circumstances, because of its tendency to facilitate the spread of any shortfall away from an underwriter, in assessing whether a rights issue and underwriting arrangements constitute unacceptable circumstances?
- (b) When should the Panel not treat a shortfall facility as mitigating circumstances?
- (c) Should the Panel consider that dispersion strategies are less necessary for small companies, given the expense of putting them in place and the difficulty of finding a suitable market for dispersion?
- (d) Is there an argument that the provision of a dispersion strategy takes the entire rights issue outside the ambit of the exception in item 10 of section 611 in that such a rights issue is then not in proportion to the pre-existing

- holdings? Or should the rights issue itself be considered to be an offer which is separate from the offer comprised by the dispersion strategy?
- (e) What is the appropriate structure of a shortfall facility? Are there types of shortfall facilities which should not be allowed?
 - (f) Is there any way that a dispersal strategy (other than through the underwriter and sub-underwriters) can be structured which would allow acquisitions under it to be protected by of the exception in item 10?
 - (g) What disclosure should (or indeed can) the company make in a rights issue prospectus about the potential control effects on the company of a dispersion strategy?
 - (h) It has been argued that if a person presents an irrevocable application under a shortfall facility immediately after the launch of the offer, then they have contracted with the company to assume the risk that the shares for which they apply under the shortfall facility will not be taken up. On that basis, it is argued, they meet all of the criteria for being considered an underwriter. Is this analysis correct?
 - (i) Should the Panel encourage the use of back-end bookbuilds for rights issues which seek to rely on item 10 of section 611? In what circumstances would such back-end bookbuilds be appropriate, in terms of whether the issue is underwritten, whether the underwriter is a related party, whether the issue is renounceable and any other factors?

Disclosure

70. A rights issue which is undertaken without full and meaningful disclosure of the consequences of any potential effect on control will carry a heightened risk of a declaration of unacceptable circumstances. Without this information, shareholders are unable to make an informed decision whether to invest under the rights issue with a clear understanding of the issuer's business, financial performance, plans and prospects and the effect of the issue on their investment.
71. It is normally ASIC's role to consider whether or not a prospectus provides sufficient disclosure as to the rights and values attached to securities being offered under that prospectus. However, applications to the Panel concerning rights issues have frequently asserted that one or more of the grounds for making a declaration of unacceptable circumstances is that the prospectus has not made adequate disclosure as to the rights and interests attaching to the securities offered under the rights issue prospectus. The Panel considers it appropriate to take into account the adequacy of disclosure in a prospectus in considering whether unacceptable circumstances exist.

Control effects

72. It is important for the reasons behind the choice and roles of any supporting shareholders, underwriters and sub-underwriters to be disclosed to shareholders. If the possible control scenarios can be and are properly

disclosed, including the identities of those who may end up owning any shortfall, and the future shareholding pattern of the issuer is frankly discussed, shareholders will be able to make informed decisions on participating, or not participating, in the rights issue and the potential control consequences.

73. In addition, the intentions for the company of persons who may obtain control of it as a result of the rights issue should also be disclosed, to the extent that the information is able to be ascertained by the company (this should be feasible in relation to underwriters and sub-underwriters but not necessarily in relation to major shareholders whose voting power may increase simply by taking up their entitlement in a non-underwritten offer while other shareholders do not).

Prospectus

74. One of the issues raised by the questions below is whether reliance on the exemption in item 10 of section 611 should require the rights issue to be offered under a prospectus which has been lodged with ASIC.
75. The Panel considers that a company raising capital by way of a rights issue must be conscious of the increased importance of disclosure in circumstances where shareholders are considering not merely the desirability of making a further investment in the company, but also whether to take steps to protect against the dilution of their existing holding. As such, a rights issue undertaken without a lodged disclosure document is highly likely to face increased scrutiny of the disclosure made to shareholders. In such cases the onus is likely to fall onto the company to assure the Panel positively that adequate disclosure has been made. It is likely, also, that the onus will be on the company to rebut assertions that there has been inadequate disclosure.
76. The Panel does not see its role as being a primary regulator of the disclosure content of prospectuses. Therefore the Panel considers that while it may advise what aspects of a rights issue offer document it finds deficient, it might be undesirable and infeasible for it to provide extensive or detailed guidance to a company as to what will constitute complete disclosure once the Panel has found that the disclosure document for the rights issue is deficient. Further, a Panel decision about a disclosure document should not be taken to be an approval of the document in respect of any item of disclosure other than those raised in the application or reasons.

Questions on disclosure:

- (a) Should the Panel decline to entertain any disclosure issues on the basis that the regulation of prospectuses is the domain of ASIC?
- (b) If a company seeks to conduct a rights issue without a disclosure document that has been lodged with ASIC, should the Panel expect the company to be able to demonstrate to the Panel's satisfaction that adequate disclosure has been made?
- (c) Should, instead, the Panel advise that a company undertaking a rights issue must lodge a prospectus where item 10 of section 611 is sought to

be relied on, given the heightened importance of disclosure in a control scenario?

Extent of control effect

77. The size and significance of the effect, or likely effect, of the rights issue on the control of the company may also be a relevant consideration in assessing whether or not a rights issue (and any related arrangements or circumstances) constitutes unacceptable circumstances. While any rights issue which affects control (and which, therefore, must rely on the exemptions in items 10 and 13 of section 611) is within the scope of the proposed guidance, rights issues which cause effective control to pass to a shareholder or an underwriter may receive more scrutiny than those which slightly increase the voting power of an existing controller. For example, the Panel proposes it may be more in the public interest to make a declaration of unacceptable circumstances in relation to a rights issue which may increase a person's voting power from 10% to 40%, than in relation to otherwise similar circumstances in relation to a rights issue which increases a person's voting power from 51% to 55%.

Question on extent of control effect

- (a) Should the Panel adopt this approach, or should it treat both of the types of scenarios discussed above the same?

Additional Question

Are there any further issues that are relevant to the Panel's enquiry as to whether a rights issue may give rise to unacceptable circumstances? (Attached as Annexure A to this issues paper is the list of relevant factors enunciated in the Panel's decision in InvestorInfo [2004] ATP 06.)

Annexure A

List of criteria from *InvestorInfo*

The following is extracted from *InvestorInfo* [2004] ATP 06 at paragraph [38]:

The Panel's Guidance Note 1 "Unacceptable Circumstances" (GN 1)⁸ and ASIC Policy Statement 159 "Takeovers: discretionary powers" (PS 159)⁹ both set out factors that are relevant in assessing whether or not a rights issue (especially if underwritten) and its benefits have been made genuinely accessible to shareholders in general. Some of these factors (and an explanation of their relevance to whether the issue is accessible) are:

- (a) whether the issuing company received advice from securities advisers – if advice from professional financial advisers (for example, investment banks, and other corporate advisers such as stockbrokers and accountants) is received concerning the various means by which funding could be raised and their respective advantages and disadvantages, it becomes clearer why the issuer chose to raise funds by a rights issue and, potentially, for the commercial terms of the rights issue (for example, amount to be raised, price per share and issue ratio);
- (b) whether the issuing company made attempts to find unrelated underwriters and sub-underwriters – this indicates that someone who has no collateral involvement is prepared to take the risk of a shortfall; such a person will seek to reduce that risk by seeking to increase the likelihood of shareholders taking up their rights and by attempting to lay off their risk to other investors through sub-underwriting;
- (c) the attractiveness of the pricing of the rights issue – a significant discount to market will indicate that the issuer is seeking to attract shareholders to exercise their rights;
- (d) whether the rights issue is renounceable – renounceability, especially when combined with an attractive issue price, indicates that the issuer wants the rights exercised and that, given that there is no relevant exception from section 606 for the buyers of rights who then exercise them, that the exercise of rights should have the least effect possible on proportionate interests of existing shareholders;
- (e) market factors during the rights issue – these may incline or disincline shareholders to participate;
- (f) what disclosures are made or not made by the issuing company before and during the rights issue – full and meaningful disclosure ensures that shareholders and other investors have a clear understanding of the

⁸ See [1.25] - [1.27].

⁹ See [159.152] - [159.187].

- issuer's business, financial performance, plans and prospects and the effect on them of the issue and will enable shareholders and investors to make a better informed decision in relation to investing in the issuer;
- (g) the ratio of the rights issue (although we acknowledge that once a company has determined the total amount that needs to be raised, and has settled on a price that will be sufficiently attractive, the ratio offered under the rights issue is a pre-determined result);
 - (h) the financial situation of the company (i.e. whether it has a need or use for the funds in the near term) – this may indicate that a rights issue, particularly one underwritten by a related underwriter, is the only rational means by which necessary funds may be raised;
 - (i) whether there is an adequate explanation of the purpose of the issue and the company's prospects in the disclosure document – by explaining the use of funds in some detail the issuer helps to show that there is a genuine need for the funds and makes the issue more attractive to shareholders by showing a commercial justification rather than just asking investors to trust the directors;
 - (j) whether the underwriter has entered into the underwriting in the ordinary course of its business – as with (b);
 - (k) whether the company has explored other capital-raising alternatives – as with (a);
 - (l) the terms of the underwriting – unusual terms may suggest that the issuer or the underwriter do not expect the shareholders to take up the rights or an intention that control of the issuer pass to the underwriter;
 - (m) the shareholding structure of the company - if a substantial shareholder is close to control and is also involved in the underwriting this may indicate the matters discussed in (l);
 - (n) the response of the substantial shareholders to the rights issue – this may indicate whether there is likely to be a large shortfall with the corresponding effects discussed at [31] to [33];
 - (o) recent variations of the company's capital, such as a buy-back – this can indicate whether there is a genuine need for the funding;¹⁰
 - (p) whether the identities of any sub-underwriters have been disclosed to shareholders – if the likely control scenarios are disclosed, including the identities of those who may end up owning any shortfall, the future shareholding pattern of the issuer is being frankly discussed, which suggests that shareholders are being openly invited into the rights issue;

¹⁰ See *Phosphate Resources Limited* [2003] ATP 03.

- (q) dealings by an underwriter or sub-underwriter in securities or renounceable rights before or during the rights issue – this may suggest an attempt to build up a base from which control may be obtained and evidence that the issue is not genuinely accessible to shareholders; and
- (r) if the underwriter or sub-underwriter is associated with any directors or substantial shareholders and the role of the underwriter (if any) in the making of the offer under the rights issue – as in (a), (b) and (i).

None of these factors is decisive on its own; a decision whether any particular rights issue complies with the policy underlying the Rights Issue Exception and each of the Underwriting Exceptions as they relate to rights issues will depend on assessing each of these factors, as relevant in the particular circumstances, and any other factor which bears on a consideration of whether participation in that rights issue has been made genuinely accessible to shareholders in general, within the limits of the particular company's position and the constraints set by Chapter 6D. That is, the list is not exhaustive, and the importance of the different factors will alter from rights issue to rights issue (even for the same issuer).