

# **Strengthening Australia's equity capital markets**

ASX Listing Rule 7.1A after three years

CONSULTATION PAPER

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### Invitation to comment

ASX is seeking submissions on the matters canvassed in this paper by Monday 9 November 2015

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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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## CONTENTS

<b>Introduction .....</b>	<b>3</b>
<b>Use of rule 7.1A by mid to small caps during the review period .....</b>	<b>4</b>
<b>Investor protection mechanisms under rule 7.1A .....</b>	<b>5</b>
<b>No indications of inappropriate use of rule 7.1A during the review period .....</b>	<b>5</b>
Disclosure requirements .....	5
List of allottees .....	8
Pricing – calculation of 75% floor price on rule 7.1A issues .....	9
Valuation of non-cash consideration .....	10
Existing quoted class .....	11
<b>Are changes required to improve the operation of rule 7.1A? .....</b>	<b>11</b>
Disclosure requirements under rule 7.1A .....	11
Calculation of 75% floor price on rule 7.1A issues .....	13

## Introduction

In 2012, ASX introduced new Listing Rule 7.1A as part of a package of amendments to strengthen Australia's equity capital markets.

Rule 7.1A applies to entities which are not included in the S&P/ASX300 index and which have a market capitalisation equal to or less than \$300 million ("mid to small caps"). It allows these entities to obtain a 12 month shareholder mandate to issue up to 10% of issued capital without further shareholder approval, in addition to the 15% permitted under rule 7.1.

Rule 7.1A recognises the importance of equity placements as a capital raising mechanism for mid to small caps, and provides them with the ability to increase their placement capacity.

At the same time, ASX recognised the need to ensure that the interests of investors in mid to small caps are adequately protected, and introduced a set of requirements to accompany the additional 10% mandate, including:

- Shareholder approval by special resolution at the subsequent annual general meeting;
- Enhanced disclosure requirements;
- A floor on the issue price of 75% of the market price; and
- A 12 month limit on the mandate before it must be refreshed.

ASX has monitored the implementation of rule 7.1A over two annual general meeting cycles from its implementation. During that review period:

- More than \$660 million was raised by mid to small caps in 404 equity issues under rule 7.1A
- Of a total of 1,991 rule 7.1A resolutions put to shareholders by mid to small caps, shareholders approved 94 per cent.

The results indicate that the rule has been well received by mid to small caps and their investors, and has provided valuable assistance to these companies during a period when uncertainty in equity markets made capital raising challenging.

ASX notes the study recently released by CGI Glass Lewis '*ASX Listing Rule 7.1A: Much to dilute about nothing?*' Based on a sample group of 47 companies, the study identifies among other things that companies with a 10% mandate under rule 7.1A are more likely to raise capital in the short term, but "found no evidence that companies were abusing" their mandates, which were used "sparingly". Further information on this study is available at <http://www.glasslewis.com>.

This review by ASX of the operation of rule 7.1A examines whether the rule has had its intended effect, whether there have been any indications of inappropriate use or unintended consequences of the rule, and whether any further amendments are required to improve its operation. The findings indicate that the rule is working as intended but that some refinements could make compliance easier for companies.



## Use of rule 7.1A by mid to small caps during the review period

Period <sup>a</sup>	7.1A resolution approved	7.1A resolution not approved	7.1A resolution withdrawn	Number of 7.1A equity issues	Number of 7.1A issuers <sup>b</sup>	Value of 7.1A equity issues	7.1A issues for non-cash consideration
2012 <sup>a</sup>	588	31	27	193	140	\$265,579,066	0
2013	658	13	12	195	168	\$242,305,779	7
2014	620	31	11	107	96	\$155,124,271	15

<sup>a</sup> Period from the introduction of rule 7.1A on 1 August 2012 to 31 December 2012.

<sup>b</sup> Entities that had a rule 7.1A resolution passed and issued securities under the mandate.

As indicated above, a very high proportion (approximately 94%) of rule 7.1A resolutions put to members were passed, giving the entity a 10% mandate for 12 months. This is notwithstanding the robust hurdle that requires a rule 7.1A resolution to be passed as a special resolution (i.e. by at least 75% of votes cast by members entitled to vote).

The number of placements conducted on the basis of a 7.1A mandate approved by shareholders was fairly consistent over the first two years, before dropping off in the third year as market conditions weakened, particularly for small mining and oil and gas exploration companies. Significant falls in commodity prices saw the S&P/ASX 300 Resources Index fall almost 20 per cent over the year to 30 June 2015.

In each year, the number of placements conducted was a fraction of the number of mandates approved (20-35%). Most companies did not use their mandate to issue securities, and where a mandate was used, the number of issues under the mandate was low (on average around 1.2 issues per issuer over the three year period).

Most placements under a 10% mandate were made for cash, very few issued equity for non-cash consideration (for instance, for the acquisition of an asset, or for services performed). This is discussed further below in the section, *Valuation of non-cash consideration*.

## Investor protection mechanisms under rule 7.1A

ASX developed a rule framework to ensure that appropriate investor protections were in place in relation to rule 7.1A issues. This rules framework includes measures adopted in response to feedback from public consultation. The protections include:

- A requirement that a 10% mandate under rule 7.1A be approved by special resolution of members at the next annual general meeting.
- Enhanced disclosure requirements at the time of: approval of the mandate; issue of any securities under rule 7.1A; and any subsequent approval of a new mandate. Further detail of these disclosure requirements is provided below.
- A requirement that securities issued under rule 7.1A be issued at no less than 75% of the market price of those securities, based on a 15 day volume weighted average price (VWAP).
- A 12 month limit on any mandate before it must be refreshed.

The framework requires a mid to small cap entity with a 10% mandate under rule 7.1A to be clear which rule it is proceeding under whenever it issues securities or agrees to issue securities. This ensures that the entity is able to track its placement capacity under rule 7.1 and rule 7.1A, and that it can demonstrate its compliance with the 75% floor price and additional disclosure requirements applicable to rule 7.1A issues.

## No indications of inappropriate use of rule 7.1A during the review period

The experience of the past two annual general meeting cycles indicates that the regulatory framework for rule 7.1A is generally working well. ASX has not identified any serious or systemic problems in relation to the operation of the rule.

ASX has noted some relatively isolated compliance matters, which are outlined in further detail below. These issues generally appear to have arisen as a consequence of error or misunderstanding of the requirements of the rule, and are considered by ASX to be adequately addressed through corrective disclosure and education. Proposals to facilitate improved compliance with the enhanced disclosure requirements of the rule are put forward below in the section, *Are changes required to improve the operation of rule 7.1A?*

### Disclosure requirements

Mid to small caps are required to meet enhanced disclosure requirements at three stages in a rule 7.1A mandate cycle: at the time of approval of a rule 7.1A mandate, at the time of issue of any securities under rule 7.1A, and at the time of any subsequent approval of a new rule 7.1A mandate.

### *Disclosure at the time of approval of a rule 7.1A mandate*

Under rule 7.3A, disclosure at the time of approval of a rule 7.1A mandate is made in the notice of annual general meeting, which must include statements of:

- The minimum price at which securities may be issued.
- The risk of economic and voting dilution to existing ordinary security holders, including prescribed worked examples of the potential dilution effect.
- The last date that securities may be issued.
- The purposes for which the funds raised will be used, including whether any securities may be issued for non-cash consideration.
- The allocation policy for the issue of securities, including an explanation, in as much detail as is reasonably practicable, of how the entity will decide who to offer securities to.

### *Disclosure at the time of issue of securities under rule 7.1A*

The enhanced disclosure requirements at the time of issue of securities under rule 7.1A include:

- Specific disclosures under rule 3.10.5A.
- The list of allottees and the number of securities issued to each (this information is not for release to the market).
- The valuation of any non-cash consideration.
- Calculation of rule 7.1 and rule 7.1A placement capacity in the form of Annexure 1 to Appendix 3B (this applies to all issues during a rule 7.1A mandate period).

The specific disclosures required under rule 3.10.5A apply in addition to any information about the issue required by rule 3.10, Appendix 3B, and any other applicable rules, and require the mid to small cap entity to release to the market statements of the following in relation to an issue under rule 7.1A:

- The dilution to the existing holders of ordinary securities caused by the issue. This generally involves a statement of the percentage of the issued capital of the entity represented by the securities issued under the placement, and the percentage of the post-placement issued capital held by the pre-placement security holders. If some existing security holders (or a class of them) participated in the placement, the entity will normally disclose an additional breakdown of the percentage interest of participant and non-participant security holders in the post-placement issued capital.
- Where the equity securities are issued for cash consideration, a statement of the reasons why it was decided to conduct the capital raising as a placement under rule 7.1A and not as (or in addition to) a pro rata issue or other type of issue in which existing ordinary security holders would have been eligible to participate.
- Details of any underwriting arrangements, including any fees payable to the underwriter.

- Any other fees or costs incurred in connection with the issue.

If any securities are issued under rule 7.1A for non-cash consideration, the company must also release a valuation of the non-cash consideration that demonstrates that the issue price of the securities complies with the pricing restrictions under the rule (see further below in the section *Valuation of non-cash consideration*).

In addition to these requirements for issues under rule 7.1A., a mid to small cap entity with a 10% mandate under rule 7.1A must complete and release to the market with each Appendix 3B during the period of the mandate, a table setting out the calculations of its placement capacity under rule 7.1 and rule 7.1A. The table is set out in Annexure 1 to Appendix 3B, and must be released to the market with each Appendix 3B during the mandate period, regardless of whether or not the particular Appendix 3B relates to an issue under rule 7.1A.

#### *Disclosure at the time of any subsequent approval of a rule 7.1A mandate*

If the company has previously obtained approval for a 10% mandate under rule 7.1A and seeks another approval under that rule at a subsequent annual general meeting, then in addition to the disclosures outlined above for the notice of annual general meeting, rule 7.3A.6 requires disclosure in the notice of the following information in relation to all issues of equity securities it made during the 12 months prior to the meeting:

- The number and class of equity securities issued.
- The names of the persons to whom the entity issued the securities or the basis on which those persons were determined.
- The price at which the equity securities were issued and the discount (if any) that the issue price represented to closing market price on the date of issue.
- If the issue was for cash: the total cash consideration, the amount of that cash that has been spent, what it was spent on, and what is the intended use for the remaining amount of that cash (if any).
- If the issue was for non-cash consideration: the non-cash consideration that was paid and the current value of that non-cash consideration.

#### *Compliance with the disclosure requirements*

ASX has observed some instances of non-compliance with the above disclosure obligations. Common compliance errors include:

- Late lodgement of the information required under rule 3.10.5A.
- Failure to provide ASX with the list of allottees required under rule 7.1A.4(a).
- Late or non-lodgement of an independent valuation of non-cash consideration.

ASX has received feedback from mid to small caps and other stakeholders that the rule 7.1A disclosure obligations raise compliance difficulties, particularly in view of the number, volume and timing of announcements required.



ASX notes that the rule 7.1A disclosure obligations are substantially in the form released for public consultation in 2012. There were a range of responses in consultation to the proposed requirements. These responses ranged from requests for additional disclosure, through support for the proposals, to opposition to the proposals on the basis that they would be unduly burdensome on listed entities.

ASX remains of the view that, taken overall, the current disclosure obligations for rule 7.1A issues are appropriately targeted to ensure that the interests of investors in mid to small caps are adequately protected. ASX is nonetheless open to proposals that would simplify and reduce the compliance burden on listed entities without removing the current investor protection mechanisms. In view of that (and as further outlined below in the section *Are changes required to improve the operation of rule 7.1A?*):

- ASX is proposing to reduce the compliance burden on mid to small caps and the risk of non-compliance with the requirements, by relocating the current disclosure requirements that apply at the time of issue of securities under rule 7.1A, and placing those requirements in an updated Appendix 3B (which must be released to the market when securities are issued). This will require a rule amendment to update Appendix 3B.
- ASX is considering a proposal to remove or reduce the additional disclosure requirements that apply under rule 7.3A.6 at the time of any subsequent approval of a rule 7.1A mandate.

Comments are invited on the current requirements and the proposals for simplified requirements outlined below.

### List of allottees

As noted above, rule 7.1A.4(a) requires an entity that issues securities under rule 7.1A to give ASX a list of names of the persons to whom the securities were issued and the number of securities issued to each. This list is for review by ASX but not for release to the market.

ASX has observed instances of failure to provide the list of allottees required under rule 7.1A.4(a). To date, these failures have been addressed by ASX raising them directly with the entity and requiring disclosure of the list. This can be better addressed through the changes outlined below in the section, *Are changes required to improve the operation of rule 7.1A?*

Nothing has come to ASX's attention to indicate that the existing restriction on issues to related parties under rule 10.11 has been undermined by the introduction of the rule. ASX notes that rule 7.1A does not provide an exception to rule 10.11 – specific approval is still required for any issue of securities to a related party.

Similarly, ASX is not aware of rule 7.1A being used as mechanism to effect a control transaction without complying with existing regulatory requirements for such transactions.



## Pricing – calculation of 75% floor price on rule 7.1A issues

As outlined above, one aspect of the investor protections put in place in relation to rule 7.1A issues, is the requirement that securities issued under rule 7.1A be issued at no less than 75% of the market price of those securities, based on a 15 day VWAP. This requirement is set out in rule 7.1A.3.

The 15 day period for purposes of rule 7.1A.3 is the 15 trading days immediately before the date on which the issue price was agreed, or if the securities are not issued within 5 trading days of that date, the 15 trading days immediately before the date on which the securities are issued.

Rule 7.1A.3 recognises that without the flexibility to place shares at a discount to market price, it may be impossible for a mid to small cap to successfully market a placement to new investors. The 75% floor on that discount seeks to protect the interests of current investors by setting a limit on the economic dilution that can occur.

The original proposal released for public consultation by ASX was that the 75% floor price should be determined over the 15 trading days prior to the issue date. In response to consultation feedback, this was changed so that the floor price was determined over the 15 trading days to the date that placement was agreed and priced. However, ASX required that the securities must be issued within 5 trading days of that date, otherwise the floor price must be determined over the 15 trading days to the issue date. ASX's intention was to limit the risk of economic dilution of current investors.

ASX has observed that companies with a rule 7.1A mandate have issued securities from their 15% rule 7.1 capacity and their 10% rule 7.1A capacity at the same time as part of a single capital raising. Unlike rule 7.1A issues, there is no floor price on an issue from an entity's 15% rule 7.1 capacity, assuming that the issue is at a fixed price.<sup>1</sup> The fixed price of the issue is a matter to be determined by the directors, having regard to their duty to act in good faith in the best interests of the entity.

The different rules that apply to the pricing of issues under rule 7.1 and issues under rule 7.1A can result in different issue prices for the securities issued under what is effectively a single placement, depending on whether the securities are issued from the entity's rule 7.1 capacity or its rule 7.1A capacity.

This can occur where there is a delay of more than 5 trading days between the agreement of the issue price for the placement, and the issue of the securities. In those cases, the 15 day VWAP must be determined over the period up to the issue date. Consequently:

- the entity must agree an issue price that allows for any increase in the price at which the entity's securities are traded between the date on which the issue price is agreed and the date on which the securities are issued; or

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<sup>1</sup> Under rule 7.3.3, the issue price of securities issued with the approval of members under rule 7.1 must be either a fixed price, or a minimum price. A minimum price must be fixed or a stated percentage that is at least 80% of the 5 day VWAP to the issue date or (if there is a disclosure document) the date that the disclosure document is signed.

- it risks not being able to issue securities under its rule 7.1A capacity without a further approval (and consequent delay and uncertainty), if the price at which the entity's securities are traded increases such that the agreed issue price is now below the 75% limit of the 15 day VWAP.

ASX has received feedback from mid to small caps and other stakeholders that 5 trading days from agreement of the price can be a challenging timeframe within which to effect a placement, particularly if the placees are interstate or overseas and there is a delay in the transfer of funds. This feedback suggests that a 10 trading day period would be a more appropriate timeframe.

ASX is open to the view that increasing the time period in rule 7.1A.3(b) from 5 trading days to 10 trading days would not disturb the current balance between flexibility for issuers and protection from economic dilution for current investors. Before proceeding with a rule amendment to make this change, ASX invites comments from stakeholders.

### Valuation of non-cash consideration

A company proposing to issue securities under rule 7.1A for non-cash consideration must comply with the 75% floor price under rule 7.1A.3, and therefore must calculate the value of the non-cash consideration and confirm that it is no less than 75% of the 15 day VWAP. The valuation must be performed by an independent expert or appropriately qualified directors, and released to the market when the securities are issued. A valuation performed by appropriately qualified directors must contain a similar level of analysis to that which would be expected in an independent expert's report.

ASX has observed very few instances of issues under rule 7.1A being made for non-cash consideration during the review period. Of the 22 issues for non-cash consideration during the review period, 12 were for the acquisition of assets, five were in satisfaction of financial debt, and five were for services performed for the entity.

ASX noted substantial non-compliance with the requirement to provide a valuation of the non-cash consideration. Of the 12 issues for assets, valuations were produced for only five. Of those five, three were produced late, and one approximately four months late. Four of the five were independent expert's reports, and one was a directors' valuation.

The requirement to provide a valuation of non-cash consideration for release to the market is set out in the note to rule 7.1A.3. ASX has made it clear in the note that this valuation is the means by which an entity can demonstrate that the issue price of the securities complies with the 75% floor price requirement described above in the section *Pricing – calculation of 75% floor price on rule 7.1A issues*), when the price is not paid in cash.

ASX emphasises that a valuation that meets the requirements set out in the note to rule 7.1A.3 must be provided for release to the market for all issues under rule 7.1A for non-cash consideration. The valuation must be provided when the securities are issued. ASX advises that if an entity that fails to comply with these requirements in future, ASX will not be satisfied that the entity has complied with the 75% floor price requirement. As a consequence, ASX may require the entity to reallocate the issue to its rule 7.1 capacity, or take other or additional compliance action as appropriate.

## Existing quoted class

Under rule 7.1A.3, an issue under rule 7.1A must be of an existing quoted class of securities. In a small number of cases, a company has issued non-quoted securities and has purported to use its rule 7.1A capacity to do so. In these cases, ASX has required the entity to reallocate the issue to its rule 7.1 capacity. If the entity's rule 7.1 capacity would be exceeded as a consequence of the issue, then the issue will be in breach of the rule and will result in a reduction of the entity's future rule 7.1 capacity. The reduction in the entity's future rule 7.1 capacity must be disclosed to the market.

ASX's observation is that these breaches have arisen as a consequence of errors in interpretation of the requirements of rule 7.1A. Consequently, ASX's practice has been to educate mid to small caps through the release of a *Listed @ASX Compliance Update* prior to the annual general meeting season, alerting entities to aspects of rule 7.1A and referring them to the Listing Rule 7.1A User Guide. ASX plans to produce a new Guidance Note covering listing rules 7.1 and 7.1A to assist market participants as understand and comply with the rules.

## Are changes required to improve the operation of rule 7.1A?

### Disclosure requirements under rule 7.1A

As outlined above, the enhanced disclosure requirements at the time of issue of securities under rule 7.1A include:

- Specific disclosures under rule 3.10.5A. These requirements are signposted from rule 7.1A.4.
- The valuation of any non-cash consideration for the issue. This requirement applies under rule 7.1A.3, as a consequence of ASX's note to that rule explaining how the entity must establish that it has complied with the 75% floor price requirement.
- Calculation of rule 7.1 and rule 7.1A placement capacity in the form of Annexure 1 to Appendix 3B (this applies to all issues during a rule 7.1A mandate period). This requirement is signposted from item 6i of Appendix 3B, while the requirement to complete Appendix 3B for a placement is in turn signposted from rule 3.10.5.

ASX considers that compliance with these disclosure requirements would be facilitated by:

- Updating Appendix 3B to incorporate the disclosures required under rule 3.10.5A for an issue under rule 7.1A. This will consolidate the disclosure requirements at the time of issue into the one place.
- Producing a new Guidance Note covering rules 7.1 and 7.1A to better inform entities and investors about the operation of these rules, and assist entities to understand and comply with their obligations.

In addition, ASX is considering feedback that has been put to it, that the disclosure requirements in rule 7.3A.6(b) that apply at the time of any subsequent rule 7.1A approval, are duplicative of requirements that apply at the time of issue and/or that they place a compliance burden on listed entities that outweighs any benefit to investors. These requirements are outlined above (see the section *Disclosure at the time of any subsequent approval of a rule 7.1A mandate*).

A number of the disclosure requirements in rule 7.3A.6(b) are duplicative of information that must be provided in the Appendix 3B on issue of the securities. These are:

- Rule 7.3A.6(b) bullet point one, which requires disclosure of the number of securities issued and duplicates information provided in item 2 of Appendix 3B.
- Rule 7.3A.6(b) bullet point two, which requires disclosure of the class and principal terms of issue and duplicates information provided in items 1 and 3 of Appendix 3B.
- Rule 7.3A.6(b) bullet point four, to the extent that it requires disclosure of the issue price and duplicates information provided in item 5 of Appendix 3B.
- Rule 7.3A.6(b) bullet point five, to the extent that it requires disclosure of the total cash consideration and duplicates information provided in (or that can easily be calculated from) items 2 and 5 of Appendix 3B.
- Rule 7.3A.6(b) bullet point six, to the extent that it requires disclosure of the non-cash consideration and duplicates information provided in item 5 of Appendix 3B.

In addition:

- The information provided under rule 7.3A.6(a), which requires disclosure of the total number of equity securities issued in the past 12 months and the percentage that they represent of the total number of equity securities on issue at the beginning of the 12 month period, is arguably duplicative in that it can be readily calculated by aggregation of the Appendix 3Bs issued by the entity during that period.
- Rule 7.3A.6(b) bullet point four, to the extent that it requires disclosure of the discount to market price, is duplicative with respect to issues under rule 7.1A, but not with respect to other issues during the 12 month period. For issues under rule 7.1A, it duplicates information provided in (or that can easily be calculated from) items 5 and 6g of Appendix 3B.

ASX invites comment from stakeholders on whether there is a value to investors in having these disclosures made again at the time of any subsequent rule 7.1A approval, which outweighs the compliance burden on listed entities. ASX will take this feedback into account in determining whether there is a persuasive case for change.

Some of the disclosure requirements in rule 7.3A.6(b) are not (or not directly) duplicative of information that must be provided in the Appendix 3B. These are:

- Rule 7.3A.6(b) bullet point three, which requires disclosure of the names of the allottees or the basis on which they were determined, for each issue of equity securities in the 12 month period.

- Rule 7.3A.6(b) bullet point four, to the extent that it requires disclosure of the discount to market price with respect to any issues not made under rule 7.1A during the 12 month period.
- Rule 7.3A.6(b) bullet point five, to the extent that it requires disclosure of the uses of cash consideration, although there is some duplication with item 6 of Appendix 3B, which requires disclosure of the purpose of the issue.
- Rule 7.3A.6(b) bullet point six, to the extent that it requires disclosure of the current value of non-cash consideration.

ASX invites comment from stakeholders on whether these disclosure requirements should be retained, or whether the compliance burden on listed entities from these requirements outweighs any benefit to investors. Again, ASX will take this feedback into account in determining whether there is a persuasive case for change.

#### Calculation of 75% floor price on rule 7.1A issues

ASX proposes to amend listing rule 7.1A.3(b) to allow for a period of 10 trading days between the date that the issue price is agreed for a placement under rule 7.1A, and the date that the securities are issued. This is based on feedback that the current 5 trading day period is too short, particularly if the placees are interstate or overseas and there is a delay in the transfer of funds.

ASX invites comments from stakeholders on this proposal.

#### Feedback to the proposals in the consultation paper

ASX invites feedback from any interested parties on the findings contained in this paper about the current operation of Listing Rule 7.1A or any of the proposed refinements to the arrangements designed to improve its operation.

Written submissions should be forwarded by email to: [regulatorypolicy@asx.com.au](mailto:regulatorypolicy@asx.com.au).

The closing date for submissions is Monday 9 November 2015.