HERBERT SMITH FREEHILLS

2020 AUSTRALIAN IPO REVIEW: REGULATORY DEVELOPMENTS

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Guides – By **Philip Hart and Cecilia Mehl**

In 2020, regulatory developments in relation to IPOs have been relatively limited compared to previous years, with ASIC and ASX increasing their focus on regulation of secondary raisings during the Covid-19 pandemic. Nevertheless, the issue of ASIC class relief in relation to IPO communications and voluntary escrow arrangements, along with new regulatory guidance on the product design and distribution obligations, has been welcomed by market participants. ASX has also continued to refine its regulatory guidance, including through the release of updated guidance notes on performance securities and co-operatives and mutuals listing on ASX.

ASIC

FORECAST FINANCIAL INFORMATION IN DISCLOSURE DOCUMENTS

Prospectuses and other disclosure documents may include information that is prospective or forward-looking in nature, including forecast financial information. In a pre-Covid-19 world, issuers seeking to list in the first half of the financial year would typically include a financial forecast to the end of that financial year, while issuers seeking to list in the second half of the financial year would typically include a financial forecast for the remainder of that financial year plus the following financial year.

As we have seen with listed companies, Covid-19 has impacted the ability of IPO issuers to forecast their financial performance. In September 2020, ASIC observed that the Covid-19 pandemic has had many negative and positive impacts on companies across industries – the ongoing effect and duration of which is hard to predict. This makes it difficult to compile forecasts that comply with Regulatory Guide 170 Prospective financial information, particularly in demonstrating that assumptions are based on reasonable grounds.

During the second half of 2020, IPO issuers adopted varying approaches to the inclusion of financial forecasts in prospectuses, with some opting not to include forecasts and instead including a trading update (for example for the first quarter of the FY21 financial year), others opting for a shorter forecast period (for example for the period to 31 December 2020) and others opting to include a forecast to 30 June 2021, but with additional detail in relation to the assumptions underlying the forecast and the sensitivity analysis.

ASIC has adopted a proactive approach to the issue of the inclusion of forecasts in the prospectus, engaging with issuers and their advisers to understand how the forecast has been built up, the impact of Covid-19 on the particular business and industry and how changes to the Covid-19 situation may impact the business.

Whether, and if so, the extent to which an issuer is in a position to include forecasts in a prospectus that comply with Regulatory Guide 170 will need to be assessed on a case by case basis. Issuers should ensure that sufficient time and resources are devoted to the compilation of forecast financial information, as this will continue to be a focus for due diligence committees and directors. Issuers and advisers will need to work closely together to understand how the forecast has been built up and how changes to the Covid-19 situation may impact the business and its financial performance. Going forward, we expect that there will be a continued regulatory focus on forecast financial information disclosures in prospectuses, and the reasonableness of the assumptions underlying those financial forecasts and sensitivities. We also expect to see ASIC continuing to engage proactively with issuers and their advisers in relation to forecast financial information disclosure.

ASIC RELIEF IN RELATION TO IPO COMMUNICATIONS AND VOLUNTARY ESCROW ARRANGEMENTS

In August 2020, following public consultation, ASIC issued conditional class relief for two common forms of "minor and technical" relief applications. Specifically:

- *ASIC Corporations (IPO Communications) Instrument 2020/722* allows issuers to communicate with their security holders and current and former employees about their proposed IPO prior to prospectus lodgement; and
- *ASIC Corporations (Amendment) Instrument 2020/721* disregards the relevant interests of an issuer, underwriter or lead manager arising from voluntary escrow arrangements for the purposes of the takeover provisions, but not the substantial holding provisions, under the *Corporations Act 2001* (Cth) (Corporations Act).

The conditional class relief is a welcome development that will reduce costs for issuers undertaking an IPO, through both fees payable to ASIC and the time spent preparing individual relief applications. ASIC has also updated its Regulatory Guide 5: Relevant interests and substantial holding notices and Regulatory Guide 254: Offering securities under a disclosure document to further explain this conditional class relief.

IPO communications

The Corporations Act provides that, subject to certain limited exceptions, an issuer must not advertise or publish a statement that refers to an IPO or is reasonably likely to induce applications under the offer prior to prospectus lodgement. However, issuers typically need to communicate with their security holders and current and former employees as part of the IPO process (eg communicating information relating to IPO pricing in order to facilitate a sell-down). As a result, issuers have routinely applied to ASIC for specific relief from this prohibition.

Under the conditional class relief, non-promotional IPO communications may be permitted in relation to:

- the IPO timetable, structure and offer period
- proposed escrow arrangements
- employee incentive plans, including the treatment of existing securities and option plans and any associated changes
- sell-down facilities, and
- IPO-related matters that require shareholder approval (eg appointment of directors).

However, issuers should continue to ensure that all advertising campaigns, promotional materials and employee/shareholder communications during the IPO process fall within the scope of the relief. In particular, ASIC's relief is only available where no advantages, benefits or merits of the offer are communicated and where companies have adequate arrangements to ensure that any exempted communications given to security holders and current and former employees are kept up to date.

Voluntary escrow arrangements

The takeover provisions in the Corporations Act prohibit the acquisition of a “relevant interest” in voting shares if a person’s voting power increases from 20% or below to over 20% (or from a starting point above 20% and below 90%). In the context of an IPO, the issuer, underwriter or lead manager may request existing security holders to enter into voluntary escrow arrangements to promote investor confidence in the IPO. Such voluntary escrow arrangements may give rise to a technical relevant interest in the issuer‘s own securities (and if such relevant interest would breach the takeover provisions, the issuer would need to apply to ASIC for specific relief).

Under the conditional class relief, the relevant interests of the issuer, underwriter or lead manager pursuant to voluntary escrow arrangements in connection with an IPO may be disregarded for the purpose of the takeover provisions, provided certain conditions are met (e.g. the escrow agreement must restrict disposal but not voting). The relief does not extend to relief from the requirement to lodge substantial holder notices.

NEW REGULATORY GUIDE ON PRODUCT DESIGN AND DISTRIBUTION OBLIGATIONS

In our *2019 Australian IPO Review* we discussed the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (Cth), which introduced a new financial product design and distribution obligations (DDO) regime into the Corporations Act. In particular, we considered the obligations under the new regime to publish an appropriate target market determination (TMD) for financial products offered, and the application of DDO to certain IPOs. The DDO regime was scheduled to take effect from 5 April 2021 following a two year transition period. However, the commencement was deferred for six months due to Covid-19 and the regime will now take effect on 5 October 2021.

On 11 December 2020, following extensive consultation, ASIC released new regulatory guidance on the DDO regime as set out in ASIC Regulatory Guide 274: Product design and distribution obligations (RG 274). The guidance in RG 274 makes it clear that the new obligations are intended to help consumers obtain appropriate financial products, by requiring issuers and distributors to have a “consumer-centric” approach to the design and distribution of such products and consider whether the ”choice architecture” of a financial product (features that influence consumer decisions and actions, including the sales process and website design) may impact the likelihood that the product will reach its target market.

The DDO regime does not apply to financial products issued or sold to wholesale clients, to offers of fully paid ordinary shares (unless they are intended to convert into preference shares within 12 months of issue or are shares in an investment company) or to employee share scheme offers.

TMD requirements

If the DDO regime applies, the issuer (or seller in a regulated sale situation) must prepare a TMD for a product if:

- a PDS must be prepared (eg for interests in a managed investment scheme, general insurance, and interests in a superannuation fund) or a prospectus must be prepared (eg for hybrid securities) in relation to the issue or sale;
- the product is within the scope of the *Australian Securities and Investments Commission Act 2001* (Cth) (eg short term credit facilities) and is issued (or sold under a regulated sale) to a retail client; or
- the *Corporations Regulations 2001* (Cth) require a TMD to be prepared (eg where the product is exempt from prospectus or PDS disclosure, for example simple corporate bonds and ADI debentures).

A TMD must set out:

- the target market for the financial product, being a class of consumers for whom the financial product is likely to be consistent with their likely objectives, financial situation and needs;
- conditions and restrictions on distribution of the financial product, intended to make it likely that consumers that acquire the financial product are in the target market;
- why these distribution conditions will make it more likely that the consumers who acquire the product are in the target market and sufficient information to reasonably conclude that the product, including its key attributes, is likely to be consistent with the likely objectives, financial situation and needs of consumers in the target market (these are new requirements in RG 274 which were not part of the consultation);
- what information the distributors must provide to the TMD issuer and when (eg complaints data); and
- details of the review triggers and when the TMD will be reviewed.

Issuers and sellers who make a TMD are expected to develop and maintain effective "product governance arrangements" covering each stage of development and distribution of financial products (being product design, product distribution and monitoring/review), and must take reasonable steps that will, or are reasonably likely to, result in products being distributed consistently with the TMD. Such reasonable steps include assessing the likelihood that particular conduct will be inconsistent with the TMD, the nature and degree of harm that may result from dealings that are inconsistent with the TMD, and the practicalities of mitigating or eliminating such risks and harm.

Issuers and sellers who make a TMD must notify ASIC as soon as practicable, and in any case within 10 business days of becoming aware, of a significant dealing in a financial product that is not consistent with the product's TMD. Additionally, issuers must keep complete and accurate records of decisions made in relation to the issuer's TMDs and associated reviews, together with the reasons (and underlying data) for those decisions, for up to seven years. ASIC has broad powers under the DDO regime including with respect to information gathering, providing relief through exemptions and modifications, making stop orders and imposing other penalties.

In anticipation of the DDO regime's implementation, issuers, sellers and distributors of financial products are encouraged to familiarise themselves with the new regime, consider the extent to which they need to update their governance processes to ensure compliance, and commence preparing TMD documentation with respect to the financial products that they issue, sell in a regulated sale or distribute.

Relief applications and documents now lodged via ASIC Regulatory Portal

ASIC has made changes to the way various fundraising and corporate finance documents (eg prospectuses) and applications for relief are submitted.

From 27 July 2020, these documents and applications for relief are to be submitted via the ASIC Regulatory Portal, an online platform designed to make it easier for stakeholders to provide ASIC with the required information (via online forms). The portal also allows users to monitor the status of their submissions, correspond with ASIC about their submissions and pay lodgement fees.

ASIC intends that the portal will become a central access point for its growing suite of regulatory services. As such, we expect to see increasing use of the portal on a broader range of transactions in the future.

ASX

IMPACT OF CHANGES TO ASX LISTING RULES IN DECEMBER 2019

As discussed in our *2019 Australian IPO Review*, ASX made a range of amendments to the ASX Listing Rules, its appendices and Guidance Notes that, with limited exceptions, came into effect on 1 December 2019. As such, these amendments have been in effect for just over a year. Our key observations of the impacts of the changes relevant for companies seeking to undertake an IPO relate to eligibility for listing, deferred settlement trading and escrow requirements.

Eligibility

In our experience, ASX has been considering and applying the eligibility requirements more stringently in recent times. As such, we would encourage IPO candidates and advisers to be mindful of this early in their IPO process. If a listing application does not meet ASX's eligibility requirements, ASX is likely to ask questions and request further information, which may impact the IPO timetable. Ultimately, if the prospective issuer is unable to satisfy ASX's eligibility requirements, ASX may reject the listing application.

In connection with this, at the outset of the IPO process, ASX is encouraging IPO candidates to seek in-principle advice in connection with the entity suitability for listing on ASX under listing rule 1.1 condition 1 and listing rule 1.19. This application is in addition to any other application for in-principle relief that an IPO candidate may make in connection with the application of specific listing rules (for example, ASX's mandatory escrow rules under chapter 9 of the ASX listing rules). There is a prescribed form for this application, which can be accessed from the ASX website, and covers matters such as the experience of the directors and management of the entity, the entity's history, structure, business model and risks, as well as its historical financial performance.

Some practical tips for dealing with ASX's eligibility requirements in the current environment include:

- **having at least one director with ASX listed entity experience** – when assessing if an entity has a structure and operations appropriate for listing, ASX will consider the proposed board composition, including experience with directing or managing another ASX listed entity. To assist with satisfying this requirement, we would recommend that IPO candidates have at least one director on the board with such experience. If this is not the case, IPO candidates should ensure that their company secretary has experience working with ASX listed entities;

- **identifying potential regulatory issues early** – ASX will appreciate advance notice to consider potential regulatory issues. Identifying any such potential issues early in the IPO process should help to minimise "surprises" and allow IPO candidates to meet their desired transaction timetable;

- **making written submissions** – ASX prefers to consider any issues before engaging with prospective issuers and is also unlikely to make any decision without being provided with all the relevant facts; and

- **basing submissions on precedent** – ASX is more likely to grant a listing rule waiver if there is a relevant precedent for it. While it is possible to receive a waiver without precedent, submissions will need to articulate the reasons why the waiver will not infringe the spirit and intention of the relevant listing rule(s). However, even if this is the case, ASX may nevertheless refuse to grant the waiver. This may happen where ASX is concerned about setting an undesirable precedent for others.

Deferred settlement trading

Following the 2019 amendments, deferred settlement trading has generally been limited to IPOs that include a "general public offer" or a conditional market. There are very limited exceptions to this general rule.

Consistent with this new approach, on TPG Telecom's demerger and IPO of Tuas, ASX granted a conditional market in respect of Tuas shares to facilitate the commencement of trading of Tuas shares on the same day as Vodafone shares on the day following the suspension of trading of TPG Telecom shares, but before the transfer of Tuas shares to eligible TPG Telecom shareholders under the demerger. One of the conditions to the conditional market was that Tuas shares were transferred to eligible TPG shareholders under the demerger. Following the satisfaction of the conditions to the conditional market, Tuas shares commenced trading on a normal T+2 basis, rather than having a period of unconditional but deferred settlement trading until the despatch of holding statements. In our experience, ASX would have previously permitted the shares in the demerged entity to trade on a deferred settlement basis (rather than on a conditional basis) for the entire period up to the transfer of the shares under the demerger and issue of new holding statements. This may indicate a potential trend for future demerger IPOs.

Mandatory escrow

The market continues to adapt to ASX's updated mandatory escrow regime. Key mandatory escrow issues for IPO advisers to consider include:

understanding when cash formula relief applies (eg cash formula relief does not apply to unexercised options issued under an employee incentive scheme);
being mindful that spouses, de facto spouses, parents and children of related parties of the company (such as its directors) and any of their respective transferees will be mandatorily escrowed for 24 months and must sign a restriction deed; and
allowing sufficient time for execution of restriction deeds (where required), particularly in the remote working environment.

UPDATE TO ASX GUIDANCE NOTE 19: PERFORMANCE SECURITIES

An entity applying to be admitted to the official list of the ASX is required to satisfy ASX that its structure is appropriate for a listed entity. This includes demonstrating that the terms of its equity securities are appropriate and equitable.

ASX has made substantial changes to the way it applies the ASX Listing Rules to performance securities. The changes came into effect on 28 August 2020 via an amendment to Guidance Note 19. The ambit of Guidance Note 19, which previously only applied to performance shares (being shares that convert into ordinary shares when a nominated performance milestone is achieved), has been expanded considerably to now also cover performance options and performance rights, and will generally apply to any "contractual entitlement to receive ordinary shares if a nominated performance milestone is achieved".

Entities applying to be listed which have or propose to have performance securities on issue at the date of admission should expect to provide ASX with more detailed information on these securities than was previously required. This includes the terms of the performance securities and details on how the entity determined the number of performance securities to be issued and why the entity considers that number to be appropriate and equitable. Entities may also need to include detailed disclosure of the terms of the performance securities and other information required by Guidance Note 19 in their disclosure documents (such as a prospectus). ASX has requested this additional information even where the performance securities have or will be issued to directors and management under what are generally regarded as "plain vanilla" remuneration and other incentive arrangements.

Further, entities may need to obtain an independent expert's report to provide an opinion on whether the issue of performance securities is fair and reasonable to non-participating security holders. ASX will require an independent expert's report where the number of ordinary shares into which the relevant performance securities will convert (if the applicable milestone is achieved) is greater than 10% of the number of ordinary shares the entity has on issue at the date of admission (on a fully diluted basis taking into account any ordinary shares that the entity may be issuing in connection with its listing).

ASX may deny an entity's application for admission to the official list of the ASX if the entity does not comply with this regime.

Whilst ASX continues to refine the practical application of this new regime, we recommend discussing with your legal advisers how best to navigate the requirements with ASX, ensuring you have sufficient time to address any issues.

UPDATE TO ASX GUIDANCE NOTE 3: CO-OPERATIVES AND MUTUALS LISTING ON ASX

On 28 August 2020, ASX updated Guidance Note 3 to include the listing of "mutual capital instruments" (MCIs) issued by a mutual entity and "co-operative capital units" (CCUs) issued by a co-operative entity. ASX confirmed that if the MCI or CCU has debt-like features, it will be favourably disposed to declaring the security a "debt security" for the purposes of the ASX Listing Rules and admitting the issuer as an "ASX Debt Listing".

Mutual companies provide a variety of services to their members, such as insurance, banking and investment services. Each member of a mutual company is entitled to no more than one vote at a general meeting for each capacity in which the person is a member. MCIs are a form of permanent, fully-paid capital that can be issued by certain mutual companies, similar to a share. A mutual is able to raise capital through the issue of MCIs, while protecting its mutual status.

A co-operative is an association whose members co-operate to achieve a benefit for the members, such as agricultural co-operatives or consumer co-operatives. A CCU is an interest issued by a co-operative conferring an interest in the capital (but not the share capital) of the co-operative. The holder of a CCU is not entitled to the rights or entitlements of a member of the co-operative.

In April 2019, the Corporations Act was amended to allow certain mutual entities to raise capital through the issue of MCIs. In contrast to ordinary shares, MCI holders have limited voting rights at a general meeting of members, holding one vote regardless of the number of MCIs held. As a result, MCIs are not subject to the takeover and control provisions of the Corporations Act. Herbert Smith Freehills was significantly involved in the development of the MCI legislation, including commenting on successive drafts of the legislation and attending meetings with the Business Council of Co-operatives and Mutuals, Treasury and ASIC to discuss the proposed legislation.

Herbert Smith Freehills subsequently acted on behalf of Australian Unity Limited (Australian Unity) in relation to the first issue and listing of MCIs as a debt security on ASX in December 2020. Australian Unity was already admitted to ASX as a debt listing with three listed debt securities at the time. Given the novelty of the securities, we were able to leverage our engagement in the development of the MCI legislation to effectively engage with ASIC, ASX and the ATO on the nature and terms of Australian Unity's MCIs to guide the listing process. In addition to the listing rules applicable to an ASX Debt Listing set out in listing rule 1.10, ASX agreed to apply a number of additional listing rules to Australian Unity's MCIs, including to allow future issues of fungible MCIs and the ability for Australian Unity to undertake a buy-back or a dividend reinvestment plan. The ATO also provided a class ruling confirming certain Australian income tax consequences for Australian resident MCI holders.

We look forward to seeing what other mutual companies do in this space.

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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

PHILIP HART
PARTNER, SYDNEY

+61 2 9225 5703
philip.hart@hsf.com

CECILIA MEHL
EXECUTIVE COUNSEL, MELBOURNE
+61 3 9288 1219
Cecilia.Mehl@hsf.com

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