HERBERT SMITH FREEHILLS

AUSTRALIAN IPO REVIEW 2021: REGULATORY DEVELOPMENTS

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Legal Briefings – By **Philip Hart, Fiona Smedley, Timothy Stutt and Jennifer Wong**

In 2021, ASIC and ASX have continued their focus on disclosure and conduct issues, while keeping an eye on the ongoing impacts of the Covid–19 pandemic. The Australian regulators have addressed topical issues such as "net zero" statements and "greenwashing" in disclosure documents and modernising meeting requirements through the use of technology, as well as commented on crypto assets and SPACs in the Australian market. As with previous years, ASX has continued to refine its regulatory guidance, including through the release of updated guidance notes on escrow requirements and performance securities.

ASIC

FORWARD–LOOKING STATEMENTS IN DISCLOSURE DOCUMENTS (INCLUDING "NET ZERO" COMMITMENTS AND OTHER ESG TARGETS)

Prospectuses and other disclosure documents may include information that is prospective or forward–looking in nature, including forecast financial information and non–financial targets.

In our *2020 Australian IPO Review* we discussed the proactive approach taken by ASIC to the inclusion of forecasts in disclosure documents, including 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. ASIC has remained focused on this issue during 2021 and we expect this to continue given the ongoing uncertainty surrounding the impact of Covid–19 on businesses.

ASIC has also raised the issue of including commitments to achieving “net zero” greenhouse gas emissions in disclosure documents. ASIC’s position is that “net zero” commitments and other climate targets can be forward–looking statements for which there must be reasonable grounds. As noted in its December 2021 Corporate Finance Update, ASIC’s recent intervention on these grounds includes an issuer being required to re–write their climate commitments in their prospectus. In that case, the issuer’s “net zero” commitment was taken to be a forward–looking statement and ASIC noted that any such statements must be supported by reasonable grounds, including details of any work proposed to achieve projections, and the uncertainties and risks associated with achieving those projections. Anecdotally, we are aware of two other recent examples where ASIC has raised similar concerns about the inclusion of climate commitments in prospectuses without reasonable grounds.

Going forward, we expect that there will be a continued regulatory focus on potential misrepresentation of the extent to which businesses or investments are environmentally sustainable (known as “greenwashing”) or socially sustainable (known as “social–washing”). While it is important to ensure strategies and policies on key environmental, social and governance (ESG) issues and risks reflect institutional investor expectations and are integrated into prospectus disclosure and marketing materials, these matters should be framed in a way that meets disclosure requirements and pre–empts (and positions the issuer to respond to) any potential queries on environmental and other sustainability claims.

FINANCIAL INFORMATION IN DISCLOSURE DOCUMENTS

AASB 16

Over the past few years, many issuers have been pro–forma adjusting historical income statements in their prospectuses to highlight the impact of changes to AASB 16: Leases (AASB 16). For reporting periods commencing on or after 1 January 2019, AASB 16 requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value.

In its September 2021 Corporate Finance Update, ASIC commented that it does not believe that pro–forma adjustments for AASB 16 will continue to be necessary beyond financial years ended 2021, given that most historical reporting periods are now likely to have been compiled under AASB 16.

Disclosure of “underlying profit”

ASIC has also recently commented on the disclosure of alternative profit measures such as “underlying profit”. ASIC accepts that limited pro–forma adjustments can be made to show the effect of acquisitions, “one–off events” (such as JobKeeper payments) and changes in accounting standards. However, ASIC has stated it does not accept that any further adjustments should be made to derive alternative profit measures which are then prominently disclosed in the prospectus. Pro–forma adjustments to profit measures should be confined to the financial information section of the prospectus only.

Disclosure of revenue–based valuation ratios

Another frequently asked question over the last year was whether a company is able to disclose in its prospectus a revenue–based valuation ratio without a corresponding profit–based valuation ratio. ASIC has confirmed its view that, if a company wishes to disclose a revenue–based metric and is profitable (even if only marginally), profit–based ratios should also be disclosed, and with equal prominence.

REFORMS REGARDING VIRTUAL MEETINGS AND PROSPECTUS DISCLOSURE

In August 2021, Parliament passed *Treasury Laws Amendment (2021 Measures No. 1) Act 2021* (Cth), which amends the *Corporations Act 2001* (Cth) (Corporations Act) to allow companies and registered schemes to convene and hold hybrid and virtual meetings until 31 March 2022. Under these temporary amendments, an entity is permitted to hold hybrid or virtual meetings regardless of the requirements in its constitution. Each entity must ensure that any virtual meeting technology allows attendees, as a whole, a reasonable opportunity to participate in the meetings, including to exercise their right to speak orally or in writing.

On 10 February 2022, Parliament passed the Corporations Amendment (Meetings and Documents) Bill 2021 (Cth) to permit the changes described above on a permanent basis, although wholly virtual meetings may only be used if they are expressly required or permitted by the entity's constitution. These amendments will commence on 1 April 2022, upon expiry of the current measures.

Entities should consider whether their constitution should be updated to permit wholly virtual meetings. If an entity seeking to undertake an IPO already has a constitution that permits wholly virtual meetings, ASIC has stated that this is an important fact that should be clearly and prominently disclosed in the "Investment Overview" section of an IPO prospectus.

PRODUCT DESIGN AND DISTRIBUTION OBLIGATIONS NOW IN EFFECT

In our *2020 Australian IPO Review* we discussed:

- the introduction of the new financial product design and distribution obligations (DDO) regime into the Corporations Act; and
- ASIC's regulatory guidance on the DDO regime as set out in ASIC Regulatory Guide 274: Product Design and Distribution Obligations.

The DDO regime has now commenced, on and from 5 October 2021.

Late changes

On 1 October 2021, some late changes were made to the DDO regime by two ASIC instruments (*ASIC Corporations (Amendment) Instrument 2021/785* and *ASIC Corporations (Design and Distribution Obligations Interim Measures) Instrument 2021/784)* to address some unintended consequences of the drafting of the DDO regime.

These welcome changes included:

- extending the usual wholesale client tests to the DDO regime;
- removing the "nil complaints" reporting obligation on distributors;
- removing the "nil reporting" obligation on distributors in relation to information that the issuer specified for reporting in its target market determination (TMD); and
- expanding the concept of excluded conduct to include the provision of a prospectus or a PDS in the course of providing personal advice about a financial product.

Enforcement of the DDO regime

At the date of publication, no public enforcement action has been taken by ASIC in relation to the DDO regime.

Although ASIC did not grant a period of "facilitative compliance" as it did with the introduction of FOFA in 2013, ASIC Chair Joe Longo acknowledged in a media release on 12 August 2021 that a significant amount of regulatory change was taking effect at the same time in early October 2021 and said:

"While these reforms have been in the pipeline for some time, ASIC recognises they require significant changes to businesses' systems and processes and take effect at the same time industry is facing other challenges, including from COVID–19 and renewed lockdowns.

We therefore recognise there will be a period of transition as industry finalises implementation of additional compliance measures, and ASIC will take a reasonable approach in the early stages of these reforms provided industry participants are using their best efforts to comply."

Recap of the DDO regime

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.

If the DDO regime does apply, the issuer (or seller in a regulated sale situation) must prepare a TMD for a product if a PDS must be prepared (e.g. for interests in a managed investment scheme) or if a prospectus must be prepared (e.g. for hybrid securities) in relation to the issue or sale.

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;
- what information the distributors must provide to the TMD issuer and when (e.g. 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, 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.

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.

ASX

UPDATE TO ASX GUIDANCE NOTE 11: RESTRICTED SECURITIES AND VOLUNTARY ESCROW

On 8 October 2021, ASX provided updated guidance in relation to its mandatory escrow requirements. As detailed in IPOs by the numbers, given escrow commonly applies in the context of new listings, it is important for entities seeking admission to understand ASX's application of these rules and any related updates.

In an updated version of Guidance Note 11, ASX provides guidance on its experience in relation to transactions entered into to avoid or reduce escrow. ASX has observed instances of entities entering into transactions with the holder of securities in the entity to avoid the application of escrow (for example, through the buy–back of securities that would otherwise be subject to ASX–imposed escrow following its admission, effectively cashing out those securities and avoiding the application of escrow to them). In the future, ASX indicates that it would likely request such entity to effectively reverse the buy–back by having the holder subscribe for new securities in the entity and applying mandatory escrow to those securities with certain technical modifications. Should ASX's request be denied, ASX is likely to exercise its discretion to reject the entity's application for admission. This updated guidance highlights ASX's continued focus on entities undertaking activities to circumvent escrow requirements, which entities should follow both in "letter and spirit".

ASX has also updated its guidance on the definition of "controllers" of restricted securities. Where mandatory escrow applies, the entity, the holder of the restricted securities and each controller are generally required to enter into a restriction deed. The inclusion of controllers is essentially an anti–avoidance measure – that is, to prevent those who have an economic interest in restricted securities from avoiding ASX's escrow regime by using a chain of entities to hold that interest and then transferring the interest in an entity "up the chain" to dispose of that interest. Previously, ASX's definition of controller did not specifically mention discretionary trusts. ASX has rectified this by providing guidance on the way it interprets and applies this definition in the context of discretionary trusts. Specific applications are detailed in updated Guidance Note 11.

In addition, ASX has clarified the scope of its enforcement powers, including to reflect that such powers may be exercised in respect of proposed or threatened breaches of listing rule obligations relating to restricted securities.

UPDATE TO ASX GUIDANCE NOTE 19: PERFORMANCE SECURITIES

In our *2020 Australian IPO Review*, we discussed the substantial changes made to the way that ASX applies its rules to performance securities, being the term used by ASX to refer to securities that convert, or may convert, into certain ordinary shares if and when the nominated performance milestone is achieved.

As foreshadowed, ASX has continued to refine the practical application of this regime, including via publication of an updated version of Guidance Note 19 on 12 March 2021. However, these updates have limited application to IPO candidates, as they generally clarify ASX's approach to performance securities for existing listed entities and in the context of M&A transactions.

As a result, entities intending to seek admission are continuing to engage with ASX prior to listing. In our experience, this may involve making submissions to ASX about the application of Guidance Note 19 to performance securities as part of an entity's application for in–principle advice on suitability for listing. This continues to include any performance securities that have been or will be issued to directors and management under what are generally regarded as "plain vanilla" remuneration and other incentive arrangements.

As we continue to observe ASX's approach in this space, we reiterate our recommendation to consider with your legal advisers how best to navigate these requirements, ensuring you have sufficient time to address any issues.

OTHER

AUSTRALIAN REGULATORY POSITION ON CRYPTO ASSETS

2021 has seen Australian regulators respond to the growing demand for crypto assets.

Crypto assets, also known as cryptocurrency, virtual or digital assets, is an emerging type of asset class that does not physically exist as coins or tokens, but as digital tokens stored in a digital "wallet". They rely on cryptography and technology such as blockchain for security and other features, and may or may not have an actual asset underlying it.

ASX has recently acknowledged its historically cautious approach to crypto assets, and has said that it recognises that the world is moving on. Whilst historically crypto businesses and funds aspiring to list on ASX have faced difficulty convincing ASX of their suitability for listing, this change in sentiment was observed in November 2021, when BetaShares successfully listed its Crypto Innovators exchange traded fund (ETF) (CRYP) on ASX. CRYP invests in companies involved in servicing crypto asset markets, and attracted record breaking trades on its ASX debut, demonstrating Australian investors' appetite for crypto assets. ASX has not provided any formal guidance in relation to its views on crypto assets since its compliance update in August 2019, but we expect that ASX will have more to say on crypto assets in 2022.

In October 2021, ASIC released guidance for product issuers and market operators (including ASX) on how they can meet their regulatory obligations in relation to crypto asset exchange traded products (ETPs). At this stage, only crypto assets which have robust and transparent pricing mechanisms, a high level of institutional support, a mature spot and regulated futures market trading derivatives linked to the crypto asset are permitted to underpin ETPs. To date, ASIC has stated that Bitcoin and Ether each appear to be appropriate underlying assets for ETPs. Since ASIC's update, ASX has received several listing applications for Bitcoin and Ether–backed ETFs and indicated its goal to bring investment grade opportunities in various crypto asset classes to ASX in the coming months and years.

Globally, a number of jurisdictions including Singapore, the UK and the US have also acknowledged the growing prevalence of crypto assets and are working towards enhancing their regulatory frameworks to assist in driving investment whilst also providing consumer protections.

This will be a space to watch in 2022.

AUSTRALIAN REGULATORY POSITION ON SPACS

With the surge in popularity of special purpose acquisition companies (SPACs) in the US market, there has been speculation as to whether SPACs will be allowed to list on ASX.

SPACs or "blank cheque companies" are newly formed companies with no assets or operations. They are used to raise initial capital in an IPO (most commonly in a US public offering) with the purpose of finding an operating company to buy with the proceeds of the raise within a set time frame.

Currently, various listing rules and guidance prevent prospective SPAC applicants from successfully listing on ASX. These include:

- Listing Rule 1.1 condition 1, which provides that an entity's structure and operations must be appropriate for a listed entity (ASX has maintained that it does not consider the structure and operations of a SPAC to be appropriate for listing on ASX – by their nature, SPACs do not have any commercial operations as their sole purpose is to identify and acquire an existing business with the funds raised at IPO); and
- Listing Rule 1.3.2, which provides that an entity seeking admission under the assets test must have less than half of its total tangible assets in cash or a form readily convertible to cash, or commitments to spend at least half of its cash and assets in a form readily convertible to cash (the majority of a SPAC's tangible assets is represented by cash maintained for future acquisition purposes).

ASX has maintained its stance on SPACs, reiterating that there are no plans to waive ASX's anti–cash box rules to facilitate SPAC transactions. ASX has referenced the poor history of cash box entities in Australia to highlight its steadfast position against SPACs. In response to the popularity of SPACs in the US, ASX has highlighted that there are important scale, regulatory and commercial differences between the Australian and US markets.

In addition, ASIC has commented that before SPAC listings could occur in Australia, ASIC (together with market operators such as ASX) would need to be satisfied that any potential commercial benefits would outweigh any possible regulatory detriments. In particular, ASIC has acknowledged that it may not be feasible to simply replicate the US model for SPACs without considerable changes to allow for differences in the way Australia's laws and markets operate. ASIC has also suggested that SPACs may not be required in Australia as forecasts can be included in prospectuses (provided there is a reasonable basis), financial thresholds for listing are generally lower and IPOs can be brought to market within a shorter timeframe than overseas jurisdictions.

We anticipate that our regulators will continue to monitor overseas developments in relation to SPACs.

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

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