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CURRENT ISSUES IN AUSTRALIAN FINANCIAL MARKETS

"CREATING THE ASX BOOKBUILD FACILITY: PRINCIPLES, HURDLES, SUCCESSES AND IMPLICATIONS FOR POLICY"

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INTRODUCTION

The ASX BookBuild Facility was launched in October 2013. It allows companies seeking to raise capital to reach every eligible investor, using existing ASX securities market infrastructure. This is a world first both in terms of the technology deployed and the adoption by a market operator.

The development of the facility marks the first time that companies can raise capital on-market. Previously, all capital raisings occurred off-market, in a private process conducted by brokers and investment banks. This was irrespective of whether a company was already listed or was seeking to list via an initial public offer.

A facility that accepts bids from all legally eligible investors is considered to be a market under Australian securities laws, and consequently must be operated by a licensed market operator (being in this case, ASX). Regulatory clearance from ASIC and Treasury for new ASX Operating Rules to govern the ASX BookBuild Facility was received in April 2013.

The ASX BookBuild Facility forms part of ASX Trade and is the only primary market capital raising facility that enables issuers to take bids from the entire market of eligible investors via their brokers. Since launching in October 2013, five deals have been completed with ~$100m raised

A privately owned company, On-Market BookBuilds ("OMB"), created this world-first intellectual property. OMB has patents for the intellectual property sealed in 6 countries and pending in another 42 jurisdictions. In Australia, OMB has exclusively licensed the patented IP to ASX.

The facility:

- enables issuers and brokers to access demand from the entire market;
- provides every legally eligible investor the opportunity to bid for securities;
- facilitates the lowest cost of new equity for companies via contestable pricing;
- provides a fair, transparent and efficient process for issuing new capital;
- enables risk to be disseminated prior to, & during the capital raising process; and
- allows companies and their lead manager/broker to continue to control the issue price and allocation decisions.

The leaders of the most significant peak bodies in finance: the BCA, AMEC, ASA, Governance Institute of Australia, ACSI, and AICD have been publicly supportive. These groups represent, respectively, the interests of retail shareholders, superannuation funds, company directors, the ASX100 companies, and mining and exploration companies.

> *By creating more transparency on how shares are priced and allocated in placements, this tool will hopefully give boards greater confidence that their company is tapping the widest possible range of investors for a capital raising and getting the best possible deal at the time*
>
> John Colvin, CEO Australian Institute of Company Directors
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> *We support the workings of the ASX BookBuild Facility and the involvement of all parties in providing transparency and fairness to the new issue market*
>
> Ian Curry, Chairman Australian Shareholders Association

This will deliver more transparency on the pricing and allocation process for new shares, whilst reducing unfair dilution through improved pricing of capital raisings and greater compensation with the sale of renounced rights

Australian Shareholders Association Equity Magazine October 2013

PRINCIPLES

The following is a general summary of the ASX BookBuild Facility process:

1. A company (the "issuer") wishes to raise capital from public markets – this can be either via a placement of new securities for an existed listed company or an initial public offer ("IPO"). The issuer identifies an ASX participant (for example, a broker or investment bank) (the "lead manager") and contractually appoints that lead manager to manage the capital raising.
2. The issuer and lead manager identify preferred investors, and invite "priority bids" from those investors. Those investors may be existing shareholders of the issuer or persons perceived to be important or strategically valuable to the company.
3. For a placement by a listed company, the lead manager and issuer must seek a trading halt, announce the transaction, lodge any bid conditions on the ASX Market Announcement Platform and open the ASX BookBuild Facility, at which time the ASX BookBuild Public Parameters are disclosed to the market.
4. For an IPO, the lead manager and the issuer will align the offer period under the prospectus with the period during which ASX BookBuild will be open, and the bookbuild will commence following the exposure period for the prospectus.
5. In both a placement and an IPO, a company will be issued with a unique ticker by ASX which allows bids to be put into the book (for example, company ABC Limited with an ASX code "ABC" would be given a ticker "ABCXBB").
6. All brokers can bid on behalf of all eligible investors. For a placement, this is generally only institutional and "sophisticated investors"; for an IPO, all eligible investors includes all retail investors (subject to the usual exclusions, for example, no offers to US Persons).
7. A live bid price (but not market depth or volume) is visible to all bidders.
8. The lead manager, on behalf of the issuer, controls the input parameters that determine pricing and allocation in light of the demand from the entire market. This is done via an ASX web based interface.
9. The issuer and the lead manager can see the number of bids and the depth and can adjust parameters according to their desired commercial outcomes.
10. This allows the issuer and the lead manager to assess, for instance, the benefits from having a greater proportion of priority bidders versus on-market bidders via other brokers. Considerations such as price, likely after-market support and register composition are able to be considered in light of whole-of-market demand.
11. When the lead manager and issuer determine that sufficient time has passed to receive market bids, and they are satisfied with those bids, they can close the bookbuild.
12. Any bids in the bookbuild at the time of close are binding.
13. Investors are not given prior notice as to the time at which the book is closed, to avoid any gaming opportunities.
14. Bids at or above the final bookbuild price receive an allocation according to prescribed procedures which operate to treat all investors fairly.
15. The methodology of pricing and allocations, procedures, rules, minimum market allocation, participation by all and price disclosure, ensures that the market is fair, transparent and efficient.

The ASX BookBuild Facility gives issuers and their lead manager transparency of the bid prices and volumes offered by selected identified investors and the prices and volumes offered by market bidders.

Issuers can then price the offering, having regard to the demand curve from the entire market of eligible bidders. This allows issuers to make more informed decisions when setting how much of an offer is allocated to selected, identified bidders and how much is offered to market bidders.

HURDLES

There are both structural features and reinforcing behavioural market practice, combined with a general preference for the status quo among certain market participants that require a process of education for the continued adoption of the ASX BookBuild Facility. To date, the use of the ASX BookBuild Facility has been concentrated among smaller companies and opinion leaders that have been focussed on corporate governance and understand the benefits of taking bids from the widest possible audience when raising capital. OMB has briefed more than 250 ASX listed companies and has received an overwhelmingly positive response to the facility. Like all market changes, there is a period of learning and adoption before broader use takes place.

Some of the inhibiting structural market features are discussed below:

Discretionary and Non-Transparent Process

New securities that are issued in IPOs and selective placements are currently priced and allocated in an off-market, non-transparent and discretionary process.

Typically, a lead manager invites bids from selected clients. Often clients will be selected on the basis of the brokerage they have paid the lead manager for other transactions. Institutional clients of the lead manager receive feedback about the bookbuild through the course of the process, and may revise their bids and bid at price increments. Lower brokerage paying clients who may be part of the wealth management business of the lead manager (for example, smaller fund managers and HNW individuals) may also be invited to bid what is called “final price”. They are usually required to bid a total dollar amount and accept the final price selected by the lead manager, before knowing what that final price is. Investors that are not clients of the lead manager are largely excluded from the process, unless there is a “general offer” component for an IPO (and not at all in the case of a placement).

If the offer is highly sought after, typically the institutional clients will be allocated a higher percentage of their bid than smaller bidders, who can be heavily scaled back. Alternatively, in the absence of strong institutional demand, those smaller bidders will be ‘filled’ with allocations as they have bid ‘at final’. The process is therefore skewed towards certain investors and clients of lead managers, often at the expense of the issuer itself and smaller investors.

Conflicts of Interest

There is a general acknowledgement that the role that lead managers play in capital raising processes creates the potential for a conflict of interest. In the traditional method of raising capital, lead managers are paid by the company to achieve the highest price per share and identify long term investors. They are also paid by institutional investors that seek to pay the lowest price per share (and whose brokerage is correlated to turnover/ i.e. short term trading).

Indeed, there is significant commentary on failings of the current system in terms of fairness. This has resulted in widely reported investor disillusionment. A survey conducted by the London Stock Exchange in 2011 found that “*95% of investors do not trust banks when they are pricing and allocating IPOs, or want more transparency from them.” [Leadership In a Changing Global Economy: The Future of London’s IPO Market - 8 December 2011]*

The main concern with current practices in how selective placements are conducted is that bids are limited to selected clients of the lead manager. These clients generally pay significant brokerage to the lead manager and expect that, in return, they will be given access to discounted stock in capital raisings. Clearly, receiving payments from bidders (that want the cheapest price) and payments from the issuer (that wants the highest price) places lead managers in a conflicted situation.

In the case of a placement, this conflict is to some degree enhanced by the nature of the disclosure requirements for a selective placement. Currently, when conducting a selective placement, there is no requirement to disclose to the market, or shareholders:

- The number of shares being offered or the amount raised under a selective placement.
- Who is invited to bid, and why.
- Any contractual or other arrangements between invited bidders and the lead manager
- The allocation policy between invited bidders (sometimes very general statements are made to bidders such as ‘price leaders & early bidders’ will be rewarded, however there is no regime for compliance, enforcement or review)
- Which legally eligible investors have been excluded from bidding, and why.
- The amount that the lead manager has been paid to conduct a selective placement.

IMPLICATIONS FOR POLICY

There are two areas where the ASX BookBuild facility gives rise to important policy implications: (1) the regulation of securities markets; and (2) the disclosure framework for investors.

These policy implications are largely predicated on and flow from the broader policy which underpins the operation of securities exchanges globally – that that operation is based on fair, transparent and efficient principles.

What we see with the ASX BookBuild Facility is the logically consistent extension of the features of a modern, technology embracing securities market to a process which has hitherto not availed itself of the transparency that public markets offer.

The use of the ASX BookBuild Facility is at the election of an issuer, and the process by which this happens still includes all of the features of a traditional primary raising. It is also important to note that the commercially key factors in a bookbuild – price, demand, knowledge of investor identity – are not excluded from this adoption of this technology. The approach that the facility takes is therefore best understood as an augmentation of the existing process.

It would therefore seem difficult to argue the view that the ASX BookBuild Facility should not at least be considered by the boards and management all companies undertaking capital raisings. The possible application of the "if not, why not" principles that apply to corporate governance disclosure in annual reports could be extended to the use (or non-use) of the facility. This would serve to address a number of the issues identified above, in particular the potential conflicts of interest associated with the role of the lead manager. It would also give shareholders confidence that, for a discounted placement, an issuer has undertaken a price discovery process linked to the whole market and thereby has obtained the most correct pricing possible.

In terms of disclosure, at present, the company law rules around the requirements for a prospectus state that an offer can only be made to retail investors if it is accompanied by prospectus level disclosure (with some exceptions). In all other cases, for example a placement, that placement can only be made to sophisticated investors (as no prospectus is prepared; retail investors are often offered shares under a share placement plan which is capped at $15,000 per investor per annum).

It is worthwhile to note the recent changes that have been introduced by the New Zealand government in respect of its securities laws. From April this year (in addition to a number of other changes designed to streamline capital raising processes) an issue of new securities in a class that are already listed on NZSX does not require a prospectus. Listed issuers will be able to conduct placements that include retail investors via a process that is akin to the Australian "cleansing notice" regime.

The policy underpinnings for this are relatively clear. It is well established that retail investors either do not read or selectively read long form prospectus document. It is also a simple matter of logic and understanding of the fungibility of securities to note that a share in company ABC can be acquired on the day prior to a placement and the day after a placement by a retail investor, at full price, without any additional disclosure. The day of the placement however, where the only difference is that the shares are usually offered at a discount, that share cannot be acquired. The purpose of a continuous disclosure regime is to ensure that the market is fully informed at all times, and logic would indicate that the additional disclosure requirement of a prospectus at the time of a placement arguably does not enhance the level of pre-existing disclosure.