ASX changes to M&A disclosure must be savvy

Opinion

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Although predictions of a COVID-19-induced flood of M&A deals are more conjecture than forecast, what is clear is that business performance is much more volatile and likely to stay that way for the foreseeable future.

So, it's hard to see why the ASX has issued new rules about performance securities that could leave shareholders more, rather than less, exposed to commercial uncertainties – particularly as existing rules already prevent the dilution and shady behaviour the new rules appear to target.

The amended rules make it more complex, time-consuming and costly for boards to use deal mechanisms employed in M&A transactions to protect and benefit shareholders, namely earn-out clauses and contingent consideration arrangements settled through a share issue.

Access to scrip is one of the benefits of being listed, reflecting the reality that business performance shifts over time. Scrip-based earn-outs and contingent consideration arrangements are a tried-and-tested mechanism for protecting shareholders by making sure the full purchase price flows only if post-transaction performance lives up to pre-transaction expectations. In doing so, they also serve to better align the interests of purchaser and vendor.

In amending its guidance, the ASX has ignored the first point and has effectively rendered this sensible, well-regulated risk mitigation mechanism uncommercial.

Where earlier guidance only applied to a particular class of shares, which had limited rights unless and until performance milestones were achieved, the new version encompasses any form of contractual earn-out or other performance-based payment mechanisms settled through shares.

The ASX now says a listed company that proposes to issue performance-based scrip consideration must obtain written confirmation from the exchange that the terms are "appropriate and equitable"; shareholder approval; and, in some cases, an independent expert's report.

The ASX has also assumed responsibility for dictating the type of performance milestones that are, and are not, acceptable. Historically, the ASX has done a good job of protecting shareholders' interests without encroaching on directors' business judgment. It is appropriate and necessary for the ASX to protect shareholders from undue dilution via sweetheart deals based on bogus hurdles that are either too easily satisfied or ripe for abuse. Which is why existing listing rules and corporate governance laws already prevent it.

The dilutionary effect of a company issuing shares is heavily regulated, with listed companies restricted from issuing more than 15 per cent of share capital without shareholder approval unless specific exceptions apply. Directors' duties under the Corporations Act ensure boards are accountable to shareholders when agreeing the terms of M&A deals.

The ASX amendments are more likely to undermine shareholder interests because they give boards pause for thought about using one of the strongest tools in their armoury for negotiating solid M&A transactions. By encouraging companies to either pay in cash or issue more shares upfront or deferred but without any performance milestones, the ASX rules will make shareholders more vulnerable to business performance volatility.

Our respectful advice to the ASX, conveyed in a letter last week,is to:

- Give boards greater flexibility to determine what performance milestones are appropriate for a transaction.
- Limit the requirement to have measures attached to performance milestones signed off by an auditor to the small number of cases where this is warranted.
- Realign the shareholder approval requirement with existing ASX rules around placement capacity, which already strike balance between a company's freedom to negotiate deal terms it thinks in its best interest and concerns to protect shareholders.

It is critical for the ASX to ensure any changes to its regime are commercially savvy and support boards to fulfil their responsibilities to shareholders.

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