Australian Private Equity &
Venture Capital Association Limited

4 March 2019

Ms Mavis Tan
ASX Limited
PO Box H224
Australia Square NSW 1215

Dear Ms Tan,

Simplifying, clarifying and enhancing the integrity and efficiency of the ASX listing rules

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to contribute our views to the consultation on simplifying, clarifying and enhancing the integrity and efficiency of the ASX listing rules.

AVCAL represents the private equity (PE) and venture capital (VC) industry in Australia, which has a combined total of around $26 billion in funds under management on behalf of domestic and overseas investors including Australian and offshore superannuation and pension funds, sovereign wealth funds, and family offices. VC and PE firms invest billions of dollars in early stage and established businesses spanning across almost every sector of our national economy. In the financial year ending 30 June 2018 alone, PE and VC invested around $4.1 billion into Australian businesses.

An April 2018 study by Deloitte Access Economics provides some deeper insights into the economic contribution of PE, including:

- In FY2016, PE-backed businesses contributed $43 billion in total value added to the Australian economy – equal to 2.6% of Australian GDP;
- PE-backed businesses supported 327,000 FTE jobs (172,000 directly, and 155,000 indirectly);
- In FY2016, PE-backed businesses added almost 20,000 FTE jobs, accounting for 11% of total Australian employment growth in FY2016;
- PE-backed businesses typically delivered annual revenue growth of 20%**,** while boosting the size of their workforce by 24%;
- More than 85% of PE-backed businesses introduced some type of process or product innovation in FY2016, far greater than the average profile of non-PE backed businesses.

There is a fundamental link that exists between private businesses, sources of private capital that back those businesses and help them to grow, and the public markets.

As Australia's primary and largest securities exchange, the ASX plays an outsized role in domestic financial markets and the economy. Ensuring that companies are able to list on the ASX in an efficient and transparent manner without disadvantaging either the original or new investors in those companies is important to enable capital to flow to promising companies, thereby driving economic growth and job creation.

Our submission focuses largely on changes that relate to restricted securities and voluntary escrow rules. Our detailed comments are provided below.

1. Guidance Note 11 – Restricted Securities and Voluntary Escrow

There are a number of proposed changes to the application of escrow rules in Guidance Note 11 – Restricted Securities and Voluntary Escrow. AVCAL would like to provide feedback in relation to Guidance Note 11, which assists entities wishing to apply for admission to the official list as an ASX Listing to understand ASX's escrow requirements for new listings.

a) Definition of 'promoter'

Under the current Guidance Note 11, an investor (including a VC investor) who holds or has an interest in at least 10% of the capital (and/or voting securities) of a company proposing to list via an IPO can be deemed a 'promoter', and therefore be subject to mandatory escrow provisions, unless they are classed as a 'genuine venture capitalist'.

Section 40.2 of the current Guidance Note 11 states:

> *Factors that the ASX will take into account in assessing submissions that the holder is a genuine venture capitalist include the following:*
>
> - *The holder has a strategy of investing in businesses of the kind conducted by the [listing] entity and there are no personal connections between the holder and the founders of the entity.*
> - *The holding does not exceed 30% of voting securities.*
> - *The holder's Board representation is limited to one non-executive position.*
> - *The holder has paid an issue price for securities that are comparable to the issue prices paid by other unrelated parties investing at or around the same time and has not obtained any identifiable benefit for itself over and above the benefit of the opportunity to invest in the entity.*

Under the proposed changes to Guidance Note 11, the wording in relation to the definition of a 'promoter' is changed to the following:

> *For the purposes of paragraph (b) of the definition of "promoter", ASX will generally treat a substantial holder [greater than 10%] of an entity undertaking a new listing as a promoter unless it is clear to ASX that they have had no material involvement in the formation or promotion of the entity. The onus is on the entity to establish this to ASX's satisfaction. ASX is likely to accept that this onus has been discharged where:*
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> - *the holder became a substantial holder because:*
> - *…they were a professional venture capital enterprise who subscribed genuine venture capital to the entity in one or more tranches and paid subscription prices for their securities comparable to the subscription prices paid by any other parties investing at or around the same time;*
> - *before… subscribing the venture capital, the holder had no material economic interest in, and no involvement in the management of, the entity; and*
> - *after… subscribing the venture capital, the holder has had no involvement in the management of the entity beyond being represented on the board by a single non-executive director who has not been actively involved in the planning and preparation for the entity's listing.*
>
> *The fact that a vendor or venture capitalist in these circumstances may not be regarded by ASX as a promoter does not mean that their securities will not be restricted securities. A venture capitalist may still be subject to escrow as a seed capitalist if they acquired their securities at a price less than 80% of the entity's IPO price.*

There are some material changes in the proposed new wording that we believe would impact negatively on VC investors that hold an interest in a company looking to list on the ASX.

VC representatives (often senior partners who have personally invested into the VC fund) accept a non-executive director (NED) position as a matter of common practice in relation to their investments. There is a dual function in this role – firstly, to act on behalf of the investors in the VC fund as a steward of the substantial amounts of capital invested in the company and secondly, to provide governance and structure to a board that is often comprised of founders who, whilst having built fantastic businesses, can be inexperienced in board best practice, leaving room for improvement from a governance perspective.

The proposed changes, namely including that "after… subscribing the venture capital, the holder has had no involvement in the management of the entity beyond being represented on the board by a single non-executive director who has not been actively involved in the planning and preparation for the entity's listing," would appear to encapsulate the role of a VC-appointed NED. That NED would normally be expected to be involved in an IPO process as an exit strategy for the VC fund. In many cases, the involvement and experience of a VC-appointed NED would in fact strengthen the overall IPO process.

As such, this inclusion in the draft Guidance Note creates a disincentive to genuine VC representatives from joining boards of companies looking to list on the ASX given the fact that the VC fund investor would be bound by onerous escrow rules. This could have a number of negative effects.

Firstly, it would weaken overall governance standards across private companies that are looking to list on the ASX because of the disincentive for VC funds to invest and partners to join the boards of investee companies. Secondly, it could decrease the overall flow of venture funding to unlisted but high growth companies that would eventually need to become listed entities once they reach a certain size and level of maturity. Lastly, it could induce VC-appointed NEDs to play a far less significant role in the evolution and growth of the companies that they are involved with, thereby depriving them of valuable advice and guidance (this may raise further questions regarding directors' duties under the relevant legislation).

AVCAL believes that the reference to an NED being "actively involved in the planning and preparation for the entity's listing" should be taken out of the draft guidance.

Any risks inherent in this requirement being taken out of the Guidance Note is mitigated by the other proposed requirements. For example, the proposed new wording amends the current rules by establishing that if the VC has had more than one NED on the board at any stage since the investment, then ASX could deem the VC as a promoter – assuming they hold an interest of at least 10% – and therefore be captured by the mandatory escrow provisions. This would capture those instances where a VC fund has a particularly large stake and significant degree of influence in a company by holding more than one board seat.

Further mitigation is achieved through the added wording in the proposed guidance which states that: "A venture capitalist may still be subject to escrow as a seed capitalist if they acquired their securities at a price less than 80% of the entity's IPO price." This parameter would capture VCs who have invested at a valuation that is less than 80% of the issue price at IPO, and this would typically capture a VC investment given the nature of VC as an early stage investment. In such instances, the VC fund would thus be bound by a 12 month escrow period, which we believe is more reasonable.

b) Acceptable track record of revenue

Section 3.6 of the draft Guidance Note 11 introduces some definition around what constitutes an acceptable track record of revenue for escrow rules not to apply to the listing entity:

> ***3.6 What is an acceptable track record of revenue?***
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> *What constitutes an acceptable track record of revenue for escrow not to apply is considered by ASX on a case-by-case basis. Generally, for an entity to meet this requirement, it must:*

- *be a going concern or the successor of a going concern that has had continuing operations for at least 3 full financial years;*
- *have conducted the same main business activity during the last 3 full financial years and through to the date it is admitted;*
- *have aggregated revenue from continuing operations for the last 3 full financial years of at least $30 million;*
- *have consolidated revenue from continuing operations for the 12 months to a date no more than 2 months before the date it applied for admission of at least $20 million;*
- *be raising at least $20 million in its IPO; and*
- *have a market capitalisation at the date of listing of at least $100 million.*

Again, even where an entity meets these thresholds, ASX still retains a discretion to apply escrow if ASX considers it appropriate in the circumstances.

Overall, AVCAL believes that the above measures reasonably balance the risks inherent to small/micro-cap investment with the need for capital into this part of the economy, and that they provide an alignment of interests between the existing shareholders of soon-to-be-listed companies and new or potential investors in the listed market through the use of escrow lock-up arrangements. This balance is particularly important for companies that do not have enough size or a well-established track record and cannot easily rely on other forms of institutional financing such as bank debt.

However, we maintain that some of these thresholds may be too high and would better serve the market (including both the institutional investors that back private companies as well as the retail investor segment of the market) by slightly lowering them to more modest levels.

In particular, we believe that more reasonable threshold levels should be set as per the below:

- consolidated revenue over the last three years of at least $20m; and
- consolidated revenue for the 12 months to a date no more than 2 months before the date the entity applied for admission of at least $15 million.

The ASX would still retain the discretion of applying mandatory escrow provisions when deemed appropriate. The market often also serves as a mechanism by requiring existing investors to take up voluntary escrow provisions when raising capital in the listed market. We believe that in its totality, the right balance is struck between protecting investors from undue risks and the ease with which companies would be able to raise capital to fund their existing operations, pursue growth opportunities and increase the number of people that they employ.

2. Next steps

We look forward to the release of final rule amendments and the new and amended guidance notes in May 2019. If you would like to discuss any aspect of this submission further, please do not hesitate to contact either me or Kosta Sinelnikov, AVCAL's Head of Policy & Research, on 02 8243 7000.

Yours sincerely

Yasser El-Ansary
Chief Executive