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Current Issues for the Mining Company IPO

Anne Keaney*

SUMMARY

This paper is in two parts. The first part deals with some of the recent amendments to the Corporations Law in relation to prospectuses, having regard to issues arising in a mining company Initial Public Offering (IPO). The second part of the paper deals briefly with some recent changes to the Listing Rules and considers the practices of the Australian Stock Exchange (ASX) in relation to the imposition of escrows on mining company listings.

INTRODUCTION

In 1992 the AMPLA conference devoted a major session to prospectuses and the mining company IPO. The session was timely of course because the previous year had seen the introduction of the *Corporations Law* which included a radical rewrite of the legislation regarding fundraising. Since the 1992 session AMPLA does not seem to have focused on this area. This is probably because until this year the underlying law in this area has not changed radically although market practices have matured and developed.

On 13 March of this year legislation under the Corporations Law Economic Reform Programme (CLERP) came into effect. This legislation included an entire rewrite of the chapters of the *Corporations Law* dealing with fundraising. However unlike the 1992 amendments the law has not been radically transformed. The old scheme and approach has largely been maintained but it has been extended and in particular in relation to the prospectus, which is still the primary disclosure document, it has been amended in some important ways.

* BSC (Geol), LLB (UNSW); Gadens Lawyers, Sydney.

Of course the IPO listing process is a two stage process. The first part is the offer to the public and in particular the prospectus. The second part is the listing on ASX and ASX have in recent times introduced some significant changes to their listing requirements which are worthy of comment.

Interestingly in the 1992 AMPLA session on prospectuses it was noted that from the time of the inception of the *Corporations Law* in January 1991 to the time of the session in July 1992, there had only been one mining company float. In the four months since March to the time of this paper in which the new legislation has been in effect, there have been at least five resource company listings and over 50 new listings overall. At the time of writing this paper several more were pending and there are no doubt many others in the planning stages. It has been suggested that there is renewed interest in the market for resources floats because of a general re-rating of the resources sector. So given the upturn in the level of activity in this area and the changes to the law and Listing Rules a review of this area seems opportune.

AMENDMENTS TO THE CORPORATIONS LAW

As noted above the entire chapter of the *Corporations Law* on fundraising has been rewritten. However notwithstanding this entire rewrite the old scheme has generally been left intact. This part of the paper discusses some of the modifications and their relevance to a mining company float. However, a discussion of all of the changes is beyond the scope of this paper. It should also be noted that this discussion only extends to the issue of ordinary shares by a public company vehicle. Significant changes have been introduced with regard to the issue of other types of securities.

The General Disclosure Obligation

The general disclosure test as to what a prospectus must contain, now set out in s 710 of the *Corporations Law* is very similar to its predecessor s 1022.

Section 710 provides, in part, that:

> "The prospectus must contain all information that investors or their professional advisers would reasonably require to make an informed assessment of:
>
> > the assets and liabilities, financial position and performance, profits and losses and prospects of the body that is to issue the securities."

Notably, changes from the previous wording are the inclusion of the word "performance" and the words: "advisers would reasonably *require*".

Under the old s 1022 a prospectus was not required to include information on the performance of the issuer. However the inclusion of this word may be of no great importance. The Explanatory Memorandum to the legislation suggests that the purpose of the inclusion is to bring the language into line with the company reporting requirements introduced under the *Company Law Review Act* of 1998 rather than broaden the disclosure obligations for prospectuses. In any case it is submitted that the accepted practice of including historical financial information such as the profit and loss statements of the issuer would address the requirement to disclose the issuer's financial performance.

The wording "information that advisers would reasonably require" replaces the wording "information that advisers would reasonably expect". The purpose of this amendment is to remove the suggestion that certain types of information should be included merely because in the period since 1992 accepted market practices have developed and advisers have come to "expect" information to be included in prospectuses in line with these practices.

Overall, in the case of a company issuing shares under a prospectus, the general disclosure obligation has hardly changed. It should be noted that the specific disclosure obligations which were previously found in s 1021 and are now found in s 711 have changed to a greater extent and merely following the disclosure formats set out in the additional information sections in pre-March 2000 prospectus will not result in a statutorily compliant prospectus.

The most interesting change from the perspective of a securities lawyer is the new requirement for all advisers to the float and not just those providing expert reports to disclose their fees in relation to the float. This means that the lawyers on the float must now disclose their fees and ASIC have advised that merely stating something to the effect of "an agreed hourly rate" is not adequate.

Forward Looking Statements

As noted above s 710 requires the disclosure of the prospects of the issuer. This was also required under the old s 1022. The accepted method for this disclosure has been the inclusion of forecasts where possible, and projections if forecasts cannot be given. If projections are not possible then some type of disclosure of the issuer's business plan is the usual practice. The availability of forecasts lies in the

extent to which directors can reasonably expect to achieve the assumptions underlying forecasts.

Of course from the point of view of the investor the prospects of the company is the most important disclosure item. From the point of view of the directors (and now underwriters) who have potential liability for misleading or deceptive statements they are also the most contentious. However for those considering whether or not to include forecasts or projections it should also be remembered that the directors can be liable for an omission and it is arguable that the omission of forecasts or projections where it is reasonable to provide them can give rise to liability.

A mining company seeking to include forecasts or projections will need to make a whole series of assumptions. These assumptions would include parameters over which they have some control such as production costs and other budgeted expenditures but absent high levels of hedging will also cover parameters over which they may have no control including exchange rates and commodity prices. For this reason mining company prospectuses will frequently include a sensitivity analysis disclosing impacts on earnings for changes in these assumptions. Of course the most significant factor is likely to be reserve grade and the directors should look at the reasonableness of their expectations in this areas with particular care.

Section 728(2) of the amended legislation provides that: "a person is taken to make a misleading statement about a future matter if they do not have reasonable grounds for making the statement."

However under the previous legislation a person making a statement was deemed not to have reasonable grounds for making it unless the person adduced evidence to the contrary. This deletion has reduced the burden on issuers in including forecasts and projections because it has reversed the burden of proof. Previously those making the statement had to prove they had reasonable grounds. Now those challenging the statement must prove that they did not.

Overall this change to the legislation has made the task of including forecasts and other forward looking statements easier.

Expert Reports

One of the questions that is always asked at the beginning of a float by the company is what expert reports are required. The answer of course is as many or as few as the company desires. Previously it was a requirement that some reports be included, however all of

these requirements have now been removed. That is why older prospectuses commonly included solicitors' reports on material contracts. In relation to mining exploration companies, until September of 1999 it was a requirement of listing that a mining exploration company applying for listing under the assets test give the ASX a report from an independent expert on certain aspects of the company's exploration and expenditure programme. This report commonly appeared in the prospectus itself.

More recent prospectuses tend to contain fewer experts' reports although the Investigating Accountant's report and report on the forecasts remain standard. Because of the type of information to be disclosed mining and exploration company prospectuses continue to frequently include consulting geologists' reports and solicitors' reports on tenements and native title. The issue of disclosure in relation to native title is discussed further below.

There are various advantages to including experts' reports. One of the main drivers will be the marketing appeal, however it is also a useful tool for disclosing information in the prospectus for which an opinion is required that the directors feel they are not in a position to give themselves. However it should be noted that amendments introduced this year have reduced that benefit.

Under the old s 1008A(2) directors would not be liable if a defective statement was based on a statement by an expert, the inclusion of which, the expert had consented to, and the directors after making reasonable inquiries believed that the expert was competent to make the statement.

Section 733, the closest equivalent provision under the amended law, does not allow the directors to take such a passive role. The directors must prove that they placed reasonable reliance on the information given them by the person. It is submitted that this would involve more than merely satisfying oneself as to the competence of the person but would also involve a review of that information itself, how it was arrived at and the data sources upon which it is based. In effect the directors must now make reasonable enquiries to ensure that the contents of an expert report are correct. The fact that the report is provided by an expert does not of itself remove the burden of liability as to the accuracy of that report.

Consents

The change of wording from the old s 1032 to the new s 716(2) is a classic example of how the devil is in the detail in the amendments brought in under CLERP this year.

The old s 1032 provided, in effect, that a prospectus could not be issued that included a statement by or purporting to be made by an expert unless that expert had given his consent to the inclusion of the statement.

Under the new legislation that requirement has been broadened to a statement by any person. The consents provided must be cast in certain terms and must be set out in the prospectus.

It is surprisingly difficult to write about a company, its business and the market in which it operates without including statements that fall within that rule. A failure to obtain such a consent, being a breach of the requirements of a prospectus is grounds for a stop order by ASIC. Prior to CLERP it was exactly the type of error that ASIC would look for when reviewing a prospectus prior to registration, and is now the type of error that ASIC is seeking notice of during the exposure period.

A mining company seeking to raise capital is likely to include in the prospectus a narrative regarding previous exploration work on the company's tenements and where appropriate the results of that work. This type of information showing the history of exploration and the style of such work is extremely valuable to the investor and his advisers. However the effect of s 716 is that where this work was done by other companies it is very difficult to discuss the work because the consent of the previous explorer is now likely to be required. Under the old s 1032 consent would only have been required where the statement is made in the context of the person being an expert or where the disclosure was relevant to a confidentiality restriction.

The result is that the company can either describe the exploration history without naming any of the parties, or, obtain a very large number of consents. Describing the exploration history without naming parties reduces the impact of the story. Further, care should be taken to ensure that even though the party is not named it is not obvious who that party is. In these circumstances consent would still be required. In the alternate, obtaining consents is notoriously difficult, particularly since the consenter is at least, theoretically, exposing itself to potential liability and is receiving nothing in return.

A number of recent mining company floats have constituted the repackaging under new management of old assets held by companies which did not survive the recession in the mining industry in the late 1990s. The application of the new s 716 has been a particular source of frustration to these companies.

Recent mining prospectuses seem to be adopting both courses. One prospectus observed, in addition to the normal adviser consents,

contained 22 consents from other mining companies and mining consulting firms. Care should be taken to closely review the independent mining or geologist report since the rule applies equally to the contents of any reports in the prospectus and this new broadening of the consent requirement is one that mining consultants do not yet seem to have caught up with.

Materiality

Materiality is a concept that is still used in the new amended legislation although it has been removed from the principle civil liability clause.

Prior to CLERP the legislation provided that it was a contravention of the law for which one could be liable if there was an issue of a prospectus in which there was a material statement that was false or misleading or from which there was a material omission. The equivalent provision s 728(1) provides in effect that a person must not offer securities under a disclosure document if there is a misleading or deceptive statement or there is an omission of material required to be disclosed. Thus under the amended law no threshold test of materiality is imposed in relation to misleading or deceptive statements or omissions.

Because of the stated significance of materiality in the old legislation the determination of materiality has traditionally been an important task for the due diligence committee during the float process. However notwithstanding the removal of this test from the liability provisions it is submitted that it remains necessary to determine a materiality level for investigation by the due diligence committee and disclosure in the prospectus.

Section 728(1) has three limbs; the first being that there is no statement that is misleading or deceptive, the second that there is no omission of information required to be disclosed and the third that there has been no new circumstance that has arisen since the prospectus was lodged which would also require disclosure.

Addressing the second of these first, the amended legislation continues to use the self-determination regime. That is, that it is up to the issuer to determine what needs to be disclosed in the prospectus. A prospectus cannot, in practical terms, disclose everything about the issuer and the offer but it must disclose everything that an investor and adviser requires to make an assessment. It follows that an investor and adviser would only need to know information that is material in order to make an assessment and that therefore the issuer is under no obligation to disclose information which is not material.

In relation to the first limb materiality also remains relevant. Section 729 provides that the directors will be liable if a party suffers loss or damage *because* the offer contravened s 728. The inclusion of the word "because" gives the provision a causal requirement and it is difficult to envisage how a person could suffer loss or damage *because* a statement in a prospectus was misleading or deceptive unless that statement was also material.

Case law in the area suggests that the quantum of damages is the actual value of the shares subscribed for at the date of allotment and the amount paid for the shares which is in itself notoriously difficult to assess.[1]

It should be noted that the concept of materiality has been specifically retained in two key areas. Firstly the amended law has introduced criminal liability for issuing a prospectus from which there is an omission or misleading or deceptive statement when the statement or omission is materially adverse from the point of view of the investor.

The other area is in relation to consequences of issuing a supplementary or replacement prospectus. If the supplementary or replacement prospectus was necessary because of a new circumstance that was *materially* adverse from the perspective of the investor, those parties who applied for shares under the original document must be given an opportunity to ask for their money back.

It is also interesting to note that "false and misleading" under the old law has been replaced by "misleading and deceptive". This change is apparently to bring the wording into line with the language in the *Trade Practices Act* and no great legal implications are expected to arise from the difference.

ASX AND THE LISTING RULES

For many years the ASX has applied specific rules to mining and exploration companies. The rules relate mainly to eligibility for listing and disclosure obligations. Notwithstanding all this special attention, mining and exploration companies do not comprise a major part of the Exchange. At the time of this paper they account for only about 12 percent of the aggregate market capitalisation of companies quoted on the ASX and this number has apparently been declining steadily for quite some time. The additional rules placed on mining exploration companies and the ASX's current approach to escrow might be interpreted as, at best, not discouraging this decline.

[1] *McConnell v Wright* [1903] 1 Ch 546.

Eligibility for Listing – Assets Test

Rule 1.3.3(b) provides that all companies applying for admission under the assets test must have working capital of at least $1.5 million or if not, at least $1.5 million if the entity's budgeted revenue for the first full financial year that ends after listing, was included in the working capital.

In September 1999 most of the requirements for listing specific to mining exploration companies were removed, however r 1.3.3 continues to provide that in addition to the above working capital requirements:

> "For mining exploration entities, the amount [ie the working capital] must be available after allowing for the first full financial year's budgeted administration costs and the cost of acquiring plant and equipment and mining tenements."

It should be noted that the requirement applies only to mining *exploration* companies and not mining companies. A mining *exploration* company is one whose principal activity is *exploration* for oil and gas or minerals.

The mining exploration company will also need to provide additional information and documents when submitting its listing application. These include geological maps disclosing prescribed information, a tenement schedule, information regarding the company's exploration programme and a statement of compliance with the Australasian Code for Reporting of Mineral Resources and Ore Reserves (JORC Code). The documents need to be prepared by an appropriately qualified person.

Overall these requirements are greatly reduced from what they were nine months ago, however if the issuer is one whose activities encompass both mining and exploration and it is not clear that the company principally engages in one or the other, it may be worth seeking an "in principle" ruling from the ASX on this issue early in the float process.

Disclosure

Disclosure has been the subject of a paper earlier in the conference and therefore will not be discussed in detail here, however it is worth remembering that the ASX's special treatment of mining companies continues in relation to the additional disclosures required of them under Ch 5 of the Listing Rules. There are also some minor additional disclosure obligations in Ch 4. The recent removal of the requirement to automatically disclose drilling results is an interesting move by the ASX to attempt to meet the commercial realities of member

companies. Certainly the introduction of the JORC Code has been a worthwhile exercise in raising and standardising the form of reporting on mining company results in this country.

Restricted Securities and the Application of Appendix 9B

Under the Listing Rules securities issued prior to listing of a company may in certain circumstances be barred from trading for a period after listing.

Listing Rule 9.1 provides, in effect that:

The restrictions in Appendix 9B will be applied to securities of the company unless:

- the company is admitted under the profits test; or
- the company has a track record of profitability or revenue acceptable to the ASX; or
- the company in the opinion of the ASX has a *substantial proportion of its assets as tangible assets or assets with a readily ascertainable value.*

The purpose of the rule is to prevent entrepreneurs from using the ASX as a means by which to make a quick cash profit rather than a market by which companies may raise capital and investors invest in business. The rule forces the entrepreneur to retain his stake in the listed vehicle for a period during which the company will need to perform, in order for the investing public to similarly retain their investment in the company.

The escrow rule has a very appropriate application in the mining area. It prevents mining entrepreneurs from putting together a portfolio of exploration acreage, promoting to the market that exploration potential, listing the company and walking away with profits without ever putting in the hard work, money and time required to take a mining property from grass roots exploration to production.

However in enforcing Listing Rule 9.1 the ASX at present does not appear to be making a distinction between blue sky exploration acreage and advanced stage properties or even mining operations.

The third limb of Listing Rule 9.1 has three elements worthy of review. These are:

- substantial proportion;
- tangible assets; and
- assets with readily ascertainable value.

Substantial proportion

The ASX will not stipulate what proportion of a company's assets constitute a substantial proportion, but it seems that the fact that the balance sheet of a company shows 50 to 60 percent of a company's assets are tangible assets will not in the ASX's view, be a substantial proportion. Whether this means that 70 percent would constitute a substantial proportion is unclear.

Tangible assets

In the context of a mining operation there are certain assets which are obviously tangible and certain assets which are obviously intangible. Cash, plant and equipment and stockpiles will clearly fall within tangible assets. Exploration tenements would fall within intangible assets. But what about those assets in between? Unfortunately in considering a company's balance sheet the ASX will not necessarily apply the Accounting Standards approved by the Australian Accounting Standards Board to the meaning of tangible and intangible. For example under the Accounting Standards capitalised expenditure is treated as a tangible asset. In the context of a mining company capitalised expenditure could be both exploration and development expenditure and often is a major asset on the balance sheet of the company. While treating capitalised expenditure as a major asset can be open to abuse, it is unwise to assume that because it is a tangible asset for the purpose of the Australian Accounting Standards it will be given this treatment by the ASX. In fact it will be excluded by the ASX.

Assets with a readily ascertainable value

Corporate financiers apply various valuation methods to different types of businesses, however in relation to an operating mine with a finite life, the net present value calculated by using a discounted cash flow analysis is almost universally accepted as the appropriate method. One would therefore expect that a company with an operating mine had an asset of ascertainable value. However it seems that ASX do not at present accept this position. This is apparently because it is based on a forecast performance rather than a historic performance and the value requires the fulfilment of these forecasts. The result is that the securities of a company seeking to list with an operating mine (which does not fall within any of the other exceptions to escrow) will be escrowed unless the mine has an extended, uninterrupted operating history. The fact that the mine has sufficient reserves to take it beyond the prospectus forecast period, that an independent expert has signed off on the reserves, the mine

plan and the mine costs and that an independent accountant has signed off on the assumptions applied to the forecasts is not sufficient. Of course if the mine has an extended, uninterrupted operating history it is likely to fall within one of the other exceptions in any case.

It is submitted that in applying its current practices the ASX is failing to recognise the enormous difference between untested exploration acreage and an operating mine. While the ASX may have good cause for being sceptical about valuations prepared by experts based on forecast performances, it is submitted that if the directors of the company are prepared to sign off on the forecasts under a prospectus and accept the potential liability if those forecasts are not met, then the ASX should give some credence to a valuation based on those numbers.

NATIVE TITLE DISCLOSURES

The final area addressed in this paper is an area that, it is submitted, is not being treated with nearly sufficient respect in mining prospectuses. That is the extent of, and the approach used for native title disclosures in prospectuses. The author has sat in many due diligence meetings where appropriate levels of disclosure for what are really quite minor risks or quite non-material issues have been fought out between directors, lawyers and underwriters. It is suggested that in relation to mining titles the fact that they may or may not be subject to the full right to negotiate regime under Native Title legislation is a highly material issue. This is because it will impact on costs, time and ultimately the right to mine.

It appears that virtually all mining prospectuses will now contain a Native Title section which may include a solicitor's report summarising the relevant law in the States in which the mining company's titles are located. But these prospectuses commonly fail to clearly link the exploration prospects of a company that are described in the prospectus to the native title risk attaching to the tenement in which that prospect is located. From the point of view of an investor there is a very significant difference between, for example, a prospect located on an exploration title and one located on a mining title granted prior to 1994. In failing to make this connection sufficiently clear, the issuer is failing in its disclosure obligations, exposing the directors, the underwriters and possibly their legal advisers to liability.

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