COMMENT ON PROSPECTUSES AND NATURAL RESOURCES

By S. J. Milthorpe*

D. Scott's paper is a useful and well-researched examination of some of the issues relating to prospectuses for resources companies. It would be both presumptuous and taxing for me to attempt to take issue with the observations in that paper, and fortunately the subject matter is wide enough for such an approach to be unnecessary.

I propose instead to offer a few insights of a somewhat practical nature into various aspects of the preparation and registration of a prospectus.

CORPORATE AFFAIRS COMMISSION REVIEW PROCEDURES

One of the first questions asked by clients when giving instructions to commence a public float is: 'How long will it take until the company is listed?' Your reply should of course be that 'It depends'; and one of the things on which it most significantly depends will be the time elapsed between lodgment of the first draft Prospectus with the Corporate Affairs Commission (the CAC), and registration of that prospectus. This period is likely to be 3–4 months, possibly longer in the case of a prospectus for a mining or petroleum company because of the additional reports that will be required from the geologist, the solicitor and (sometimes) the mining engineer.

The CAC is mindful of the problems which can arise out of delay, and has taken some recent steps to attempt to reduce the time for prospectus review. Two of these steps (verified Procedures Checklists, and the requirement for a Solicitors Report in respect of all material contracts) are discussed further below. However, one major cause of delay in the CAC's review of prospectuses (and especially prospectuses for resources issues) is the CAC's long-standing policy of requiring a review of the prospectus contents by experts outside the CAC. The New South Wales CAC advises that it presently takes approximately 6–10 weeks to obtain reports from its outside experts. It is claimed that this period usually fits into the issuing company's timetable, but I suggest that there may be some confusion between cause and effect — that is, the timetable is prepared on the assumption that the usual CAC delay will occur.

It is the CAC's policy not to disclose the identity of the 'experts' to whom it refers prospectuses for review, although it is common knowledge that, in the case of resources issues, geological and tenement matters are referred to the appropriate Mines Departments in each State. The policy of anonymity is, I am informed, intended to prevent 'harassment' of unsuspecting officers of the public service by anxious promoters and their lawyers.

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Some CAC officers may privately acknowledge that a review by experts outside the public sector might achieve a faster turnaround time, but defend the present policy on two grounds: first, that it would be impossible for the CAC to determine who in the private sector was, in any particular case, both independent and expert, and second that insufficient funds are available for the engagement of private consultants. The former claim is unconvincing, and in respect of costs it is submitted that there would be few promoters who would not, in the interests of expedition, willingly meet the required additional expense. A review by private consultants would also, having regard to experience in dealing with the Stock Exchange's consultants, be in all likelihood more exacting.

CHECKLISTS AND STATUTORY DECLARATIONS

Some time ago the CAC produced a Prospectus Procedures Summary (the 'Summary') and a Prospectus Procedures Checklist (the 'Checklist'). Solicitors were advised that priority would be given to the examination of draft prospectuses which were accompanied by Checklists and supported by appropriate unsworn declarations as to the accuracy of those Checklists made by the lodging party and the investigating accountant.

The CAC have in June 1986 determined that it will be obligatory for a lodging party to lodge with the first draft of a prospectus a duly completed Checklist (previously optional). More significantly, the lodging party *may* also now lodge one or more Statutory Declarations verifying the accuracy and completeness of the Checklist which, if lodged, will result in 'some reduction in examination by Commission officers.' The CAC's stated reason for the new procedures is that insufficient care was being given to the completion of unverified Checklists.

The CAC states that it intends to rely substantially on the new Statutory Declarations, as is evident from a recent CAC letter circulated to practitioners in the field:

> Inaccurate statements in checklists to which statutory declarations relate will be viewed seriously. Whether the inaccuracy is the result of inadvertence or otherwise, the prospectus will rank for examination with drafts which are not accompanied by statutory declarations, and the company's directors informed in writing. The Commission will consider initiating legal action against the person who made the declaration and, where appropriate, referral to the appropriate professional body.

Whereas the unsworn declaration which previously accompanied the Checklist was more often than not signed by the solicitor (with the exception of that portion of the Checklist which related to the Investigating Accountant's Report), it is anticipated that a series of verifying declarations will henceforth be supplied dealing with different portions of the Checklist. Each portion will be verified by the person whose knowledge is most relevant to the subject matter concerned. Various declarants would be the solicitor, the auditor, the client, the geologist and the mining engineer. There will obviously be additional work for solicitors in identifying the separate portions of the Checklist to which each party's verification will relate, preparing the necessary Declarations and arranging for the same to be executed, but it is hoped that this additional work will be

more than offset by the reduction in examination by the CAC. Whether or not there occurs a sufficient reduction in processing time to warrant the additional time and expense incurred by the lodging party, is a matter that can only be answered by future events.

The wording stipulated by the CAC for the operative part of the verifying Declaration is:

> All answers contained in [the relevant parts of] the Checklist to which this Declaration relates are, *to the best of my knowledge and belief*, correct.

Many parts of the Checklist raise no difficulties in verification by a solicitor, but this is not universally the case. For instance, what enquiries should be made in order to verify the question 'are all of the directors not subject to a S.227 prohibition, S.227 order or S.562 order'? Will a reply from each director suffice? Or should a director verify the answer? Or should each director severally verify the answer?

Different problems arise out of other Checklist questions which require value judgments. Two examples — 'Are the methods used (relating to forecasts) and the assumptions made *adequately* described?' and, 'If the prospectus contains *or should contain* any statement or claims relating to taxation legislation, has the lodging party supplied a letter from either the Taxation Office or a recognised authority . . .?' It is clear that a solicitor can not reasonably verify the first question. The second question appears innocuous at first glance, but perhaps implies a conclusion that there are no significant taxation aspects relevant to the issue or to the company's business operations.

The notion that a lodging party should be required to accept responsibility to the CAC for any of the matters for which the promoters are liable under the Code seems insidious. At the very least, it involves unnecessary and undesirable reliance on regulatory procedures as a solution to what essentially constitutes a problem of management. One would have thought that a management solution would have been called for.

DISCLOSURE OF MATERIAL CONTRACTS

The CAC claims that one of the most time-consuming exercises which it undertakes is the reviewing of material contracts and ensuring that such contracts are properly disclosed in the prospectus.

In order to reduce that review the CAC have determined that all new prospectuses will be required to include a report by an independent solicitor to the effect that the terms of the company's material contracts have been 'adequately disclosed' in the prospectus.

The first issue to arise is, who may qualify as being sufficiently independent to complete the Solicitor's Report? The CAC have stipulated that, prior to having the report prepared, the lodging party should contact the CAC to determine if the proposed writer is 'independent'. This proviso implies that, in some instances at least, the company's solicitors will not be regarded as independent. A representative of the CAC has confirmed that,

except in exceptional circumstances, a company's solicitor will be regarded as not being independent if:

— he is a promoter of the company;
— he is a director of the company; or
— he has any financial interest in the company other than being paid normal professional fees.

The question remains, especially in the case of larger firms, whether or not one partner will be precluded from preparing a Solicitor's Report if one of his partners comes within any of the above.

The Solicitor's Report is required to indicate that the terms of material contracts have been 'adequately disclosed' in the prospectus, *cf.* section 98(1)(k) of the Companies Code which provides only that 'the dates of, the parties to and the *general nature* of' every material contract shall be set out. It would appear that on the face of it 'adequate disclosure' is a more stringent test than 'general nature', and this is confirmed by the Prospectus Procedures Summary, which asks two distinct questions: first, whether or not the general nature of every material contract entered into within two years before the date of issue of the prospectus is set out; and second, whether '*all* material terms *and their effect* are accurately disclosed and given sufficient prominence where warranted.' A further question within the Summary queries whether or not, if the prospectus refers to the benefits that will accrue to a company by virtue of a contract, there are shown with equal prominence the costs, other burdens and risks (*e.g.* default clauses) associated with a contract.

The solicitor preparing the report will of course have to satisfy himself as to what is 'adequate disclosure'. For instance, it seems obvious that a clause in a farm-in agreement which provides for withdrawal or forfeiture if the farmee fails to meet expenditure commitments within a specified time, is a material condition requiring disclosure. On the other hand, what of a provision for forfeiture in the event of the farmee's substantial default or liquidation? Such a clause would be unexceptional and reasonable, yet it clearly gives rise to consequences of a material nature. There will be a host of similar examples which will have to be determined by each individual solicitor. There is little doubt that most solicitors will err on the side of caution having regard to the potential liabilities which arise out of the provision of an experts report, and that therefore more and more particulars of material contracts will be disclosed in prospectuses.

There is no specified form for the Solicitor's Report. A 'long-form' version could be supplied which would specify and deal in detail with each material contract; other parts of the prospectus could then be cross-referenced to the Solicitor's Report. Alternatively, I believe that the CAC would be content with a short-form report which, omitting formal parts, provided:

> I have reviewed the terms of the material contracts referred to on page X and in paragraph Y of the Additional Statutory Information, and report that those contracts have been adequately disclosed in this prospectus.

Possibly the most difficult area in this respect will be for the solicitor

to determine the extent, if any, to which he should comment on 'the effect', or the enforceability, or the validity, of a contract or its material provisions. Is the solicitor to be placed in the onerous position, analogous to that of a borrower's solicitors, of asserting (either expressly or, by omission, impliedly) the due execution and validity of each contract? Is he to investigate the underlying facts of the transaction in order to ascertain the existence and terms of any collateral agreement? Is he to satisfy himself that the Company has not concealed the existence of any other material contracts? Is he to satisfy himself that the Company will be able to satisfy or perform or observe all relevant warranties and conditions?

Thus notwithstanding the CAC's expectations as to the contents of a Report, I believe that in the light of these matters a solicitor should qualify any Prospectus Report by providing, for example:

> This report only relates to disclosure of the express terms of the said contracts. I have not investigated, and do not comment on, the corporate power of the contracting parties [apart from the Company], the due execution of those contracts by the contracting parties [apart from the Company], the validity or enforceability of those contracts under all applicable laws [apart from the law of the State of], the existence or effect of any collateral or amending or further contracts, or any other similar act matter or thing.

The difficulty with this approach is that NCSC Release 131, which deals with Investigating Accountant's Reports, provides that a 'qualified' Investigating Accountant's Report is not acceptable to the CAC; this policy is applied, by analogy and with limited exceptions, to all 'expert' reports. It remains to be seen how far the CAC will go in permitting a Solicitor's Report to be qualified in the manner suggested.

NCSC RELEASE 135 – REVALUATIONS

NCSC Release 135 (the Release) provides that 'where through a *revaluation* a *material value* is placed on *intangible* assets such as goodwill, patents pending registration, intellectual property, *mining tenements* and licences' the CAC will not register the prospectus unless certain requirements are satisfied. Included in these requirements are the following:

- Details of the valuation and underlying assumptions are to be clearly disclosed in the prospectus.
- An additional valuation report is to be included in the prospectus and is to be prepared by an independent expert or, if necessary, a number of independent experts.
- The Investigating Accountant is to confirm in writing in the prospectus that he is satisfied that section 269(7)(c) of the Code, and Australian Accounting Standard 10 paragraph 22, have been complied with. (The wording of the Release indicates that if the Investigating Accountant is not prepared to include such confirmation in his Report, then that Report will not be regarded as sufficient.)

The Release is being applied, mainly to 'Hi-Tech' companies, and merely reflects principles which have been followed inconsistently in New South Wales for some years.

The Release is expressed to relate only to *revaluations* of *intangible* assets, and does not on its face deal with the position where a mining tenement is acquired at a price higher than the cost of that mining tenement to the vendor. In respect of mining and petroleum prospectuses this matter is to some extent covered by Listing Requirement 2B(11), but not as extensively as in the Release. In any event, where the 'intangible asset' (*e.g.* mining tenement) is acquired indirectly through the company acquiring a subsidiary which holds that asset, Listing Requirement 2B(11) does not by its terms apply (and in the writer's past experience has not been applied by the Stock Exchanges) nor does the Release apply since there has been (I assume) no revaluation.

It should be noted that the CAC in similar recent circumstances required that a mining company include in its Information Summary a statement as to the estimated net tangible assets following the successful completion of the issue (normally only required in industrial floats). The CAC was of the opinion that this would at least go some way towards indicating to potential investors that assets had been purchased at above book value, although this requirement was nowhere near as severe as the provisions of the Release. In this instance the CAC specifically accepted that the value of mining tenements could be included in the calculation of net *tangible* assets, although the Release alleges that mining tenements are 'of an intangible nature'.

VARIATIONS DURING THE CURRENCY OF A PROSPECTUS

Scott notes in his paper that 'the question of disclosure of new or changed material depends on the nature thereof'.

In essence, Scott states that there is a requirement to disclose 'material *adverse* changes to the information in a prospectus', but not 'new information which bears on existing information but does not adversely change it, *e.g.* upgrading of reserves.'

I suggest that a requirement of disclosure will arise in respect of any new information which is of a material nature, whether adverse or favourable to the company's interests. Paraphrasing section 125 of the Securities Industry Code, a promoter must not knowingly disseminate information that is false or misleading in a material particular and is likely to have the effect of (*inter alia*) *lowering* the market price of securities. Acknowledging that the likelihood of the Commission instituting proceedings for such a breach of Section 125 may be small, nevertheless, a technical breach could thereby result. Furthermore, there remains the remote possibility of a civil action under section 107 of the Code by a subscriber who would have sought a greater allocation if all material facts had been disclosed; or of an action pursuant to section 574 of the Code.

One effect of the disclosure requirements, when coupled in practice with the period of time which elapses between preparation of a prospectus and the close of the issue, is that mining or exploration companies are materially restricted in their freedom of commercial action during this period. An exploration company may only at its peril acquire title to, or

even apply for, new ground because it may then be obliged to amend its schedule of titles, geologists report, solicitors report and so forth. Likewise, an exploration company may only at its peril during this period allow any exploration programmes to progress to the stage of drilling or assay results; positive or negative results will require the directors to amend the prospectus with consequential delays and costs.

Accordingly in drafting contracts (farmins, joint ventures *etc.*) prior to a proposed public issue of shares, it may be important to provide that operations under the contract will, so far as possible, not generate progressive information during this sensitive period.

Scott observes in his paper that a not uncommon variation of a material contract occurs when one of the 'out clauses' in an underwriting agreement is triggered. The CAC's policy is to monitor all 'index-type' clauses applicable to any current prospectus, and if a trigger event is identified, to contact the company and/or the underwriters. Unless the underwriters are prepared to confirm in writing that the relevant trigger event has been waived then the CAC will regard the issue as no longer underwritten, *i.e.* will take the view that the prospectus is materially misleading. The CAC will accordingly require notification of the changed circumstances to all current and prospective applicants. One may speculate in this context whether the required 'waiver' from the underwriters amounts to a prohibited variation under section 112 of the Code.

As to the procedure to be followed by an issuing company when a material variation does occur requiring disclosure after registration, the current policy of the CAC is to approve an appropriate amendment or addendum to the prospectus, for insertion into copies not yet despatched.

In those cases where application moneys have already been forwarded to the company the Commission requires (at least in the case of adverse information) that an appropriate notice be forwarded to those applicants, affording them the opportunity to withdraw their application, and indeed requiring that a refund be forwarded unless their 'booking' is 'reconfirmed' within twenty-one days.

PRE-PROSPECTUS CONTRACTS – MATTERS TO CONSIDER

There are several matters which the lawyer acting for a company which proposes to offer its shares to the public, and which is seeking to acquire mining or exploration interests, should consider at the time of preparing those contracts, and which otherwise tend to be remembered only too late.

Some of those matters are:

Where commercially appropriate, the company's commitment should be conditional upon registration of a prospectus and completion of the issue. Usually a time for this process will be stipulated, and the time estimated to elapse before the issue can be completed should be assessed conservatively and should not be less than four months from lodgment of the first draft prospectus. This time should probably be extended for those

clients who are prone to claim that they are 'a friend of the Commissioner'.

It should be a condition of any farmin or joint venture agreement that the vendor of the relevant interest disclose all information which will in due course be required for purposes of the prospectus, in particular under Listing Requirements 2B(ll) and (llA). Those provisions outline a range of matters which must be disclosed including details of how and when the vendor acquired the subject mining tenement, details of all beneficial interests in the mining tenement, details of the shareholding in the vendor (unless the vendor is a listed company), and details of all previous work done by or on behalf of the vendor on prospecting or developing the tenement. It should also be borne in mind in this context that the prospectus will be required to contain 'a detailed analysis' of the price paid to the vendor 'showing how it was arrived at', and whether or not the company had recourse to expert reports before the purchase.

As suggested above, a contract to farmin to a mining tenement or to join an existing joint venture should not require the conduct of continuing exploration, other than preliminary or grass-roots operations (ground surveys, seismic work *etc.*) during the 'stalemate' period prior to completion of a proposed public issue. In the case of an existing operating venture, and subject to commercial considerations, continued operations by the farmors should also be precluded.

Where the consideration payable in respect of a farmin or other acquisition includes the allotment of shares in the company to be floated it can save considerable effort at a later time if the contract itself incorporates the 'vendor restrictions' which are required by Listing Requirement 3M(l). The vendor should be required to acknowledge those restrictions and (preferably) to deposit the relevant share certificates with the company or with a stipulated escrow holder pending Official Quotation.

Note also that under Listing Requirement 3M(3) vendor restrictions also apply to securities issued for cash out of consideration paid to the vendor for the acquisition of a mining property.

If your client happens to be a promoter who is transferring a tenement to the public-company-to-be, you should also note Listing Requirement 3M(5) which precludes the payment of any consideration to a director or any of his associates, other than vendor securities, 'except where the consideration is for reimbursement of exploration expenditure incurred'.

A vendor company, or joint venture farm-out parties, should be required to exclude from 'normal' confidentiality requirements attaching to mineral exploration, all information which will require to be published in the geologist's report.

Finally an observation on one rather bizarre statutory provision applicable to oil and gas floats where tenements are held in the State of Queensland. Section 63 of the Petroleum Act of Queensland requires not only that the Minister's consent be obtained to any prospectus seeking money for purposes of petroleum exploration in that state, but also that the prospectus be 'signed by every promoter *and vendor*'. Despite this provision, it seems that in practice the Minister's approval can be obtained for a prospectus which otherwise complies with section 63 without the necessity for obtaining signatures from all 'vendors'.

SCHEDULES 4 AND 5 OF THE CODE

Schedule 4 of the Companies Code stipulates the matters which are required to be stated in each prospectus pursuant to section 98(l)(ea) and Regulation 43.

Paragraph 6 of Schedule 4 requires that particulars of all options granted or agreed to be granted be set out, together with '(d) the names and addresses of the persons to whom it or the right to it was given or, if given to existing shareholders or debenture holders as such, the relevant shares or debentures'. Thus it has been necessary in some cases to list the names and addresses of hundreds of pre-float investors, although this obligation can be avoided by making an across-the-board allotment of options to all persons holding shares at the relevant date (*e.g.* on a one thousand for one basis).

Note also that there is no similar requirement to disclose the names and addresses of the holders of shares issued at a discount by an N.L. company, although such issues are now widespread and possibly more common than the issue of options.

Schedule 5 to the Code lists the matters and things which are required to be included in an approved deed under section 166(2) of the Code, an approved deed being a prerequisite to a public offering of prescribed interests.

Paragraph 5 of Schedule 5 is of particular concern to those foolish enough to contemplate the establishment of a trust to operate in the resources field. It provides that an approved deed must contain a provision precluding the manager and the trustee/representative from investing any money that is available under the deed in any prescribed interest, or vesting any prescribed interest in the trustee, 'unless there is in existence in respect of that prescribed interest' another approved deed. The effect of this provision is to prohibit a resources trust from participating in a joint venture, which according to accepted wisdom is comprised within the definition of 'prescribed interests' in section 5(l) of the Code.

In the case of the public issues made by the Western Australian Diamond Trust, the First National Resource Trust and (I believe) the Queensland Coal Trust, the NCSC granted specific exemptions under section 215C of the Code to permit participation by each Trust in nominated joint ventures. In the case of the BA Petroleum Trust, an essential feature of which was the freedom to participate in a range of unspecified exploration joint ventures and farmins, the NCSC was persuaded, after much consideration, to grant a more general exemption. That exemption permitted the Agent (as agent for holders of Explorer units) to participate in farmins and the like, only if the Manager was entirely at arm's length from the other participants, and if at least one other party to the proposed agreement was a public company listed on an Australian or major overseas stock exchange. I should add that the NCSC was most reluctant to grant the exemption, and stressed that it was not to be regarded as a precedent; their fears of a rash of similar floats have not, however, crystallized.