



Market Announcement

19 February 2019

Merlin Diamonds Limited (ASX: MED) – Continuation of Suspension from Official Quotation

Description

To assist the market to understand why the shares in MED continue to be suspended from quotation, ASX is today releasing a copy of a letter from MED to ASX dated 18 December 2018 and an ASX query letter to MED dated 4 January 2019.

Following the receipt by MED of ASX's letter and prior to the deadline for its response, MED sought a meeting with ASX to discuss the actions MED needed to take to allow MED's shares to be reinstated to trading on ASX. On that basis, ASX granted MED a two week extension to respond to ASX's query letter to put a proposal to ASX that, if acceptable to ASX, might see MED's shares reinstated to trading on ASX.

Although MED outlined such a proposal in its market release dated 11 February 2019 headed 'Update on Suspension', ASX has not received any details of the proposal from MED for it to consider, nor has it received a response to its query letter to MED dated 4 January 2019.

MED's securities will remain suspended in accordance with listing rule 17.3 until further notice.

Issued by

James Gerraty
Manager, Listings Compliance (Melbourne)



4 January 2019

Mr Peter Lee
Company Secretary
Merlin Diamonds Limited

By email: peterl@axisc.com.au

Dear Mr Lee

Merlin Diamonds Limited (“MED”) – Further queries

We refer to your letters of 18 and 20 December 2018 and ASX’s letters of 20 and 21 December 2018.

By market release dated 2 November 2018 ASX advised that trading in MED’s securities would remain suspended until the matters raised in ASX’s query letters to that date had been addressed to our satisfaction.

MED subsequently provided further responses by letter of 18 December 2018. We have carefully considered those further responses and, for the reasons outlined in this letter, we consider that MED has not satisfactorily addressed ASX’s queries to date and therefore its securities will continue to remain suspended.

The purpose of MED’s loans to AXIS

In ASX’s letter of 9 October 2018 (question 2(e)), ASX asked “For what purpose(s) was the loan advanced to AXIS?”

MED responded in its letter of 15 October 2018: “*AXIS provides management and geological services to MED. AXIS has built up specialized knowledge in the mining and exploration industry including detailed knowledge of diamonds. It has also built up knowledge of the markets for the sale of diamonds internationally and has access to those markets. Pursuant to the Service Agreement, AXIS has performed such functions as payroll, maintaining employee records required by law and by usual accounting procedures, providing insurance, human resources, company secretarial, land management, certain exploration and mining support in the form of providing project managers, exploration managers, environmental officers, geologists, field assistants, safety personnel, financial, accounting advice and services. It also provides for the Company various services, including but not limited to the making available of office supplies, office facilities, and any other services as may be required from time to time by the Company as and when requested by the Company. The Company has provided loan funds to ensure the services are still available to the Company.*”

Not considering this an adequate response ASX asked in its letter of 17 October 2018 (question 2): “*Why are the funds advanced to AXIS in the form of a loan, rather than paid as an expense for the services provided?*”

MED responded in its letter of 22 October 2018: “*It is more beneficial for Merlin to treat the amount as a loan rather than payment for services. Merlin balances its cash requirements between the need for funds for mining, development, exploration and working capital needs which ensures that the services required from external sources are balanced.*”

This latter response simply makes no sense. MED has not been balancing its cash requirements as suggested. MED has over-provided cash through loans to its related party AXIS since 2012 which have accumulated to \$13,752,124 (including interest). These loans have not offset the services provided to MED by AXIS under the Service Deed. Since MED began lending to AXIS, the services provided by AXIS have been paid for by MED as evidenced by the following figures extracted from MED’s published financial statements (located at the Related Party Transactions note in each year’s accounts):

	2013	2014	2015	2016	2017	2018
Management services paid	\$4,049,237	\$6,024,582	\$3,871,528	\$1,508,324	\$2,173,985	\$1,974,497

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Question 1: Please provide a meaningful explanation as to why MED has lent, and continues to lend, substantial amounts to AXIS (a related party) on an unsecured basis, especially when there has to be substantial doubt that those amounts will be repaid (as evidenced by the fact that the board of MED has fully provisioned the amount of the loan).

The arms' length nature of the loans from MED to AXIS

The Loan Agreement between MED and AXIS was put in place on an unspecified date in June 2017. According to your 18 December letter, this was to formalise, by written terms, previous loans and accommodations that had been provided by MED to AXIS over several years and that:

"The Loan Agreement was required by the Board following an audit review which commented that the terms of the prior year loans and accommodations were not recorded in writing. As a result, the Board determined that it would be prudent to record the terms of the loan in a written document."

Yet despite the Loan Agreement allegedly being brought into existence at the instigation of the Board, when ASX asked for board minutes authorising the execution of the Loan Agreement, we were told in MED's letter of 22 October 2018 that the Loan Agreement was *"verbally approved by the independent directors. Mr MZ Gutnick was the Chairman and Managing Director at the time, was in the office, and therefore signed the document"*.

In your 18 December letter you told us that while Mr MZ Gutnick was a director of MED at the time the Loan Agreement was executed, in fact he was not a director of AXIS at that time, presumably because you thought that relevant to whether or not he had a conflict in signing the Loan Agreement. However, we note from MED's accounts for the year ended 30 June 2017 that Mr MZ Gutnick appears to have been an employee of AXIS at the time of executing the Loan Agreement, giving rise to a similar conflict.

When ASX requested to see drawdown notices raised under the Loan Agreement, ASX was told in MED's letter of 22 October 2018 *"Merlin typically receives a verbal request for drawdown. AXIS staff makes Merlin generally aware of the nature of the costs to be covered by the drawdown"*.

This process appears not to be in accordance with clause 3 of the Loan Agreement which indicates requests are to be in writing, stating as follows:

"I. The Borrower may deliver to the Lender a Drawdown Notice requesting the drawdown of further funds under the Loan.

II. The Lender in its sole discretion and giving consideration to its financial position shall determine whether it has available funds to provide the Loan the subject of the Drawdown Notice.

III. If the Lender determines that it has the capacity to honour a Drawdown Notice from the Lender, it shall provide the funds to the Borrower in a method agreed between the Lender and the Borrower".

Drawdown Notice is defined in clause 1.1 of the Loan Agreement to mean a notice prepared by the Borrower as set out in Schedule 2. Schedule 2 was not provided to ASX with the Loan Agreement, but presumably there is no provision for such informality as verbal communication of drawdowns.

Suffice to say, the original making of material related party loans over a 5 year period without any proper documentation, combined with the level of informality associated with the entry and administration of the subsequent loan agreement evidencing those and other advances is not in keeping with the governance standards that ASX would expect of an ASX listed entity.

It appears from a review of MED's published accounts since the financial year ended 30 June 2012 that the loan from MED to AXIS was first advanced by MED to AXIS during that financial year. The balance of the loan has grown substantially since then, as evidenced by the following figures extracted from MED's published financial statements:

	2012	2013	2014	2015	2016	2017	2018
	\$	\$	\$	\$	\$	\$	\$
Advance to AXIS	740,000	5,719,079	393,614	585,037	107,729	3,920,283	455,903
Repayment by AXIS	None disclosed	None disclosed	(2,442,300)	(1,211,505)	(898,913)	(1,210,000)	-

Interest payable by AXIS	19,053	205,368	444,926	626,469	791,184	924,636	1,138,189
Impairment of receivable owing by AXIS	None disclosed	None disclosed	(4,907,915)	(3,560,854)	(54,345)	(3,634,918)	(1,594,191)
Accumulated Impairment provision	None disclosed	None disclosed	(4,907,915)	(8,468,770)	(8,523,114)	(12,158,032)	(13,752,124)

References: 2012 Financial Statements Notes 9 and 23; 2013 Financial Statements Notes 10 and 26; 2014 Financial Statements Notes 9 and 25; 2015 Financial Statements Notes 9 and 25; 2016 Financial Statements Notes 10 and 27; 2017 Financial Statements Notes 10 and 27; 2018 Financial Statements Notes 10 and 27.

In ASX's letter of 29 October 2018 (questions 7 to 9), ASX asked:

- “7. Noting that the Loan Agreement would appear to involve the giving of a financial benefit by MED to a related party of MED (see F. above), please advise:
- whether MED sought shareholder approval to giving of that benefit under section 208 of the Corporations Act;
 - if MED did not seek such approval, why did it not do so?
 - if it was because the board considered the Loan Agreement was entered into on arm's length terms and therefore exempt from shareholder approval under section 210 of the Corporations Act, please advise the basis and evidence on which the directors formed that view.
8. Noting that the Loan Agreement was for a considerable sum of money and unsecured, what due diligence did the board of MED undertake to satisfy itself that AXIS had the financial wherewithal to meet its obligations under the Loan Agreement before approving the entry of the Loan Agreement and the making of the loan thereunder (“Loan”)?
9. Prior to approving the entry of the Loan Agreement, did the directors of MED ask AXIS to provide financial statements or any other financial information to confirm its financial capacity to repay the Loan? If so, provide a copy of those financial statements (this is not for release to the market). If not, why not?”

Your letter of 1 November 2018 first responded to these queries with the following.

- “7. The independent directors took the view that the terms and conditions, given the status of the loan at the time of entering into the loan agreement, were at arms' length, noting the interest rate, term etc.
8. The Company has had a long relationship with AXIS. Accordingly the independent directors did not believe it was necessary to undertake a due diligence.
9. No”.

Your response to this issue was expanded upon in the following statement in your 18 December 2018 letter:

- “In further answer to paragraphs 7 and 9 of your letter, the Board did not at the time the Loan Agreement was entered into undertake a due diligence as to the ability of AXIS to repay the Loan. Nor did it consider it necessary to seek shareholder approval or to make any announcement as to its entering into. This was because:
- The Loan Agreement did no more than document existing loans and accommodations that had previously been agreed with AXIS and which had been previously disclosed in the audited financial statements of MED – i.e the balance was already owed and had been previously disclosed;
 - MED was not agreeing to make any new advance to AXIS under the Loan Agreement. Any further advances were at the complete discretion of MED”

Question 2: Please explain how the board of MED can maintain that the advances made by MED to AXIS are on arm's length terms when the advances are being fully provisioned in the same financial year that they are being made.

Question 3: If, as you say in point 26(b) of your 20 December letter, the loan agreement only covered advances to the date of the loan agreement and that any further advances were “at the complete discretion of MED”, please:

- (a) explain who on behalf of MED approved the further advances from MED to AXIS after the date of the Loan Agreement;**
- (b) if it was the board of MED, provide a copy of the board minutes authorising the making of those further advances and explain how the board considered it consistent with their duties as directors of MED to make such advances, knowing that they had provisioned the full amount of the loan made prior to the execution of the Loan Agreement and presumably knowing that they intended to do the same in relation to those further advances;**
- (c) if it was not the board of MED, explain the authority of the approving person to agree on behalf of MED to advance substantial sums of money to a related party without an authorisation from the board and to do so on an unsecured basis when there had to be substantial doubt that those funds would be repaid (as evidenced by the fact that the board of MED had provisioned the full amount of the loan made prior to those further advances).**

When and where to send your response

This request is made under, and in accordance with, Listing Rule 18.7. It goes to whether MED is in compliance with Listing Rules 3.1 and 12.5.

As advised to you in our letter dated 20 December 2018, we also intend to notify these queries and your responses to ASIC for investigation of potential Corporations Act breaches, in accordance with our obligations as a licensed market operator under the Corporations Act.

Your response to this letter is required as soon as reasonably possible and, in any event, by not later than half an hour before the start of trading (ie before 9.30 a.m. AEDT) on Friday, 25 January 2019.

ASX reserves the right to release a copy of this letter and your response on the ASX Market Announcements Platform under Listing Rule 18.7A. Accordingly, your response should be in a form suitable for release to the market.

Your response should be sent to me by e-mail. It should not be sent directly to the ASX Market Announcements Office. This is to allow me to review your response to confirm that it is in a form appropriate for release to the market, before it is published on the ASX Market Announcements Platform.

If you have any queries or concerns about any of the above, please contact me immediately.

Yours sincerely

[Sent electronically without signature]

James Gerraty
Manager, Listings Compliance (Melbourne)



18 December 2018

ASX Limited
20 Bridge Street
Sydney NSW 2000

Dear Sir

Merlin Diamonds Ltd ("MED"): related party Agreement: Query

- 1 MED refers to previous correspondence in respect of the Query, the last correspondence being your letter of 1 November 2018.
- 2 We have now further considered the residual queries raised by your letter of 29 October 2018 and taken advice from Senior Counsel. Our further responses are below.
- A The Service Deed ("Deed")**
- 3 Pursuant to the Deed, AXIS provides managerial and administrative services and facilities and equipment required for the business conducted by MED ("services") as requested by MED from time to time: see clause 1.
- 4 AXIS has been providing like services to members of what has historically been described as the *"Gutnick Network of Companies"* since 1987.
- 5 This includes former ASX listed companies such as Great Central Mines Ltd, Quantum Resources Ltd, Centaur Mining & Exploration Ltd, Johnson's Well Mining NL, Astro Mining NL and others ("**the other companies**").
- 6 All of those like services were provided to the other companies through a Service Deed in the same substantial form as the Deed to which MED is now party.
- 7 No auditor of MED or any of the other companies has ever questioned the arms' length nature of the services provided by AXIS, including the pricing arrangements and the terms of the respective Service Deeds. Nor did the ASX ever address any relevant Query to the other companies.

- 8 In determining to enter into the Deed the Board considered that shareholder approval was not required because the terms of the Deed are at arms' length. The Board so determined on the following basis:
- (a) all services are billed on a cost plus 15% basis. This was considered to be below market rates: see clause 8;
 - (b) there is no *'take or pay'* requirement. MED only pays for services as and when requested: see clause 1;
 - (c) internal controls, including time sheets, are used to ensure that MED is only charged for services properly provided to it;
 - (d) the Deed permits MED to terminate the Deed on sixty days' notice: see clause 14.1.
- 9 MED is of the considered view that the terms of the Deed remain at arms' length.
- 10 MED is also of the considered view that the Deed has operated to its significant financial advantage, noting the following.
- 11 The arrangements have permitted MED to significantly reduce, and average down, its operating costs and expenses by relieving it of the need to, among other things, lease head office premises and employ head office and other employees, including geologists and accounting staff.
- 12 As touched upon in our letter of 1 November in 2018, the head office function of MED (then named North Australian Diamonds Ltd) was moved to Melbourne in 2009. Prior to that time the head office was based in Perth. The Company then maintained, at significant expense, corporate offices located at the Hyatt Hotel in Perth. The offices were large even though there were only 2 or 3 employees and it otherwise outsourced its company secretarial function to Grange Consulting Pty Ltd, also at significant expense. The Company also, at further considerable expense, used the services of another independent contractor that provided the financial controller function. In addition it maintained a laboratory at Wangara which employed around 3 people plus casuals as required.
- 13 It should also be noted that in consequence of the Deed MED has not had to pay all of the executive salaries and wages (and associated costs) to any of Mr Joseph Gutnick, Mr Mordechai Gutnick and Mr Peter Lee (and others) whose services have been provided by AXIS on an as requested basis. MED estimates the resulting savings to be several million dollars.
- 14 Additionally, MED has had access to, and been able to use, geological and related expertise made available to it by AXIS under the Deed. That expertise would not

otherwise have been available to MED given its limited financial means and junior status and certainly not on an *as requested cost plus 15% basis*.

15 AXIS also provided its fund raising expertise which has resulted in capital raisings of approximately \$80.8 million by MED. AXIS did not charge any commission or fees for such services. The savings to MED on this basis alone would equate to significant sums having regard to standard market commissions. We estimate those savings to be in the order of \$4.85 million.

B Loan Agreement

16 Your Query in respect of the Loan Agreement proceeds on a mistaken basis.

17 In paragraph 8 you make the assumption that the Loan Agreement provided *new* financial accommodation to AXIS in the sum of \$11,997,353.98. Note the use of your phrases:

(a) *“Noting that the Loan Agreement was for a considerable sum of money”*; and

(b) *“the making of the loan thereunder (“Loan”)”*.

18 Your assumption is wrong.

19 What the Loan Agreement did was formalise, by written terms, previous loans and accommodations that had been provided by MED to AXIS over several years.

20 The existence of those prior year loans and accommodations had been consistently and properly recorded in the audited Financial Statements of MED, and never previously queried by the ASX.

21 As at the entering into of the Loan Agreement (June 2017) the balance of the prior year loans and accommodations (*“balance”*) stood at \$11,997,353.98 which, you will observe, is the exact sum set out in clause 1.1 of the Loan Agreement: *“Loan means the amount of \$11,997,353.98 as at 31 May 2017 ...”*.

22 At the time the Loan Agreement was entered into there had been repayments made to MED by AXIS totalling \$6,951,858.

23 We also note that at the time the Loan Agreement was entered into Mr Mordechai Gutnick was not a director of AXIS, he was not appointed as a director of AXIS until 18 October 2017, and had only been a director of MED from 7 July 2016, when the balance owed to Merlin stood at approximately \$8.5 million.

24 The Loan Agreement was required by the Board following an audit review which commented that the terms of the prior year loans and accommodations were not

recorded in writing. As a result, the Board determined that it would be prudent to record the terms of the loan in a written document.

- 25 The Loan Agreement records the original terms that had been agreed between AXIS and MED.
- 26 In further answer to paragraphs 7 and 9 of your letter, the Board did not at the time the Loan Agreement was entered into undertake a due diligence as to the ability of AXIS to repay the Loan. Nor did it consider it necessary to seek shareholder approval or to make any announcement as to its entering into. This was because:
- (a) the Loan Agreement did no more than document existing loans and accommodations that had previously been agreed with AXIS and which had been previously disclosed in the audited financial statements of MED— i.e. the balance was already owed and had been previously disclosed;
 - (b) MED was not agreeing to make any new advance to AXIS under the Loan Agreement. Any further advances were at the complete discretion of MED.
- 27 We refer to paragraphs 10(a), (c) and (d) of your letter. We have been advised by Senior Counsel that these subparagraphs reveal legal error. We are advised as follows:
- (a) first, the fact that Mr Mordechai Gutnick is a director of AXIS, and therefore has access to the financial information of AXIS, did not create an obligation on him to disclose information so obtainable by him to MED;
 - (b) secondly, it would be a breach of his duty as a director of AXIS to do so without approval;
 - (c) thirdly, and correspondingly, the fact that he did not disclose such information did not involve any breach by him of any duty he owed to MED;
 - (d) fourthly, the fact that Mr Mordechai Gutnick has access to information about the financial standing of AXIS which he did not provide to the Board of MED:
 - (i) did not negate his honest opinion that the financial statements of the Company gave a true and fair view of MED's financial position;
 - (ii) did not "*consequentially*" lead to a qualification to those financial statements. The two issues cannot be conflated. The accounts were qualified because such information was not available, not because Mr Mordechai Gutnick did not provide it;
 - (e) fifthly, MED has no legal right to require disclosure from AXIS of its current financial position.

C Lifting of Suspension

- 28 Having taken advice from Senior Counsel, it is the position of MED that it is currently in compliance with the listing rules and that there is no basis upon which the quotation of MED's securities may remain suspended.
- 29 MED is not currently in breach of any of the listing rules mentioned on page 2 of your letter of 9 October 2018. If MED was ever in breach of those listing rules, which is denied, those breaches have been remedied by the publication of MED's subsequent responses to the ASX (including this letter) and are not ongoing.
- 30 Referring again to those specific listing rules, it is our submission that:
- (a) listing rules 3.1 and 3.1A: there is no information concerning MED that has not been disclosed and which a reasonable person would expect to have a material effect on the price or value of its securities;
 - (b) listing rule 12.2: the financial position of MED is adequate to warrant the continued quotation of its securities;
 - (c) listing rule 3.1A: the accounts given to the ASX have been prepared in accordance with Australian accounting standards.
- 31 Specifically, there is no basis upon which it can be said that the market is not fully informed as to MED's *current* financial position – noting that the Company, based on requests from auditors, have fully provided for the “*loan receivable*” from AXIS. In those circumstances the market will proceed on the assumption that such loan receivable is not recoverable, noting again that the balance of the loan due from AXIS is not repayable until June 2020 in any event.
- 32 Further, no further advances are to be made.
- 33 If you are of the opinion that MED is not *currently* in compliance with specific listing rules then we ask you to immediately identify those listing rules and tell us the basis for that opinion explaining in adequate detail why that asserted non-compliance justifies continued suspension.
- 34 We respectfully remind you that the ASX is not an enforcement agency and that it is not within the remit of the ASX to seek to establish whether or not directors of listed companies have or have not complied with their duties at law. Nor is it qualified to investigate such matters.
- 35 If the ASX suspects that there have been significant contraventions of the *Corporations Act* or of ASX's listing rules then the mandated course of action is to refer those matters to the Australian Securities and Investments Commission

("ASIC") pursuant to the Memorandum of Understanding between the ASX and ASIC dated 28 October 2011. It is for the ASIC to investigate matters referred to it by the ASX and the ASX is not entitled to use the power of suspension as some *defacto* enforcement tool that pre-empts investigation by the ASIC and, if found justified, enforcement action by the ASIC. Continued suspension is only prejudicing current security holders.

36 The above responses have been approved and authorised by the Board of Directors.