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EQUITY DERIVATIVES AND CONTROL TRANSACTIONS – GUIDANCE FROM THE TAKEOVERS PANEL

The Takeovers Panel has released Guidance Note 20 to assist market participants to understand the Panel's approach to disclosure of equity derivatives, particularly the circumstances in which positions taken by parties to equity derivatives must be disclosed to the market even though no 'relevant interest' may have been acquired. Partner Jeremy Low and Senior Associate Julian Donnan outline those circumstances, the position with respect to market makers, and the content and timing for disclosure.

The undisclosed use of equity derivatives may constitute grounds for a finding of 'unacceptable circumstances'

HOW DOES IT AFFECT YOU?

- 'Takers', ie 'acquirers' of equity derivatives, will need to review their positions in the market, and the circumstances surrounding relevant companies, to determine whether their interests (which is an aggregation of any long position held in the relevant company pursuant to equity derivatives and physical holdings of the company's securities) exceed 5 per cent and/or whether any 'control transactions' have commenced. In certain circumstances, even an interest in a company that is not the subject of a formal takeover bid may generate a disclosure obligation.
- Takers will need to consider whether their internal systems are appropriately set-up to identify the target company and facilitate timely disclosure of the information required to be disclosed.
- Although the Takeovers Panel provides for a nominal transitional period of six months from 11 April 2008, for any applications considered during that period the Panel will take into account any steps taken to minimise adverse effects of any non-disclosure. In other words, the message from the Panel is to start house-keeping efforts early.
- 'Market makers', ie providers of equity derivatives who hold an Australian Financial Services Licence or equivalent, would generally not be required to disclose their position as the primary disclosure obligation



relates to the 'taker'. This position does not apply, however, if the market maker is associated or acting in concert with its client in a control transaction.

BACKGROUND

Following a consultation period, the Takeovers Panel (the **Panel**) has finalised the position it adopted in September 2007 when it issued its draft guidance note – that the use of equity derivatives¹, if undisclosed when certain conditions are met, may constitute grounds for a finding of 'unacceptable circumstances'.

The background to the enhanced regulatory position taken by the Panel is derived from concerns that potential bidders were utilising equity derivatives – essentially equity swaps, options, future contracts or contracts for difference – in a manner that had the potential to affect the market in the underlying securities (for example, by bringing about a reduction in the 'free float' of the company). This is on the basis that entering into a purely cash-settled contract, combined with the economic incentive of the writer to acquire securities in the underlying entity to hedge its risk, allows the holder to 'put its foot' on the underlying securities. This may affect supply (and possibly the price) of the securities and, in turn, affect:

- the control or potential control of a company; and
- whether or not there is an efficient, competitive and informed market for the control of the company's voting shares.

These issues came to the fore in the takeover bid launched by Centennial Coal for Austral. In that matter, the Panel found that Glencore International AG, which held equity derivatives of around 6.49 per cent (in addition to an existing physical holding of securities of approximately 7.42 per cent) had engaged in unacceptable circumstances by failing to disclose its position to the market.

1. An 'equity derivative' is an arrangement in which a party to the arrangement is or may be required to provide consideration to another person, and the amount of the consideration is ultimately determined, derived from, or varies by reference to (wholly or in part) the value of a security or group of securities, and may be payable at a future time (see s761 of the Corporations Act. For example, one party (the **taker**) may contract with another party (the **writer**) to give or receive payments according to increases or decreases in the share price of a particular company or a basket of securities.

The stance embodied in the Guidance Note broadly reflects a similar approach taken by the United Kingdom's Takeovers Panel in November 2005, when it directed that equity derivatives must be disclosed if they, when aggregated with any interest in the physical securities, exceed 1 per cent.

The final Guidance Note is considerably shorter than the draft guidance note and contains a number of substantive changes.

CIRCUMSTANCES WHEN DISCLOSURE OUGHT TO BE MADE

The Guidance Note provides that the Panel expects that where a **control transaction** exists, all long positions² created via entry into an equity derivative that already exists, or which are created, ought to be disclosed unless they are under 5 per cent.

A control transaction is defined as a transaction that affects, or is likely to affect:

- control or potential control of a company; or
- the acquisition or proposed acquisition of a substantial interest in a company.

A control transaction is considered by the Panel to have **commenced** under paragraph 10 of the Guidance Note when:

- a) a proposal that is likely to affect control or potential control of a company is announced;
- b) an acquisition of a substantial interest occurs; or
- c) a proposed acquisition of a substantial interest is announced.

A **substantial interest**, as used in paragraphs (b) and (c) above, is defined as a parcel of securities, of whatever size, that:

- forms a step in the direction of takeover or change in corporate control but not limited to:
- a relevant interest; or
- a legal or equitable interest; or
- a power or right in relation to the company or securities (see section 602A of the *Corporations Act 2001* (Cth)).

2. The holder of a long position will benefit from an increase in the price of the equity derivative.

The Guidance Note also cites Justice Emmett in *Brierley Investments Ltd and Others v Australian Securities Commission and Others*³ for the view that 3 per cent of the voting shares in a company could constitute a substantial interest.

Non-disclosure of a short derivative position by the taker may give rise to unacceptable circumstances if the taker's long position exceeds 5 per cent and the short derivative position affects the total position.

COMMENTARY

The draft guidance note had originally proposed that disclosure of all derivative transactions above the notional 5 per cent ought to be made – a replication of the existing position with respect to physical securities. The inclusion of a 'control transaction' concept as a qualifier to disclosure might be seen as a response to a number of submissions made during the consultation period that disclosure should be so limited.

However, the manner in which 'control transactions' are said to have commenced introduces some uncertainty for market participants. In particular, when a particular action or event can be said to 'form a step in the direction of takeover or change in corporate control' (as an indicator of a substantial interest) will necessitate a judgment. This position might be contrasted with the UK position where the disclosure (albeit of 1 per cent interests) of equity derivatives is only required in an offer period in connection with offeree companies listed on the UK Takeover Panel's website at the relevant time. The Australian Panel's position shifts the onus for determining whether such an event or step has occurred to the disclosing entity and impliedly assumes that they will have in place systems for doing this, ie sufficient media and market monitoring to determine how companies in which they have significant long positions are affected.

POSITION OF MARKET MAKERS

The Panel provides certain carve-outs for market makers where they have assumed a role as writer in a disinterested, professional capacity. The Panel takes the view that non-disclosure of equity derivative positions by a market maker is unlikely to give rise to unacceptable circumstances if each of the following apply:

- the equity derivative is written at arm's length;
- the equity derivative is written for a non-associate or one with whom the writer is not acting in concert in relation to the affairs of the relevant company; and
- the market maker is not acting for the client in a corporate advisory capacity, or if there is an effective Chinese wall in place between the different divisions.

The Guidance Note provides that a market maker who seeks to hedge its risk via entry into a back-to-back equity derivative as taker will be treated in those circumstances as if it were a writer.

COMMENTARY

For the most part, market makers should be relieved of an obligation to disclose as this burden will fall on the writer.

Clearly, investment banks engaged by prospective bidders will not be able to assist their clients in acquiring a pre-bid stake greater than 5 per cent via utilisation of equity derivatives (derived by aggregating any physical securities in the company held by the client and the bank), unless entry into the transaction by the bank is unrelated and it is prepared to expose the integrity of its Chinese walls to scrutiny by the Panel.

For bona fide market makers, the Panel has sought to provide some reassurance that it will take into account when framing orders that certain orders it could make if 'unacceptable circumstances' were found to exist, such as declaring a long equity derivative void, could leave the writer exposed to market risks.

WHAT MUST BE DISCLOSED?

In deciding whether the level of disclosure will give rise to unacceptable circumstances, the Panel will take into account whether the following has been disclosed:

- the identity of the taker (but not the writer);
- relevant security;
- price (including reference price, strike price, option price, etc as appropriate);
- entry date;
- number of securities to which the derivative relates;
- type of derivative (eg contracts for difference (*CFD*), cash settled put or call option);

3. 24 ACSR 629.

- any material changes to information previously disclosed to the market;
- long equity derivative positions held by the taker and its associates, its relevant interests and its associates' relevant interests (and the identity of all associates referred to);
- short equity derivative positions that offset physical positions; and
- short positions of more than 1 per cent that have been acquired after a long position is disclosed, whether by notice or substantial holding notice.

Disclosure is not required to be made via a formal substantial shareholder notice (ASIC Form 603 and 604), unless required due to holding an interest in physical securities.

ISDA documentation is not required to be disclosed. Disclosure may be made as a note annexed to a substantial shareholding notice (if one is required to be lodged) or by a written notice to the company if a substantial holding notice is not required. In the latter circumstance, because the disclosure is likely to be price sensitive, the Panel expects that the company would then release the notice to the Australian Securities Exchange.

COMMENTARY

The Panel noted that submissions were received from a number of respondents to the draft guidance note raising concerns about the level of disclosure, including pointing out that the nature of equity derivatives makes disclosure more difficult because it was less susceptible to an automated process. The Panel responded by clarifying that normally the disclosure of the period of the derivative and the identity of the writer of the derivative will not be required by the market.

The Panel also focuses on disclosure of the prices set out in the equity derivative agreements in the context of bidder's statements. It expects that a bidder's statement – which is required to include information about consideration given or agreed during the four months prior to a takeover bid – will contain information about any consideration given to equity derivative positions in relation to the target's securities (whether short or long).

The Guidance Note does not address whether the reference price contained in an equity derivative agreement entered into by a bidder in the four months preceding a takeover bid is relevant to the 'minimum bid rule' found in s621(3) of the Corporations Act. In the UK, the mandatory and minimum bid rules take

into account the prices paid under derivatives transactions and stipulate for these purposes that 'the price paid will normally be treated as the initial reference price together with any fee paid on entering into the derivative'. However, this position was achieved through amendment to the Takeover Code rather than the issue of guidance in the form of a Practice Note by the UK Takeovers Panel.

TIMING FOR DISCLOSURE

Generally, the Panel expects that relevant disclosures should be made:

- within two business days of the taker becoming aware of its position; and
- in a takeover context, by 9.30am on the next trading day.

This position reflects the disclosure position for acquisitions of physical securities.

ORDERS THAT MAY BE MADE TO ADDRESS NON-COMPLIANCE

When the Panel finds unacceptable circumstances, it may give a range of orders, including:

- disclosure of the derivatives;
- disposal of any securities; and
- cancellation of any agreements.

COMMENTARY

In the draft guidance note, additional examples of the Panel's powers were referred to, such as:

- requiring that those affected by the non-disclosure be given a right to take back their securities (as was the order made in Austral Coal O2 and Austral Coal O2R);
- excluding an equity derivative writer from voting any underlying securities that have been acquired; and
- requiring the bidder to increase the bid price to reflect the higher price under the derivative or any collateral benefit given under the equity derivative.

No explanation was given as to why the Panel thought to remove these further examples from the final version.

The jurisdictional reach of the Panel to make orders in certain circumstances was examined by Justice Emmett in the Glencore case. In that case, Justice Emmett noted that the Panel's conclusion about the likely effect of the Glencore's cash-settled equity swaps on control or potential control of Austral Coal were not based on probative evidence (which was a precondition of the Panel's remedial powers).

The passing of the *Corporations Amendments (Takeovers) Act 2007* (Cth) following that case, to clarify and affirm a number of provisions of the Corporations Act relating to the Panel, signifies a firm intention on the part of the legislators to provide the Panel with wide discretion when responding to takeover circumstances and control scenarios. Therefore, parties to equity derivatives will need to be aware of this stance and the broad range of potential orders that the Panel can make. Central to this understanding is that the circumstances in which such orders can become relevant, notwithstanding that no takeover bid is actually on foot or even proposed.

TRANSITIONAL ISSUES

The Guidance Note takes effect from 11 April 2008. The Panel has noted that for six months after publication of the note, it will bear in mind that:

- market participants will require some time to adapt their systems for compliance; and
- disclosure of some positions now may cause some commercial disadvantage.

COMMENTARY

It is interesting that the Panel retreated from the original position on transition as set out in its discussion paper on equity derivatives, released in September 2007. The original position contemplated that if the draft guidance note became published as final Panel policy, then no transitional period would be available on the basis that there was to be a 12-week exposure period after the issue of the draft guidance note and that market participants would have this period to disclose or unwind their positions.

The timing between the release of the discussion paper and the draft guidance note, and the final Guidance Note, was six months – not 12 weeks as initially envisioned. Reasons for this delay and the shift in the Panel's policy on transition have not been made clear.



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