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CLEARER GUIDANCE ON THE WAY: THE TAKEOVERS PANEL SEEKS SUBMISSIONS ON EQUITY DERIVATIVES GUIDANCE NOTE

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Legal Briefings – By **Andrew Rich and Ken Ooi**

The Takeovers Panel has recently released a consultation paper on a draft revised Guidance Note on equity derivatives (**GN 20**), which proposes a number of important changes to the public disclosure of equity derivative positions. Significantly, the changes are of general application and will apply whether or not the equity derivatives have been entered into in the context of a takeover.

IN BRIEF

The key proposed changes in GN 20 include:

- that all long positions (whether capable of physical or cash settlement) over 5% should be publicly disclosed, importantly, irrespective of whether there is a control transaction that has commenced;
- confirmation that the accumulation of an aggregate long position (whether capable of physical or cash settlement) in excess of 20% would constitute unacceptable circumstances; and
- guidance on the Panel's considerations when determining what orders should be made if the Panel finds that non-disclosure is unacceptable.

BACKGROUND TO THE CONSULTATION PAPER

THE ISSUE

If an equity derivative directly gives a purchaser of a derivative contract (the '**taker**') a relevant interest in any underlying securities, the disclosure regime in Chapter 6C of the Corporations Act will apply. The tests for a relevant interest under this disclosure regime, however, are concerned with ownership and control - rather than economic interests.

Accordingly, Chapter 6C does not generally require the disclosure of certain types of derivative instruments (such as cash-settled equity swaps) in the absence of circumstances which give rise to a relevant interest by indirect means.

As described below, this has led to concerns surrounding the use of derivatives to potentially acquire undisclosed stakes in target company leading up to a takeover and the potential use of derivatives to obtain an undisclosed blocking stake in a target.

BRIEF SUMMARY OF EVENTS LEADING UP TO THIS GUIDANCE NOTE

BRIERLEY INVESTMENTS LIMITED / JOHN FAIRFAX HOLDINGS LIMITED (1997)

The use of equity derivatives in Australian control transactions began attracting media attention in 1997 when the Australian Securities Commission raised claims of unacceptable conduct by Brierley, who through a subsidiary, had entered into five cash-settled equity swap arrangements with Merrill Lynch to increase Brierley's stake from 19.98% to approximately 25% in Fairfax. Three of these swaps were structured to mature after 6 months, at which time the creep rules would permit Brierley to increase its entitlement by 3%. The balance was to mature six months later. The effect of these arrangements was to effectively fix the effective purchase price for Brierley, which was performed without disclosure of these swap arrangements to the market. The Panel was not satisfied that unacceptable circumstances existed, for a number of reasons including that even if the market had been aware of the swaps, in their view, the market would not have reacted materially differently, meaning that there were no benefits to Brierley from the use of these derivatives.

BHP BILLITON / WMC (2004)

Equity derivatives were again the subject of media attention in late 2004 when BHP Billiton entered into a range of cash-settled equity swap arrangements with Deutsche Bank referencing approximately 4.3% of its listed takeover target WMC that were initially undisclosed despite WMC's efforts to find out whether there was a strategic party behind Deutsche Bank's buying.

GLENCORE PROCEEDINGS (2005 / 2006)

During 2005 and 2006, there were a number of proceedings in the Takeovers Panel and the Federal Court that arose from the use of cash-settled equity swap arrangements entered into by Glencore (who was considering a rival offer) in the context of a takeover bid by Centennial Coal for Austral Coal. It was ultimately held by the Federal Court that Glencore did not acquire a substantial interest as a result of these cash-settled equity swaps, as a substantial interest required Glencore to have either a “relevant interest” in the shares or a positive power or right in relation to voting shares. This decision raised a number of concerns relating to the scope of the substantial interest concept, as well as the Takeover Panel’s jurisdiction.

CORPORATIONS AMENDMENT (TAKEOVERS) ACT 2007 (CTH)

In response to the Glencore decision, the *Corporations Amendment (Takeovers) Act 2007* (Cth) was passed to clarify the Takeover Panel’s jurisdiction. The relevant amendments included inserting a broader definition of “substantial interest” and a clarification of the Panel’s ability to declare unacceptable circumstances.

CHALLENGER INFRASTRUCTURE FUND / ARKMILE (2008)

Equity derivatives gained media attention in Australia again in early 2008 when Arkmile made a takeover bid for Challenger Infrastructure Fund, and Challenger raised a Takeovers Panel query relating to Arkmile’s use of derivatives to build its economic interest beyond 20 per cent.

Challenger ultimately agreed to withdraw its application to the Takeovers Panel after Arkmile confirmed to Challenger that it did not have any control over the voting rights to the securities underlying its equity derivative positions and agreed that it would not (directly or indirectly) seek to have any such securities voted at any meeting.

THE 2008 GUIDANCE NOTE

Following these events, in order to address the concerns arising from these events and to clarify the Panel's approach to disclosure of equity derivatives, the Panel released the original Guidance Note 20. This Guidance Note required disclosure by a taker of interests in such equity derivatives, even if such disclosure was not technically required by the substantial holding rules of Chapter 6C.

The original Guidance Note clarified that equity derivatives may be considered a substantial interest even though they give rise only to an economic interest, and that all long positions should be disclosed unless they are under a notional 5% of voting power in a company. The applicability of these disclosure requirements, however, were limited to a “control transaction” scenario.

TREASURY ISSUES PAPER (2009) AND SCOPING PAPER (2012)

In 2009, the Treasury released an Issues Paper in response to G20 discussions which highlighted the need for effective financial market regulation, international developments involving equity derivatives, and the recent developments stemming from the Glencore proceedings and Guidance Note 20. The focus of the Issues Paper and responses to this related to the lack of transparency surrounding equity derivative positions in the context of the substantial holding provisions. Eight bodies made public submissions to the Treasury in response to this Issues Paper.

In 2012, the Treasury released a Scoping Paper on various takeovers law policy issues raised by ASIC. The Scoping Paper again raised concerns that equity derivatives could be used:

- to build up an undisclosed stake in a company in the lead up to a formal takeover bid, allowing a bidder to offer a lower premium than would be required for a successful bid if the bidder did not have that derivative stake; and
- to acquire a blocking stakes without a requirement to disclosure. A related concern is that the writer of a derivative contract may hold the underlying securities to hedge its position, which may have potential to frustrate a takeover bid by a third party.

The Treasury did not announce any proposed legislative changes or further action in relation to either the 2009 Issues Paper or the 2012 Scoping Paper.

PROPOSED CHANGES IN THE UPDATED DRAFT GUIDANCE NOTE

In summary, the proposed changes in GN20 provide a clearer more concise document than the original Guidance Note. The key proposed changes confirm the Panel's view that all long positions (whether capable of physical or cash settlement) over 5% should be publicly disclosed, irrespective of whether there is a control transaction that has commenced, and provides guidance on the Panel's considerations when determining what orders should be made if the Panel finds that non-disclosure is unacceptable.

Importantly, the Panel has also confirmed that an acquisition of a long position (whether capable of physical or cash settlement) that would breach the 20% rule, if it were a physical holding of securities, may also give rise to unacceptable circumstances.

Further detail is set out below:

EQUITY DERIVATIVES AND HEDGING

The Panel has clarified its view that the seller of a derivative contract (the ‘**writer**’) will usually have an economic incentive to hedge its position, which means that the actions of the taker may have an effect on the market. This recognises that the effect on the supply (and therefore price) of securities may affect control or potential control of the entity, the acquisition of a substantial interest in the entity, or the efficient competitive and informed market for control of the entity’s underlying securities.

DISCLOSURE OF EQUITY DERIVATIVES

GN20 clarifies that the Panel expects public disclosure to be made where the long position of a person and their associates is 5% or more of the voting rights in an entity and, if so, subsequent public disclosure changes by at least 1% or falls below 5%.

Detail has also been included on both the method and the level of information that should be disclosed, to ensure that the market is able to fully understand the nature of the taker’s long position.

REMEDIES

If the Panel makes a declaration of “unacceptable circumstances” in relation to disclosure of equity derivatives, GN20 sets out that the Panel can make any order, including remedial orders, it thinks appropriate. This may include disclosure, disposal of any securities, cancellation of agreements, or make orders to reverse a benefit or reverse an effect on control, potential control or acquisition.

In considering what orders to make, GN20 states that the Panel may consider:

- any effect on the control or potential control of an entity (including the effect on any control transaction or proposed control transaction);
- the nature of the equity derivative; and
- the period for which the equity derivative is held and the timing of any disclosure made.

THE WAY FORWARD

The purpose of the consultation paper is to seek comments on the draft Guidance Note 20, with comments due by 31 May 2019. Specific questions are set out in the paper for comments.

The Panel’s proposed amendments are, in our view, generally sensible and welcome changes.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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