Takeovers Panel

Discussion Paper
Equity derivatives

10 September 2007

DISCUSSION PAPER

SUBJECT: EQUITY DERIVATIVES

1. Overview of the issue

1. In this discussion paper, and the draft Guidance Note that it accompanies, the Takeovers Panel seeks public comment on its proposed guidance in relation to disclosure, and control implications, of cash settled equity derivatives[1] (which may or may not give rise to a relevant interest in securities acquired by the writer of the equity derivatives to hedge the equity derivatives).

2. It has been suggested that equity derivatives have been used to attempt to avoid provisions of Chapters 6 and 6C of the Corporations Act 2001 (**Act**)[2]. The Panel considers that if this were allowed to continue it would reduce the confidence of the market for Australian securities and adversely affect the efficient, competitive and informed market for voting securities in listed Australian entities.

3. In its draft guidance, the Panel proposes that when considering any applications for unacceptable circumstances in relation to equity derivatives the Panel should, subject to submissions made in the particular proceedings and the Panel otherwise being satisfied, consider that a failure to comply with the requirements of this [*Guidance Note*] constitutes unacceptable circumstances in relation to the acquisition or proposed acquisition by a person of a substantial interest in relation to the relevant company.

4. The Panel recognises that there is a significant, and legitimate, market for equity derivatives which have no control or disclosure implications, which the Panel seeks to ensure is not unreasonably adversely affected by its proposed guidance.

5. Compliance with this Guidance Note is not to be regarded as a substitute for compliance with the provisions of Chapters 6 or 6C of the Act in relation to cash settled equity derivatives. Parties to equity derivatives agreements should consider taking legal advice on their obligations under the Act.

2. Guidance Note History

6. In March 2005 the Panel commenced its internal discussion of the use of equity derivatives in connection with an acquisition or potential acquisition of control. The Panel's discussions were prompted by a range of events including a number of examples in the Australian market where it had been alleged that

[1] In this discussion paper and in its draft Guidance Note, where the Panel refers to equity derivatives it is referring only to cash settled equity derivatives unless otherwise stated.

[2] In this discussion paper, all statutory references are to the Act, unless otherwise stated.

equity derivatives had been used to avoid the substantial holding disclosure provisions, developments overseas (especially by the London Takeover Panel) and the experience and market knowledge of the Panel's members. By mid May 2005 the Panel had prepared a draft Guidance Note and discussion paper for public consultation. However, shortly after, events intervened which caused the Panel to delay consultation on the draft Guidance Note until now.

7. The events included:

   (a) the making of an application to the Panel by Centennial Coal Ltd in relation to the acquisition by Glencore of cash settled equity derivatives over approximately 7% of the shares in Austral Coal, when Glencore owned 4.9% of Austral Coal shares, without disclosure to the market of Glencore's combined holding of physical and derivative interests in Austral Coal which (at its peak) amounted to interests in relation to 11.5% of the voting power in Austral Coal;

   (b) three Panel decisions which declared that Glencore should have disclosed its combined holding when it increased above 5%;

   (c) two decisions in the Federal Court[3] (***Glencore*** decisions) which:

      (i) found that the Panel had made jurisdictional errors in its decisions;

      (ii) quashed the Panel's decisions; and

      (iii) made findings as to the interpretation of "substantial interest" in the Act;

   (d) the commencement of the Corporations Amendments (Takeovers) Act (*Cth*) 2007 (**Amendments Act**) which clarified and affirmed a number of interpretations of the provisions of the Act which relate to the Panel; and

   (e) a decision of the Full Federal Court[4] (***Alinta***) which found section 657A(2)(b)[5] to be invalid for purporting to vest the exclusive judicial power of the Commonwealth in the Panel (the Attorney-General has been granted special leave to appeal *Alinta* in the High Court).

8. The Panel now considers it is appropriate to publish the draft Guidance Note and this discussion paper for public comment.

3. Background

9. It has emerged in recent years that derivative positions are being increasingly taken by potential bidders, and by speculators such as hedge funds, in respect of target shares prior to the announcement of, or during, a takeover and in other circumstances. In such cases, the potential bidder may take a 'long' position – that is, the potential bidder as "holder" enters into a contract with, commonly, an investment bank as "writer", under which the holder benefits from a rise in the price of the securities from the reference price agreed in the contract

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[3] Glencore cases
[4] Alinta case
[5] The provision which was found to be invalid in *Alinta* is now section 657A(2)(c) following the commencement of the Amendments Act.

(usually the market price at the time the contract is entered into). (With a 'short' position, the holder benefits from the fall in the price of the securities.)

10. There is a view that entering into a purely cash settled contract, combined with the economic incentive on the writer to the derivative to acquire securities to which the equity derivative relates (**hedge securities**) in order to hedge its risk, allows the holder of an equity derivative to 'put its foot' on the hedge securities, without being required to disclose this interest to the market under Chapter 6C.

4. Guidance proposals

11. The proposals under the Panel's draft Guidance Note are essentially as follows:

    (a) equity derivatives can be used to avoid or undermine the purposes set out in section 602, and it would give rise to unacceptable circumstances if that were the case;

    (b) equity derivatives may give rise to substantial interests;

    (c) the purposes of Section 602 are best satisfied if there is appropriate and timely disclosure to the market of long equity derivative positions;

    (d) for disclosure purposes, short and long equity derivative positions should not be netted against each other;

    (e) disclosure of short equity derivative positions should not be required in the absence of a Combined Holding of 5% or more;

    (f) if a person's long equity derivative positions and physical holdings of securities (Combined Holding) would require disclosure, then any relevant short equity derivative positions should also be disclosed with the Combined Holding;

    (g) ordinarily the Panel should not take account of the hedge status of an equity derivative when considering whether or not circumstances are unacceptable circumstances;

    (h) the Panel should not require disclosure of the hedge status of an equity derivative, nor should it require the holder to enquire as to the hedge status;

    (i) if acquiring an equity derivative would, under the Panel's Guidance Note, require a person to make disclosure of their Combined Holding, the person need only disclose the interest it gains under an equity derivative as, and to the extent, the writer agrees to give exposure under the equity derivative on a "firm" basis (which may occur on a progressive basis as the writer is able to put appropriate hedging in place);

12. The Panel considers that in certain circumstances the equity derivatives or the arrangements under which they are established may give the holder a relevant interest in the underlying hedge securities, or an association with the writer. However, as mentioned in paragraph 4A, this Guidance Note does not deal with disclosure obligations under Chapter 6C in relation to equity derivatives.

13. Consistent with the findings of the Full Federal Court in *Alinta*, the Panel's draft Guidance Note is not based on contravention of, or compliance with, the Act.

The draft Guidance Note is based on the purposes of Chapter 6, as set out in section 602, and on the provisions of section 657A. The Panel considers that considering whether circumstances avoid the intention and purpose of the legislature in implementing provisions such as Chapter 6C is not inconsistent with the findings of the Full Federal Court in *Alinta.*

5. Chapter 6 implications of equity derivatives

14. Under Chapter 6, there is an important distinction between:

    (a) equity derivatives which involve a right to physical settlement; and

    (b) purely cash-settled equity derivatives.

Delivery/Physical -settled equity derivatives

15. Delivery-settled equity derivatives will, in the absence of an exception, ordinarily give rise to a relevant interest under section 608(8), and would therefore be treated in the same way as a physical holding of the underlying security. Note however that section 608(8) requires the writer to have a relevant interest in the securities (which may not be the case throughout the entire contract period).

16. This discussion paper, and the Panel's draft Guidance Note, therefore do not generally relate to delivery-settled equity derivatives.

17. However, the Panel would be likely to treat as unacceptable circumstances any attempt to avoid the intent of its Guidance Note by persons entering into deliverable equity derivatives in a manner which was argued did not give rise to an obligation to make disclosure under Chapter 6C where an otherwise similar cash settled equity derivative would give rise to a disclosure obligation under the Panel's proposed Guidance Note.

18. For example, a holder might enter into a deliverable equity derivative with a writer when the writer advised that it had no relevant interest in the underlying securities. The holder might assert that as the writer had no relevant interest in underlying securities at the time of entry into the equity derivative, the holder believed that it had gained no relevant interest. However, the Panel would likely consider that the statement was a contrivance if:

    (a) it considered that market practice would be that the writer would cover its risk shortly after entering the equity derivative; and

    (b) it considered that the holder and writer had deliberately not communicated the change in the writer's relevant interests; and

    (c) the holder made no disclosure to the market.

19. On that basis, the Panel considers that when considering whether or not to make disclosure to the market, holders of deliverable equity derivatives should assume that the writer has a relevant interest in an equivalent number of securities, or treat the deliverable equity derivative as if it were a cash settled equity derivative and follow the Panel's Guidance Note.

Section 609(6)

20. A relevant interest gained under section 608(8) via a delivery-settled equity derivative is excepted by section 609(6):

> "A person does not have a relevant interest in securities merely because of:
>
> (a) a market traded option over the securities; or
>
> (b) *a right to acquire the securities given by a derivative.*
>
> This section stops applying to the relevant interest when the obligation to make or take delivery of the securities arises." [emphasis added]

21. Section 609(6) was introduced by the CLERP Act 1999. The EM for the CLERP Act notes that under the new exception, a person will only acquire a relevant interest in a security under an exchange traded option or 'futures contract' when the option is exercised or they are obliged to take delivery.

22. The term 'futures contract' was later replaced with 'derivative' by the Financial Services Reform Act 2001 and had the result of widening the operation of the exception in section 609(6). Para 6.72 of the Explanatory Memorandum for the Financial Services Reform Bill states:

    "As recommended by CASAC in its report entitled 'Regulation of On-exchange and OTC Derivatives Markets' the definition focuses on the functions or commercial nature of derivatives rather than trying to identify each product that will be regarded as a derivative."

23. The definition of derivative is now found in section 761D and regulation 7.1.04. Subject to some specific exceptions, a derivative is an arrangement under which the writer is required to pay the holder consideration that is ultimately determined, derived from, or varied by reference to (wholly or partly), the value or amount of something else such as a security, a rate, an index or a commodity.

24. The new derivatives definition extended the operation of section 609(6) in relation to OTC delivery-settled equity derivatives. However, a relevant interest will arise at the time that an obligation to make or take delivery of the securities arises.

25. The derivatives exception does not apply for the purposes of giving substantial holding disclosure in accordance with Chapter 6C. Under section 9, a person will have a 'substantial holding' if they or their associates 'would have a relevant interest but for section 609(6)' in respect of more than 5% of the total number of voting shares. Accordingly, a substantial holding notice, if required, must be given within two business days of the investor entering into the delivery settled equity derivative arrangement.

Cash-settled equity derivatives

26. There is a view that a cash settled equity derivative will not give rise to a relevant interest if it is *solely* an economic transaction under which the holder takes only the risk of changes in the price or value of the shares, but does not acquire any right to have the shares transferred (as settlement of the swap or otherwise). This assumes that the transaction does not include any agreement,

arrangement or understanding restricting the writer's ability to deal with or vote its shares.

27. Given that cash-settled equity derivatives can be structured so that disclosure is not required under Chapter 6C, there is a view that cash-settled equity derivatives can be used to obtain effective control, at least over their disposal, of underlying shares without the need for disclosure, and therefore without detection.

28. However, although there is no contractual requirement for delivery of the physical shares, the writer of a long equity derivative will have a strong economic incentive to acquire a matching number of physical securities at the beginning of the equity derivative period to hedge its position. When the holder of the derivative closes out its position, the writer has an economic incentive to sell the hedge shares simultaneously at the equity derivative settlement price. This is especially so in relation to equity derivatives/Combined Holdings of the size that the Panel's draft Guidance Note addresses.

29. The holder's control of the shares in the case of a cash-settled equity derivative may depend on the structure of the hedging and the terms under which the equity derivative may be 'unwound'. If the writer holds physical shares and the equity derivative is for a fixed period, the holder will be aware of the identity of the writer and when the writer will be likely to dispose of the shares. The holder is therefore in a privileged position to acquire the hedge shares when the contract ends.

30. Further, if settlement is based on the price of the physical in the market on the day the equity derivative is unwound, the holder may have a reduced price restraint in acquiring the hedge shares (especially if the size of the equity derivative is large compared to the normal market volume of the security)– the more it pays in the market to buy the shares on the unwind date, the higher is the pay-off on the swap. No-one else in the market has that reduced price restraint. Conversely, in that case, the writer is likely to have the commercial incentive to sell its shares for the price in the market on the day the equity derivative is unwound.

31. The writer will be required to count its holding of hedge securities when considering its substantial holder disclosure under Chapter 6C. However, it is possible that a derivative holding could be structured so that even the counterparties are not required to give disclosure e.g. if the holder takes derivative positions with a number of writers each for less than 5%.

32. The question of whether this "economic incentive" could give rise to a "substantial interest" was considered in *Glencore* and Emmett J found that it could not. The Amendments Act, however, provides that a substantial interest is not to be read as being limited in the way that it was held in *Glencore.*

6. Recent examples in Australia

33. In March 2005, CSFB lodged a substantial holding notice describing itself as the beneficial holder of approximately 11% of Portman, a takeover target of a bid by

US iron ore miner Cleveland Cliffs. Portland was reported to have sought confirmation (on behalf of Cleveland Cliffs) from CSFB through a notice under section 672A as to the underlying party interested in the shares. Separately, Seneca Capital Management, a New York based hedge fund was reported to have claimed to "hold" 9% of Portman via CSFB.

34. Another example arose out of cash-settled equity derivative arrangements between BHP Billiton Ltd and Deutsche Bank in relation to WMC Ltd shares. Between November 2004 and January 2005, BHP Billiton entered into a number of swap contracts with Deutsche Bank to give BHP Billiton economic exposure to approximately 4.3% of the voting shares in WMC.

35. According to media reports at the time, WMC sought to find out whether there was a strategic party behind Deutsche Bank's buying. WMC was reported to have issued notices under section 672A disclosure to which the bank responded that it was the sole beneficial owner.

36. Disclosure of the arrangements with Deutsche Bank was included by BHP Billiton in an announcement of its takeover bid for WMC and was included in BHP Billiton's bidder's statement. The bidder's statement noted that BHP Billiton derived profits from increases, and incurs losses from decreases, in the market price of a particular number of WMC shares from an initial price specified in each relevant contract (the 'calculation prices'). The bidder's statement disclosure included the range of calculation prices as well as the volume weighted average calculation price. BHP Billiton noted that the contracts "do not permit delivery of shares to BHP Billiton to satisfy payment obligations". However, the timing and structure of the unwinding of the equity derivative were not disclosed.

7. Panel decisions in Australia and UK

37. The Panel considered the use of equity derivatives in relation to dealings in John Fairfax Holdings Ltd (**Fairfax**) shares[6]. In late 1996, a shareholder of Fairfax announced that it had agreed to sell down its 25% holding in Fairfax to subsidiaries of Brierley Investments Limited (**BIL**):

    (a) 19.9% to be acquired unconditionally; and

    (b) 4.99% to be acquired subject to shareholder approval.

38. At a shareholders' meeting in February 1997, Fairfax shareholders refused to pass a resolution to allow BIL to acquire the remaining 4.99%. In media reports, BIL was reported as saying that it proposed to acquire further Fairfax shares in reliance on the 3% creep exception.

39. In March 1997, BIL entered into undisclosed cash-settled equity swaps in respect of approximately 5% of Fairfax shares with Australian subsidiaries of Merrill Lynch & Co. Inc. (**Merrill Lynch**). The total face value of the swaps was more than $110 million. There was no obligation on Merrill Lynch to acquire or refrain from selling Fairfax shares (although it was submitted that there was a

[6] *Re Australian Securities Commission and John Fairfax Holdings Ltd* (1997) 15 ACLC 1457

natural imperative for it to do so). The pricing structure and period of the contracts were such that the hedge was to be unwound 6 months after BIL's acquisition with respect to 3% and after 12 months for the remaining 2% based on the volume weighted ASX market price of Fairfax shares on the settlement date.

40. Merrill Lynch sold approximately 3% of Fairfax shares to unwind the 6 month hedge on 17, 24 and 27 June 1997 (each being separate 'valuation dates' for approximately one third of the initial 3%) by way of market trades with various brokers, some of which were buying on behalf of BIL. The total percentage of shares acquired by BIL across the three days was 3%.

41. The Panel found that the circumstances were not unacceptable.

42. In its reasons, the Panel noted that it was constrained by the definition of unacceptable circumstances in the Corporations Law. Because of the delay in lodging the application, the Panel did not consider that it could 'look back' to BIL's entry into the derivative arrangements and therefore primarily focused on whether BIL's resulting 3% would be a substantial interest. The Panel noted that BIL had publicly stated that it intended to acquire further Fairfax shares under the creep exception – thereby weakening arguments that directors and shareholders should have had an opportunity to consider BIL's 'proposal'. The Panel noted that it had not received submissions from Fairfax, its directors or shareholders. On this basis the Panel conclude that interested parties or the market generally did not identify that there were any missed or lost benefits.

43. The Panel noted that "[d]esirably, in a fully informed market, swap arrangements should be disclosed". It also noted that the process adopted in that case required the Panel to take an overly legalistic approach. The Fairfax Panel recommended legislative change to allow the Panel to take a more commercial approach to takeovers disputes.

44. Equity derivatives were also considered in the UK in relation to a bid by Trafalgar House Plc for Northern Electric in 1994. Before the announcement of its offer, Trafalgar House entered into a number of cash-settled equity derivatives (known in the UK as 'contracts for difference') with its investment bank adviser. The London Panel concluded that there had been no breach of the Takeover Code but did not give any reasons for its decision.

45. After consultation with the London Panel, the FSA's predecessor issued guidance that derivative arrangements could not be entered into on the basis of inside information (including information that a bid may be made) where the counterparty would only provide a cash benefit and would not constitute a step towards the progress of the bid. As discussed below, the London Panel in 1994 changed the rules to require the disclosure of CFDs in such circumstances and in 2005 introduced changes to the London City Code which in essence treat long equity derivatives as if they were physical holdings for control and disclosure purposes, similar to the approach proposed in the Panel's draft Guidance Note.

8. London Panel Consultation Paper

46. In January 2005, the London Panel released a Consultation Paper in relation to equity derivatives suggesting various amendments to the Takeover Code and in November 2005 released two further papers detailing changes proposed to the Takeover Code in relation to Disclosure Issues and Control Issues. The proposals were incorporated into the Takeovers Code on 7 November 2005 [7]. Under the new provisions derivative positions are treated as acquisitions of securities for the purpose of the disclosure, mandatory bid and minimum bid price rules.

47. Under the 2005 changes, the Takeovers Code extends the disclosure regime to all holders of long derivative positions of 1% or more in any class of shares (regardless of whether the holder holds any underlying shares). Further, if a disclosing person also holds a short position, they are also required to disclose that position. The rule applies to any derivatives (rather than being limited to contracts for difference) on the basis that market participants could rapidly develop instruments which fall outside the definition of a CFD.

48. The key policy basis for the changes was that the London Panel considered, on the basis of its members' knowledge of market practices, that persons with long derivative positions may exercise a significant degree of de facto control over the shares to which the derivative is referenced. With reference to recent examples, the London Panel noted that derivative holders are "increasingly behaving as if they were shareholders".

9. Alinta

49. In light of the Full Federal Court's decision in *Alinta* the Panel has reviewed the draft Guidance Note to ensure that the Panel's policy and guidance is based on the principles set out in section 602 , and do not consider whether or not circumstances might give rise to a contravention of the Act.

50. The Panel does not consider that the decision in *Alinta* prevents it considering whether or not the intention and policy of the Act and its provisions are being avoided by arguably legal actions.

10. Substantial interest

51. The Panel notes the changes to the definition of substantial interest following the Corporations Amendments (Takeovers) Act 2007. The Panel proposes to proceed on the basis that any doubts about its ability to consider that an equity derivatives may give rise to a substantial interest have been removed.

11. Long equity derivatives

52. The Panel has adopted an approach that is consistent with that of the London Takeover Panel and the decisions in Austral Coal 02, 02R and 02RR, that the economic incentives for a writer to hedge is likely to give some form of effective control over the disposal of an equivalent number of the underlying securities.

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[7] Summary of 07/11/2005 Changes

This is especially the case where the equity derivative is of a size to require disclosure under the Panel's proposed Guidance Note.

53. The Panel considers that the existence of significant long equity derivatives is likely to be material information for an efficient, competitive and informed market for control of listed securities in terms of control over the disposition of the underlying securities and over the entity, and for determining the market price of the underlying securities.

54. Given the similarity in pricing and control effects of long equity derivatives and physical holdings, the Panel considers that aggregating the two for disclosure purposes is appropriate.

12. Short equity derivatives

55. The Panel considers that entering into a short equity derivative of material size is likely to cause the writer to seek to hedge its risk. However, it is unlikely to cause the writer to acquire the physical, it is more likely to cause it to sell existing securities it holds, or borrow to sell[8]. On that basis, the Panel considers short equity derivatives are unlikely to have an effect on control or proposed control of an entity or the acquisition of a substantial interest in the entity.

56. The Panel notes that the Act does not require disclosure of short selling physical securities under Chapter 6C, or treat them as giving a relevant interest in the underlying securities for control purposes, presumably for similar reasons to the paragraph above.

57. On that basis, the Panel proposes not to require the holder of short equity derivatives to make disclosure if their Combined Holding would not require them to make disclosure, but will require a person to disclose any short equity derivatives if they would otherwise be required to make disclosure because their Combined Holding becomes more than 5% or changes by 1% or more above 5%.

13. Hedge status

58. A fundamental tenet of the Panel's Guidance Note is that in circumstances where a holder acquires an equity derivative that is large enough to require disclosure under the Panel's Guidance Note it is likely that the writer will consider it prudent to hedge the equity derivative in as closely matching a manner as possible i.e. acquiring the underlying securities.

59. The Panel accepts that this may not always be the case, for example where the writer is confident that the holder is a portfolio investor with no strategic or corporate interest in the listed entity, and thus its Guidance Note will require some holders who do not have a substantial interest in the entity will be required to make disclosure.

60. However, the Panel considers that:

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[8] If the writer borrows to sell short to match its exposure a securities lending agreement will normally require it to return an identical number of securities so securities lending will not affect control of the entity by aggregating blocks of securities.

(a) instances where holders who do not have a substantial interest in the entity will be required to make disclosure are unlikely to be common;

(b) the holder, in such circumstances, will be unlikely to be adversely affected by disclosure of its Combined Holding; and

(c) disclosure of the equity derivative is likely to be material to the price discovery process for the securities and thus material to the efficient, competitive and informed market for control of the securities.

61. However, more importantly, the Panel considers that the hedge status of an equity derivative can easily be disguised, for example by entering into one or more back to back equity derivatives with the hedge securities controlled by the last writer. The Panel considers it would be poor public policy to require disclosure of the hedge securities of disclosed equity derivatives if the disclosure requirement could easily be avoided. If that were the case, equity derivatives disclosure might cause more harm than good by misleading the market. Rather, the Panel considers that the market will be better served by:

(a) not requiring disclosure of the hedge status of equity derivatives;

(b) not requiring holders of equity derivatives to make enquiries of the writer; and

(c) not taking the hedge status into account when considering whether or not an equity derivative give rise to unacceptable circumstances.

14. Avoidance

62. The Panel notes the decision of the Full Federal Court in *Alinta.* The Panel will not address, or take into consideration, whether or not circumstances before it give rise to a contravention of the Act.

63. The Panel does not consider that addressing whether or not ostensibly legal circumstances breach the purposes of Chapter 6 is contrary to the decision in *Alinta.*

64. The Panel considers that structuring a transaction in such a way that it complies with the provisions of the Act, but breaches the intent and purposes of Chapter 6, should be unacceptable and should be characterised as avoidance of the provisions and purposes of the Act. The Panel does not consider addressing issues such as these is contrary to the decision in *Alinta*.

65. The Panel considers that the explanatory material in relation to its legislation indicates that part of the Panel’s role is one of anti-avoidance and ensuring compliance with the spirit of the law. The issues were discussed in the Austral Coal 02RR reasons for decision at paragraph 275:

> "275 If further evidence of this is required, we note the following statements:
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> *The purpose of this provision [section 60 of CASA] is to discourage activities which would frustrate the aims of the code. This is to be achieved by the NCSC*

> *having power to act in those circumstances where it considers that the acquisition or conduct does not satisfy certain criteria in the clause*[9].
>
> *The Panel will retain its existing jurisdiction to enforce compliance with the spirit of the law*[10].
>
> *"unacceptable circumstances may not involve any contravention of the Law"*[11]
>
> *Further, Part 6.9 [of the Corporations Law, now Part 6.10]? provides some flexibility in the regulation of the acquisition of shares in circumstances where the literal operation of the regulatory regime is either unnecessarily restrictive or ineffective to achieve the object of Chapter 6. ?it is clear enough that the regime involving the Panel established by Part 6.9 is designed to ensure regulation of the acquisition of shares over and above the provisions contained in the balance of Chapter 6?*[12]*"*

15. Transition

66. The Panel is publishing the draft Guidance Note and this discussion paper for public comment for a period of twelve weeks. Following that period, the Panel will review any comments received, consult internally (and externally again if needed) and then consider any changes to the policy or drafting of the Guidance Note. Therefore, the Panel considers that any person who holds equity derivative positions which would require disclosure, or which might give rise to unacceptable circumstances for other reasons on the basis of the policy set out in the draft Guidance Note will have a minimum of twelve weeks in which to address any non-compliance with the principles set out in the draft Guidance Note. Such persons may look to make disclosure or unwind such positions.

67. If the draft Guidance Note is published as final Panel policy. The Panel considers, given the exposure period in relation to the draft Guidance Note and the opportunity that persons have to make disclosures or unwind positions in the meantime, that equity derivatives in existence at the date of publication of the Panel guidance note should not be "grandfathered" from the application of the Guidance Note.

16. Discussion points

68. The following questions are a guide to issues on which the Panel considers the market and the public may wish to make comments. However, the Panel is interested in any submissions on the issues relating to equity derivatives. If you wish to provide comments on other issues please feel free to do so.

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[9] *Explanatory Memorandum to the Companies (Acquisition of Shares) Bill 1980*, para 170.
[10] *Second Reading Speech introducing the CLERP Bill, House of Reps Hansard, Thursday 3 December 1998, page 997.*
[11] *Cullen v Wills, Adler and Jooste (in their capacity as members of the Corporations and Securities Panel)* (1991) 9 ACLC 1450 at 1458 per Black CJ, Sweeney and Burchett JJ concurring.
[12] *Brierley Investments Limited v Australian Securities Commission* (1997) 15 ACLC 1341 at 1348, per Emmett J, rejecting a submission by Mr Bathurst QC.

General

69. Do you support the issue of specific guidance regarding equity derivatives? In the form proposed?

70. Can equity derivatives be used to avoid compliance with provisions of Chapters 6 – 6C? Consider, for example:
    (a) substantial holding and beneficial holding notices;
    (b) 20% limit;
    (c) minimum bid price rule;
    (d) escalation clauses; and
    (e) collateral benefits.
    (f) Can equity derivatives be structured to avoid other provisions?

71. Should the Panel require compliance with the purposes, or spirit, of these provisions on a case by case basis or publish the draft Guidance Note to address such transactions as a whole?

72. Should disclosure guidance be limited to cash-settled equity derivatives (given that equity settled derivatives are already required to be disclosed)?

73. Should the Panel decline to publish any guidance and await legislative reform? If so, how should it approach any applications that are made to it in relation to equity derivatives in the interim?

74. The draft Guidance Note has substantial discussion of the mechanics, use and descriptions of equity derivatives. Is such description useful, or should the Panel cut the draft Guidance Note back to simply description of its proposed response to specific issues? Is any of the Panel's description of the mechanics or uses of equity derivatives inaccurate or likely to date rapidly with market developments?

Deliverable equity derivatives

75. Do you agree with the Panel's approach to deliverable equity derivatives i.e. treat them as if either the writer holds a relevant interest in an equivalent number of the underlying securities, or treat them as if they were cash settled equity derivatives and follow the Panel's Guidance Note?

76. Should the Panel only make a declaration of unacceptable circumstances where it appears that the equity derivative has been structured, or entered into, for the purpose of avoiding the provisions of the Act? For example, a holder entering into a **deliverable** equity derivative with a writer knowing that the writer had no relevant interest in any relevant securities and then ensuring that it did not become aware of the writer subsequently acquiring hedge securities to cover the equity derivative.

Substantial interest

77. Do you agree, or disagree with the Panel's approach to the "substantial interest" concept in the draft Guidance Note?

Netting

78. The Panel proposes that for calculation of Combined Holdings the Panel will consider the maximum Combined Holding without netting off long and short positions. This is consistent with the rule in the UK and consistent with disclosure and other treatments of physical positions. It is also consistent with the Panel's view as to the ease with which disclosure could be avoided if positions were netted for disclosure and other purposes. It also gives the market the best view of a maximum possible result or position, which is material information in itself.

79. Do you agree with the Panel's proposed treatment?
Are there any adverse consequences of the Panel's proposed treatment, if so how might those consequences be mitigated?

Hedge status

80. The Panel's draft Guidance Note says that the Panel proposes:

    (a) not to take into account whether or not equity derivatives which might be required to be disclosed are hedged in the physical stock; and

    (b) not to require holders either to enquire or disclose the hedge status of equity derivatives.

81. Do you agree with the Panel's view as to the ease with which such disclosures could be avoided, thus making a disclosure principle which was effectively fully voluntary or discretionary?

82. Is the hedge status of equity derivatives material information to the market, or will the market assume (as the Panel does) that equity derivatives of the size to be disclosed will far more likely than not be fully hedged?

83. If the Panel did require enquiry or disclosure of the hedge status, how could it draft guidance to prevent easy avoidance?

84. Would a routine enquiry obligation on the part of a holder cause harm to the normal equity derivatives market? If so, how could the Panel mitigate any adverse effect?

Avoidance

85. Do you agree with the Panel's approach to its draft Guidance Note as intended to prevent avoidance of the purposes of Chapter 6?

Disclosure

Long positions

86. Do you agree with the Panel's approach to disclosure of Combined Holdings?

87. Is the Panel's approach likely to affect the bona fide market for equity derivatives unduly? If so, how could the Panel mitigate any adverse effect?

88. Are there any types of Combined Holding that should be excluded from the Panel's disclosure requirement?

89. Is it appropriate to impose a blanket disclosure rule consistent with the thresholds in Chapter 6C? Should it be a question of the number of shares to which the derivative relates or the resulting exposure of the holder?

Short positions

90. Should short derivative positions also be disclosed as required by the UK Takeover Panel regardless of other interests?

91. Should the Panel continue its proposed guidance that short positions need not be disclosed unless the person has a Combined Holding which requires to be disclosed in which case short positions should be disclosed in addition and separately?

92. Should the Panel only require disclosure of net positions?

93. Should disclosure of either pure short, or mixed short and long positions, also be required in the bidder's statement (if the investor makes a takeover bid)?

Holder vs writer

94. The proposed Guidance Note currently proposes that only holders of equity derivatives, not writers, be required to make Combined Holding disclosure.

95. Should the Combined Holding/equity derivatives disclosure obligation fall on the holder or the writer of the equity derivative or both?

96. Would disclosure solely by the writer be adequate where a holder may have a number of derivative positions of less than 5%?

97. Should the writer be required to disclose any equity derivatives which it has entered into which its physical holding is being used to hedge? Would such a requirement be easy to avoid?

98. Would a disclosure obligation of this type on the part of a writer cause harm to the normal equity derivatives market? If so, how could the Panel mitigate any adverse effect?

Control transactions

99. Should the Panel's Guidance Note be limited to circumstances where the equity derivative is entered in connection with a control transaction?

100. If so, what should the Panel mean by "in connection with control transaction" e.g. is it a question of whether the holder proposes to use the position as a platform for making a bid;

101. Would limiting the Guidance Note to control transactions:

    (a) make avoidance of the purpose of the Guidance Note too easy;

    (b) create evidentiary difficulties where a person asserted that at the time of entering the equity derivative they had no intention of commencing a control transaction;

    (c) place a person at risk of retrospectively having not complied with the Guidance Note if they subsequently decided to consider a control transaction?

Disclosure process

102. Do you agree with the Panel's proposal that a person need only consider its Combined Holding on the basis of equity derivative exposure that the writer has agreed to give "firm"?

103. Should the Panel define "firm", if so how?

104. Is the Panel's proposed process likely to lead to easy avoidance by parties not settling a "firm" exposure until some time later?

105. Should the Panel take hedging activity of the writer as evidence of agreeing to give firm exposure under equity derivatives, regardless of when parties submit the exposure became "firm"?

106. Would a disclosure obligation of this type on the part of a writer cause harm to the normal equity derivatives market? If so, how could the Panel mitigate any adverse effect?

Disclosure content

107. Do you agree with the information that the Panel proposes to be disclosed in relation to equity derivatives?

108. In particular, what documents need be, or need not be, annexed to Combined Holding disclosure notices? Should the derivative contract be attached to a disclosure notice or just a summary? If just a summary is considered appropriate, what information should be included e.g. price, length of contract, structure of unwind? How will a disclosure rule apply to a market traded derivative?

109. If not, what additional information should be disclosed, or what information does the Panel propose which is excessive?

110. Does the proposed disclosure concerning price ensure that the real consideration payable by a holder for an equity derivative, and the underlying securities if it acquires them, are disclosed to the market and target shareholders?

111. If not, what additional disclosure concerning price and consideration should the Panel include in the Guidance Note?

112. Should the Panel require different types of disclosure where the relevant company is bidder, target, or not part of a disclosed control transaction?

113. Should the Panel adopt the time differences for disclosure in takeover situations that are adopted for substantial holding notice disclosures?

Tracing notices

114. The draft Guidance Note currently does not propose that writers of equity derivatives which also hold securities of a listed entity should be required to disclose, in response to a beneficial ownership notice under section 672A, information about any equity derivatives they have written in relation to securities of the relevant entity.

115. It has been submitted to the Panel that it should uphold the policy of the beneficial ownership provisions in Part 6C.2 as much as it currently proposes under the Guidance Note to uphold the policy of the substantial holding provisions in Part 6C.1.

116. On the other hand, it has been submitted to the Panel that because the beneficial ownership provisions do not have the thresholds that exist under the substantial holder regime, applying the principles of the Guidance Note to the beneficial ownership policy would cause unwarranted harm to:

    (a) the market for smaller, non-control equity derivatives; and

    (b) the commercial interests of writers of equity derivatives (in that a beneficial ownership notice in relation to shares held by the writer would require the writer to disclose the identity of all of the writer's equity derivative clients).

117. Should the Panel require a writer, who holds hedge securities and has been given a direction under section 672A, to disclose the information set out in section 672B, about the holders of equity derivatives that the writer has written in relation to the securities subject to the direction?

118. Is disclosure of the holders of equity derivatives by the writers necessary to protect the policy of Chapters 6 and 6C, or would the Panel's approach of making enquiries (see paragraphs 126 to 138 below) be sufficient?

119. What are the disadvantages of requiring disclosure of the holders of equity derivatives by the writers under section 672A notices, in particular for:

    (a) the "non-control" market for equity derivatives which would not be disclosed under a Combined Holding disclosure notice as the Guidance Note is currently drafted;

    (b) the commercial interests of writers of equity derivatives. For example in terms of their equity derivative client list?

120. If it proposed to require disclosure of equity derivatives in responses to beneficial ownership notices, how could the Panel mitigate any unintended adverse effects of such an approach?

121. Could the Panel otherwise achieve the objectives of protecting the policy of Chapters 6 and 6C without requiring disclosure of the holders of equity derivatives under a direction given under section 672A? If so, how?

122. Would the burden on the holders of equity derivatives from this disclosure obligation outweigh the benefits to the market?

Remedies

123. Are the remedies that the Panel proposes adequate?

124. Should the Panel adopt any specific approaches to remedying unacceptable circumstances relating to equity derivatives?

125. Are there specific remedies that the Panel should foreshadow for particular examples of unacceptable circumstances in relation to equity derivatives?

Enquiries

126. Should the Panel be prepared to make enquiries of the holders of securities if it receives an application alleging that unacceptable circumstances exist because for example, of non-disclosure of a Combined Holding above 5%?

127. Should the Panel require that the applicant make a reasonable case that unacceptable circumstances exist and that the holders of securities are likely to have entered into equity derivatives with a person who has not disclosed a Combined Holding of more than 5%?

128. What level of certainty should the Panel require of an applicant?

129. How might the Panel prevent such applications being used as "fishing expeditions"?

130. Should the Panel limit disclosure of information from holders of relevant securities until it forms a view that there is a likelihood that unacceptable circumstances exist? If so, how should the Panel quarantine the commercially sensitive information while it makes that initial assessment?

131. If the Panel puts adequate quarantine arrangements in place, should the Panel take negative inferences from the holder of relevant securities declining to advise the Panel as to the identity of persons (if any) with whom the holder has entered into equity derivatives in relation to securities of the relevant entity?

132. Should the Panel be prepared to make similar enquiries if it receives an application alleging that unacceptable circumstances exist because non-disclosure in response to beneficial ownership notices, of information concerning the holders of equity derivatives in relation to a parcel of securities of less than 5% has an adverse effect on the efficient competitive and informed market for a listed entity's voting securities? For example, a listed company notices that an investment bank has acquired a parcel of 1% of its securities and gives the investment bank a notice under section 672A, to which the investment bank responds that the shares are held on its own account as a principal position. The listed entity has a belief that the parcel is in fact hedge securities to cover an equity derivative written by the investment bank for a possible bidder for the listed entity, and that disclosure of that fact would be price sensitive information. Should the Panel consider commencing proceedings, and making enquiries of the investment bank, on the basis that the lack of disclosure under section 672A notices may have an adverse effect on the efficient, competitive and informed market for the listed entity's voting securities?

Transition

133. Is the Panel's proposed approach to transition appropriate?

134. Is the proposed consultation period adequate?

135. Is there any basis for "grandfathering" any existing equity derivatives?

Other issues

136. Are there any other comments that you wish the Panel to consider?

137. Are there any other current Guidance Note's that the Panel should review when considering the draft Guidance Note and responses to the draft Guidance Note and discussion paper?

138. Do you wish your submission to the Panel to remain confidential? If you do not advise the Panel that you wish any response to remain confidential the Panel may publish it, or extracts from it in the Panel's consultation response document in relation tot eh draft Guidance Note.