Takeovers Panel

Guidance Note
Equity Derivatives

GUIDANCE NOTE #: EQUITY DERIVATIVES

Overview

This Guidance Note sets out the Panel's guidance as to when, and in what circumstances, the use of equity derivatives may constitute unacceptable circumstances. The Panel also provides some guidance as to measures that bidders and other persons may take to reduce any risk that conduct they take in relation to equity derivatives would give rise to unacceptable circumstances.

The Panel is concerned to ensure that equity derivatives are not used in ways that undermine the policy of Chapter 6. However, the Panel notes that there is a significant market for equity derivatives that are not relevant to control or potential control or the acquisition or proposed acquisition or a substantial interest, and this Guidance Note is not intended to interfere with that market.

In considering whether unacceptable circumstances arise as a result of the use of an equity derivative, the Panel will normally treat long equity derivative positions and relevant interests in securities as if they both gave the holder voting power in relation to the securities to which they relate, for disclosure and other purposes (referred to in the Guidance Note as **Combined Holding**).

The Panel will not normally consider:

(a) whether or not the writer of the equity derivative had hedged the equity derivative;

(b) the form of hedging;

(c) the knowledge of the holder of the equity derivative of that hedging (if any); or

(d) the purpose for which the equity derivative was entered into.

The Panel considers that taking such matters into account would likely encourage attempts at avoidance of the purpose of this Guidance Note or impose unreasonable enquiry burdens on the holders of equity derivatives.

Compliance with this Guidance Note is not to be regarded as a substitute for compliance with Chapter 6 or 6C of the Corporations Act (*Cth*) 2001 (**Act**)[1] [2] in

[1] The Act was amended by the Corporations Amendments (Takeovers) Act 2007. This GN refers to the provisions of the Act as amended.

[2] All statutory references are to the Act, unless otherwise indicated.

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relation to cash settled equity derivatives. Parties to equity derivative agreements should consider taking legal advice on their obligations under the Act.

The Panel notes the decision of the Full Court of the Federal Court in *Australian Pipeline Limited v Alinta Limited* [2007] FCAFC 55 (see TP 07/19). This Guidance Note does not relate to compliance with the Act, and the Panel will not take compliance or non-compliance with the Act into account when considering whether or not circumstances are unacceptable.

Introduction

2. In this Guidance Note,[3] the Takeovers Panel (**Panel**) sets out:

   (a) the criteria that it will apply in assessing whether any particular equity derivative position constitutes unacceptable circumstances; and

   (b) the Panel's approach to the disclosure of equity derivatives.

3. The Panel may declare circumstances relating to an equity derivative to be unacceptable if it appears to the Panel that the circumstances are unacceptable:

   (a) having regard to the effect of the equity derivative position (or disclosure of the equity derivative position) that the Panel is satisfied the circumstances have had, are having, will have or are likely to have on control or potential control of a company, or the acquisition or proposed acquisition of a substantial interest in a company; or

   (b) because they are otherwise unacceptable (whether in relation to the effect that the Panel is satisfied the circumstances have had, are having, will have or are likely to have in relation to the company or another company or in relation to securities of the company or another company) having regard to the purposes of Chapter 6 of the as set out in section 602 (**Purposes of Chapter 6**)[4];

   in both cases, having regard to the public interest and the provisions set out in section 657A(3) of the Act.

4. The Panel will generally consider the acquisition, or proposed acquisition of a substantial interest, or an effect on a proposed acquisition of a substantial interest as having an effect on control of a company. Marks J in *Elders IXL Ltd v NCSC* [1987] VR 1 described a substantial interest as:

[3] The Panel's Guidance Note will guide the Panel's administrative decision-making when implementing the purposes of the takeovers Chapter.

[4] Following the decision of the Full Court of the Federal Court in *Australian Pipeline Limited v Alinta Limited* [2007] FCAFC 55 (see TP 07/19) the Panel will not accept applications, and will not make declarations, under s657A(2)(c), unless a court finds that it may.

"a step in the direction of takeover or change in corporate control. It is not to be considered in a vacuum as relating solely to size. The size must have relationship to a threat or potential threat to the stability of corporation control."

Emmett J in *Brierley Investments Ltd and Others v Australian Securities Commission and Others* — 24 ACSR 629 held that 3% of the voting shares in a company could constitute a substantial interest.

5. The Panel notes section 602A, following the Corporations Amendments (Takeovers) Act 2007, which avoids any limitation on the scope of "substantial interest" which the decisions of the Federal Court in the *Glencore*[5] decisions may have implied. On that basis, the Panel considers that an economic interest that an equity derivative may give to the holder of the Equity Derivative is capable of being a substantial interest.

6. The Panel will require applicants and parties in any proceedings to provide evidence and/or submissions on the effect on:

   (a) the control or potential control of a company; or

   (b) the acquisition or proposed acquisition of a substantial interest; or

   (c) the purposes of Chapter 6;

   of the entry into, or disclosure or non-disclosure, of an equity derivative.

7. Equity derivatives have been considered by the Panel in a number of matters that have come before it.[6] Since the *Fairfax* decision, the equity derivatives market has evolved significantly in Australia (as has the corporations legislation). This evolution was reflected in the facts and the decision of the Panels in *Austral Coal 02, Austral Coal 02R* and *Austral Coal 02RR*. The Panel expects that it will need to continue to monitor the evolution of, and its own experiences with, equity derivatives, and to update this Guidance Note from time to time to keep it relevant.

8. Given that the Panel considers it more likely than not that equity derivatives of the size and nature which this Guidance Note addresses will be physically hedged, and that holders of those equity derivatives will operate on this presumption, the Panel has drafted this Guidance Note largely on the basis that such equity derivatives will be physically hedged and that the holder will be operating on this presumption. The Panel recognises that this will not always

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[5] Glencore International AG & Anor v Takeovers Panel & Ors [2005] FCA 1290
Glencore International AG (ACN 114 271 055) v Takeovers Panel [2006] FCA 274

[6] Australian Securities Commission and John Fairfax Holdings Limited (1997) 25 ACSR 441 (Corporations and Securities Panel); Austral Coal 02 [2005] ATP 13; Austral Coal 02R [2005] ATP 16; Austral Coal 02RR [2005] ATP 20.

be the case but, in the interests of brevity, has not set out the alternative possibilities in all scenarios.

9. It has been argued that cases where an equity derivative is not fully physically hedged, or the holder does not actually know the hedge status[7] of the equity derivative, are less likely to cause unacceptable circumstances. However, for the reasons set out in paragraphs 32 to 34 below, the Panel does not consider that it should normally take the hedge status of an equity derivative into consideration when assessing whether or not the circumstances surrounding an equity derivative give rise to unacceptable circumstances.

Legislative basis for Panel guidance

10. The Panel is concerned to ensure that equity derivatives are not used with the effect of avoiding or undermining the purposes of Chapter 6.

11. The Panel will consider unacceptable circumstances to arise if the use of an equity derivative avoids or is inconsistent with the legislative purposes of the provisions of Chapters 6–6C as set out in section 602.

12. Equity derivatives may be used to avoid the legislative purposes of the provisions of Chapters 6–6C as set out in section 602 where it is argued that the equity derivative does not give the holder of the equity derivative voting power, or a relevant interest, in the underlying securities. On that basis, the holder may argue that it is not required to disclose their interest in the underlying securities or comply with one or more of the provisions of Chapter 6, when in fact the holder has an economic interest in, and some form of control over, the underlying securities.

13. The Panel will consider the purposes set out in section 602 when determining whether unacceptable circumstances exist in relation to the affairs of a company. For example, a failure to disclose a relevant equity derivative position where the Panel considers that the objectives of Chapter 6C have been avoided or negated would affect the following purposes of Chapter 6:

    (a) that "the acquisition of control … takes place in an efficient, competitive and *informed* market" (section 602(a)) [emphasis added]; and

    (b) that the target's security holders and its directors:

        (i) "know the identity of any person who proposes to acquire a substantial interest in the company" (section 602(b)(i)); and

[7] The **hedge status** of an equity derivative is the degree to which the writer has hedged its risk under the equity derivative and the different means by which it has done so (see paragraphs 18 and 19).

(ii) "are given enough information to enable them to assess the merits of the proposal" (section 602(b)(iii)).

14. Other equity derivative positions may prevent security holders of bid class securities from receiving a reasonable and equal opportunity to participate in the benefits flowing from the acquisition of a substantial interest in the relevant company. For example, the minimum bid price principle.

Meaning and potential use of equity derivatives

Definition of derivative

15. For the purposes of this Guidance Note, 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.[8]

16. The term 'derivative' is intended to focus on the functions or commercial nature of derivatives rather than trying to identify each product that will be regarded as a derivative.

Use of long derivative positions

17. Long derivative positions may be taken, inter alia, by potential bidders, or by speculators such as hedge funds, in respect to target securities prior to the announcement of, or during, a takeover. Even where they relate to 5% or more of the securities in a company, these positions may not confer voting power which requires the position to be disclosed in a substantial holder notice.

18. The writer of a long equity derivative has an economic incentive to hedge its position against the risk that it takes on under the equity derivative. This is usually done by acquiring securities of the entity to which the derivative relates (**Hedge Securities**).

19. However, the writer is not ordinarily contractually obliged to hedge in the physical[9] (or at all). Depending on the nature of the underlying security, there may be other alternatives to hedging. For example, the writer could acquire a long derivative position from another person in relation to the same security.

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[8] Although the remainder of this Guidance Note refers to equity derivative positions in relation to a "security" in the singular, it may equally apply to equity derivatives over a basket of securities. However, the Panel's guidance is unlikely to apply to a listed index of securities, if the price movement in one security is unlikely to affect the price of the index.

[9] If the writer was obliged by the terms of the contract to hold Hedge Securities, the holder would acquire a relevant interest in the Hedge Securities.

There may be market traded derivatives or other analogous securities that the writer considers would provide an appropriate hedge.

20. Once the holder unwinds its position, which under the commonly used equity derivative ISDA contract it can usually do at short notice by agreement with the writer, the writer no longer needs the hedge position, and would have an open long position if it retained the hedge. Accordingly, at the time that the derivative is unwound, the writer of a long cash-settled equity derivative will usually have an economic incentive to unwind its hedge position if any (and dispose of any Hedge Securities held).

21. By creating the economic incentive to hedge the equity derivative contract in the first place, and then by controlling the time at which the writer of the equity derivative has an economic incentive to unwind the hedge position if any, the holder of a long cash-settled equity derivative position may obtain some degree of control over the acquisition and disposal of any Hedge Securities held by the writer even if the holder has no particular right to acquire those Hedge Securities at or after the equity derivative is closed out.

22. If the holder has a relevant interest in Hedge Securities, or if the writer has a relevant interest in Hedge Securities and is associated with the holder, then those Hedge Securities will be included in the holder's voting power for the purposes of sections 606 and 671B. If the holder has voting power of 5% or more or is a bidder, the holder is required under section 671B to disclose its voting power, including the relevant Hedge Securities.

23. If a long equity derivative position does not confer voting power, the holder may not be required to disclose the position in a substantial holding notice. Similarly, unless the holder of the equity derivative has a relevant interest in any Hedge Securities or has given instructions in relation to such Hedge Securities, the equity derivative (or the holder's interest in the equity derivative) will not be required to be disclosed in response to a notice to the writer under section 672A.

24. In those circumstances, the market will not be aware of the holder's economic interest in any Hedge Securities held by the writer and the holder's potential advantage in acquiring any such Hedge Securities on unwind of the equity derivative. If the position is material, any disclosure the holder does make under section 671B may be misleading if it does not include disclosure of the long derivative position.

25. For the reasons set out above, the Panel considers that disclosure of long equity derivative positions in accordance with this Guidance Note is required by and is consistent with the purposes of Chapter 6 as set out in section 602. Further, the Panel believes that the statutory triggers in relation to voting power are the appropriate triggers for disclosure of long equity derivative positions. This will be particularly important where, if aggregated with any physical holdings of the relevant security, a person's Combined Holding is more than 5%, or more

than 20%, or if there is a change of more than 1% in the person's Combined Holding.

Use of short derivative positions

26. Under a 'short' equity derivative position, the holder benefits from a fall in the price of the securities of the entity to which the derivative relates. In that case, the writer would have an economic incentive to sell the entity's securities to which the derivative relates or enter into some other hedging arrangement resulting in selling pressure in relation to the entity's securities.

27. The purposes of Chapter 6 maybe affected if such action is taken in relation to securities of the target of a takeover bid, or a scrip bidder. An effect of a person acquiring a short position may be to reduce the market price of target securities, making a bid appear more attractive and possibly reducing the price at which a bidder acquires securities for the purposes of section 621, and consequently the price it offers to all target holders. Conversely, the market price of securities offered as consideration under a scrip bid may fall as a result of a person taking a short derivative position in those securities, making the bid appear less attractive. Such actions may undermine an efficient, competitive and informed market in either issuer's securities, particularly if not disclosed.

28. The Panel does not consider, currently, that non disclosure of a 'short' equity derivative position, in the absence of any other Combined Holdings which would trigger disclosure obligations, would be likely to cause unacceptable circumstances.

29. However, where a person has an existing disclosure obligation (under this Guidance Note, under the bidder or target statement disclosure requirements, or under the substantial holding notice provisions) non-disclosure of a new 'short' equity derivative position of more than 1% (or an increase of 1% or more in an existing 'short' equity derivative position) would be likely to cause unacceptable circumstances.

30. Similarly, where a person commences to have a disclosure obligation (as recommended under this Guidance Note, under the bidder or target statement disclosure requirements, or under the substantial holding notice provisions) non-disclosure of an existing 'short' equity derivative position of more than 1% would be likely to cause unacceptable circumstances.

Netting long and short positions in calculating Combined Holdings

31. In calculating a person's Combined Holding, the Panel will not normally net out short and long equity derivative positions. The Panel considers that the ability to cash settle most equity derivatives means that there is no reason why, when they are unwound, short and long derivative positions will be translated exactly into offsetting short and long physical positions. Therefore, the Panel will address the largest long position which a person's equity derivative positions might produce. The Panel also considers it relevant that short and

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long derivatives could be unwound at different times and may be used for different purposes so that netting the positions is inappropriate and may be misleading.

Hedge status as element of unacceptable circumstances

32. The Panel accepts that not all equity derivatives will be fully physically hedged by the writer acquiring or holding the underlying securities, and that this will be the case for a variety of reasons.

33. The acquisition by the writer of the underlying securities to physically hedge an equity derivative will affect the "free float" (i.e. the number of securities readily available for trading in the open market and not being held for strategic or other reasons which would reduce their availability to an alternative acquirer) of the underlying securities (to a greater or lesser degree). This is likely to have an effect on the control or potential control of the company, or an effect on the acquisition or proposed acquisition of a substantial interest in the company by its effect on the supply, demand and price of the securities.

34. However, the Panel does not consider that it should normally take the hedge status of an equity derivative into consideration when assessing whether or not the circumstances surrounding the particular equity derivative gives rise to unacceptable circumstances. This is because:

    (a) the size of those equity derivatives to which this Guidance Note relates is likely to be sufficiently material information to the market for the underlying securities that disclosure is appropriate of hedged, unhedged or partially hedged equity derivatives;

    (b) the Panel considers that the majority of equity derivatives to which this Guidance Note relates are likely to be fully or largely physically hedged given the size of the threshold which is set for disclosure in the Guidance Note; and

    (c) excluding unhedged equity derivatives from the provisions of this Guidance Note may encourage attempts to avoid the purposes of this Guidance Note by writers or holders entering into arrangements to disguise the hedge status of the equity derivative, thus reducing the effectiveness of the Guidance Note.

Disclosure of hedge status as element of unacceptable circumstances

35. The Panel also accepts that the holder of an equity derivative may not know the hedge status of the equity derivative which it has entered with the writer. For example, the writer may have written the equity derivative without having acquired any Hedge Securities and does not wish to give that type of information to its client which might use it to extract greater profit from the equity derivative at the cost of the writer. Alternatively, the writer may simply have strict internal compliance rules which state that it does not provide that information to its counterparties.

36. While the hedge status of the equity derivative may be information which the market might prefer to be given, the Panel does not consider that non-disclosure of the hedge status of an equity derivative should give rise to unacceptable circumstances. This is in part for the reasons outlined above in relation to the actual hedge status of an equity derivative, and in part because of the added difficulties which imposing such an additional disclosure requirement would cause to holders, and potentially to writers.

37. The Panel considers that it would be inappropriate to require routine disclosure of the hedge status because:

    (a) the holder of an equity derivative may not know the hedge status of the equity derivative. The writer, for perfectly good commercial reasons, might not give the holder any information on the hedge status and the holder may have no power to require the writer to disclose that information. Similarly, the hedge status of the equity derivative may change at short notice without the holder being advised;

    (b) a routine disclosure requirement would impose an enquiry obligation on the holder of an equity derivative for information which they may not be able to acquire;

    (c) it would be easy to avoid any disclosure if only physically hedged equity derivatives required disclosure, by arranging a series of back to back derivatives to hide the actual holdings of hedge securities;

    (d) routine disclosure of the hedge status of equity derivatives may adversely and unreasonably affect the use and market for equity derivatives, to the detriment of the Australian securities markets overall. For example, routine disclosure might force writers to change their risk appraisal of equity derivatives materially increasing the need for them to hedge all equity derivatives fully, alternatively it may make writers less willing to write equity derivatives. It is not the Panel's intention to cause such changes to the market where there is not a positive countervailing benefit.

38. The Panel considers that a requirement for routine disclosure of the holder's knowledge of the hedge status of an equity derivative would appear likely to be easily avoided where either the writer or holder wished to hide the information from the market. A disclosure requirement which became essentially discretionary would not be good public policy.

Settlement of equity derivatives

39. There is a distinction between equity derivatives that may be settled by the transfer of securities (on the one hand) and purely cash-settled equity derivatives (on the other hand).

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Equity derivatives settled by the transfer of securities

40. An equity derivative with a right (or obligation) to acquire the underlying securities will, in the absence of an exception, give rise to a relevant interest under section 608(8) (assuming the writer has a relevant interest in the securities at some point during the contract period).

41. However, section 609(6)(b) provides the following exception: [10]

    "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 subsection stops applying to the relevant interest when the obligation to make or take delivery of the securities arises".

    This exception does not apply to Chapter 6C.[11]

42. 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).

43. The Panel would be likely to treat as unacceptable circumstances any attempt to avoid the intent of this 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 this Guidance Note.

44. On that basis, the Panel considers that when considering whether or not to make disclosure to the market, holders of deliverable equity derivatives should either:

    (a) assume that the writer has a relevant interest in an equivalent number of securities, or

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[10] Although deliverable market traded options are also excepted by section 609(6)(a), the exception is not required given that the definition of "derivative" is broad enough to cover a market traded option.

[11] Section 671B(7) provides that for the purposes of section 671B, a person has a relevant interest in securities if the person would have had a relevant interest in the securities but for "subsection 609(6) (market traded options)". The Panel considers that the words "market traded option" should not be taken to be an indication of Parliament's intention to limit the operation of the provision. The Panel sees no proper policy purpose or intention to limiting the operation of section 671B(7) only to 609(6)(a), and good policy reasons to believe that the operation of section 671B(7) should apply to both limbs of section 609(6).

(b) treat the deliverable equity derivative as if it were a cash settled equity derivative and follow the guidance set out in this Guidance Note.

Section 609(6)

45. The current definition of "derivative" in the Corporations Act replaced the previous definition of "futures contract" by the *Financial Services Reform Act 2001*. The new definition had the result of widening the operation of the exclusion by section 609(6) of certain interests under derivatives from the definition of a relevant interest such that privately negotiated deliverable equity derivatives (i.e. those under which either party can require settlement by the transfer of securities) no longer gave rise to relevant interests, except for the purposes of Chapter 6C.

46. The Panel understands that the expansion of the derivative exception may have results which were not intended by the legislature, as there was no discussion in preparatory legislative documents of the effect of dropping the former limitation to futures contracts and other market-traded derivatives. [12] Accordingly, the Panel would regard it as unacceptable if the broader exception in section 609(6) was used to undermine the purposes of Chapter 6 or avoid its provisions.

47. Therefore, persons who come before the Panel in relation to equity derivatives should not assume that the Panel would decline to declare that circumstances were unacceptable based on an argument that a person had not contravened the Act because of the operation of section 609(6). The Panel's decisions will be based on whether or not the circumstances appear unacceptable when considered under section 657A(2)(a) or (b) rather than any consideration of whether or not the circumstances gave rise to a contravention of the Act.

48. The exception in section 609(6) does not apply to substantial holding notice obligations. Accordingly, where a deliverable equity derivative gives rise to a relevant interest and the holder is, or because of the equity derivative becomes, a substantial holder, the derivative position will need to be disclosed by the holder. This means that such equity derivatives will not go undetected by the market. Therefore, discussion in this Guidance Note in relation to disclosure is relevant to cash settled and deliverable equity derivatives under section 657A(2)(a) and section 657A(2)(b). However, the discussion which relates to avoidance of the purpose of other Chapter 6 provisions remains relevant to both classes of equity derivatives.

[12] Paragraph 8.118 of the CASAC 1997 Report entitled 'Regulation of On-exchange and OTC Derivatives Markets' notes that Treasury (rather than CASAC) was to look at the impact of derivatives on takeovers as part of the CLERP 06 review. The Explanatory Memorandum for CLERP 06 includes little commentary about the expansion of derivatives exception.

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Cash-settled equity derivatives

49. A cash-settled equity derivative may not give rise to a relevant interest (and therefore may not require disclosure under Chapter 6) if the holder takes only the risk of changes in the price or value of the securities, but does not:

    (a) acquire any right or obligation (formal or informal) to have any Hedge Securities transferred (as settlement of the equity derivative or otherwise);

    (b) acquire any right in relation to voting or disposal of any Hedge Securities; or

    (c) make any agreement, arrangement or understanding restricting the writer's ability to deal with or vote the Hedge Securities.

50. As discussed above, because of the economic incentives which an equity derivative creates for the writer of an equity derivative, the holder of a cash-settled equity derivative may have some degree of knowledge of the size, price and timing of the acquisition and disposal of any Hedge Securities held by the writer. In many cases, although a holder may be able to influence the writer's decision whether and when to dispose of its Hedge Securities (by closing out the equity derivative), that influence may not be enough control over their disposal to give rise to a relevant interest in the Hedge Securities. However, the question of what circumstances may cause a cash settled equity derivative to confer the holder sufficient practical control of the acquisition and disposal of Hedge Securities to constitute a relevant interest has not been determined by the Panel or by the Courts.

51. Further, an equity derivative does not necessarily cause the writer and the holder to become associates. It may do where the equity derivative (or a side arrangement) constitutes an agreement for the purpose of controlling or influencing the composition of the board or the conduct of the affairs of the issuer or where the holder and writer are acting in concert. But, without such an agreement or concert, a holder and a writer would not be associates.

52. If the terms and context of the equity derivative appear to be constructed to facilitate avoidance of the provisions of Chapter 6-6C, the Panel may infer that the equity derivative is evidence of such an agreement or concert and gives rise to an association between the writer and the holder. However, the Panel considers that maintaining the holder's combined voting power and equity derivative positions to be below 5% should not be taken to be avoidance of the provisions of Chapter 6-6C.

Disclosure

Disclosure of long equity derivative positions

53. If a person has a Combined Holding of 5% or more, and did not make adequate disclosure to the market of their derivative positions and voting power, their

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failure to disclose the Combined Holding is likely to mean that the market is not adequately informed.

54. The lack of information is likely to have an effect on:

    (a) the control or potential control of the relevant company;

    (b) the acquisition of a substantial interest in the company; and

    (c) the efficient competitive and informed market for control of the securities of the company,

    because it will affect supply and demand and prices of the relevant securities. The market effects of a transaction in physical securities which flow from the entry or unwind of a long equity derivative position and related hedging arrangements may also affect control or potential control, and the efficient competitive and informed market for control of the securities of the company. The omission of information about the derivative position may also make the information disclosed in a substantial holding notice, or bidder's statement, about the substantial holding or the bidder's voting power misleading.

55. The Panel considers that the information and efficiency purposes of Chapter 6 are intended for the benefit of various market participants, not just potential bidders. For example, if a major fund manager took a long equity derivative position in relation to a company's securities, and that position was known, it would be likely to have an effect on the price of the relevant securities. If the relevant company was the target of a takeover bid, the fund manager's position would also be likely to influence whether target security holders accept the bid.

56. Accordingly, the Panel considers that disclosure of Combined Holdings of 5% or more (and movements above 5% of Combined Holdings of 1% or more) (**Combined Holdings Disclosure**) by all market participants will support the competitiveness, efficiency and information in the market for the securities, and failure to do so is likely to constitute unacceptable circumstances.

57. Combined Holding Disclosure should separately specify the holder's Combined Holding represented by long equity derivative positions held by it and its associates, its relevant interests and its associates' relevant interests (and the identity of all associates referred to). The information to be included in relation to the equity derivative arrangement is set out below in paragraphs 70 to 72.

Effects of the Combined Holdings Disclosure guidance

58. The Panel recognises that its guidance in relation to Combined Holdings Disclosure may result in a reduction in the use of equity derivatives and, in the short term, potentially a reduction in market liquidity. However, the Panel also recognises that a large long equity derivative position is likely to result in the equivalent number of Hedge Securities being removed from the relevant market, which, if undisclosed, will have a distorting effect on the market for

control of the company and the securities. The Panel considers that the benefits of the Panel's approach to disclosure will outweigh any adverse effects on the liquidity of securities in the Australian market.

59. The Panel notes that there is a significant market for equity derivatives and that many such arrangements are not relevant to control or potential control or an acquisition or proposed acquisition of a substantial interest. Accordingly, the Panel's guidance only proposes disclosure where a person has a Combined Holding of 5% or more in relation to the relevant securities. The Panel considers that the 5% threshold is high enough to reduce the potential burden that will be placed on participants of the derivatives market as a result of this Guidance Note.

Treatment of equity derivative writers

60. The Panel's equity derivative guidance applies to holders of equity derivative positions, not the counterparties or writers (who, in the case of long positions, may already be required to disclose relevant interests in any Hedge Securities). This reduces any incentive for holders to attempt to avoid the purpose of the guidance by splitting their equity derivative positions amongst different writers.

Disclosure of offsetting short equity derivative positions

61. Holders of equity derivative positions making Combined Disclosure should ensure that the disclosure presents a true and balanced picture of the position taken by the holder. For example, a holder who makes Combined Disclosure in relation to 5.5% may have a short equity derivative position of 4.5%, which, if not disclosed, could render the holder's Combined Holding Disclosure misleading.

62. For example, the Panel perceives that holders could "rent" voting power by acquiring physical securities and simultaneously taking offsetting short equity derivative positions. The holder could thus acquire the right to vote securities without being exposed to movements in the price of those securities. A failure to disclose the offsetting position in these and other control related circumstances, where one aspect of the position was disclosed to the market, may constitute unacceptable circumstances.

63. Similarly, the market for acquisition of control over voting securities would be likely to be misled (and neither efficient, competitive nor informed) if a person, having given a substantial holding notice for say 10% of a listed company, subsequently entered into a short derivative contract in respect to say 5% without making disclosure to the market.

64. Accordingly, holders making Combined Holding Disclosure should also disclose the holder's short position (if 1% or more) in relation to the relevant securities. If a short position of more than 1% is acquired after a Combined

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Holding or substantial holding notice has been lodged, the holder should update its disclosure with reference to the short position.

65. Such disclosure of offsetting short positions will assist to ensure that that a holder's disclosure is not misleading as a result of a failure to disclose its offsetting equity derivative position and will reduce the risk of a Panel declaration of unacceptable circumstances.

Disclosure process

66. Where disclosure is made under this Guidance Note, such disclosure should be made:

    (a) as a note annexed to the holder's or associate's substantial holding notice; or

    (b) as a media release and be given to the company, if a substantial holding notice is not required.

    The information is likely to be price sensitive information and the Panel expects that the information would be disclosed by the company to ASX after the company has received a notice from the holder or associate of the position. The holder should disclose its position to the company by 9.30 a.m. on the second business day after the holder receives confirmation that the swap exposure is available, whether or not documentation has been signed or the swap exposure is enforceable, or 9.30 a.m. on the next business day if the position relates to securities of a target to a takeover bid or to securities of a scrip bidder.

67. The Panel notes that in some cases, entry into an equity derivative is a multi stage process, especially where the writer will only provide equity derivative exposure to the holder once the writer has established adequate hedging. For example, an equity derivative process might run as follows:

    (a) the client (**holder**) approaches an investment bank (**writer**) seeking an equity derivative over the percentage or number of securities it desires; (say Day 1)

    (b) the writer, after satisfying its internal approval process etc, proposes to the holder the terms etc of the equity derivative it will agree to enter into with the client; (say Day 2)

    (c) a term sheet (or sometimes merely the terms) is negotiated between the writer and the holder setting out the total dollar value, interest rates, investment bank fees, termination clauses etc of the proposed equity derivative. It is signed on say Day 3. The term sheet is expressly stated to be "non-binding" and subject to best endeavours etc. It also expressly states that the holder had no interest in any hedge securities and that there is no agreement that the writer will or will not buy physical securities to hedge its exposure under the equity derivative;

(d) between days 4 and 18, the writer goes into the market and buys physical securities to hedge its exposure (if that is the way the writer has decided to manage its risk exposure). Progressively through the period, the writer goes back to the holder and says "We are prepared to offer you firm, exposure to this many additional shares, taking the total exposure we are currently prepared to agree to give you to this total number." The holder then agrees to accept this increase to the swap exposure holder until the total dollar value of the swap which had been proposed on Day 1, and set out in the term sheet on Day 3, is reached; (say Day 18)

(e) on Day 19, the writer sends the holder a final, binding equity derivative agreement for review and signature. There is a day or two of discussion about the finer points of the wording, and the final "binding" swap agreement is signed on day 20.

68. In the example above, the Panel considers that, when assessing whether it ought (under this Guidance Note) to make disclosure to the market concerning its Combined Holding, the holder should include the number, or value, of securities to which the writer agrees to grant exposure, from the times at which the writer advises the holder. In some circumstances, the Panel may infer from the parties' actions, that the writer has advised the holder as to the progressive amount of exposure. The Panel would likely make a declaration of unacceptable circumstances if it appeared that parties had structured their transaction to avoid progressive disclosure as the writer acquired Hedge Securities to cover the equity derivative or as the writer agreed to provide firm exposure.

69. Similarly to a buyer not being required to disclose to the market the size of a buy order given to a broker unless and until the broker acquired the securities and a disclosure obligation was triggered under the Act, the Panel does not consider that a holder should be required to disclose the size of exposure it has sought from a writer, only the exposure that the writer agrees to offer on a firm basis where the holder's Combined Holding would trigger a disclosure obligation under this Guidance Note.

Disclosure content

70. Although the disclosure guidelines in this Guidance Note are analogous to the disclosure requirements in Chapter 6C, the Panel does not consider that adequate disclosure of equity derivatives would require equity derivative holders to lodge an equivalent of a substantial holder notice (ASIC Form 603 and 604), which would require the holder to annex any documentation relevant to the Combined Holding.

71. The Panel does not consider that adequate disclosure of equity derivatives would require the holder to release a copy of any document setting out the terms of any relevant agreement that contributed to the equity derivative position. Many equity derivative positions are taken under the standard ISDA

agreement, which is a lengthy document. In many cases the standard ISDA agreement is unlikely to assist the market to understand the nature of the holder's position. Many terms used in the ISDA agreement are defined separately, such that the ISDA agreement is incomplete without reference to the definitions. Further, the documentation may not be executed at the time that the holder makes Combined Holding Disclosure.

72. Adequate disclosure of equity derivatives would include information as to price, entry date, derivative period, number of securities to which the derivative relates, termination rights and unwind terms, the identity of the derivative writer(s) and any material changes to the information disclosed to the market.

Bidder's statement disclosure

73. The Panel considers that adequate disclosure of equity derivatives would require bidders and targets to disclose any relevant equity derivative position in relation to the bidder's or target's securities (short or long) in their bidder's statement and target's statement respectively, where the equity derivative contract was on foot within 4 months before the bid. Similarly, the Panel considers that adequate disclosure of equity derivatives would require new or changed derivative positions in relation to the bidder's or target's securities during the period of the bid to be disclosed in a supplementary bidder's statement or supplementary target's statement.

74. On that basis, the bidder or target would disclose similar information to that set out in paragraph 72 above.

Remedies

Enquiries to ensure adequate disclosure

75. If the Panel receives an application and is given a reasonable basis to believe that there has been inadequate disclosure of a Combined Holding, the Panel will be prepared to commence proceedings in order to make enquiries of the holders of securities of the relevant entity. The Panel's enquiries are likely to require the holders to provide to the Panel the identity of persons with whom the holder has entered into equity derivatives relating to the securities. Provision of false information to the Panel for the purposes of Panel proceedings is an offence.

76. The Panel will not be prepared to make those enquiries where the applicant fails to provide a reasonable basis to believe there has been inadequate disclosure of a Combined Holding. In order to ensure that Panel proceedings are only instituted for appropriate purposes, the Panel may be prepared to limit the disclosure of the responses to any enquiries within any proceedings.

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Orders

77. The Panel has a wide power to make orders (including remedial orders) if it finds that circumstances relating to an equity derivative are unacceptable circumstances. For example, the Panel may:

    (a) require the disposal of securities acquired;

    (b) require that those affected by the non disclosure be given a right to take back their securities (as was the order made by both Panels in *Austral Coal 02* and *Austral Coal 02R*);

    (c) cancel or declare voidable the equity derivative agreement or any other agreement;

    (d) exclude an equity derivative writer from voting Hedge Securities; and

    (e) require the bidder to increase the bid price to reflect the higher price under the derivative or any collateral benefit given under the equity derivative.

78. It can also accept undertakings that have the effect of remedying the unacceptable circumstances.

79. The Panel recognises that equity derivative arrangements involve third parties, who may be affected by a Panel order. For example, an order declaring a long equity derivative agreement void could leave the derivative writer exposed in relation to any Hedge Securities. In appropriate circumstances, the Panel will consider the potential effect on those parties prior to making and in framing any orders.

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