GUIDANCE NOTE 20 Equity Derivatives

Background

1. This Guidance Note has been prepared to assist market participants understand the Panel's approach to disclosure of equity derivatives. It includes measures that may help reduce the risk of unacceptable circumstances in relation to equity derivatives.

2. Nothing in the note binds the Panel in a particular case.

3. This note is not concerned with disclosure required under section 671B, or in response to tracing notices under section 672A, of the Corporations Act (Cth) 2001[1].

4. Equity derivatives are valuable trading and risk management products. There is a significant market for them and the Panel does not want to interfere with that market where equity derivatives are not used in ways that undermine the policy of chapter 6.

5. Equity derivatives have been considered by the Panel in a number of matters[2] and the market continues to evolve. The Panel will update this note from time to time to keep it relevant.

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

[2] *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.

Introduction

6. In this note the following definitions apply:

Term	Meaning
Long position	Either a long equity derivative position or a relevant interest in securities or a combination of both.
Control transaction	A transaction which affects or is likely to affect: (a) control or potential control of a company or (b) the acquisition or proposed acquisition of a substantial interest in a company.
Market maker	a writer of equity derivatives who is: (a) an Australian Financial Services Licensee authorised to provide arm's length, professional, intermediary services or (b) the holder of an equivalent licence to AFSL in a jurisdiction with equivalent regulatory supervision.
Substantial interest	A parcel of securities, of whatever size, that: (a) forms a step in the direction of takeover or change in corporate control[3] but not limited to: (b) a relevant interest or (c) a legal or equitable interest or (d) a power or right in relation to the company or securities.[4]

[3] *Elders IXL Ltd v NCSC* [1987] VR 1
[4] Section 602A.

Term	Meaning
Taker	Person who 'acquires' an equity derivative, usually the client.
Writer	Person who 'provides' the equity derivative, usually an investment bank.

7. If an equity derivative gives the taker a relevant interest in any underlying securities, disclosure is required by chapter 6C. This note applies to equity derivatives which may not involve a relevant interest being obtained on the part of the taker.

8. Emmett J in *Brierley Investments Ltd and Others v Australian Securities Commission and Others*[5] held that 3% of the voting shares in a company could constitute a substantial interest. Section 602A avoids any limitation on the scope of "substantial interest". The Panel considers that equity derivatives may be a substantial interest even though they give rise only to an economic interest.

Unacceptable circumstances

9. The Panel considers that non-disclosure of long positions may give rise to unacceptable circumstances. Where there is a control transaction, the Panel would expect that all long positions which already exist, or which are created, are disclosed unless they are under a notional 5%. As explained below, the disclosure that the Panel considers would normally be appropriate follows the disclosure required under chapter 6C.[6]

10. A control transaction will be considered by the Panel to have commenced when (as applicable):

    (a) a proposal that is likely to affect control or potential control of a company is announced

    (b) an acquisition of a substantial interest occurs or

    Example: acquisition of 3% as part of a creeping acquisition

    (c) a proposed acquisition of a substantial interest is announced.

11. The Panel is generally not concerned with transactions that have little to do with control. However, the Panel may examine situations where a person holds a long position above 5% even though there is no control transaction.

[5] 24 ACSR 629

[6] See para 35 and following.

12. In considering whether unacceptable circumstances exist, the Panel will look at the following factors (among others):

    (a) the type of equity derivative

    (b) the parties involved and

    (c) the relationship of the derivative transaction to a control transaction.

The type of equity derivative

13. Equity derivatives that do not affect the efficient, competitive and informed market for control of a specific security, or control or potential control of a company, or the acquisition or proposed acquisition of a substantial interest, are unlikely to give rise to unacceptable circumstances.

    Example 1: An index derivative, such as over the ASX 200, Standard & Poors, FTSE, Dow Jones or Morgan Stanley Capital Index.

    Example 2: A derivative over a basket, provided it is broadly-based and does not affect control or potential control over the securities of one of the constituents of the basket. [7]

14. Because "baskets" generally contain fewer securities than indexes, the possibility of an equity derivative over a basket affecting control of individual securities within the basket and giving rise to unacceptable circumstances is higher.

Market makers

15. For the market to be properly informed, disclosure of the derivative by both the taker and writer of an equity derivative is not necessary. For one thing, when a taker is long it means the writer is short and disclosure by the writer as well as the taker is not needed.[8] The Panel regards disclosure by the taker as sufficient.

16. Moreover, a market maker as writer is unlikely to have any interest in control. If the writer is a market maker, the Panel will usually take the view that its role is a disinterested, professional one, compared to the taker who is likely to be interested.

17. A similar approach is adopted in the legislation when considering relevant interests: see sections 609(2) and (3). By analogy, therefore, the Panel takes the view that non-disclosure of an equity derivative by a market maker is unlikely to give rise to unacceptable circumstances if each of the following apply:

    (a) The equity derivative is written at arm's length

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[7] Section 308(5) of the HK Securities and Futures Ordinance 2003 is an example of a broadly-based basket. It provides for the basket to contain 5 or more listed securities and no security to comprise more than 30% weighting in the calculation of the basket value.

[8] This does not address disclosure obligations under chapter 6C of a physical hedge.

(b) The equity derivative is written for a client with whom the market maker is not associated, or acting in concert, in relation to the relevant company and

(c) The market maker is not acting for the client in a corporate advisory capacity, or if it is there is an effective Chinese wall in place between relevant divisions.

18. Equally, the market maker may be the taker under an equity derivative that specifically hedges another equity derivative it has written as above (ie, back-to-back equity derivative on essentially identical terms). In this case, it will be treated in the same way as if it were a writer.

19. The Panel will normally consider a market maker to be the writer, and the client to be the taker, whether the equity derivative is short or long.

Relationship to control transaction

20. Equity derivatives, in the hands of the taker, may be long (ie, the taker is to benefit from an increase in the price of the underlying security) or short (ie, the taker is to benefit from a decrease in the price of the underlying security). In either case, the terms may provide that they are cash-settled or "exchanged for physical" (ie, the underlying security is transferred).

21. Equity derivatives may or may not be hedged. While the hedge status of an equity derivative may be a relevant consideration when considering disclosure of the derivative, the taker may not know the hedge status, or be able to ascertain it, or the hedge status might change frequently, or the hedge may not be the underlying security. It would follow that non-disclosure of the hedge status (as opposed to non-disclosure of the derivative) would not normally give rise to unacceptable circumstances, although it may do if, for example, the derivative was being used to hide the actual holdings of hedge securities. In considering these situations, the Panel will have regard to the fact that it is common for there to be no legal obligation on the writer to inform the taker of the hedge position.

22. Nevertheless, the writer usually has an economic incentive to hedge its position, regardless of whether the derivative is cash-settled or exchanged for physical. The hedge is often established by acquiring the underlying securities. The writer is not ordinarily contractually obliged to hedge (or else a relevant interest may arise). Nevertheless, even if the derivative is actually hedged, the long position may not confer voting power on the taker (which, above 5%, would require the position to be disclosed in a substantial holder notice under section 671B).

23. On the unwinding of the position, the writer has an economic incentive to unwind any hedge.

24. By creating the economic incentive to hedge and then by controlling the unwinding, the taker of a long equity derivative position (even one that is cash-settled) may affect the market in the underlying securities, for example by bringing about a reduction in the "free float" of the company. Such an effect on the supply (and perhaps therefore the price) of the securities may, in turn, affect:

    (a) control or potential control of the company

    (b) the acquisition or proposed acquisition of a substantial interest in the company or

    (c) the efficient, competitive and informed market for control of the company's voting securities.

25. It should be noted that a taker of a cash-settled equity derivative may get a relevant interest in hedge securities if the taker:

    (a) acquires any right or obligation (formal or informal) to have them transferred (eg, at settlement of the equity derivative or otherwise)

    (b) acquires any voting or disposal right in them or

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

26. Accordingly, the Panel considers that non-disclosure of the long derivative position may give rise to unacceptable circumstances unless:

    (a) as a part of any disclosure the taker makes under section 671B (ie, where the physical exceeds 5%), the long position is included. This would normally avoid the substantial holding notice being misleading.

    (b) disclosure is made of a long position of the taker that exceeds a notional 5%, or above that level it changes by more than a notional 1% (ie, the physical is less than 5% but combined with the derivative exceeds 5%, or the derivative alone exceeds 5%).

27. Similarly, the writer of a short position is likely to have an economic incentive to sell the underlying securities. This can affect the market particularly during a scrip bid. For example, it may reduce the market price of the target's securities, making a bid appear more attractive; or reduce the market price of the bidder's securities, making the bid less attractive.

28. Accordingly, the Panel considers that non-disclosure of a short derivative position by the taker may give rise to unacceptable circumstances if the taker's long position exceeds 5% (requiring a substantial holding notice or disclosure) and the short derivative positions affects the total position. The Panel would not consider it adequate in normal circumstances simply to net the positions.[9]

[9] But see para 29.

29. The Panel will not normally take into account the net position arising from short and long derivatives unless the derivatives being netted are exchange traded equity derivatives that are exactly offsetting in nature, period and price.

Physical hedging

30. Under section 609(6)(b), a person does not have a relevant interest in securities merely because of a market traded option over the securities; or a right to acquire the securities given by a derivative.[10] This exception ends when the obligation to make or take delivery of the securities arises; and is not applicable to disclosure under chapter 6C.[11] Without this section, section 608(8) would create a relevant interest in the taker of the derivative, provided the writer had one.

31. Market traded derivatives with "exchange for physical" settlement terms, because there is no relevant interest counted, are not required to be disclosed until the obligation to settle arises (if at all).

32. However, the Panel would generally treat such derivatives in the same way as it would treat similar cash-settled equity derivatives when considering whether non-disclosure gives rise to unacceptable circumstances. Takers of such equity derivatives should not assume that the Panel would decline to declare circumstances unacceptable on the basis that there was no contravention of the Act because of section 609(6). Rather, the taker should assume that the writer has a relevant interest in the underlying securities.

Association

33. An equity derivative may cause the writer and the taker to become associates if:

    (a) it (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 of the underlying securities or

    (b) the taker and writer are acting in concert in relation to the affairs of the company.

34. The Panel will take into account whether it appears that the terms or context of the equity derivative have been constructed to avoid chapters 6-6C. If it appears so, the Panel may infer that the equity derivative is evidence of association between the writer and the taker. The inference is less likely when the long position is below 5%.

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[10] There is no discussion of the reason for the former limitation to futures contracts and other market-traded derivatives being expanded to all derivatives. See also paragraph 8.118 of the CASAC 1997 Report entitled 'Regulation of On-exchange and OTC Derivatives Markets'.

[11] Section 671B(7), which in terms is limited to "subsection 609(6) (market traded options)", but the same policy should apply to other derivatives.

Disclosure

35. Adequate disclosure of equity derivatives should enable the market to fully understand the nature of the taker's long position.

36. In deciding whether the level of disclosure gives rise to unacceptable circumstances, the Panel will take into account whether the following information has been disclosed (as applicable):

    (a) identity of the taker (but not the writer)

    (b) relevant security

    (c) price (including reference price, strike price, option price etc as appropriate)

    (d) entry date

    (e) number of securities to which the derivative relates

    (f) type of derivative (e.g. contract for difference, cash settled put or call option)

    (g) any material changes to information previously disclosed to the market

    (h) long equity derivative positions held by the taker and its associates, its relevant interests and its associates' relevant interests (and the identity of all associates referred to)

    (i) short equity derivative positions that offset physical positions

    Example 1: a taker might "rent" voting power by acquiring physical securities and simultaneously taking offsetting short equity derivative positions to avoid market exposure.

    Example 2: A substantial holding of, say, 10% that is disclosed but subsequently a short equity derivative contract is entered for, say, 5%.

    (j) short positions of more than 1% that have been acquired after a long position is disclosed, whether by notice or substantial holding notice (ie, the taker should update its disclosure with reference to the short position).

37. The Panel does not think that the market would normally need to be informed:

    (a) of positions in derivatives by lodgment of a formal substantial holder notice (ASIC Form 603 and 604), unless otherwise required because of an interest in physical securities or

    (b) of standard ISDA documentation, which is lengthy and sufficiently well known.

38. Disclosure may be made:

    (a) as a note annexed to a substantial holding notice, where lodged or

(b) by written notice to the company if a substantial holding notice is not required.

39. In considering whether timely and adequate disclosure has been made, the Panel will take into account the disclosure time frames established by the Act for substantial holding notices – that is, within 2 business days of becoming aware or, in a bid period, by 9.30 am on the next trading day.[12]

40. Disclosure is likely to be price sensitive. Therefore, the Panel expects that the company would disclose any written notice received by it to ASX.

41. Entry into an equity derivative may be a multi-stage process, especially if the writer is providing exposure to the taker only after it has established adequate hedging.

Example:

Day	*Event*
1	*Client (taker) approaches investment bank (writer)*
2	*Term sheet negotiated and signed. It is said to be non-binding and subject to best endeavours. It gives the taker no interest in any hedge securities and is expressed not to be an agreement that the writer will hedge.*
3-18	*Writer buys securities to hedge its exposure. Progressively it offers the taker firm exposure to the value of its hedge position. Taker progressively accepts the increased exposure.*
19	*Writer sends the taker a final, binding equity derivative agreement, which is signed.*

42. The fact that a derivative is multi-staged may mean that disclosure is required as it is progressively increased, regardless of when the formalities are completed. Normally, the Panel will take the view that a taker is only required to disclose the exposure it has firm. This is similar to a buyer not being required to disclose its order, only its acquisitions.

Disclosure in takeovers

43. Under section 636, a bidder's statement is required to include information about consideration given or agreed during the 4 months prior to a bid. An equity derivative position in relation to the target's securities (whether short or long) may not trigger this requirement, but the Panel may consider that the policy

[12] Section 6671B(6).

underpinning it would warrant equivalent disclosure being made. Non-disclosure may give rise to unacceptable circumstances.

44. In appropriate situations, the Panel may consider that similar disclosure is warranted in a target's statement.

Remedies

Declaration

45. If the Panel is given a reasonable basis to believe that there may have been inadequate disclosure of a long position (or a long and short position), it is likely to commence proceedings. It will not normally do so if the applicant fails to provide it with a reasonable basis to believe there may have been inadequate disclosure.

46. The Panel is likely to require the taker of an equity derivative identified in an application to provide:

    (a) the identity of any persons with whom the taker has entered into equity derivatives relating to the securities and

    (b) details of the equity derivatives.

47. The Panel may limit the disclosure to ensure that proceedings are only instituted for appropriate purposes.

Orders

48. The Panel has a wide power to make orders (including remedial orders) if it finds unacceptable circumstances. This includes requiring:

    (a) disclosure of the derivatives

    (b) disposal of any securities and

    (c) cancellation of agreements.

49. Equity derivative arrangements may involve third parties (eg, a back-to-back derivative), or create unique exposures for the writer (eg, if a long equity derivative is declared void, the writer may be exposed to market risk on the hedge securities it holds). The Panel will take these features of derivative transactions into account in considering appropriate orders.

Transition

50. For six months after publication of this note, the Panel will bear in mind in any application that systems necessary to ensure adequate identification and disclosure of equity derivatives may need to be changed, particularly in large organisations that undertake a lot of derivative business.

51. It is unlikely, though, that the taker of a derivative would be unaware of its position.

52. The Panel also recognises that, at the time of publication of this note, some positions may be undisclosed. Disclosure now may cause the taker some commercial disadvantage. When considering any application in the six months after publication of this note, the Panel will take such issues into account, as well as considering any steps the person has taken to minimise adverse effects on the efficient, competitive and informed market for the relevant voting securities in the intervening period.

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