Law Council
OF AUSTRALIA

Business Law Section

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Allan Bulman, Director
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Level 10
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By email: takeovers@takeovers.gov.au

Dear Mr Bulman

Submission in response to Consultation Paper on proposed rewrite of Guidance Note 20 – Equity Derivatives

The Corporations Law Committee of the Business Law Section of the Law Council of Australia (**Committee**) welcomes the opportunity to provide this submission to the Takeovers Panel (**Panel**) on the Consultation Paper on Guidance Note 20 – Equity Derivatives (**Consultation Paper**).

Summary

While acknowledging a diversity of views in the market and amongst its members, the Committee is generally supportive of the Panel's approach to equity derivatives set out in the Consultation Paper.

The Committee agrees with the Panel that disclosure of all long positions in equity derivatives (aggregated with any relevant interest in the underlying voting shares) over 5% will promote an efficient, competitive and informed market, in line with the purposes of Chapter 6 of the *Corporations Act 2001* (Cth) (**Corporations Act**).

However, the Committee submits that the position of the Panel outlined in the draft Guidance Note is an expansion of the position set out in the current issue of Guidance Note 20, and that the market would benefit from the changes being more clearly enunciated in the final version of Guidance Note 20.

We set out below the Committee's responses to the specific questions posed by the Panel in the Consultation Paper, together with suggestions regarding possible clarifications to the draft Guidance Note. Even if the Panel is unable to accommodate the views expressed by the Committee in these specific responses, the Committee overall remains supportive of the Panel issuing the draft Guidance Note.

1. Do you agree that the Panel should expect disclosure of all long positions over 5%? If not, what do you consider should be the Panel's policy position on disclosure of equity derivatives?

There is a general consensus within the Committee that the Panel should expect disclosure of all aggregated long positions over 5%.

Application of the substantial holding regime to equity derivatives

The Committee agrees that the substantial holding notice regime generally does not apply to equity derivatives that are compulsorily cash-settled if:

- the writer and the taker are not associates; and
- the taker does not acquire a relevant interest in any securities in which the writer has a relevant interest (including as a result of section 608(8) of the Corporations Act).

Practical effect of settlement of an equity derivative

In our experience, the writer of a cash-settled equity derivative is not ordinarily contractually obliged by the taker to dispose of the underlying securities upon settlement of the derivative (in contrast, it is common for the taker explicitly to acknowledge that the writer is not required to hedge its position). However, again in our experience, the writers of a cash-settled equity derivative do often hedge all or most of their position under the derivative by acquiring the underlying securities.

Further, as the draft Guidance Note acknowledges at paragraph 6, the writer does have an economic incentive to unwind the hedge and dispose of the underlying securities on settlement. The taker therefore may seek to acquire securities on-market at that time.

The Committee considers it material from a policy position that, whether or not a taker acquires the underlying securities from the writer on settlement, the taker will have effectively "locked in" an effective purchase price for the parcel of underlying securities to which that equity derivative is referable. After taking into account the cash flows on the unwind of the derivative, a taker will be able to acquire securities for a net value broadly equal to the strike price of the derivative, even if the share price has increased following entry into the derivative. A taker has an economic interest – even if it does not have a relevant interest – in the underlying securities.

Irrespective of what occurs on settlement of an equity derivative, the majority of the Committee considers that the way in which cash-settled equity derivatives operate means that entry into, and the material terms of, equity derivatives should be disclosed to the market, to facilitate an efficient, competitive and informed market for control of voting securities. The majority of the Committee therefore considers that the Panel should expect disclosure of all aggregated long positions over 5%, regardless of whether the position is held directly through a relevant interest in "securities" (including a physical derivative) or through a cash-settled equity derivative. The Committee notes that this would be consistent with the disclosure positions adopted in analogous jurisdictions, such as the United Kingdom, Hong Kong and New Zealand.

Enunciation of the Panel's updated policy position

The Committee unanimously considers that, if the Panel's policy position is that the Panel expects disclosure of all aggregated long positions over 5%, then this should be clearly stated in the revised issue of Guidance Note 20. This would be helpful in promoting consistency in disclosure and to achieve the purposes set out in section 602 of the Corporations Act, given current market practice and existing guidance.

In this regard, the Committee notes that the current issue of Guidance Note 20 (at paragraph 9) states:

> "*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%*" (emphasis added)

The Committee considers that the Consultation Paper reflects an "updated" policy position of the Panel, which differs significantly to the position set out in the current issue of Guidance Note 20. The Committee further considers that if the Panel's "updated" policy position is adopted through the issue of a revised version of Guidance Note 20, then this change should be made clearer and more explicitly in the text of the revised version of Guidance Note 20, for example by amending paragraph 2 so that it states:

> "*If an equity derivative gives the taker a relevant interest in any underlying securities, the disclosure regime in Chapter 6C applies. This note applies to equity derivatives that may not require disclosure under Chapter 6C, and applies irrespective of whether a control transaction has commenced.*" (footnotes omitted)

The Committee considers that the proposed Guidance Note 20 is an important opportunity for the Panel to state its position that the guidance applies to disclosure of equity derivatives outside of a control transaction occurring, and that this change would provide greater clarity to the market and thereby facilitate increased consistency in market practice.

2. Do you agree with footnote 2? What further guidance (if any) do you think the Panel should provide in cases when a person obtains a long position of over 20%?

There is a general consensus within the Committee that the text of footnote 2 should be retained. However, the general consensus of the Committee is also that, given the significance of this guidance, it should be given greater prominence and included in the body of Guidance Note 20, not as a footnote.

The Committee notes that section 606 of the Corporations Act prohibits a person from acquiring a relevant interest in issued voting shares if (inter alia) that acquisition will result in a person's voting power increasing from 20% or below to more than 20%, or from a starting point that is above 20% and below 90%, unless one of the exceptions set out in section 611 of the Corporations Act applies.

However, as discussed in section 1 of this submission, in the experience of Committee members, writers of cash-settled equity derivatives often hedge their position by acquiring some or all of the underlying securities, and have an economic incentive to unwind the hedge and dispose of the underlying securities on settlement. Further, takers may seek to acquire securities on-market at the time of settlement.

In this context, the Committee could envisage circumstances in which a person holds an equity derivative (or a combination of securities and equity derivatives) in an entity and, due to the number of underlying securities of that entity to which the equity derivative is referable (either alone or in aggregate with the number of securities in which that person holds a physical position), the person is interested in greater than 20% of securities in that entity. For example, if a person held a physical position of 19% of the voting shares of an entity, and took a cash-settled equity derivative in relation to 10% of the voting shares of that entity.

The Committee agrees with the Panel (at paragraph 7 of the draft Guidance Note) that this could affect:

- control or potential control of the entity;
- the acquisition or proposed acquisition of a substantial interest in the entity; or
- the efficient, competitive and informed market for control of the entity's voting securities,

contrary to the purposes of Chapter 6 of the Corporations Act and the other stated policy positions of the Panel.

The majority of the Committee therefore agrees with the Panel's position that the acquisition of an aggregate long position that would contravene section 606 of the Corporations Act if it were comprised entirely of a physical holding <u>may</u> give rise to unacceptable circumstances (even if the acquisition does not result in a person acquiring a relevant interest in contravention of section 606 of the Corporations Act).

The Committee considers that this position is a significant departure from the position expressed in the current issue of Guidance Note 20, and is of sufficient import, that if the text of footnote 2 is retained by the Panel then this text should be set out in the body of Guidance Note 20, not in a footnote.

The Committee discussed at length whether, if the Panel retains the text of footnote 2, then the Panel should provide examples of circumstances arising from the acquisition of a long position that may (or may not) give rise to unacceptable circumstances. One of the examples discussed at length by the Panel was that members of the Committee would expect that the acquisition of a long position under one of the exceptions set out in section 611 of the Corporations Act (e.g. Item 9), as if the long position was comprised entirely of a physical holding, would be unlikely to give rise to unacceptable circumstances.

The risk is that, without examples, market participants could not be properly advised as to how to ensure that they do not take a position that may give rise to unacceptable circumstances, in which case footnote 2 could have the effect of being a de facto prohibition.

The Committee considers that it would assist the market if the Panel provided examples of, or further guidance regarding, the situations in which the acquisition of an aggregate long position of over 20% is likely to give rise to unacceptable circumstances. However, the Committee acknowledges that it would be difficult for the Panel to provide examples while keeping the guidance concise. The Committee further acknowledges that whether the acquisition of an aggregate long position of over 20% will give rise to unacceptable circumstances will need to be considered by the Panel on a principled, case-by-case basis. If the Panel does not provide examples of situations in which the acquisition of an aggregate long position of over 20% is likely to give rise to unacceptable circumstances, the Committee would suggest that the Panel add a further sentence after the text of footnote 2, which states "*The Panel will consider whether such an acquisition has given rise to unacceptable circumstances on a case-by-case basis*".

3. **Should there be more guidance provided in relation to what information is required to be disclosed (see paragraphs 11-17)? If yes, what guidance would assist? Should the taker of an equity derivative be expected to disclose the identity of the writer(s) of that derivative?**

The Committee considers that the guidance in paragraphs 11-17 regarding the information to be disclosed will be helpful to market participants. The Committee has the following comments on these paragraphs:

- Paragraph 12(i) should be amended by replacing the words “physical positions” with the words “long physical or other equity derivative positions” in recognition that derivative positions may be offset against other derivative positions.

- It would be useful for the Panel to clarify, at paragraph 13, whether the swap confirm (as opposed to the standard ISDA master) is to be attached to the notice. The Committee notes that there are mixed views amongst market participants regarding the disclosure of this document.

- The majority of Committee members do not consider that disclosure of the identity of the writer(s) of the derivative would necessarily assist in informing the market, and accordingly the Committee does not consider that the taker should be expected to disclose this information.

4. Are there any other changes you would make to the draft Guidance Note? Please explain.

Apart from the changes discussed above, the Committee would also suggest that the Panel makes one change to footnote 4. Footnote 4 currently refers market participants to the factors noted in *Tribune Resources Limited* [2018] ATP 18 and *Auris Minerals Limited* [2018] ATL 7. The Committee would recommend the Panel consider expressly enunciating those factors in footnote 4, as this would be more helpful to market participants. The Panel may wish to consider enunciating these in the body of the Guidance Note.

The Committee is otherwise generally supportive of the draft Guidance Note.

I trust these observations are of assistance.

Please contact Shannon Finch, Chair of the Corporations Committee at shannonfinch@jonesday.com or on +61 428 894 002, or David Friedlander at David.Friedlander@au.kwm.com or on +61 2 9296 2444, if you require further information or clarification.

Yours sincerely,

Greg Rogers

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